

IMMORALITY OF THE TRANSITION INDUSTRY: THE CASE OF EASTERN EUROPE

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1. IMMORALITY OF THE TRANSITION INDUSTRY

The rejection of private property rights was the central premise of socialism from its earliest days, and the abolition of private property rights was the driving ideological force behind all socialist experiments in the twentieth century. The best examples of those institutional arrangements are the former Soviet Union and the former Yugoslavia. The Soviet centrally planned economy and the labor-managed economy of Yugoslavia were not *ad hoc* models; indeed, they were the consequence of the basic philosophical and economic premises of the socialist doctrine as it has evolved since the eighteenth century. And they have both failed. Apart from the fact that socialism in Eastern Europe and the former Soviet Union failed the efficiency test, the system turned out to be an unnatural and inhuman choice. The vast amount of resources the ruling elite in every socialist country had to spend to maintain the system is the best evidence of the immorality of socialism as an alternative method for the allocation of resources.

Apologists for socialism argue that by pursuing their own ends, the political leaders in Eastern Europe and the former Soviet Union ruined the chance for socialism to prove itself as a viable alternative to capitalism. The argument is both correct and self-defeating. It is correct because ever since the fiasco in the Garden of Eden, human beings have been pursuing their private ends. The argument is self-defeating because the socialist leaders are human beings, too; that is, they pursue their own ends within the system of incentives embedded in socialist institutions. Thus, the incentive structures of its institutions rather than noncognitive valuations and beliefs explain the social and economic consequences of socialism in Eastern Europe and the Soviet Union.

Today, the consequences of the socialist experiment, perhaps the costliest experiment in human history, are fading from our memories. For university students in the West, the socialist rule in the Soviet Union and Eastern Europe is fast becoming an ancient history; something that could not possibly happen again. Young men and women are busy with their careers in competitive markets. Baby boomers in the United States are focusing on the value of their retirement annuities. At the same time, consumer advocates, labor unions, pressure groups, and all sorts of public interest defenders are pushing for more public spending and more governmental controls. President Clinton has almost succeeded in socializing health care in the United States. A huge bureaucracy is being created in Brussels, which will slowly but surely replace the freedom of choice in Western Europe with legislated outcomes. John Paul II has expressed serious misgivings about the free-market, private-property economy. In *Laborem Exercens* (1981), the pope identified social justice with the development of labor unions. In *Sollicitudo Rei Socialis* (1988), he criticized **both** classical liberalism and Marxism as being unjust movements. In *Centesimus Annus* (1991), the pope defended the collectivist approach in achieving human rights.

Memories are in the short supply in the East as well. In many East European countries pro-collectivist parties (communists, socialists, nationalists, etc.) are gaining votes. In the former Soviet Union and the former Yugoslavia people are talking about good old days under Stalin and Tito. They forget that Stalin and Tito were cold-blood murderers. Stalin purges are well known in the West. Tito's "war of liberation" freed Yugoslavia from the German occupation not a day sooner than it would have happened anyhow. To seal his victory over the opponents of communism, Tito organized concentration camps that were as bad and probably worse than Stalin's gulags. As late as

in the 1970s, Tito conducted a major purge that condemned thousand of people in Serbia and Croatia to unemployment and jail sentences.

Unfortunately, the ugly head of socialism is in hiding but not dead. Some people are clearly unhappy with the fact that the private-property free-market economy has proved its superiority over socialism. In 1989, Western scholars associated with Russian Centers, East European Centers and associations for study of comparative systems discovered, practically overnight, that the demand for their “skills” was gone with the wind. Given their knowledge and skills, the survival trait for those scholars is to favor economic policies based on more government and more public spending. In the East, universities were not de-communized (except in East Germany). After many decades of research and teaching about economic planning, East European professors had to do a complete turnaround and switch to lecturing about the essentials and benefits of competitive markets. Leaving aside the morality of East European scholars, their human capital is not adequate to help them understand and even less appreciate the economic forces at work in the private-property, free-market economy.

Predictably, a new rent-seeking coalition, the *transition industry*, emerged early in the 1990s. The transition industry is an umbrella for the latter-day socialists, social engineers, bureaucrats, reformed and non-reformed communists, policy makers from the World Bank and IMF, and others. The common denominator of this diverse group of rent-seekers, who prefer public policy to spontaneous changes and favor restricting the right of ownership, is the culture of collectivism. And their survival trait is to be able to use the strong-hand-of-the-state to “build” capitalism in Eastern Europe and the former Soviet Union. From the standpoint of ordinary people in the region, the transition process has substituted one set of institutions for another set, neither of which they chose for themselves.

