

An Economic Theory of Property

Lecture 2



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An Economic Theory of Property

- *Blackstone*-property means providing its owner with complete control over resources, freedom to control material things, *Gluckman*-property law means obligations owed between persons in respect of things
- *Marx and Engels*-property is institution, by which the few enslaved the many
- *Classical philosophers*: property is an expectation (Bentham), the object of fair distribution (Aristoteles), means of self-expression (Hegel)
- *Economics*-tries to predict the effects of alternative forms of ownership, especially in terms of efficiency and distribution, (instead of what property really is)



Legal Concept of Property

- The law of property-the legal framework for allocating resources and distributing wealth (but disagreement about...?)
- Rights-immutable
- The owner free to exercise the rights over his property
- Others are forbidden to interfere with owner's exercise of rights



Bargaining Theory

- ▶ Adam wants to sell his 1957 Chevy convertible for repair and has worth for him 3000 USD. Blair, coveting cars, that pleasure of owning this car is worth 4000 USD for him. Adam will accept not less than 3000 USD, Blair inherited 5000 USD, but will not pay more than 4000 USD. Reasonable sale price 3500 USD, (in between). It is beneficial to cooperate, because of cooperative surplus-value created by movement to a more valuable use. If price 3500 USD, each of them will enjoy 500 USD (equal share of value) because of exchange. Otherwise share unequal.
- ▶ Cooperative solution?
- ▶ Non-cooperative solution?
- ▶ *Threat values, cooperative surplus, agreeing on terms for distributing surplus*

The State of Nature and Civil Society

Farmer	Corn grown	Corn gained by theft	Corn lost through theft	Net corn consumption
A	50	40	-10	80
B	150	10	-40	120
Totals	200	50	-50	200

Farmer	Corn grown	Share of Surplus	Net corn consumption
A	80	50	130
B	120	50	170
Totals	200	50	300



Coase Theorem

- ▶ Famous example outlined by R. Coase:
- ▶ Cattle rancher runs cattle and farmer grows corn and leaves some uncultivated. The boundary between ranch and farm is clear, but without fence, and sometimes cattle wander onto the farmer's property and damage the corn. The damage could be reduced by building fence, supervising cattle, keeping fewer cattle, growing less corn.
- ▶ The rancher and the farmer could bargain to decide who should bear the cost of the damage.....
- ▶ Which law is better?
- ▶ the concept of fairness X the concept of efficiency
- ▶ **If parties can bargain successfully, the efficient outcome will be achieved regardless of the rule of law**



Coase Theorem

- If the second rule controlling? What will happen?
- Problems of Coase theorem
- Transaction costs



The Level of Transaction Costs and Appropriate Legal Rule

Threshold	
Bargaining succeeds	Bargaining fails
Legal rights do not matter to efficiency	Legal rights matter for efficiency
Low	High

Transaction Costs



Theorems

- **Normative Coase Theorem**

structure the law as to remove the impediments to private agreements

- **Normative Hobbes Theorem**

structure the law so as to minimize the harm caused by failures in private agreements

Rule followed by efficient courts:

- $IC \prec TC$ → allocate the legal right initially to the person who values it the most
- $TC \prec IC$ → strictly follow precedent



Enforcement of Property Rights

- ▶ **Legal remedy**

- compensatory money damages, (backward-looking)

- ▶ **Equitable remedy**

- order by the court directing the defendant to perform an act or to refrain from acting in particular manner (forward-looking)

Laundry and Electric Company: An Example

		LAUNDRY	
		No Filter	Filter
ELECTRIC COMPANY	No Scrubbers	1000 100	1000 200
	Scrubbers	500 300	500 200



Efficient Solution?

- ▶ Three options for the court to decide:
- ▶ **polluter's right**-E is free to pollute
- ▶ **pollutee's right to damages**- L is entitled to compensatory damages from E (up to the size of loss)
- ▶ **pollutee's right to injunction**- L is entitled to an injunction forbidding E to pollute

two ways how to achieve it:

- ▶ Non-cooperative solution (Normative Hobbes theorem)
- ▶ Cooperative solution (Coase theorem)

Laundry and Electric Company

Profits from Bargaining Under Three Legal Rules

	NONCOOPERATION		SURPLUS	COOPERATION	
	E	L		E	L
rule 1 <i>polluter's right</i>	1000	200	0	1000	200
rule 2 <i>damages</i>	800	300	100	850	350
rule 3 <i>injunction</i>	500	300	400	700	500



The Distribution of Cooperative Surplus

- ▶ If transaction costs zero and successful bargaining takes the place, what is the difference between Coase solution and law solution?

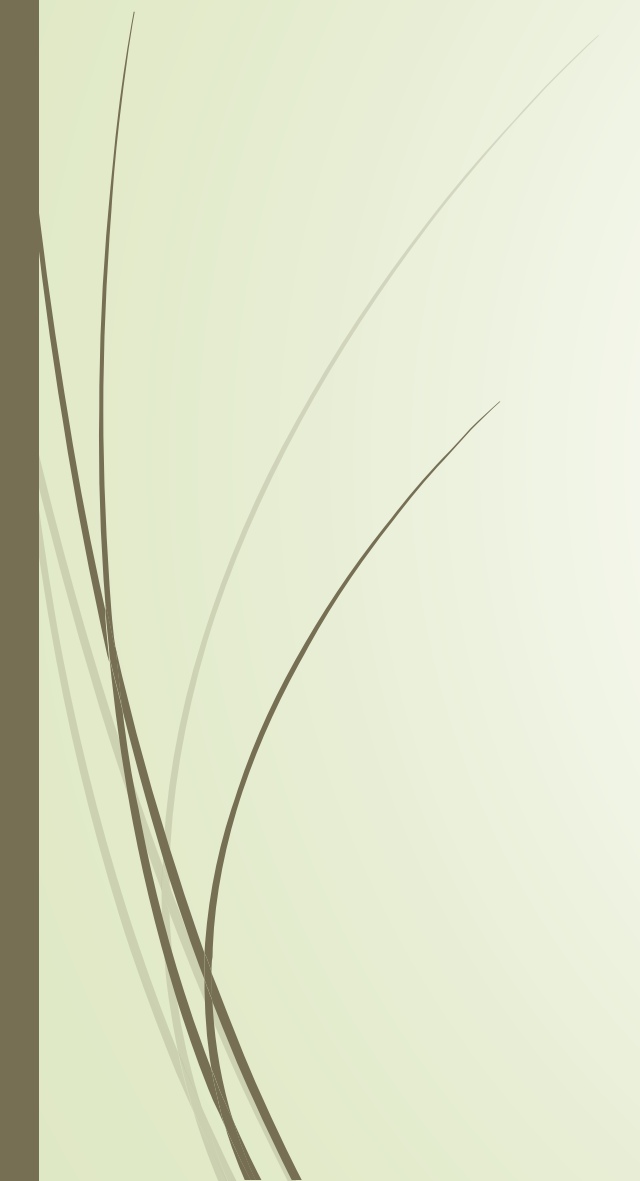



Efficient Remedies

- If transaction costs high, then damages superior over injunction
- If transaction costs low, then injunction superior over damages

Guido Calabresi and A.Douglas Melamed rule

-traditional prescription of the law-lawmakers choose



Národohospodářská fakulta VŠE v Praze



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