

# Privatization in Economic Theory

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**Summary:** In reality privatization has never occurred according to the handbook rules of ordinary market transactions. Not even in advanced market economies can privatization transactions be described by the Walrasian or Arrowian, or Leontiefian equilibrium models, or by the equilibrium models of the game theory. In these economies transactions of privatization take place in a fairly organic way – which means that those are driven by the dominance of private property rights and in a market economy. But despite this fact Western privatization also some peculiar features as compared to ordinary company takeovers, since the state as the seller may pursue non – economic goals. Changes in the dominant form of property change positions and status of many individuals and groups in the society. That's why privatization can even less be explained by ordinary market mechanisms in transition countries where privatizing state-owned property have happened in a mass scale and where markets and private property rights weren't established at the time process of privatization began. In this paper I'll discuss and analyze the phenomenon of privatization in context of different economic theories, arguing that empirical results go in favor of the public choice theory (Buchanan, 1978), theory of “economic constitution” (Brennan and Buchanan, 1985), (Buchanan and Tullock, 1989), and theory of “collective action” (Olson, 1982). These theories argues that transition from one economic system into another, for example transition from collectivistic, socialistic system into capitalism and free market economy with dominant private property, will not happen through isolated changes of only few economic institutions, no matter how deep that changes would be. In other words privatization can not give results if it's not followed by comprehensive change of economic system, because privatized companied wouldn't be able to operate in old environment.

**Key words:** Private property rights, Privatization, Transaction, Institutions, Transition

**JEL:** L33, P48

## Introduction

Despite the fact that property rights are the keystone of an economic system and provide the basis for trade and a market economy, until 1960s there almost was no theoretical work on the central role they play in economic development. Until Coase, Demsetz, and Alchian began writing, economists were taking property

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*Received:* 16 November 2006.

rights as a given and their economic analysis lied on the assumption that the western-style rules and norms regarding the use and allocation of property were present. This assumption is usually valid in developed capitalistic world, but not in the areas where those institution are absent.

Along with property right issues phenomenon of privatization has come in the focus of economic analysis in last few decades of previous century. However, people have recognized importance of private property much before that. According to the theory of natural law, property and property rights are considered to be one of the natural rights that belong to people. The idea of natural right has roots in the philosophy of ancient Greeks, even before Aristotle, in the works of Greek stoics (5th century before Christ). Romans stoic school, which put moral values above all other values, took over the idea of natural rights. *Digesta*, the piece that systematizes and provides easier implementation of very complex Roman law at the time, begins with three famous Ulpianus law commandments<sup>1</sup>

1. Live honestly - *Honeste vivere*
2. Don't offend others - *Alterum non laedere*
3. Everybody should get what belong to him - *Suum cuijue tribuere*.

The third commandment, i.e. answer on the question: *how everybody could get what belongs to him* is related to property rights – one of the basic institutions of the society.

The issue of property was not discussed only in economic theory. Thus one of the characters in Gete's literal opus, the hero from Greek mythology Epimeteus<sup>2</sup> asks his brother Prometheus<sup>3</sup>: "*What belongs to you?*". Clever Prometheus answers: „*Only things that are result of my activity: nothing more and nothing less then that*". The whole history of civilization can be viewed in between the Ulpianus' requirement and Prometheus' answer.

When we speak on property rights and privatization in economic terms, as many other economic ideas, this one was also discussed in Adam Smith's work. He writes on privatization in his *An Inquiry into the Nature and Causes of the Wealth of Nations*: „As soon as the land of any country has all become private property, the landlords, like all other men, love to reap where they never sowed, and demand a rent even for its natural produce.”<sup>4</sup>

“When the crown lands had become private property, they would, in the course of a few years, become well-improved and well-cultivated...the revenue

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<sup>1</sup> Beside *Digesta*, there are few more acts that provide implementation of Roman law: *Institutiones*, *Regulae/Definitiones*, *Comments of civic code*, *Responsa*, *Sententiae*.

<sup>2</sup> Epimeteus is character from Greek mythology, the son of Japet, brother of Prometheus and Atlas, and Pandora's husband. Epimeteus is a greek word for transparency.

<sup>3</sup> Prometheus is the titan who stole the fire from Zevs and gave it the people. Zevs punished him for that.

