

# CRCE Briefing Paper

**From Social Democracy to Liberal Socialism:  
A Property Rights Analysis of the Transition in Europe**

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## **FROM SOCIAL DEMOCRACY TO LIBERAL SOCIALISM: A PROPERTY RIGHTS ANALYSIS OF THE TRANSITION IN EUROPE**

### **ABSTRACT**

Two important lessons of all socialist experiments to date are: socialism has repeatedly failed to duplicate the accomplishments of capitalism, and socialism refuses to die. At the turn of 21st century, a new type of socialism, liberal socialism, is growing in Europe. Analysis shows that a major reason for the rise of liberal socialism lies in its success in eroding the two key institutions of capitalism, private property rights and the freedom of exchange. Unlike communism, which used brute force to replace private property rights and free exchange with state ownership and central planning, liberal socialism is spreading the wealth around, creating entitlement programs, supporting labor unions and promoting “fair” trade. The common objective of those and similar policies is to lower the costs of the emergence of liberal socialism by replacing the capitalist culture of independence based on self-responsibility and self-determination in open and competitive markets with the culture of dependence on the state.

## INTRODUCTION

*The problem with socialism is that you eventually run out of other people's money.*

*Margaret Thatcher*

A defining feature of the 20<sup>th</sup> century was the struggle between capitalism and socialism. Three major applications of the socialist doctrine: Fascism, National-Socialism and Communism waged this fight against capitalism. Consistent with the socialist doctrine, as it developed in the eighteenth and nineteenth centuries, fascism, national-socialism and communism blamed the economic and social inequalities of capitalism on the behavioral consequences of private property rights and competitive markets.

All three types of socialism shared a major premise that their respective visions of a “just” society should replace the spontaneous order of capitalism. This premise provided fascists, national-socialists and communists with the political justification to replace the rule of law and individual liberties with the rule of men. Hence, all three types of socialism were equally unconstrained by law, customs and morality. The individual was a mere instrument for the achievement of the ends as defined by the ruling elite. Communism was openly hostile to the right of ownership, whereas fascism and national-socialism settled for controlling and directing the use of resources nominally owned by individual citizens. Like the competing families of underworld, fascism, national-socialism and communism went to war (hot and cold) with each other as well as with the rest of the world.

While all three types of socialism were equally oppressive, fascism and national-socialism played a relatively minor ideological role in the century long competition between socialism and capitalism. Communism, on the other hand, was a major player in the last century. By promising salvation on this side of heaven, Marxism-Leninism gave socialism a pseudo religious content. This pseudo-religious content of Marxism-Leninism justified the dictatorship of the communist party as the self-appointed avant-garde of the self-proclaimed laws of history.

Two important lessons of all socialist experiments to date are: (1) socialism has repeatedly failed to duplicate the accomplishments of capitalism, and (2) socialism refuses to die. Every time one type of socialism failed, the critics of capitalism have been quick to come up with a new one. And there has been no shortage of the *White Knights* riding into the town to salvage socialism. Central economic planning in Stalin's Russia, self-management in Tito's Yugoslavia, the Red Guard in Mao's China, Che's crusade in South America, Ho's re-education in Vietnam and Castro's rape of Cuba had the same objective of making the economic performance of socialism superior to capitalism. And they have all failed to accomplish that objective.

At the turn of 21<sup>st</sup> century, socialism is on the march once again. Western Europe is in the process of transition from social democracy to socialism. Socialists and pro-collectivists parties in Central and Eastern Europe are recovering after the collapse of communism. What in the early 1990s was supposed to be the transition from socialism to capitalism is slowly turning into the transition from socialism to socialism. The European Union is helping the transition to socialism *via* numerous regulations supportive of ‘fair trade’,

wealth redistribution, environmentalism, global warnings, multiculturalism and all other movements that require government controls of the allocation of resources. In the United States, the Obama Administration is using the economic crisis that began in 2008 as an excuse to initiate the process of 'spreading the wealth around'.

Given the lesson of history, there is no compelling reason to assume that this new type of socialism that is emerging on the European continent, I call it *liberal socialism*,<sup>1</sup> will not, like its predecessors, fail to duplicate the economic efficiency of capitalism. The purpose of this paper is to show why and how the emerging liberal socialism in Europe is more dangerous than its predecessors, even though, like its predecessors, liberal socialism is equally incapable of duplicating the accomplishments of capitalism.

However, a few remarks about the United States seem in order. President Obama is using the current economic crisis to open the gates for the import of liberal socialism into the United States. His three major programs, socialized medicine, federalized education and federal government energy policy will, if implemented, transfer decisions on winners and losers from competitive markets to Washington D.C. However, the importation of socialism and even social democracy into the United States is going to be more difficult enterprise for Obama than for his European counterparts because the United States has neither the tradition of social democracy, a close relative of socialism, nor have American intellectuals ever shared the fascination of Western intellectuals with various socialist doctrines. Obama and his advisors have also repeatedly said that the current crisis has proved that "unrestrained" free markets do not work. Their remarks are misleading because they are not telling us which system has done better than Anglo-American capitalism; what is the system they want to replace the free-markets, private-economy with, and on what evidence?

The paper has four sections. The introductory section reviews a few elementary characteristics of private property rights, free exchange and economic efficiency that are relevant for analysis of the economic performance of liberal socialism. The second section discusses the meaning of liberal socialism, its causes and consequences, and the role of the European Union in supporting the institutions of liberal socialism. The last section of the paper focuses on the behavior of business firm in liberal socialism. Except for occasional references, the paper is about liberal socialism in Western and Eastern Europe. The United Kingdom, the United States and the rest of the world are left out of analysis.

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<sup>1</sup> To the best of my knowledge the term liberal socialism was used only once before and in a very different context. See Chilosi, Alberto, 'Duhring's Socialitarian Model of Economic Communes and its Influence on the Development of Socialist Thought and Practice" (September 15, 1997, revised). Available at SSRN: <http://ssrn.com/abstract=55155>

## ECONOMICS 101

*It is not true that administration of an economy is simply technical problem devolving from the basic "given" conditions.*

*G. Warren Nutter*

### Free Exchange and Economic Efficiency

We live in a world of scarcity; that is, what we want exceeds what we have. The desire for more satisfaction is a predictable consequence of scarcity. Exchange is a means by which people seek more satisfaction for themselves. Individuals enter into exchange because they *expect* that their *benefits* from acquiring a good will exceed their *costs*.<sup>2</sup>

The satisfaction a person receives from a good is purely subjective. There is no way for others to know the subjective satisfaction that one derives from acquiring that good. Thus, only voluntary exchange can move goods from lower- to higher-valued uses. To leave some exchange opportunities unexploited means that the allocation of resources is not efficient. By holding people to their promises, the law of contract increases the extent of exchange.

An important aspect of the spontaneous order that emerges from the voluntary interactions of individuals pursuing their own ends is that the value of resources in their alternative uses is identified by the only source of value: *the individual* as he acts on his subjective preferences. James Buchanan wrote: "Economic performance can only be conceived in values; but how are values determined? By prices, and prices emerge only in markets. They have no meaning in a non-market context ...where the choice-influenced opportunity costs are ignored." This quote captures the meaning of economic efficiency which is here defined as. The economic efficiency of the use of resources to produce goods and the allocation of goods among competing uses is expressed in the process through which voluntary interactions are carried out, leading into the unknown outcomes.<sup>3</sup>

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<sup>2</sup> The meaning of three underlined terms is as follows: The benefit from exchange is the increment in the subjective satisfaction a person derives from acquiring the right to use a good. The *cost* of exchange is the subjective satisfaction a person has to give up. When someone spends \$100 on a bottle of wine, the true cost of that wine is the satisfaction that would be available from another bundle of goods that \$100 could buy (i.e., opportunity cost). In a world of uncertainty and incomplete information, no one can predict the exact consequences of exchange

<sup>3</sup> To judge the economic efficiency by the attainment of a predetermined outcome or some quantitative measurements ignores our subjective preferences. And ignoring our subjective preferences leads to misleading conclusions about economic performance. A relevant example is the evaluation of the economic performance of the former Soviet Union by three neo-classical economists shortly before the country disintegrated. Robert Heilbroner and Lester Thurow wrote: "Can economic command significantly compress and accelerate the growth process? The remarkable performance of the Soviet Union suggests that it can. In 1920 Russia was but a minor figure in the economic councils of the world. Today it is a country whose economic achievements bear comparison with those of the United States" (1984, 629). Paul Samuelson said: "It is a vulgar mistake to think that most people in Eastern Europe are miserable... The gap between Western and Eastern living standard may narrow in the future" (1980, 624).

At this point, two side-comments are appropriate. First, in a world of uncertainty and incomplete information we can never be sure that an outcome of human interactions is efficient. The best we can do is to determine whether the prevailing system of incentives and constraints encourage human interactions that are consistent with economic efficiency. For that reason, I prefer to use the term *efficiency-friendly*. Second, the paper's references to the so-called Anglo-American capitalism, which is the institutionalized classical liberalism impregnated with positive transaction costs and not-so-limited government.

