Task Force on Institutional Design for China's Evolving Market Economy

Introductory Essay

I. Objectives

The project has several distinct, but related, objectives:

1. China is now entering a critical phase in its move to a market economy, in which it will be establishing the basic institutional foundations of a market economy, including legal frameworks that will govern property rights, competition, corporate governance, intellectual property, bankruptcy, contracts, etc. There is, of course, more than one form of market economy—the Scandinavian model differs from the Anglo-American, the Japanese, and the Continental European models, and by the same token, there are marked differences in legal structures. China has committed itself to developing a market economy with its own distinctive characteristics. On going debates and discussions, and discussions over the next few years, will have a major effect in determining the kind of market economy into which China will evolve.

This provides a unique opportunity to think about the differences in the institutional arrangements and their consequences—and what would normally be an academic exercise could turn out to have enormous impact for a quarter of the world's population.

2. Thinking through what might be an appropriate legal and institutional infrastructure of China forces one to address basic foundational questions about, for instance, the rule of law. Discussions at the Manchester meeting and at the Columbia sub-group meeting highlighted the differences between the Chicago "law and economics" perspective, which has dominated most of the discussions of the design of legal institutions in recent years, and an alternative set of perspectives held by most members of the group. Articulating this alternative perspective, setting it in contrast to the Chicago perspective, and explaining the deficiencies in that perspective, would be a contribution in its own right. But the real task is to contrast the concrete implications of this alternative view for the design of legal and other institutional arrangements.

One of the important tasks of the task force should be to bring these issues to surface, to clarify the underlying models of the economy and human behavior which underlay different perspectives, and to identify areas of theoretical and empirical research which might help in assessing the merits of alternative approaches.

II. Conceptual foundations of property rights

Property rights define the terms by which individuals (or corporations) exercise control over the use of an asset and the income derived from an asset. We are using the term in a broad way, to include the restrictions and obligations that are placed on

the "owner," and the conditions under which control of the asset and the income derived from it are turned over (in part or in their entirety) to others.

In this broad conception, property rights discussions include discussions of liability (torts), bankruptcy, and contracts, as well as the adjudication of disputes. Laws determine when individual A has to turn over some of his assets to individual B, e.g. because individual A has injured individual B (a tort or a breach of a contract), or because individual A owes money to individual B which he has not paid (as in the event of bankruptcy). Laws governing corporations can also be viewed as part of property law; they provide for limited liability—thus limiting the claims that a creditor can make on a debtor; corporate governance rules also restrict actions by majority shareholders, that might adversely affect the interests of minority shareholders; or by managers, that might adversely affect shareholders; or by shareholders and mangers, that might adversely affect bondholders.

(There are other "obligations," such as those to members of one's family, which also can affect entitlements to property; but they will not be considered here.)

Many of the constraints and obligations on property rights are directed at redressing market failures, and especially *negative externalities.* Some (especially in the discussion of section VII. On distributive concerns) focus on imperfect competition and imbalances of economic power. There are, of course, other market failures, such as those that arise when there are positive externalities. These are typically not addressed within property rights regimes.[1]

The discussion below is based on four premises. The first is that property rights are social constructions, designed to promote social objectives (growth, efficiency, equity). This is most obvious in the case of newer "innovations," such as intellectual property and limited liability corporations; but as we think are the design of, say, intellectual property rights, we recognize that there are similar "design" questions in other areas of property rights: it is only that certain design questions seem to have been so settled by long tradition that they are no longer the subject of discussion. But they were often "settled" in the context of an economy markedly different from that of today's world. China has the opportunity to readdress these issues. There is no reason that it should accept the answers that were arrived at in other countries—especially as we have become increasingly aware of what is wrong with these answers.

The second premise follows: there is not a unique answer to the question of the "design" of property rights regime. There are complex trade-offs. The circumstances

[1] There are principles, such as "unjust enrichment," that are occasionally invoked in determining "fair and equitable division of the returns associated with an asset. (U.S. law called for the fair and equitable distribution of the oil revenues generated by certain federal offshore tracts. The positive information externality conveyed by successful exploration of state tracts, which had led to increased bids on the federal tracts, it was argued, should be a factor taken into account in determining the states' fair share. The Courts supported this view.)

confronting China today are markedly different from those confronting other countries, so that even if the system that they had chosen for themselves were optimal *for their circumstances*, it is not clear that that system would be optimal for China. In the discussion below, I will highlight a number of the salient features of the property rights regime.

The third premise is that any property rights regime must be based on the recognition of the limits of the market. Property rights are important, but it makes a difference how property rights are defined and assigned. Simply defining property rights (in any way) and enforcing contracts will not lead to either an efficient or fair society. Simply put, Adam Smith, Ronald Coase, Friedrich Hayek, Hernando DeSoto, and the Chicago School are, in a fundamental sense, wrong—in spite of the enormous influence they have had in shaping the global discourse on law and economics in general, and property rights in particular.

The final premise is that the rights of individuals are (or should be viewed as) different than the rights of corporations. As we have said, corporations are social constructions that have no inherent rights. Society grants limited liability, which means that, necessarily, incentives are distorted (the corporations do not bear the full downside consequences of their actions.) Especially in large corporations, control rights are inherently ambiguous, but even if they were well defined, assigned to shareholders, there is an inherent problem: if shareholders are disperse, then the fact that the good management of the company is a public good (i.e. all shareholders benefit) means that there will be underinvestment in monitoring by each shareholder. Effective control will, as a result, reside elsewhere, in management and in banks, whose interest may differ markedly from those of the shareholders and workers. It is inevitable that governments will want to ensure that the decisions made by the firm advance the interests of stakeholders (and society more broadly), and not just those who have effect control of the assets. This means that government will want to impose constraints on corporations, on how they make decisions, including how control of the assets under their control is changed.