<sup>4</sup> Smith, A. (1776) "*An Inquiry into the Nature and Causes of the Wealth of Nations, Book I Chapter VI*", Translation: Global book, Novi Sad, 1998

which the crown derives from the duties of customs and excise, would necessarily increase with the revenue and consumption of the people.

In every great monarchy of Europe the sale of the crown lands would produce a very large sum of money, which, if applied to the payment of the public debts, would deliver from mortgage a much greater revenue than any which those lands have ever afforded to the crown...<sup>5</sup>

Dominant form of property<sup>6</sup> in a society influences features of many social relations and the way these relations are regulated. Changes in the prevailing form of property change positions and status of many individuals and groups in the society. That's why this phenomenon is always just one element of comprehensive change of social system that take place simultaneously with changes in other area of society. Development of market mechanisms is immanent to the societies with dominant private property, while plan and command economy operate in societies where collective property prevails.<sup>7</sup>

From this point of view, privatization is the key stone and basic foundation of transition processes. In almost each of the former socialistic countries privatization, along with introduction of multiparty political system, has been the sign that transition process has begun, at least in mechanical terms.<sup>8</sup> It is also the true that there is almost no country in the world that has not privatized at least one state or public company in last few decades.

However, when privatization wave spread over Europe there was no too much theoretical work in economics on the issue. Privatization has become popular in Western countries after Reagan and Thatcher, but East and Central European countries could hardly use Western experiences to create privatization programs. Privatization in (nominally or real) capitalist economies occurred in individual cases and as isolated transactions, and was not, as in transition economies, comprehensive process aimed to start complete change of social system. Privatization on the West is usually related to public goods, so-called „natural monopolies“, utilities, sector of telecommunication and energy, but these transaction look pretty simple in comparison to the privatization in transition economies, which was supposed to attain complex set of economic, political and

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<sup>5</sup> Smith, A. (1776), *“An Inquiry into the Nature and Causes of the Wealth of Nations, Book I Chapter VI”*, Book V Chapter II Part II, Translation: Global book, Novi Sad, 1998

<sup>6</sup> When I say dominant form of property I mean by that whether state or private property is prevailing in a society.

<sup>7</sup> See: Vukotic, V. (1993), *“Privatization and Development of Market Economy”*, Institute of Social Sciences, Center for Economic Research, Belgrade

<sup>8</sup> One of the assumptions I start with is that there is significant difference between mechanical transition (meaning privatization, liberalization, macroeconomic stabilization) and organic transition (meaning real changes of prevailing way of thinking in ex-socialistic countries, introduction of capitalistic structures in real life). While mechanic transition need several years to happen, depending on the country, organic transition takes much more time and is still happening in, I would dare to say, in all ex-socialistic countries, including those, which have visibly “finished” transition phase and joined EU. See more on this in Vukotic, V. (2003), *“Is transition heading the wrong way”*, Postgraduate Studies “Entrepreneurial Economy” available at: [www.vukotic.cg.yu](http://www.vukotic.cg.yu)

social goals. It is clear that privatization in transition countries has features of economic, political and social phenomenon, but there was no clear answer in theory whether that is the case in the West. Vickers i Yarrow (1988) say that privatization on the West is „very high on the political agenda“<sup>9</sup>, but they explore its economic consequences, trying to prove that privatization is just an economic phenomenon, and as such privatization transactions are as same as regularly market transaction with some special features. However, in case studies they've presented in the book, political causes and implications of many activities related to the privatization transactions in the West can not be avoided. In other words political dimension of privatization is evident both in ex-socialist countries with dominant state property, and in the societies with dominant private property.

### 1. Microeconomic analysis of privatization market

Ordinary markets of goods and services differ depending on mechanisms that influence demand, supply and price formation, rules of entry and exit and the issue of competitiveness. No matter whether the market is competitive, oligopolistic or monopolistic, which rules regulate entry or exit, commodity, capital and money market can be characterized as ordinary market when the goods traded on the market are reproducible, and transaction of market exchange can be repeated. Mechanisms that influence demand, supply and price formation can be defined as repetitive game between the participants in market exchange – the buyer and the seller. The fact that the transaction can be repeated and that traded goods can be reproduced, doesn't mean static stability. On the contrary, factors that determine supply and demand are changing, as well as the prices. But, the rules according to which market transactions are happening are stable. All exchange parties on ordinary markets must act according to the rules, no matter who they are. State, if involved in ordinary market transaction should follow market rules, but this is usually not the case.

