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Designing the Legal Frameworks for Markets in Eastern Europe

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Designing the Legal Frameworks for Markets in Eastern Europe

Paul H. Brietzke*

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I. INTRODUCTION

The “Revolution of 1989”—a “springtime of peoples”—caught the experts on Eastern Europe by surprise. It is sometimes difficult to be an expert, and it is usually easier to predict and analyze small, incremental changes. But the recent cataclysmic events in Eastern Europe lacked historical precedent, a convincing theory of causation, and ideological justification as opposed to slogans. Thus, the experts have sought novel paradigms to anchor their analyses, and have hit upon the rich and apparently exportable literature on the “transition to democracy” in

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some Third World countries. Democratization does indeed capture many facets of the Eastern European "transition" from certain authoritarianism to an uncertain new system, but other factors should also be considered. As with any revolutionary change, the past has crept back into the new order—President Boris Yeltsin abolishes parliament and authoritarians gain in subsequent elections, while Poles elect ex-Communists—and a government bent on survival will seek to strengthen the state and to use virtually all means of maintaining order.¹

Nascent democracies in Eastern Europe must "accomplish simultaneously three steps which the Western-style democracies have performed in three consecutive steps requiring . . . a century or more[:] the generation of a market economy, the establishment of the rule of law (*Rechtsstaat*) and the institutionalization of democratic rule."² We might expect that comparative lawyers, economists, and political scientists would be consulted while tackling so demanding an agenda, but to date almost all of the influential foreign consultants in Eastern Europe have been neoclassical economists.³ Their ethnocentric—largely U.S.—prescriptions are given lip service and only a few genuine attempts at implementation. Perhaps this is because the economists can exert influence over the sources of foreign investment and aid that new Eastern European regimes so desperately need. Harvard's Jeffrey Sachs and numerous Chicago-trained economists at the International Monetary Fund, the World Bank, and the U.S. Agency for International Development assume that there are enough similarities in human behavior and economic mechanisms to make textbook microeconomics directly applicable to recent events in Eastern Europe.

In the hands of these neoclassical economists, democratization in Eastern Europe becomes the pursuit of a *liberal* democracy, an idealized vision of the United States prior to the New Deal, rather than some form of social democracy that may better suit Eastern European tastes and needs. While their analyses neatly parallel Lenin's argument that "bourgeois democracy" fits capitalism nicely, neoclassical economists draw very different conclusions. They state that broad and unregulated property and contract rights, exerted in the unregulated

1. GUILLERMO O'DONNELL & PHILIPPE SCHMITTER, TRANSITIONS FROM AUTHORITARIAN RULE: TENTATIVE CONCLUSIONS ABOUT UNCERTAIN DEMOCRACIES 3 (1986); Valerie Bunce, *Leaving Socialism: A "Transition to Democracy?"*, 3 *CONTENTION* 35, 35-39, 44 (1993); Jack Goldstone, *Why We Could (and Should) Have Foreseen the Revolutions of 1989-1991 in the U.S.S.R. and Eastern Europe*, 2 *CONTENTION* 127, 133 (1993); Claus Offe, *Capitalism by Democratic Design? Democratic Theory Facing the Triple Transition in East Central Europe*, 58 *SOCIAL RES.* 865, 866-67 (1991). See Jane Perlez, *Why Poland Swung to Left*, N.Y. TIMES, Sept. 21, 1993, at A4; *All or Nothing*, *ECONOMIST*, Sept. 25, 1993, at 15. But see Bunce, *supra*, at 37. The "transition to democracy" is a rather "mechanical way of understanding political, social and economic evolution" that is analytically akin to the Stalinist transition from capitalism to socialism. *Id.* The Eastern European countries that experienced "revolutions" from 1989 to 1991 are Albania, Bulgaria, the former Czechoslovakia, the former East Germany, Hungary, Poland, Romania, and the former Yugoslavia.

2. Ulrich K. Preuss, *The Politics of Constitution-Making*, 13 *LAW & POL'Y* 107, 111-12 (1991).

3. Paul H. Brietzke, *Law, Democratization and Markets*, in *LAW AND ECONOMICS: NEW AND CRITICAL PERSPECTIVES* (Robin Malloy ed., forthcoming 1994).

markets that will spring up automatically, necessarily precede or are coextensive with the political freedoms of democracy.⁴ Eastern European governments must therefore apply "shock therapy" or cause a "Big Bang"—the simultaneous deregulation and privatization of virtually everything. This must be done quickly, before political support for reform evaporates and opponents entrench themselves ostensibly to minimize the amount of suffering. Analogous, efficient-market policies promoted by the recent GATT Round and by the European Community's (EC) 1992 program are in a shambles, and international agencies and Western governments have little to show for the billions of dollars spent on attempts to export market economies to the Third World. The neoclassical economists' need to succeed in Eastern Europe is thus all the more urgent.

Naturally, there are critics of the neoclassical economists' enterprise. Capitalism begins with bizarre entrepreneurial exploits amid appalling poverty, and the rapid introduction of a full-blown capitalistic system into Eastern Europe will likely retard the reestablishment of civil societies there. Civil societies are the organizational bases for nongovernmental sources of power that are expected to displace authoritarian states and are essential to long-term democratic stability. The empirical correlation between private enterprise and economic growth is in fact rather weak. Furthermore, it "is far from clear that the proliferation of financial instruments, markets, arbitrage opportunities, and paper transactions in advanced countries has created social product to justify the high-quality human capital resources it devours."⁵

Nevertheless, the primary article of faith in the neoclassical school is that imperfect or nonexistent markets can be made to work better than imperfect

4. *Id.*; MILTON FRIEDMAN, CAPITALISM AND FREEDOM 4-5, 7-10, 15 (1962); FRANCIS FUKUYAMA, THE END OF HISTORY AND THE LAST MAN (1992) (stating that the "end of history" means that all societies will find their natural resting point—or what economists would call an equilibrium—in liberal democracy); FRIEDRICH HAYEK, THE CONSTITUTION OF LIBERTY 124, 232 (1960) [hereinafter CONSTITUTION OF LIBERTY]; FRIEDRICH HAYEK, 3 LAW LEGISLATION AND LIBERTY 4, 151 (1979); William Nordhaus, *Stabilizing the Soviet Economy*, in WHAT IS TO BE DONE? PROPOSALS FOR THE SOVIET TRANSITION TO THE MARKET 83, 93-94 (Merton Peck & Thomas Richardson eds., 1991) [hereinafter PROPOSALS FOR THE SOVIET TRANSITION]; Steven Popper, *Assistance to Eastern Europe from Western Governments: The First Steps*, in PROMOTING DEMOCRACY AND FREE MARKETS IN EASTERN EUROPE 144, 147 (Charles Wolf ed., 1991) [hereinafter PROMOTING DEMOCRACY]; DIETRICH RUESCHEMEYER ET AL., CAPITALIST DEVELOPMENT AND DEMOCRACY 1 (1992) (noting that events in Eastern Europe are seen as the "final proof" that "capitalism and democracy go hand in hand"); *id.* at 300 (discussing the collapse of Eastern European state socialism and stating "that capitalism is a necessary precondition for democracy"); Hernando de Soto, *The Missing Ingredient*, ECONOMIST, Sept. 11, 1993, at insert 8; Jeffrey Sachs, *Accelerating Privatization in Eastern Europe: The Case of Poland*, 1 NEW EUR. L. REV. 71 (1992); *French Farmers Against the World*, ECONOMIST, Sept. 11, 1993, at 47. *But see Duty Calls*, ECONOMIST, June 12, 1993, at 100 ("After a winning decade for free-market economics, the 1990s are shaping up to be the decade of the backlash."); *New Deal Chic*, ECONOMIST, Apr. 4, 1992, at 30 (quoting Arthur Schlesinger, Jr.) ("America had long oscillated between spurts of social reform and periods of laissez-faire reaction.").

5. James Tobin, *One or Two Cheers for the "Invisible Hand,"* DISSENT, Spring 1990, at 229, 233. See JOHN FREEMAN, DEMOCRACY AND MARKETS: THE POLITICS OF MIXED ECONOMIES 8 (1989); Charles Wolf, *Introduction: Transforming Command Systems*, in PROMOTING DEMOCRACY, *supra* note 4, at 5-6 (quoting James Brown); *Final Rites*, ECONOMIST, July 24, 1993, at 87-88.

governments in Eastern Europe.⁶ (Such a precept is hardly supportive of the fledgling democracies that are widely expected to *do* something, *right now*, to improve citizen welfare.) The economic freedoms that necessarily accompany political freedoms require that all social relations be wholly voluntary and private. Markets will then foster unanimity without conformity, and reduce social strain by decreasing the number of highly contested political decisions. Neoclassical economists thus see politics as an inferior kind of economic transaction, a long-term service contract used to dupe citizens.⁷

In sum, the neoclassical perspective on Eastern Europe is individualistic, microeconomic, and focused towards private law. As such, it gives rise to a dichotomy with communitarian, macroeconomic, and public law perspectives. Such a dichotomy requires that one or the other perspective on a policy problem constantly be chosen. For example, a law regulating factory pollution is an inefficient and otherwise unwelcome intrusion from the individualistic (factory owners'), microeconomic, or private law perspective. The same law *may* be necessary to correct individual acts in imperfect markets from the communitarian, macroeconomic, or public law perspective. This private versus public dichotomy is false in logic, and it undermines the means for creating viable economic and political reforms in Eastern Europe. I will describe the private law and public law horns of this dilemma in turn, and conclude with some suggestions for transcending this dichotomy and thereby creating integrated frameworks for Eastern European reforms.

II. PRIVATE LAW

Neoclassical economists, especially those who adhere to the tenets of the Chicago school of law and economics, have given some thought to appropriate legal reforms for Eastern Europe. They reason that constitutions should establish broad and absolute property rights that would narrowly constrain governmental activities and give free play to private initiatives under private law.⁸ Their

6. See *infra* notes 36-39 and accompanying text (discussing monitoring costs).

7. FRIEDMAN, *supra* note 4, at 7, 10; Milton Friedman, *Capitalism and Freedom*, in ECONOMIC FOUNDATIONS OF PROPERTY LAW 77, 80-81 (Bruce Ackerman ed., 1975). See RUESCHEMEYER ET AL., *supra* note 4, at 2, 58.

