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A COMMENT ON PRIVATIZATION AND DEMOCRATIZATION

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Modern western societies have both a functioning market system and democratic political institutions. The relationship between these two aspects of society prompted Professor Rose's article, *Privatization—The Road to Democracy?*.[1] Although her title identifies "privatization" as her subject, the article is much more ambitious. It really considers the market itself and the relationship between the market and democratization. Professor Rose says that privatization and democratization are siblings,[2] but I would say that the market system and the political system are the siblings. In fact, they are Siamese twins, because you cannot have an economic system without a political system.

The libertarian longing for a laissez faire economy, free of government intrusion, is fascination with a fantasy.[3] Even a simple economy cannot exist without rules that define and protect property rights and exchange.[4] A modern market system—with impersonal non-simultaneous exchange, complex multi-party transactions, and esoteric financing methods, to name just a few attributes—requires significant government involvement. The debate, really, is over the degree of government interaction in economic matters, not over whether the government should be involved.

The market and political systems are related in another way that can lead to serious economic problems. Economic growth depends on competition in economic markets, which encourages efficiency, innovation, better products, and entrepreneurial skills. If the market works so that resources flow into their highest use, the breadbasket of goods and services grows to its fullest. Monopolies prevent this from happening, however, and the natural tendency of people is to try to dominate markets. Furthermore, people try to use the government to obtain and defend their monopoly power. Power in political markets is used to obtain power in economic markets. Political power can

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1. *See* Carol M. Rose, *Privatization—The Road to Democracy?*, 50 ST. LOUIS U. L.J. 691 (2006).
2. *Id.* at 694.
3. DOUGLASS C. NORTH, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE 122 (2005).
4. *See id.*

come from various things: affinity with government officials (from relationships of kinship, friendship, tribal identity, religious affiliation, etc.) or corruption, to name two examples. These can close off competition in political markets and then in economic ones. One of the reasons that the rule of law is so important is its protection of competition in both economic and political markets. With a regime of laws, not people, with transparent and predictable rules, everyone has the opportunity to compete on a level playing field (putting aside wealth disparities).

Some of the complaints against privatization noted by Professor Rose are really complaints against a market system—a market system that causes great disparities in wealth and sometimes richly rewards lucky people who are not investors or entrepreneurs but are only in the right place at the right time.[5] The choice, however, is only between a market system and a command and control economy. The collapse of the Soviet Union showed what is bound to happen to a command and control economy. Those types of economies are bound to fail over time from the weight of the transaction costs required to run the system and also from the absence of the signaling system that is provided by the intersection of supply and demand.[6] The magic of a market system comes from its inherent signaling mechanism. By purchasing goods and services—by "voting with their dollars"—consumers disclose their preferences about what they want to buy and, hence, to have produced. With this information, producers invest in and produce more of the goods and services desired by consumers.[7] This creates an efficient way to allocate resources and leads to a bigger breadbasket of goods and services.[8]

In a command and control economy, the government decides by fiat what to produce. It requires economic plans, like the Soviet Union's regular five-year plans, and complex input and output production matrixes.[9] As an economy grows, this process takes so much time and consumes so many resources that it can undermine the economy; this happened in the Soviet Union.[10] Furthermore, without the signaling mechanism of a market system, a command and control economy results in shortages of some goods and services in high demand and surpluses of undesired products. It is much more difficult

5. *See* Rose, *supra* note 1, at 707–710.

6. Douglass C. North, *Cognitive Science and the Study of the "Rules of the Game" in a World of Uncertainty*, *in* NORMS AND THE LAW (John N. Drobak ed., forthcoming 2006).

7. *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 44 & n.13 (1988).

8. *See id.* at 44.

9. *See* NORTH, *supra* note 3, at 147.

10. *Id.* at 154. Party-dominated industries are also inefficient because party goals lead to the promotion of poor managers and the creation of inefficient incentives for workers. *See generally* EMPIRICAL STUDIES IN INSTITUTIONAL CHANGE 59–62 (Lee J. Alston, Thrainn Eggertsson & Douglass C. North eds., 1996); Jan Winiecki, *Why Economic Reforms Fail in the Soviet System—A Property Rights-Based Approach*, 28 ECON. INQUIRY 195 (1990).

to sustain a command and control economy today than it was fifty years ago. If a country wants to participate in today's global economy, it is compelled to adopt many aspects of a market system. Otherwise it could not compete in the world market and attract investment from outside the country. China's economic liberalization is a good illustration of this.[11]

Neoclassical price theory, the predominant model of economics, assumes away wealth effects and disregards distributive consequences.[12] The theory assumes all consumers have enough resources to participate in the economy—have enough wealth to register their "votes" for their preferred goods and services. There are probably millions of people in the market economies of the world too poor to participate in the market. Even worse, many of these people live in poverty and lack basic necessities of life, like stable jobs and health care. Many of these ills of a market system can be tempered by social programs that provide a true safety net for those too poor to participate in the market. This requires, however, the courage to raise taxes and to tolerate the inefficiencies—and the waste—that are bound to be part of anything as large as a government bureaucracy. The market economies of the world provide for their poor in different ways and to different degrees. Both the "third way" of the Scandinavian countries and the social democracies of Europe are still market economies allocating resources through the signaling mechanism of supply and demand.[13] Like it or not, a market system is the only feasible way to organize a modern economy today.