Opposite from ordinary market the state has a privileged position on the privatization market and fully exploits it. The state, as a seller on privatization market has an exclusive and unilateral right to initiate transaction and manages it, whether the state wants to sell its property, or to give away its property right<sup>10</sup>. The seller on ordinary market can also exercise his unilateral and exclusive right to sell his property. Yet, there is significant difference between the seller on ordinary market and the state as a seller on privatization market. Goods traded on ordinary markets have market price determined by ordinary market rules, and potential demand for these goods exist. Thus, a market agent who wants to buy – potential buyer can initiate transaction of exchange and become actual buyer.

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<sup>9</sup> Vickers, J; Yarrow, G (1988) *“Privatization: An Economic Analysis”* Cambridge, MA:MIT Press

<sup>10</sup> In case of free share distribution or voucher privatization

The relation between demand, supply and the price are determined by ordinary market rules.

Privatization transaction usually means selling of an existing state-owned company that still operates. Privately owned companies are also sold permanently on the capital markets. Where are the differences? The criteria for determining who is going to be exchange partner in transaction on capital market is straight forward – the price. On the other side, state as a seller of its property put many requirements in front of potential buyer. Beside the price, potential buyer need to fulfill certain technological requirements; to have satisfactory market share in certain industry; investment plans for the future; program of restructuring; to keep the determined level of employment in the company, social programs for redundant employees... If the state as a seller accepts a buyer, and a buyer is ready to agree on the requirements, then these become buyer's promises for future. When the deal is made and the property is sold, the state has mainly non-economic tools available to put pressure on the buyer to keep the promises. Whether he's going to attain promised, very much depend on the buyer and his business strategy, but even more on the economic environment overall. As Major (1993) says, in the conditions of well protected property rights it is less likely that the buyer will fail to fulfill the promises<sup>11</sup>.

It can be concluded that principles behind supply and demand are completely different on ordinary as opposed to privatization market. Buyers and sellers on ordinary markets are driven by economics motives: buyers want cheaper price and better quality, and sellers want to get the highest price possible for his good. On the other side the act of exchange on privatization market is unique! State as a seller want to achieve more then just pure economic goal represented through higher price of property for sale. Sometimes these proclaimed goals are contradictory, so you can hear that the state wants restructuring, but at the same time to keep employment in the company on certain level. Besides, the procedure of evaluation and price determination of property for sale can not be featured as regular, due to the fact that the process can not be repeated. Price is set on certain date, between specified buyer and seller, and if the agreement fails, new potential buyer and the state as a seller will go into negotiation on the price again, independently on the previously set price.

Bargains procedure is common in price determination on ordinary market, but it follows certain rules: price is dependent on price of substitutes and complementary good. On the other side there is no benchmark for price determination on privatization market. There is no such thing as comparable price of property that is to be privatized, because even when the value of equipment and buildings of two companies are similar, the price can not be the same because the object of exchange is not equipment, but complex organization of company

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<sup>11</sup> See more: Mayor, I. (1993) "*Privatization in Eastern Europe: A Critical Approach*", Aldershot, UK and Brookfield, US: Edward Elgar

consisted of material and non-material elements: knowledge of employees, human capital, image, brand,...

Mainstream economists would formalize previous statements in mathematical manner: functions representing supply and demand on privatization market are not continuous, and as such not differentiable. Consequently, the price of state owned property can not be determined only as function of supply and demand. This because supply of and demand for state owned property are undetermined themselves, and there are many factors other than supply and demand that influence the price.

There are several approaches aimed to explain determination of the price on privatization market.

One of them bases on Tobin's  $q$  theory<sup>12</sup>. It says that the price of state owned property is value of discounted sum of all future profits that will be generated from the property for sale. This assumes existence of capital market, which will generate market value of the state property. However, capital market development follows privatization so this doesn't hold. On the other side, if we apply Tobin's  $q$ -theory in determination of the price of state property, we assume that the profitability of privatized company will not change significantly after privatization, which is contrary to the main purpose of privatization. To conclude, applying Tobin's theory is not feasible in price determination on privatization market.

The attempt to define the price function of the state property in the game theory seemed convenient. But, having in mind the fact that non-economic factors play important role in price formation, game theory approach is also impossible.

The transaction of privatization is unique, but there are also other infrequent transactions when the object of exchange is some rare good, piece of art, or real estate. Despite the fact that these transactions are rare, or have happen for instance just once, they are based on economic principles and following rules of ordinary market transactions.

