In the memory of
Novka, Vida, Desa and Dara
I wish we could all be like them

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INTRODUCTION

1. THE ECONOMICS OF PROPERTY RIGHTS: LEGAL AND MORAL FOUNDATIONS

1.1 Definition and meaning of Property Rights

Early in the 20th century, Irving Fisher wrote:

A property right is the liberty or permit (under the sanction and protection of custom and law) to enjoy benefits of wealth—in its broadest sense—while assuming the costs which those benefits entail… It will be observed that property rights, unlike wealth or benefits, are not physical objects nor events, but are abstract social relations. A property right is not a thing.¹

Fisher’s quote is consistent with the way most cultures, religions, Roman law, common law, and the history of economic ideas (including Karl Marx’s writings) have thought of property rights. We can say that property rights are relations among men that arise from the existence of scarce goods and pertain to their use.

This definition of property rights says that the distinction between human rights and property rights is artificial and serves no purpose. The right to vote defines the relationship between an individual citizen and all other legal adults in the community with respect to the choice of government. The right to own a computer defines the relationship between the owner and all other people with respect to the access to that computer. The right to travel, the right to be protected from unlawful search, the right to own earning assets, etc., specify the norms of behavior with respect to scarce goods that each individual must observe in the interaction with other individuals or bear the cost of non-observance. They are all property rights.

1.2 The Property Rights School

From the dawn of human history, individuals have appreciated the importance of property rights for their survival.² Primitive men fought each other for the right of access to better caves. Clans settled in the area where fishing, hunting and/or trades were profitable. Then, they tried to deny others the access to those areas. Great religions wrestled with the issue of reconciling the behavioral consequences of property rights with their moral teachings (e.g., usury laws). Kings granted various bundles of property rights to their subjects in exchange for services and taxes. The entire twentieth century was consumed with a struggle between two different concepts of property rights, as represented by capitalism and socialism.

Social scientists and philosophers also recognized the importance of property rights.³ However, it was only in the 1960s that a systematic study of property rights began in the earnest. Within a few decades a significant body of empirical and analytical research demonstrated that property rights create incentives and transaction costs affecting economic performance, and that, in turn, the economic conditions of life are a factor influencing changes in property rights. Without denying the contributions made by numerous scholars, Armen Alchian, Ronald Coase, Harold Demsetz, Henry Manne, Douglas North and Oliver Williamson deserve the highest praise.
demonstrating that systematic two-way relations exist between property rights and economic behavior, those scholars translated the centuries of awareness of the importance of property rights into the economic theory of property rights.

While the economics of property rights is a fast growing method for analysis of real-world events, it is still in the process of creating its own mainstream. As readings in this book show, some scholars see the economics of property rights as an attempt to expand the ability of neoclassical economics to explain a larger class of real-world events. Others tend to subsume the economics of property rights under the general heading of the new institutional economics. Many social scientists consider the economics of property rights to be a *sui generis* method of analysis closely related to the Austrian School and Public Choice School.

Yet, most scholars agree that the economics of property rights is about internalizing into a theoretical framework (1) the effects of alternative property rights on the costs of transactions and incentive structures, (2) the effects of the costs of transactions and incentive structures on economic behavior, and (3) the evidence for refutable implications of those effects. Scholars allied with the Austrian School and the Public Choice School, and to a lesser extent those allied with the New Institutional Economics, also maintain that the property rights approach provides a better understanding of real-world events than neoclassical economics, which is the mainstream economics today. Those scholars see the advantage for the economics of property rights in the neoclassical silence on two critical issues: (1) The effects of alternative property rights on the agent’s costs of acquiring the knowledge required to make optimal choices, and (2) the effects of new knowledge on property rights. Andrew Schotter wrote:

…the only institutions existing in [the neoclassical model] are markets of the competitive type in which all information on the economy must be transmitted through the prices formed in these markets. The economy is therefore assumed to have…none of the many institutions that are created by societies to help coordinate their economic and social activities by offering information not available in competitive prices.4

And Herbert Simon said:

[New economic theories] are not focused upon, even much concerned with, how variables are equated at the margin, or how equilibrium is altered by marginal shifts in conditions. Rather they are focused on qualitative and structural questions, typically, on the choice among a small number of discrete institutional alternatives.5

1.3 Property Rights and the Rules of the Game

From the beginning of human history, individuals had realized that teamwork is an efficient method for producing the subsistence and beyond. In the pursuit of survival, a number of different communities emerged such as extended families, clans, tribes, townships, religious groups, kingdoms, republics, empires, and modern entities such as European Union. The survival requirements for all those communities have always been cooperation and coordination among their members. The role of formal and informal institutions (i.e., the rules of the game) is to enhance cooperation and coordination among interacting individuals in the community. Formal
and informal rules are the aggregation of property rights that individual members of the community have. One can think of formal and informal institutions as containers holding, protecting and enforcing various bundles of property rights.

