

Course: Economics of Industry



Lecture 3: Property Rights Theory

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Property Rights Theory:

- **Libecap (1989):**
Contracting for Property Rights
- **North (1990):**
Institutions, Institutional Change and Economic Performance
- **Barzel (1989):**
Economic Analysis of Property Rights
- **Eggertsson (1990):**
Economic Behavior and Organization
- **Hart (1995):**
Firms, Contracts and Financial Structure

Libecap (1989): Contracting for Property Rights

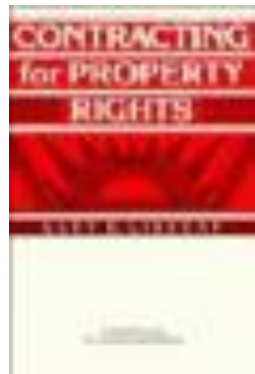
- **Property rights provide the basic economic incentive system that shapes resource allocation.**
- **Libecap (1989) maintains that property rights are formed and enforced by political entities, and that property rights reflect the conflicting economic interests and bargaining strength of those affected.**



Libecap (1989):

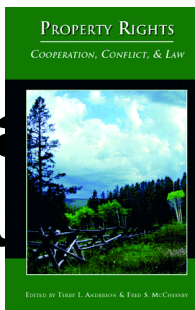
Contracting for Property Rights

- **Property Rights, are the social institutions that define or delimit the range of privileges granted to individuals to specific resources, such as parcels of land or water.**
 - **Right to exclude non-owners from access;**
 - **Right to appropriate the stream of economic rents; and**
 - **Right to sell or otherwise transfer the resource to others.**



Libecap (1989): Contracting for Property Rights

- **Property rights institutions range from formal arrangements, including constitutional provisions, statutes, and judicial rulings, to informal conventions and customs regarding the allocations and uses of property.**
- **Such property rights institutions critically affect decision making regarding resource use and, hence, affect economic behavior and economic performance.**



Libecap (1989): Contracting for Property Rights

- **Property rights institutions are determined through the political process, involving either negotiations among immediate group members or lobbying activities that take place at higher levels of government.**
- **The political process of defining and enforcing property rights can be divisive because of the distributional implications of different property rights allocations.**



Libecap (1989): Contracting for Property Rights

- **Even though society would be better off with the public goods provided by new property rights (e.g., the correction of “common pool losses” such as can be found for open fisheries and oil field dissipation), the distributional implications lead influential parties to oppose institutional change.**



Libecap (1989):

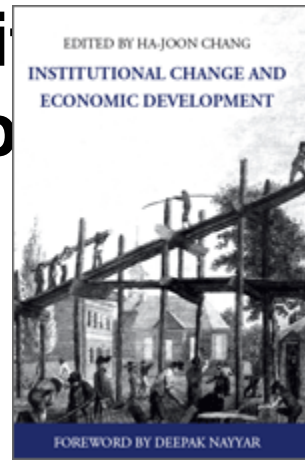
Contracting for Property Rights

- **Pressures to change existing property rights can emerge from the following factors:**
 - **Shifts in relative prices;**
 - **Changes in production and enforcement technology; and**
 - **Shifts in preferences and other political parameters.**



Libecap (1989): Contracting for Property Rights

- **All else being equal, the greater the size of the anticipated economic benefits of institutional change (the greater the economic losses of the common pool), the more likely new property rights will be sought and adopted because it is more likely that a politically acceptable share arrangement can be devised by politicians to make enough influential parties benefit so that institutional change can proceed.**



Libecap (1989): Contracting for Property Rights

- **The larger the number of competing interest groups, the more likely distributional conflicts will block or delay institutional change because the greater the number of competing interest groups with a stake in the new definition of property rights, the more that claims must be addressed by politicians in **building a consensus for institutional change****



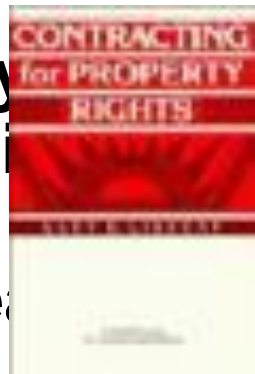
Libecap (1989): Contracting for Property Rights

