

PRIVATE PROPERTY—A PREREQUISITE FOR CLASSICAL CAPITALISM

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Introduction

It is not true that administration of an economy is simply a technical problem devolving from the basic 'given' conditions. (Warren G. Nutter, *Political Economy and Freedom*, Indianapolis, Liberty Press, 1983, p.102.)

In 1968, the late G. Warren Nutter published an article on “Markets Without Property: A Grand Illusion.” While some scholars consider this article a classic, all others should. As the following quote shows, back in 1960s, Nutter anticipated the direction as well as the findings of contemporary research on the social and economic significance of private property rights. “Markets without divisible and transferable private property rights are a sheer illusion...There can be no competitive behavior, real or simulated, without dispersed power and responsibility.”¹ This paper follows in Nutter’s footsteps. Hence, its purpose is to argue that capitalism without credible and stable private property rights is an illusion.

The first section of the paper describes classical capitalism and its relationship with individual liberty. The second section is about private property rights and their behavioral incentives. The last two sections of the paper identify major critics of classical capitalism and discuss a few attempted alternatives. The following terms are used interchangeably throughout the paper: classical capitalism, the Anglo-American capitalism and the private-property, free-market economy.

Classical Capitalism and Individual Liberty

Liberty, what crimes are committed in thy name.
(Mme Roland, quoted by Lamartine, *Histoire des Girondinas*, Oxford Dictionary of Quotations, 1964, p. 408.)

Classical capitalism emerged toward the end of the 18th century in response to the social, political and economic consequences of many factors dating as far back as the 15th century. Those factors included new frontiers, the advance of science, new entries into the market for salvation, the rise of entrepreneurship, and development of capital

markets. Adam Smith called it the Natural System of Economic Liberty, an appropriate but also a clumsy name. Marxists and other critics of the system, with a tone of disapproval, named the system capitalism. It is surely a wrong name, but it prevailed.

The cornerstones of the private-property, free-market economy are classical liberalism and methodological individualism. Classical liberalism is about individual liberty, openness to new ideas, and tolerance of all views. We can trace the birth of classical liberalism to the writings of great thinkers from the 15th to 18th centuries, such as John Locke, David Hume, Bernard Mandeville and Adam Smith. And we should attribute the resurrection of classical liberalism and individualism in the second half of the last centuries to a number of scholars including Milton Friedman, James Buchanan, Bruno Leoni, Friedrich Hayek and Ludwig von Mises.

Methodological individualism means that the unit of analysis is the individual. Governments, think tanks, universities and other organizations do not make decisions; only individuals can. Individuals conceive ideas, invest time and effort in formulating them, and persuade others to accept them. Professor Alan Macfarlan traced the origin of individualism in the West to 13th century England. He defined it as “the view that society is constituted of autonomous, equal units, namely separate individuals and that such individuals are more important, ultimately, than any larger constituent group. It is reflected in the concept of individual property, in the political and legal liberty of the individual, in the idea of the individual’s direct communication with God.”²

To move classical liberalism and individualism from the realm of ideas into the real world required a new set of institutions or the rules of the game. Indeed, the process of institutionalizing classical liberalism and methodological individualism is traceable to numerous events which occurred between the 17th and 18th centuries. Among those events are the Glorious Revolution, the Religious Reformation, the adoption of common law in England, and the US Constitution. The institutionalization of classical liberalism and methodological individualism created a self-generating, self-propelling and self-

¹ G. Warren Nutter, “Markets Without Property: A Grand Illusion,” in *Money, the Market, and the State* (eds. N. Beadles and L. Drewry, jr.), Athens: University of Georgia Press, 1968, p.144.

² Alan Macfarlane, *The Origins of English Individualism* (London: Blackwell, 1979), 196.

regulating system which we refer to as classical capitalism or private-property, free-market economy or Anglo-American capitalism. The behavior of individuals in classical capitalism is guided by self-interest, self-responsibility and self-determination. Simply put, classical capitalism is about letting each individual pursue his private ends, given other individuals' right to do the same.

Adhering to the basic premises of classical liberalism and methodological individualism, the Anglo-American capitalism has a strong dose of skepticism about public-decision makers' foresight and their goodwill. It perceives the state as a predator requiring *the rule of law* to tame it. Bruno Leoni and Friedrich Hayek defined the rule of law as the absence of arbitrary power on the part of the ruling group; subjection of all citizens to the same laws; stable and credible rules for property rights; and democratic elections.¹ Properly considered to be a key guarantor of negative rights, the rule of law protects the rights of individuals from potential predators including a majority rule, decision makers in governments, labor unions, and other rent-seekers. The bottom line is that classical capitalism requires the rule of law.

