
Corporate and public governances in transition: the limits of property rights and the significance of legal institutions

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Abstract

Post-socialist transition raises crucial issues about the institutional setting of a market economy. The priority has been given to property rights, and privatization has been advocated as a means to depoliticize economic activities. The dismissal of external interventions, allied with the attraction to the American model and Hayekian ideas, often led to the introduction of minimal laws and wait for their evolutionary development. The failure of corporate and public governance, notably in Russia, helps to show why, on the contrary, democratically established legal rules are essential. Legislation should not only protect corporate shareholders and stakeholders, but more fundamentally all citizens against predatory collusive behavior of political, economic and criminal elites.

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"No question is ever actually raised as to the State limiting freedom of contract in many directions and encouraging agreements of other sorts. It also necessarily appropriates through taxation a considerable part of the usufruct of things privately 'owned', thus modifying ownership in both its phases. And this modifying influence on private property extends rapidly in scope as the laissez faire theory of the State loses ground in the modern world".

Frank H. Knight, 1921, *Risk, Uncertainty and Profit*

"Above all, we must bear in mind that the critical issue should be how to strengthen the legal base of free market capitalism: the property rights of shareholders and other owners of capital. Fraud and deception are thefts of property. In my judgment, more generally, unless the laws governing how markets and corporations function are perceived as fair, our economic system cannot achieve its full potential".

Alan Greenspan, July 16, 2002, testimony before the U.S. Senate

Privatization and transition strategies implemented in post-socialist countries have been widely criticized (Kornai, 2000, Stiglitz, 2000, Andreff, 2003). The attention given to privatization, it was said, was too exclusive, leaving unanswered crucial issues about the general institutional setting of a market economy. Institutions should create order and reduce uncertainty, transaction costs and opportunism which hinder exchanges (North, 1990, 1991). According to the theory of property rights, private property rights and corporate ownership structures emerge endogenously as an optimal response balancing benefits and costs (Demsetz, 1967, 1983). Institutional economics

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tends however to reject this view of optimal outcomes. And the historical record shows that institutional environments are rarely conducive to efficient behavior and economic growth.

The recent experience proves that reasoning in terms of universal “models” to imitate is hazardous. The Japanese system with the peculiar Japanese firm, praised in the 1980s, has shown its limits. The Asian crisis in 1997 threw light on the perverse incestuous connections between governments, banks and big companies. The Rhineland capitalism based on developed social relations exhibits deep troubles. The Parmalat scandal questions the virtues of Italian family capitalism. The Enron and WorldCom affairs violently unveiled deep inadequacies of the American corporate governance system. Concerning transition economies, the Czech strategy based on massive voucher privatization has been initially favorably assessed, but scandals revealing flawed corporate governance qualified this judgment. Poland has then been the focus of attention, thanks to its impressive growth partly attributable to new private start-ups. Its current fiscal problems, combined with rising unemployment, put these achievements into perspective.

Interestingly enough, corporate governance and the behavior of enterprises are central components of each story. Studies of corporate governance arrangements conclude that practices change over time, and no single optimal model can be identified (Shleifer and Vishny, 1997, Mayer, 1998, OECD, 1999). The bundle of rights and the quality of their enforcement differ greatly across common law and civil law countries, and among the latter, across French, German and Scandinavian subfamilies. The diverse protection of investors and stakeholders shapes their incentives and leads to differentiated ownership and financial structures (La Porta *et al.*, 1998, 1999b). If management has a public good nature (Stiglitz, 1985, 2000), it requires institutional solutions in order to avoid under-supply, free riding behavior, and opportunism typical of public goods. The property rights theory and Coase theorem address these issues. But property rights can not be exhaustive, while transaction and negotiation costs make Coasian contracting often impossible. Complementary formal institutions, including laws, regulations, and accounting rules, prove essential. The post-communist transition entails a change in property rights and legal infrastructure as well as in state missions. Legal protection of property rights and contracts, corporate, bankruptcy, competition and securities laws were called for. This paper insists on the fundamental part of these formal institutions².

Transition strategies based on simplistic Coasianism have been denounced and evolutionist Austrian ideas praised (Kornai, 2000, Stiglitz, 2000). Yet, Austrian views on the legal basis of a liberal society have been influential in post-socialist countries. It is rather natural, because most observers conclude from the real socialist experience that Hayek and Von Mises were right against Lange. The dominant approach of transition gave the priority to property rights (section 1), and dismissed state and legal interferences (section 2). Property rights and transaction costs theories, allied with liberal evolutionist conceptions of law, offer foundations for such a *laissez faire* strategy.

² Few observers gave initially a great attention to this legal dimension. Fischer and Gelb (1991) insist on the need to quickly start legal overhaul and on the lengthy process it requires. In his discussion of Lipton and Sachs (1990), Summers remarks: “a nation whose legal infrastructure cannot stop blatant self-dealing by managers of huge enterprises seems unlikely to carry out any sort of corruption-free distribution of assets” (p. 335). He adds: “a government that cannot reform itself cannot reform its economy” (p. 338).

In accordance with his focus on spontaneous orders, Hayek (1973) insists on the spontaneous emergence of stable general laws, which are selected, applied and improved by judges in common law systems, and are more essential than government-led intentional legislation³. This stance can be disputed on both empirical and theoretical grounds. Poland and Hungary have initially devoted a lot of efforts to the legal change, simultaneously with the change in property regime. The Czech Republic and Russia, on the contrary, gave priority to rapid privatization. Transition experience helps therefore to understand why legal rules are significant (section 3) and why depoliticization of economic activities is an ambiguous objective (section 4). The paper concludes by examining the relation between informal and legal institutions.