A market system could not exist without private property, which makes privatization so important. Privatization is a way to create private property out of government-owned property. A market system also depends on a framework of laws and norms that create incentives for economically productive activities.[14] This is where the set of laws Professor Rose labels as

11. *See generally* RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW (2002); MURRAY WEIDENBAUM & SAMUEL HUGHES, THE BAMBOO NETWORK: HOW EXPATRIATE CHINESE ENTREPRENEURS ARE CREATING A NEW ECONOMIC SUPERPOWER IN ASIA (1996); Karen Halverson, *China's WTO Accession: Economic, Legal, and Political Implications*, 27 B.C. INT'L & COMP. L. REV. 319 (2004).

12. *See generally* Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 CORNELL L. REV. 1, 32 (2005) ("Neoclassical price theory holds that in perfect competition, firms price at marginal cost, which leads to optimal deployment of social resources.").

13. *See* Roger Cohen, *Redrawing the Free Market; Amid a Global Financial Crisis, Calls for Regulation Spread*, N.Y. TIMES, Nov. 14, 1998, at B9 (the term "third way" has been applied during the twentieth century to German social democracy and attempted economic reforms in the Soviet Union); William E. Schmidt, *In a Post-Cold War Era, Scandinavia Rethinks Itself*, N.Y. TIMES, Feb. 23, 1992, at 4-3 (stating that Social Democrats in Sweden refer to the "third way" as their neutrality between Europe's East and West).

14. *See* Frank B. Cross, *Law and Economic Growth*, 80 TEX. L. REV. 1737, 1739–40 (2002); John N. Drobak, *Law Matters*, 76 WASH. U. L.Q. 97, 97–99 (1998).

"recognition," "deregulation," and "enablement" come into play.[15] By lowering the costs of transacting in the market and by creating productive incentives, these types of laws can advance economic growth. For example, economic transactions can occur even with informal title, but the lack of formal legal title can create uncertainty and increase risk. Laws that create formal title in squatters, a form of "recognition," make economic transactions less costly and less risky, and hence more likely. These kinds of laws can help make unproductive land productive and help the poor get a better life.[16]

Laws that provide for "recognition," "deregulation," and "enablement" do not necessarily increase economic growth, however. They can be counterproductive in some circumstances. For example, laws that give legal title to squatters destroy existing property rights and effectively take property from its owner and transfer it to someone else, without any compensation to the owner. Laws recognizing squatters' rights make property ownership more risky; this can inhibit investment and limit transactions involving property subject to squatting. We may applaud when poor peasants in the Amazon become productive when they take over undeveloped parts of large plantations, even if they take part in the destruction of the rain forest.[17] We may be less enthusiastic when the government of Zimbabwe evicts white ranch owners and their long-time black ranch hands in order to give the ranches to political supporters of the president.[18]

Laws concerning "recognition," "deregulation," and "enablement" do not deal with privatization, although they have important economic consequences. It is the set of policies that Professor Rose labels as "divesture"[19] that most people would consider to be privatization, i.e., transferring government-owned property into private hands.[20] In considering the economic aspects of privatization, it is important to consider two separate questions: (1) What theories justify government versus private ownership? and (2) Why do countries choose to divest themselves of the ownership of companies and of entire industries?

15. *See* Rose, *supra* note 1, at 694–98.

16. *See* Bernadette Atuahene, *Land Titling: A Mode of Privatization with the Potential to Deepen Democracy*, 50 ST. LOUIS U. L.J. 761, 762 (2006).

17. *See* Lee J. Alston, Gary D. Libecap & Bernardo Mueller, *Property Rights and Land Conflict: A Comparison of Settlement of the U.S. Western and Brazilian Amazon Frontiers*, *in* LATIN AMERICA AND THE WORLD ECONOMY SINCE 1800, at 55, 66–67 (John H. Coatsworth & Alan M. Taylor eds., 1998); Lee J. Alston, Gary D. Libecap & Robert Schneider, *Property Rights and the Preconditions for Markets: The Case of the Amazon Frontier*, 151 J. INSTITUTIONAL & THEORETICAL ECON. 89, 89–91 (1995).

18. *See* MARTIN MEREDITH, OUR VOTES, OUR GUNS: ROBERT MUGABE AND THE TRAGEDY OF ZIMBABWE 124–27 (2002).

19. *See* Rose, *supra* note 1, at 696–97.