### **Property Rights**

From the dawn of human history, individuals have recognized the importance of property rights for their survival. Primitive men fought each other for the right of access to better caves; tribes claimed property rights in the area where fishing or hunting was good; and a struggle between two different concepts of property rights, as represented by capitalism and socialism, consumed the entire 20<sup>th</sup> century. Roman law and the common law of England developed a number of well-defined categories of property rights that are still with us, such as private property right, communal property rights and state (public) ownership. However, it was only in the 1960s that scholars began to translate the centuries of awareness of the importance of property rights into the economic theory of property rights.

Property rights are the legal and customary relations among individuals that arise from the existence of scarce goods and pertain to their use. That is, property rights are the norms of behavior that individuals must observe in interaction with other individuals and groups or bear the costs of violation. By implication, different property rights have different economic consequences. An economic theory of property rights must then identify the effects of alternative property rights on transaction costs and incentives, analyze the effects of transaction costs and incentives on human behavior, and offer evidence for refutable implications of alternative property rights on the economy. With respect to business firms, the property rights approach has to explain the consequences of alternative property rights on the relationship between the supply efforts of value-creating resources and the appropriation of economic rents.

The exclusivity and transferability of ownership are two components of private property rights that set it apart from other types of property rights. The exclusivity of ownership means that the owner decides what to do with his goods, captures the benefits of his decision, and bears the costs. The marriage between bearing the costs of one's decision and capturing the benefits from that decision has two efficiency-friendly consequences. The owner has incentives to seek the highest-valued use for his goods, and the owner has strong incentives to take risk associated with the creation of new wealth (i.e., entrepreneurship).

The transferability of ownership also has two efficiency-friendly consequences. The owner can sell his property, say apartment building, for a lump sum, or the owner can choose to take the value of his asset as a flow of rents. An important consequence of this choice, which other types of property rights do not provide, is that individuals can adjust the composition of their wealth in accordance with their attitude toward risk.

## LIBERAL SOCIALISM

*My reading of history convinces me that most bad government results from too much government*

Thomas Jefferson

### Meaning of Liberal Socialism

Liberal socialism, like its predecessors, has two interdependent objectives that set it apart from capitalism: (1) the state should control the use of resource and (2) the collective choice should replace the rights of individuals to pursue their ends. Individual preferences need to be shifted in more “acceptable” directions. The French term, *dirigisme*, correctly describes this mind-set

Liberal socialism has also two characteristics that set it apart from its socialist predecessors. (1) Liberal socialism is emerging from within European social democracies via free and democratic elections. The transition from social democracy to liberal socialism is a process characterized by the erosion of private entrepreneurship and the middle class acceptance of mandated benefits. Analysis would gain little from attempts to identify the exact moment of transition from social democracy to liberal socialism, and even less from attempts to provide a narrow definition of liberal socialism. If, once upon a time, we insisted on establishing the exact time capitalism was born and its exact definition we would be still arguing those points and miss all the knowledge of the history and economic consequences of the system.

(2) Liberal socialism accepts private property rights. However, the attainment of pre-determined outcomes means that the state has to attenuate private property rights. The term attenuation of private property rights refers to restrictions of either the exclusivity of ownership (e.g., the owner of an apartment cannot simply tell his tenant to vacate the place), or the transferability of ownership (e.g., price controls) or the legal protection of private property rights (e.g., the enforcement of property rights in Venezuela or Putin’s Russia). The attenuation of private property rights has three interdependent consequences. It weakens the owner’s freedom to use his goods in accordance with his subjective preferences; it enables the state to replace competitive markets in choosing winners and losers in total disregard of individuals’ subjective preferences; and it raises the transaction costs of allocating resources to their highest-valued uses.

The fact that European leaders seriously consider the concept of ‘fair trade’ is the best evidence that liberal socialism attenuates private property rights and rejects the spontaneous order that emerges from the voluntary interactions of individuals in open markets. Fair Trade is a neutral term that has non-neutral implications. It imposes non-market terms of exchange between developed and developing countries. The term is also used by labor unions in developed countries to demand restrictions on the import of goods produced by ‘exploited’ workers elsewhere. In essence, fair trade is a façade of words hiding attenuation of the transferability of private property rights.

The consequences of the attenuation of private property rights define the major difference between the social fabric of capitalism and liberal socialism. Liberal socialism sees the community as an organic whole that has a common good. The term common good or, to use modern jargon, social justice, is the facade of words hiding the redistribution of wealth organized and directed by people who do not own the resources that are being



distributed. In contrast, the capitalist community is a voluntary association of individuals who enter and leave the community in the pursuit of their own ends. The function of capitalist institutions is to enhance individual interactions leading to the unknown outcome. If the rules encouraging voluntary interactions were fair and good then any outcome that emerges from voluntary interactions is good and fair outcome.

### **Philosophical and Legal Origins of Liberal Socialism**

In the seventeenth and eighteenth centuries, France became the birth place of socialist ideas. French socialists raised a question: What can be done to eliminate the social and economic inequalities of capitalism? The answer was syndicalism and revolution. In the 19<sup>th</sup> and early 20<sup>th</sup> century, French socialists saw syndicalism as the training school for the socialist revolution (Laidler, 378-9). The French Revolution of 1789 was not a socialist enterprise but it did favor weak property rights and a strong state. Moreover, the French Revolution was not carried out in the name of the individual. It was carried out in the name of centralism enforced by “enlightened” ruling elite. In that sense, the French Revolution made a contribution to the-then developing socialist doctrine.

At the time of their birth, most European social democratic parties were Marxists. For example, at the Erfurt Congress in 1891, the social democratic party of Germany accepted orthodox Marxism.<sup>4</sup> In the 20<sup>th</sup> century social democratic parties began to move away from Marxism. It was as late as 1959 that the social democratic party of Germany explicitly rejected Marxism. The major reason was the realization that democratic processes could slowly bring about liberal socialism. The fact that the role of powerful state was never seriously questioned on the European continent, as it has been in the Anglo-American legal and cultural tradition, is helping the on-going transition from social democracy to liberal socialism.<sup>5</sup>

### **Liberal Socialism and Private Property Rights**

Liberal socialism is suspicious of the freedom of choice not necessarily because of any lack of interest in individual liberties but because individual choices in the free market do not generate output and income distribution consistent with its concept of common good or social justice. As said earlier, to remedy this shortcoming, liberal socialism attenuates private property rights. The attenuation of private property rights interferes with voluntary interactions among free individuals. Interference with voluntary interactions in open markets means the interference with the subjective preferences of interacting individuals. The interference with the subjective preferences of interacting individuals, in

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<sup>4</sup> Yet, social democratic parties also had critics of orthodox Marxism. For example, Eduard Bernstein (1850-1932), the leader of the Bavarian Social Democrats, was a leading critic of the orthodox Marxism. Bernstein and his followers argued that Marx’s criticism of capitalism was right in principle but that evidence called for adjustments in orthodox Marxism. They asserted that social conditions did not develop as the Communist Manifesto predicted; that the increase in wealth was not accompanied by a decrease in the number of wealthy capitalists; and that Marx’s economic interpretation of history underestimated the effects of morals, culture and customs on economic performance (Laidler, 295-302).

<sup>5</sup> Labor and business laws throughout Europe offer good evidence of the effects of the philosophical origins of liberal socialism. In Germany, the attenuation of property rights in business firms (i.e., state interference with the subjective preferences of property owners) has a long history. As early as in 1835, professors Robert Von Mohl, Wilhelm Roscher and Bruno Hildebrand proposed the creation of “workers’ committees” in business firms because, they argued, capitalism had failed to emphasize moral issues. The trend of transferring property rights in business forms continued in Germany to date.

turn, interferes with the flow of goods and services from lower- to higher-valued uses. In the end, liberal socialism fails to duplicate the economic efficiency of capitalism. How?

The value of goods depends less on the flow of services from the goods that are being traded and much more on the bundle of property rights to do things with those goods. John takes better care of the car he owns than the one he leases, even though they offer the same flow of services. Jane takes better care of the apartment she owns than the one she rents. Public housing projects deteriorate faster than privately owned buildings. Private lakes are cleaner than public lakes. Labor unions attenuate the rights of workers to get jobs at wages they find acceptable. The owner of apartment building subject to price controls has fewer incentives to maintain his property than the owner of apartment building that is not subject to such restrictions (that is so because the rate of return on resources invested in maintaining buildings subject to price controls are less than the return from investing the same funds elsewhere). In all these cases, the values of goods that are traded are determined less by the flow of services from those goods and much more by the bundle of rights to do things with the goods that are being traded.

### **Measuring the Effects of the Attenuation of Private Property Rights**

The Index of Economic Freedom published jointly by the Heritage Foundation and the Wall Street Journal, and the Economic Freedom of the World Index published by Fraser Institute have established that strong positive correlation exists between economic freedom and economic growth.<sup>6</sup> To measure economic freedom, both indexes use categories that are consistent with the institutions and policies supportive of economic efficiency. To say that a country has become freer means that it has become more efficiency-friendly.