Informal rules include traditions, customs, moral values, religious belief and all other norms of behavior that have emerged spontaneously via repeated human interactions, and passed the test of time. Informal rules are enforced by sanctions, which include expulsion from the community, ostracism by friends and neighbors, or loss of reputation. Those norms of behavior, or principles of ethics, define the social fabric of the community. The synthesis between ethical principles and their daily applications in real life is the community’s prevailing ethos. Predictably, different communities have developed different informal rules.

Formal institutions include constitutions, statutes, common law, and other governmental regulations. Formal rules are enacted, changed, and enforced by legislators, judges, civil servants, and other public authorities. Governments enforce formal rules by means of sanctions such as fines, imprisonment’s, or executions.

The success of prevailing rules in enhancing cooperation and coordination among members of the community depends on their stability and credibility. Rules that are loosely enforced do not encourage human interaction and cease to be a predictor of human behavior. The result is higher transaction costs of exchange and fewer exchanges. Also, as time goes by, individuals become better acquainted with the rules. They learn how to adjust to the system, identify exchange opportunities, and exploit the most beneficial ones. Thus, the flow of benefits from institutions depends on their stability as well as credibility.

Bruno Leoni conceptualized the meaning and importance of the rule of law. The rule of law means absence of arbitrary power on the part of the ruling group; subjection of all citizens to the same laws; stable and credible rules; and democratic elections. An implication is that the political elite in a rule of law country has incentives to satisfy preferences of the median voter on key issues. On the strict interpretation of the rule of law no country would qualify. However, the concept of the rule of law provides an ideal yardstick for comparison of alternative property rights, and their economic and social consequences. The further a country travels away from the rule of law the greater the power of the ruling group to reallocate property rights to their supporters.

Replacing old statutes with common law in the seventeenth century contributed to the development of the rule of law in England. The United States inherited the rule of law tradition from the British. In both countries, individual rights are generalized from specific decisions (precedents) entered by common law courts. According to Buchanan, “The object of never-ending search by loosely coordinated judges acting independently is to find the law, to locate and redefine the structure of individual right, not ab initio, but in existing social-institutional arrangements.” That is, legal precedents tie changes in property relations to changes in the game. In his Farewell Address on September 19, 1796, George Washington emphasized the importance of the rule of law:
The basis of our political systems is the right of the people to make and to alter their Constitutions of Government. But the Constitution that at any time exists, until changed by an explicit and authentic act of the whole people, is sacredly obligatory upon all.... All obstructions to the execution of the Laws, all combinations and Associations, under whatever plausible character, with the real design to direct, counteract, or awe the regular deliberation and action of the Constituted authorities are destructive of this fundamental principle and of fatal tendency.8

On the other hand, seventy years of the Soviet rule and ten years of “transition” have subverted the meaning of law in Russia. In an arbitrary state like Russia, formal rules are a vehicle used by rent-seeking coalitions to reallocate property rights. For example, in the 1990s, many Protestant denominations have found people in Russia receptive to their religious and ethical norms of behavior. The response of the Russian Orthodox Church was to lobby the government to pass laws prohibiting (or at least seriously restricting) other religions from marketing their services in Russia. Otherwise, leaders of the Russian Orthodox Church said Russian culture would be westernized. Of course, the argument is merely the façade of words hiding the true purpose of Church leaders, which is to enhance their survival by closing the market for religion. An unintended consequence of using the strong-hand-of-the-state to protect the Russian Church from competition is to deprive Russians of an important property right: the right to choose the package of beliefs and the associated norms of behavior.

1.4 Property Rights, Incentives and Transaction Costs

The more rights a person has in a good, the closer that person’s private cost is to the social cost of using that good. And bearing more costs of using a good creates strong incentives for the person to seek ways to reduce transaction costs of discovering the best use for the asset.9 By internalizing most if not all social costs of using scarce resources, the right of ownership provides such incentives more efficiently than other property rights.