20. *Id.*

I. THEORIES OF GOVERNMENT OWNERSHIP

Although it does not justify government ownership per se, the economic theory of natural monopoly justifies the use of only one firm to meet the entire demand of a market. Natural monopolies result in industries with marginal or incremental costs continually decreasing with increasing sales.[21] These cost characteristics mean that prices can decrease with increasing sales as well, so customers are better off as more and more of the good is sold. The monopoly is "natural" because even with competing firms, only one firm will survive, namely the firm with the greatest sales and hence lowest price.[22] These industries are typically those with high fixed costs, such as railroads, airports, and distribution companies, like water, electricity, and natural gas. The cost to begin business is extremely high, while the cost to supply each successive unit is smaller and smaller. High-tech industries with large research and development expenditures and low production costs, such as software and pharmaceutical companies, also exhibit natural monopoly characteristics. That is one of the reasons that the market for a software applications program, such as for word-processing or for spreadsheets, may be dominated by one particular program until it is replaced by another, in a succession of mini-monopolies.[23]

If it makes sense economically for only one firm to supply the entire market, a question remains as to whether the firm should be owned by investors or by the government, i.e., whether the firm should be private or public. A private firm in a natural monopoly market will charge a monopoly price unless restrained by the government, hence the history of price-setting commissions at the federal and state levels.[24] Commissions alone, however, are not enough. Regulation requires educated bureaucrats who understand engineering, accounting, and finance. In examining the desirability of privatizing telecommunications in various countries, two World Bank economists emphasized that privatization required a qualified and expert bureaucracy that was beyond the capability of some countries.[25] If the government is to provide a natural monopoly good or service rather than a private firm, however, the bureaucrats still must perform some of the tasks of a ratemaking commission when they set prices. They must determine costs, including the cost of capital, and deal with such ratemaking functions as

21. N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS 318 (2d ed. 2001).

22. *Id.* at 318–19.

23. *See* W. Brian Arthur, *Increasing Returns and the New World of Business*, HARV. BUS. REV., July–Aug. 1996, at 100, 102–03.

24. *See, e.g.*, LOUIS B. SCHWARTZ, JOHN J. FLYNN & HARRY FIRST, FREE ENTERPRISE AND ECONOMIC ORGANIZATION: GOVERNMENT REGULATION 316–17 (6th ed. 1985).

25. Brian Levy & Pablo T. Spiller, *The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation*, 10 J.L. ECON & ORG. 201, 240–242 (1994).

allocating costs between various customer classes, such as residential, commercial, and industrial. Since the process of a government utility setting its own rates does not entail an adversarial hearing and procedural safeguards, as with a proceeding before a public utility commission, it is probably much less expensive than setting rates for an investor-owned utility.

Economists usually prefer regulated private firms over government ownership because they believe private firms will be operated more efficiently.[26] To the extent that politicians hand out jobs with government utilities for patronage, the risk of inefficiency is high. However, the vast majority of government utilities have been operated professionally in the United States. Just compare the public entities that provide water, irrigation, and electricity across the country with the investor-owned utilities. In fact, studies of the efficiency of electric utilities in the United States have found no significant differences between public and private ownership.[27] That makes sense because the people who work in either type of utility respond the same way to supervision, salaries, and motivation. Plus, a private firm with a monopoly lacks the spur to efficiency that comes from competition; rather, its incentives come from regulatory oversight.

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26. One economist explains the preference for private firms as follows:

> The key issue is how the ownership of the firm affects the costs of production. Private owners have an incentive to minimize costs as long as they reap part of the benefit in the form of higher profit. If the firm's managers are doing a bad job of keeping costs down, the firm's owners will fire them. By contrast, if the government bureaucrats who run a monopoly do a bad job, the losers are the customers and taxpayers, whose only recourse is the political system. The bureaucrats may become a special-interest group and attempt to block cost-reducing reforms. Put simply, as a way of ensuring that firms are well run, the voting booth is less reliable than the profit motive.

MANKIW, *supra* note 21, at 333. This is, of course, only a theory and a generalization of how the world works. It probably is impossible to know empirically how accurately it describes the efficiency of private and government-owned firms operating in natural monopoly markets. In addition, regulated utilities do not have the same profit motive as firms in a competitive market.