1. The priority to property rights, but property rights are not enough

Giving special attention to the change of property rights was logical. The property system was the last economic pillar, which was largely excluded from failed reform attempts during the socialist period. Secure, exclusive, transferable private property rights represent the main element of the incentive system of a market economy. They are the necessary complement of financial discipline and competition, and allow the development of efficient product, factor and financial markets (World Bank, 1996). The Coase theorem moreover shows that the initial allocation of property rights does not matter from an efficiency perspective as long as they are clearly defined in the first place, and can be freely and costlessly contracted on and exchanged. On the contrary, poorly defined property rights, the lack of protection against theft and expropriation, the lack of contract enforcement, i.e. weak institutions, are all obstacles to efficiency (Boycko, Shleifer and Vishny, 1995).

The limits of the Coase theorem have nonetheless been repeatedly highlighted. Conditions necessary to reach efficient decentralized agreements, in terms of information and negotiation costs, are so strong that the theorem is a tautology. Contract incompleteness, making impossible a complete ex ante bargaining, invalidates the theorem. The latter ignores wealth effects, which are critical in transition economies where massive property transfers are at stake. But deeper difficulties arise. The first lies in the tendency to inflate the content of the definition. Demsetz (1967, p. 348) claims that “property rights specify how persons may be benefited and harmed, and therefore, who must pay whom to modify the actions taken by persons”. Pejovich (1994, p. 525) defines property rights as “relations among individuals that arise from the existence of scarce goods and pertain to their use”. As a matter of fact, Coase (1960, p. 19) does not speak of property rights but of “the arrangement of rights established by the law”. Coase’s decentralized solutions depend on the initial provision of these exchangeable legal rights, like the right to be free from a nuisance or the right to harm somebody. All the rights cannot therefore be analyzed as property rights⁴.

Secondly, can property rights be perfectly and clearly defined? Does the imprecision concern their content or their assignation? For a given asset, multiple uses are possible and can be divided among multiple agents. This complexity makes hardly

³ *Nomos* and *thesis* designate these two kinds of law.

⁴ This definition problem also exists in empirical studies. For instance, Johnson, McMillan and Woodruff (2000) range under the property rights heading very different phenomena: the possibility to use courts, government regulations, taxes, extralegal payments and bribes, other costs of doing business... This heterogeneity can explain why the empirical effect of the property rights variables is often insignificant or very fragile.

possible exhaustive, precise definitions and assignments. As emphasized in the modern property rights approach (Grossman and Hart, 1986, Hart and Moore, 1990), and following the path-breaking work of Alchian and Demsetz (1972), a central component of ownership lies in residual rights of control over assets. The latter exist under two conditions: they have not been contracted on *ex ante* because contracts are absent or incomplete; strict legal provisions do not bind them. In that sense, they consist in unspecified rights. Instead of property rights *per se*, the most important issue then becomes the partition into legal, contractual, and residual rights.

Furthermore, reasoning in terms of property rights does not lead to a convincing and fruitful theory of the firm (Nivet, 2003). The definition of property rights and the ensuing argumentation put forward by Coase (1960), Demsetz (1967), Furubotn and Pejovich (1972), Alchian (1987), Boycko, Shleifer and Vishny (1995), are essentially presented in terms of a single asset, and focus on the right to decide its uses. The firm is almost absent in this picture. This gap is perfectly illustrated in the analysis provided by World Bank (1996), where the connection between the developments on privatization of enterprises and the two initial paragraphs devoted to property rights is non-existent. The firm studied by Grossman and Hart (1986) remains composed of an individual owner-manager; ownership and control go together. It leads to a theory of firm boundaries, under the restrictive assumption of *ex ante* relationship-specific investments. Like in Williamson (1985), the focus is on inter-firm relations, hold-up problems and integration. And theories centered on property rights ultimately lead to very destructive and paradoxical conclusions. Shareholders own only their shares, not the corporation, and are accordingly not owners but lenders of capital (Demsetz, 1967). Ownership of the firm is an irrelevant concept (Fama, 1980). Ordinary markets and firms are only competing types of markets (Alchian and Demsetz, 1972). Distinguishing things inside and outside the firm does not make sense (Jensen and Meckling, 1976), the same for the distinction between intrafirm and interfirm transactions (Klein, 1983). The firm is dead (Alchian and Woodward, 1988). But understanding privatization is illusory if both ownership and the firm vanish.

2. The dismissal of state and legal interferences

Several obstacles hindered the rapid emergence of an appropriate and effective legal infrastructure in transition economies (World Bank, 1996). In the socialist regime, laws and judicial decisions were discretionary instruments subordinated to political and bureaucratic decisions. The heritage accordingly includes the low legitimacy of legal institutions. Laws cannot be designed from scratch but should be made country specific, and adapted to cultural and legal norms, economic and financial structures, and to the general institutional framework⁵. Central and Eastern European countries and Baltic States, contrary to CIS and China, could rely on local pre-war laws, but they were partially outdated. And the import of foreign laws is not a panacea. A negative “transplant effect” arises if law is not adapted to local conditions (Berkowitz, Pistor and Richard, 2003). Governments and Parliaments were unskilled and initially overburdened, making it necessary to have priorities in the legislative work. Efficient courts are necessary to fill the inevitable gaps through their interpretation of texts and their judicial decisions that develop precedents. The enforcement of good laws by courts or

⁵ For instance, Black, Kraakman and Tarassova (2000) note that the concept of fiduciary duty cannot be accurately translated into Russian legal language.

police can fail, due to insufficient legal skills and experience, overworked courts, or corruption favored by low salaries and lack of deontological rules⁶. Lastly, the supply of legal rules and their enforcement are usually not sufficient. The demand for legal reforms and law is an essential complement. Economic liberalization providing market incentives and hardening budget constraints was prone to favor such a demand.