Those incentives affect economic behavior in specific and predictable ways. People have more incentives to take better care of homes they own than of those they rent. They have more incentives to add oil to cars they own than to those they lease from rental companies. The buffalo is extinct in the United States but the cattle is not. Public lakes are dirtier than private lakes. Observations like those do not support a claim that human greed destroys resources. They are, however, consistent with saying that different property rights create their own incentives. And those incentives, in turn, affect human behavior through their effect on the relationship between the private and social costs of using scarce goods. A Nobel Laureate Ronald Coase wrote:

[Individuals,] who are normally only interested in maximizing their own incomes, are not concerned with social cost and will only undertake an activity if the value of the product of the factors employed is greater than their private cost.... But if private cost is equal to social cost, it follows that [individuals] will only engage in an activity if the value of the product of the factors employed is greater than the value which they would yield in their best alternative use. That is to say, with zero transaction costs, the value of production would be maximized.10
Coase made two points that brought together property rights, transaction costs and economic behavior: (1) clearly defined private property rights are an essential requirement for resolving the conflict of interests among individuals via market exchange, and (2) an efficient allocation of resources is independent of the initial assignment of private property rights as long as transaction costs are insignificant. Those two points address the world in which the costs of identifying, negotiating, and monitoring exchanges are negligible; the costs of protecting and maintaining the environment are ignored; and the maximum output is taken to be merely a function of the supply of inputs, their substitutability, and technology. However, the world of zero transaction costs is not the one we live in. Coase's purpose has been to persuade his colleagues to devote their energies to better understanding of the real world of uncertainty and incomplete knowledge. The relevant choice for policy is not between two or more frictionless models. The relevant choice is between two or more discrete property rights arrangements with positive transaction costs. Coase said:

The reason why economists went wrong was that their theoretical system did not take into account a factor, which is essential, if one wishes to analyze the effect of a change in the law on the allocation of resources. This missing factor is the existence of transaction costs.11 Transaction costs are the costs of all resources required for transferring property rights from one economic agent to another. Transaction costs include the cost of making an exchange (i.e., discovering exchange opportunities, negotiating exchange, monitoring exchange, and enforcing it) and the cost of maintaining and protecting the institutional structure (i.e., the judiciary, police, and armed forces).12 Readings in this book show that different property rights have different effects on transaction costs.

1.5 Development and Changes in Property Rights

If property rights were a major factor affecting economic behavior, the process of making and changing property rights is an important circumstance upon which that factor depends. Property rights can change spontaneously from within the system or they can be imposed from the outside.

Property rights emerge spontaneously (e.g., repeated voluntary interactions that are eventually integrated into prevailing informal rules and formal rules) in response to changes in the economic conditions of life. That is, more efficient property rights develop in response to the interaction between changes in the economic conditions of life and individuals' search for more utility; they help individuals to negotiate more effectively the contractual agreements that new economic and social developments have made available. Being the result of selective evolution, property rights that emerge endogenously tend to be “friendly” to the prevailing ethos. An implication is that the transaction costs of monitoring and enforcing those property rights are low. Angelo Petroni wrote:

The fact that the mechanism of evolution, when large numbers and long periods of time are involved, may be treated by the economist as if it were a Darwinian one, does not imply that individuals do not have a purposive objective-seeking behavior including imitation of others' successful behavior.13
While not enough is known about the process of spontaneous changes in property rights, the following sequence of events is both plausible and verifiable. Suppose an exogenous shock hits the community; that could be new ideas and beliefs, new technology, new markets, better communications with others, etc. An important economic consequence of the exogenous shock would be to enlarge the set of opportunity choices for human interactions. However, if new exchange opportunities were not in tune with the prevailing ethos or formal rules, the community would consider the behavior of those exploiting the opportunities as submarginal. But if operating below the margin of accepted behavior provided a differential return, the success of those individuals doing so would attract imitations from others. And if the returns were substantial enough to generate and sustain a large number of repeated interactions relative to the community’s willingness to bear the costs of enforcing prevailing property rights, the success of new activities would eventually oblige the community to accept a change in property rights. With this change in property rights, the behavior that used to be submarginal eventually becomes marginal (e.g., change in the property rights of arranging marriages from their parents to the couples themselves).