De Haan and Sturm (2000) tested the Fraser Index and found that improvements in economic freedom foster economic growth. Stocker (2005) got similar results. He found (p.589) that “increases in economic freedom are associated with higher equity returns, while the absolute level of beginning and ending economic freedom do not affect equity returns.” James Gwartney wrote (2003, p.3): “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 per cent of the cross-country variations in 2000 per capita GDP.” Bernhard Heitger (2004) found that “estimating the direct relationship between property rights and end-of-period per capita incomes yields a highly significant regressor and indicates that a doubling in the index of property rights more than doubles living standards.” It is fair to say that both indexes have passed the test of time.

The paper uses the Index of Economic Freedom published by the Heritage Foundation and the Wall Street Journal (hereafter: *Index*).<sup>7</sup> The Index uses ten categories to measure economic freedoms. Given the purpose of this paper, the most important categories affecting private property rights in liberal socialism are *Property Rights*, *Business*

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<sup>6</sup> Both indexes are about economic freedom only. Political and civil freedoms are not included in either of these two indexes.

<sup>7</sup> The Index classifies all countries into five groups: *free* (80-100), *mostly free* (70-79.9), *moderately free* (60-69.9), *mostly unfree* (50-59.9), and *repressed* (0-49.9). The score of 1 is the worst and the score of 100 is the best.

*Freedom and Labor Freedom.* Property rights category measures primarily the legal protection of private property, including the effectiveness and honesty of judicial system. Business Freedom is primarily about the transaction costs (red tape) of opening, operating and closing business firms. Labor Freedom is about the state interference with the rights of individuals to work for wages they find acceptable, the rights of businesses to hire and fire workers, wage controls, support for labor unions, and various safety regulations.

There is a critical difference between these three categories<sup>8</sup>. The first one (property rights) measures the protection of the bundle of property rights *without* specifying the contents of the bundle of rights that are being protected. The second and third category (business and labor freedoms) specify the bundle of rights that *need* to be protected.

The backbone of the Anglo-American common law tradition is that the primary function of private property rights is to serve the subjective preferences of property owners. Those preferences create incentives that maximize the extent of exchange (i.e., move resources to their highest valued uses). The political and legal tradition of Western Europe (not including the United Kingdom and Ireland, two common law countries) has constrained the function of private property rights from serving the subjective preferences of owners. In many West European countries the owner of an apartment cannot simply ask his tenant to vacate the place within a customary period. The German law protects private property rights as long as they serve ‘human dignity’ and welfare programs (Alexander 2003). The owner of a business in Spain is reluctant to hire workers because the costs of firing them are high. In France, the owner has to pay a tax (penalty) in order to close down his establishment. Italian legal system protects private property rights only insofar as they serve a social function as defined by the state (Mingardi 2005).

The tradition of the rule of law in Western Europe predicts high scores for the protection of property rights which the emerging liberal socialism wants to preserve, and lower scores for business and labor freedoms, which liberal socialism wants to attenuate. Indeed, the Index for Germany shows a high score for property rights category (90) and a low score for labor freedom category (43) even though both categories are about property rights. The former defines the protection of private property rights, while the latter defines the bundles of private property rights that are being protected. Also, the United States and Germany have the same score of 90 for property rights category. Yet, the bundle of rights that is being protected is not the same in those two countries.

In Central and Eastern Europe (hereafter: C&EE), the social forces affecting the attenuation of private property rights are different from those in Western Europe. Except for lingering memories of the rule of law in the parts of C&EE that belonged to the Austro-Hungarian Monarchy, the years of socialist rule has completely destroyed people’s confidence in the legal system. The law is perceived as a mechanism the rulers use to do whatever the rulers want; the law is taken no more seriously than the promises of used car dealers

The prevailing culture in C&EE is not homogenous but it has a bias toward collectivism, egalitarianism, and shared values that pre-dates communism. The heterogeneity of culture

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<sup>8</sup> The statement is challengeable because categories overlap and the paper uses only the most important part of the description of each category.

in C&EE stems from the influence of three empires (Austro-Hungarian, Russian, and Ottoman) and three religions (Roman Catholic, Orthodox, and Islam). The culture of collectivism and egalitarianism gets stronger the farther east and southeast one travels. The following three quotes capture the essence of the socio-economic effects of three empires and three religions in C&EE.

Perry Anderson (1974, 429) explained the lingering memories of the rule of law from the days of Austro-Hungarian Monarchy as follows: “The age in which ‘absolutist’ public authority was imposed was also simultaneously the age in which ‘absolute’ private property was progressively consolidated. It was this momentous social difference which separated the Bourbon, Habsburg, or Tudor monarchies from any Sultanate, or [the Romanovs].” Antonina Zhelyazkova (2003, 140-141) described today’s Albanian family. “Family community [is] composed of three or four generations, with a high level of internal solidarity. Within the [family] there is a strict, clear-cut age hierarchy, where the father’s...word is law...this is due to the age-old internal ethno-cultural mechanism, which ...contributes to the preservation of their tradition.” Writing about Russian culture, Silke Stahl (2001, 157) said: “In Russia [cultural] institutions found their expression in egalitarianism and collectivism...The reasons for egalitarianism, and collectivism [in Russia] can be found in religious beliefs.”

To measure the effects of liberal socialism on the attenuation of private property rights, Table 1 includes information from *2009 Index of Economic Freedom* on property rights, business freedom and labor freedom.

Since the effects of liberal socialism on private property rights are qualitatively different in Western Europe and C&EE, Table 1 divides European continent into two groups: Sixteen West European countries and nineteen East European countries. The first group consists of all West European countries including Finland and Greece but not the United Kingdom and Ireland. The United Kingdom and Ireland have different (common law) legal systems from the rest of Western Europe. The informal institutions in those two countries also differ from the rest of Western Europe. The second group includes all countries that belonged to the Warsaw pact plus all countries that belonged to the former Yugoslavia. The only East European country left out from Table 1 is Bosnia and Herzegovina, which is not a functional state. C&EE countries are then divided into countries that were the subject of greater influence of Western culture and those that were the subject of lesser influence from the West. The first group includes nine countries. The Czech Republic, Croatia, Hungary, Slovakia and Slovenia used to be part of the Austro-Hungarian Monarchy, which was short on democracy but strong on the rule of law. The Catholic Church brought Western culture to Poland. Religious influence of protestant churches and the centuries of strong trade with Germany and Sweden, contributed to customs and traditions in the Baltic States. The second group includes Bulgaria, Albania, Romania, Macedonia, Montenegro, Serbia, Moldova, Russia, Ukraine and Belarus.

The benchmark against which to compare the effects of liberal socialism in Europe on private property rights includes Hong Kong, Singapore, Australia, New Zealand, United States and Canada. All those countries are common law countries. Moreover, the Index classifies all of them as free or the most capitalist countries (scores 80-100).

**Table 1: Private Property Rights in Liberal Socialism**

	Private	Business	Labor	Average
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	Property	Freedom	Freedom	Score
Benchmark	90.83	94.97	90.95	92.25 (free)
Western Europe	81..25	84.59	59.51	75.12 (mostly free)
C&EE	44.42	66.88	56.42	55.91 (mostly unfree)
Pro-Western C&EE	58.63	71.79	59.24	63.22 (moder. free)
Non-Western C&EE	32.00	62.57	54.66	49.74 (repressed)

Source: Calculated from *2009 Index of Economic Freedom*, Heritage Foundation and Wall Street Journal, Washington D.C. Grading Scale: 80-100 Free; 70-79.9 Mostly Free; 60-69.9 Moderately Free; 50-59.9 Mostly Unfree; 0-49.9 Repressed

Information about the effects of liberal socialism on property rights (last column in Table 1) confirms analysis in the paper. Six capitalist countries have stronger property rights than liberal socialist countries of Western Europe. Property rights in Western Europe are stronger than in C&EE. And predictably, property rights within C&EE gets weaker as one moves farther East and Southeast.

### **The Seditious Role of EU in Promoting Liberal Socialism**

The European Union was born in Western Europe, while C&EE was home of one of the most oppressive rules in human history. It would be surprising if the expectations about the role of EU were the same throughout the region. Western Europe is a heterogeneous region as is C&EE. Marxism-Leninism changed the rules of the game in C&EE at will and the secret police enforced the rules with no regard for human rights and privacy. Predictably, some people in member countries from C&EE (especially Czech Republic and Slovakia) see the flow of regulations coming down from Brussels as a betrayal of the post-communist hope for a society of free and responsible individuals. It is also true that many east Europeans see EU regulations as replacing the old despotic dictatorship with a flow of benevolent rules that are helping to control corrupt domestic politicians.

The issue that affects all member countries is that EU has added one more layer of bureaucracy to those already existing in member countries. Like all bureaucracies, EU bureaucracy has strong incentives to grow. And issuing and enforcing regulations is the most efficient way for any bureaucracy to grow. Some regulations enacted by EU are pro-free market while others are not. However, the distribution of regulations between pro-free market and anti-free market is not as important for judging the direction of economic changes as is the power of Brussels bureaucracy to issue and enforce regulations. And it is this growing power of Brussels bureaucracy to regulate that cannot be trusted.

Professor Epstein (2004, 31) understood the problem and formulated his impressions of the direction of EU as follows: “[The proposed EU] 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.”