Empirical studies suggest that alternative mechanisms are available in inter-firm relations, like reputation and authority mechanisms (De Sousa, 2002), relational networks and mutual commitments (Rizopoulos and Grégoire-Borzeda, 2001), personal relationships and trust (Hendley, Murrell and Ryterman, 1998). From a theoretical point of view, transaction costs economics (Klein, 1980, 2000, Williamson, 1985, 1998) puts into perspective the importance of legal institutions and opposes the “legal centralism tradition”. It argues that private ordering and self-enforcing agreements provide substitutes for legally enforced detailed long-term contracts. Court ordering is a costly time consuming noisy process. It is often ill adapted and can be contrary to the intent of the contractual understanding, because it is based on general rules and imperfect information. Increased contractual specification and the threat of court enforcement could even create new problems and rigidity, and contribute to organize hold-up⁷. Private internal and market enforcement mechanisms, like the threat of termination of business relationships would be more frequent and effective.

More fundamentally, external interventions through law and regulations are considered in the theory of property rights as a restriction or “attenuation” of property rights (Furubotn and Pejovich, 1972). However, on Furubotn and Pejovich’s own testimony, this idea was incomplete because a theory of the state was lacking. Progress has been achieved in this direction, inspired by the transition experience (Boycko, Shleifer and Vishny, 1995, 1996, Shleifer and Vishny, 1993, 1994). Politicians and bureaucrats can use their political control rights on economic assets to impose political goals and private agenda on firms. So corruption represents an application of Coasian bargaining, and improves efficiency. But the “bribe contract” cannot be enforced in court and is open to ex post renegeing. And bribing perspectives encourage the creation of new detrimental regulations. Depoliticization and deregulation are then priority objectives, and privatization represents the main means of action against political discretion.

Corruption and taxation-regulation are essentially considered as sister activities, going grabbing hand in hand. On that score, the sizeable unofficial activities have been imputed to excessive taxation, regulation, and corruption (Johnson *et al.*, 1997, 1998). It is nevertheless essential to stress that the matter is not the existence of taxation and regulation *per se*, as long as they are not confiscatory. Formally, the tax system introduces quasi-contractual rights. This quasi-contract is not freely chosen but the owner keeps benefiting from the residual income. Problems arise only when taxes are arbitrarily defined ex post in an unpredictable way and at extortionate levels, without effective legal recourse. In that case, the tax authority has no more quasi-contractual rights, but becomes residual claimant alongside the owner. Now empirical studies generally find a negative or insignificant relation between tax rates and the size of the shadow economy (Johnson, Kaufmann and Zoido-Lobaton, 1998, Friedman *et al.*, 2000). In Central

⁶ The same obstacles handicap privatization and regulation agencies.

⁷ Klein (2000) offers such an interpretation of the famous General Motors-Fisher Body case. Other analysts dismiss this interpretation (see *The Journal of Law & Economics*, 43 (1), April 2000).

European countries, no significant relation exists at the firm level between tax payments and the share of underreported sales (Johnson, Kaufmann, *et al.*, 2000).

All the same the state is still considered first and foremost as the main threat to property rights. From that viewpoint, rapid economic reforms, mainly privatization, bring about the initially missing private business. The latter would resist undue state interventions through the political process (Rapaczynski, 1996), and press to introduce political and institutional reforms, including good laws and regulations conforming to the standard business practices (Hay, Shleifer and Vishny, 1996, Shleifer, 1997). The development of property rights and legal systems should be a product of market forces, preferred to governmental fiat and legislation. In accordance with Hayek's views, changes of rules are an unconscious product of endogenous competitive processes, and derive from individual actions based on learning and experience. Consciously designed legal institutions and regulations are secondary and require an already functioning private property regime. The rapid creation of better laws is not a priority because they would remain pieces of paper and lack supporting market-driven institutions (Frydman and Rapaczynski, 1994, Pejovich, 1994, Rapaczynski, 1996)⁸.

The history of common law systems demonstrate that laws are more often the endogenous evolutionary products of practices and idiosyncratic historical developments, than the outcome of intellectual deliberations by jurists or economists (Black, Kraakman and Hay, 1996). Rights emerge from below, from established individual modes of behavior. This would notably be the case for the corporation as a legal entity and the laws applying to it (Jensen and Meckling, 1976, North, 1983). In the early modern Europe, courts specialized in commercial disputes were less significant than internal voluntary mechanisms designed by the contractors themselves, like internal codes of conduct in merchant guilds. The state became a major player only when its credibility, conditional on its fiscal needs, improved (North, 1991).

The previous arguments, inspired by the American system, militate against significant initial efforts in building legal foundations. In that vision, the scarce political energy should be directed to ensure rapid privatization during the narrow window of opportunity. The need for depoliticization makes privatization urgent and makes it impossible to wait for the time-consuming implementation of good laws. Self-regulation and self-enforcement provide better remedies. Uncertainty and the unpredictability of bad and good practices call for limited, pragmatic, flexible laws, and more generally flexible institutional structures allowing successful evolution and adaptive efficiency. The reliance on court enforcement will be facilitated if the rules follow and formalize existing business and contracting practices. Fundamentally, contracting, based on individual free consent and autonomy, is preferable to law, prescribing statutes, rights and duties independently of agents' consent⁹.