8. See, e.g., BRUCE ACKERMAN, THE FUTURE OF LIBERAL REVOLUTION 10-11 (1992) (arguing that for Hayek, a revolutionary laissez-faire government, protecting private property and freedom of contract, would be "a moral triumph over the false claims of autocracy"); CONSTITUTION OF LIBERTY, *supra* note 4, at 20 (stating that the only relevant freedoms are those of the 18th and 19th centuries—of legal status, immunity from arbitrary arrest, freedom of occupation and movement, and the right to own property); Leif Olson, *Intellectual and Political Barriers to Free Markets*, in PROMOTING DEMOCRACY, *supra* note 4, at 127, 132 ("The first and most basic element in the creation of a free market economy is the creation of a legal framework," especially rules that resolve privatization disputes.); Richard Epstein, *All Quiet on the Eastern Front*, 58 U. CHI. L. REV. 555, 560, 564-65, 568-69 (1991) [hereinafter Epstein I]; Cass Sunstein, *Against Positive Rights*, 2 E. EUR. CONST. REV. 35 (1993); Cass Sunstein, *Constitutionalism and Succession*, 58 U. CHI. L. REV. 633 (1991). See also

proposals look suspiciously like the "substantive due process" for state economic legislation that the United States considered and decisively rejected after the U.S. Supreme Court's 1937 "switch in time."⁹ The proposals complement the adoption of an *idealized* U.S. private law of property, contracts, corporations, bankruptcy, and securities regulation.¹⁰ The reader may see an admixture of public-law regulations in some or all of these private-law categories, but the idealized aspect of the proposed reforms is that law should be restricted to promoting individualistic economic activity—much as U.S. law did prior to the New Deal. Many of these private-law prescriptions are quite sensible, especially if they are purged of their more blatant Americanisms. However, these prescriptions all operate within the common-law tradition we inherited from England, and display a marked antipathy toward public law that arguably does not suit Eastern European circumstances.¹¹

For neoclassical economists, the few preconditions to market economies in Eastern Europe are easily supplied through private law: the authority of private managers to attract capital, hire and fire, set prices and wages, and make other production decisions; and the corresponding accountability of managers (through markets and "hard" budget constraints) to the owners of capital. Bankruptcy and the loss of managerial jobs are the sticks, and profit is the carrot, that will cause private managers to act in the public interest. Foreign investors and Eastern Europeans alike will feel much more secure under such law that no longer implements party policy, ideology, and centralized planning. Such an approach should explicitly, and will implicitly, mimic the inherently most efficient of social institutions—markets—by streamlining channels of communication and action.¹²

RICHARD EPSTEIN, *TAKINGS* (1985) [hereinafter EPSTEIN II]; BERNARD SIEGAN, *ECONOMIC LIBERTIES AND THE CONSTITUTION* (1980); *Capitalism or Bust*, *ECONOMIST*, Feb. 8, 1992, at 49, 50.

9. The Court's substantive due process analysis, which narrowly restricted state government ability to intervene in the economy, dominated from *Lochner v. New York*, 198 U.S. 45 (1905) until *West Coast Hotel v. Parrish*, 300 U.S. 379 (1937). Under extensive criticism and some political pressure, the Court relaxed the rigor of its scrutiny of state economic regulations. See *United States v. Carolene Products*, 304 U.S. 144, 152 n.4 (1938).

10. See *infra* notes 14-32 and accompanying text (discussing property and contract law).

11. See ROGER COTTERRELL, *THE SOCIOLOGY OF LAW: AN INTRODUCTION* 249 (2d ed. 1992) (stating that the distinction between public and private law is the distinction between the state and civil society in classical social theory, a distinction which is eroded by subtle and complex state intrusions into "private" spheres); FREEMAN, *supra* note 5, at 90; O'DONNELL & SCHMITTER, *supra* note 1, at 12; Epstein I, *supra* note 8, at 559 (finding that common-law rules have "great temporal durability" because their assumptions hold across time, space, and a wide range of cases); *id.* at 562 (stating that "differences between the Roman and the common law are best understood as matters of detail rather than as matters of fundamental logic . . . and there is very little in the legal rules of one system that makes them inoperative in a separate legal culture"); *id.* at 572 (describing that stable property and contract rights count for little in the face of political currency manipulations).

12. The Chairman of the Study Groups and Others, *The Soviet Economic Crisis*, in PROPOSALS FOR SOVIET TRANSITION, *supra* note 4, at 25-26; Nordhaus, *supra* note 4, at 97-98; RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 15, 70, 252, 519-22 (4th ed. 1992); Burkhard Bastuck, *Unity, Law, and Freedom: Legal Aspects of the Process and Results of German Unification*, 25 INT'L L. 251, 265 (1991); Stephen Handelman, *Inside Russia's Gangster Economy*, N.Y. TIMES MAG., Jan. 24, 1993, at 12, 50. See ROBERT CAMPBELL, *THE*

Property laws will efficiently *allocate* control over resources that are extremely scarce in relation to the developmental needs of Eastern Europe. If this process is not completed quickly, still more of the resources freed up by the Revolution of 1989 will pass into *nomenklatura* (former government official) or criminal hands. Contract law then serves to move these resources to more highly valued uses, by *assigning* the right to control or use resources to others desiring to maximize wealth. Bankruptcy laws will rectify both contracts and corporations that fail to compete in the market. Corporate law is a conflation of property and contract law in neoclassical economics. It will enable the *aggregation* of resources (as well as their allocation and assignment) in ways that foster efficient, large-scale production. Such a foundation for private economic decision making is seen as superior to the arbitrary and wasteful allocation, assignment, and aggregation of resources by government.

Some private-law scheme similar to the one outlined in the previous paragraph is clearly necessary, but is arguably insufficient, for Eastern Europe. Private property, freedom of contract, and private corporate autonomy are important advances over bureaucratic tyranny, but additional reforms are needed. The past is likely to creep back into whatever legal system is transplanted; for example, bureaucratic habits and the informal law of the underground economy. The intense individualism seen in U.S. and some Western European private law will likely be given some communitarian and egalitarian twists in Eastern Europe, in line with local histories, cultures, and political indoctrinations. The South Commission, a group of Third World leaders interested in development issues, summarizes many of the objections to the neoclassical approach:

[U]nregulated market systems pay little or no heed to such strategic areas as basic industries, health and educational services, scientific and technical research, and the preservation of the environment and natural resources Excessive reliance on market forces can lead to concentration of economic power and wider disparities in income and wealth, to the underutilization of resources, to unemployment and to the wastage of the savings potential, with the result that the pace of development and technical progress is slowed.¹³

SOCIALIST ECONOMIES IN TRANSITION: A PRIMER ON SEMI-REFORMED SYSTEMS 194-95 (1991); Preuss, *supra* note 2, at 117 (discussing the need to overcome the "impasse of transition" to create the security of legality when there is no established legal practice to refer to); Peter Reddaway, *The End of the Empire*, N.Y. REV. OF BKS., Nov. 7, 1991, at 53, 59 (quoting a Moscow lawyer, "A generation or more may have to pass before people regard judges and lawyers as anything but lackeys for the state, as the expeditors [*sic*] and legitimators of tyranny.").

13. SOUTH COMMISSION, THE CHALLENGE TO THE SOUTH 114-15 (1990). See ACKERMAN, *supra* note 8, at 36; CAMPBELL, *supra* note 12, at 167 (stating that it is impossible to legislate freedom of enterprise while leaving the old bureaucracy intact, and that it is politically unrealistic simply to abolish this bureaucracy); COTTERRELL, *supra* note 11, at 118 (quoting H.C. Gutteridge on "the consecration of the spirit of unrestricted

A. Property

Property law is the foundation of neoclassical legal reform, which is complicated by deep disputes over the nature and extent of the private property rights to be recognized in Eastern Europe. The range of subject matter over which private ownership existed was relatively narrow in the communist party-states of Eastern Europe. Most citizens would now expand this range substantially, but certainly not to the extent demanded by neoclassical economists. There is, for example, a widespread desire to reserve some property for corrective justice on behalf of those who suffered most under the previous regime.¹⁴ Property reforms are also complicated by what economists might call an "intransitive preference." The *Economist* could be describing Eastern European attitudes when it notes that many Russians "want a market economy—but one that takes account, as they say government does not, of the hardships Russians now face."¹⁵ This preference is politically, philosophically, and economically incoherent because markets as markets do not take account of "hardships." Instead, such must be dealt with through an implausible private charity (for example, George Bush's "thousand points of light") or substantial governmental interventions that constitutes an abandonment of the "market economy" from a neoclassical perspective. This is part of a more fundamental intransitive preference that bedevils democracies worldwide: Many citizens demand broad private property rights in theory, only to reject outright the distribution of wealth that necessarily flows from such rights in practice.

Such complications can only be resolved politically, by implementing the structures and functions of property that are desired in a particular country; these

egoism" in Western law); Andras Sajó & Andrew Arato, *Editor's Introduction*, 13 LAW & POL'Y 101, 103-104 (1991) (discussing the contemporary influence of "the old Eastern European paternalistic, clientelistic, hierarchical-authoritarian state").

14. Since "much of the land in Bulgaria has been transferred on a temporary basis while claims are sorted out, it can neither be used as collateral, nor sold to create an embryonic land market." *Trouble on the Farm*, ECONOMIST, Aug. 7, 1993, at 57. In the former Czechoslovakia, Hungary, and Poland, a "difficulty for many private businesses is that claims for restitution of property confiscated by the communists have yet to be settled." *Pioneers of Capitalism*, ECONOMIST, Apr. 4, 1992, at 79. In the former East Germany, these restitutionary rights have not been developed, and they conflict with policies of promoting direct investment and reconstruction. Bastuck, *supra* note 12, at 261-62. The "understaffed Federal Property Office in Berlin . . . has a backlog of around 2.5 million unsettled claims for the compensation or return of state property to previous owners." *Ossifying or Modernizing*, ECONOMIST, May 23, 1992, at 7. Hungarian privatizations have gone rather smoothly, but they are slowed and complicated by ambiguous property rights. Rebecca Hanson, *Note: The Legal Framework for Privatization in Hungary*, 23 LAW & POL'Y IN INT'L BUS. 441, 442 (1991-92). See *Hungary: The Constitutional Politics of Compensation*, SOVIET & E. EUR. L., June 1991, at 1.

15. *Battling On*, ECONOMIST, Apr. 18, 1992, at 46. See ACKERMAN, *supra* note 8, at 70; CAMPBELL, *supra* note 12, at 193 (arguing that the primitive property arrangements of the socialist system permitted bureaucrats to be feckless stewards); *id.* at 197, 203; *id.* at 206 (claiming that the likely outcome of successful land reform is windfall profits to owners, which will raise equity concerns until markets signal realistic land values); Epstein I, *supra* note 8, at 557 (suggesting that a major Eastern European problem is the failure to achieve consensus over "strong institutions of private property for both political liberty and economic growth").

are political decisions about whom should have the opportunity to take which private initiatives, and to what extent others should be excluded from these opportunities as trespassers.¹⁶ Neoclassical economists largely ignore such political complications, reasoning that protracted and ultimately futile attempts at a distributive justice will continue to distort the incentives to invest and produce in Eastern Europe.¹⁷

Neoclassical economists reason that control over all conceivable resources should be quickly and fully allocated in the form of private property rights, so as to avoid perpetuating the "tragedy of the commons": The ravages that result from the fact that community or state property, which belongs to everyone in theory, belongs to no one in practice.¹⁸ Indefinite or nonexistent individual property rights mean that no one has the incentive to use resources efficiently. Resources are thus wasted or exhausted prematurely. In the many cases in which it is unclear to whom to initially allocate private property rights—and some of the efforts to privatize public enterprises in Eastern Europe are quite arbitrary in this regard¹⁹—such rights should be allocated to the persons in whose hands they will become the most valuable. In neoclassical economics, these are always the people presently willing and able to pay the most for the property.²⁰

Neoclassical economists believe that "only private owners can establish an enduring basis for self-financing and managerial independence."²¹ This independence offers a major means to economic growth, by implementing private plans that are efficient alternatives to centralized planning, and a means also of resisting governmental coercion. Such independent-minded economic growth fosters the formation of private power bases which will further democracy when used to constrain centralized state power.²² Although much of the United States' experience is otherwise, the hope is that these constraints will curb the incentive-distorting property rights that from time to time lie within the gift of the state: a bewildering variety of licenses and subsidies. For example, this kafkaesque

16. See BRUCE ACKERMAN, *ECONOMIC FOUNDATIONS OF PROPERTY LAW* vii (1975).

17. See *infra* notes 18-24 and accompanying text.

18. Garrett Hardin, *The Tragedy of the Commons*, 162 *SCIENCE* 1243-48 (1968).

19. See *infra* note 40 and accompanying text.

20. See ACKERMAN, *supra* note 8, at 72, 90; POSNER, *supra* note 12, at 32-35; Richard Agnello & Lawrence Donnelley, *Property Rights and Efficiency in the Oyster Industry*, 18 *J.L. & ECON.* 521 (1975); Terry Anderson & P.J. Hill, *The Evolution of Property Rights: The Case of the American West*, 18 *J.L. & ECON.* 163, 164-66 (1975) (citing Harold Demsetz); Epstein I, *supra* note 8, at 557 (quoted *supra* note 11); *id.* at 560; Alan Friedman, *The Economics of the Common Pool: Property Rights in Exhaustible Resources*, 18 *UCLA L. REV.* 855 (1971); Hardin, *supra* note 18, at 1243-48.