It is important to understand that the idealized model of the rule of law, which classical capitalism requires, is merely a perfect blueprint for evaluating and comparing legal institutions in capitalist countries. The closer the country comes to the rule of law the stronger is classical capitalism in that country. Moreover, given a country's distance from the rule of law, the critical policy issue is: what kind of institutional changes would move that state closer to classical capitalism? Depending on the incentives under which they operate, and the constraints on their decision-making powers, the carriers of change (social, political and/or economic innovators) have two basic choices. They can give individuals more rights to pursue their private ends. Conversely, the carriers of change can take some rights away from individuals.

Economic theory and empirical evidence have demonstrated that the choice of institutional changes determines economic performance. James Gwartney, one of the founders of the Economic Freedom of the World Index, wrote "The maintenance over a

lengthy period of time of institutions and policies consistent with economic freedom is a major determinant of cross-country differences in per capita GDP; cross-country differences in the mean rating during 1980-2000 explain 63.2 percent of the cross-country variations in 2000 per capita GDP."²

It follows that the economic efficiency of the use of resources is expressed in the process through which voluntary interactions are carried out, leading into the unknown results. That is, economic efficiency does not depend on the attainment of some desired quantitative results. In fact, emphasis on quantitative results invites *dirigisme*.³ It is not to say that quantitative results are not relevant. They are meaningful as long as they are the result of voluntary interactions among competing individuals. A set of institutions that offers greater incentives for voluntary interactions is then more efficient than another set of institutions that provides weaker incentives for free exchange.

It is then misleading to consider classical capitalism as an alternative method for the allocation of resources. The Anglo-American capitalism is *a way of life*. It endows individuals with credible and stable rights to voluntarily interact in the pursuit of their own private ends and, in doing so, create an order. This interaction of utility seeking individuals takes place in competitive markets, which are a network of contractual rights and responsibilities. Competitive markets assure individuals of the right to exploit all exchange opportunities they subjectively consider beneficial as well as to invest their time and resources in the search for new exchanges. Thus, competitive markets are both just and efficient. They are just because they free individuals from having to pursue someone else's objectives. And they are efficient because in combination with the incentive effects of private property rights, the issue to which we now turn, open market

¹ See Friedrich Hayek, *The Constitution of Liberty*, Cicago: University of Chcago Press, 1960, especially part II; and Bruno Leoni, *Freedom and the Rule of Law*, New York: Van Nostrand Inc. 1960.

² James Gwartney and Robert Lawson, "What Have We Learned From the Measuremnt of Economic Freedom," in *The Legacy of Milton and Rose Friedman's Free ti Choose* (eds: M.Wynne, H. Rosenblum, R. Formaini), Federal researve bank of Dallas, 2003, p.220

³ There is no a priori reason for judging a policy that promises 5 percent growth of GDP to be more efficient than a policy that promises a zero percent growth. My freely chosen decision to spend \$1,000 on wine and women represents a more efficient use of resources than my being forced (or induced via tax or other incentives) by the state to invest the same \$1,000 in a project that promises a 5 percent rate of return.

competition tends to eliminate differences between private and social costs of using scarce resources.

Private Property Rights and their Significance

A property right is the liberty or permit (under the sanction and protection of custom and law) to enjoy benefits of wealth--in its broadest sense--while assuming the costs which those benefits entail... It will be observed that property rights, unlike wealth or benefits, are not physical objects nor events, but are abstract social relations. A property right is not a thing. (Irving Fisher, *Elementary Principles of Economics*, New York: Macmillan, 1923, p.27.)

The right of ownership contains three components setting it apart from other types of property rights: exclusivity of ownership, transferability of ownership, and constitutional guarantees of ownership. Those components of private property rights generate their own incentives which, in turn, affect human behavior in specific and predictable ways.

The exclusivity of ownership means that the owner has the right to choose what to do (or not do) with his goods.¹ He bears the costs of his decision and captures the benefits. The exclusivity of ownership then generates strong incentives for the owner to invest time and effort (up to the point of marginal equivalencies, of course) in seeking the most beneficial use for his good. The world is full of observations that support this proposition. Individuals take better care of cars they own than of those they rent, private lakes are cleaner than public lakes, and to blame human greed (as environmentalists and conservationist like doing) for the disappearance of the buffalo from Texas prairies begs the question of why the same greedy Texans have preserved cattle.