III. The Chicago School and the underlying economic and behavioral hypotheses

The Chicago School has had enormous influence in thinking about legal and other institutions. It provided, for instance, a well defined approach for evaluating alternative legal frameworks, for instance, for liability (tort), competition (anti-trust), and consumer and investor protection. Within that framework, one could assess whether one set of rules was more likely to enhance economic efficiency. And it was efficiency upon which they focused.

Underlying their analysis are assumptions of rational and well informed consumers interacting with profit maximizing firms in competitive markets, in a world in which there are perfect risk and capital markets. As I noted, central to that school is a focus on efficiency, and central to that is the notion that clear and unambiguous assignments of

property rights lead to efficiency (the Coase Conjecture). Indeed, while standard competitive theory argued that markets lead to inefficient outcomes whenever there are externalities, Coase seemed to argue that if there are well defined property rights, even externalities will not be a problem. If "non-smokers" are given the rights to the air, then smokers will pay them to be allowed to smoke if and only if the value of what they gain from smoking exceeds the value of what the non-smokers lose. If smokers are given the rights to the air, then non-smokers will pay the smokers not to smoke, so long as the value of what they gain from having a smoke-free room exceeds the loss that smokers incur in not being able to smoke. There are, of course, distributional consequences to these alternative assignments of property rights, but these are not the focus of the analysis.

There is a rationale for the focus on efficiency: Underlying this school is also the view that distributional issues can be separated from efficiency issues (the neoclassical dichotomy); political processes can deal separately with the appropriate distribution of income.[2]

There are some derivative implications: The scope for anti-competitive behavior is limited, so there is little need for anti-trust action (indeed, the risk is that government intervention would impede real competition in the market place)[3]. Individuals should be allowed to freely contract with each other; the government's only role is to enforce the contracts that have been made.[4] The stronger the intellectual property rights the better.

In this view, the role of government is limited: ensuring property rights and enforcing contracts. Individuals and firms will have an incentive to make use of assets efficiently and to make the set of contracts which is best for themselves; and in pursuing their private interests, they ensure the efficiency of the economy as a whole.

Modern economic theory has questioned most of the underlying economic propositions:

- Markets are not in general efficient, whenever there is incomplete markets, or imperfect information.
- The Coase conjecture is not correct, whenever there are transaction costs, public goods, or imperfect information
- Distributional issues cannot be separated from efficiency issues (the neoclassical dichotomy is not in general correct). The most obvious case in which this is true is whenever there are "agency" costs, and these arise whenever there is imperfect information in labor, land, capital, or product markets.
- Markets are not contestable, so long as there are epsilon sunk costs.

[2] There are other arguments for ignoring distributional concerns. One is the belief on the part of some in trickle down economics, the belief that the best way to enhance the well being of the poor is to increase overall income. But there is little theoretical or empirical support for this hypothesis.

[3] Some go so far as to argue that even when there is a single firm in the market, potential competition—competition for the market place—suffices to ensure efficiency. The recent U.S. Supreme Court decision (reference) limiting the scope of claims on anti-competitive predatory behavior is illustrative of the influence of the Chicago school in this area.

[4] Some go so far as to point out the inefficiencies that result from restricting bonded labor, with an overtone that perhaps even these restrictions should be eliminated.

- Free contracting does not in general result in economic efficiency; in particular, problems arise when contracts between two parties affect third parties (e.g. a loan between parties A and B affects the likelihood of default with Party C). Competitive contracting equilibria are also not efficient whenever there are signaling problems. (e.g. bankruptcy provisions may be used as a costly and inefficient signal.)
- Knowledge is a public good, and intellectual property rights thus introduce a static inefficiency in the economy; whether intellectual property rights is in general the best way of ensuring the efficient production of knowledge is a moot question; but poorly designed property rights, giving temporary monopoly power to a particular corporation or individual, can actually impede innovation at the same time that it distorts the short run allocation of resources.

But more deeply, the Coase conjecture suggests it makes little difference (at least for efficiency) on how property rights are assigned, as longer as they are clearly assigned. But if the neoclassical dichotomy is not true, then how property rights are assigned can affect the efficiency of the economic system; and societal well being may be affected by distributional considerations—which may not be simply and easily altered by political processes.

Rights and obligations

The focus on property rights almost prejudges the nature of the economic system: rights need to be matched with obligations (responsibilities), including the obligation not to abuse one's property rights.

Accompanying intellectual property rights is, for instance, an obligation to disclose information so that others can build on the knowledge. And though intellectual property rights give one a temporary monopoly power in the use of that knowledge, it does not give one the right to *abuse* that monopoly power by engaging in anti-competitive practices. One may even have an obligation to provide interconnectivity.

An owner of land may have the right to use his land, but he may also have the responsibility to make sure that no one uses his land to dump a toxic waste that spoils the underlying ground water. There are efficiency argues for the assignment of these responsibilities (as well as rights): the owner of the land may be in the best position to monitor its usage; it is a natural by-product of other economic activities, including those associated with ensuring the value of the asset.

The Complex nature of property

Property rights can be sliced and diced in different ways, and contrary to Coase, there may be efficiency consequences (e.g. arising from coordination problems) in how property rights are sliced and diced, and how they are bundled.