21. Kimio Uno, *Privatization and the Creation of a Commercial Banking System*, in *PROPOSALS FOR SOVIET TRANSITION*, *supra* note 4, at 149, 150.

22. See *CONSTITUTION OF LIBERTY*, *supra* note 4, at 140. See also RICHARD CARSON, *COMPARATIVE ECONOMIC SYSTEMS* 12 (1990) ("Efficiency is the ideal, imperfectly attained, of complete, well-defined, and well-enforced property rights, but problems of waste will inevitably arise from congestion and overuse, monopolies, barriers to entering markets, opportunities for economic rents, and overcentralization and an excessive decentralization.").

situation was noted in Prague during 1992: "Permits must be obtained from seemingly countless numbers of government agencies—two years and seventy-three permits so far on redevelopment of a major hotel by the Hyatt chain—before any work can be done."²³ It is difficult to imagine anything like an efficient property market emerging from so much government intervention.

The creation of enforceable property rights is a productive and often costly activity, which competes with other productive activities in Eastern Europe. But the mere creation of such rights guarantees neither a relatively free access to markets nor that distortions in the incentives to produce and to invest will disappear. Administrative law must be invoked, in the form of antitrust-type enforcement, and price liberalizations should also be effectuated. The uncertainties and extreme risk aversion generated by postrevolutionary circumstances, and the incomplete information and imperfect bargaining over unclear entitlements, reduce the efficiency of any private property regime that is established in Eastern Europe. For the moment, the neoclassical desire seems to be to establish the rightfulness and the sanctity of broad private property rights rather than getting mired in the details that will take years to elaborate fully.²⁴ But as many have observed, the soul of the law is in the details.

B. Contracts

Like property principles, neoclassical contract law shrinks the public sphere by establishing an expansive private sphere and even delineating the nature of democracy itself. "Contract means voluntary and unanimous agreement among affected parties. It is therefore a powerful concept. It shows up in arguments about 'social contracts' that justify political society. The founding of the United States was accompanied by much contractarian reasoning."²⁵ Such reasoning also looms large in current neoclassical thinking under the Chicago school's Coase theorem.²⁶ For example, contracts will be efficient and frequently used tools of

23. Ivana Edwards, *Is There Life After Havel?*, WORLD MONITOR, Oct. 1992, at 42, 48.

24. See ACKERMAN, *supra* note 8, at 90; FRIEDMAN, *supra* note 4, at 26-27; Anderson & Hill, *supra* note 20; Jon Elster, *Constitutionalism in Eastern Europe: An Introduction*, 58 U. CHI. L. REV. 447, 466 (1991); Offe, *supra* note 1, at 884; CAMPBELL, *supra* note 12, at 168 (stating that the creation of market-oriented products requires a shift from vertical bureaucratic communications to lateral negotiations between producers and users to establish prices and quantities); Paul Roberts, *Private Property Is the Solution*, CATO POL'Y REP., Jan.-Feb. 1991, at 1. I would argue that extreme risk aversion arises from the fact that, having incurred the enormous risks of revolution, politicians and private and public bureaucrats are keen to conserve new opportunities, however modest.

25. FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 15 (1991).

26. R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Coase's major and admittedly unrealistic assumption is that transaction or information costs are zero. Costs of shopping around, negotiating, monitoring performance, enforcement in the event of breach, and the risks of legal error, are frequently ignored when analysts apply his theorem to the real world.

development, only if property rights are clearly and comprehensively allocated in advance.²⁷ However, these are extremely demanding criteria, in law if not in economics, since such clarity is often problematic or realized after the fact of the underlying contract. If neoclassical liberals are right in assuming that it is feasible and moral to bargain away almost all social problems through isolated transactions in competitive markets, contracts will consistently be socially useful outlets for the energies of individuals and organizations.²⁸ Contracts will, for example, perform the useful political function of shifting questions of fairness from considerations of substance to matters of procedure—that is, matters for individual negotiation.²⁹

In economic terms, contracts serve to move resources from lower to higher valued uses; “value” being measured by the neoclassical, marketplace standard of what individuals are currently willing and able to pay. By definition, a voluntary transaction will not occur unless it enhances the wealth of all of the parties to the bargain.³⁰ But this efficiency canon creates potential unfairness since someone willing but unable to pay is unable to contract.

Contracts are also a bridge over time making future exchanges more predictable. This function is particularly useful for Eastern Europe in interrelated ways. First, it caters to risk aversion by reducing uncertainty about the future, lengthens time horizons, and accordingly helps promote capital accumulation. Thus, it facilitates the private business planning that must grow to replace centralized planning. Second, it creates a market-oriented economy which shifts from vertical bureaucratic communications to the lateral contractual negotiations that set prices and quantities. During Eastern European transitions, most business enterprises are created or closed by administrative fiat. These transitions could also be accomplished contractually, as could implementation of the novel proposition that an individual must either do the job efficiently or lose it.³¹

27. *Id.*

28. See Lawrence Friedman et al., *The Impact of Large Scale Business Enterprise on Contract*, 7 INT. ENCY. COMP. L. 1, 6 (1973) (discussing the ideas of Willard Hurst).

29. See COTTERRELL, *supra* note 11, at 119 (citing Max Weber, “[U]nder Western law, we are a community of strangers whose relations are specific and limited—contractual—rather than all-embracing and ‘fraternal.’”); *id.* at 290; CONSTITUTION OF LIBERTY, *supra* note 4, at 141.

30. For example, if two people voluntarily agree that Buyer will buy a car for \$10,000, Seller must necessarily value the money more than the car and Buyer must necessarily value the car more than the money. The social value of car and money alike is increased since neoclassical economists assume that society is nothing more than all of us.

31. CAMPBELL, *supra* note 12, at 168. See ROBERT ALFORD & ROGER FRIEDLAND, POWERS OF THEORY: CAPITALISM, THE STATE AND DEMOCRACY 115, 134 (1985) (stating that the information costs revolving around the use of centralized planning as a hedge against uncertainty are so high as to make bureaucratic rationalization impossible); ERNST-ULRICH PETERSMANN, CONSTITUTIONAL FUNCTIONS AND CONSTITUTIONAL PROBLEMS OF INTERNATIONAL ECONOMIC LAW 73 (1991) (discussing James Buchanan’s “contractarian paradigm” of voluntary, mutually beneficial exchanges as the bedrock of all economic theory); POSNER, *supra* note 12, at 92-93, 95-96, 135-36; Ian Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974); Anatoly Sobchak, *Creating a Market Economy*, CATO POL’Y REP., Jan.-Feb. 1991, at 13, 14. *But see* CARSON, *supra* note 22, at

U.S. contract law efficiently reduces the costs of transactions in several ways: by (1) providing a standard set of risk allocation terms, which the parties are generally free to change if they wish, (2) enhancing the flow of information, especially as information is reflected in market signals, and (3) promoting risk sharing. The general policy behind this body of law is that an individual who bears no risk under a contract has little incentive to guard her own interests. In particular, the introduction of an expectation damages remedy in Eastern Europe would reduce the need for the clumsy remedy of specific performance and enhance business rationality by encouraging "efficient" breaches of contract—breaches that occur because the costs of completing performance exceed the expected benefits of performance to the other party. There thus seems little harm in transplanting U.S. or other fully elaborated contract law if it has been carefully modified to take account of circumstances in particular Eastern European countries, and if some qualifications are observed. A modicum of equality of access to markets, and some attempt to redress manifest inequalities in bargaining power within the marketplace, seem essential to winning widespread public support for a new market economy. Doctrines akin to U.S. quasi-contract, unconscionability, and the obligation to act in good faith seem responsive to these needs. Yet scholars reject such doctrines as inefficient interference with "market" forces, and they make the important point that the stronger party's freedom of contract will always be expressed somehow.³²

Even so, freedom of contract cannot be as absolute as neoclassical economists would wish. Such a freedom licenses the reduction or elimination of competition, and the creation of other market failures, undermining the market economy justifications for promoting freedom of contract in the first place.

C. Corporations

Historically, the pursuit of individualism within a civil society has required the emancipation of individuals from coercive associations, such as: feudalism, guilds, the patriarchal family, slavery, the Church,³³ and the Communist party in Eastern Europe. But private law emancipation leaves individuals isolated and powerless in the face of the largest compulsory association, the state, unless they are allowed or encouraged to augment their productivity and bargaining power by

447-48 (discussing the Japanese model, where human relations, trust and loyalty, intangible forms of capital, serve as an alternative to detailed contracts). I would add that the "transaction costs" of this Japanese model, e.g., the time spent drinking together after work to build loyalty and trust, rather than spending time with one's family, are quite high.

32. See ALFORD & FRIEDLAND, *supra* note 31, at 366; CONSTITUTION OF LIBERTY, *supra* note 4, at 230 (discussing Herbert Spencer's freedom of contract approvingly); POSNER, *supra* note 12, at 91, 116, 118-20, 128-29, 263; Michael J. Trebilcock, *The Doctrine of Inequality of Bargaining Power*, 26 U. TORONTO L.J. 359 (1976).