The question being raised here is why are privatization transactions so different from ordinary market transaction, even those in which the object of exchange is some extremely valuable good? If the buyer and the seller of state property are guided with same motives as buyer and seller as unique piece of art, then features of privatization transaction can be similar to the features of the transaction on auction type markets. But, state administration and bureaucrats can hardly be guided with motives similar to those which move sellers of unique values on action, and it influences the feature of transaction.

Analysis has shown there is no transaction of privatization that can be explained by equilibrium models of Walrass, Arrow and Leontief, no matter

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<sup>12</sup> Tobin, J. (1971) "Monetary Policies and the Economy: The Transmission Mechanism", Southern Economic Journal (January), pp. 421-431

whether it happened in economies with dominant private property and capitalistic structure, or ex socialist countries with dominant state property. Privatization market is influenced not only by economic factors, but also with political and social issues, and there is no pure economic explanation of privatization. That's why all classic microeconomic theoretical models are impotent in explaining privatization transactions.

## **2. Theories of organic evolution of property rights**

Feasible theories of privatization in modern economic history originate from institutional theory of firm, introduced by Coase<sup>13</sup>, and later developed by Demsetz<sup>14</sup>. Coase has also dealt with issue of privatization within theory of transaction costs (social costs)<sup>15</sup>. These theories served as a base for the study of Alchian and Demsetz<sup>16</sup>, O.E. Williamson<sup>17</sup> and Pejovich<sup>18</sup> who founded the theory of property rights. These theories have its roots in Austrian school of economics and can be related to von Hayek's<sup>19</sup> and von Mises's<sup>20</sup> critics of collective economic systems.

All of these theories describe what conditions are necessary and sufficient so as private property can prevail in a society. These theories suggest that individual economic agents, whether they are individual owners or firms, form foundation of economic system. If private property is prevailing then individuals and firms can act as autonomous economic agents in economic system. Besides, these theories explain the transactions among economic agents through which property rights can be and are actually being exercised.

Steve Pejovich emphasizes two important dimensions of property rights.<sup>21</sup> First, it would be wrong to separate property rights from other human rights. The rights of an individual to write or talk are property rights of that individual, because they regulate the relations between that individual and other people. Thus, property rights always refer to relation between people. Second dimension of property rights originate from the first: property rights are always related to individuals. If I own the car, my possession of the car doesn't regulate the relation between me and the car, but the relation between me and all other individuals in the society with regard to the right to use the car. This confirms

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<sup>13</sup> Coase, R. (1937) "The Nature of Firm", *Economica*, (4), 386-405

<sup>14</sup> Demsetz, H (1988) "Ownership, Control and the Firm", Oxford: Basil Blackwell

<sup>15</sup> Coase, R (1960) "The Problem of Social Costs", *Journal of Law and Economic*, (3), 1-44

<sup>16</sup> Alchian, A; Demsetz, H. (1973) "The property right paradigm", *Journal of Economic History*, 33 (17), 16-27

<sup>17</sup> Williamson, O. (1985) "The Economic Institutions of Capitalism: Firms, Markets, Rational Contracting", London: Macmillan

<sup>18</sup> Pejovich, S. (1990) "The Economics of Property Rights: Toward the Theory of Comparative System", Dordrecht: Kluwer

<sup>19</sup> Hayek, F. (1944) "The Road to Serfdom", Global book, Novi Sad, Translation, 1997

<sup>20</sup> Mises, L. (1935) "Economic Calculation in the Socialist Common-wealth", London, Routledge

<sup>21</sup> Pejovich, S. (1990) "The Basis of American Capitalism", Naucna knjiga, Belgrade,

the notion of property rights as an institution regulates norms of behavior with regard to scarce economic resources.<sup>22</sup>

Theory of transaction costs, the theory of firm and property rights theory give a clear picture what mass privatization will give as a result at the end. But, none of them deals too much with the features of the path how to get there. And that was the source of many critics addressed on these theories.<sup>23</sup> But argument that theories of „organic“ evolution of property rights are not giving instructive advices how to transfer society from the point where state or collective property prevails, to the point where private property prevails has not strong point. Especially having in mind the fact that all attempts and empirical studies aimed to determine which privatization method is the most effective and give the best results have failed. The same methods implemented in different countries give completely different results; depending on the circumstances in the environment privatization is taking place. These theories developed much before the transition process has started and if they had given any instructions on how to privatize, they would probably have failed. On the other side, when we speak about the choice of privatization method, even though the theories of organic evolution of property rights don't give clear instructions which privatization method or model will give the best results, they indicate some important features of privatization transaction that can serve as an benchmark for decision makers who manage privatization processes.