That is why the development of stable and credible property rights in business organizations has been a critical issue in Eastern Europe and the former Soviet Union. Stable and credible rights have two important effects. First, they create incentives for resources to seek their best uses. Second, they reduce the transaction costs of making decisions that have future consequences. However, stable and credible property rights are a threat to the transition industry, whose members derive benefits from having discretionary powers to choose what to do with resources.

In this paper, the term immorality refers to this conflict between the transition industry’s demand for discretionary powers, and the community’s need for stable and credible property rights. By identifying the effects of the transition industry on transaction costs and the production of wealth, the term immorality takes on analytical content. And the farther we go to the East (including the Balkans) the more power the transition industry has to sabotage the development of stable and credible property rights in business firms. The purpose of the paper is analysis of the consequences of the immorality of the transition industry on the choice of business firms and their governance structures.

2. THE CHOICE OF GOVERNANCE STRUCTURES

The firm is a group of people in teamwork. It is a set of contracts involving separately owned inputs whose value as a team exceeds the sum of the market values each member of the team could

produce by contracting the use of his inputs across markets. Business firms exist because teamwork is an efficient method for organizing production. *The privately owned firm is a set of contracts between the owners of cooperating inputs with one party who is central to all contracts*

The source of the gains from teamwork is incentives arising from the contents and terms of contractual agreements among members of the team. Thus the governance structure of business firms matter.

Legal rules that specify governance structures could be a source of inefficiency of business firms. The problem is that those laws freeze governance structures into a rigid system. In effect, they substitute preferences of the ruling elite and social engineers for the agreements between equity owners, potential investors, senior executives, the employees, and all other members of the team who know their own preferences, bear the risk of their choices, and are directly affected by the firm's performance. On the other hand, the freedom of contract allows members of the team to choose what kind of firm they want to have (e.g., corporation or partnership); to decide whether they want a centralized or decentralized firm, inside or outside directors, a strong CEO or a strong board; to choose the method of rewarding performance (stock options, cash bonuses, premium over market wages, non-cash benefits such as long holidays, etc.); and to specify trade-offs between profit and other objectives (as the York Times and the Wall Street Journal have done).

For example, in a large manufacturing firm in Dallas, four out of thirteen members of the board are former employees ("inside" directors). Two members of the board are current employees (chairman of the board and the president) of the Company. Remaining seven members of the board are "outside" directors selected for their accomplishments in finance, business and academics. As a condition of their tenure on the board, "inside" directors must seek membership on the board of other firms.

All the different governing structures that we observe in the United States have emerged through voluntary contractual agreements and passed the market (survival) test. The survival of alternative governance structures is the best evidence that no two firms are alike. Some boards specialize in handling crises, others produce CEOs from among their members, and some boards are minutely interested in day-by-day operations, while others prefer to remain more detached. But, no single model can specify the interrelation of functions.¹

The transition industry's attempts to justify its power to enact (and modify) a set of fixed rules about governance structures by saying that those rules reflect the evolving trend is plain wrong.² No firm needs the law in order to adapt to emerging practices. And many firms need to be free to deviate from the trend. Analysis and empirical observations suggest that the best way to go is to let

¹ Andrews, K. R. (1981): **Rigid Rules Will Not Make Good Boards**, *Harvard Business Review*, 60: p.46.

² The American Law Institute, a Philadelphia based non-profit legal research center made the most comprehensive (and failed) proposal in 1983 entitled *Principles of Corporate Governance and Structure: Restatement and Recommendations*.

members of the team develop governance structures in accordance with *their* judgment of *their* survival needs.

3. THE CHOICE OF BUSINESS FIRMS

3.1. Industrial Democracy

Industrial democracy is the transition industry's favorite institutional arrangement. It is an umbrella for all the different forms of labor participation in the governance of business firms. Evidence shows that industrial democracy has not emerged voluntarily on any significant scale and has failed to perform successfully whenever and wherever imposed by *fiat*. Yet, the demand for labor participation in the governance of business firms continues to be relatively strong. The reason is quite simple: industrial democracy offers too many rent-seeking opportunities, and satisfies too many ideological preferences to be discarded on account of its poor performance.