33. Henry C. Adams, *Relation of the State to Industrial Action*, 1 PUB. AM. ECON. REV. 471 (1886-87).

forming voluntary associations.³⁴ Neoclassical economists regard the corporation as the only association of importance. Corporations are treated simply as intermediaries between individuals in their productive activities, so that all relations within and between corporations can ultimately be reduced to voluntary contracts. In particular, contributors to the corporation of capital, labor, and other resources succeed in "splitting the property atom": They contract away to the corporation much or all of their right to control their asset in exchange for income from the corporation that rewards the ownership rights they retain.³⁵

In neoclassical economics, corporations are organized to reduce the costs of production by aggregating resources and creating opportunities for the division of labor and economies of scale. As efficient surrogates for isolated exchanges through the marketplace, corporations (really their senior managers) are better able to take advantage of the organizing, controlling, and planning functions of contracts. But the costs of monitoring the performance of employees at various levels of the corporation increase substantially. The fact that employees are no longer paid in direct proportion to their contribution to output enables the employees to shirk their responsibilities and to express their preference for leisure, with little or no financial penalty.³⁶ Layers of corporate, and perhaps government-

34. *See id.*

35. *See* ALFORD & FRIEDLAND, *supra* note 31, at 49 (stating that like public bureaucracies, corporations seek to embody Wilbert Moore's "institutionalization of rationality"—the "normative expectation that objective information and rational procedure will be applied in pursuit . . . of any utilitarian goal"); CAMPBELL, *supra* note 12, at 195 (maintaining that contracts operate to unbundle ownership rights, to permit a specialization in the functions of ownership); EASTERBROOK & FISCHER, *supra* note 25, at 15 (similar to the social contract—see text accompanying *supra* note 25—the corporate contract is a "constructed" rather than a "real" contract); *id.* at 16 ("Everything to do with the relationship between the firm and the suppliers of labor . . . , goods and services . . . is contractual . . .") and much in the articles of incorporation "is a contractual choice."); Friedman et al., *supra* note 28, at 6 (describing a freedom of contractual association plays a major role in stimulating the release of creative energies); FRIEDMAN, *supra* note 4, at 133 (discussing that the only social responsibility of business in the "free economy" is to increase profits within the rules of the game, and that society is responsible for structuring the rules so that the social interest is promoted thereby); CONSTITUTION OF LIBERTY, *supra* note 4, at 37 (stating that an organization is likely to be beneficial, and to reflect the minds that plan it, so long as it is voluntary and embedded in a "free sphere"); Adams, *supra* note 33. *But see* ALFORD & FRIEDLAND, *supra* note 31, at 369 (quoting Alan Wolf) (stating that the "accumulative state" creates the legal possibility of the corporation and the simultaneous limitation of state regulatory power, and such a state need be responsive only to the demands of capital); COTTERRELL, *supra* note 11, at 124 (explaining that as the most important legal "persons" under capitalism, corporations spark legal, religious, and philosophical struggles in a society increasingly dominated by a corporate rationalization and bureaucratization); EASTERBROOK & FISCHER, *supra* note 25, at 3 (relating that the Chicago-school authors admit that "any theory of corporate law must account for the mandatory as well as the enabling features," for a pattern of managerial freedoms and constraints that is puzzling from all but an economics perspective).

36. *See* Armen Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, in *THE ECONOMICS OF LEGAL RELATIONSHIPS* 555 (Henry Manne ed., 1975) [hereinafter *LEGAL RELATIONSHIPS*]; ALFORD & FRIEDLAND, *supra* note 31, at 40 (maintaining that organizations emerge when isolated exchanges are insufficient to achieve collective goals, and organizations survive on the basis of cost-benefit analyses and of the shifting coalitions that constantly reshape them); CARSON, *supra* note 22, at 59-64 (arguing that organizations evolve in all economies to maximize the benefits of cooperation among inputs that markets cannot manage, yet supervision costs increase); Henry Manne, *Our Two Corporate Systems: Law and*

tal, monitoring costs can ultimately dissipate many or all of the benefits of incorporation. These monitoring costs are largely responsible for the loss of managerial control that sets an upper limit on the efficient size of a corporation.³⁷ Roemer and Elster argue that Eastern European economic crises are due largely to earlier failures to solve similar principal-agent problems—in this case the inability to control shirking within the state bureaucracy³⁸—and we can see that private corporations will not solve these problems.

Lal Jawarenda summarizes the dilemma that Eastern European privatizers face:

If most state capital were sold rapidly at knockdown prices to the few people who now have financial assets [as neoclassical economists would wish], these people would reap [politically] unacceptable gains. So fairness requires that the main method of distribution be free[, especially as Eastern Europeans have already “paid” for this state capital through their forced savings in the past]. But efficiency requires that each firm have a major shareholder.³⁹

Economics, in LEGAL RELATIONSHIPS, *supra*, at 511; Nordhaus, *supra* note 4, at 98; Richard Hemming & Ali Mansoor, PRIVATIZATION AND PUBLIC ENTERPRISE (Int'l Monetary Fund, Washington, D.C.), 1988, at 5 (Paper No. 56) (noting that a property rights or agency theory suggests that market failures give way to bureaucratic failures in public enterprises, and I would add private corporations, because managers lack the information to monitor and provide the appropriate incentives).

37. See *supra* notes 35-36.

38. John Roemer & Jon Elster, *A Third Way?*, 2 E. EUR. CONST. REV. 38, 38-39 (1993).

39. Lal Jawarenda, *Preface* to OLIVER BLANCHARD ET AL., REFORM IN EASTERN EUROPE viii-ix (1991); see BLANCHARD ET AL., *supra*, at 32 (stating that while a clear system for ownership claims can be—but, I would add, has not so far been—established quickly, the transformation of state enterprises into smaller, leaner, and more efficient corporations will take time); *id.* at 38; Alfred Kahn & Merton Peck, *Deregulation, Corporatization, and Competition*, in PROPOSALS FOR SOVIET TRANSITION, *supra* note 4, at 38, 58 (noting that it will take time to find the means of making owners' and managers' interests coincide); *Pioneers of Capitalism*, *supra* note 14, at 79; *The Revolution Begins*, ECONOMIST, July 3, 1993, at 67 (“Mass privatization has been the great success of Russian economic reforms,” but now “the difficult bit begins: turning the monoliths into competitive companies.”).

For a well-reasoned discussion of the complex issues involved, see Steven Greenhouse, *It's Sink or Swim in East Germany*, N.Y. TIMES, June 24, 1990, § 3, at 1. In the former Soviet Union and, I would add, Eastern European countries, the public frequently blames private enterprises for shortages and price increases. Marshall Goldman, *The Hunt for Red Enterprise*, WORLD MONITOR, Dec. 1990, at 50, 52. “Hungary has eight incorporated businesses for every 1,000 people[in the urban work force], Poland has three and [former] Czechoslovakia has less than one. For unincorporated businesses, the ranking is reversed.” *Pioneers of Capitalism*, *supra* note 14, at 79. Do these figures show a correlation between corporatization and development? What other factors are at work? The former East Germans merely assumed “that real estate previously used by the socialist businesses would become the property of the new corporations once they had changed their corporate status.” Bastuck, *supra* note 12, at 261-62. Hungary's Company Act of 1988 aimed to promote foreign investment and thus competition, but it permitted much opportunistic behavior. Hanson, *supra* note 14, 443-45. For example, the “spontaneous” and large-scale transfer of assets into private hands that leaves corporate shells with up to 100% of the enterprise's debts. *Id.* Emerging corporations are seen as threats to the “mafia” organizations that thus try to subvert corporate purposes. Handelman, *supra* note 12, at 13.

The conversion of state enterprises into private corporations is not as straightforward as neoclassical economists expect, and the contributions such corporations will make to democratization in Eastern Europe are far from clear: "Hierarchy, control, and coordination at the top is matched by subordination, passivity, and helplessness at the bottom."⁴⁰

Nevertheless, and ignoring the legal details once again, neoclassical economists advocate the freedom of enterprise enshrined in much of corporate law, and the corresponding need to abolish all governmental interference with freedom. The economists do not specifically advocate U.S.-style corporate law, apparently for two reasons: First, most Eastern European countries have already adopted Austro-German codes that echo the rules prevailing in the region prior to World War II; second, most law and economics scholars are not particularly fond of U.S. corporate law.⁴¹ However, the economists do recognize some good things about such laws. For instance, general contract law and corporate law reduce the costs of forming and acting through the corporation by providing a standard set of risk allocation terms. For example, the limited liability of shareholders caters to their risk aversion by enabling them to stake a fraction of their savings without potentially disastrous consequences. This throws a relatively greater risk onto other creditors, banks for example, who then become efficient specialists at evaluating and pricing credit risks.⁴²

Many law and economics scholars nevertheless complain that U.S. corporate law is cumbersome, unrealistic, and inefficient.⁴³ They deal with the collective, collaborative activities of corporations only as the acts of legal "persons." Reality quickly disappears when other legal fictions are used to correct the shortcomings of this legal fiction. U.S. law posits extensive monitoring and controlling roles for shareholders and directors, which they are usually unwilling or unable to play in reality. Privatizers in Eastern Europe encounter similar difficulties, which are the consequences of individuals having contracted away control over their capital to "their" corporation. This lack of control exacerbates the extensive discretion conferred on senior managers by other rules and, *in legal terms*, there are few guarantees that senior managers will act either in the corporation's best interest

40. ALFORD & FRIEDLAND, *supra* note 31, at 198. See BLANCHARD ET AL., *supra* note 39, at 32, 44 (proposing a separation of ownership and control among shareholders—the proliferation of holding companies to economize use of expertise, manage other corporations efficiently, and nevertheless permit a widespread and democratic share ownership); COTTERRELL, *supra* note 11, at 126 (quoting Thurmond Arnold) (stating that the "laissez[-]faire religion, based on a conception of a society of competing individuals, was transferred automatically to industrial organizations with nationwide power and dictatorial forms of government").

41. See *infra* notes 43-44 and accompanying text.

42. CAMPBELL, *supra* note 12, at 167, 195. See POSNER, *supra* note 12, at 393-96; Hanson, *supra* note 14, at 443-47 (discussing the Hungarian Companies Act of 1988). But see Roman Frydman & Andrzej Rapaczynski, EVOLUTION AND DESIGN IN THE EAST EUROPEAN TRANSITION (Colo. Univ. Center for Law & Econ. Stud.), 1991, at 17-18 (Working Paper No. 60) (stating that reform requires the design of a corporate governance structure to which manages complex interrelations among many markets).

43. See *supra* notes 36, 42; *infra* note 44.

or in the public interest. Most neoclassical economists reason that U.S. corporations succeed in spite of, rather than because of, corporate laws and the confusing patchwork of tangential regulations.⁴⁴

Neoclassical economists tend to ignore that to further the development of civil societies in Eastern Europe, an efficient law of noncorporate organizations is also needed: laws promoting proprietorships, partnerships, producers and consumers' cooperatives, foundations, and other religious and citizens' organizations. The goals would be to foster competition and to expand the number of viable niches for social, economic, and political activities.

D. Financial Markets

Although U.S. law fails to force managers to act consistently in the corporate or the public interest, most neoclassical economists see this vital control function being efficiently performed by financial markets.⁴⁵ The argument is that an efficient stock market, where the shares of many corporations can be readily bought and sold, enables insurgents to take over weak, inefficient corporations by purchasing a controlling interest. Knowing that a successful takeover usually means the loss of their own jobs, the incumbent management has every incentive to make their corporation an unattractive takeover target. This is accomplished by making the corporation as efficient as possible; satisfying shareholders by keeping dividends and share prices as high as possible so a takeover becomes too expensive in relation to the benefits insurgents can reasonably expect. Neoclassical economics holds that there should be little governmental or stock exchange regulation of this process since such regulations are inefficient restraints on competition in the market, especially during takeover situations. While this theory has been widely criticized as applied to the United States,⁴⁶ especially as the

44. See FREEMAN, *supra* note 5, at 62 (discussing the need to remove the structural deficiencies that prevent "Pareto gains"—basically, that gainers gain so much that they *could* compensate losers and still come out ahead—especially deficiencies relating to the separation of ownership from control); LEGAL RELATIONSHIPS, *supra* note 36; CONSTITUTION OF LIBERTY, *supra* note 4, at 89 (discussing a monopolist as if it were a biological individual, while arguing that group rather than individual selfishness is the chief threat); RUESCHEMEYER ET AL., *supra* note 4, at 295; *supra* note 40 and accompanying text; *infra* notes 48-49, 71, 81 and accompanying text. But see EASTERBROOK & FISCHEL, *supra* note 25 (showing ingeniously that almost all of corporations law is consistent with sound neoclassical economics).