For instance, an ownership right in a corporation or other property can entail a right to an income and a *control* right, that is a right to determine what can be done with the asset. But there are non-voting shares, which provide an entitlement to income, but no control rights. But the rights of the voting shares are circumscribed: they may not take actions which are considered "unfair" to minority shareholders or non-voting shares. (In a world with perfect contracting, the minority shareholders would know what actions the majority would take before they bought the shares; restrictions would be imposed to protect the interests of the minority. In reality, there are no such protections; they would be impossible to write, and even more difficult and costly to enforce.)

In real estate, there are often covenants and rights of ways, which impose limitations on the sale or use of the asset, and which give rights to others (such a right of passage.)

The complexities are particularly important in the case of claims on corporations, which (like intellectual property, or property rights more generally) is a social construction, providing the "owners" with limited liability. Governments, in creating these "artifices," can impose any set of constraints they wish: they can, for instance, impose constraints on the structure of the governance of the corporations.

The meaning of control

Ownership is defined by certain rights to control. It is actually very difficult to specify fully what one might mean by control rights (and therefore, what one might mean by fully specified property rights); governments, at all levels, have some control rights, in the sense they restrict the kinds of actions that firms can undertake. In the case of "real assets" there are a myriad of constraints on the use of property, imposed by zoning laws, the endangered species act, etc. Governments can affect firm actions more broadly through tax policy and a variety of incentives; banks can insist that the firm take certain action, if they are to extend or not withdraw credit—the firm may have little choice but to accept these demands, especially if has debt obligations that could force it into bankruptcy. I use the term residual rights to control to reflect that, given all of these other constraints, there may still be some scope of choice, and presumably the "owner" has the right to make a choice among this set.

(The issue, of course, is often not what actions are "allowed," but what are the consequences of particular actions. There may be a law that prohibits polluting, but the firm can do it anyway; it simply faces a fine. More generally, others affect the opportunity set of firms, and thus affect what the firm chooses to do. By the same token, legislation may affect what the government does—a law which requires the government to compensate firms for "regulatory takings," for the decrease in the value of an asset as a result of a change in regulation, affects government's incentives for regulating.)

In the simple neoclassical paradigm, workers and the suppliers of other factors have a horizontal supply curve at the competitive market price, so that the actions of the firm have no effect on them. The actions of the firm only affect the residual returns. Thus, the controller of residual rights, in exercising those rights, only affects his own well being; and that is why allowing him to do so freely naturally results in economic efficiency.

But in the real world, that is not the case. There are many stakeholders who are affected by the firm's actions. That this is so can be said to reflect a "market failure," but it is worthwhile

digging deeper to ask, more specifically, why it is that this is the case. Part of the reason is that there is incomplete contracting and incomplete insurance. A worker who goes to work for a firm does not know fully the jobs that will be assigned to him, how difficult or unpleasant the tasks, the hours that he might have to work. The firm might know either (i.e. there may or may not be asymmetries of information.) There are contingencies which cannot be perfectly anticipated. But different actions by the firm can affect the likelihood of more or less pleasant contingencies occurring—and therefore affect the well being of the worker. They might, for instance, increase the likelihood that he will be redundant. The worker may have invested in (firm specific) human capital. But there is no insurance against the destruction of the value of that capital should he be fired.

Bondholders are aware that the firm may take actions which adversely affected their claims on the firm, and that is why there are typically bond covenants. But it is well recognized that these covenants only constrain a fraction of the possible actions which the firm might undertake.

In short, actions of firms—including subsequent contracts with third parties—affect the well being of those who have previously signed (implicit or explicit) contracts. Different governments may take different positions on how these externalities might best be dealt with, e.g. through voice on the boards of directors, restrictions on the kinds of contractual arrangements that can be undertaken, etc. To date, economic theory has not provided a simple set of prescriptions which defines the best set of ways by which these externalities may be handled in all situations.

As an example, some governments take collective action clauses in bonds, which allow a qualified majority (say 85% of the bondholders) to restructure. It is recognized that there may be circumstances in which renegotiation (a new bond) is desirable, but that in such circumstances, a small minority can hold up what might otherwise be a Pareto superior renegotiation, demanding a ransom. On the other hand, the ability of a (qualified) majority to restructure the debt contract means that they can, in principle, redesign the contract in ways that work markedly to the disadvantage of the minority: the minority may not simply be holding up the majority, but may have legitimate differences in interests and perspectives. Regrettably, it is difficult to write a simple legal framework that protects against one abuse without opening up the window to another abuse.

There is another set of "externalities" which may arise, which relate to signaling. Bankruptcy provisions may be used to signal one's likelihood of going bankrupt. Firms that have a low probability of going bankrupt may signal that that is the case by imposing heavy penalties on themselves should they go bankrupt. But it is easy to see that the resulting signaling equilibrium is not Pareto efficient. Signals are costly, and in general, signaling equilibria are inefficient. Governments may enforce a better equilibrium by eliminating the scope for signaling, e.g. by imposing a standardized bankruptcy regime.[5]

[5] In technical terms, this is referred to as imposing a pooling equilibrium. A competitive market equilibrium cannot be characterized by pooling (one of the central results of Rothschild-Stiglitz [See M. Rothschild and J. E. Stiglitz, "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information," *Quarterly Journal of Economics*, 90(4), November 1976, pp. 629-649. The inefficiencies in contractual equilibria are, however, not limited to problems of signaling. In moral hazard models, contracts by one party affect reservation levels and behavior within other contracts. See, e.g. P. Rey and J. E. Stiglitz, "Moral Hazard and Unemployment in Competitive Equilibrium," October 1993, and R. Arnott and J. E. Stiglitz"Labor Turnover, Wage Structure & Moral Hazard: The Inefficiency of Competitive Markets," *Journal of Labor Economics*, 3(4), October 1985, pp. 434-462.

