

## Chapter 4

### *An Economic Theory of Property*

#### I. Introduction

From an economic perspective, we are interested in how property law influences the allocation of scarce resources and goods and services.

An important point to recognize is the potential for the exercise of property rights to conflict.

Creating a system of clear, workable property rights facilitates voluntary exchange and better ensures that property rights will end up in the hands of those who value them most.

##### A. Four fundamental questions in property law

1. How are ownership rights established? *Thought experiment focusing on the benefits of well-established property rights*
2. What can be privately owned? *Private vs. Public Goods*
3. What may owners do with their property? *Externalities*
4. What are the remedies for the violation of property rights? *Positive and Normative Coase Theorems and Normative Hobbes Theorem: Legal vs. Equitable Relief*

#### II. The Legal Concept of Property

##### A. Property is a “bundle of rights”

1. The owner is free to exercise the rights over his or her property
2. Others (private persons and the government) are forbidden to interfere with the owner’s exercise of his or her rights
3. A major question to be decided is the nature/extent of the rights in question, i.e., what can the owner do/not do when exercising property rights?

#### III. Bargaining Theory

For our purposes, the upshot of bargaining theory is that in certain situations exchange of property is mutually beneficial, i.e., voluntary exchange results in a *cooperative surplus* that is shared by the parties to the transaction. Technically, the *cooperative solution* is that which causes resources, goods and services to be allocated to their most highly valued uses. The result of such exchanges is that *all* of the parties are better off with the exchange than they are without it.

Distinguish between *threat values* and the *non-cooperative solution* on the one hand and *cooperation* and the *cooperative surplus* on the other.

It is also important to recognize the relationship between efficiency and the distribution of income.

Example: I own a painting I value at \$5,000. You are willing to pay \$10,000 for it. What happens to total value if the exchange takes place?

	No Trade	Trade 1	Trade 2
Owner			
Buyer			
Totals			

#### IV. The Origins of the Institution of Property

The thrust of this section is that by collectively defining and protecting property rights, society can achieve a more efficient allocation of resources and increase consumption opportunities by directing resources to more productive uses. This is accomplished by eliminating wasteful duplication of services, e.g., protection and enforcement of property rights.

#### V. An Economic Theory of Property

##### A. The Coase Theorem

1. What should we do when one party's exercise of his/her property rights results in an externality?

Smoking example: Graphical analysis.

2. According to the Coase Theorem, when transactions costs are sufficiently low, resources will be used efficiently, regardless of the initial assignment of property rights. Why?

However, an important implication of the Coase Theorem is that when transactions costs are high, the efficient use of resources will depend on the initial allocation of property rights. Why?

3. Implications of the Coase Theorem for resolving disputes over property rights:
  - When transactions costs (TCs) are low, parties to a dispute over property rights are in the best position to efficiently resolve the dispute.
  - When transactions costs are high, court intervention is warranted.

B. The elements of transactions costs

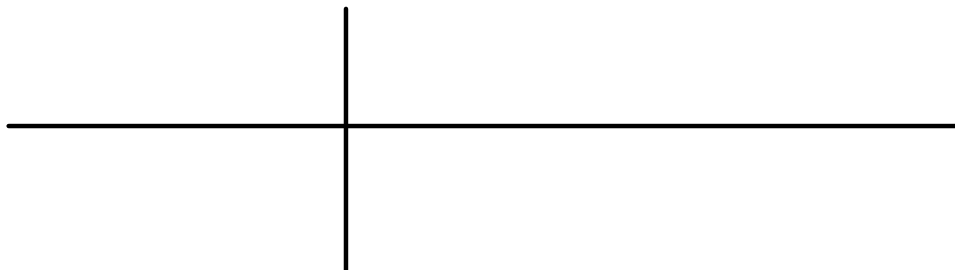
Define transactions costs as “Any cost incurred in completing an exchange,” and consider the following:

1. *Search costs*: tend to be high for unique goods and services and low for standardized goods and services.
2. *Bargaining costs*: vary depending on the extent to which information is public (lower) or private (higher). In any event, the number of parties involved in the dispute is a critically important determinant of bargaining costs. *Ceteris paribus*, the fewer parties involved, the lower transactions costs will be.
3. *Enforcement costs*: arise when an agreement takes time to fulfill, e.g., a promise to make a series of payments over time.