Corporate laws offer an enlightening illustration. Two Western models are usually distinguished. The enabling or accompanying model, existing now in the United

⁸ Pejovich (1994) simultaneously states that a priority is to establish the rule of law, independent courts and a credible and stable legal system, all being a critical requirement for the development of the competitive market for institutions. But if rules come from agents and are competitively tried and selected, how can they be established and stable?

⁹ The same "philosophical" difference opposes accounting systems. The International Accounting Standards offer explicit general principles whose letter and spirit should be followed. The US General Accepted Accounting Principles allow interpretation and significant accounting creativeness. The latter have been a key ingredient in the Enron affair.

States and in Great Britain, leaves managers with extensive discretion and shareholders with great flexibility in the choice of internal structures and contracting solutions. Market mechanisms, private institutions, and cultural norms provide incentives to maximize profit. Sophisticated and effective judicial and administrative instances of last resort address enforcement and litigation problems¹⁰. The prohibitory model applied in the United States and Great Britain a century ago, remains partially in Continental Western Europe today. It is founded on substantive protections, flat prohibitions of behavior conducive to abuses, and strong judicial and administrative enforcement. Obstacles to contracting and market mechanisms made the first model ill suited to transition economies. Conversely, the reliance on courts and formal enforcement was difficult, because public organizations functioned badly. So a third new model, supposedly adapted to transition constraints, has been advocated. It includes few rigid prohibitions, private enforcement of public rules, voluntary compliance, self-protection and self-discipline (Black, Kraakman and Hay, 1996, Hay and Shleifer, 1998)¹¹. Actions by direct actors (shareholders, directors, managers) are preferred to decisions by external actors (judges, legal professionals...). But this faith in the respect of the law without reliance on external enforcement, intervention and sanction, is illusory.

3. The significance of legal rules and third parties

Exchanges can be based on kinship, trust, ethnic or religious relationships, where the threat of being excluded or punished acts as a discipline device. Pre-modern organizations relied on non-contractual multilateral tools, facilitating mutual information, and coordinated punishments and rewards of members and external rulers (Greif, 1993, Greif, Milgrom and Weingast, 1994). The threat of losing reputation and the prospect of long-term relationships are however weakened when future uncertainty is high and time horizons shortened. Moreover, during the transition period, reputation loses part of its effectiveness, because breaking rules and grasping new opportunities often bring about sizeable benefits. These informal mechanisms tend to be effective only in groups with few players and repeated interactions, where the detection of a deviant behavior is easier, the costs for the excluded person and the gains for excluding people significant. These characteristics exist in inter-firm relations, but are generally missing in other contexts, like the relations between corporate shareholders and managers¹².

Networks and collective action are essential ingredients of informal norms. They reduce their capacity of reacting to exogenous changes (Greif, 1993). The decentralized nature of enforcement makes likely free riding behavior. Large changes of norms are very costly and unlikely. Slow and incremental evolution is accordingly the rule, which can be problematic in a rapidly evolving society (Posner, 1997). Social conventions can

¹⁰ This legal model echoes the positive theory of agency, according to which agency costs are endogenously minimized through market mechanisms and the separation of control and ownership is optimal (Nivet, 2003).

¹¹ Djankov, La Porta, Lopez-De-Silanes, and Shleifer (2003) are then in bad faith, when they assert: “commentators on transition from socialism see the reform of the public legal system as an antidote to the violence associated with private enforcement (e.g., Hay and Shleifer [1998] and Hay, Shleifer and Vishny [1996])” (note 1 p. 454).

¹² For example, informal employment relations based on verbal agreements proved relatively rare in the new Russian private sector. They concerned essentially friends and relatives of the owner-employer, and were mainly relied upon in very small, informal family businesses (Clarke and Borisov, 1999).

even become retrogressive (Arrow, 1974). Markets need pro-market social norms to work, but these norms do not appear spontaneously and instantaneously, specially in societies where the market has been repressed for decades. State enforced laws turn out to be more effective institutions in complex societies, even if law and social norms maintain dual relations, being simultaneously complements and substitutes. Free abstract contracting requires faith in a third guarantor, usually personified by courts and the state. And law should help in the battle against misconduct, bad social norms, and substitute for missing ethics.

The Coase theorem helps to clarify the role of laws. Voluntary exchange and participation can hinder *ex ante* Coasian efficient bargaining from taking place (Dixit and Olson, 2000). It makes helpful the involvement of third parties, coercion and compulsory centralized solutions through external formal rules. Laws fundamentally reduce transaction costs. They define what kinds of contracts are necessary and valid, and express general standardized principles and frames, according to which precise contracts can be tailored to specific conditions. They consequently reduce the number of potential *ex post* conflicts. They prohibit some kinds of contractual provisions, even if they are voluntarily agreed upon. This restriction of individual contracting freedom is a recognition that interests of non-contracting parties should also be protected, and that freedom can be partially illusory, because it depends on personal income and ownership. Laws also facilitate *ex post* bargaining and conflicts resolution, and consequently facilitate *ex ante* contracting. Bankruptcy law is a good example. Debt contracts are incomplete and do not generally include private solutions in case of default, which can lead to an uncoordinated inefficient run among creditors or an inefficient agreement between numerous shareholders and creditors. General external rules enforced by an external party (judge, official receiver) become necessary. Laws can in some cases hinder efficient *ex post* voluntary agreements, but potential *ex post* inefficiencies can be necessary to achieve *ex ante* efficiency. Finally, even if laws, like contracts, can not and should not be complete, for flexibility reasons, both are complementary.