Finally, it is impossible (prohibitively costly) to have contracts that anticipate every contingency. All contracts are incomplete, and there is an important role for government to specify what happens in those contingencies which have not been anticipated—a set of "defaults" which greatly simplify the writing of contracts.[6]

In addition to these externalities, there are a host of more widely discussed macro economic externalities, where decisions by firms have social costs which they do not appropriately take into account (just as firms do not appropriately take into account environmental externalities.) For instance, even without unemployment insurance benefits, firm decisions concerning lay-offs do not, in just, lead to Pareto efficiency[7]; with unemployment benefits in unemployment systems that are not fully experienced, it is obvious that when firm's lay off an individual, it imposes a social cost on others.

Defining property rights

The point of this discussion is to emphasize that the very nature of what is meant by property—the rights, obligations, and constraints-- is defined by the government. And just like there cannot be fully specified contracts (defining what each party will do in every contingency), property (all the rights, obligations, and constraints) cannot be fully specified. New contingencies, not fully anticipated, will arise, and decisions will have to be made. Before society was aware of the dangers of ground water pollution, there was no need to impose restraints on the use of land as a toxic waste dump. Once the danger becomes clear, it is imperative that some constraints be imposed. There is no obvious answer to the question of who should bear the risk. Most governments have decided that society as a whole should not pay compensation for the loss in market value as a result of

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[6] Asymmetric information can also explain why the economy may get stuck at an inefficient contractual equilibria. See "Contract Theory and Macroeconomic Fluctuations," in *Contract Economics*, L. Werin and H. Wijkander (eds.), Basil Blackwell, 1992, pp. 292-322.

[7] This is seen most obviously in efficiency wage models, where wages affect productivity either because of effects on incentives, selection, morale, or labor turnover. For instance, in the Shapiro-Stiglitz "shirking" model, firms must pay a high enough wage to induce individuals not to shirk. The requisite wage depends on the unemployment rate and the late of time that individuals remain in the unemployment pool. Firms that have a policy of letting go of labor more easily lead to higher labor turnover, and, at any unemployment rate, a shorter duration in the unemployment pool. This means that the equilibrium unemployment rate will be higher. More generally, it is optimal to throw "sands in the wheels": some friction, e.g. associated with mandatory severance pay. See C. Shapiro and J. E. Stiglitz, "Equilibrium Unemployment as a Worker Discipline Device,", *American Economic Review*, 74(3), June 1984, pp. 433-444; Richard Arnott and J. E. Stiglitz, "Labor Turnover, Wage Structure & Moral Hazard: The Inefficiency of Competitive Markets,", *Journal of Labor Economics*, 3(4), October 1985, pp. 434-462; Patrick Rey and J. E. Stiglitz. "Moral Hazard and Unemployment in Competitive Equilibrium,". October 1993; J. E. Stiglitz, "Alternative Theories of Wage Determination and Unemployment in L.D.C.'s: The Labor Turnover Model," *Quarterly Journal of Economics*, 88(2), May 1974, pp. 194-227; J. E. Stiglitz, "Alternative Theories of Wage Determination and Unemployment: The Efficiency Wage Model," In *The Theory and Experience of Economic Development: Essays in Honor of Sir Arthur W. Lewis*, M. Gersovitz, et al. (eds.), London: George Allen & Unwin, 1982, pp. 78-106; and J. E. Stiglitz, "Prices and Queues as Screening Devices in Competitive Markets," in *Economic Analysis of Markets and Games: Essays in Honor of Frank Hahn*, D. Gale and O. Hart (eds.), Cambridge: MIT Press, 1992, pp. 128-166

the pssage of a regulation (a so-called regulatory taking), perhaps because it is clear that paying firms not to pollute introduces an inefficiency in the economy. There is a long standing presumption that one should not impose externalities on others; polluting is imposing costs on someone else. A regulation restricting such behavior is simply a more efficient way of inducing good behavior than forcing those engaging in pollution to compensate those that have been damaged.

Particularly problematic are definitions of rights, obligations, and constraints associated with social constructions, like corporations and intellectual property.[8] In the previous section, we considered some of the issues concerning corporations.

In the case of intellectual property, there are a host of issues: does owning intellectual property give one the right to stop others from using that knowledge, or only the right to be compensated? There are important consequences to how this question is answered, particularly in a world of costly transactions and imperfect information. (With perfect information and costless transactions, the owner would act as a perfectly discriminating monopolist, ensuring that the knowledge was used efficiently, but extracting the full value of the rents. With imperfect information, the costly bargaining between the owner of the intellectual property and those who might use it as a basis of a new innovation may result in the restricted use of the knowledge—a dynamic inefficiency.)

From Coase to Desoto and beyond

In short, there is a certain emptiness to the slogan that there should be well defined property rights: it is impossible to have perfectly defined property rights; there may be large costs associated with further refinements (removing further ambiguities); and saying that there should be well-defined property does not say how these questions should be answered. And contrary to Coase, how one answers these questions does make a difference.

There is a further problem: In the status quo (*before* "precisely" defining property rights), there are certain outcomes to economic interactions. They may not be perfectly predictable, but there are still patterns that can be ascertained. There may have been some ambiguity about ownership claims in TVE's, but still, there was a governance structure (someone made decisions), and there were consequences of those decisions (some individuals received some of the income generated by the TVE's; some bore some of the risks.) Thus, assigning property rights typically means a *reassignment*, and this is especially true in circumstances where property rights are ill defined, so that it is hard to determine who is the effective recipient of the returns to the assets or who has effective residual control. In other words, the "clear" assignment of property rights is almost never just a conversion of *de facto* rights into *de jure* rights. That is why property rights legislation is often so contentious. If it were just a matter of clarifying existing rights, it

[8] In a sense, all property rights are social constructions; the definitions of rights, obligations, and constraints associated with real property have evolved over centuries, and therefore are more likely to be taken for granted.

would presumably be a Pareto improvement, simply because it would lower transactions costs.