45. The best discussion of the theory, and of some of the criticisms of it, is Daniel Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

46. See CARSON, *supra* note 22, at 25, 452; EASTERBROOK & FISCHEL, *supra* note 25; Tobin, *supra* note 5, at 233 (stating that Eastern European and Third World countries "should go slow in copying the financial institutions and markets" of the U.S., U.K., or Japan); *id.* (explaining that Keynes likened the stock market to a beauty contest, where success requires voting for the same contestant as everyone else); *id.* (noting that efficient-market theorists have not explained the excessive volatility of prices in relation to dividends and earnings). But see, e.g., EASTERBROOK & FISCHEL, *supra* note 25, at 31 (proclaiming as one form of the survivor principle in neoclassical economics, competition will "weed out the practices that do not assist investors").

threat of takeovers fosters a management time horizon that is too short to take account of gradual development processes, neoclassical economists recommend that rapid privatizations in Eastern Europe be accompanied by rapid development of unregulated stock exchanges, where shares in newly privatized companies can be traded.

Neoclassical economists' hopes for Eastern European stock markets seemingly cannot be realized in the foreseeable future. Only a few companies currently have shares being traded, and market signals often create "speculative noise" that can tempt corporate managers into poor decisions or short-term expedients.⁴⁷ Other financial markets are similarly fragmented or nonexistent, so that marketplace efficiency in the allocation of financial resources cannot be attained in Eastern Europe at any time soon. Many of the risk diversification markets common in the West, especially those involving insurance and financial intermediation, do not function in Eastern Europe to reduce transaction costs, to cater to risk aversion, nor otherwise to create institutional infrastructure for capitalism. As in many developing countries, finance is largely provided by direct foreign investment, through a tightly regulated banking system which retains large shares of governmental ownership. Poland's experience is perhaps typical; privatization of its banks has not proceeded as neoclassical economists would wish.⁴⁸ In the absence of reliable bankruptcy laws, Polish banks expect the state to bail out insolvent state firms, and the government is generally ready to oblige.⁴⁹ Banks thus carry a large load of bad debt, and, if the government reduces its subsidies in an attempt to curb inflation or budget deficits, large-scale bank failure is likely.⁵⁰

47. See *supra* note 46. See also *infra* note 50.

48. *Poland's Economic Reforms*, ECONOMIST, Jan. 23, 1993, at 21, 23.

49. *Id.*

50. *Id.* See BLANCHARD ET AL., *supra* note 39, at 83; Chairmen of Study Groups, *supra* note 12, at 25-26 (discussing the importance of a clear debtor-creditor law, which can be applied to property management agencies); Lawrence Krause, *Introduction*, in LIBERALIZATION IN THE PROCESS OF ECONOMIC DEVELOPMENT 1, 20 (Lawrence Krause & Kim Khiwan eds., 1991) [hereinafter LIBERALIZATION]; ROBERT WADE, GOVERNING THE MARKET: ECONOMIC THEORY AND THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION 364-65 (1990); Yung Chul Park, *Financial Repression and Liberalization*, in LIBERALIZATION, at 332, 333-35; Tobin, *supra* note 5, at 233; Hemming & Mansoor, *supra* note 36, at 6; *Capitalism Without Capital*, ECONOMIST, Nov. 28, 1992, at 91 ("If a thriving stockmarket is the sign of a robust capitalism, Hungary is in trouble."); *Mass Appeal*, ECONOMIST, Aug. 29, 1992, at 16 (stating the assumption is that shareholders acting through stock markets are better monitors than is government, especially if there are attempts to finance corporate expansion by issuing new shares); *Yeltsin Cornered*, ECONOMIST, Jan. 23, 1993, at 51, 52 (stating that the Supreme Soviet's refusal to pass a bankruptcy law "makes the restructuring of state-owned industry almost impossible"). Consider the questions arising from operations of the Czech and Slovak stock exchanges:

Will the share prices of these newly-privatized companies crash as soon as trading starts? Will investment funds, as new to capitalism as the companies they own, provide effective corporate governance? Will banks, which control most big investment managers, abuse their powers? Will the share registry and exchanges cope with the strain of trading?

Making It Work, ECONOMIST, Mar. 13, 1993, at 90.

Financial liberalization is much more difficult than the creation of market-oriented economies in other economic sectors of Eastern Europe. Under conditions of acute market failure, much corporate finance must necessarily be left in the hands of banks dominated by the state. This is done to permit the oversight of crucial public functions such as the allocation of scarce resources among industries, implementation of fiscal policies, mobilization of savings, and the related maintenance of public confidence. Such confidence requires that banking "panics" be avoided, as well as generating widespread public support for new market economies.⁵¹ This can only be done by mitigating the effects of a manifestly inequalitarian access to capital and the wealth that flows from it.

My survey of the legal foundations of private economic decision making suggests that, despite the best efforts of neoclassical economists, public law and regulation will inevitably be smuggled in at the end of the process. The reality of "private" law is one of complex tradeoffs between legal certainty, complexity, and sensible public policy.⁵² The intense individualism of the neoclassical perspective on law is necessary for Eastern European reform, but ultimately not sufficient.

III. PUBLIC LAW

Many prescriptions from neoclassical economists seem uncontroversial, however "stabilizing an economy is one thing[, b]ringing it capitalism is another."⁵³ The economic benefits of competition in markets are obvious. The relevant questions are how to get markets and competition jump-started in Eastern Europe, and how far markets should then hold full (unregulated) sway. As in the baseball fantasy, *Field of Dreams*, the neoclassical attitude seems to be that "if you build it" (a capitalist legal system), "they will come" (entrepreneurs and investors, who will compete efficiently in the markets that will spring up automatically). Unfortunately, Eastern European realities do not resemble this attractive ideal. Creating markets is "an overwhelming task"⁵⁴—the creation of

51. CARSON, *supra* note 22, at 26; Krause, *supra* note 50, at 18-20, 24; Anne Krueger, *Industrial Development and Liberalization*, in LIBERALIZATION, *supra* note 50, at 27, 39; Uno, *supra* note 21, at 149. See COTTERRELL, *supra* note 11, at 305-06; Kahn & Peck, *supra* note 39, at 76 (suggesting that cooperatives could play useful roles, especially under conditions of capital scarcity); Roemer & Elster, *supra* note 38, at 39 (proposing a Japanese-style public banking system for Eastern Europe).

Serious banking problems are likely in Eastern Europe. While the financing of worthwhile projects may not otherwise occur, government as the lender of last resort may blunt any existing market signals. Public savings is a poor substitute for private savings because a financial decentralization never occurs. Liquidity is reduced, and credit rationing and interest rate ceilings are likely to persist. The absence of an efficient secured transactions law, and of a reliable registration system for security interests will likely lead to credit rationing which favors the politically powerful. CARSON, *supra* note 22, at 456; Krueger, *supra*, at 47; Assar Lindbeck, *Public Finance for Developing Countries*, in LIBERALIZATION, at 102, 127; WADE, *supra* note 50, at 364-67.

52. Werner Hirsch, *Reducing Law's Uncertainty and Complexity*, 21 UCLA L. REV. 1223 (1974).

53. *Ossifying or Modernizing*, *supra* note 14, at 7 (discussing problems of German reunification). See WADE, *supra* note 50, at 11-12.

54. Olson, *supra* note 8, at 130-31.

cultural and institutional preconditions, and the careful coordination of a wealth of detail, cannot safely be left to the "invisible hand" of markets that remain underdeveloped.⁵⁵ When the "uncertainties, risks, and deficits of information characteristic of the transition"⁵⁶ are taken into account, it seems unlikely that economic crises can be overcome simply by the "myopic, piecemeal responses" of Eastern European markets.⁵⁷

The recent history of Eastern Europe shows that the transition to capitalism will take significantly longer than the shock therapists hoped, and that more governmental intervention will be required than neoclassical economists would permit. This intervention will require a great deal of imagination. Suffocating statism was a major reason why citizens rebelled against the Communist party-states, but their rebellion offers no clear vision of how to reorganize government so as to replace suffocation with democratic politics and market economics. Ever the Old Testament prophet, Alexander Solzhenitsyn voices some of the worries of Eastern Europeans: "We are now going through a stage of the collapse of Communism in which its upper floors have fallen in, but the middle level is still alive and well and busy laying its hands on everything around it."⁵⁸ Eastern Europeans may follow Solzhenitsyn by inveighing against the former

55. *Id.* See Brietzke, *supra* note 3; WADE, *supra* note 50, at 348-49; Krishnamurthy Sriram, *Markets and States in Development: The Search Continues for an Optimal Mix*, 11 SCAND. J. DEV. ALTERNATIVES 41, 48 (1992) ("Leaving things to the market gambles on a fortuitous aggregation of independent activities."); *supra* notes 32-33 and accompanying text.

Much of neoclassical economics implies that markets occur naturally or spontaneously, in the sense that actors do not construct markets in advance of transactions and that markets precede corporations and other hierarchies. John Campbell & Leon Lindberg, *The Evolution of Governance Regimes*, in GOVERNANCE OF THE AMERICAN ECONOMY 319, 348-49 (John Campbell et al. eds., 1991) [hereinafter GOVERNANCE] (citing Armen Alchian, Albert Chandler, Harold Demsetz, and Oliver Williamson). In fact, the state plays an active and autonomous role in constructing markets and in displacing nonmarket mechanisms. *Id.* at 349, 352 (citing Linda Weiss in part). The notion of state economic *intervention* perpetuates the assumption of a clear separation between state and economy, but "politics does not 'triumph' over economic forces. It enters into their overall configuration." *Id.* at 356, 356-57 (quoting Linda Weiss).

56. O'DONNELL & SCHMITTER, *supra* note 1, at 19, 48.

57. *Id.* See Jawarenda, *supra* note 39, at xi ("An uncontrolled rush to the market will lead to failure."). In Poland, there are "no domestic investment banks, low household savings, and only the most rudimentary stock exchange." Sachs, *supra* note 4, at 74-75. It will take time to match reforms with local cultural advantages and constraints. In any event and not just in Poland, "imagine running an industry with managers who are entirely unfamiliar with the concept of depreciation, or who find it hard to understand how checkbooks work." Alan Ryan, *Twenty-First Century Limited*, N.Y. REV. OF BKS., Nov. 19, 1992, at 20, 22.

58. Solzhenitsyn's *Homecoming*, ECONOMIST, July 31, 1993, at 79 (quoting Solzhenitsyn's pamphlet, *How We Should Remake Russia*). See Brietzke, *supra* note 3; *Capitalism or Bust*, *supra* note 8, at 50 ("The ex-communist economies lack the institutions of capitalism"—legal and tax systems, banks and other intermediaries, settled accounting conventions, etc.); *The Third Way, Alias Cul-de-Sac*, ECONOMIST, Apr. 14, 1993, at 54, 55 (stating that in a system "caught half-way between an efficiency enforced by party discipline and by the desire to make profits, factory managers no longer fear the local party committee but nor do they worry about making money because . . . cronies in government and banking will bail them out").

nomenklatura, the "financial sharks," and the "raging nouveaux riches,"⁵⁹ but as Lenin once asked, what is to be done?