Furthermore, ownership has a fundamental legal basis¹³. The main advantage of modern corporations highlighted by the property rights school derives from their legal nature, namely from limited liability¹⁴. The latter protects shareholders against adverse management decisions and allows unrestricted and anonymous share trading. Hence these protections rest on laws, and especially corporate laws. They give a legal status and personality before relying to contracting. They set general objectives, organizational principles, rights and obligations of organization's members and contracting parties. These legal provisions allow the corporation to continue when some contracts are broken. External rules protecting shareholders are essential because rights conveyed by shares are ambiguous and incomplete. Shares do not include a pre-fixed promised payment, contrary to standard debt and labor contracts. The room for opportunism is accordingly larger, monitoring and acknowledgment of default more difficult. Corporations are then privileged channels of abuses if legal provisions are lacking or inappropriate. The problem is exacerbated in privatization dealings, because privatization is fundamentally a legal change in the identity of residual claimants, which is not automatically accompanied by a parallel change in the allocation of residual rights

¹³ At a basic level, the right to own property and to be guarded against arbitrary deprivation is recognized in article 17 of the Universal Declaration of Human Rights, and should be constitutionally protected.

¹⁴ Jensen and Meckling (1976) characterize the private corporation as a "legal fiction", becoming a nexus of contracts.

of control. And protection of shareholders was even more urgent in transition countries, because enterprises which would typically be owned and controlled by individuals or family in other regions, are there corporations, often with dispersed and unskilled stockholders. In addition, numerous ailing companies were waiting for liquidation or reorganization.

In some transition countries, the first policies towards enterprises have been of a legal nature. The perceived urgency in Hungary and Poland has been to enact new laws preventing the private misappropriation of public assets through self-dealings and sale to related parties. This legal reaction against “spontaneous” or “wild” privatization of state-owned enterprises sent an important signal¹⁵. The protection of property rights should not be limited to private ones. Another major step prior to privatization lies in the corporatization of state enterprises, i.e. the change of their legal status and their conversion into limited liability companies fully owned by the state, whose representatives seat on boards. Besides, Hungary has been active in the enforcement of bankruptcy law. A major feature of the successful bankruptcy law in Hungary and law on bad debts in Poland lies in the fact that they relied mainly on decentralized negotiations between creditors and debtors. But the main outcome of quickly imposing laws has been to trigger change¹⁶. The prior design of a comprehensive legal and regulatory environment also significantly contributed to the initial development of the Warsaw stock exchange (Nivet, 1997).

The Czech Republic initially adopted a different attitude and dismissed legal interventionism¹⁷. It postponed the installation of a securities commission and the implementation of bankruptcy law after the completion of the privatization program. The latter, based on vouchers and free entry of privatization intermediaries, has been initially praised as the most successful in giving birth to real property rights (Rapaczynski, 1996). The millions of private shareholders would create political pressures to defend their rights. Investment funds, driven by reputation concerns, would defend the interests of shareholders. The reliance on competitive market mechanisms, contrary to the bureaucratic creation of Polish privatization funds, would allow “to privatize privatization” (Frydman and Rapaczynski, 1994). The emergence of privatization funds was actually largely unexpected and took place in a legal quasi-vacuum, which opened room for numerous opportunistic actions by the management of funds. Tunneling, siphoning off assets and skimming profits have been common practices. Insider dealings and opaque trading have undermined the stock exchange¹⁸.

¹⁵ In the analysis offered by Boycko, Shleifer and Vishny (1995), spontaneous privatization is favorable, because political control vanishes.

¹⁶ Stiglitz (2000) maintains on the contrary that formal bankruptcy brings about few restructurings.

¹⁷ Using the Heritage Foundation's measure of regulation in 1996, the Czech Republic is the only country to get the score of 1, while most OECD countries get the score of 2.

¹⁸ Boycko, Shleifer and Vishny (1995) praise the self-regulation (opposed to regulation by third party) of Russian stock markets. Johnson and Shleifer (1999) attribute conversely the near collapse of Czech stock markets to the hands-off regulation. “Some Coasians” would have ignored that the Coase theorem identifies laws and regulation, alongside private contracting, as remedies to inefficiencies. Johnson and Shleifer recognize however that they have difficulty finding in Coase's writings a positive assessment of government regulation. References to Coase have been almost completely removed in the revised version of the paper (Glaeser, Johnson and Shleifer, 2001), which nonetheless retains its title. These contradictions illustrate the ambiguity and danger of the theorem. As a matter of fact, Coase (1960) fundamentally recommends private decentralized solutions, and challenges Pigou's approach advocating regulation or taxation.

The change in the political party in power and the prospective membership of European Union subsequently prompted correction through a deep legislative effort¹⁹.

In Russia, commercial, corporate and securities laws were rudimentary, incomplete and inconsistent at the time privatization has been implemented. It has been blamed on the Russian historical tradition of weakened rule of the law. But it was more fundamentally a choice, founded on arguments presented in the previous section. This legal vacuum, coupled with the entrenchment of insiders favored by the privatization program, encouraged detrimental and fraudulent behavior in Russian corporations²⁰: missing shareholder meetings, manipulation of voting and share trading, dilution of external shareholding, sale of products and assets to affiliated parties at transfer pricing or even without payment... The banking sector provides another example of legal laxity. The initial regulation of bank entry was overly permissive. In 1998, the financial collapse triggered massive asset stripping at the expense of banks' depositors, without proper reaction by courts or the Central Bank.