The evidence suggests that Epstein got it right. Appendix on the protection of pigs and tomatoes is just a top of the iceberg, which contains a huge and growing number of similar regulations that are amusing, costly and inefficient. What makes EU regulations costly and inefficient is that they are less concerned with the protection of private property rights and a society of free and responsible individuals and much more with fair trade, environment, global warming, the right of all species (other than humans), and the scientific-political elite conviction that they know what people would demand if they knew what was good for them.

Vaclav Klaus has frequently spoken and written on the way Brussels has high-jacked the great idea of creating the United Europe based on free trade and individual liberties. Recently, he said: “The undergoing weakening of democracy and of free markets on the European continent, connected with the European unification process, is a threatening phenomenon...[which] was the main building block of the European Constitution and it remains without substantial change in its new version, in the Lisbon Treaty.” Klaus is right. When the proposed Constitution was voted down, Brussels invented the Lisbon Treaty. Now that the Lisbon treaty is not working out, there is talk of doing something else in order to get things rights. We observe that every time a country votes down one of EU preferred rules or propositions, Brussels tries to engineer another election, and then another until the rule wins a majority vote. Once that happens, another election is never suggested.

Professor O’Hear (2008, 231) wrote that one important consequence of Brussels’ hunger for power is that “the enterprise to which EU is committed is first and foremost the creation of itself as a supra-governmental authority, a task of Hegelian pretension and of Sovietic proportion.” Professor Norma Berry (2004, 33) argued that EU leaders have no intention of enacting a body of laws that would take away their discretionary powers: “As long ago as 1964, the Costa vs. ENEL decision from the European Court of Justice (ECJ) struck down an Italian statute that happened to conflict with an EU regulation on the ground that European law was superior to domestic legislation. It was the beginning of the activism of the ECJ.” Vaclav Klaus has been even more specific about the effects of “harmonization”. The essence of his position is that Brussels has been attenuating private property rights, constraining free-market competition, eroding the sovereignty of member states, and transferring decision making from member states to Brussels.

Many years ago, Professor Nutter (1969, 39) provided a succinct and powerful description of the policies pursued by the Soviet leadership. Nutter wrote:

It was Lenin’s genius to recognize the importance of embellishing the Soviet system with all the trappings of democracy. If the people want a constitution, give them one, and even include the bill of rights. If they want a parliament, give them that, too; and a system of courts. If they want a federal system, create that myth as well. Above all, let them have elections, for the act of voting is what the common

man most clearly associates with democracy. Give them all these, but make sure that they have no effect on how things are run

It is arguable that the same description fits EU leadership. That is so because the story of EU is the story of unstoppable drive to replace local laws with European-wide rules leading to the centralization of power in Brussels. Appendixes at the end of this paper are evidence of this drive. And in the process of centralizing the power in Brussels, the EU supports the emergence of liberal socialism in Europe

### **THE BUSINESS FIRM IN LIBERAL SOCIALISM**

*Some regard private enterprise as if it were a predatory tiger to be shot. Others look upon it*

*as a cow that they can milk. Only a handful see it for what it really is - the strong horse that pulls the whole cart.*

*Winston Churchill*

The economic performance of any system depends on the performance of business enterprises. And the performance of business firms depends on the prevailing property rights in resources used by business firms. The focus of this section is on the incentive effects of the attenuation of property rights in liberal socialism. For comparison, analysis begins with the incentive effects of private property rights in capitalism.

#### **The Behavior of Capitalist Firm**

The ownership of the firm is about rights (Alchian and Demsetz, 1972). To say that a firm is privately owned means that the owner has a well-defined bundle of rights in that firm. Three important rights that set the privately owned firm apart from other types of business firms are:

(1) *The owner's right to the revenue of the firm.* The owner has to pay contractual obligations of the firm. Any residual left after all other obligations of the firm are met from its revenue belongs to the owner. (2) *The owner's right to hire and fire members of the team.* The owner must have the right to hire and fire members of the team. Otherwise, the owner's incentives to monitor members of the team would be unenforceable. If in hiring new members of the team the owner had to satisfy criteria not related to the past performance and expected productivity of potential candidates, the team would be smaller, the costs of production would be higher, and marginal firms would not survive. An owner who had to incur high costs in order to justify firing a member of the team would have no credible threat to enforce incentives to supervise and monitor the performance of team members. (3) *The owner's right to sell the preceding two rights.* The right to transfer one's rights to others at a mutually agreed upon price is a basic component of the right of ownership. The market price of a firm is the value of the owner's bundle of rights, which is the present value of the expected residual over the firm's life discounted at a going rate of interest.

The most important consequence of the bundle of rights that define privately owned firm is that *the owner bears changes in the value of the firm*. It means that the owner has incentives to seek ever larger profits. And the search for ever larger profits provides incentives for the owner to seek both the highest-valued uses for resources controlled by the firm as well as entrepreneurial profits. The former is about the efficient use of resources. The second is about economic development.

The incentives to seek ever larger profits mean that the owner of business firm has to satisfy consumers' preferences. To satisfy consumers' preferences, the owner has to incur the transaction costs of allocating resources controlled by the firm to their highest-valued uses. In addition to seeking the best use for resources controlled by the firm, the owner has to be alert to changes in consumers' preferences.

The bundle of property rights that define privately owned firm also provide the owner with strong incentives to seek entrepreneurial profits; that is, profits over and above normal rate of returns. Innovation, a major activity for seeking entrepreneurial profits, means doing something that was not done before. Doing something that was not done before increases the community's set of choices. By implication, voluntary acceptance of an innovation means that the community is better off. Thus, innovation is the engine of economic development. Being a novelty, it is impossible to know the risk of innovation. A powerful incentive to accept the uncertainty about the outcome is the innovator's property right in the *entire* entrepreneurial (temporary monopoly) profit of a successful innovation. Any attenuation of the innovators property rights in the entire profit reduces the incentives to innovate and slows down economic development.

Finally, academic research and empirical evidence have shown that better understanding of the efficiency implications of antitrust laws by judges (Kovacic and Shapiro, 2000), the protection of owners-investors by parliaments (La Porta et.al. 1999), the efficient market for management control (Manne, 1965) and decline in the power of labor unions increases the bundle of rights in privately owned firms and, in doing so, improves the performance of capitalist firms.

### **The Behavior of Liberal Socialist Firm**

Unlike socialist movements of the past, liberal socialism accepts private property rights. The acceptance of private property rights takes the form of various ways of attenuating them. The purpose of the attenuation of private property rights is to use privately owned resources to serve the objectives of socialist leaders.

The concept of industrial democracy is an umbrella for all the different method of attenuating private property rights in business firms. The focus of this section is on the efficiency consequences of labor participation in the management of business firms.

The concept of labor participation in the management of business firms has been thriving in Western Europe and EU long before the fall of socialism in Central and Eastern Europe. The former president of France, Giscard d'Estaing, said "Participation of workers' representatives in the life of their company reflects the workers' aspirations not be left out of decisions that concern them." Former chancellor of Germany, Willy Brandt, a devout socialist, said; "We consider the development of [labor participation in the management of business firms] to be one of our main tasks...in this, we start from the



principle of equal rights and even balance of weight of employees and employers. Most importantly, the European Commission proclaimed labor participation in the management of business firms as one of its fundamental objectives. It said: “No less than one third of the members of the supervisory organ (i.e., board of directors) shall be appointed by the workers or their representatives.”

In post-communist C&EE countries the tendency is to give managers and employees a large number of shares in their respective enterprises either free of charges or at a significant discount (Mitra, Selowsky, et al. 2000, 75). This method of ‘privatization’ changes the balance of power between shareholders, managers and employees at the expense of shareholders. Freed from the pressure to maximize the residual, the alliance between labor and management tends to employ unneeded workers, make business decisions that maximize near-term cash flows, and offer pecuniary and non-pecuniary benefits to local bureaucrats in exchange for favorable treatments (Milovanovich (2007).

Two consequences of labor participation are inefficiencies in the allocation of resources within labor participatory firms and inefficiencies in the allocation of resources in the economy. Let us start with inefficiencies within the firm. Labor participation in the management of business firms means that employees have incentives to seek investment alternatives that shift incomes forward and postpone costs. The former benefits current employees, while the latter shifts current production costs to future generations of workers. For example, consider two investment alternatives of equal cost. The expected present value of one alternative is \$1,000 while the other yields only \$750 at a going rate of interest. However, if the returns from the first alternative are expected over a period of 20 years and those of the second over only 5 years, workers have incentives to push management in the direction of choosing the less efficient one. And they are likely to win because the attenuation of private property rights in liberal socialism shifts the balance of power away from shareholders to the coalition of managers and workers.

Let us now assume an open economy that has a mix of labor participatory forms and non-participatory enterprises. Attenuations in the owner’s right to capture the residual (via sharing with workers) and the owner’s right to hire and employees raise the costs of capital for labor participatory firms. . Given differences in the costs of capital, the rates of return in the labor participatory sector would fall relative to the rates of return in the labor non-participatory sector. The flow of capital from the labor participatory sector into the non-participatory sector would increase the returns on investment in the labor participatory sector relative to the returns on investment in the labor non-participatory sector. The flight of capital into the non-participatory sector would continue until the equality in the rates of return is re-established. In the end, the labor participatory sector with attenuated private property rights would be smaller, produce smaller output, and charge higher prices relative to the non-participatory sector with private property rights.