Whatever the facade of words, terms such as industrial democracy, stakeholding, or labor participation are code words for wealth transfers. Involuntary labor participation in the governance of business firms restricts the freedom of individuals to negotiate mutually beneficial organizational forms. By increasing the risk borne by equity holders, involuntary labor participation in the governance of business firms raises the cost of equity capital. When the shareholders invest their wealth into an investment project that turns out to be successful, they share the gains with labor. When the investment decision is not successful, shareholders alone bear the losses. Employees experience no loss of wealth; their cost is limited to the cost of changing jobs.

The fact that labor participation in governance has to be mandated by the government and protected from competition is the best evidence of its inefficiency. A major source of this inefficiency lays in the fact that by attenuating the right of ownership, all the different forms of industrial democracy create a gap between private and social costs of using scarce goods. If labor participation had positive effects on the firm's productivity, why don't we observe the labor participatory firm on a significant scale? Why don't shareholders negotiate with employees a contract that would make both groups better off? If labor participation has to be mandated by law, how can we assert that it is a superior method for organizing production? There is no law in the United States that says that there shall be no labor participation. Indeed, there are cases in which labor participation has emerged voluntarily, but it has not happened on any significant scale.

Germany is a good case for analysis of the consequences of involuntary labor participation in the governance of business enterprises. The Codetermination Act of 1976 in Germany—a capitalist version of the labor-managed firm--applies to all business firms that have more than 2,000 employees. The supervisory council (i.e., the board of directors) for such firms has twelve members, of whom six are representatives of the shareholders and six are representatives of the employees. The chairman of the supervisory council is elected by the shareholders and holds the deciding vote in case of a deadlock.

Empirical evidence is simply not consistent with the claim that codetermination bestows benefits on workers without any detrimental effects on other members of the team. Immediately after the passage of the Codetermination Act of 1976, many business firms tried to escape the parity

representation on the supervisory board through mergers, reorganizations, moving their headquarters abroad, and other structural changes. In the late 1970s, codetermination applied to about 650 firms. By the early 1980s codetermination covered only about 480 firms. About 120 firms had reduced their labor force below the 2,000 limit, while about 50 firms had changed their corporate charters. Assuming that both the size and contractual forms of those 170 firms reflected efficient business decisions, the post-1976 adjustments are a social cost of codetermination.

Jensen and Meckling summarized the economic effects of involuntary constraints on the freedom of contract in the following passage:

Indeed, labor can start, and in rare cases has started firms of its own. Moreover, firms are free to write any kind of contracts they wish with their employees. If they choose to, they can offer no-dismissal no lay-off contracts (tenure at universities). If they choose to, they can establish worker councils and agree not to change production methods without worker approval. Moreover, employers would [encourage] such practices if the benefits exceeded the costs. Furthermore, if laborers value the security and "self-realization" which such participatory arrangements afford them at more than their costs to the employer, they are in a position to offer voluntary changes, which it will pay the employer to take. ...Since those arrangements are [rarely] observed, we infer that workers do not value the security, management participation, etc. at more than the cost of providing them [emphasis mine].¹

3.2 The Corporate Firm

In the United States, we observe a large number of different types of business firms such as single proprietorships, partnerships, corporations, mutuals, not-for-profit firms, cooperatives, etc. All those firms have emerged through voluntary contractual agreements and survived competition from other types of firms; that is, law mandated none of those types of business firms. They reflect the freedom of individuals to write any kind of contract they wish with each other and bear the costs (risk) of their choice.

The corporate firm is a product of this competitive environment. It has emerged spontaneously and survived competition from other methods of organizing production. The corporate firm is the best example of the wealth-creating consequences of stable and credible property rights. Predictably, the transition industry finds the corporate firm to be politically incorrect.

The advantages of the corporate firm over other types of private ownership firms arise from the rule of limited liability, the dispersion of shareholding and the market for corporate control. Let us briefly describe each of them.

3.2.1 The Law of Limited Liability

¹ Jensen, M; Meckling, W. (1979): **Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination**, *Journal of Business*, 52: pp. 472-3.