The transferability of ownership means that the owner has the right to transfer his asset to another person at a mutually agreed upon price. The transferability of ownership creates two important incentives. First, the owner of an asset can capture the value of his assets in a lump sum or as a flow of benefits over that asset's life (i.e., I can sell the building I own or choose to continue collecting rent). This choice, which no other type of property

rights makes available, provides individuals with incentives to adjust their portfolios in accordance with their attitudes toward risk. That is, a risk averter can sell stocks and buy government bonds, while a risk taker could do just the opposite. Second, the transferability of ownership provides individuals with incentives to move privately owned goods from less productive to more productive owners.

Suppose that my income from the barber shop I own is \$1000 per year. My neighbor believes that he could earn \$1,500 per year operating the same business. At 10% interest, and assuming that my subjective evaluation of this business is below \$15,000, my neighbor and I have incentives to negotiate a deal. Depending on our respective bargaining skills, my barber shop will move from a less productive to a more productive user at a price between \$10,000 and \$15,000.

The constitutional guarantee of private property rights makes private property credible (enforced) and stable. Property rights that are not enforced or are only loosely enforced result in higher transaction costs of exchange and, consequently, fewer exchanges. And that is bad for economic performance. On the other hand, credible (enforced) private property rights reduce the transaction costs of exchange and provide individuals with incentives to identify and exploit additional exchange opportunities. Credible private property rights also create incentives for individuals to seek and accept contracts with individuals who are either far removed from their location or whose values they not know or both.

Frequent changes or expectations about changes in the rules governing private property rights reduce the stability of private property rights. A reduction in the stability of property rights increases the risk and uncertainty associated with decisions that have long-run consequences. And an increase in the risk and uncertainty raises the costs of decisions that have long-run consequences (e.g., purchasing land, investing in buildings and other not-so-liquid assets) relative to short-run exchange opportunities. Thus, stable private property rights provide individuals with incentives to exploit the most beneficial exchange opportunities regardless of their time horizon.

¹In a rule of law state, the exclusivity of ownership is limited only by restrictions explicitly stated in the

Two examples illustrate the importance of stable and credible property rights. The first example is from today's Russia. Referring to the purchase of Yukos Oil Company by the 100 percent state-owned oil company Rosneft as both legal and done in absolute conformity with market mechanisms(!), Vladimir Putin has accelerated the on-going destabilization of private property rights in Russia.¹ Predictably, the Index of Economic Freedom, has downgraded the score for private property rights in Russia from 3.0 in 2001 to 4.0 in 2005.² I conjecture that investors in Putin's Russia are seeking a shorter payoff periods than in the West. The second example goes back to the Great Depression in the United States. Economic theory and empirical evidence have shown that president Roosevelt's New Deal attenuated private property rights and, consequently, prolonged the Great Depression until after World War II ended. Robert Higgs wrote: "From 1935 through 1940, with Roosevelt and the ardent New Dealers who surrounded him in full cry, private investors dared not risk their funds in the amount typical of the late 1920s. In 1945 and 1946, with Roosevelt dead, the New Deal in retreat, and most of the wartime controls moved, investors came out in force."³

It is clear that private property rights endow the owner with more rights in a good than other types of property rights. And the more rights the owner has in a good the more costs he bears from using it. To say that the owner bears more costs means that social costs are being internalized. Internalizing social costs of using privately owned goods means that the right of ownership eliminates the gap between private and social costs. Ronald Coase captured this difference between private and other types of property rights as follows: "[Individuals] who are normally only interested in maximizing their own incomes, are not concerned with social costs and will only undertake an activity if the value of the product of the factors employed is greater than their private costs...But if private cost is equal to social cost, it follows that individuals will only engage in an activity if the value of the product of the factors employed is greater than the value which they would yield

law.

¹ <http://www.rferl.org/featuresarticle/2004/12/e9671558-8078-4725-87b0-2a944347b37d.html>

² Scale is 1 to 5, with 1 representing the best score. See *2005 Index of Economic Freedom*, Heritage Foundation and the Wall Street Journal.