The liberal democratic constitutionalism proposed by neoclassical economists does not solve the problems created by broad, common-law property rights which tightly constrain collective choices, and a strictly separated, elaborately checked-and-balanced government that might collapse during the next crisis. Rather, Eastern Europeans expect their constitutions to incarnate revolutionary success in the sensible institutionalization of revolutionary forces and ideas. There are no inherent boundaries to the power of collective choice, and new leaders have no desire to replicate U.S. gridlock nor to abolish the public sector. Presumably, the key public-law question in Eastern Europe today becomes how can better performance be elicited from the public sector and the emerging private sector, in the service of local democratic preferences? Answers to this question lie more in the realm of administrative law than in a (hopefully) rigid constitutional law.⁶⁰

The Communist party-states of Eastern Europe asserted administrative discretion of a breadth unimaginable to U.S. lawyers. It was this discretion that enabled new governments to deregulate and privatize rapidly and extensively, and this discretion remains relatively untouched by the new constitutions. Further, reform is possible. How should this discretion now be exercised, in the face of the telling points that neoclassical economists make about U.S. "government failures"? Government overspends while inefficiently producing more than the average citizen is willing to financially support. It acts to increase political control over the economy for its own bureaucratic and even corrupt purposes. It confers privileges on special interest groups able to pay, privileges which are expensive taxes on the rest of society.⁶¹ These seem to be strong arguments for narrowing administrative law discretion as much as possible, but such a prescription ignores

59. See Solzhenitsyn's *Homecoming*, *supra* note 58. If Solzhenitsyn's vision is too stark, consider a description of Polish capitalism, not as fulfilling the neoclassicists' 19th century ideal, but as the "teeming Brueghelscape" of a "fifteenth-century trade fair." Lawrence Weschler, *Deficit*, NEW YORKER, May 11, 1992, at 41, 47. There is a "mad finagling" in petty trade rather than competition in manufacturing. *Id.* at 59. Polish bureaucrats operate for themselves alone, and corruption has increased. *Id.* Under a "capitalizing of *nomenklatura*," former senior officials take jobs with foreign companies or head mysteriously privatized companies which have privileged access to credit and other resources. *Id.* As a surrogate for the emergence of markets, many unfair practices persist, including side-door deals, inefficient barter, and cross-indebtedness. *Id.*

60. Brietzke, *supra* note 3; CARSON, *supra* note 22, at 77-78; FREEMAN, *supra* note 5, at 90; O'DONNELL & SCHMITTER, *supra* note 1, at 3, 12; Preuss, *supra* note 2, at 107, 111-12. See also Solzhenitsyn's *Homecoming*, *supra* note 58. For example, there are four examples of how weak democracies paved the way for the rise of authoritarianism: Kerensky's regime, the Weimar Republic in Germany, the Italian republics prior to Mussolini, and Chiang Kai-shek's China. *Id.* I would argue that the last example was never plausibly democratic.

61. See, e.g., William Landes & Richard Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875 (1975); William Niskanen, *Bureaucrats and Politicians*, 18 J.L. & ECON. 617 (1975); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). Special interest groups pay for privileges in the form of bribes, support for programs the decision makers want to implement, and credible promises or threats to deliver a certain number of votes on election day.

the fact that administrative law transmits politics to the economy for good by curing market failures as well as for ill by causing government failures.

Because they assume markets to be ubiquitous and nearly perfect, neoclassical economists are likely to ignore or neglect the prevalence of market failure in Eastern Europe. Some of the many causes of market failure are discussed elsewhere in this article.⁶² Much of the infrastructure for capitalism and economic development of the "public goods" that individuals have too few market incentives to provide, is still lacking in Eastern Europe. Even extensive privatization will not lead to a market-oriented economy if cartels or monopolies are able to substitute their judgment for marketplace dynamics. The marketing of certain kinds of goods, services, and labor is relatively easy, but it is much harder and time consuming to make marketable technology, capital, other financial assets, foreign exchange, land, and natural resources. An imperfectly privatized economy sends the wrong price signals, along with incomplete and inaccurate information and incentives, which foster an inefficient allocation of resources, and opportunistic behavior by the "robber barons" or "mafia" who benefit from the market disequilibrium they helped create. The sectors most hurt by liberalization, such as energy and heavy industry, may further distort resource allocations by obtaining the government subsidies to save jobs. Democratic processes may thus be more appropriately responsive to "demand" than are economic markets. Privatization and a market economy produce a politically unacceptable, stability-endangering distribution of the new wealth. Unwilling to trade their past dependence on the state for a new dependence on imperfect markets, citizens forcefully demand that subsistence needs be withdrawn from the marketplace.⁶³

As these are some of the market failures seen in Eastern Europe today, it is clear that market failures are literally matters of definition, describing what Eastern Europeans want from their markets that is not presently provided. Whether or not neoclassical economists agree, citizens will demand that government fix these failures. Government will comply as best it can, by turning to

62. See *supra* notes 13-15, 24, 47-51, 54-58 and accompanying text.

63. BLANCHARD ET AL., *supra* note 39, at 66; Brietzke, *supra* note 3; CAMPBELL, *supra* note 12, at 7, 216; PETER SCHNEIDER, *THE GERMAN COMEDY: SCENES OF LIFE AFTER THE WALL* 85 (1991); ANDREW SCHONFIELD, *IN DEFENSE OF THE MIXED ECONOMY* 181 (Zuzanna Schonfield ed., 1984) (citing Arthur Okun); Offe, *supra* note 1, at 869, 886. See Krueger, *supra* note 51, at 48 (maintaining that people "cannot be certain that liberalization of any particular market will increase welfare in the presence of other, immovable distortions," especially since policy makers are constrained as to the number, speed, and magnitude of reforms); Sajo & Arato, *supra* note 13, at 102 (discussing the "ambiguous development of a market-oriented business law" in the face of the preservation of Communist and welfare law in Hungary). While neoclassical economists neglect market failure, welfare and institutional economists make it the centerpiece of their justifications for a governmental activism.

In some Eastern European countries, "mafia" organizations are seen as a major law-and-order problem. See Sachs, *supra* note 4, at 73 (stating that in Poland, there are fears of an Italian or Argentinean-style dominance of companies by political parties, which will use companies as a source of funds and patronage); *Poland's Wrong Turn*, *ECONOMIST*, Feb. 22, 1992, at 16 (discussing the need to end "the good climate for swindlers, crooks and thieves").

administrative law. Eastern European governments must thus walk a tightrope: fixing as many market failures as possible, without creating too many government failures, to deal pragmatically with a fascinating paradox. Massive governmental intervention is required to end massive governmental intervention⁶⁴ in what U.S. citizens might see as the New Deal in reverse.

The government failures properly stressed by neoclassical economists are almost always failures of organization and incentive, much like those stemming from the separation of ownership and control in the private corporation. A neoclassical agency theory ignores this similarity, which is based on the failure to design incentives that align bureaucratic self-interest with the public interest. Private business bureaucrats in Eastern Europe are unlikely to be significantly more efficient than the public bureaucrats, because most private bureaucrats were public bureaucrats only a few years ago. Fortunately, government failures can be fixed in much the same way as can market failures—through a more rational, often market-mimicking institutional design. Unfortunately, such institutional reforms are given less attention than are the other elements in an Eastern European administrative “package”, such as privatization, price and trade liberalization, fiscal and monetary reform, and social welfare policies lamented by neoclassical economists. A revolution in administrative law is needed to devise and coordinate all of these reforms in their best sequence, and to change official habits. Such major reforms would necessarily be incremental, and emergency decrees will sometimes be necessary to keep the economy limping along, but reforms should be consistent with an overall plan of where the country wants to wind up. Limited public tolerance and administrative capacities will restrict the number, scope, and speed of reforms,⁶⁵ and they will thus be most effective if complementary to the creation of the market-oriented economy. Reform should

64. Brietzke, *supra* note 3. A wholesale purge of former officials would have been undemocratic, so new officials were empowered to do battle against the incumbents who would slow and water down reforms in Eastern Europe. *Id.* Having deferred gratifications for so long, the public democratically demanded economic growth and welfare safety nets, of a magnitude and at a speed that no reform can provide. *Id.* Reformers are tempted to curb democracy “temporarily,” to “make the trains run on time” while “laying the foundations for further democratization.” *Id.* But political reforms have gone too far for this “Chinese solution,” economic growth through a political repression, to work successfully. *Id.* The paradox described in the text involves making reforms work, without the reformers becoming the kind of authoritarians that reformers were empowered to replace. *Id.* In effect, the paradox is that governments use their power to create or empower institutions of a civil society, including but certainly not limited to markets and corporations which later challenge and limit state power. See *infra* notes 76-77 and accompanying text.

65. ALFORD & FRIEDLAND, *supra* note 31, at 430; Brietzke, *supra* note 3; CARSON, *supra* note 22, at 71-72; Krause, *supra* note 50, at 6; WADE, *supra* note 50, at 372; Paul Brietzke, *Administrative Law and Development*, 26 HOW. L. J. 645 (1983). See ALFORD & FRIEDLAND, *supra* note 31, at 49: (suggesting that administrative law can institutionalize socially valuable “expectation[s] that objective information and rational procedure will be applied in pursuit of any utilitarian goal”); PETERSMANN, *supra* note 31, at 82 (“The law and practice of the IMF . . . promote the use of transparent, non-discriminatory and market-conforming policy instruments that tend to increase national economic welfare.”).

be phased out, through something like “sunset” laws,⁶⁶ if and when marketplace competition takes hold.

Eastern European policy agencies, staffed with the best and brightest, could perform many vital tasks, such as charting the policy and administrative law routes, and determining sunrise and sunset industries. Interagency as well as intra-agency and corporate competitions could be promoted to enhance efficiency. Bureaucratic performance could be evaluated so as to reward and punish the individuals concerned. Agencies could act as gatekeepers for foreign inflows and outflows, variously following, leading, and creating markets. It is difficult to know whether the lack of thoroughgoing industrial policies in Eastern Europe is due to inattention, the neoclassical hope that the “invisible hand” will sort everything out, or both. Industrial policy has often conjured up the unsavory Stalinist image of subsidizing outmoded heavy industries. But the newest guru of developmental economics, Robert Wade, offers a very different and appealing view that straddles the false dichotomy of plan versus market:

The “new interventionism” seeks to guide, not replace, the market. It uses price and non-price methods to channel investments away from unproductive uses, expand technological capacity, strengthen links with foreign firms and give a directional thrust to selected industries.

These interventions need to be based on a plan . . . [that] must be open to feedback from the market.⁶⁷

This would be a superior alternative to government-maintained control of banks. Some East Asian governments have created industrial “winners” with this kind of “light” planning.⁶⁸ Limited administrative capacities in Eastern Europe will dictate that only the most important market failures in the most important industries be targeted.

Eastern Europe’s experience with the privatization of public enterprises illustrates the need for comprehensive industrial policy, coordinated through administrative law. The rate of privatization and the resulting inflows of revenue to the governments have been well below those expected and budgeted.⁶⁹ State

66. That is, laws which have a definite expiration date when enacted, or which must be extended periodically by the legislature to remain in effect.