- **The greater the heterogeneity of competing interest groups, the more likely distributional conflicts will block or delay institutional change.**
 - **Important differences across the parties in information regarding the resource, as well as in production costs, size, wealth, and political experience, will make formation of winning political coalition and a consensus on the proposed assignment of**



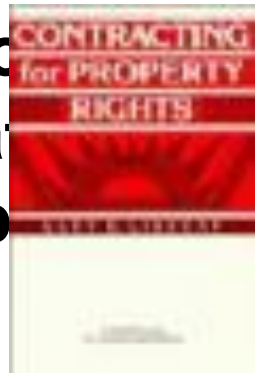
Libecap (1989): Contracting for Property Rights

- **Distributional conflicts will be intensified if there are known serious information asymmetries among the competing parties regarding the evaluation of individual claims.**
 - **These distributional conflicts will occur quite aside from any strategic bargaining efforts if private estimates of the economic value of current property rights and of potential economic losses from the new system cannot be conveyed or credibly to politicians and the**



Libecap (1989): Contracting for Property Rights

- **The greater the concentration of wealth under the proposed property rights allocation, the greater the likelihood of political opposition and the less likely institutional change will be adopted without modification by politicians.**
 - **In these circumstances, enough influential parties may see their economic welfare made worse, or at least not improved, by change that political support for such change does not**



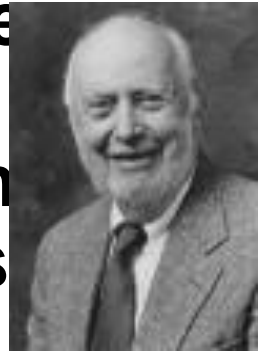
Libecap (1989): Contracting for Property Rights

- **Contrary to the optimistic assertions of Chicago School economists, the failure of oil field unitization in Oklahoma and Texas, despite well-recognized and significant aggregate economic gains from unitizing oil production, is an exemplar of how asymmetric information and distributional conflicts over rental shares can limit the adoption of property rights to reduce common pool losses.**
- **To assert that property rights will evolve to achieve efficiency seems to gloss over much of the impediments that can block institutional change in under-developed**



North (1990): Institutions, Institutional Change and Economic Performance

- **North (1990) abandons the efficiency view of institutions, which he himself promoted in the 1970s, and maintains that rulers devise property rights in their own economic interests and that positive transaction costs result in the persistence of inefficient property rights.**
- **As a result, it is possible to provide an account for the widespread existence of property rights throughout history (and in the present) that did not produce**



North (1990): Institutions, Institutional Change and Economic Performance

- The contrast between the neoclassical assumptions about the evolution of property rights evolving toward efficiency and the performance of economies (however defined and measured) is startling.
- The coercive power of the state has been employed throughout most of history in ways that have stymied economic growth.



North (1990): Institutions, Institutional Change and Economic Performance

- **The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the third world.**
- **Enforcement in the third world economies is uncertain not only because of ambiguity of legal doctrine (a measurement cost) but also because of uncertainty with respect to the behavior of the judicial system.**



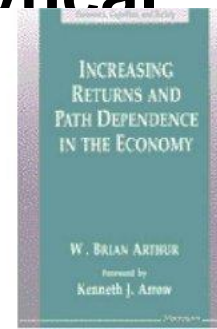
North (1990): Institutions, Institutional Change and Economic Performance

- **Contrasting the institutional framework in countries such as the United States, England, France, Germany and Japan with Third World countries makes clear that the institutional framework is the critical success factor of economies both cross-sectionally and through time.**
- **The institutional framework shapes the direction of the direction of the acquisition of knowledge and capabilities, and direction will be the dominant factor for the long-run development of that society.**



North (1990): Institutions, Institutional Change and Economic Performance

- **Property rights and economic incentives are the underlying determinants of economic performance.**
- **One gets efficient institutions by a polity that has built-in economic incentives to create and enforce efficient property rights.**
- **Path dependence is the key to an analytical understanding of long-run change in property rights.**