Mass production of goods, production of durable goods, production of heavy machinery, the implementation of new technologies, innovations, and many other investments and commercial activities require pulling together large amounts of capital. Banks could not satisfy this huge demand for capital without driving interest rates to a level at which many opportunities for economic growth would fail to be exploited. We have enough research and empirical evidence to know that the state can neither raise *voluntarily* large amounts of capital nor be trusted with the allocation of investable funds. Except in frictionless blackboard models, state ownership provides strong incentives for the allocation of resources to by-pass the market test.

In response to economic pressures from within the system, numerous contractual agreements were tried in order to resolve the need for pulling together large amounts of capital. Eventually a new legal concept evolved the rule of limited liability.¹ This law limited each owner's (i.e., equity investor's) liability to the market value of his investment in the firm, which created incentives for equity investments to be divided into small shares and traded in financial markets. By breaking up equity interests into relatively small shares, corporate firms were able to attract funds from small savers. This advantage derives from the anonymous alienability of shares, which enables shareholders to sell their shares without requiring the approval of other shareholders. By contributing to a substantial reduction in the transaction costs of raising large amounts of investable funds, the rule of limited liability made the corporate firm *the most effective method of voluntarily gathering large amounts of capital for long-lived ventures.*²

3.2.2 The Dispersion of Shareholding

Starting with the dispersion of shareholding, which is a fact of life, A. Berle and G. Means³ developed the separation of ownership and control thesis. The separation thesis quickly acquired a strong following among the critics of capitalism, who routinely ignore the difference between one's desires and the reality of market processes. Branko Horvat from Croatia and Mihailo Markovich from Serbia applied the separation thesis to their own vision of the world. Some decades ago they blamed private ownership for transforming humanity into a horde of profit-seeking beasts. Today, they argue that there is no need to encourage the development of private-ownership firms because the dispersion of shareholding has already socialized private property rights in business firms.

The separation thesis basically says the following: The dispersion of shareholding insulates the management from the owners. Thus, the right of ownership is empty because the shareholders have no control over the use of their resources. Managers control resources, make decisions affecting

¹ An excellent source is Easterbrook, F; Fischel, D. (1991): *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge, MA. For a different analysis of the rule of limited liability see R. Ekelund, R.; Tollison, R. (1981): *Mercantilism as a Rent-Seeking Society*, Texas A&M University Press, College Station, TX.

² See Easterbrook, F.; Fischel, D. (1991): *The Economic Structure of Corporate Law*, chapter 2.

³ Berle, A; Means, G. (1933): *The Modern Corporation and Private Property*, Macmillan, New York.

shareholders' wealth, and can easily protect themselves by soliciting proxies at the company's expense. The bottom line is that the dispersion of shareholding leads to (1) withering away of private property rights in the corporate firm, (2) the transfer of a part of the residual (i.e. shareholders' wealth) to managers, and by implication (3) a reduced flow of capital into business firms with dispersed ownership.

Empirical observations are consistent with none of these three outcomes. The fact is that millions of individuals continue to invest in common stock. Why do they not choose other investment opportunities that exist in the United States? Why is equity financing not being driven out by investments in fixed claims? Why do we not observe a lower bid price for stocks of corporations with dispersed ownership relative to those firms that have less dispersed ownership? Why do dispersed ownership corporations not have lower rates of growth of shareholders' wealth?

The Benefits of the Dispersion of Shareholding. The dispersion of shareholding is, in fact, an important source of the efficiency of corporate firms.

1. There is no law in the United States that says that people have to buy shares in corporate firms. It is their choice. And they have many other alternatives for their savings. Thus, when people buy shares they *voluntarily* separate themselves from controlling their property. And for a good reason. Those who buy shares in corporate firms choose to specialize in bearing the risks. Managers are individuals who specialize in managing the risk. *The dispersion of shareholding is then fully consistent with the law of comparative advantage.*

2. In the United States, even small savers can diversify their investment portfolios and avoid the firm-specific risks. The separation thesis then “leads to *lower capital costs for firms in the economy*, and to greater innovation, as shareholders are capable of investing in riskier ventures due to their ability to mitigate such risk through diversification.”¹

3. The fact that shareholders have incentives to include innovative ventures into their portfolios means that the dispersion of shareholding is *a source of capital for small start-up companies.*

4. The diffusion of ownership provides the funds required for economic growth *without a concentration of economic power* within a society. An alternative is a concentration of share ownership in the hands of the state or state protected rent seeking coalitions, which means a concentration of economic and political power within a society.²

5. The separation thesis contributes to the *development of a large middle class with significant and diversifiable stakes in the economy.* Highly competitive money managers who quickly punish non-performing firms by selling their shares in financial markets represent this group, which includes millions of retirees.