27. *See* Paul M. Hayashi, Melanie Sevier & John M. Trapani, *An Analysis of Pricing and Production Efficiency of Electric Utilities by Mode of Ownership*, *in* REGULATING UTILITIES IN AN ERA OF DEREGULATION 111, 112 (Michael A. Crew ed., 1987); Scott E. Atkinson & Robert Halvorsen, *The Relative Efficiency of Public and Private Firms in a Regulated Environment: The Case of U.S. Electric Utilities*, 29 J. PUB. ECON. 281, 293 (1986); Robert A. Meyer, *Publicly Owned Versus Privately Owned Utilities: A Policy Choice*, 57 REV. ECON. & STAT. 391, 398 (1975). *Contra* Donn R. Pescatrice & John M. Trapani III, *The Performance and Objectives of Public and Private Utilities Operating in the United States*, 13 J. PUB. ECON. 259, 259–60, 274–75 (1980). For studies of the efficiency of utilities in other countries, see MICHAEL G. POLLITT, OWNERSHIP AND PERFORMANCE IN ELECTRIC UTILITIES: THE INTERNATIONAL EVIDENCE ON PRIVATIZATION AND EFFICIENCY 21–22 (1995); Johan Willner, *Ownership, Efficiency, and Political Interference*, 17 EUR. J. POL. ECON. 723 (2001). Rates are lower for government-owned utilities because, as government entities, they pay no federal income tax. The income taxes paid by private utilities are passed on to the customers as part of the rates. *See* SCHWARTZ, FLYNN & FIRST, *supra* note 24, at 566–67.

For industries that are natural monopolies, in which only one firm should serve the market, a comparison of the relative costs of setting prices and the relative efficiency of operating the firm does not point to a clear preference for a public or private firm. Countries and governments throughout the world have made different choices for the same type of industries. For example, there is a patchwork of municipal and private water companies throughout the United States.[28] As Professor Rose points out, sometimes a government shifts back and forth between public and private, as New York City has done with its water supply.[29] Professor Rose also points out that this choice may stem from a perception that private firms can more readily raise capital and charge customers for plant improvements, free from interference by unhappy voters who dislike rate increases.[30] I suspect that ideological preference for government over investor-owned firms, or vice versa, has played a role in the choices made by governments over the years and throughout the world. I also believe that many people have viewed the products and services of these natural monopoly firms (e.g., water, electricity, and natural gas) to be a too-important part of the infrastructure to be trusted to the market. In today's terminology, the concern would be a fear of outsourcing some parts of the business of government.

The theory of public goods also justifies government providing goods and services. Public goods are those automatically provided to the entire community when they are provided at all. In economic terms, public goods are "nonexcludable" because no one can be excluded from enjoying the good, which leads to free-riding by people who will use the good without paying.[31] Military defense, flood control, and clean air are common examples.[32] Roads are another example, because it is impracticable (in terms of both time and money) to charge every user for traveling on every road.[33] The government can use taxes to force free riders to pay, while a private firm could not prevent free riding by any type of pricing method.[34]

28. Craig Anthony Arnold, *Privatization of Public Water Services: The States' Role in Ensuring Public Accountability*, 32 PEPP. L. REV. 561, 562 (2005) ("Although the portion of all public water services in the United States provided by privately-owned water suppliers is small (about eleven to fifteen percent), this portion has increased dramatically over the past two decades . . . .").

29. Rose, *supra* note 1, at 708.

30. *Id.*

31. MANKIW, *supra* note 21, at 226–31. Public goods are not only nonexcludable, they are also "non-rival," meaning that one person's use of the good does not deplete the good or diminish another person's use of the good. *Id.* at 226. If some people's use of clean air made the air dirty for others, it would not be a public good. *See id.*

32. *See id.* at 226–30.

33. *See id.* at 227.

34. *See id.* at 228.

In addition to supplying natural monopoly products and public goods, governments commonly provide goods and services that will not be provided by the market.[35] This would be the case for people too poor to buy essential goods and services at market prices. Public housing for the poor, provided by countries throughout the world, is the most common example.[36] It is true that the market can be used to supply housing to the poorest people through the use of government subsidies. However, it may be less expensive to provide government housing than to operate a subsidy system, and more politically acceptable to avoid allowing landlords to get richer under the subsidy scheme.[37] A second class of products that is not adequately supplied by the market are those products with social benefits exceeding the aggregate of the private benefit to their current users. Consider the national park system, for example. If the provision of parks were left to the market, there would be an under-supply because the revenues paid by the users would not reflect the benefits to future users, including unborn generations who cannot pay to preserve the park for their use in the future and living potential users who would attempt to free ride. In addition, it is impractical to charge people for the benefit they get just from knowing that there is a Yosemite Park preserved for us and for future generations, even if these people have no intention of visiting the park. Passenger railroads and subways probably fall into this category, as well. Many governments subsidize them, reflecting a belief that society benefits beyond the aggregate of the private benefit to each passenger.

The three types of goods described above—natural monopoly goods, public goods, and goods with social benefits exceeding aggregate private benefits—would not be adequately provided by the market. Consequently, it does no harm to a market system to have the government provide these goods. Likewise, it does no harm to supply goods to people too poor to buy them in the market. In addition, these goods make up such a small percentage of the economy that a market system would still exist even if the government chose to provide all of them. Economic competition would still be possible, so government participation in these parts of the economy would not hinder

35. *See id*. at 229–30.

36. *See* MANKIW, *supra* note 21, at 229.