³ R. Higgs, "Regime Uncertainty: Why the Great Depression Lasted So Long and Why the Prosperity Resumed after the War," *The Independent Review* 1, 4 (1997), p. 587.

in their best alternative use. That is to say, with zero transaction costs, the value of production would be maximized.”¹

The right of ownership has then two refutable implications. Private property rights tend to eliminate differences between private and social costs of using privately owned goods and they protect property owners from the redistribution of wealth. Thus, private property rights are a necessary prerequisite for classical capitalism.

Critics of Classical Capitalism

Political leaders in capitalist countries who cheer the collapse of socialism in other countries continue to favor socialist solutions in their own. (Milton and Rose Friedman in *The Legacy of Milton and Rose Friedman's Free to Choose*, Federal Reserve Bank of Dallas, 2003, pp. vii-viii.)

The focus of this section of the paper is on academics and opinion makers whose criticism of classical capitalism centers on private property rights. On the right, we have conservative theologians, philosophers and economists. On the left, we find socialists and former socialists. The middle is occupied by mainstream political-scientific elite.

Critics from the right are apprehensive that the incentive effects of private property rights, freely expressed in open markets, generate a morally unsatisfying set of preferences. And if so, the freedom to pursue one's private ends has to end up eroding morality and the rejection of 'absolute' values. Wilhelm Roepke was concerned with "undesirable" social consequences of the pure market mechanism, and regarded the consequences of unconstrained classical capitalism as intolerable.² Peter Koslowski argues that the freeing of individual pursuit of private ends and the unrestrained coordination of these goals via competitive markets lead to an exaggerated subjectivism and the neglect of more substantial social values.¹ In 1987, the National Council of Catholic Bishops called for the avoidance of "consumerism". The Bishops admonished people to limit their consumption to the necessities of life as long as there are other people who have less.

¹ Ronald Coase, "Notes on the Problem of Social Cost," in *The Firm, the Market, and the Law* (R.Coase, ed.), Chicago: University of Chicago Press, 1988, p.158.

² Wilhelm Roepke, *Social Crisis of Our Time*, London: Thames and Hudson, 1958, p.119.

John Paul II was also critical of Anglo-American capitalism. 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. In response, a group of American scholars wrote: “Official Catholic social and economic policy emphasizes serious restraints on private ownership of property and unlimited acquisition of material goods....The ideal society that still shapes Catholic doctrine is that of the feudal state ...and its dedication to things spiritual...fundamental Church doctrine is antithetical to Smith’s concept of self-interest as the guiding motive of capitalism.”¹

Those who question the morality of the right to accumulate property in competitive markets fail to appreciate that the incentive effects of private property rights do not generate preferences. Instead, critics of the freedom of choice and non-attenuated private property rights should direct their attention toward institutions that participate in the formation of our preferences, such as schools, churches, the streets, family and the media. A major difference between classical capitalism and other economic systems is that the former gives individuals the freedom to reveal their values and bear the cost of doing it (e.g., losing friends), while the latter merely suppresses individuals’ freedom of choice without changing their values.

Critics from the left (early socialists, Marxists, post-Marxists) claim that private property rights are a major cause of poverty, income inequalities, long working hours, child work and all other social problems. The remedy is to prohibit the right of ownership. Karl Marx was certainly the most influential socialist critic of the free-market, private-property economy. While most other socialists are emotional about their criticism of capitalism and private property rights, Marx did try to develop a theory of property rights. He argued, within the self-imposed constraints of his interpretation of the laws of history, that property rights are endogenously determined from within the prevailing economic system and that they change as one system is replaced by another. Thus, as socialism

¹ Peter Koslowski, “The Ethics of Capitalism.” In *Philosophical and Economic Foundations of Capitalism* (ed. S. Pejovich), College Station: University of Texas A&M Press, 1983, pp.37 and 56.

replaces capitalism more advanced socialist property rights will replace private property rights.

The less than glorious end of the system of central planning in Russia and workers' self-management in Yugoslavia, the failure of all other socialist experiments to duplicate the results of capitalism, and the theoretical research and empirical evidence about the efficiency of private property rights have created strong incentives for socialists to seek professional survival elsewhere. Indeed, in an about-face many socialists from both the West and the East have turned into "transition experts" in the early 1990s and are helping the countries of central and Eastern Europe to get nowhere. Less adaptable socialists are blaming nomenklaturits (decision-makers) in former socialist states for pursuing their own private ends and, in doing so, ruining a chance for socialism to prove itself as a viable alternative to classical capitalism. Their criticism is right but for wrong reasons. The political elite in socialist states did what every person on this planet has been doing ever since the fiasco in the Garden of Eden: they pursued their private ends. The reason socialism failed is because nomenklaturists pursued their private ends within the system of incentives embedded in socialist institutions.