This is one of the reasons that "legal transplanting"—taking the legal frameworks developed for one country to another—often encounters problems. (The other reason is that there are typically a host of implicit rules and understandings that govern the interpretation of language and practice. Even if the formal language is transplanted, the accompanying interpretations are not. What would the parties to the contract reasonably have understood by the words of the contract? What is meant by "due care"?)

Those, like Desoto, who seem to suggest that the most important problem facing developing countries is the assignment of well-defined property rights make two further errors. Not only do they follow Coase in suggesting that assigning property rights will *solve* complex social problems, but they also often seem to suggest that it is the only way.

We have already illustrated some of the ways in which the first proposition is wrong, e..g. in the case of externalities. The one inefficiency which is most often discussed which assigning land property rights is asserted will solve is credit market imperfections; using land as collateral will facilitate the development of credit markets, and thus improve overall economic efficiency. But giving title to land will not necessarily give rise to a land market, especially of a thickness that can support its use as collateral. Moreover, local courts may be loath to turn over land to creditors in the event of a default. And there are other ways of improving credit markets, e.g. through the revolving credit schemes used by Grameen bank and other micro-credit institutions. In addition, one can collateralize the *produce* of the land, even if one can't collateralize land itself.

By the same token, assigning property rights to the lords in the 17th century enclosure movements may have been one way of avoiding the tragedy of the commons, the problem of overgrazing. But most communities have found more equity ways of overcoming the tragedy of commons, e.g. by restricting the usage of the commons, i.e. by regulation. Indeed, the distributive consequences of the enclosure were almost surely larger than the efficiency gains.

Many contend that this may be true today, for the current enclosure movement, the enclosure of common knowledge, its privatization through unbalanced intellectual property regimes.

The fallacious nature of the simplistic property rights school is deeper; for it may not even result in enhanced efficiency.

Consider the efficiency consequences of allowing individuals to sell (without restriction) their land. To answer this question, one can construct a dynamic model of land ownership, which specifies the conditions under which individuals sell (or buy) land, e.g. illnesses of parents for which there is a medicine that is available that can provide treatment, but for which the public sector will not pay; the societal costs of inequalities in land ownership (or more accurately, the agency costs associated with a disparity between

labor and land ownership). Such a dynamic model could describe the incidence of landlessness, the consequences of which in turn may depend on the pace of job creation in the urban sector, and the levels of education in the rural sector. Finally, one could contrast the outcomes of unrestricted property rights with a system in which individuals are allowed to mortgage (a fraction) of this year's output, but not the land; there would be a short run static inefficiency, arising from capital market imperfections (the extent of which might depend on other attributes of the capital market), but this short run inefficiency might be much less than the long run inefficiency associated with the greater agency costs arising from more extensive landlessness that would emerge in a system with unfettered rights to sell. In short, while unfettered rights to sell might lead to enhanced efficiency in a world without agency costs, it may lead to reduced efficiency in a world with agency costs.

By the same token, many laws and regulations arise to protect individuals against the abuse of market power; or to enhance the efficiency of the market, when there is some other form of market failure. With imperfect information, restrictions on conflicts of interest may lead to increased efficiency.

To be sure, in many of these cases, contract terms (with penalties for breach) might do as well, but there are savings in transactions costs[9] in having standard contracts[10].

[9] Not only savings in writing contracts, but in interpreting them. Again, standard contractual forms could arise naturally. But difficulties arise with interpreting the (inevitably) incomplete contracts.
[10] Additional problems may arise from signaling inefficiencies.

IV. Hayek and the "Second Generation" Chicago School

The Chicago school focused on the design of institutions to ensure economic efficiency. There has been another "conservative" tradition, derived not so much from neo-classical economics, as from Hayek. This focused on evolution: the design of an economic system should be such as to facilitate growth and change. It sees its intellectual antecedents more in evolutionary biology than in classical physics. It, too, focuses on "efficiency," but often economic objectives are seen as secondary to a broader objective of individual fulfillment, and this necessitates individuals have "freedom" to pursue their own desires and ambitions.

There are several problems with this perspective. Focusing on the narrower economic conception, there is, in fact, no theory that unfettered markets will facilitate efficient evolution. While evolutionary models have not been the object of the careful kind of scrutiny to which the equilibrium models discussed in the previous section have been subjected, it is already clear that many of the "market failures" are as relevant to evolutionary behavior as they are to equilibrium behavior. A firm that has, for instance, high long run growth potential may be wiped out by a macro-economic downturn; it cannot borrow against its long run profit potential to tide it over its current difficulties. Firms that are weeded out in crises may be just as efficient as those that survive; the main difference may be their choice of financial structures (debt equity ratios), which may have little to do with their real dynamic potential.[11]

There are at least two problems with the broader perspective. First, one individual's freedom may impinge on the rights of others. One individual's right to smoke takes away another individual's right not to die from second hand pollution. Externalities constitute on the main reasons for collective action.

There is another reason for collective action: through collective action, all individuals can be made better off; or in the language of "fulfillment," all individuals can be made better off, e.g. through collective expenditures on public goods. To be sure, forcing individuals to pay taxes may impinge on their "freedom," but (if we could get them to tell the truth) they would agree that the benefits they get more than compensate.

