

Property Rights Dynamics

A law and economics perspective

Edited by

**Donatella Porrini and
Giovanni Battista Ramello**

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Property Rights Dynamics

This volume should be a welcome addition to the bookshelf of every person interested in the function of property rights and their evolving nature. The volume contains twelve original chapters on property rights, both on their basic nature and on their application in a wide arena, including intellectual property, human tissue, and marital assets. It's a must read.

(Steven Shavell, Harvard University)

This stimulating set of essays responds to an important need. Private property increasingly extends its reach – particularly noticeable in the domain of copyright – and new property forms continually evolve. Every reader will come away from this volume with new insights and information.

(Wendy Gordon, Boston University)

This volume deals with the contemporary property rights, examining its role and effect in light of the law and economics approach, while maintaining a focus on the real world and the specificities of practical cases. In particular, this volume questions the transformation of a specific institutional remedy for a market failure – one of many available solutions – into a quasi-universal religion that dogmatically assumes property rights are always a good solution for externalities. *Property Rights Dynamics* questions why property rights have trumped other institutional devices and eroded precise evaluation according to the rule of reason, as is familiar to normative analysis where it concerns matters of economic policy.

A host of prominent contributors investigate specific milieus, support divergent theses on the effects of today's extensive propertization trend and cast new light on this crucial institution by balancing its power and its limitations.

Donatella Porrini is Associate Professor of Economics at the Università di Lecce, Italy and **Giovanni Battista Ramello** is Associate Professor of Industrial Economics at the Università del Piemonte Orientale "Amedeo Avogadro," Italy.

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Property Rights Dynamics

A law and economics perspective

Edited by Donatella Porrini and Giovanni Battista Ramello

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1 Property rights dynamics

Current issues in law and economics

Donatella Porrini and Giovanni B. Ramello

Introduction

This book deals with property rights, a complex institution common to all human groups. Property rights grant the holder exclusive rights over a given resource, and as such, have been a constant concern throughout the history of human societies. However, their definition, realization, and pervasiveness vary according to the specific context in which they emerge and depend largely on their function within a given society. Moreover, since social needs change over time, property rights are subject to constant evolution and transformation. This is caused primarily by group dynamics, but occasionally by the successful imposition of special interests by the major stakeholders in a particular group.¹

In the market economy, a powerful force behind the ubiquity of property rights is the fact that clear fragmentation of the commons and the subsequent entitlement to well-defined commodities is the prerequisite for trade and market existence. Accordingly, market stimuli serve as the main impetus for change in the field of property rights in Western society.

However, if this constant change can be ascribed to the very nature of the legal institution and market needs, the increasing pervasiveness of property rights can be explained in part by influential support from the law and economics theory, which have justified them for their power to internalize externalities and promote efficiency. The domain of property rights has become so omnipresent as to create a “property rights society,” where property is seen as a panacea for any type of market failure.

This point of view is often used to justify the creation of new property rights or the extension of old ones, but it disregards the fact that there is no single way to stimulate efficiency and that, in general, efficiency can be pursued only by adopting the use of reason.

In some cases, it appears that there is so much enthusiasm for the potential economic benefit of property rights that in the actual context, their effectiveness is simply overstated: a different legal institution would probably better serve the social good. On the whole, this calls for a more cautious approach when studying and applying the property paradigm.

The purpose of this book is not to dispute the usefulness and virtues of property rights. Rather, from the perspective of law and economics, and with the

input of an international panel of distinguished scholars, it attempts to cast new light on this crucial institution by evaluating its power and its limitations. It also offers insights for future research.

This chapter presents the theoretical basis that contributors were given for their work, and summarizes the main topics of the book. Following this introduction the next section describes the origins of property rights. In sequence we discuss the revolutionary theory of property rights as a solution to the externality problem, and the current dynamic of the institution. The topics addressed in the following chapters, are summarized before concluding the introduction to the chapters.

The pervasiveness of property rights throughout human history

It is impossible to say exactly when and where property rights first appeared in human history. To some extent, appropriation and property rights came about as the unavoidable consequence of the exploitation by individuals of scarce resources (Demsetz, 1998). Since the beginnings of human life, hunting a wild animal or gathering fruit implied excluding other human beings from doing the same with that specific resource.