It is only in January 1996 that a new corporate law is applied, more than four years after the beginning of the privatization program. It is drafted according to the previously discussed self-enforcing model (Black, Kraakman and Hay, 1996, Hay and Shleifer, 1998). But are self-enforcement mechanisms effective? Black, Kraakman and Hay (1996) answer in the affirmative, counting on peer and reputation effects, social negative consequences of misbehavior, risk of retaliation, extralegal enforcement tools like violence or threat of violence exercised by injured shareholders. Yet, the effectiveness of informal mechanisms, like social sanctions or reputation, is doubtful in the transition period. And invoking illegal means to enforce legal rules proves worrying. The injuring party is more ready and able to rely on violence. If private violence is tolerated, it is used to impose bad private rules and encourages organized crime.

Lastly most of debates focus on inter-firms relations and investor rights²¹. It is consistent with the standard conception of corporate governance, centered on the provision of external financial means. A larger view suggests that all stakeholders, including employees, are involved in firm's performance. And legal rules on labor contracts prove essential because disputes are prone to arise, in relation with contractual provisions and residual control rights given to the employer. More fundamentally, labor laws are essential in facilitating specialization and division of labor, and in ensuring social cohesion. The failure of the Russian legal environment applies to labor relations too. Wage arrears have been pervasive in Russia and CIS countries, far less frequent in Central Europe. They testify that labor contracts were not respected. Wage arrears are equivalent to a forced loan from the worker to the firm, notably imposed on workers with few outside options. Employees become unwitting residual claimants, and their basic rights are flouted. Mobility costs were increased and bias in favor of multiple jobs and informal sector introduced, because employees usually lost their wage claims if they

¹⁹ Roland and Verdier (2003) show how accession to the European Union can solve coordination problems in law enforcement.

²⁰ Black, Kraakman and Tarassova (2000) offer a vivid discussion and numerous astonishing examples of these misbehaviors.

²¹ Transition countries would have on average reached rapidly from 1992 to 1998 remarkable levels of shareholder and creditor legal protection. For instance, most CIS countries score higher than France or Germany (Pistor, Raiser and Gelfer, 2000). But legal effectiveness differs greatly among transition countries.

left the firm²². Payments in kind also undermined employees' rights, because they restricted the exchange possibilities compared with monetary payments. Such practices deeply weakened the individual confidence in contractual relations. The confidence of citizens in the government greatly eroded as well.

4. Depoliticization, corruption and democracy

Privatization, deregulation, tax reductions, and *laissez faire* policies have been forcefully advocated as a mean to achieve depoliticization of economic activities. This objective was consistent with the vision according to which institutional development conducive to long-run economic growth requires the reduction of arbitrary state economic intervention (North, 1990, 1991). However, making depoliticization the central concern of privatization leads to a contradiction, because property rights are redistributed and enforced through the polity in the first place. The fact that politicians are not benevolent, which justifies privatization, makes simultaneously likely opportunist, inefficient privatization policies. How can state servants use their monopoly power over violence to guarantee secure property rights but refrain from confiscating assets and capitalizing political powers into economic ones²³? Who guards the guardians? During transition, this question is central for corporate governance but also for public and political governances. In both political and economic spheres, delegation of powers requires appropriate incentives, through external and internal competitive procedures, checks and balances, restricted mandates. Controlling governmental behavior and power requires political guarantees and procedures, including transparency, publicizing of decisions, and deliberative processes giving political actors a sense of responsibility and accountability. Constitutional restraints are essential, as well as the distinction between independent executive, legislative and judiciary powers, complemented by independent mass media and civic groups²⁴.

In countries like Russia, however, democratic principles form the subject of very ambiguous positions. The call for "dictatorship of the law" by Vladimir Putin reflects this ambiguity. The historical tradition of absolutist autocratic governments and weakened rule of the law can be put forward, but is only part of the story. Parliament has been primarily considered as a major obstacle. The comprehensive powers granted to the President in the new constitution allowed Boris Yeltsin to impose major decisions through decrees. One of the consequences for Russian politics lies in the absence of organized and long-lasting reformist democratic parties, as opposed to *ad hoc* election stables. Besides, the liberal law on right of association voted in 1995 has been hardened. Administrative and fiscal harassment is frequent against organizations, which are considered politically unfriendly by authorities. A significant number of Russian people

²² The upholding of the residence certificate ("propiska"), despite decisions by the Russian Constitutional Court, also restricts labor mobility and undermines individual freedom, because it conditions access to work, housing, health care... In addition, it favors discrimination and corruption.

²³ North (1991) remarks that private profit opportunities can be created by political organizations establishing property rights that redistributed rather than increased income. Only external constraints on the ruler's power can limit arbitrary seizure of assets. It necessitates a fundamental change of the polity, like in England after 1688. Self-restraint of the ruler is fragile and usually abandoned during fiscal crisis and war periods. Both factors have notably been present in contemporary Russia.

²⁴ Civic groups allow overcoming the traditional free riding behavior in political action. And non-state organizations can make available services or goods not provided by the state (Rose-Ackerman, 2001). In Eastern Europe, the nonprofit sector remains small though often growing, financially fragile and dependent on the state.

believe that a strong man is called for, rather than improved democratic political institutions. And Vladimir Putin is striving to embody this man.

From a theoretical point of view, political competition would favor patronage, whose political benefits are on the contrary zero under “a perfectly secure dictatorship” (Shleifer and Vishny, 1994). Hay and Shleifer (1998) then consider that strengthening the legal and administrative apparatus would worsen things, without a benevolent dictatorship or a very strong and unified democratically elected government. These positions are reminiscent of the criticism made by Hayek (1979) of unlimited democracy and weak governments dependent on interest groups, leading him to propose the introduction of significant limits. But it is worth emphasizing that substantial progress in legal and institutional environments has been achieved in Hungary and Poland, where democratic governments have been unstable and far from being very strong and unified.