37. In explaining why the government still supported rent control while it was moving the rest of the economy to a market system, Vaclav Klaus, who was then the prime minister of the Czech Republic, said that higher rents would mean that

> the state would have to pay large sums of money as social help to those in need. And the state support that would be granted to the tenants would in fact be a hidden form of indirect support of the houses' owners. Then, it would be more rational to channel the money from the state budget (if there are any) directly to those areas where the state of houses is really critical.

Vaclav Klaus, *Why Do We Still Control Rents?*, LIDOVE NOVINY, Apr. 27, 1994 (on file with the author).

economic growth. Consequently, economic reasons do not *compel* privatization of these government activities, although a government could choose to privatize for other reasons.[38]

Governments throughout the world have also owned many different kinds of firms that do not fit into the above categories. Even outside the command and control economies of the Communist world, the range of industries owned by governments has been broad, including mines, oil companies, steel mills, refineries, banks, and airlines.[39] Sometimes a belief that these were "strategic" industries provided the rationale for government ownership.[40] Sometimes public ownership was used to provide revenues for the state treasury.[41] There should be no objection to government ownership of these firms from an economic perspective, as long as there is competition. For example, if there is competition in the steel market, government ownership of one steel firm should have no ill economic effects. Competition in the steel market will discipline a government-owned steel company that runs inefficiently, serves as a haven for patronage workers, or encourages bribes and corruption. On the other hand, if the government monopolizes the steel market, nothing will check those abuses, and the government monopoly will harm economic growth. Thus, whereas government monopolies of otherwise competitive markets are objectionable economically, government ownership per se is not.

II. REASONS FOR PRIVATIZATION

Until the Thatcher privatization in the United Kingdom in the 1980s, most governments sold off their industries to raise revenue, often in difficult economic times.[42] Mexico's massive asset sales that were begun in response to international loan defaults and Egypt's privatization program that was started

38. Of course, a government could choose to have less participation in economic affairs by authorizing regulated private firms to provide natural monopoly products and by subsidizing market supply of the other types of goods.

39. *See* William L. Megginson & Jeffry M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LITERATURE 321, 323 (2001).

40. *Id.*

41. *See id.*

42. *See id.* at 321–23.

to correct a deteriorating economy are such examples.[43] Ideology played only a minor role in these divestitures.[44]

Margaret Thatcher, who was a strong advocate of the economic benefits of a market system, made it a high priority of her government to dismantle the heavy socialist aspect of the United Kingdom by selling most of the state-owned industries.[45] Many of the companies did not fit in any of the three categories described above: the North Sea oil and gas companies, British Petroleum, British Coal, British Steel, and British Airways.[46] Some were classic natural monopolies: the national telephone system, the national electric company, airports, and British Gas.[47] The privatization of the natural monopolies not only created private firms, it also created a need for new government agencies to supervise the new monopolies and control their prices.[48] Thatcher's policies were very successful, reducing the role of state-owned enterprises from more than ten percent of Britain's gross domestic product in 1980 to essentially nothing when the Conservative Party lost control of the government in 1997.[49]

The British privatization policies were followed by other European countries in the last two decades of the twentieth century, including massive divestitures by France and Spain and significant privatizations by Italy and Germany.[50] In the same period, privatization spread to countries in Asia, South America, and Africa.[51] Since the fall of the Iron Curtain in 1989, countries of Central and Eastern Europe privatized their command and control economies as part of the transition to a market system.[52] Privatization was a way to create private property and firms, prerequisites to a market system, as well as a way to raise revenues to pay for the costs of the transition. According

43. Taeko Hoshino, *Privatization of Mexico's Public Enterprises and the Restructuring of the Private Sector*, 34 DEVELOPING ECON. 34, 40–47 (1996); Rafael La Porta & Florencio Lopez-de-Silanes, *The Benefits of Privatization: Evidence from Mexico* (Nat'l Bureau of Econ. Research, Working Paper No. W6215, 1997), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=225973; Mohammed Omran, *Performance Consequences of Privatizing Egyptian State-Owned Enterprises: The Effect of Post-privatization Ownership Structure on Firm Performance* __ (Soc. Sci. Research Network, Working Paper No. 281866, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=281866.

44. *See* Megginson & Netter, *supra* note 39, at 323–24.

45. DANIEL YERGIN & JOSEPH STANISLAW, THE COMMANDING HEIGHTS: THE BATTLE BETWEEN GOVERNMENT AND THE MARKETPLACE THAT IS REMAKING THE MODERN WORLD 114–15 (1998).

46. *See generally id*. at 119–20.

47. *See id.* at 115–21.

48. *Id.* at 120–21.

49. Megginson & Netter, *supra* note 39, at 324.

50. *Id* at 324–25.

51. *Id.* at 325–26.