The labor participation in the management of business forms is not efficiency-friendly method of organizing production. Not surprisingly, labor participatory firms do not appear voluntarily in any significant numbers.<sup>9</sup> To avoid the embarrassment, social democrats and socialists have incentives to mandate labor participation in the

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<sup>9</sup> There is no law in the United States that says that there shall be no labor participation in the management of business forms. Yet, we observe an insignificant number of labor participatory firms

management of business firms and then to protect labor participatory firms from competition by other types of enterprises.

We can say that the attenuated private property rights in liberal socialism transfer the guidance of production from the competitive process in which the knowledge of all is used to generate efficiency-friendly outcomes to specific individuals with limited knowledge, such as regulators, politicians and bureaucrats.

### **The Rate of Investment in Capitalism and Liberal Socialism**

Liberal socialism preserves private business firms. It, however, attenuated the bundle of right that defines privately owned firms. And the attenuation of that bundle of rights has consequences discussed in the preceding section. One such consequence is the increase in the cost of capital. A growing body of literature shows that business firms in countries with Anglo-American capitalism earn returns on investment that is at least as large as their costs of capital, while enterprises on the continent of Europe earn on average returns on investment below their costs of capital.<sup>10</sup> Of course, those returns have no relationship to the returns shareholders earn on their investments. Adjustments in share prices eventually bring the expected returns to shareholders on their investments into equality.

The issue is the efficiency effects of the higher costs of capital in liberal socialism on the rate of investment of business firms and the redistribution of wealth. In the 1960s, Professor Witte (1963) developed a model on the determinants of the rate of investment of business firms. Key proposition of Witte's model was that "the firm's demand is for stock rather than for flow of capital goods because the services it wishes to have available are at least functionally related to the stock and not to the rate of change of the stock;" and "I find that a sufficient condition for the existence of a market-equilibrium relationship between the aggregative rate of investment and the rate of interest is a capacity and cost constraint on the rate of output of capital goods."<sup>11</sup>

Witte's model was limited to analysis of the determinants of investment by business firms in the private-property, free-market economy. In the early 1970, I expanded Witte's model to show the effects of three additional types of property rights on the rate of investment by business firms (1971). The rest of this section relies on my 1971 research to highlight the efficiency effects of the attenuation of private property rights in liberal socialism on the redistribution of wealth and rate of investment by business firms.

As a footnote, it is true that macroeconomics has made large advances since Witte wrote his article. Yet, Witte's model is, I believe, still conceptually relevant because of his emphasis on the microeconomic foundations of the aggregate demand for investment. Moreover, most of advances in macroeconomics have been technical improvements at the expense of the incentive effects of alternative institutions. And in 1990s, Central and Eastern European countries were in the initial stages of institutional restructuring; that is, they were moving away from their prevailing institutional arrangements. Yet, a major

<sup>10</sup> Gugler, K, Mueller, D., Yurtoglu, B. (2004), "Corporate Governance and Globalization," *Oxford Review of Economic Policy*, 20, No 1, 129-156. The evidence is about the rates of return in common law and civil law countries. However, those differences in legal systems coincide with the difference in Anglo-American and Continental capitalism. Moreover, they are also consistent with the ranking of countries in the Index of Economic Freedom.

<sup>11</sup> Witte, J. (1963), "The Microfoundations of the Social Investment Function," *Journal of Political Economy*, 75, No5, pp. 441 and 456.

advice they kept getting was to maintain macrostability. Macrostability presumes policies based on and directed at the prevailing institutions. It means that whatever macroeconomists wanted to stabilize had to raise the transaction costs of the spontaneous development of new institutions. Stabilization programs were then based on technically impeccable models based on assumptions that new equilibriums are created instantaneously or that government fine-tuning of economic process is possible or both. For those assumptions to be borne out, Central and Eastern Europe needed the Second Coming.

The basic line of Witte's analysis of the aggregate rate of investment in capitalism is as follows: The SS curve in Figure 1 is the assumed supply of the existing stock of capital in the community. The demand curve ( $D_1D_1$ ) is the demand for the capital stock to hold at the rate of interest ( $r_1$ ). This price of capital is determined in the capital market where the rate of interest is equated to the percentage return from the capital stock.

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Suppose now that individuals' preferences change in favor of future income. The price of nonhuman assets would increase, and the rates of return from those assets fall. The switching activity among different markets would reduce the market rate of interest to ( $r_2$ )

and shift the demand for the capital stock to hold to ( $D_2D_2$ ). The ( $S_kS_k$ ) is the supply schedule of capital goods. Like all supply schedules in competitive markets, the  $S_kS_k$  schedule equates the marginal supply price to the market prices of capital. The investment function ( $I_1I_1$ ) is then a market equilibrium curve and not a demand curve for investment. The market rates of interest ( $r_1$  and  $r_2$ ) bring into equality the rates of return from capital goods and bonds, the community's time preference, and the interest rate implicit in the price of the capital stock to hold.

Let us now adjust Witte's analysis to the effects of attenuated private property rights on the aggregate investment in liberal socialism. As discussed earlier, the attenuation of private property rights has many forms. One form of attenuation of private property rights is restrictions on profits earned by business forms. Public utilities in the United States have operated for decades under such restrictions, profit restrictions (formal and/or informal) exist in European countries practicing industrial democracy, and windfall profit tax is still remembered in the United States. .

The control of profit earned by business firms has, like most other forms of the attenuation of private property rights, two consequences: the redistribution of wealth and

re-allocation of resources. Figure 2 illustrates the effects of profit controls on the distribution of wealth. (OM) is the maximum profit the firm could earn, while (OD) is what the firm is allowed to earn. (MM) is the rate at which the managers can increase his total earnings by exchanging non-allowed profits for the consumption of nonpecuniary goods. The managers' nonpecuniary income consists of variety of goods such as monthly staff meetings in Las Vegas, membership in private clubs, generous expense accounts, opulent offices, lots of beautiful secretaries including one that can type, and a company plane.

It is clear that the managers have incentives to ignore profit controls and maximize profits as long as they could spend (OC) amount on the supply of nonpecuniary goods. Those incentives are constrained by the reaction of shareholders and state regulators. Shareholders have no reason to object to the managers' behavior, which in a non-regulated firm would reduce their wealth. The managers hide their consumption of nonpecuniary goods from the state by reporting those expenditures as the costs of doing business.

It is obvious that the control of profit means the redistribution of income from shareholders to managers. What is much less obvious is that this redistribution of income reduces the community's wealth. Reporting the expenditures on the nonpecuniary goods as the costs of doing business limits the kind of goods the managers' can purchase for themselves and get away with. It means non-reported profits (OC) in Figure 2 are not allocated to their highest-valued uses.

For example, if the managers spent \$1,000,000 on nonpecuniary consumption (i.e., liberal use of the company plane, membership in golf clubs, expense accounts, etc.) that consumption would make them better off but not as well off as the most preferred bundle of goods worth \$1,000,000 would. At the same time, shareholders loss is \$1,000,000 in cash, which in the absence of profit controls they would be free to put to the highest-valued use. The result is a loss wealth. And lower wealth has implications on the rate of investment by business firms.

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The control of profit results in a decrease in net earnings of the firm (DM in Figure 2). Given the rate of interest ( $r_1$ ) the demand curve for capital stock shifts downward to ( $D_3D_3$ ) in Figure 3, and the market price of capital goods falls. A corresponding increase in the demand for monetary and human assets would, via switching activities in different markets, reduce the market rate of interest to ( $r_2$ ) and shift the demand curve for capital stock upward to say ( $D_2D_2$ ), where ( $r_1$ )  $>$  ( $r_2$ ). The investment function shifts from ( $I_1I_1$ ) to ( $I_2I_2$ ) is due to a loss of wealth. Given the consumers' time preference, savings are less at each rate of interest. An increase in demand for monetary and human assets would then not be strong enough to shift ( $D_2D_2$ ) schedule back to ( $D_1D_1$ ) and reduce the rate of interest  $r_1$  to  $r_3$ . Thus, the market rate of interest will be found somewhere between ( $r_1$ ) and ( $r_3$ ), say at ( $r_2$ ). The effect of the attenuation of private property rights via profit controls is loss of wealth, less investment and lower rate on interest.

## CONCLUSIONS

*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*

All three major socialist movements from the last century, Communism, National-Socialism and Fascism, were either imposed by force (e.g., USSR, Spain) or were the outcome of one-man, one-vote, one-time type of election (e.g., Germany). Once in power, all three types of socialism relied on secret police to stay in power. Unlike its predecessors, liberal socialism is neither been imposed from without nor maintained by force. Liberal socialism has been emerging from within capitalism.

