

# The Basics of Property Rights

## Institutional Economics Lecture 2

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- 1 Why Property Rights?
- 2 What are Property Rights?
- 3 Social Consequences of the PR Allocation
- 4 How to Get a Nobel Prize in Economics;-)?

# Setting the Stage

Alchian, A. (1950): Uncertainty, Evolution, and Economic Theory, *JPE*

What are the neoclassic assumptions which do not work?

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“Success accompanies relative superiority” (as opposed to mathematically optimal behavior) “The crucial element is one’s position relative to actual competitors, not some perfect competitors. Even in a world of stupid men there would still be profits.”

# Setting the Stage (Conclusion)

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The outcome of this discussion: “It is straightforward if not heuristic to start with *complete uncertainty* and *nonmotivation* and then to add elements of foresight and motivation in the process of building an analytical model.”

Think:

- ① implications for economic analysis.
- ② add property rights and transaction costs. How will they change the complete uncertainty and non-motivation?



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→ PRs help form expectations → guide incentives → rational behavior

# What are Property Rights?

Alchian & Demsetz (1973). The Property Rights Paradigm

Scarce resources → Competing demands for the use of those resources → conflict of interest between interested parties → Resolution of conflict:

- by the market – through negotiation (or brute force?..)
- by the allocation of property rights
- by a combination of the two

## Property Rights

Socially recognized rights to do things with a scarce resource.

What is owned are rights to *use* resources. It is not *the* resource itself which is owned; it is a bundle, or a portion, of rights to use a resource that is owned.

# Three main questions

Alchian & Demsetz (1973). The Property Rights Paradigm

Three questions are suggested by the growing literature on property rights:

- ① What is the structure of property rights in a given society?
- ② What are the consequences of this structure for social interaction?
- ③ How has this property right structure come into being? (The political economy of property rights)

# The Structure of Property Rights

## Different legal traditions

- Civil Law (Continental tradition): property rights are *indivisible*, and the object of property is viewed as a whole. More recently, this tradition was converging to the Common law system
- Common law (Anglo-Saxon tradition, UK, US, etc.): the rights are viewed over a *specific feature* of the object:
  - 1 using
  - 2 deriving income
  - 3 changing the physical properties of the object
  - 4 transferring rights to another entity

Think: how the structure of rights affects the allocation of resources?

# Social Consequences of the PR Allocation

## Example 1: Freeways VS Toll-based highways

- Freeways – a communal good: free but oversubscribed → congestion, high maintenance costs
- Toll-based highways – privately owned right to exclude people from driving on the roads:
  - 1 (+) efficient allocation of drivers along the roads
  - 2 (+) saving costs to the government to maintain the roads
  - 3 (-) highways not free
  - 4 (-) introducing monitoring costs

Think: When will it be efficient to build free highways and when to concession them?

# Social Consequences of the PR Allocation

## Example 2: Who gets the kill?

- the kill belongs to the hunter: proper incentive to kill
- the kill belongs to the community:
  - ① hunters do not have enough incentive to kill
  - ② those who consume the kill do not have incentive to become hunters
  - ③  $\Rightarrow$  excess demand  $> 0$  (shortage of food)
  - ④  $\Rightarrow$  "it is necessary for societies which fail to establish private rights to move ever closer to a social organization in which the behavior of individuals is directly regulated by the state or indirectly influenced by cultural indoctrination"

Think: When will it be efficient to have private allocation of hunting rights VS public allocation?

Think: Are there situations in which privatizing property rights is inefficient?

$\Rightarrow$  The importance of specifying property rights well

# The Reciprocity of Cost & Benefit

Coase, Ronald (1960). The Problem of Social Cost, J. Law & Econ., 3, 1-44

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“The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is: **how should we restrain A?** But this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would inflict harm on A. The real question that has to be decided is: **should A be allowed to harm B or should B be allowed to harm A?** The problem is to avoid the more serious harm.”

## Coase theorem

In a regime of zero transaction costs negotiations between the parties would lead to arrangements which maximize wealth irrespective of the initial assignment of property rights

“My conclusion: let us study the world of positive transaction costs.”

# The Reciprocity of Cost & Benefit (2)

Coase, Ronald (1960). The Problem of Social Cost, J. Law & Econ., 3, 1-44

Discuss: Smoking in public spaces should be banned.

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Discuss: Smoking in public spaces should be banned.

“Economists who study problems of the firm habitually use an opportunity cost approach and compare the receipts obtained from a given combination of factors with alternative business arrangements. It would seem desirable to use a similar approach when dealing with questions of economic policy and to compare the total product yielded by alternative social arrangements”

“The cost of exercising a right (of using a factor of production) is always the loss which is suffered elsewhere in consequence of the exercise of that right-the inability to cross land, to park a car, to build a house, to enjoy a view, to have peace and quiet or to breathe clean air”

# The significance of the Coase theorem

## The problem of social cost (1960)

The significance of the Coase theorem:

- there is no economy with zero TC
- inefficient allocation of resources is normal
- reducing TC may bring the economy closer to efficient allocation of resources – institutions matter

“The time has surely gone in which economists could analyze in great detail two individuals exchanging nuts for berries on the edge of the forest and then feel that their analysis of the process of exchange was complete...” - from his Nobel lecture

- 1 Is the world certain or uncertain? Are agents perfectly rational?
- 2 How property rights help reduce uncertainty?
- 3 What are PRs?
- 4 What are the differences between Civil and Common Law over the specification of property rights?
- 5 What are the main questions related to PRs?
- 6 What are the main types of property rights?
- 7 State the main problem Coase is addressing in *The Problem of Social Cost* (1960)
- 8 State the Coase theorem
- 9 Discuss the significance of the Coase theorem

Voluntary homework: Design two examples in which an alternative allocation of property rights may benefit society (the sum of both sides) in a world of zero transaction costs. Would the allocation be different with non-zero transaction costs? Can you build a simple model (even if it is only numerical) to demonstrate your point?

- ① \*\*\* Coase, Ronald (1960). The Problem of Social Cost, *Journal of Law and Economics*, 3, 1-44.
- ② \*\*\* Coase, Ronald H. (2005). The Institutional Structure of Production. In: C. Menard and M. M. Shirley (eds.), *Handbook of New Institutional Economics*, 31-39
- ③ Alchian, Armen (1950, Jun.). Uncertainty, Evolution, and Economic Theory, *Journal of Political Economy*, 58(3), 211-221
- ④ Demsetz, Harold (1967, May). Toward a Theory of Property Rights, *American Economic Review*, 57(2), 61-70
- ⑤ Alchian, Armen & Demsetz, Harold (1973, Mar.). The Property Rights Paradigm, *The Journal of Economic History*, 33(1), 16-27