The real problem facing socialists in 21st century is that they have no choice but to change their attitude toward private property rights. That means going back to drawing boards to find a way to integrate their preference for the equality of outcome via big government with the incentive effects of private property rights. A few studies have claimed that accepting limited property rights might improve the economic efficiency of socialism. Those claims beg a question, and not a very pleasant one: if limited private property rights could make socialism a bit less inefficient, why not accept unlimited private property rights and maximize economic efficiency?

The political-scientific elite in the West accept capitalism but not classical capitalism. The argument is that a just society exists in which people could live in peace and harmony, and that human reason is capable of discovering the institutions and policies required to bring such society about. The contrast between their version of capitalism

¹ Robert Ekelund et al. *Sacred Trust*, Oxford: Oxford University Press, 1996, p.184.

(hereafter: the continental capitalism) and Anglo-American capitalism is striking. Reflecting its skepticism about rulers' foresight and goodwill, classical capitalism considers any outcome to be fair and just as long as it emerges from the process of voluntary interactions under the umbrella of negative rights. In contrast, continental capitalism believes in rulers' foresight and goodwill. It means that continental capitalism does not view the government as a predator requiring the rule of law to tame it. On the contrary, it wants the government to be an active factor in running the economy.

Continental capitalism is then more concerned with the desired outcome of economic activities than with the process of voluntary interactions leading to unanticipated results. Terms such as public interest, social justice and other grand-sounding names are used to justify the desired outcome of economic activities. Whatever term is used to explicate the desired outcome, it is a façade hiding subjective preferences of the political-scientific elite. For example, German law protects property rights only to the extent that they serve "human dignity" (as if free markets were not doing precisely that) and the German welfare state.¹ Property rights in Italy are also attenuated; the Italian Constitution allows protection of private property insofar as it serves a social function.² Thus, property rights in Germany and Italy neither protect the subjective preferences of their owners nor block legislative and regulatory redistributive measures.

The attenuation of private property rights is a mechanism that enables the government to interfere with the right of individuals to seek the best use for the goods they own. And government's interference with the freedom of choice in competitive markets creates (or recreates) differences between private and social costs. Clearly, the pursuit of subjective preferences of the political-scientific elite is costly. And they know it. However, the political-scientific elite consider the pursuit of 'their concept' of social justice worth the costs. An unanswered question is: if some limitations on private property rights produce positive social gains why are not those limitations negotiated in free markets?

¹ See Alexander, G., "Property as a Fundamental Constitutional Right: The German Example," *Cornell Law Review*, 88, 2003, pp.101-144.

² See Alberto Mingardi, *Wall Street Journal*, January 19, 2005, p. A12

(Attempted) Alternatives to Classical Capitalism

The sacrifice of cognition is particularly easy to detect in objections to the market system introduced by discrepancies between one's desires, glorified as social values, and the results of market processes. However, our ability to visualize 'better' states more closely reflecting our preferences yields no evidence that this state can be realized. (Karl Brunner, "Knowledge, Values, and the Choice of Economic Organization," *Kyklos*, 23, 1970, p. 563.)

Critics have suggested numerous alternatives to classical socialism. Most of those alternatives are blackboard fictions and should be ignored. The paper is interested only in a few alternatives to classical capitalism that have been tried, specifically two brands of socialism, German Social Market Economy, and European Union.

*However, let us begin with Douglas North's analysis of the role played by secure property rights at the dawn of capitalism.*¹ At the beginning of the sixteenth century, institutional arrangements in England and Spain were similar and so were their respective levels of economic development. The wool trade was a major source of royal revenues in both countries. However, the relative security of property rights was not the same. And economic development proceeded along different paths in England and in Spain.

In England, the prevailing statutes covered only existing industries so that new industries were not bound by old rules. Moreover, law enforcement in the countryside was in the hands of judges, who were not paid by the crown. Predictably, new industries moved into the countryside where guilds were much weaker, and price and wage controls were not effectively enforced, and, in consequence, property rights were more secure. The result was the spontaneous development of joint-stock companies and growing resentment against the crown-sponsored monopolies. Eventually, political power shifted from the crown to Parliament. Toward the end of the seventeenth century, common law replaced old statutes as the law of the land. By helping to replace statutes with common law, competition among various courts with overlapping jurisdiction contributed to more secure property rights and local political controls. All of that helped to enhance economic

growth in England.² In Spain, major sources of the king's revenue were the shepherders' guild, revenues from the empire, and sales tax. In return for the right of sheep owners to move their flocks around the country from one suitable pasture to another, guilds guaranteed the king a stable flow of income. Consequences of this arrangement were insecure property rights and the absence of incentives to prevent soil erosion, both of which arrested economic development.