There is a final problem—and perhaps the most important. And that is one individual's "fulfillment" may come only at the expense of constraints imposed on others, not just because of externalities, but because the realization of an individual's potential requires expenditures (on education, food, health care), that that individual may himself may not be able to afford. To finance these, taxes must be imposed on others.

Political Economy

[11] Indeed, the evidence in the case of the Korean crisis of 1997-1998 is consistent with this perspective.

The focus on *change* is picked up in another strand of (what I loosely call) the Chicago School. Political decisions are viewed as endogenous; decisions today (about institutions, or about the distribution of income, or about policies) affect decisions in the future. A decision today about the voting rule (whether a majority is required, or a supermajority for making a particular decision) affects the decisions that will be made in the future. Each decision has to be evaluated for its future consequences; and the most important decisions are those that affect decision making processes.

Earlier we discussed the Coase Theorem (or conjecture.) More recent discussions of transition from Communism to the Market have emphasized the Political Coase Theorem, arguing that the assignment of control rights, even before there is a clear rule of law which specifies how those rights might be used or abused, will lead to the adoption of a Rule of Law, with clearly specified property rights. Hoff and Stiglitz have argued, to the contrary, that the way control rights were assigned (under shock therapy, rapid privatization) as well as specific policies that were adopted (high interest rates, capital market liberalization) undermined the demand for the rule of law and help explain why in so many of the FSU countries a rule of law has not emerged.

Legitimacy of property rights

We have noted that governments have a variety of ways (short of outright expropriation) of imposing restrictions and taxes which, in effect and in a sense, deprive the "owner" of his property rights. They decrease the (expected present discounted) value of the asset (to the owner).

There are always, of course, questions about the extent to which they do so. If the increase in a tax or a new regulation was anticipated, then there will be no change in market value; and indeed, failure to enact the tax or regulation as anticipated would lead to an increase in market value. No government will (or should) fully circumscribe its ability to adopt legislation that will allow it to respond to new information and changing circumstances. As noted earlier, if a firm has been polluting groundwater, poisoning others, in a way that was unnoticed (and perhaps even not known), once it becomes known, it should be stopped—and it is not obvious that it should be compensated for not poisoning others.

Inevitably, this gives rise to a certain sense of insecurity of property rights. Insecurity of property rights adds to the risk premium, discouraging investment. Property rights legislation must balance out the costs and benefits. In the United States, recent trends have emphasized paying more attention to the costs (and perhaps resulting inequities) of changing regulations—though I suspect that this is motivated little by an analysis of the economic costs; legislation has focused on forcing those proposing new regulations to quantify the costs and benefits.

There are many countries (including most of the economies in transition) where questions have been raised about the legitimacy of existing ownership claims (see discussion below.) Some have advocated that such issues should be put aside; it is more important to have secure property rights. Hoff and Stiglitz have argued, however, that it is not possible for any society to provide such security. So long as there is a widespread view in society that such rights were obtained illegitimately, there will always be political pressures for property rights reform. And no government can fully bind successors (though they can make it more difficult or most costly for successor governments). One of the reasons for having "good" property rights laws (widely accepted as "legitimate," and not the result of special interests) accompanied by good judicial procedures (see section below) is that it enhances the chances that ownership claims will be viewed as legitimate, and thus that property rights will be more secure.

V. Adaptive Frameworks

The evolutionary approach rightly stresses change: just as no contract can fully anticipate all the contingencies that the parties to the contract may face, no law can fully anticipate all the contingencies, all the disputes, that might arise. (If the law could anticipate all of these contingencies, so presumably could the parties.) These concerns are especially important for China: it has an economy with distinctive characteristics, and it is changing rapidly. It can learn from the problems facing other economies, but inevitably some of the issues which will be faced are *sui generis.*

Problems arise when society and the economy change in ways which make the legal (and other aspects of the institutional) infrastructure inappropriate—unable to deal effectively with the new problems that confront society. That is why one of the most important features of a good legal framework is adaptability and flexibility.

At the same time, there is a cost: excessively frequent changes give rise to legal uncertainty. And the frameworks that allow for flexibility often have their own problems. Ordinary legislation requires broad consensus (in the U.S., for instance, a minority can often effectively veto at least major pieces of legislation.) Powers are delegated to regulatory bodies to enact regulations that respond to the changing situations. But the regulatory bodies are often captured by special interests, and in particular by those they are supposed to be regulating.

Some advocate self-regulation as a more flexible alternative. But it is hard for an industry group to reflect adequately the interests of its customers. (The problems were brought to the fore by the difficulties at the New York Stock Exchange.)

In short, there needs to be flexibility in the degree of flexibility and adaptability, accompanied by regular review processes that highlight problems in the institutional/legal infrastructure, that allow some changes to the regulatory framework under the aegis of a regulatory agency, but which submit more fundamental changes to political processes.

VI. Ex ante vs. ex post regulatory frameworks

Regulations, broadly defined, change the opportunity set facing firms and individuals in ways which alter their behavior, to induce behavior which is more congruent with social objectives. One can induce individuals not to pollute either by taxing pollution, by imposing formal regulations, or by making individuals pay for the damage done by the pollution, through a liability system. The last forces individuals to take into account more fully the costs of their actions. With a fully articulated set of liability laws, regulations directed at least at negative externalities would be unnecessary. There would be no negative externalities; they would all be internalized. But such a system is likely to entail high administrative costs. Perhaps the worst example is provided by the U.S. law concerning toxic wastes, where litigation costs represent more than a quarter of the amount spent on clean-up. It is often difficult to ascertain who is to blame for a particular problem. And sometimes, it is difficult to ascertain how much the individual should be compensated—in some cases no amount of money would really adequately compensate an individual. Thus, in many cases, it is more efficient to rely on a system of ex ante regulations and inducements.