Analysis in this paper shows that a major reason for the rise of liberal socialism lies in its success in eroding the two key institutions of capitalism, private property rights and the freedom of exchange. Unlike communism, which used brute force to replace private property rights and free exchange with state ownership and economic planning, liberal socialism is 'bribing' people to voluntarily accept the erosion in those two key capitalist institutions and relies on free elections to validate the resulting institutional changes. The term bribing refers to government policies that are spreading the wealth around, creating entitlement programs, supporting labor unions, promoting fair trade, and enacting various legal restrictions on hiring and firing employees in privately owned firms. The common objective of those and similar policies is to lower the costs of the emergence of liberal socialism by replacing the capitalist culture of independence based on self-responsibility and self-determination in open and competitive markets with the culture of dependence on the state. I conjecture that the emergence and survival of liberal socialism depends, as Professor James Buchanan argued, on whether those policies succeed in making individuals 'afraid to be free'.<sup>12</sup>

Liberal socialism is the clear and present danger to free trade, competitive markets and individual liberties. It is unfortunate but also undeniable that Brussels bureaucracy is promoting policies that support cultural changes that liberal socialism needs for its survival. Speaking before the European parliament on February 19, 2009, Vaclav Klaus talked about the role of EU in enhancing the threat to the private-property, free-market economy and individual liberties. A few excerpts of Klaus' speech are the most effective summary of the message of this paper.

"We must say openly that the present economic system of the EU is a system of a suppressed market, a system of a permanently strengthening centrally controlled economy. Although history has more than clearly proven that this is a dead end, we find ourselves walking the same path once again. This results in a constant rise in both the extent of government masterminding and constraining of spontaneity of the market processes. In recent months, this trend has been further reinforced by incorrect

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<sup>12</sup> Buchanan, J. (2005), "Afraid to Be Free," Public Choice, 24, No 2, 19-31.

interpretation of the causes of the present economic and financial crisis, as if it was caused by free market, while in reality it is just the contrary – caused by political manipulation

Many of you certainly know the name of the French economist Frederic Bastiat and his famous ‘Petition of the Candlemakers’, which has become a well-known and canonical reading, illustrating the absurdity of political interventions in the economy. On 14 November 2008 the European Commission approved a real, not a fictitious Bastiat’s Petition of the Candlemakers, and imposed a 66% tariff on candles imported from China. I would have never believed that a 160-year-old essay could become a reality, but it has happened. An inevitable effect of the extensive implementation of such measures in Europe is economic slowdown, if not a complete halt of economic growth. The only solution is liberalization and deregulation of the European economy.”



## APPENDIX

### Brussels Bureaucracy at Work

The three examples of EU directives on pigs and tomatoes are much more than an amusing message about its bureaucracy's hunger for power. They tell the story of the kind of society that has been, for some time, replacing the free-market, private-property economy in Europe and is a serious threat to the future of liberty in the United States. .

*Example One:*

#### Protection of pigs

**The European Union has laid down minimum standards for the welfare of pigs kept for rearing and fattening in order to protect the pigs and prevent distortion of competition between producers in different Member States.**

#### ACT

**Council Directive 91/630/EEC of 19 November 1991 laying down minimum standards for the protection of pigs [ See amending acts ]**

#### SUMMARY

Established on the basis of the European Convention for the Protection of Animals Kept for Farming Purposes, Directive 98/58/EC lays down the Community provisions on animal welfare. It stipulates that all animals must be provided with housing, feed and care appropriate to their needs.

This Directive provides for minimum standards for the protection of pigs confined for rearing and fattening.

All holdings newly-built or rebuilt and/or brought into use for the first time after 1 January 2003 must comply with the following requirements:

- each weaner or rearing pig reared in a group must be provided with a minimum statutory unobstructed floor area, depending on its weight;
- each sow and gilt (a female pig that has not yet farrowed) must be provided with a minimum statutory unobstructed floor area of 2.25 m<sup>2</sup> and 1.64 m<sup>2</sup> respectively;
- flooring surfaces must meet standards concerning the minimum slat width and the maximum width of openings;
- the construction or conversion of installations in which sows and gilts are tethered is prohibited. The use of tethers for these animals is prohibited from 1 January 2006;

- sows and gilts shall be kept in groups during a period starting from 4 weeks after the service to 1 week before the expected time of farrowing.  
This provision does not apply to holdings with fewer than ten sows;
- sows and gilts kept in groups must be fed using a system which ensures that each individual can obtain sufficient food even when competitors for the food are present;
- to satisfy their hunger and given their need to chew, all dry pregnant sows and gilts must be given a sufficient quantity of bulky or high-fibre food as well as high-energy food;
- pigs kept in groups that are aggressive, have been attacked by other pigs or are sick or injured may temporarily be kept in individual pens whose size would be sufficient for the animal to roam around easily, provided this does not contravene specific veterinary advice.

These provisions are obligatory for all holdings from 1 January 2013. However, they do not apply to holdings with fewer than six pigs or five sows with their piglets.

The Directive lays down minimum welfare standards concerning:

- the materials used in the construction of housing;
- the layout of housing: each pig must be able to lie down, rest and stand up without difficulty and see other pigs;
- the insulation, heating and ventilation of buildings and the light and noise levels within them;
- inspection of the pigs, which must be carried out at least daily: any sick or injured pigs must be treated without delay and, where necessary, examined by a veterinarian.
- measures to prevent aggression between animals;
- the cleaning and disinfection of the housing, utensils and equipment used;
- the daily provision of healthy feed suited to the age and weight of the pigs.

Specific provisions on the different categories of pig: boars, sows and gilts, piglets, weaners and rearing pigs.

Preferably before 1 January 2005, the Commission must submit to the Council a report on the socio-economic, sanitary and environmental conditions affecting intensive pig-farming systems accompanied, where appropriate, by proposals for improvements. The Council must then act by qualified majority no later than three months after receiving the report.

By 1 January 2008, the Commission must present a report to the Council on pig welfare, covering the effects of stocking density in different farming systems, the impact of stall and flooring design and the risks associated with tail biting. The report must also cover further developments of group-housing systems for pregnant sows, the determination of the space required by each animal and an examination of consumers' behaviour towards pigmeat.

The Commission and the Member States conduct on-the-spot checks to ensure that the Directive is being applied. Experts from the Commission may make on-the-spot checks in cooperation with the competent authorities, which must then take any measures revealed to be necessary by the checks.

In order to be imported into the Community, animals from third countries must be accompanied by a certificate stating that they have received treatment similar to that provided for in the Directive.<sup>11</sup> Member States have until 1 January 1994 to bring into force the laws, regulations and administrative provisions, including any penalties, necessary to comply with the Directive. They may maintain or apply more stringent provisions.

*Example Two:*

**LONDON, England -- A report that claimed British pigs would have to be supplied with toys to keep them content has been described as "utter eurosceptic rubbish" by European Union officials.**

It had been reported that UK pig farmers would have to supply toys to pigs or face fines up to £2,500 under an EU directive.

But EU and UK officials knocked down the report, saying that under EU legislation on pig welfare, the animals only need to be given such rooting materials as straw, hay, wood, sawdust, compost or peat.

Jim Dougal, head of the European Commission in the UK, said: "There is no mention of toys in the EU directive. Yet again we see sections of the press resorting to invention in order to propagate their eurosceptic agenda.

"If the UK wants to tell farmers that they should supply toys for their pigs, that is matter for them."

UK Animal Welfare Minister Elliot Morley said: "Like many Euro myths, to suggest farmers are being ordered to give pigs toys is not true.

"Although it sounds amusing, there is a serious point to animal welfare behind the new pig directive which requires animals to have access to manipulable materials.

"This and other forms of environmental enrichment are examples of good management and it is already included in industry-run quality assurance schemes which farmers have applied for many years."

**The EU legislation was introduced following scientific evidence that showed boredom in pigs could lead them to harm themselves and each other.**

A spokesman for the UK Department of the Environment, Food and Rural Affairs (DEFRA) had been quoted as saying the regulations required all pigs to have access to a "sufficient quantity of manipulable materials."

"While straw and hay would do, obviously the use of a football or a chain would also do," the spokesman said.

"For many years now vets have been suggesting that you put a football or something to kick around into the stall with a horse if it is restless," he said.

"Basically, the same is true for pigs. If you put in a football or you dangle a chain they could nose it around and play with it, it is helpful."

Joyce D'Silva, chief executive of Compassion in World Farming, was critical of the way DEFRA handled the announcement of the new regulation.

"The EU directive on providing pigs with 'manipulable material' is a welfare measure designed to ensure they can carry out their natural rooting behaviour -- instead of living on barren, concrete slatted floors.

**"The intention is to provide pigs with materials like straw or mushroom compost to allow them to root -- not basketballs as quoted by DEFRA.**

"It is quite clear that there are people in DEFRA with little knowledge of pigs, apart from perhaps those they see in Hamleys toy shop.

"With this announcement, DEFRA are completely trivialising animal welfare issues."

**It is true that farmers who fail to follow the new regulations could be fined up to £2,500 but would not face a jail sentence.**

*Example Three:*

**Proposed draft Codex standard for tomatoes (CX FFV 00/16)**

The European Community wishes that the proposed draft concerned be amended on numerous points, in order to be harmonised with the existing international standards for this product: standard recommended by the UN/ECE Working Party on standardisation of perishable goods, OECD standard. These standards have existed for several decades and it is important that a possible new Codex standard for the same product is similar to them, if not identical, in order to avoid any confusion on the markets and to minimise overlapping between the work of the Codex Committee for fresh fruit and vegetables and the work of other international organisations. In these comments, account was taken of the draft revised standard for tomatoes, as approved by the last session of the UN/ECE

specialised section of the standardisation of fresh fruit and vegetables, which proceeded in May 2000.