National Socialism and Marxism-Leninism were two major attempts by socialists to replace classical capitalism. National Socialism and Marxism-Leninism shared many basic premises of socialism. Both operated a command economy and considered the individual a mere instrument in the pursuit of their political ends. Both despised classical capitalism and, consequently, considered England and the United States as primary threats. National Socialism and Marxism-Leninism paid no heed to the rule of law. They also had some differences. Marxists-Leninists were openly hostile to the right of ownership, whereas national socialists settled for controlling the behavior of property owners. National Socialism considered racial purity as its major political and social objective. Marxists-Leninists considered the physical annihilation of the bourgeoisie as the vehicle for the development of their brand of socialism. Both socialist alternatives failed to deliver on their promises. Defeat in World War destroyed National Socialism, while Marxism-Leninism collapsed as a rotten hulk.

The German Social Market Economy was the result of the transition of Germany from socialism to capitalism in the late 1940s. The principal architect of the transition was Ludwig Erhard, the then minister of economic affairs. He received the assistance of a group of free-market scholars centered at the University of Freiburg. Their efforts were subject to an important constraint: German tradition.

German tradition has a strong bias toward collectivism. While the community in the Anglo-American tradition is a voluntary association of individuals who interact in the

¹ Douglas North, "Institutions, Economic Growth and Freedom: A Historical Introduction," in *Freedom, Democracy and Economic Welfare*, M. Walker, ed. (Vancouver, B.C.: Fraser Institute, 1988), pp. 14-19. This summary of North's research is mine.

² See an excellent analysis in Douglas North and Barry Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *Journal of Economic History*, 49, 1989, pp. 803-32.

pursuit of their own ends and, in doing so, create both order and unintended outcomes, the community in German tradition is an organic whole in which members are expected to cooperate with one another in the pursuit of a common good. Hence, individualism and limited government are alien to German tradition. Even Walter Eucken, a leader of the free-market economists who provided Erhard with theoretical arguments for the transition to the private-property, free-market economy did not consider classical capitalism to be self-regulating, self-generating and self-propelling. He held that “the economic system cannot be left to organize itself.”¹ According to Victor Vanberg, the current holder of Hayek’s chair at the University of Freiburg, Erhard believed that a well-functioning market cannot arise spontaneously. That is, the development of capitalism requires a constitutional choice.²

Initially, the German state was supposed to take care of the so-called market failures, even though theory and evidence suggests that for markets to fail they need help from the government.³ Making the government an active player in the economy created incentives, which, in turn, produced unintended consequences. Before long, rent-seeking coalitions learned how to use the state to obtain favorable regulations, while legislators and bureaucrats learned how to profit from using laws regulations and redistributive measures to give or deny favors. As the trend toward an ever-increasing role for the state accelerated in the 1970s, real market failures occurred and the rate of economic growth declined.⁴

The active role of the state led to restrictions on private property rights in Germany. The employer has restricted rights to fire unneeded employees. Hence the costs of employing workers are high and the rate of unemployment is greater than it otherwise would have been. The owner of an apartment building cannot simply decide to kick his tenants out in order to convert the property into a more profitable use (e.g., a parking lot). Thus,

¹ Walter Eucken, *The Unsuccessful Age*, Edinburgh: William Hodges, 1951, p.93.

² private correspondence with the author of this paper.

³ See Henry Manne, “The Follies of Regulation,” *The Wall Street Journal*, September 27, 2005, p.A18. The term market failure has no economic justification. Markets are not about successes and failures; they always do precisely what they are supposed to do. The so-called market failures are predictable outcomes of market exchanges in which property rights are absent or transaction costs high or both. Moreover, there is no theory suggesting that government interference with market failures is likely to succeed.