This stems essentially from the nature of wild animals, fruits, and many “subject matters” as private goods, in the sense that their consumption by an individual always entails the exclusion of someone else.

Generally speaking, a property right is the right to decide how a resource is used and, complementarily, the right to exclude someone else from doing so (Alchian, 1965). Property rights, as a *de facto* if not a *de jure* institution, have therefore existed for almost as long as human society (Bailey, 1992 and 1998).²

Nonetheless, at the dawn of human history, the sparse population, high fragmentation of social groups, and considerable abundance of unclaimed resources made conflicts over their consumption and use less likely and intense than today. The pivotal role of property rights was at that time barely recognized. Their importance emerged with the growing complexity of human societies and, of course, the increased scarcity of resources (Levmore, 2002).

As Demsetz writes, “In the world of Robinson Crusoe property rights play no role” (Demsetz, 1967, p. 347). The need for strong, secure property rights intensifies with the evolution and development of economic activities and their value in social contexts, driven by the concept of scarcity (Levmore, 2002).

Property rights appear recurrently in human groups – in a sense, they are a universal trait of social interaction – but their features vary so widely among social groups and from one historical period to another that no universal definition exists (Munzer, 1990). Indeed, the design, allocation, and enforcement of property rights involve a complex set of issues that different societies have managed in a variety of ways.

On the whole, a property right is a bundle of rights over the likely uses identified by the law. According to Hohfeld’s paradigm of legal entitlements (Hohfeld, 1913),

this bundle complies with the social organization and its values, as it defines not just what the holder can do with the right and the protected resource – his or her entitlement – but how other individuals must behave in order to preserve the holder's right, that is, the correlative obligation (others' duties).

The holder of a property right can be an individual, a group or the government. Again, there is no one solution: almost every society has designed and granted distinct property rights to different owners according to its preferences and needs (Munzer, 1990; Demsetz, 1998).

In addition, since social relationships change over time along with these preferences and needs, property rights have been continuously transformed in order to accomplish their changing roles. In other words, the history of property rights is nothing if not dynamic, and all we can do is study snapshots to understand their precise function at a given time and in a specific social context.

Property rights, therefore, are not a static ornament of human society. They are the expression of specific social groups and they play a crucial role in regulating the behavior of individuals within that group. From this perspective, the architecture of property rights speaks volumes about a society (Demsetz, 1967). Because of their idiosyncratic nature, closely related to the social dimension, they can serve as sort map through which we can infer the socially shared value system of a specific human group.

In Western culture, for instance, many scholars hold that the creation of an extended framework of property rights granted to single individuals – what is familiarly termed “private property” – is the cornerstone of the capitalist society and, to some extent, the necessary condition for freedom of its citizens and existence of the market. Today, private property is considered an irrefutable component of individual liberty. But that thesis is actually the outcome of a process several centuries long.³

Property rights and economic theory

A well-defined set of private property rights is central to the existence of trade. The fragmentation of the commons cannot be accomplished without a specific set of rules assigning the various fragments to individuals. Thus, the market as we define it today cannot exist without property rights. Economic theory cannot neglect this pivotal role and has always recognized the importance of property rights.

For a long time, however, economists focused their energy on understanding the price system from a micro and macro perspective. They assumed that the property rights framework was exogenously determined and, having acknowledged its value, paid it no further attention (Demsetz, 1998).

Not until the second half of the twentieth century did new thinking emerge on the subject of property rights. Rather than a simple prerequisite for the existence of markets and trade, they were now viewed as organic to economic activity and responsible for promoting efficiency.

This new awareness was driven by the seminal work of Ronald Coase (1960) and gradually extended and refined by Alchian (1965), Demsetz (1967),

Calabresi and Melamed (1972), and the proponents of the “new property rights” school (Hart, 1995).⁴ The Coasean interpretation of property rights was revolutionary for both legal and economic theory. It cast new light on this apparently quiet institution that had accompanied human beings throughout their history: property rights were a crucial device for economic activity. “In all societies, primitive and modern, property rights [were and still are] an important part of social technology that helps to determine economic efficiency” (Bailey, 1998, p. 155).