In order to prove this, I'll analyze mass privatization in the context of Coase's theorem.

The Coase's theorem says: *Efficient allocation of resources doesn't depend on original allocation of property rights over resources, if 1) there are no transaction costs and 2) property rights are clearly defined.*

The transaction costs are costs of exchange of property rights. They include direct costs of exchange (seeking opportunities for exchange, collecting information, negotiation costs, fees economic agents must pay in order to complete exchange transaction) and costs of maintaining institutional structure needed for any kind of economic activity to take place (judiciary, police, infrastructure). Clearly defined property rights<sup>24</sup> means that the property rights are protected and that owners can freely exercise property rights and use their property according to their free will. The protection of property rights means that the state guarantees inviolability of private property and strong commitment that the state won't usurp private property through high taxes.

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<sup>22</sup> See more: Vukotic, V. (1993), „*Privatization and Development of Market Economy*“, Institute of Social Sciences, Center for Economic Research, Beograd,

<sup>23</sup> See more Mayor, I. (1993) „*Privatization in Eastern Europe: A Critical Approach*“, Eldershot, UK and Brookfield, US: Edward Elgar

<sup>24</sup> This is my free interpretation of the term «clearly defined property rights» suitable for the analysis given below, and is in accordance with Coase's theorem. The Coase's theorem is originally created with purpose to analyse externalities, but it can be stated and interpreted on many different ways depending on the phenomenon that is being studied.



If we consider problem of choice of privatization method in the context of Coase's theorem we can conclude: If the property rights are clearly defined and transaction costs are low enough, then privatization method is not of big importance. The resources will always go toward most efficient uses in certain circumstances.

In the context of Coase's theorem privatization method determines the features of „original“ allocation of resources. As we have concluded, the choice of privatization method from theoretical point of view is not important, which means that it doesn't influence the efficiency. Original distribution of property rights among private individuals or firms doesn't influence final outcome of privatization with regard to efficiency. After the mass privatization take place, property rights are distributed among private individuals or firms. The way these private property rights are distributed depends on the privatization method, but further flows of privately owned resources toward efficient uses does not depend on the original distribution of property rights, but on the fact whether other two conditions are satisfied. In other words it is important whether transaction costs are low, and whether private property rights are clearly defined, meaning protected and transferable.

The real world is, however, the world of positive transaction costs. In the world of no transaction costs at all, original allocation of property rights is not of importance for the efficiency, because exchange transactions are smooth and clear. In real world, the exchange transactions are in certain cases neither fast, nor easy, and sometimes even not possible. That's why original allocation of property rights matters. High transaction costs usually characterize privatization transactions, and that's why privatization method that determines „original allocation“ of property rights over resources influence the structure of economy and economic efficiency for a longer period of time.<sup>25</sup>

The features that differs privatization transactions from ordinary market transactions are already outlined before, but the question raised here is what are the chances for efficient distribution of property rights through privatization in the environment with positive (and high) transaction costs? What is necessary so as the allocation of resources can be characterized as efficient? How can we determine whether the allocation of resources will be efficient or not? The answer is clear: the price mechanisms. Critics would say that price mechanism can work only on ordinary markets, not on privatization market. The differences between the way price mechanism functions on ordinary in comparison with privatization market are outlined above. But, no matter whether we are speaking about ordinary market transaction or privatization transaction, featured with different price determination, the level of price is the key variable in the process of property rights exchange. The informative role of price is very important – the agents that

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<sup>25</sup> Drakic, M. (2004) „*Privatization in Transition Economies*“, Master Thesis, Postgraduate Studies „Entrepreneurial Economy“

are the most likely to earn the highest profit from exercising certain property right; will offer the highest price to obtain that property right. Thus, the price offered by a potential buyer indicates perspectives of his investment and likelihood that investment will be efficient. The resources will go toward their most efficient uses only if they are being held by economic agents who are ready to pay the highest price to obtain these resources.