52. *Id.* at 326.

to two commentators on privatization, most governments have used divestiture to achieve six goals: "(1) raise revenue for the state, (2) promote economic efficiency, (3) reduce government interference in the economy, (4) promote wider share ownership, (5) provide the opportunity to introduce competition, and (6) subject [State-Owned Enterprises] to market discipline."[53]

The Czech Republic is a good example of privatization by the transition countries, because it used the broadest array of privatization methods with relative success.[54] Restitution was the process of returning property confiscated by the Communist government to the original owners or heirs.[55] All kinds of property were returned under this program, including factories, farms, estates, castles, houses, store fronts, apartment buildings, and apartment units. Although the primary purpose of this system was to symbolically atone for the government's wrongs, it also effectively created all kinds of private property.[56] Small-scale privatization allowed the occupants of stores and small businesses, like butcher shops, florists, and restaurants, to purchase the facilities if the facilities were not contested under the restitution laws.[57] In a relatively short period of time, not only did considerable private property come into existence, small business owners and merchants became independent of the state, strengthening the middle class in the country. Large-scale privatization, the most massive, complex, and time consuming of the types of privatization used in the Czech Republic, required selling much of the government-owned economy to bidders who tendered offers to the government.[58] Most of the large enterprises were purchased by other large firms, usually foreign. Volkswagen purchased Skoda Auto, the main Czech auto manufacturer;[59] Air France purchased Czech Air,[60] only to sell it back when the merger proved unsuccessful; the international company SABMiller purchased the famous Czech brewer Pilsner Urquell;[61] and Telefonica, the large Spanish telephone company, purchased Czesky Telecom,[62] to give some

53. *Id.* at 324 (relying on two 1989 studies conducted by Price Waterhouse).

54. *See* Michele Balfour & Cameron Crise, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 FORDHAM INT'L L.J. 84, 93 (1993).

55. *See id.* at 93–94.

56. *See id.*

57. *Id.* at 93.

58. *See id.* at 94.

59. *See* Alan Cowell, *THREATS AND RESPONSES: The New Capitalists; Western Investment Provides a Bonanza for East Europe*, N.Y. TIMES, Feb. 22, 2003, at A6.

60. *See Daily Briefing*, ATLANTA J. & CONST., July 27, 2000 at 2G (noting that Air France and Delta Air Lines were offered a stake in the state-controlled Czech airline).

61. Alan Cowell, *Big Brewer Withdraws Plan to Offer New Stock*, N.Y. TIMES, July 12, 2002, at W1 (stating that SABMiller's brands include Pilsner Urquell).

62. *World Business Briefing*, N.Y. TIMES, Apr. 7, 2005, at C6 (reporting that the Czech government approved the sale of the country's largest telecommunications company to Telefonica).

examples. This process involved some corruption and bribes to government officials,[63] but nothing on a scale compared to Russia and many of the other transition countries. In the end, it proved to be a way to convert nearly all of the large state-owned enterprises into private firms.[64]

Shortly after the fall of the Communist government in late 1989, a group of government leaders in the then-Czechoslovakia, led by Minister of Finance Vaclav Klaus concluded that the transition to a market system would be speeded along if all the citizens had a personal stake in the economy.[65] They devised voucher privatization as a way to make the people shareholders of privatized state firms.[66] Each citizen was allowed to purchase a booklet of vouchers at a nominal price and then exchange the vouchers in an auction for shares of stock in new companies created out of some state-owned enterprises.[67] Thousands of companies of all kinds were privatized this way.[68] The process did not work out as intended, however. Out of a concern that insider information would give some people a real advantage in the process of choosing which stock to obtain, the government permitted investment firms to participate in the process.[69] The hope was that the firms would have an incentive to obtain and publicize information about the various investment opportunities before the vouchers were exchanged for stock, ameliorating the asymmetric information problem, and then to help supervise the management of those firms whose stock they held. The investment firms offered to buy vouchers at multiples of the nominal purchase price, so a good percentage of the citizens sold their vouchers to investment firms for a small but certain profit rather than participate in the exchange process.[70] As a result, the investment firms came to dominate voucher privatization.[71] With the largest and most successful investment firms owned by banks, the privatization

63. *See generally* Peter S. Green, *Havel Steps Back into a Familiar Role: Czech Dissident*, N.Y. TIMES, July 22, 2003, at A2 (referring to the "often corrupt post-Communist privatization").

64. Yuliya Mitrofanskaya, *Privatization As an International Phenomenon: Kazakhstan*, 14 AM. U. INT'L L. REV. 1399, 1410 (1999); Nandini Gupta, John C. Ham & Jan Svejnar, *Priorities and Sequencing in Privatization: Theory and Evidence from the Czech Republic* 5 (William Davidson Inst., Working Paper Series No. 323, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=294541; Nemat Shafik, *Making a Market: Mass Privatization in the Czech and Slovak Republics* 2–4 (World Bank: Policy Research, Working Paper No. 1231), *available at* http://www-wds.worldbank.org/servlet/WDSContent Server/WDSP/IB/1993/12/01/000009265_3961005150829/Rendered/PDF/multi_page.pdf.