¹ Macey, J. (1998): **Gli Stati Uniti: Un Paese Senza Legge**, *International Centre for Economic Research Working Papers*, Torino, Italy. 17/98, p. 2.

² *Ibid.* p. 3.

The Costs of the Dispersion of Shareholding. Berle and Means were right in saying that the dispersion of shareholding has its costs. But, the fact that the corporate firm has continued to prosper could only mean that the benefits of the dispersion of shareholding exceed its costs. Let us now identify those costs and the circumstances upon which they depend.

Major costs of the dispersion of shareholding are the transaction costs of monitoring managerial decisions that affect shareholders' wealth, and the costs of hiring and firing corporate managers. Given their estimate of transaction costs, corporate managers should then be able to transfer some wealth from shareholders to themselves. They can do that in a variety of ways such as liberal expense accounts, plush offices, company planes, large number of beautiful (but not necessarily efficient) secretaries and receptionists, pleasant co-workers, opportunities to contribute to the causes they believe in, and so on. The consumption of those goods increases managers' total income over and above their contractual pay, and is conveniently reported as the cost of doing business.

An observable implication of the separation thesis should then be a negative relationship between the dispersion of shareholding and the shareholders' gains in wealth; or--the same thing--a lower bid price for stocks of corporation with dispersed ownership. However, academic research and empirical evidence have demonstrated that no statistically significant relationship exists between the dispersion of shareholding and the shareholders' gains in wealth. Clearly, the private-property free-market economy creates incentives to reduce the transaction costs of monitoring managerial decisions. To understand those incentives, we must turn to the market for corporate control.

3.2.3 The Market for Corporate Control

The market for corporate control has an important consequence: it assures shareholders that their wealth is well guarded. Three important ways in which that is done are:

1. In competitive (i.e., non-regulated) *financial markets*, market valuation of the expected future consequences of current decisions by corporate managers raises their costs of making decisions that are contrary to the interests of shareholders. With bounded rationality and positive transaction costs, market evaluations of the future consequences of current decisions are often wrong and are continuously modified. However, the critical factor protecting shareholders is that the (top) manager knows that his decisions are immediately scrutinized in financial markets, and that market (ex ante) valuations of the expected effects of those decisions on the profitability of his firms are quickly incorporated into stock prices. That is, financial markets raise the manager's costs of pursuing activities that deviate from the profit-seeking behavior or--the same thing--guard the shareholders' wealth.

2. *The opportunity costs* of corporate managers depend on the profitability of business firms they manage. That is, the present value of a manager's future earnings depends on the current profitability of his firm. An implication is that the pursuits of objectives other than the shareholders' wealth are costly in terms of the manager's future marketability. The consumption of nonpecuniary goods at the expense of potential profits has to appear to the manager as a choice between more utility now or more income tomorrow.

3. *Hostile takeovers* are the most effective mechanism by which the market for corporate control assures shareholders that their wealth is well guarded. By disciplining corporate managers, hostile takeovers have increased the operating efficiency of corporations, their employee productivity, and their shareholder value. Macey wrote: “The threat of a takeover creates a positive externality as managers of all firms, even those that are not subject to an outside bid, have incentives to maximize share value in order to reduce the arbitrage possibility for outside bidders, and thereby retain their posts.”¹

4. CONCLUSION

The transition industry imposed institutional changes in Eastern Europe and the former Soviet Union with little regard for either the region’s philosophical and moral heritage or the rule of law. By identifying the results of the transition process with capitalism, East Europeans are voting free-market parties out of power. An alternative approach to institutional reforms would be to focus on the development of the rule of law, impartial justice and economic freedoms including the choice of business organizations. However, it is naïve to assume that the transition industry and its rent-seeking cohorts would be willing to forgo the benefits they derive from their discretionary power to make rules. Yet, that is precisely what happened in the United States and England in the 1980s, when Margaret Thatcher and Ronald Reagan made an important dent in the culture of collectivism.

¹ *Ibid*, pp. 6-7.