The conclusion we could draw is: if state property is privatized through sales, then the method, which transfer state property into hands of economic agents ready to pay the highest price will allocate the resources on the most efficient ways. If this condition is satisfied, with regard to Coase's theorem implemented in the real world of high transaction costs, then the original distribution of private property rights will be as efficient as possible.

However, as already outlined in the first part of paper, price offered by a potential buyer of state property is not the key criteria when the state determines who will get the deal. It is much more important whether potential buyer intends to invest in the company or not; what is the core business of a potential buyer; or what social program he offers. The emphasis is put on non-economic features and that is the reason why privatization transaction differs from ordinary market transaction. It is not understood here, that the price someone offers is the best indicator of his intentions. In other words price indicate the likelihood that the company will be successful. If potential buyer offers the highest price, it means that he has already invested the most and he considers his investment profitable. That's why it is more likely that he'll be successful and will continue to invest in the company in the future. Otherwise he wouldn't enter the deal.

If anybody thinks that there are better criteria for efficient allocation of resources than price, then the goals and aims in the background are usually of different nature and are not related to efficient allocation. The problem of discretionary power to make decisions always arise when there is no unique criteria for decision making. When the price is not criteria to determine who'll be the buyer of state property, then the politicians can arbitrary determine the buyer and space for corruption is open.

Condition that the buyer must be well known company from the same industry as the company that is being sold is interesting, because the seller put limits on the demand himself. Thus, he consciously reduces selling price. The costs of social program are built into the price. It is just the different way of expressing the total amount of money someone is willing to offer to buy the company. Finally, social policy is the job of the state, not the job of an entrepreneurs and foreign investors.<sup>26</sup>

To conclude, Coase's theorem indicates that more the privatization transactions are similar to ordinary market transactions it is more likely that original allocation of resources will be efficient. Privatization transactions driven

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<sup>26</sup> Prokopijević M. (2000) „*Constitutional Economy*“ E press, Belgrade

by the price as main criteria to determine the partner of state in the exchange are more likely to be successful, i.e. to provide efficient allocation of resources. One more conclusion can be drawn with regard to the level of transaction costs and protection of property rights. Namely, reduction of transaction costs and protection of property rights are extremely important for the success of privatization.

This conclusion must be put in broader context. Transaction costs of privatization can be roughly divided on the costs of seller and costs of buyer. Transaction costs of seller include costs of institutional changes, costs related to estimating value of capital, costs related to issuing and distributing shares, costs of collecting information, etc. Transaction costs of buyer consist of costs related to collecting information on real value of the companies, shares' price and alternative investment opportunities, as well as costs induced by different barriers to the exchange. This means, that after the initial distribution of property rights is made (privatization transaction is closed) the key condition for the success of privatization is reduction of informative costs, simplifying procedures and removing barriers to the exchange. Property rights are determined by the scope of actions owner can undertake when exercising them, and the value of property rights changes depending on what owner can do with his property. Benefits of private property are higher when the set of choices how to use that property is wider. Private property can give positive results only in the environment that doesn't limit possibilities to exercise property rights; environment that promote freedom and protection of contract.<sup>27</sup>

### **3. Privatization – return to Smith's ideas**

The emergence of crucial institutions that form the framework of economic system and determine rules of economic game is not only and exclusively under the influence of economic factors. History and culture, tradition, sociological and psychological patterns, as well as geographic factors, significantly influence evolution of economic institutions. The importance of these non-economic factors is recognized by Adam Smith, who didn't studied and discussed them separately from economic theory. At the time of late feudalism, institutions of capitalism emerged evolutionary, spontaneously, as an organic process.

Representatives of neo-classical economics consider that emergence of economic system and its institutions are exclusively determined by economic factors. But, new institutional economics and new political economy are bringing back Smith's ideas to economic theory and recognize the importance of non-economic factors in emergence of economic institutions. According to the new theoretical approaches economic phenomena and emergence of economic insti-

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<sup>27</sup> Drakic, M. (2004) „*Privatization in Transition Economies*“, Master Thesis, Postgraduate Studies „Entrepreneurial Economy

tutions can not be explained exclusively by economic factors. North<sup>28</sup> was among the first who outlined multidisciplinary evolutionary theory of economic institution of capitalism. Explanation of economic phenomena by both economic and non-economic factors characterizes new political economy, more precisely public choice theory<sup>29</sup>, theory of economic constitution<sup>30</sup> and theory of collective action<sup>31</sup>. Evolutionary theories of capitalism have shown why private companies and private property are featured with more productive allocation of resources and higher level of economic efficiency on the firm level, as well as on an economy level in comparison with an economic system where collective property prevails and central planning is coordinative mechanism. These theories also explain why individual and social transaction costs are lower in the system with prevailing private property than in a system with prevailing state property. Buchanan, Brennan i Olson go further in their theories and discuss the way how economy can be transferred from the system with prevailing collective property and central planning to the system with dominant private property and markets.