However, history offers many examples of those in power assuming an active role in changing the prevailing property rights. The effect of exogenous changes in property rights is to force the game to adjust to new rules. While some exogenous changes in property rights might be prudent and justifiable, the problem is that the ruling elite compels people to accept new rules containing changes in property rights whether they like them or not. New property rights that emerge from this process might or might not be in tune with the prevailing ethos. In fact, much depends on the incentive structures of public decision-makers. If the interaction between new property rights and the prevailing ethos were not smooth, the transaction costs of monitoring and enforcing those property rights are likely to be high. For example, in Shasta County, California, the residents prefer to rely on a set of endogenous informal rules rather than on legal norms to resolve disputes arising from damages done by stray livestock.

1.6 Types of Property Rights

Roman Law provided the most enduring legal and philosophical foundation for property rights. Moreover, the borrowing from Roman law by English and American common law suggests that European legal tradition and common law have the same roots. In Roman law we find references to many types of property rights. However, it emphasized three types of property rights that are very much with us today: private ownership, communal ownership and state (public) ownership. To quote Justinian: “...Some things are by natural law common to all, some are public, some belong to a society or corporation, and some belong to no one. But most things belong to individuals, being acquired by various titles...” A section of this book covers the meaning and economic consequences of private, communal and public ownership for economic behavior. However, various readings in the book also touch upon other categories of property rights such as usus fructus (the right to use a scarce good belonging to someone else or to rent it to others, but not to sell it or change its substance), and usus (the right to use a scarce good belonging to someone else, but not to rent it or sell it or change its substance).

1.7 Rights, Exchange and Economic Performance
Exchange is a means by which people seek more satisfaction. In a world of uncertainty and incomplete knowledge, the benefit from exchange is the increment in satisfaction an agent expects to derive from acquiring property rights to use a little more of any good. The cost of exchange is the satisfaction from property rights in a good the agent has to give up. Exchange is then the transfer of well-specified bundles of rights to do things with the goods that are being traded.

An implication is that property rights, via their link with economic value, affect economic performance. A professor owns the computer at home while the one in the office belongs to the university. Both computers offer the same flow of services, but one at home is more valuable. The value of the same beauty shop would be greater if the owner had the right to sell it to others. Some people consider privacy to be a valuable property right and are willing to pay for it. Rent seeking coalitions in Washington and Brussels keep reminding us that the protection from competition is a valuable property right.\textsuperscript{16} Equal pay for equal work rules deprive some individuals of a valuable property right to offer to work at prices at which they could get jobs. In a number of papers, Allan Meltzer, Jeff Sachs and other scholars have been arguing that the so-called international financial crises are merely the consequences of serious problems with the credibility and stability of property rights.

2. THE READINGS

Readings in this book are selected for their effectiveness in demonstrating that the economics of property rights has enriched our ability to understand as well as predict a wide range of real world events. The book is divided into two volumes. The first volume is about the history, development, and consequences of property rights as they interact with informal and formal institutions.\textsuperscript{17} The focus of the second volume is on the effects of alternative property rights on economic performance.

The first volume begins with the overview of the interrelationship between liberty, institutional arrangements and property rights. By focusing on the nature of reality and the frames through which we interpret real world events, Armen Alchian and Harold Demsetz, Mark Blaug, and Ronald Coase set the framework for economic analysis of the causes and effects of property rights.

In the second section of the first volume, Fred Miller, Imad-ad-Dean Ahmad, Douglas North, Bruce Benson, Silke Stahl, and Fred McChesney discuss the appreciation of property rights in various cultures and moral traditions. The old ethos in Russia does not offer much respect for private property rights. The basic principles of Islamic society include respect for property rights and the rule of law. The recognition of the value of credible and stable property rights was one of the fundamental reasons for the formation of groups.

Papers by Richard Posner, Robert Ellickson, Douglas North and Barry Weingast, Henry Manne, Gary Libecap, Elisabeth Brubaker, Yoram Barzel and James Buchanan provide two important insights. First, the papers analyze the relationship between property rights and formal institutions such as constitutions, statutes, common law, and governmental regulations. Then, they show how and why that relationship affects economic behavior.

Contributions by Witt, Bailey, Anderson and Hill, Epstein, Schmidt, Paul and Alchian are a mix of positive and normative analyzes. They discuss a range of philosophical, legal, and economic
issues pertaining to the development of different types of property rights and their expected consequences. Some changes in property rights are endogenous responses by members of the community to changes in the social and economic conditions of life. Others are exogenous attempts by decision-makers in government to change economic behavior. In either case, changes in property rights affect economic performance.