***Paragraph 1: Definition of produce:***

It is desirable to define, at this stage of the Codex standard, the principal commercial types of tomatoes on the market, because, according to the types, the provisions of the standard will vary. The European Community proposes distinguishing four commercial types of tomatoes: round tomatoes, ribbed tomatoes, oblong tomatoes and cherry tomatoes. The following paragraph could be added following the first subparagraph of part 1:

**"Tomatoes may be classified into four commercial types:**

- "round" or spherical type,
- "ribbed",
- "oblong" or "elongated",
- "cherry" tomatoes (including "cocktail" tomatoes). "

***Paragraph 2.1 : Minimum requirements :***

- At item 2.1, the third indent mentions that tomatoes must be of characteristic appearance and development of the variety. The European Community considers that these criteria must be according to the class in which tomatoes will be classified. For example, development defects such as light bumps have to be acceptable in class I. The Community proposes therefore suppressing this indent and tackling the question of the defects of appearance and of development in paragraph 2.2 (Classification), rather than in this paragraph which should concern minimum characteristics only.

- The fifth indent stipulates that tomatoes must be free of damage caused by exposure to the sun. The Community considers that certain defects due to exposure to the sun (light sunburns of the skin for example) are acceptable in the classes I and II. It does not wish therefore this indent to be included to the minimum characteristics. When this type of defect reaches an unacceptable level, even in class II, tomatoes have reached "deterioration such as to make it unfit for consumption": the fourth indent applies therefore. Accordingly, the European Community proposes suppressing the fifth indent of paragraph 2.1.

- The sixth indent mentions that tomatoes must be free of damage caused by frost or freezing. The European Community considers that these defects are also covered by the fourth indent (see OECD interpretative booklet, page 21). The Community proposes therefore suppressing this indent.

- The ninth indent mentions that tomatoes must be "practically free of pests and disease". The European Community believes "diseases" are included in "pests". Accordingly, the European Community proposes replacing the ninth and the tenth indents by the two following indents:

**"practically free from pests,**

**- practically free damage caused by pests, "**

- Increasingly tomatoes are presented in trusses, i.e. in whole inflorescence or part of inflorescence. In this case, it is necessary to envisage minimum requirements for the quality of stalks, in addition to the requirements, which apply to tomatoes. The European Community proposes adding the following subparagraph at the end of paragraph 2.1:

**"In the case of trusses of tomatoes, the stalks must be fresh, healthy, clean and free from all leaves and any visible foreign matter."**

***Paragraph 2.2. : Classification :***

- Paragraph 2.2.1 stipulates that the shape of tomatoes must be typical of the variety. The European Community is in agreement with this requirement, but in the Extra Class, it wishes tomatoes to be characteristic of the variety in all points (shape, aspect, development). That makes it possible to suppress the indent dealing with the shape, because a tomato characteristic of the variety is inevitably "properly shaped".

With regard to the uniformity of size and colouring, mentioned in the second subparagraph of paragraph 2.2.1, the European Community considers that this consideration has its place rather in paragraph 5.1 (Uniformity). The proposed draft Codex standard stipulates moreover that tomatoes shall be uniform in size in all Classes, and uniform in colouring in Extra Class. It is not therefore necessary to mention the requirement of uniformity of size and colouring in this paragraph.

On the other hand, it is necessary to specify, with regard to colouring, that tomatoes can be not characteristic of the variety. When tomatoes reached the degree of development and maturity mentioned as in point 2.1.1, they can, according to the envisaged duration of transport and its nature (chilled or not), present a range of colouring going from the green to the red. What is important is not therefore that colouring is typical of the variety, but that colouring is such that tomatoes will arrive at destination in a satisfactory condition.

The Community proposes therefore mentioning this idea specifically.

The Community also is in agreement with the fact that tomatoes have to be firm in this class. It proposes however that this adjective applies to the flesh of tomatoes.

The proposed draft standard mentions that tomatoes must be free from damages (bruises). The Community considers that this is also envisaged by the last subparagraph of paragraph 2.2.1 which stipulates that tomatoes can present only very slight superficial defects.

Lastly, "green backs" type defects (yellow or green aureole located around the stem cavity and which corresponds to a non-edible callous part) have to be avoided in the Extra class. The European Community proposes making explicit indication of it, because such defects are not always easily visible especially when fruits are still at a colouring stage close to green.

Accordingly, the European Community proposes writing paragraph 2.2.1 in the following way:

**"Tomatoes in this class must be of superior quality. They must have firm flesh and must be characteristic of the variety as regards shape, appearance and development. Their colouring, according to their state of ripeness, must be such as to satisfy the requirements set out in paragraph 2.1.1 above.**

**They must be free from greenbacks and other defects, with the exception of very slight superficial defects, provided these do not affect the general aspect of the produce, the quality, the keeping quality and presentation in the package. "**

In paragraph 2.2.2, the proposed draft stipulates that Class I tomatoes are those which do not qualify in Extra Class but satisfy the minimum requirements. Traditionally, Class I products are defined in the Codex standards as "high quality" and characteristic of the variety (including in terms of shape) products. The European Community considers that the proposed drafting no longer describes the gradation which shall exist between classes Extra, I and II products. It proposes therefore taking up again the usual formulation of other Codex standards to define Class I products.

In Class I, the Community is in agreement that tomatoes have to present neither visible "greenbacks", nor cracks. These defects are sufficiently important to be acceptable only in Class II.

With regard to skin defects, the Community is of the opinion that the general rule must be the absence of cracks, healed or not. Skin defects must be limited to slight defects. It does not seem necessary to specify the higher limit of size for these defects. In addition, the higher limit of size proposed for skin defects in Class I seems too important for round tomatoes, oblong tomatoes and cherry tomatoes. Cracks and stem cork-like scars (of umbilical or linear shape) are rather specific to ribbed tomatoes. For this type of tomatoes, specific tolerances can be worked out: healed cracks of 1 cm at most, non excessive protuberances, small umbilicus without suberisation, as well as the defects envisaged by the last indent of paragraph 2.2.2 of the proposed draft.

Lastly, internal discoloration (coffee stain) may be acceptable as a colouring defect provided it is slight. A dimension of 25 mm in diameter (4.9 cm<sup>2</sup>) is well too important to be described as "slight".

The European Community proposes therefore replacing the second subparagraph of paragraph 2.2.2 by the following text:

**"Tomatoes in this Class must be of good quality. They must be reasonably firm and characteristic of the variety.**

**They must be free of cracks and visible greenback. The following slight defects, however, may be allowed provided these do not affect the general appearance of the produce, the quality, the keeping quality and presentation in the package:**

- a slight defect in shape and development,
- a slight defect in colouring,
- slight skin defects,
- very slight bruises.

**Furthermore, ribbed tomatoes may show :**

- healed cracks not more than 1 cm long
- no excessive protuberances
- small umbilicus, but no suberisation,
- suberisation of the stigma up to 1 cm<sup>2</sup>,
- fine blossom scar in elongated shape (like a seam), but not longer than two-thirds of the greatest diameter of the fruit. "

- In paragraph 2.2.3 (Class II), no indication is provided with regard to firmness of the tomatoes. The European Community considers that one has to fix a limit and proposes speaking about tomatoes at least "reasonably firm (but slightly less firm than in class I)".

The Community considers that tomatoes presenting unhealed cracks cannot be admitted even in class II, the product being insufficiently conservable.

Allowable defects in class II are numerous and rather important. A number of these defects are not mentioned by the proposed draft such as colouring, development and bruising defects.

With regard to skin defects, one can admit in Class II any defect which does not damage seriously the fruit. But with regard to healed cracks, the European Community proposes fixing the limit at 3 cm rather than 73 mm, because the latter value is well too important with respect to the size of the fruit.

Specific defects for ribbed tomatoes can be the subject in addition of additional tolerance: protuberances, umbilicus, cork-like scars of umbilical shape or of elongated shape. Accordingly, the European Community proposes replacing the second subparagraph of paragraph 2.2.3 by the following text:

**"They must be reasonably firm (but may be slightly less firm than in class I) and must not show unhealed cracks.**

**The following defects may be allowed provided the tomatoes retain their essential characteristics as regards the quality, the keeping quality and presentation :**

- defects in shape, development and colouring,
- skin defects or bruises, provided the fruit is not seriously affected,
- healed cracks not more than 3 cm in length for round, ribbed or oblong tomatoes.

**Furthermore, ribbed tomatoes may show :**

- more pronounced protuberances than allowed under class I, but without being misshapen,
- an umbilicus,
- suberisation of the stigma up to 2 cm<sup>2</sup>,
- fine blossom scar in elongated form (like a seam). "

***Paragraph 3. : Calibration :***

- The proposed draft Codex standard for tomatoes fixes a different sizing rule according to whether tomatoes are round or oblong. The European Community understands the proposal as following: for round tomatoes, sizing is by the maximum diameter of the equatorial section; for oblong tomatoes, it is by a double measure (minimum value of the maximum diameter of the equatorial section; maximum value of the length of the axis joining the stalk at the pistillar end.