These theories have proved that transition from one economic system into another, as for example transition from socialistic and collectivistic system to capitalistic free market economy with dominant private property, can not be achieved only through changes of economic institutions, no matter how deep and comprehensive that change is. New institutions will function if the foundations of the economic constitutions of the country are changed. That's why privatization is not just a simple transfer of ownership and control over resources. It is not simple transfer of managing function from the hands of state to the hands of private owners, but is a lever of the comprehensive process of redefining economic constitution of the country. If the privatization is not followed with comprehensive and deep change of economic constitution of a country, it can not reach set goals, because privatized companies will not be able to operate in old and unchanged environment. Unchanged system means that the rules of economic game are not compatible with private property, and private companies will not be able to do business in such an environment. This incompatibility between economic constitution of the country and new institutions resulted in modest results of privatization in terms of economic restructuring and efficiency of privatized companies in beginning phase of transition.

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<sup>28</sup> North, D (1981) *Structure and Change in Economic History*, New York and London: Norton; North, D. (1991) *Institutions, Institutional Change and Economic Performance*, Cambridge, Cambridge University Press

<sup>29</sup> Buchanan, J. (1978) *Cost and Choice: An Inquiry into Economic Theory*, Chicago: The University of Chicago Press

<sup>30</sup> Brennan, G; Buchanan, J (1985) *The Reason of Rules: Constitutional Political Economy*, Cambridge: Cambridge University Press; Buchanan, J; Tullock, G. (1989) *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, Ann Arbor: The University of Michigan Press

<sup>31</sup> Olson, M. (1982) *The Rise and Decline of Nation: Economic Growth, Stagflation and Social Rigidities*, New Haven, London: Yale University Press

These theories of privatization don't deal with the issues of efficiency of different privatization methods and models. They describe the way how the rules of the economic game, i.e. economic institutions and relations between them can be changed in a consistent manner. The basic foundations of these rules are given below.

- It is the obligation and privilege of the Government and Parliament, i.e. the state to create legal framework of the transition, which strictly defines what cannot be done after the transfer of state property into the hands of private owner.
- As a rule, state administration, should not act as a seller or buyer on privatization market, because government agencies and other government bodies are driven by different incentive structures than other economic agents, whose interests and benefits can be defined in economic terms.

As the state and local governments are legal owners of non-private property, these institutions can and should delegate its authority to private agents and managers of state enterprises to conclude individual transactions of privatization. Thus, the state restrain from interfering economic transactions with non-economic interests. Managers of state companies will use information asymmetries for their own benefits, but the same information asymmetry will be present even if government agencies administer each single privatization transaction. The reason for this is that state would only get information provided by companies' managers, who, in such case, won't have incentives to strive for successful privatization. It can be concluded that the state will be better off in case when delegates its authority to conclude individual privatization transactions to economic agents. Even though privatization transactions are unique and specific the only way to put the privatization under the control of economic rationality is to delegate transfer of ownership rights from state to economic agents. However, this will be the truth only in case of clear, transparent, predictable and competitive rules and procedures of delegating ownership rights.

Decision makers must learn that private property won't be efficient if they don't protect freedom of contract, reduce the tax and regulatory burden to a minimum, pursue a policy of monetary freedom, and open your borders to goods, services and investors. If do so, then they "will unleash the entrepreneurial creativity of your population and neighboring countries."<sup>32</sup>

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<sup>32</sup> Boettke, P. (2004) "*An Austrian. Economist Perspective on Transitional Political Economy*", The Journal of the Hayek Society at London School of Economics, pp 12-15

## **The conclusion**

Privatization process in transition economies is the basis for economic reforms in other areas. Different countries have used different methods and techniques in privatization. Privatization is aimed to increase efficiency of privatized companies, and depending on other goals, different methods of privatization were used in practice. Successes of used methods vary from country to country. Many empirical studies tried to isolate the factors that influence success of certain methods. But the same techniques gave completely different results: in some countries the results were excellent; in other the results were poor. Private property by itself can not result in increased efficiency of privatized companies in inappropriate economic environment. Privatized companies can not operate in an environment featured with non-existing protection of property rights and contracts, with weak judiciary system; in an environment with no freedom of contracting, high taxes and complicated procedures to enter and exit business.