C. The level of transactions costs and the appropriate legal rule

In the discussion that follows, it is important to bear in mind that the parties to a dispute over property rights are in the best position to know how much they each value something. Thus, bargaining between the two parties is preferred because it will better ensure that the property right ends up in the hands of the party who values it most.

1. Graphical analysis: TC on a continuum; where does bargaining stop and intervention begin? Where does the assignment (allocation) of the property right begin to matter? So long as bargaining can occur, i.e., so long as TCs are sufficiently low, the initial allocation of the property right does not matter. Note, however, that in a large number of situations, TCs are not low.



#### D. The Normative Hobbes and Coase Theorems

1. *The Normative Coase Theorem*: Structure the law so as to remove the impediments to private agreements. Private agreements are preferred for the simple fact that the parties to the dispute are in the best position to know how much they each value the property right being disputed. Clear, simple rights make threat values clear to both parties.
2. *The Normative Hobbes Theorem*: Structure the law so as to minimize the harm caused by failures in private agreements (e.g., coercive threats and the destructiveness of disagreement). When private negotiation fails the law should allocate property rights to the party who values them most.
  - Create laws that allocate the property right efficiently in the first place.
  - Contrast intervention and nonintervention in the case where negotiation fails.
3. Graphical illustration of Normative Coase and Normative Hobbes Theorems



#### VI. How Are Property Rights Protected?

##### A. Damages and injunction

1. The payment of *compensatory money damages* is referred to as *legal relief*. Legal relief is backward looking, i.e., is a remedy for past harms. However, it can be used as a remedy for future harms as well.
2. An *injunction* imposed by the court on the defendant is referred to as *equitable relief*. An injunction is forward looking, i.e., it prevents future harms.
3. Both types of remedies allow for bargains to take place and, subsequently property rights to change hands. However, the specific form of the remedy has implications for the resulting distribution of income.

B. Illustration: *Sturges v. Bridgman*

	Scenario 1		Scenario 2	
	Low TC	High TC	Low TC	High TC
Ruling 1: Do Nothing				
Ruling 2: Injunction				
Ruling 3: Damages				

Observations:

1. Damages are always efficient; assuming they are set *correctly*
2. Do nothing and injunction are efficient *so long as TC are low*. When TC are high, the potential for inefficiency exists.
3. If injunction (do nothing) is selected when TC are high, the outcome will be efficient or inefficient. In the event it is inefficient we are stuck with it because, by definition, bargaining cannot occur.
4. If damages is selected and damages are greater than the value of the property right to defendant, the defendant will simply cease the nuisance, which is efficient (so long as damages are set correctly).

Conclusion:

**When TC are low, choose injunction (in some cases do nothing is also feasible).** Because individuals are in the best position to know their own values and bargaining can occur, the property right will end up where it is most highly valued. In addition, courts can avoid the transactions costs associated with attempting to correctly assess damages.

**When TC are high, choose damages.** The assumption is that, on average, the inefficiency associated with errors by the court in determining the appropriate level of damages will be less than the inefficiency associated with the inability to transfer the property right in the event that injunction or do nothing is selected.

C. Efficient remedies

1. In the case of high transactions costs, compensatory damages is the more efficient remedy. (With damages, the defendant has 2 options. With an injunction, he has only one. Why?)
2. When transactions costs are low, injunction is efficient.
3. Note that an injunction leaves it up to the parties to the dispute to determine relative values. In the case of compensatory damages, the court is establishing relative values.
4. *An exception to the rule*: Consider the case where damages are difficult to estimate and are likely to be quite high.

VII. What Can Be Privately Owned? We are concerned here with the efficient use of resources.

A. *Private goods* versus *public goods*

- rivalry
  - nondivisibility
  - nonexcludability
1. Private goods should be privately owned.
  2. Public goods should be publicly owned. Consider the high enforcement costs associated with private property rights to public goods, e.g., what if flight paths were sold to private individuals?

VIII. What May Owners Do with Their Property?

A. *Externalities* resulting from the exercise of property rights that interfere with another person's property or other rights.

1. A simple model of the problem with externalities.



## 2. Public versus private bads

### IX. Concluding Remarks

Clearly defined property rights afford protection to the owner of the right. Thus, she will use the property in a way that maximizes its value to her.

In addition, a clear set of property rights also facilitates the exchange of property rights and ensures that such rights end up in the hands of those who value them most.

When disputes arise over the exercise of property rights, well-functioning system of property rights better ensures that the right will end up in the hands of the party who values it most