This proposal does not specify the sizing rule applicable to ribbed tomatoes. It does not specify size uniformity rules for round tomatoes. They do not specify if sizing has to be applied to trusses of tomatoes. In addition, the sizing scales for oblong tomatoes seem inapplicable: one does not understand how an oblong tomato can be, for example, at the same time of a diameter over 40 mm and of a length less than 46 mm. This sizing scale seems to be made for round tomatoes rather than for oblong tomatoes, since it limits the difference between the diameter and the length of the fruit. Lastly, the proposed size codes do not correspond to any existing commercial practice to the knowledge of the European Community.

- The European Community proposes therefore adopting the following principles for the sizing of tomatoes: size determination by means of the diameter of the equatorial section for all types of tomatoes, minimum size for oblong, ribbed and round tomatoes, size scale applicable to tomatoes in classes Extra and I (other than trusses of tomatoes) without size code indication.

The proposals of the European Community could read in the following way:

**"size is determined by the maximum diameter of the equatorial section. The following provisions shall not apply to "cherry" tomatoes.**

### ***3.1 Minimum size***

**For tomatoes classified in the Extra class and classes I and II, the minimum size is set at:**

- 35 mm for round and ribbed tomatoes,
- 30 mm for oblong tomatoes.



### 3.2. Sizing scale

The tomatoes are graded according to the following sizing scale :

- 30 mm and over but under 35 mm (only for oblong tomatoes)
- 35 mm and over but under 40 mm
- 40 mm and over but under 47 mm
- 47 mm and over but under 57 mm
- 57 mm and over but under 67 mm
- 67 mm and over but under 82 mm
- 82 mm and over but under 102 mm
- 102 mm and over

**Observance of the sizing scale is compulsory for Extra class and class I tomatoes.**

**This sizing scale shall not apply to trusses of tomatoes. "**

#### ***Paragraph 4. : Tolerances :***

- Part 4 is different from the general presentation of other Codex standards in two ways:  
 - on the one hand, the first subparagraph is written in a more complex way without the brought details being necessary since they are included in the traditional drafting of this first subparagraph.

-in addition, paragraphs 4.1.1.2, 4.1.2.2 and 4.1.3.2 envisage tolerances at the transit or point of arrival, tolerances not envisaged in the other Codex standards.

The Community proposes therefore suppressing paragraphs 4.1.1.2, 4.1.2.2. and 4.1.3.2, and writing the first subparagraph according to the following traditional formula:

**"Tolerances in respect of quality and size shall be allowed in each package for produce not satisfying the requirements of the class indicated."**

- Tolerances proposed in paragraphs 4.1.1.1, 4.1.2.1 and 4.1.3.1 are 10%. It seems more suitable to the European Community to fix less high tolerance for the Extra class in which only tomatoes of superior quality shall be classified. In addition, in each class, only produce of the category immediately below are usually tolerated. Tolerances are provided for avoiding that small mistakes of classification involve the downgrading of the whole lot in its integrality. The European Community fears that, enlarging tolerances too much, it becomes a pretext to systematically include out of grade fruits, even in Extra class or Class I. Lastly, it is necessary to avoid any product not fit for consumption, in particular those affected of rot at a point where consumption is impossible.

In addition, since an increasing share of the trade is done in the form of trusses of tomatoes, it is appropriate to envisage specific tolerances for these products.

Accordingly, the Community proposes writing paragraphs 4.1.1, 4.1.2 and 4.1.3 in the following way:

#### **"4.1.1 Extra class :**

**5% by number or weight of tomatoes not satisfying the requirements of the class but meeting those of Class I or, exceptionally, coming within the tolerances of that class.**

#### **4.1.2 Class I :**

**10% by number or weight of tomatoes not satisfying the requirements of the class but meeting those of Class II or, exceptionally, coming within the tolerances of that class. In the case of trusses of tomatoes, 5% by number or weight of tomatoes detached from the stalk.**

#### **4.1.3 Class II :**

**10% by number or weight of tomatoes satisfying neither the requirements of the class nor the minimum requirements, with the exception of produce affected by rotting, marked bruising or any other deterioration rendering it unfit for consumption. In the case of trusses of tomatoes, 10% by number or weight of tomatoes detached from the stalk.**

- With regard to size tolerances, the European Community proposes that one limit tolerance for tomatoes smaller than the minimum size, by adding the following sentence: **"... with a minimum of 33 mm for round and ribbed tomatoes, and 28 mm for oblong tomatoes".**

- The European Community considers that setting colour tolerances is not necessary in paragraph 4. Colouring defects are included within quality tolerances. With regard to the absence of uniformity in colouring for a lot or for a package, the question has to be addressed within paragraph 5.1 (uniformity) and not within paragraph 4 which deals with defects one can tolerate for each individual fruit. The European Community proposes therefore suppressing paragraph 4.3.

***Paragraph 5. : Presentation :***

- According to the proposals of the European Community made in paragraph 3, sizing of tomatoes would be compulsory only for the Extra class and class I. Size uniformity is therefore due only for these two classes and not for the class II. The European Community proposes therefore adding the following bracket to the end of the first sentence of paragraph 5.1:

**"(if sized)"**

- For class I tomatoes, which are of good quality, certain colour and maturity uniformity has to be satisfied according to the European Community. If the trader who orders class I tomatoes (good quality, but not superior quality) receives tomatoes of all colours and state of ripeness mixed in the package, he will have to, without any doubt, carry out a new sorting, which appears contradictory with the concept of good quality. In addition, in the case of oblong tomatoes, it is appropriate to fix certain length uniformity for the two higher classes. The European Community proposes therefore the following text to replace the second sentence of paragraph 5.1:

**"The ripeness and colouring of tomatoes in Extra Class and Class I must be practically uniform. In addition, the length of oblong tomatoes must be sufficiently uniform."**

- Footnote 4 in paragraph 5.2 (Packaging) stipulates that recycled materials could be used inside the packages. In commercial practice, only packages themselves are recycled, not materials used inside the package (plastic crates for example). The recycling of this type of materials should not be incited or urged, because, in general, these materials are not re-usable. Accordingly, the European Community proposes deleting Footnote (4) in the proposed draft Codex standard for tomatoes.

- The commercial practice which consists in presenting the tomatoes in trusses developed enormously during the last decade. The European Community wishes therefore a new paragraph 5.4, named "Presentation", to be inserted in the proposed draft in order to describe the two methods of presentation of tomatoes. In particular the presentation in trusses shall be described, which, having regard to the better remuneration the market gives for it, could be the subject of fraudulent practices. The European Community proposes the following text for this new paragraph:

#### **"5.4 Presentation**

**The tomatoes may be presented as follows:**

- **as individual tomatoes, with or without calyx and short stalk;**
- **as trusses of tomatoes, in other words, in entire inflorescence or parts of inflorescences, where each inflorescence or part of each inflorescence should comprise at least the following number of tomatoes :**
- **3 (2 if prepackaged) or**
- **in the case of trusses of "cherry" tomatoes, 6 (4 if prepackaged). "**

#### ***Paragraph 6. : Marking/Labelling :***

- At item 6.2. (Non-retail containers), the proposed draft Codex standard for tomatoes stipulates that particulars set out by sections 6.2.1 to 6.2.5 could only be present in documents accompanying the shipment. This possibility is traditionally reserved for bulk (in a transport vehicle or part of a transport vehicle) shipments. Tomatoes are not shipped this way. Accordingly, the European Community proposes deleting the following words :  
", or in the documents accompanying the shipment".

- In paragraph 6.2.2, the proposed draft sets out the marking of the nature of produce when the contents of the package are not visible from the outside. The European Community considers that, in the case of trusses of tomatoes, this indication, as well as that of the commercial type (round, ribbed, oblong) has also to be indicated. In addition being given their very different characteristics, cherry tomatoes should be the subject of a compulsory marking. The text of paragraph 6.2.2 could be as follows:

**"" tomatoes "or" trusses of tomatoes "and the commercial type if the contents are not visible from the outside. These details must always be provided for "cherry" (or "cocktail") tomatoes, whether in trusses or not.**

- **name of the variety (optional). "**

- Paragraph 6.2.4 stipulates that the size is indicated either by the code (see paragraph 3), either by the average diameter. Since the European Community proposes the removal of the codes referred to in paragraph 3 (the latter not being used in trade) and that the standard fixes no size uniformity rule based on an average size, the European Community proposes rather indicating the size (if tomatoes are sized) by means of the minimum diameter and the maximum diameter in the package.

#### ***Paragraph 7 : Contaminants :***

- Paragraphs 7.1 and 7.2 refer, as well as all other Codex standards for fruit and vegetables, to the maximum limits fixed by the Commission for heavy metals and pesticides. Without contesting this principle, the European Community wonders however if the Codex standard for tomatoes (as well as other Codex standards for fruit and vegetables) would not gain in legibility and in transparency by incorporating a summary table of these maximum limits fixed by the Commission.



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