65. *See* Richard S. Gruner, *Of Czechoslovakia and Ourselves: Essential Legal Supports for a Free Market Economy*, 15 HASTINGS INT'L & COMP. L. REV. 33, 35 & n.6 (1991).

66. Balfour & Crise, *supra* note 54, at 94–95.

67. *Id*.; Gruner, *supra* note 65, at 49; Mitrofanskaya, *supra* note 64, at 1409–10.

68. Mitrofanskaya, *supra* note 64, at 1410.

69. *See id.*; Baflour & Crise, *supra* note 54, at 94–95.

70. Mitrofanskaya, *supra* note 64, at 1410.

71. *See id.*

process resulted in a structure more like Germany and Japan (where banks influence management as a result of the high share of bank financing) rather than the United States.[72] Although the vision of citizen/shareholder did not come to be, voucher privatization did successfully privatize many companies, as well as lead to the creation of the stock market.[73]

III. THE RELATIONSHIP BETWEEN PRIVATIZATION AND DEMOCRACY

For centuries, scholars have suggested that democracy advances economic growth. As Douglass C. North has explained, "This positive view of the crucial role of democracy in both the perpetuation of liberty and the promotion of economic growth is the very foundation of liberal (in the classic meaning of the term) thought."[74] This belief in the benefits of democracy is related to the belief that certain social norms and religious values, generally prevalent in a democratic society, advance economic growth.[75] Professor Rose puts the question the other way: does privatization advance democracy?[76] Or, in a broader sense, does market-based economic growth advance democracy?

To answer the question, we need to consider what constitutes a "democracy" and identify the relationships between privatization and the key elements of democracy. We could say that a democracy entails governance by some type of representative majoritarian voting system with some protection for minority rights—but there is more to democracy than formal structures. Friedrich Hayek emphasized a dynamic process of opinion formation:

> Democracy is, above all, a process of forming opinion. . . . It is in its dynamic, rather than in its static, aspects that the value of democracy proves itself. . . .
>
> The ideal of democracy rests on the belief that the view which will direct government emerges from an independent and spontaneous process. It requires, therefore, the existence of a large sphere independent of majority control in which the opinions of the individuals are formed.[77]

Robert Putnam explained his view of democracy as follows:

> Democratic theorists from John Stuart Mill to Robert Dahl have asserted that "the key characteristic of a democracy is the continuing responsiveness of the government to the preferences of its citizens." Democracy grants citizens the right to petition their government in the hope of achieving some individual or

72. *See* Peter Rutland, *Privatization in East Europe: Another Case of Words That Succeed and Policies That Fail?*, 5 TRANSNAT'L L. & CONTEMP. PROBS. 1, 13 (1995).

73. Shafik, *supra* note 64, at 4 & n.4.

74. NORTH, *supra* note 3, at 56–57.

75. *Id.* at 57–58; *see, e.g.*, MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM (Talcott Parsons trans., 1958).

76. *See* Rose, *supra* note 1, at 693–94.

77. F.A. HAYEK, THE CONSTITUTION OF LIBERTY 108–09 (1960); *see* NORTH, *supra* note 3, at 56.

> social goal, and it requires fair competition among different versions of the public interest. Good government is, however, more than a forum for competing viewpoints or a sounding board for complaints; it actually gets things done. A good democratic government not only considers the demands of its citizenry (that is, is responsive), but also acts efficaciously upon these demands (that is, is effective).[78]

In his study of democracy, Putnam focused on the need for cooperation among citizens and examined how a society established and reinforced cooperative norms.[79] Formal law both forces and teaches cooperation, of course, but the norms underlying cooperative behavior are at least as important as formal law. To me, the question of how to achieve a successful democracy is part of the broader question of how groups overcome collective action problems or, to quote Putnam, how a society creates social capital "that can improve the efficiency of society by facilitating coordinated actions."[80] In economic terms, it is the same as asking how to minimize free riding; in game-theoretic terms, it is asking how to induce people to cooperate rather than to defect. The answer lies in the norms that induce this type of behavior. The question then becomes: Does privatization or increased participation in an economic market advance cooperative norms?

Participants in market exchange learn to cooperate with their trading partners. Contrary to the Russian view of "cowboy capitalism" expressed in the early stages of the Russian transition, economic actors cannot routinely cheat, lie, and renege on contracts, at least not if they want to do business again.[81] Repeat business depends on honesty, contract performance, and good reputation, which is cooperative behavior in the economic world.[82] If cooperative norms can become ingrained by participating in economic activity and if those norms translate to social and political dealings, increased economic activity will advance democracy.