Of course, all of these affect the "value" of an asset, for they reduce the return that can be obtained from it. But this discussion also helps explain why, ordinarily, there should be no compensation for regulatory takings: if the regulation is directed at limiting a negative externality, the effect on the value of the property will be limited, so long as the individual had previously faced liability for these negative externalities.

One of the problems with many liability systems is that they intertwine the design of incentive systems with compensation systems. The liability penalties that are imposed on individuals when they have an accident, to compensate those that have been injured, in general do not equal the penalties that we might impose if our objective was to induce individuals to take the right amount of care in driving. An argument can be made for the separation of these two functions.

VII. Distributive Concerns

The Chicago School emphasized the role of property rights and other institutions in promoting efficiency. But institutions (and one can think of property rights as an institution) have often served another function: maintaining existing inequalities. We have already discussed how the 17th century enclosure movement was more about redistribution of wealth than an increase in efficiency: there were alternative ways in which the tragedy of the commons could have been avoided without the distributional consequences of the enclosure movement. The current movement for the privatization of knowledge may have its roots more in a movement to increase certain incomes in the advanced industrial countries than in enhancing innovation. It may actually retard innovation. (And if it were primarily concerned with incentives, it

would have provided more incentives for the preservation of biodiversity and greater protection of traditional knowledge.)

Whatever rules are adopted, of course, will have distributive consequences. If the neoclassical dichotomy were correct, this itself might not be of that much concern: the consequences could always be undone by lump sum redistributions. But, as we have seen, efficiency and equity concerns cannot be easily separated.

Matters are worse: often the reason particular rules and regulations and institutions persist is that they have distributive effects that could not be achieved (or achieved easily) in other ways. (This is related to the earlier point: there is always an implicit set of property rights, entitlements, and a change in the legal framework accordingly inevitably has distributive consequences. One of the problems with formalizing property rights that exist is that by making such rights more transparent, they may make them political unacceptable.[12])

But while property rights (and institutions, rules, and regulations more broadly) may be used to protect existing inequalities, they can also be used to advance broader notions of social justice. One might argue that it might be more efficient to do this through lump sum transfers, but such transfers are not feasible, and especially in developing countries, there is a high opportunity cost to the funds. Social legislation may be a more effective way of targeting. For instance, affirmative action programs circumscribe what businesses can do; they may, as a result, be viewed as redistributing wealth from businesses (and, since some of these costs are passed on to consumers, from society more broadly) to the disadvantaged group. But the benefits that they bring may be far greater than the value of the profits lost by firms.

Much social legislation (restrictions on businesses) arise out of a belief that the market is unfair. Much of this is based on the premise that the economy is not really fully competitive; there are many "bargaining" problems, and in the bargains, the poor and the less educated do poorly. There are rents to be divided, and they get a disproportionately small share of these rents. Rules and regulations can change the outcome, and while there may be some efficiency costs, the redistributive benefits outweigh these efficiency costs.

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[12] This also helps explain why it is often difficult to make seeming Pareto improvements, e.g. converting distortionary agriculture subsidies into a lump sum annual equivalent. . Because governments cannot make binding commitments, farmers would not believe that those payments would continue, once their magnitudes become clear—it would almost surely be unacceptable for a rich corporation to receive millions for doing nothing, though it is acceptable for the same corporation to receive similar amounts for producing corn. But there is in fact a double commitment problem: even if the farmers were to agree to take a lump sum payment up front, in return for the elimination of their subsidies, it may be difficult to enforce. After they receive the up front payment, they may once again lobby for subsidies.

In this view, then, how property rights are designed and assigned can make a great deal of difference, and not just for the efficiency of the economy. Land reform, redistributing land from large landlords to peasants, can increase economic efficiency by eliminating agency costs. But making it more difficult for government to use its right of eminent domain to take land away from poor peasants, to be used for development projects which may be of more benefit to others, will ensure that they get a larger share of the rents associated with the redeployment of land.

Property rights in transition economies

Many transition economies have faced a difficult time in the initial assignment of property rights. Should they restore property as of 1944, 1945, 1946, etc. Often, there were a series of land redistributions. Land often changed hands. Which date one selected for restitution could have large effects on the well-being of particular individuals.

Russia is facing another problem: many of the assets held by oligarchs were obtained in methods that were questionable at best. Should one ignore how the property was acquired? Western governments do not sanction stolen property; a person who buys stolen property may still be forced to return it to the original owner. There is a responsibility imposed on the buyer to ensure that the property rights of the seller are "legitimate." Much of the property of the oligarchs can be viewed as stolen from the State.

But this raises a difficult issue: if we trace property back in history, there usually comes a point at which questions can be raised about legitimacy. Most of the land in the U.S. was taken from the American Indians in a manner which is at best questionable.

China too faces a similar problem; questions can be raised about the origins of the wealth of many individuals. If there is no security in their property rights, then they will have an incentive to take their wealth out of the country as fast as possible (a problem evident in Russia). If they are given full security, it would in effect be sanctioning behavior which is socially destructive. Addressing these questions is a key issue that has to be resolved as China defines its property rights regime.

VIII. Adjudication of disputes

Inevitably, there will be disputes, and how these disputes are resolved is critical in determining the legitimacy of property rights. In Russia, bankruptcy law has been used through corrupt judicial processes to take property "legally".