Economic activities remain highly politicized in Russia, despite the initial priority given to privatization. The presidential office directly manages sizeable industrial and real estate activities without any external control. Scandals involving political or high administrative officials have been numerous. The impenetrable relations between presidency, government and “oligarchs”, and clan struggles have been repeatedly discussed. The “NTV affair”, involving in 2001 the independent group Media-Most owned by Vladimir Gousinski, illustrates them. Although NTV, like many other corporations, had financial troubles for a long time, it is only when it has been considered politically dangerous, that the major creditor connected with the government, namely Gazprom, intervened and took control, violating at the same time shareholders rights. The recent “Yukos affair”, with the seizure of shares and the imprisonment of Mikhail Khodorkovski, includes other ingredients: the spectacular arrest by secret police agents, the fiscal justification (tax evasion), the intervention in a strategic lucrative sector (oil industry), the neutralization of an oligarch and a potential powerful political opponent just before the 2003 general election. These “political takeovers” testify that public tools (tax department, secret police, justice) are used through a fully discretionary manner to satisfy private political and financial goals. They reflect the worrying concentration of political, judiciary, economic and media powers.

Privatization often led to wealth expropriation rather than wealth creation. The institutional environment made more attractive parasitical activities, like rent-seeking, legal gambits and organized crime²⁵. Transition favors corruption for at least three reasons. Economic liberalization opens new profitable opportunities. Monetary bribes are easier because money becomes more active, and opens new access to valuable goods. The repression led by the autocratic communist party is not instantaneously replaced by efficient democratic and legal tools. Moreover, looting of firms often provides a less risky, more rapid and significant gain than restructuring. But Russian privatization, especially the “loans-for-shares” program in 1995, largely instilled the culture of law avoidance and encouraged the emergence of plutocrats and crooks. It contributed to entrench corruption and crime, and undermined the trust of the population in public organizations, law and reforms²⁶. Finally a majority of citizens in

²⁵ Baumol (1990) examines historical examples of unproductive and destructive activities rewarded by institutions, like those of landholders and politicians in Ancient Rome or state bureaucracy in Medieval China. He notes that “enterprising use of the legal system for rent-seeking purposes has a long history” (p. 907).

²⁶ Boycko, Shleifer and Vishny (1995) consider the Russian mass privatization program as a success owed to Minister Anatoli Chubais’ political skills. But Anatoli Chubais became known as the “chief grab-

many transition countries considers officials, politicians and mafia as the main agents who gained from the transition.

General studies of corruption conclude that historical economic and political factors have more robust explanatory power than cultural predisposition (Bardhan, 1997, La Porta *et al.*, 1999a, Rose-Ackerman, 2000, Treisman, 2000). The fight against corruption proves accordingly difficult and slow. Long-lasting democratic regime and economic development are missing in transition countries, and cannot be relied upon to explain why Russia is more affected by corruption than Central Europe. In addition, if socialist or French civil laws countries exhibit higher degree of government regulation and lower quality of property rights protection, corruption does not exhibit regularities ascribable to legal families (La Porta *et al.*, 1999a). And redistribution organized through appropriate tax and social policies can improve state legitimacy and efficiency, especially in a period of growing inequalities and weakened proximity solidarity. A clear empirical relation between corruption and the extent of state economic intervention does not exist (Treisman, 2000).

The influence of public bodies on business has nevertheless been the preferred one-sided explanation of transition results (Frye and Shleifer, 1997, Johnson, Kaufmann *et al.*, 2000, Shleifer, 1997). Poland would have followed the “invisible-hand” model, where benevolent governments restrict themselves to the provision of public goods. Russia would be the victim of the “grabbing-hand” model, where formerly communist local politicians and bureaucrats pursue private goals through heavy taxes, extensive interventions, red tape and predatory regulations eliciting bribes²⁷. Russian managers would be in particular unable to respect the law and be truthful towards investors about financial results, because they must lie to officials (Black *et al.*, 1996, 2000). But a careful scrutiny of empirical surveys elicits important qualifications of this stylized presentation. The share of shop managers considering that they can use courts against the government or a business partner is higher in Moscow than in Warsaw. Bribing occurs on average rarely or sometimes, and most managers maintain that local governments do not influence small business (Frye and Shleifer, 1997)²⁸. Bribing government officials is more pervasive for private manufacturing firms, and is significantly related to output hiding in Central Europe (Johnson, Kaufmann *et al.*, 2000). However, as noted by the authors, bribes could simply be needed to make possible output underreporting. And in Russia and Ukraine, hidden activities are significantly negatively correlated with payments to government and extra-legal payments to officials, and significantly positively correlated with the confidence in the legal system. These last results go counter to the traditional view.

The dominant interpretation considers that private protection provides private enforcement of law and order and replaces the missing public protection. But private protectors easily turn into private predators, creating threats and then offering their services to extract rents in official and unofficial sectors. Racketing of small shops is

privatizer” (Black, Kraakman and Tarassova, 2000). The “loans-for-shares” program proves that scandals are not circumscribed to mass privatization plans. After the Czechoslovak divorce, the voucher privatization program has been replaced in Slovakia by outrageous sales in favor of President Meciar’s allies.

²⁷ China, like other Asian countries before, would benefit from the “helping-hand” model, where bureaucratic interventions promote private activities and legal rules play a limited role. Still, data on corruption (Bardhan, 1997, Treisman, 2000) testify from close scores for Russia, Ukraine, China or Vietnam.