⁴ See Hans Willgerodt, “Planning in West Germany: The Social Market Economy,” in *The Politics of Planning* (ed. L. Chickering), San Francisco: Institute for Contemporary Studies, 1976.

incentives to build new apartments are less than they otherwise would have been. The right of investors to choose the method of corporate governance is attenuated.¹ Thus, we observe the concentration of shares in the hands of banks and other firms. The costs of starting new firms in terms of money and time are much greater than in the United States. The average time required to start a new firm in the United States and Germany are estimated at 7 and 90 days respectively.²

The following two American cases provide an important comparison between German laws that expect private property rights to serve the welfare state and the American emphasis on the owner's right to use property to serve his subjective preferences. In a 1900 case against a paper mill in Indiana, whose wastes polluted a creek, the court refused to weigh the paper mill's \$90,000 construction costs against the plaintiffs' damages, which amounted to \$250. The judge said that the issue is not the social benefits of running the mill.. The only issue is to determine who owns the land that has been damaged and order injunction against further damages.³ In June 2005, the US Supreme Court allowed the use of eminent domain for the purpose of economic development. Literally within days, the States have started enacting laws restricting the use of eminent domain. On August 3, 2005, a special session of the Alabama legislature unanimously voted to prohibit governments from using their eminent domain authority to take private property for the purpose of economic development. Calling the US Supreme Court ruling a threat to all property owners, the governor of Alabama said that a property rights revolt is sweeping the nation.⁴

Law and regulations restricting the owner's right to use property to serve his subjective preferences create inequalities between private and social costs of using privately owned goods. That much we know from economic theory. The performance of the German Social Market Economy confirms theoretical predictions.

¹ For the effects of codetermination on the German economy, see Christian Watrin, "The Case of Codetermination in Germany," in *Socialism: Institutional, Philosophical and Economic Issues* (ed. Pejovich), Dordrecht: Kluwer Academic Publishers, 1987.

² See Simeon Djankov, et.al., *The Regulation of Entry*, New York: National Bureau of Economic Research, working paper 7892, 2000, table III.

³ Elizabeth Brubaker, "The Common Law and the Environment: The Canadian Experience," in *Who Owns the Environment* (eds P. Hill and R. Meiners), Lanham: Rowman & Littlefield, 1998, p.101.

⁴ Donald Lambro, "Alabama Limits Eminent Domain," *Washington Times*, August 4, 2005.

There are differences between the German Social Market Economy and other continental economies in Western Europe. However, they are all welfare states with big governments, large labor unions, influential rent-seeking coalitions, countless labor regulations, and myriad of restrictions on business firms. In that sense, the German Social Market Economy is part of the continental capitalism.

The European Union is a paradise for the scientific-political elite. According to Anthony O’Hear, “The enterprise to which the European Union is committed is the first and foremost the creation of itself, as a supra-governmental authority, a task of Hegelian pretensions and of Soviet proportion...it is extremely unlikely that a low growth, highly taxed, socialistically regulated trade barrier area—which is what the EU actually is—is hardly likely to compete effectively with the USA.”¹ Moreover, according to Vaclav Klaus, president of Czech Republic, member states are turning into provinces.²

From the standpoint of the effects on private property rights, the most worrisome is Brussels’ push, direct or indirect, toward the harmonization of laws in EU. To ascertain the effects of the harmonization of laws on private property rights in EU let us compare their incentive with those of the US Constitution. The 10th amendment to the US Constitution says: “The Powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” The purpose of this amendment was to protect the States from federal government. Although the balance of power has, since the days of Roosevelt, shifted in favor of federal government, the States still have substantial controls over a number of important social and economic issues such as state taxes, family laws, contracts, and the governance of business enterprises.

This “de-harmonization” of the rules of the game in the US has created strong (and observable) incentives for individual states to encourage the inflow of human and physical capital as well as technological know-how. To encourage the inflow of resources, individual states have incentives to create institutional arrangements that are

¹ Anthony O’Hear, “Britain and Europe,” paper presented at XII International Meeting in Political Studies on *Ideas of Europe and the Trans-Atlantic Relationship*, Cascais, Portugal, July 7-10, 2004, pp 2-3.

² TV interview with Dennis McCuiston,

good for business as well as competitive with institutional arrangements offered by other states. Those incentives include lower taxes, protection from labor unions (i.e., the right to work laws), easy entry into business, and low level of business regulations. All those incentives have two unintended consequences: they strengthen private property rights and reduce the costs of production. Better protection of private property rights and lower costs of production translates into more investment, more employment and higher growth rates. And, the system works. Business firms have been moving from the East coast and now the West coast to the South and southwest.