One of the reasons that there are disputes is that contracts are incomplete—not all contingencies are specified. *But for the same reason, legal systems are incomplete—*

they cannot fully specify what should be done in those circumstances in which the contracts themselves do not specify what should be done. The "law" lays out a set of principles that serve as a guide to judges, and that help the litigants predict the outcome of the dispute. But if the outcome were fully predictable, then the matter would not go to court. Of course, the parties themselves may know the "truth" of the matter, but they also know that the judge has imperfect information, and therefore will not necessarily know all the facts and circumstances. In a sense, then, even were the contract complete, disputes can arise, because one party may believe that the facts can be framed for the judge in ways which will lead (with some probability) to a more favorable outcome than would have emerged had the contract been honored.[13]

Over time, there may emerge certain patterns, certain circumstances in which disputes arise with regularity. "Fairness" requires that there be a certain degree of consistency, and most legal frameworks put considerable emphasis in their attempt to maintain consistency. The facts and circumstances in each case differ, so that there is always an issue of the extent to which a particular case is sufficiently similar to others that the results of these previous outcomes should guide the current one. Much of legal analysis is directed at precisely this question.

The drive for consistency has one problem: an initially "wrong" decision (wrong from the perspective either of efficiency or equity) can lead to a series of wrong decisions. All humans are fallible, and human fallibility provides one of the justifications of our system of checks and balances. (See also Sah and Stiglitz (1984, 1986, 1987) It is one of the reasons that most important decisions are made by large groups (legislatures), often with implicit or explicit supermajority rules. Judicial decisions are, by contrast, made by small panels (sometimes by a single judge). But while the judge has, in that particular case, a large degree of power, he is constrained by a set of decisions (and legal frameworks) that have been arrived at by large numbers of individuals. Appellate processes provide some checks and balances (although again, it is typically a limited number of individuals.) But the broader implications of the decision are subject to further checks, as similar cases are reviewed by different courts. If they believe that the weight of the arguments and evidence is such as to come to a different conclusion, they will reverse the finding. Finally, the legislature can always override the Courts, redefining the "law" in the circumstances at hand.

These processes are slow and cumbersome, and particularly when the world is changing rapidly, there is a large risk that laws and interpretations of those laws made for one set of circumstances become ill suited for another. What seemed fair at one time may seem unfair at another; what provided reasonably good incentives at one time may provide distorted incentives at another. There is another aspect of the fine balance in flexibility and adaptability discussed earlier. A more flexible system (one

[13] I say, "in a sense," because a fully specified contract would presumably take into account what is observable to a third party (the judge), and specify what is to be done in these circumstances, where what is observable to a third party differs from what is observable to the parties themselves. In other words, they would take into account the possibility of dishonesty.

in which the judge was less constrained by previous decisions) would, at the same time, risk being a more capricious system. The optimal degree of flexibility will differ depending on the pace of change in society. China's rapid pace of change suggests the need for more flexibility than that embodied in many Western systems, which evolved in periods of very slow change. At the same time, to reduce the resulting risk of capriciousness, there needs to be greater investments in review processes—more review procedures, larger panels of judges, and more frequent review of the emerging legal standards by broader legislative/administrative authorities.

Westerners often talk about the important of having a judiciary that is independent of political influence. But this confuses two separate issues. What they mean (or should mean) that it is important to have a judiciary which makes its rulings based on the "law," not on wealth or political connections. What they should not mean is that the law itself should be independent of political processes.[14] The judiciary is supposed to interpret the laws passed through political processes. Shouldn't those engaged in these political processes have some say in deciding whether the interpretations that Courts have provided are consistent with what they intended? Of course, as laws get adopted through political processes, different individuals or groups may have different objectives, and understand the law in different ways. Often, ambiguity in interpretation is part of the process of compromise. But in a society where there is a clearer sense of what the "consensus" was, there may be scope for more active political reviews of the consistency of Court interpretations with what was intended, and there may be more scope for learning—as the consequences of particular rules and regulations become clearer, adapting them to ensure that the law is consistent with the intended consequences.

[14] There may, in addition, be a desire to insulate the laws from the short term vagaries of political processes.

VIII. Questions for discussion

Have we identified the most important property rights issues facing China today? And to what extent do these conceptual foundations help us answer these questions?

A. Should leaseholds in the rural sector be converted to freeholds?
    a. Should there be restrictions on the sale of land?
    b. Should there be restrictions on the use of land as collateral?
    c. Should government policy discourage land speculation? What are the social returns to land speculation? The social costs? (Increasing the opportunity for insider dealing, corruption)
        i. Is this best done through restrictions on property rights or by tax policy
B. Should there be a different legal framework for urban land?
C. Under what conditions should the government be able to exercise its right of eminent domain?
    a. Only for public use? Or for development purposes?
    b. Should compensation be based on pre-development value, or post-development value?
        i. Why should those who are "lucky" enough to own land at the right location get a larger share of the social surplus than others?
    c. Are there ways of providing compensation that avoid the economic risks of taking away a farmer's land (e.g. a non-transferable long term bond yielding annual returns, to compensate for the loss of income)
        i. Can anything be done to reduce the social disruption
        ii. Would a high tax on the capital gains enhance the sense of equity
            1. But can that be well identified?
D. How should property which has been obtained in ways that are not fully transparent, or legitimate, be treated? Can a high capital gains tax restore a sense of legitimacy?
E. How can society adequate protect "implicit" property rights? What are the most important of these rights and entitlements? Should they be made explicit?
F. How important is it that the laws and procedures of China be similar to those in other countries?

How should China balance the needs for "flexibility," "consistency," and an appropriate set of checks and balances? Should China invest more in developing review procedures for outcomes of property rights decisions, to ascertain whether they are consistent, and consistent with broader social objectives? Should there be a flexible way of "correcting" wrong *patterns* of decisions, reversing precedents that seem inconsistent with broader social objectives?