67. Robert Wade, *State and Market Revisited*, *ECONOMIST*, Apr. 4, 1992, at 81. See Brietzke, *supra* note 3; CAMPBELL, *supra* note 12, at 155; CARSON, *supra* note 22, at xviii (proposing that industrial policy is the remedy for market failure); *id.* at 26-27 (suggesting that government can guide the direction and pace of development without direct management); *id.* at 94 (stating that industrial policy is based on government being the only actor sharing property rights with all others, and on governments’ comparative advantage in producing and enforcing property rights); *id.* at 507 (“In general, Japanese-style planning has been consistent with vigorous competition and entrepreneurship . . . [and] industry-by-industry priorities have evolved systematically.”); WADE, *supra* note 50, at 157, 195, 334; Sriram, *supra* note 55, at 44.

68. WADE, *supra* note 50 (the “light” planning characterization is added).

69. See *infra* note 71.

assets were often disposed of at fire-sale prices, and privatization often became a rush to stake out impregnable positions before markets emerged or grew strong enough to foster countervailing power. Antitrust-type authorities will probably lack the knowledge and power to later undo the damage.⁷⁰ Experts continue to debate the merits of various kinds of privatization, but the reality of most privatization is the simple exchange of assets and liabilities by the public and private sectors. If government is not careful, there will also be the simple exchange of the unaccountability of a private corporation—especially in the absence of a mature market for corporate takeovers—for the unaccountability of a Communist party-state enterprise. Privatization has done little to eliminate the bottlenecks impeding economic growth, such as shortages of capital and skills and the lack of a capitalist infrastructure. Privatization has also created such significant social and political costs as enterprise bankruptcy and unemployment.⁷¹

70. U.S. antitrust authorities, the most knowledgeable and powerful in the world, have won many battles while arguably losing the war of undoing the harm caused by the rising tide of industrial concentration.

71. Brietzke, *supra* note 3; Hemming & Mansoor, *supra* note 36, at 6, 13, 19; Robert Jystad, *Privatization and Economic Rights in Central Europe*, 1 NEW EUR. L. REV. 21, 23-24, 27; Weschler, *supra* note 59, at 63; *Mass Appeal*, *supra* note 50, at 16. See CAMPBELL, *supra* note 12, at 206 (suggesting that privatization must be part of an integrated package of reforms); FREEMAN, *supra* note 5, at 69; Campbell & Lindberg, *supra* note 55, at 368; *The Revolution Begins*, *supra* note 39, at 67 (converting privatized monoliths into competitive companies is more difficult than privatization itself); *Trouble on the Farm*, *supra* note 14, at 57 (“The frustration on Eastern Europe’s farms is tied to the slow emergence of private ownership.”). But see *Escaping the Heavy Hand of the State*, ECONOMIST, July 13, 1992, at 73 (discussing a World Bank study which considers privatization in Britain, Chile, Malaysia, and Mexico and concludes that privatization does indeed work).

Some of the ways to restructure the ownership of public enterprises are: spontaneously as collaboration between workers and managers; large-scale transfers that favor foreign investors, self-dealing by the *nomenklatura* or black marketeers; transfers to holding companies, such as banks, which may issue mutual fund-like shares and which may pose serious anticompetitive dangers; folding public assets into a joint venture; government retention of some or many of the shares in a sell-off; giving some or all shares to the public to build support for reforms, perhaps under a voucher scheme which enables investors to choose companies or “mutual funds”; leasing or franchising public assets to private firms; or contracting out the financing and operating control to private firms. BLANCHARD ET AL., *supra* note 39, at 31, 33, 36, 44, 47; CAMPBELL, *supra* note 12, at 193-94; OECD Secretariat, *Introduction*, in COMPETITION AND ECONOMIC DEVELOPMENT 1, 11, 17 (Kurt Stockmann & Louis Emmerij eds., 1991); Uno, *supra* note 21, at 156.

In Hungary, a “wild” privatization was characterized by many “under-the-table” deals. Jystad, *supra*, at 42. Government bureaucrats have been reluctant to bolster the stock exchange by privatizing through it, and have botched the few offerings made in this way. *Capitalism Without Capital*, *supra* note 50, at 92. Privatization there has been slowed and complicated by a patchwork of laws that make property rights ambiguous and that have permitted many corrupting, “spontaneous” privatizations. Hanson, *supra* note 14. The Germans decided to restore property in the East to the former owners (rather than pay compensation). This policy delayed privatization, clouded titles, and encouraged people to focus on dividing the spoils rather than on an economic reconstruction. There is a backlog of 2.5 million unsettled claims. For many privatizers, the idea of the *Treuhand*, with its 3000 “monastic scribes or Prussian clerks,” bringing capitalism to Eastern Germany seems “a contradiction in terms.” The privatization market that government tried to create worked poorly. One cause was the absence of rules for valuing assets and liabilities. Bastuck, *supra* note 12, at 260; *Ossifying or Modernizing*, *supra* note 14, at 6-7; *Review*, ECONOMIST, June 12, 1993, at 101. In Poland, free marketeers prevailed over the more cautious people who sought a better-managed state ownership—note that two of the first five “flagship” privatizations have fared badly. *If It Works, You’ve Fixed It*, ECONOMIST, Jan. 23, 1993, at 21, 22-23.

IV. INTEGRATING REFORMS

In Eastern Europe, the impulse to democratize has run ahead of the creation of market-oriented economies, to say nothing of broad, neoclassical property and contract rights. Such rights would narrowly limit the political ability to cope with crises in the short run, and government's ability to achieve consensus about economic reform in the long run. The fact that economic reform is inevitably a political process means that progress is bound to be slow. After all, the rehabilitation of Western Europe after World War II, arguably a less daunting task than the one facing Eastern Europe today, took the better part of a decade to complete.⁷² While significant social change, and the related governmental processes of conciliation, concession, and outmaneuvering, are more time-consuming than most theorists assume, the pace of events still takes many citizens by surprise. It is unreasonable to expect people to acquire all of the means to capitalism and democracy quickly and automatically in the face of severe hardships and great uncertainty. Democracy and capitalism are, after all, designed to institutionalize uncertainty with respect to who will make what use of power. John Rawls' "veil of ignorance" arguably describes the plight of the many Eastern Europeans who are uncertain of their place in the new society, where reform sometimes fails or operates opposite to its stated purpose, and significant aspects of life under the ancien régime remain.⁷³

Government officials in Eastern Europe also face massive uncertainty over how to deal with extensive public demands for "equity" which appears to defeat the marketplace criterion of efficiency.⁷⁴ Officials must deal with the legacy of a particular past from an unfavorable position in the international division of labor, and in a world economy that is still in recession. Officials know that every policy decision they make will have its "opportunity costs," with some alternatives foregone or postponed. They also know that these opportunity costs are incalculable in the short run and that inappropriate policies and institutions will likely be frozen in place by the time these costs are understood. Eastern European officials are thus tempted alternately to accede to equity demands or to hold fast to prescriptions from neoclassical economics, in the hope that everything will turn out well in the indefinite future. There is, however, a growing recognition that the neoclassical prescriptions are based on a Cold War fallacy that laissez-faire capitalism under an idealized, U.S.-style law is necessarily the only alternative to

72. John K. Galbraith, *The Rush to Capitalism*, N.Y. REV. OF BKS., Oct. 25, 1990, at 51, 52.

73. BLANCHARD ET AL., *supra* note 39, at 29 n.13; Brietzke, *supra* note 3; CAMPBELL, *supra* note 12, at 213, 216; Kahn & Peck, *supra* note 39, at 46; O'DONNELL & SCHMITTER, *supra* note 1, at 11, 66; Wolf, *supra* note 5, at 6 (citing Lawrence Summers); Offe, *supra* note 1, at 870.

74. See generally ARTHUR OKUN, *EQUALITY AND EFFICIENCY: THE BIG TRADEOFF* (1975).

a strict centralized planning under an authoritarian public law.⁷⁵ When “the only force powerful enough to set the market forces in motion is the very state which is supposed to remove itself from the picture,”⁷⁶ the outcome is not *laissez-faire* but “political capitalism,” “capitalism by design,” which is launched before there are sufficient capitalists to cater to or rely upon.⁷⁷

Finally, the central theme of this article is the analytical and policy-making dilemmas facing Eastern Europeans. Democratization, the rule of law, and the creation of a free market economy must be achieved simultaneously and quickly. The false dichotomy between individualistic, microeconomic, and private law perspectives on one hand, and communitarian, macroeconomic, and public law perspectives on the other must be transcended. Tradeoffs must be made between efficiency and equity. In addition, tradeoffs must be made between legal certainty, complexity, and sensible public policy. The intransitive public preference for extensive private property that necessarily generates an unacceptable distribution of wealth must be dealt with democratically. Officials must understand the paradox of ending massive governmental intervention through massive governmental intervention, and the related paradox of using state power to bolster the institutions of a civil society—institutions that are then expected to challenge and limit state power. The maximum number of market failures must be fixed, while creating as few government failures as possible. The ultimate futility of replacing unaccountable public enterprises with unaccountable private corporations must be recognized.⁷⁸ Transcending these dilemmas requires a dialectical analysis to harmonize polarized alternatives. This is a middle or “third way” disdained by commentators accustomed to the clear choices offered by austere and elegant theories. The aim would be to develop better policy choices and sequences. These would be “second-best” choices that offer progressively better incentives and definitions of the public interest, based on better approximations of short- and

75. ACKERMAN, *supra* note 8, at 34. Compare FRIEDMAN, *supra* note 4, at 13 (stating that there are only two ways of coordinating economic activity: central direction with coercion, and the informed and voluntary transactions of “a collection of Robinson Crusoes, as it were”) with BARRINGTON MOORE, *SOCIAL ORIGINS OF DICTATORSHIP AND DEMOCRACY* 5 (1966) (“The route that ended up in capitalist democracy . . . was itself a part of history that almost certainly will not be repeated.”) and RUESCHEMEYER ET AL., *supra* note 4, at 76 (“We must expect to find patterns of multiple causation and . . . different paths leading to democracy.”). See Brietzke, *supra* note 3. See also WADE, *supra* note 50, at 348-49 (discussing “the Darwinian or Malinowskian fallacy[,] . . . the assumption that because something exists it must be vital to the survival of the organism or society.”). Under this fallacy, the long survival of U.S. constitutional and corporate forms (as heavily modified) must mean that they are essential for Eastern Europe as well as for the United States. This is a version of the neoclassical economists’ “survivor principle” and also a form of the *post hoc, ergo propter hoc* fallacy: A caused B, merely because B (democratization and the creation of the free market economies in Eastern Europe) *chronologically* followed A (the democratization and creation of a free market in the United States).

76. Frydman & Rapaczynski, *supra* note 42, at 17. See *supra* note 64 and accompanying text.

77. Offe, *supra* note 1, at 877-79. See O'DONNELL & SCHMITTER, *supra* note 1, at 48; Sriram, *supra* note 55, at 48 (“It is paradoxical that even a retreat of the state calls for a stronger state to consolidate the burgeoning market forces.”).