Property rights achieve this goal simply by correcting market failures that arise from externalities, that is, external costs or benefits associated with the production or consumption of a specific good.⁵ In other words, property rights bring back to the market exchange what has escaped from it and thus help to internalize externalities.

As a whole, the literature cited above supports the notion that if very general conditions are met – essentially the absence of substantial transaction costs – then a set of well defined property rights and the exchange mechanism are jointly able to overcome the externalities problem and promote the efficient allocation of resources, thus achieving welfare maximization.⁶ Therefore, they have the additional virtue of avoiding (or at least minimizing) government intervention to foster efficiency by way of regulation. According to the Coase Theorem, once property rights are defined, their initial ownership is irrelevant since free trade will always allocate them to the most efficient user. This feature thus preserves the social value of the competitive process and the mechanism of the invisible hand, once again confirming the central role of the market in pursuing welfare and fostering economic growth.⁷

A final new characteristic of property rights had also emerged: by producing efficiency, property rights make private and public interests converge. They are no longer tools pitting individual owners against society, but devices that by means of private interests produce the public good of economic efficiency.

It is easy to grasp the revolutionary impact of this claim: new property rights could be granted and protected in light of the superior reason of efficiency, and almost everything could become “subject matter.” Gone were the days when property rights were viewed as part of the endowment of the economic system. They had become a powerful tool, used extensively by economists, to solve the problem of externalities.

The enthusiasm toward property rights in recent decades has been so widespread that they are now becoming a sort of cure-all for a broad array of market failures. Indeed, the gradual wave of propertization is still very much in progress.

Property rights in the third millennium

This book expressly deals with contemporary property rights dynamics. The focal point here is the reconsideration of economic theory applied to property in light of the changes that have affected goods and society over the past century, and in light of new failures such markets have suffered.

From the recent history of property rights, we can observe that the main attitude of legal systems (justified by supportive economic theory) has been to extend the property paradigm to several new contexts, paying little heed to the nature of new subject matters or to specific features of the social context.

Once again, in other words, property rights are increasingly treated as “the solution” to every sort of market failure, and insufficient attention is paid to alternative devices proposed by economic theory, such as Pigouvian taxes or regulation.⁸ The widespread acceptance of the Coase theorem – in itself not at stake here, of course – has served as an excuse far outside Coase’s intentions for viewing property rights as a miraculous, quasi-universal remedy for market failures, while often totally neglecting the existence of transaction costs and additional social costs.

New or renewed property rights have recently conquered domains which can hardly be intended as “subject matter,” at least within the definition of property as we have known it in the recent past. Take, for instance, the case of property rights on pollution implemented to solve environmental contamination, or the expansion of “intellectual property” to include databases, business methods, and the human genome.⁹

Over the last 50 years, property rights have also faced in several contexts an endemic difficulty of enforcement, leading one to question whether they are always the best solution to market failures or whether they are structurally weak when applied to certain domains. Let us consider, for instance, intellectual property; several recent cases are questioning the effectiveness of property rights in expressive or inventive works.

The first case in point is Napster and the dispute over copyright in the Internet domain.¹⁰ Here, even if property infringement is evident, the broader reflection is on the conflict between a regime that rests upon exclusion of consumers and the technological changes that render communication and information sharing a crucial new phenomenon for society (Maffioletti and Ramello, 2004).¹¹

The Microsoft antitrust case, which can be compared with others like Magill TV Guide or IMS Health/NDC Health,¹² has raised the question of whether the exploitation of intellectual property – intended as a remedy to avoid a specific market failure, that is, the generation of a suboptimal level of new ideas – had the unintended side effect of producing another market failure: the substantial erosion of competition and efficiency of the markets (Ramello, 2003).¹³

Again in the intellectual property domain, the issue of patent enforcement and HIV drugs in South Africa has at least raised awareness that patent rights are not always suited to by-the-book application and can, under certain circumstances, lead to an undesirable social outcome (Scherer, 2004).

In other situations, where property rights could have welfare-enhancing consequences, they are not accepted at all or are only considered in part. In the case of human transplants, for instance, clear state (i.e. public) property rights on dead human bodies could solve the market failure of the lack of organs available for transplantation. But governments reject this kind of solution, permitting the appropriability of the genome of living people but not of dead persons’ organs, and implicitly accepting a *sui generis* solution that implies a parallel, illegal