Of the Czech privatization methods,[83] small-scale privatization would have done the most to build cooperative norms by legitimizing a class of merchants and small business people whose world consisted of economic exchange and contract performance.[84] Some of the privatizations made through restitution to merchants and small business people may have had the same effect. A strong

78. ROBERT D. PUTNAM, MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY 63 (1993) (quoting ROBERT A. DAHL, POLYARCHY: PARTICIPATION AND OPPOSITION 1 (1971)).

79. *Id.* at 3.

80. *Id.* at 167.

81. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 55 (1990).

82. *Id.*

83. *See* text accompanying notes 54–71.

84. *See* Balfour & Crise, *supra* note 54, at 94–95.

middle class seems to be present in many democratic countries. From this perspective, small-scale privatization and restitution helped the transition to democracy in the Czech Republic by strengthening the middle class. Assessing the political benefits of the ideal voucher privatization scheme is more difficult. Trading stock, which is done impersonally, on an exchange, and frequently through a broker, is very different from a merchant's buying and selling of goods and services. I wonder if cooperative norms are learned by stock trading. Perhaps if all the citizen/stock traders would have learned how to be economic actors, they would have learned cooperative economic norms in the process and possibly advanced democracy. That seems unlikely to me, but the question is purely academic because the voucher program did not lead to a country of stockowners.

The Czech large-scale privatization program was like most of the privatizations that have occurred worldwide: large state-owned enterprises are sold to large private firms.[85] It is hard to see how cooperative norms or any aspect of democracy, for that matter, could be advanced by that kind of action. These were strictly business transactions between large business entities. Looking back at all the countries that have privatized large entities does not show changes in the democratic nature of their governments. Mexico and Egypt were not functioning democracies when they made major divestitures,[86] nor were they afterwards. There were no apparent changes in the democratic governance of the United Kingdom, France, Italy, Germany, and Japan after their privatization waves.[87] Spain and the Central European countries did become more democratic, but their privatizations came in the midst of great political reform in the transition from fascism for Spain and from communism for the Central European countries.[88] Those political reforms were much more important than the privatizations in the transition to democracy. In fact, it would be impossible to assess the influence the privatizations had on the movement toward democracy because they were dwarfed by the effects of the political reforms.[89]

Another way to assess the effects that privatization and market liberalization have on democracy would be to observe the changes in China over the next decade or so. China is going through a process of economic

85. *See* Mitrofanskaya, *supra* note 64, at 1409.

86. *See* text accompanying note 43.

87. *See* text accompanying notes 50–51.

88. *See* text accompanying notes 50–51.

89. Two aspects of privatization may hinder democracy. First, many state-owned enterprises have been sold to foreign firms and investors, who may have less stake in the political affairs and governance of the country. Second, many privatizations have achieved great efficiencies through massive layoffs. *See* Megginson & Netter, *supra* note 39, at 351 (noting that the Argentine national freight and passenger railway system reduced employment from 92,000 to 18,682 workers, a 78.7 percent reduction, after privatization).

reform while still trying to retain a party-controlled government.[90] It may be that economic freedom will lead people to push for political freedoms, including greater participation in governance. Even with the extent of economic liberalization over the past two decades, the Communist Party still maintains totalitarian control over much of society in China, something that will be hard to change. Perhaps a form of democracy will emerge through competing groups within the Communist Party, rather than from the emergence of a new competing party. Political reforms do not necessarily follow economic freedoms, however. The experiences of Hungary and Poland under the communist regime illustrate that Hungary had a market economy in the small business and light industry sectors, and Poland never collectivized agriculture, but they both remained totalitarian communist countries.[91]

Let me conclude by emphasizing that many people throughout the world care much more about physical and economic well-being than about political rights and democracy. People who lack food and shelter do not give high priority to the right to vote in democratic elections; they care more about eating and having a roof over their heads. To these people, privatization and market reforms are important just for their economic effects. Once people achieve economic security, they can devote more energy to attaining political freedom. By relegating the protection of property rights to the constitutional dust bin, the United States Supreme Court was reflecting the economic well-being of the country.[92] Those of us living in the United States and in the other developed countries of the world are lucky that we can think about the political consequences of privatization and not just worry about improving the economy. In this sense we could label economic well-being as *The Road to Democracy*.

90. PEERENBOOM, *supra* note 11, at xi, 450.

91. *See* Jane Perlez, *New Bricks, Same Old Walls for Europe's Poor Nations*, N.Y. TIMES, Jan. 24, 1997, at A1 (comparing Albania to Poland, "where land was not collectivized," and Hungary, "where small businesses cropped up in the still-Communist 1980's.").

92. *See, e.g.*, Kelo v. City of New London, 125 S. Ct. 2655, 2661, 2669 (2005) (deference to city's determination of what constituted "public use" under Takings Clause of the Fifth Amendment); Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483, 487–91 (1955) (minimal review of economic regulation under Due Process and Equal Protection Clauses); United States v. Carolene Products Co., 304 U.S. 144, 152 n. 4 (1938) (greater constitutional protection for noneconomic rights).