²⁸ Shleifer (1997) comments this same survey but omits to mention this response.

more frequent in Moscow than in Warsaw (Frye and Shleifer, 1997). Paying for private protection is an extremely developed practice in Russia and Ukraine for manufacturing firms (Johnson, Kaufmann *et al.*, 2000). The fact that only a fifth of these firms agrees to provide information about their owners, while the response rate is near 100% in Central European countries, can be interpreted as a signal of a massive mafia presence. For Central European enterprises, the variable “payments for protection” is significantly negatively correlated with the variable “courts can enforce contracts”. Such a correlation does not exist for Russian and Ukrainian firms. And the correlation between payments for mafia protection and extra-legal payments to officials is very close to 1. The “grabbing-hand” is accordingly private as well as political or bureaucratic. Corruption, bureaucratic opportunism and organized crime tend to develop together. Legal and democratic remedies are requested, for which neither rapid privatization nor upholding public ownership are substitutes.

5. Conclusion

Many institutions, including social norms and trust, customs, standards of conduct, beliefs, ethics, are of an informal nature. They usually evolve historically according to slow, incremental and potentially sub-optimal dynamics, dependent on economic, political, social, educational and cultural factors (North, 1990, Posner, 1997). Many social institutions are inherited, implicit general rules, and result from individual human action, but not from a conscious, rationalist human design. They allow to reach complex and abstract self-organized spontaneous orders (*kosmos*), which are according to Hayek (1973) more fundamental than made orders and organizations (*taxi*) based on purposeful arrangements, hierarchical relations and simple specific rule.

Path dependence thus originates from belief systems and routines founded on past experience and cultural historical heritages (North, 2000). It makes unique the experience of every society. Capitalist systems exhibit great historical and national diversity. Asian experience would testify that durable economic development is attainable despite an underdeveloped legal infrastructure, thanks to the reliance on tradition, networks and trust. The success of Chinese township-village enterprises (IVEs) would deny the culture free, universal applicability of the property rights theory (Weitzman, 1993). Chinese culture and path-dependent historical heritage would promote cooperative behavior, making unnecessary explicit rules, laws, and procedures. The heavy communist and Marxist heritage would on the contrary be based on eroded work and business ethics, low moral order and generalized opportunism (Winięcki, 1998), pro-collectivist, anti-individualist and nationalist ethos (Pejovich, 1994). Post-socialist economies would follow differentiated national trajectories, whose shape is influenced by initial conditions, social and political contexts. They would be various path-dependent mixed economies, with an uncertain and open future (Chavance and Magnin, 1997).

Therefore, “privatization is not a panacea” (North, 1994, p. 366). Policies are fundamentally rough and imperfect tools because they alter at best formal rules, not informal ones (North, 2000). Changing formal rules would not be sufficient to trigger a change in behavior. A market economy cannot be simply legislated, decreed or installed from above. Standard reforms package would have been based on a *tabula rasa* top-down approach, considering history essentially as impediment (Murrell, 1995). Exogenous institutional changes introduced purposely by fiat, like privatization of state enterprises, would be pointless (Pejovich, 1994). Government-led programs are prone

to fail because of their “constructivist” pretension to build capitalism. In accordance with Hayekian principles, alternative recommendations advocate bottom-up experiments and trial and error processes, benefiting from decentralized knowledge, and favoring self-transformation and learning by agents (Murrell, 1993, 1995, Pejovich, 1994, Stiglitz, 2000).

Yet, these principles can hardly be used to conceive better comprehensive transition policies. Limited prediction and prescription capacities are indeed consubstantial with their general philosophy. An exclusive focus on cultural, historical and national factors can lead to *ad hoc* reasoning, evasion in historical and cultural determinism, and the denial of explanatory powers of economic mechanisms. The path dependence concept especially tends to be systematically or loosely relied on, and confused with inertia and persistence. Corruption is a good case in point. Game theoretic models usually exhibit multiple equilibria, making initial conditions, historical paths, and expectations essential persistent determinants of corruption. But the “moralist” view, calling for a deep change in values and norms of honesty, or the “fatalist” position, arguing that deeply rooted corruption cannot be attacked, are not fruitful (Bardhan, 1997). An appropriate change in incentive structures is able to deliver positive outcomes. Then, if transition is a curious mixture of revolution and evolution (Kornai, 2000), the first element should not be overlooked. Institutional theories concentrate essentially on the second. The change of property relations and formal rules was the major available tool to trigger evolution of behavior (Grosfeld, 1995). It is the same even for the United States, where the fight against fraudulent financial conducts demands the passing of Sarbanes-Oxley act and a fierce judicial activism by the attorney-general of New York state, Eliot Spitzer.

In the conception influenced by the Anglo-Saxon experience and defended by Hayek (1973), legal systems should protect the power and freedom of property owners *vis-à-vis* the state. Common law, its respect for just procedures and the precedents made by judges provide recourse against state regulation and expropriation. On the contrary, civil law is considered as a centrally created instrument furthering state power and intervention. Political freedom would also be higher in the former system, because economic and political freedoms go together. The post-communist transition experience qualifies this belief. Privatization represents the first engine to reach the ruling elite’s private objectives and is not spontaneously directed towards depoliticization of economic activities. Agents empowered by privatization tend to resist reforms improving legal institutions. And predation is not limited to anti-reform politicians and bureaucrats “grabbing” private assets. Law should protect citizens, primarily those deprived of property, against state representatives (including “reformers”), property owners, and criminals, because the latter tend to collude or merge.

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