The focus of the second volume is on the effects of alternative property rights on exchange and production, incentives to innovate, the transition process in Eastern Europe, and economic performance of a number of countries in the North America, Europe, Asia and South America.

Holderness, Engerman, Nutter, Bajt and De Alessi show the effects of alternative property rights on the costs of transactions and incentives as well as the effects of the costs of transactions and incentives on economic performance. Ekelund, et.al., Williamson, Jensen and Meckling, and Demsetz and Lehn address the consequences of different property rights on the performance of business firms.

Innovation is a consequence of the individual’s perceptions about new opportunities for exchange and willingness to accept the risk and uncertainty associated with doing something new. It means that innovators cannot be identified in advance and the flow of innovation cannot be charted either. The best economic analysis can do is to identify the factors that affect the flow of innovation in the community. Research and empirical studies have shown that property rights are one such factor. Contributions by Torstensson, Vanberg, Pejovich, Higgs, Kaufer, Moore, and Voigt analyze the effects of alternative property rights on the flow of innovation.

The results of the transition process in the early 1990s showed how naïve it was to assume that privatizing assets could lead to more efficient economies in the region with had neither memories of the rule of law nor the ethos and moral values supportive of the exchange culture of capitalism (the more so, the farther to the East). Sunstein, de Jasay, Colombatto and Macey, Malle, Mencinger, Pejovich and Urban show that private property rights, which are neither stable nor credible, create negative incentives and positive transaction costs that have verifiable effects on economic behavior. Property rights that are neither stable nor credible raise interest rates, lower the costs of forming rent seeking coalitions, raise the costs of non-simultaneous exchanges, reduce the supply of venture capital, and tend to convert, what the reformists hoped to be, efficient markets into oriental bazaars. An important lesson of the transition process in the early 1990s is that the word constitution has to come before the word democracy, and that stable and credible property rights have to be assured before the process of privatization begins.

The last section in the book covers a variety of economic problems in eight countries on four continents. Readings in this section of the book cut across a range of informal (cultures) and formal (legal systems) institutions. Yet, they have one common trait: they illuminate the power of the economics of property rights to address, explain, and predict economic behavior under heterogeneous institutional arrangements. Contributions include discussions about the “East Asian miracle”, reforms in China, the effects of tenants rights on investment in Ireland, labor-participation in the management of business firms in Great Britain, the role of Swiss and US constitutions in promoting credible property rights, the failures and successes of communal property rights in Iceland, the
performance of privately owned business firms in India, and the development of property rights on the Brazilian frontier.
THE ECONOMICS OF PROPERTY RIGHTS: CULTURAL, HISTORICAL, LEGAL, AND PHILOSOPHICAL ISSUES

THE OVERVIEW


THE DEVELOPMENT AND SIGNIFICANCE OF PROPERTY RIGHTS IN VARIOUS CULTURES, RELIGIONS, AND PHILOSOPHICAL TRADITIONS


PROPERTY RIGHTS AND LAW


THE DEVELOPMENT AND ECONOMIC IMPLICATIONS OF ALTERNATIVE PROPERTY RIGHTS: PRIVATE OWNERSHIP, STATE OWNERSHIP, COMMUNAL OWNERSHIP, AND AMBIGOUS OWNERSHIP


**VOLUME TWO**

**THE ECONOMICS OF PROPERTY RIGHTS: PROPERTY RIGHTS AND ECONOMIC PERFORMANCE**

**PROPERTY RIGHTS AND THE USE OF RESOURCES**


**PROPERTY RIGHTS AND ECONOMIC DEVELOPMENT**


**PROPERTY RIGHTS AND ECONOMIC REFORMS IN EASTERN EUROPE**


PROPERTY RIGHTS AND ECONOMIC PERFORMANCE OF DIFFERENT COUNTRIES


2 The book follows Armen Alchian’s use of the term survival to mean “desire for more” in a world of scarcity and uncertainty.


Ibid., 175.


The classification of some readings in this book is somewhat arbitrary because of the problem of overlapping.

The “shortage” of investable funds and subsequent financial crises in the so-called transition economies are merely the reflection of their internal institutional problems. Foreign aid, IMF “remedies” and the World Bank loans reduce the costs of maintaining inefficient property rights.

A major characteristic of oriental bazaars is the pre-dominance of simultaneous exchanges, suggesting a very short time horizon.