Barzel (1989): **An Economic Analysis of Property Rights**

- **Barzel (1989) emphasizes a particular type of transaction costs: measurement costs.**
- **Because it is costly to measure commodities fully, the potential of wealth capture is present in every exchange.**



Barzel (1989):

An Economic Analysis of Property Rights

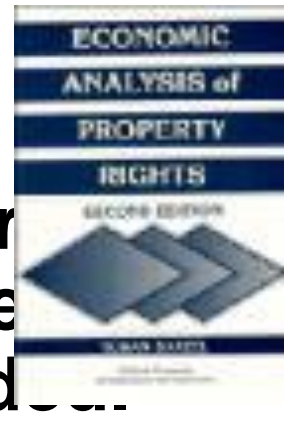
- **The sale of cherries illustrates the problem of wealth capture.**
- **Consider the problems of information that present themselves when cherries are exchanged.**
 - **Customers spend resources in order to determine whether a store's cherries are worth buying, and in order to determine which cherries to buy.**



Barzel (1989):

An Economic Analysis of Property Rights

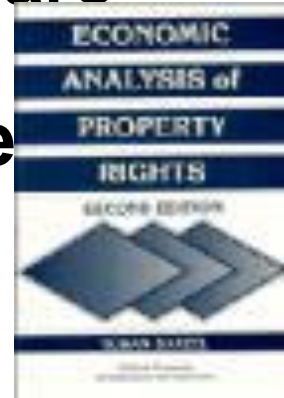
- **Storeowners who allow customers to pick and choose cannot easily prevent these customers from eating cherries after these customers decided whether or not to buy the cherries, nor can storeowners prevent customers' careless handling of cherries. Indeed, the process of picking and choosing itself allows wealth capture in the form of excess choosing.**
- **If information about the cherries were costless, pilfering, damage and excess choosing of cherries would be avoided...**



Barzel (1989):

An Economic Analysis of Property Rights

- **The property rights transaction costs model can generate a better understanding of the allocation of resources, and of the interaction of this allocation with economic organization.**
- **The research literature that assumes that the economic costs of transactions are zero and that all property rights are perfectly well delineated is incapable of dealing with a vast array of actual observed practices.**



Eggertsson (1990): Economic Behavior and Institutions

- **Property rights to a resource are often partitioned.**
 - For example, in the case of land, person A and person C may possess the right to dump ashes on the land, person A and person B may possess the right to grow wheat on the land. Person C may possess the right to dump ashes on the land. Person D may possess the right to fly an airplane over the land. And each of these rights may be transferred to various uses of land are “owned” by different persons.



Eggertsson (1990): Economic Behavior and Institutions

- **According to the Coase (1960) Theorem, the initial partition of property rights does not matter for the allocation of resources (ignoring wealth effects) when all rights are freely transferable and the costs of transacting are zero. But when transaction costs are introduced, the role of the State can have a crucial effect on resource allocation.**
- **Negotiation costs and other transaction costs may block the reassignment of rights, and the initial partitioning of property rights by the state may have important consequences for the output of an economy. Thus, the property rights approach is not complete without a theory of the State.**



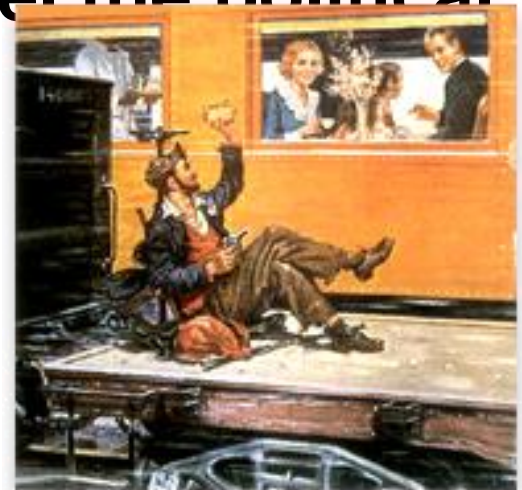
Eggertsson (1990): Economic Behavior and Institutions