On the other hand, Brussels' desire to harmonize laws eliminates competition among member states for human and physical resources.¹ Instead of limiting its role to the enforcement of the free flow of people and capital, and letting member states compete with each other, EU bureaucracy prefers the concentration of power in its hands. And the concentration of power in Brussels will only erode private property rights in Europe.

While EU bureaucracy does not necessarily mandate the harmonization of laws, it provides incentives for members states to compromise their local rules and regulations. A good example is the wooing of new members from the East to raise taxes, which they have lowered in post-socialist years. The purpose is to approximate the burden of taxation in East European states with the burden of taxation in West European states, especially France and Germany. The carrot is subsidies, which is both inefficient and dishonest. The problem is that higher taxes transfer resources from the private into public sector of the economy. The political-scientific elite like those transfers because they provide funds for the pursuit of their perceptions of public interest or social justice. Then, in exchange for raising taxes, and getting more money for public spending, governments in the East get checks from EU. The political-scientific elite in the East then get money twice. First they get money from higher taxes and then, as a reward for raising taxes, subsidies from

¹A colleague from a country in the process of being admitted to EU has been complaining about the "flood" of requests from Brussels to change local laws and regulations

Brussels.¹ The costs of the pursuit of social justice are borne by taxpayers in the West and the private sector in the East.

One does not have to be a public choice expert to figure out why East European leaders are falling over each other to join EU. Their demand for membership has not much to do with the future consequences for their respective countries. As Norm Barry, a noted British scholar wrote: “The EU constitutionalists have learned nothing from modern public choice theory. They do not have in mind a body of neutral laws which will restrain government but have normally recommended document which already contains agendas.”²

It is naïve to say that EU bureaucracy will, once the monopoly power is in its hands, continue to respect its contractual promises made to member states. Cognizant of that, Richard Epstein, a leading law and economics scholar wrote: “[EU proposed] Constitution allows for such dominance at the center that it will take a political miracle for that competition to play a powerful role in the affairs of the EU. By giving rights with one hand and taking them away with the other, this proposed EU Constitution lacks any clear definition and structure...But when the dust settles, there will be more government and less freedom for all...My recommendation is therefore this: Opt for the economic free trade zone and consign the EU Constitution to the dust heap.”³

Summary

Analysis in the paper agrees with G. Warren Nutter that competitive markets without stable and credible property rights are an illusion. And stable and credible property rights presuppose the rule of law. Together, private property rights and the rule of law eliminate differences between private and social costs of using privately owned goods, and protect individuals’ from redistributive policies. From among all the different systems that have ever been tried, the so-called Anglo-American capitalism, with its skepticism about

¹ See Miroslav Prokopijevich, “Alice Is Not Missing Wonderland: The Eastward Enlargement of the European Union,” *Economic Annals*, 50, June 2005, pp.33-53.

² Norm Barry, “Constitutionalism, Federalism and the European Union,” unpublished paper, p.14.

³ Richard Epstein, “American Lessons for European Federalism: Doubts about the Proposed EU Constitution,” Lecture presented at the Cass Business School, London, October 14, 2004, p.31.

rulers' good will and emphasis on the right of property owners to pursue their subjective preferences, comes closest to the model of classical capitalism. Predictably, it is the only system that has sustained a reasonable rate of economic growth for two centuries.

The Continental capitalism rests on the belief in *dirigisme*. To paraphrase Henry Manne, the scientific-political elite in Europe ignore the fact that market failures require active help from the government. The attenuation of private property rights is a major consequence of *dirigisme*. And government interference with the economy creates a gap between private and social costs of using privately owned goods, and reduces incentives to accumulate wealth. Predictably, West European countries have large unemployment, insignificant entrepreneurial activity, slow economic growth, and are stuck with the culture of dependency.

The European Union is accelerating the erosion of private property rights, slowly turning member states into provinces, consolidating more and more power in Brussels, and bribing low tax states in central and Eastern Europe to raise taxes in exchange for subsidies. While the Anglo-American capitalism might be moving in the direction of continental capitalism and social-democracy, the EU is taking the continental capitalism in the direction of unadulterated socialism.

It seems proper to conclude the paper with a quote from George Stigler, a Nobel Laureate: "The state is a potential resource or threat to every industry in society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries."¹

¹ George Stigler, "The Theory of Government Regulation," Bell Journal of Economics, 2, 1971, p.3.