78. See *supra* notes 2, 15, 38, 52, 64, 71, 76-77 and accompanying text.

long-term costs and benefits as these become available. This recognizes that ideal policies are unattainable because their underlying chains of causation will be constantly disrupted and delayed by real-world events. Everything fails eventually: markets, corporations, administrative agencies, political processes, even constitutions themselves.

The legal details that might emerge from such a reformist process of learning by doing cannot be described in an article of this length, especially as the process is manifestly *not* one of transplanting foreign rules and institutions more or less intact. Foreign legal experiences and solutions should be consulted while preparing a firm plan. This plan should respond to local cultures and to demands for development, and should be anchored in an administrative law which keeps rules internally as consistent as possible. If politicians refrain from advocating simplistic panaceas, a democratic electorate will be able to evaluate good faith attempts to solve complex problems and to reward these efforts accordingly. Implementation of such a legal plan will require officials to "go with the flow," as "politics make reform . . . hard to achieve, while private entrepreneurs find it easy to slip through holes in the law [and] accept private ingenuity as a helpful way (around) the difficulties."⁷⁹ If slipping through holes hinders reform efforts, the holes will have to be closed creatively and quickly. Eastern European governments apparently have "little choice but to move on all fronts at once"⁸⁰ and adjust outcomes later in the light of experience.

However, one thing is clear: The public interest is implicated in almost all large private or public commitments of resources in ways that cannot be captured by a purely voluntary and private law. Of all private law rules, those of property are most bound up with theories of a distributive justice. Many in Eastern Europe would reject outright both the Marxist formula of distributive justice and the neoclassical formula: from each according to his ability, to each according to his marginal productivity judged by imperfect markets. Theories of natural law having fallen into disuse, there is no "natural" configuration for the state-made institution of property; while private property limits state power, democratic processes limit property rights. A carefully democratic reconfiguration of these rights, in line with clear and compelling definitions of the public interest, undercuts neoclassical objections to "tyranny" and will often be to the net benefit of the individuals concerned.⁸¹ For example, abuse of rights provisions like those

79. *If It Works, You've Fixed It*, *supra* note 71, at 23.

80. Jawarenda, *supra* note 39, at xi (quoting Oliver Blanchard et al.). See CAMPBELL, *supra* note 12, at 219-20 (discussing arguments about the "phasing" of Eastern European reforms and concluding that the issue comes "to resemble the chicken and the egg"); Jawarenda, *supra* note 39, at xi (quoting Oliver Blanchard et al.) ("Savant discussions about the sequencing of reforms in Eastern European countries have been made irrelevant by the march of events.").

81. SCHONFIELD, *supra* note 63, at 35-36. See ACKERMAN, *supra* note 8, at 90 (stating that in contrast to a neoclassical, 19th-century liberalism, "Modern liberalism does not sanctify property rights above all others."); ALFORD & FRIEDLAND, *supra* note 31, at 431; Eric Roll, *Introduction*, in *THE MIXED ECONOMY* ix,

in the Dutch Civil Code can be used to declare property forfeited if the owner either persistently refuses to beneficially use or misuses the property in light of community standards.⁸²

As with rules promoting a broad private property, those promoting freedom of contract do little to foster free access to markets or to insure that distortions in marketplace incentives will be removed in anything but the very long run. Without some government control over manifest inequalities in bargaining power, the poor and powerless will be unable to sufficiently acquire property or enter into profitable contracts. Neoclassical economists would see this as the “natural” outcome of a market economy. But this outcome will be brought forcefully to the attention of Eastern European governments eager to stay in power, and eager to legitimate a new market economy broadly within a democratic electorate. As important as private-law rules of property and contract are to economic growth, *politically* they must be supplemented by income redistribution, antitrust-style enforcement, and the reregulation (rather than the neoclassicists’ cherished deregulation) of property and contractual relations. Similarly, the conventional law and structure of private corporations offer too little accountability in the public interest and insufficient controls over shirking by employees and managers. Large “private” corporations quickly acquire a “public” character, in terms of their political influence and their capacity to affect citizens’ lives. Eastern European policy makers should thus periodically redraw the boundary line between what is considered “private” as opposed to “public,” in order to improve incentives, reduce corporate failures, and implement a coherent industrial policy.⁸³

Attempts to integrate the legal reforms proposed in and for Eastern Europe lead more or less automatically to the conclusion that “mixed” economies will be

x (Eric Roll ed., 1982) (citing Maurice Preston) (private transactions have public consequences, and property is to some extent held in trust to prevent a neglect of community responsibilities). See Clive Crook, *The Future of Capitalism*, *ECONOMIST*, Sept. 11, 1993, at 52, 53:

Private ownership has usually been a feature of capitalist economies. Certainly, it is a natural counterpart, a reflection of the separation of politics and economics. But it is not in fact a necessary counterpart, because in achieving that separation, control matters more than ownership—and ownership does not guarantee control.

That is why you could argue, for example, that for much of the 1980s southern China was a more capitalist place than India.

Id. See *supra* notes 38-40, 44-45, 71 and accompanying text.

82. PETER STEIN & JOHN SHAND, *LEGAL VALUES IN WESTERN SOCIETY* 103 (1974) (discussing the Swiss and Dutch provisions).

83. Frydman & Rapaczynski, *supra* note 42, at 16. After making the statement quoted in text accompanying *supra* note 76, the authors conclude that reform in Eastern Europe amounts to designing new corporate governance structures. Frydman & Rapaczynski, *supra* note 42, at 17. See Campbell & Lindberg, *supra* note 55, at 368. “[T]he large American corporate hierarchy has become extraordinarily self-sufficient and autonomous from control of, responsibility to, or dependence upon, workers and their organizations, financial institutions, or state agencies. This power position would seem to reinforce incentives for self-interested, utilitarian, and opportunistic behavior.” *Id.* While the U.S. state is a much more aggressive economic player than much of the literature recognizes, *id.* at 390, this model is arguably not one that Eastern European countries should adopt. See *infra* notes 84-86 and accompanying text.

the reality for the foreseeable future. Private and public sectors will have to coexist, in economies that defeat the need to choose between a polarized central planning and laissez-faire capitalism. Some state-owned assets will have to remain public property for awhile, especially as privatization has proven slower and less complete than the shock therapists hoped. Capitalist development will require many interventions by rather activist governments. As O'Donnell and Schmitter put it:

It seems crucial that, during the transition, a compromise among class interests somehow be forged to reassure the bourgeoisie that its property rights will not be [unduly] jeopardized . . . , and to satisfy workers and various salaried groups that their demands for compensation and social justice will be met. Central to any such compromise is the institutionalization of representation rights and bargaining mechanisms⁸⁴

Such institutionalization would also foster the rehabilitation of civil society in Eastern Europe. Robert Dahl, a sophisticated analyst of the U.S. scene and certainly no radical, similarly recommends that Eastern Europeans consider adopting the democratic or social corporatism found in Scandinavia, Germany, Austria, and Holland.⁸⁵

No such *social* democratic system would be perfect, but it seems the "least-worst" solution for the real world of Eastern Europe. It certainly offers the best chance for circumventing U.S.-style political gridlock. Governance should proceed through open and formalized consultations among representatives of government and civil-society institutions, with government acting pragmatically to reduce opportunities for conflict and exploitation. Such a scheme would contrast sharply with the sporadic and sub rosa dipping into the special-interest pork barrel that is seen in the United States by neoclassical economists. The economic aspects of this approach would constitute the country's industrial policy and be exposed to

84. O'DONNELL & SCHMITTER, *supra* note 1, at 46-47. See CAMPBELL, *supra* note 12, at 152; FREEMAN, *supra* note 5, at 69-71; SCHONFIELD, *supra* note 63, at 3; SOUTH COMMISSION, *supra* note 13, at 126. Some public enterprises are indeed successful, particularly those which have "a high degree of managerial and financial autonomy, a manageable number of clear commercial and social objectives, and transparent accountability, government control being exercised only in such strategic areas as the setting of economic and financial targets." *Id.*

85. Robert Dahl, *Social Reality and "Free Markets": A Letter to Friends in Eastern Europe*, DISSENT, Spring 1990, at 224, 227; see CARSON, *supra* note 22, at 524, 526 (discussing the Swedish "third way" between individualism and collectivism, and involving the nationalization of a few property rights rather than the property itself); FREEMAN, *supra* note 5, at xi, 9 (stating that in Austria there is much collective gain from state ownership, much popular control over decisions, and a modicum of equity); SCHONFIELD, *supra* note 63, at 88 (stating that in the German and Japanese mixed economies, there is systematic intervention at various levels—as opposed to the Italian and French practice of taking entire or partial responsibility for particular sectors); Dahl, *supra* at 225 (stating that the Eastern European "path lies somewhere between the economic system you are rightly rejecting and full reliance on the market economy").

periodic evaluations by the electorate. Democratic procedures would have to be zealously safeguarded to forestall the emergence of an authoritarian corporatism. But there are also other means by which a fascism can come to Eastern Europe, and in the context of safeguarding democracy, the concerns voiced by neoclassical economists seem marginal at best.⁸⁶

V. CONCLUSION

The revolutionary excitement of 1989 has given way to more sober assessments of events in Eastern Europe. Neoclassical economists have to date exerted the main foreign influence over the reform process. This article has tried to show why confident neoclassical prescriptions were and are wrong. If Eastern European leaders are lucky and smart, their attempts to deal with harsh realities will prompt the evolution of partly privatized social democracies. The neoclassicists' vision of abrupt transition to wholly privatized liberal democracy never had a chance to become a reality in Eastern Europe. In particular, the neoclassical prescription of an idealized, U.S.-style private law does not offer a cure. Rather, Eastern Europeans should choose and integrate their own legal policies pragmatically, on the basis of learning by doing and hard analysis of the problems and potentials of various reforms.

The administrative law embodied in industrial policy is an excellent centerpiece of reform efforts, fixing as many market failures as possible while creating as few government failures as possible. Pragmatism is said to be the United States' only contribution to world philosophy. If the United States can discard Cold War preconceptions, Eastern Europeans could take advantage of the problem-solving imagination for which U.S. lawyers are rumored to possess in abundance.

86. See Brietzke, *supra* note 3; FREEMAN, *supra* note 5, at 78, 80, 90; O'DONNELL & SCHMITTER, *supra* note 1, at 12, 45; Roll, *supra* note 81, at x; SCHONFIELD, *supra* note 63, at 35-36, 88, 127-28, 131, 149, 161; WADE, *supra* note 50, at 275, 295, 372, 378; see also ALFORD & FRIEDLAND, *supra* note 31, at 32 (stating the need to retain as much of democracy as possible while avoiding a democratic ungovernability); CARSON, *supra* note 22, at xviii, 18, 26, 29; COTTERRELL, *supra* note 11, at 176-77 (discussing that a welfare state promises aid to the poor in exchange for their political allegiance, but without social democracy's formalization of power through rules); Campbell & Lindberg, *supra* note 55, at 368, 390. But see Dominique Audibert, *Hungary's Crumbling Castle*, WORLD PRESS REV., Apr. 1992, at 44 (proposing that Hungary's new political system is "worthy of a prosperous social democracy, but unrelated to a crisis-ridden social reality"); Martin Malia, *The August Revolution*, N.Y. REV. OF BKS., Sept. 26, 1991, at 22 ("It is precisely because Communist power has survived under the label 'social democracy' in Romania, Bulgaria, and Serbia that the political situation is still so unpromising in all these countries.").