- **Harold Demsetz’ “Toward a Theory of Property Rights” in the American Economic Review offers an optimistic theory of property rights: “Property rights develop to internalize externalities when the gains of internalization become greater than the cost of internalization” (1967: p. 350).**



Eggertsson (1990): Economic Behavior and Institutions

- **Characteristic of this optimistic view, the formulation of decision making with regard to property rights is solely in terms of private benefits and private costs. The theory does not deal with the free-riding problems that plague group decision, nor is there any attempt to model the political process.**



Eggertsson (1990): Economic Behavior and Institutions

- **Maintains that one of the first steps to modify the optimistic model of property rights involves linking this model to the “interest-group theory of property rights,” legislation and government.**
- **Property rights, which serve the narrow self-interest of special interest groups but cause substantial output losses to the community as a whole are explained in terms of transaction costs, free-riding, and asymmetric information.**



Eggertsson (1990): Economic Behavior and Institutions

- **Concludes (along with North, 1990) that there is overwhelming historical evidence to support the proposition that States typically do *not* supply structures of property rights that are appropriate for placing the economy close to the technical production frontier.**



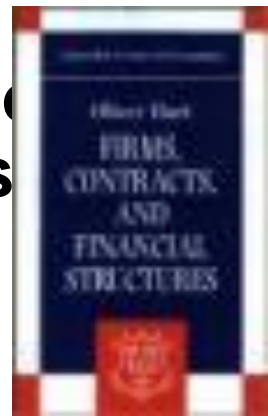
Hart (1995): Firms, Contracts, and Financial Structure

- Because contracts are incomplete, the ex post allocation of power (or control) matters.
- Contractual incompleteness and power can be used to understand a number of economic institutions.
- Power (the ex-post allocation of control) is irrelevant in agency theory because an optimal comprehensive contract is made and will not be renegotiated.



Hart (1995): Firms, Contracts, and Financial Structure

- **Modern property rights theory is closer to the incomplete contracting approach of transaction costs theory.**
- **Once we recognize that contracts are incomplete and transaction costs are positive, then the boundaries of the firm matter for economic efficiency.**
- **Specifically, modern property rights theory maintains that firm boundaries are chosen to allocate power optimally among the various parties to a transaction.**



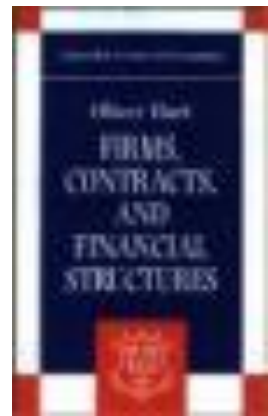
Hart (1995): Firms, Contracts, and Financial Structure

- A merger between firms with highly complementary assets enhances economic value because it reduces haggling and economic hold-up problems. (Hart provides formal modeling of transaction-cost logic.)
- The possession of power (residual control rights) is taken to be the definition of ownership in the modern property rights approach.



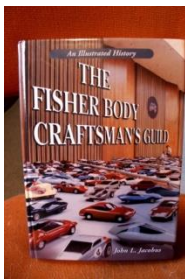
Hart (1995): Firms, Contracts, and Financial Structure

- Further, the power that employers possess by owning non-human assets gives the employer leverage.
- In reply to Alchian and Demsetz' (1972) agency theory assertion, authority and power do exist. Put compactly, control over economically relevant non-human assets leads to control over humans.
 - The law of forbearance reinforces the authority that employers possess.



Hart (1995): Firms, Contracts, and Financial Structure

- **Application:**
 - **The Vertical Merger of Fisher-Body and General Motors is persuasively explained in property rights/transaction costs terms: Much of the asset specificity can from investment in relationship-specific know-how by the Fisher Body workers, which would have made it difficult for General Motors to find another supplier if Fisher Body had tried to engage in hold-up. Vertical financial ownership replaced long-term contracting, which allowed the parties to adjust in an adaptive, sequential manner. Ownership provided necessary ex post residual control rights.**



Reference

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