These empirical results speak partially in favor of theories of organic evolution of property right, but clearly confirm public choice theory, theory of economic constitution, and theory of collective action. These theories and authors argues that transfer from one economic system into another, such as transition from collectivistic, socialistic system into capitalism and market economy, with prevailing private property can not be achieved through isolated change of individual economic institutions, no matter how deep that change would be.

New institutions will be feasible only in case of comprehensive change of economic constitution of a country. Thus, privatization is not just a simple transfer of property rights from hands of state into hands of private owners, but one of the levers of the comprehensive process aimed to change basic foundations of economic system. If the privatization is not followed by comprehensive change of economic system, i.e. economic constitution, it can not give adequate results, because privatized companies can not function in unchanged system. Unchanged system means that the rules of economic game are incompatible with private property and privatized companies will not be able to do business in such environment. This incompatibleness and discrepancy is the source of modest results privatization has given with regard to economic restructuring, improvements of productivity and rise of efficiency of privatized companies in first phases of transition.

The development of new private sector and rise of number of new private enterprises entering the business is considered to be the consequence of privatization in initial transition phases. However, transition countries' experiences has shown that, no matter which method dominated in privatization process, rise of new private sector significantly contributes to the success of privatization.

Protection of property rights, freedom of contracting, low taxes, simple procedures to start and go out of business and efficient judiciary system are the most important elements of economic environment favorable for rise of new en-

terprises. These same features are of vital importance for successful privatization of state owned enterprises. It can be concluded that the chances for successful privatization can be measured by growth of new business sector.

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### Privatizacija u ekonomskoj teoriji

**Rezime:** Nijedna transakcija privatizacije državne imovine se u praksi nije realizovala shodno teorijskim pravilima po kojima se odvijaju obične tržišne transakcije. Čak se ni transakcije privatizacije državne imovine u razvijenim tržišnim ekonomijama ne mogu objasniti Walrasovim, Arrowovim ili Leontijevljevim modelima ekvilibrijuma, niti modelima ekvilibrijuma teorije igara. U svim ovim teorijskim modelima transakcije razmene odvijaju se u tržišnim uslovima i uz dominaciju privatnih svojinskih prava. Ali, uprkos tome transakcije privatizacije preduzeća u razvijenim zapadnoevropskim privredama se razlikuju od klasičnih preuzimanja kompanija, u kojima jedan privatni vlasnik kupuje kontrolni paket od drugog, takođe privatnog vlasnika. Razlog je to što država kao vlasnik prodajom svog vlasništva želi da ostvari i ne-ekonomske ciljeve. Transakcije privatizacije u tranzicionim zemljama se u još manjoj meri mogu objašnjavati klasičnim mikroekonomskim modelima, jer se privatizacija obavljala uglavnom masovno i u uslovima kad institucije tržišta i privatne svojine nijesu postojale. U radu se analizira fenomen privatizacije sa stanovišta različitih ekonomskih teorija i zaključuje da empirijski rezultati idu u prilog tvrdnji teorije javnog izbora – „public choice“-a (Buchanan, 1978), teorije „economic constitution“ - ekonomskog poretka (Brennan and Buchanan, 1985), (Buchanan and Tullock, 1989), a još više teorije „kolektivne akcije“ (Olson, 1982). Ove ekonomske teorije tvrde da prelaz iz jednog ekonomskog sistema u drugi, kakav je npr. prelaz iz kolektivističkog, socijalističkog sistema u kapitalizam, odnosno tržišnu ekonomiju sa dominantnom privatnom svojinom ne može da se postigne kroz izolovanu promenu pojedinih ekonomskih institucija, ma kako duboka i temeljna bila ta promena. Drugim riječima privatizacija ne može dati adekvatne rezultate ukoliko nije praćena sveobuhvatnom promenom ekonomskog sistema, jer privatizovane kompanije neće moći da funkcionišu u nepromenjenom sistemu.

**Ključne reči:** Privatna svojinska prava, Privatizacija, Transakcije, Institucije, Tranzicija

**JEL:** L33, P48