Literature Review: Property Rights

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When we say we own scarce resources, such as land and houses, do we really own the resources? Can we use the land to plant opium or turn a house into a loud recording studio? What exactly do we own? Alchian and Demsetz (1973) argue that what is owned actually is a *bundle* or a portion of socially recognized *rights* to use the resource, not *the* resource itself. For example, we own the right to live, to sale, but not to force someone to buy the house. It is these rights that determine the value of what is exchanged (Demsetz, 1967).

Similarly when we identify a resource as a property, we are referring to a bundle or a portion of rights. In a society, that property rights convey the right to benefit and harm oneself or others. Specifically Demsetz (1967) states, "Property rights specify how persons may be benefited and harmed, and, therefore who must pay whom to modify the actions taken by persons."

This function of property rights easily leads us to the topic of externalities. Then the paper discusses differences between public and private ownership. Next we look at an attenuation of ownership rights in various types of firms.

I. Property Rights and Externalities

First of all, Coase (1960) points a common mistake that people make when they think about externalities[1]. When A inflicts harm on B, the question is not how should we restrain A. The real question is whether A should be allowed to harm B or B should be allowed to harm A. The problem is to avoid a more serious harm.

Demsetz (1967) states this idea in a different way. The harmful or beneficial effect is not automatically an externality. To become an externality, the cost of bringing the effect to bear on one or more of the interacting parties has to be too high to make it worthwhile. To enable the effects to bear for all interacting parties, Demsetz (1967) introduces a process of "internalizing" such effects, which is usually a change in property rights. For example, a law that establishes a person to his freedom will require a payment on the part of the firm to cover the cost of using that person's labor. But a law that gives the firm clear title to slave labor will require the slaves to pay the firm for their freedom. These costs thus become internalized in the decisions. So the property rights in a way acts as guiding incentives to achieve a greater internalization of externalities.

But still the transaction costs of negotiating the rights between parties must exceed the gains from the internalization for the costs and benefits to be considered externalities. If the transaction costs are zero, any negotiation that is in the mutual benefit of the parties will get made and lead to efficient outcome, regardless of who is assigned ownership. This is an implication from Coase Theorem (Coase, 1960). But to assume a zero transaction costs is not realistic. In a smoke pollution case, a negotiation cost may be too high to make it worthwhile to internalize a harmful effect of smoke because of large number of involved parties. Maybe the problem is the initial definition of property rights.

[1] Externalities is a situation where one person's actions impose costs (or benefits) on another (e.g. pollution).

Changes of the initial definition are probably needed to minimize the transaction costs. So a new property rights may emerge to internalize externalities, but only when the gains of the internalization becomes larger than the cost of internalization (Demsetz, 1967). Changes to the property rights usually mean conversion of ownership form, such as privatization of a public property. This raises a new question: "What are differences between public and private ownership?"

II. Public and Private Ownership

The answer is not as easy as saying the owner of public property is public instead of private group. Alchian (1965) proposes that the differences come from "*the inability of a public owner to sell his share of public ownership* (and the ability to acquire a share without a purchase of the right)". This means that public membership is a compulsory as long as one lives in a particular community. No member can divest himself of that ownership; it is not voluntary.

But what are the implications of this ownership transferability issue? If public ownership rights are made salable, we will see a movement toward a concentration of ownership; a movement from a situation where one person has a smaller share of public enterprise (because he shares with many public members) to one person with a bigger share of private enterprise (because he shares with few private members). The force behind this movement is a greater concentration of reward and costs in the private enterprise. In other words, his wealth is more dependent upon his own action by the virtue of concentrating his wealth in a particular enterprise.

The Transferability of ownership also allows people to concentrate their ownership in those areas where they believe they have a comparative advantage, if they

want to increase their wealth. People who have more knowledge of computers will invest their time and money in a computer firm. Other people who know less about computers but prefer the high risk of computer industry can invest in the computer firm to achieve a greater utility. Overall we can say that the exchange of ownership enables a more efficient allocation of knowledge, risk, and resources.

At the end Alchian (1965) summarizes the difference of public and private ownership with a theorem: "*Under public ownership the costs of any decision or choice are less fully thrust upon the selector than under private property*." This implies that we should impose extra constraints on public agents because they are less responsible for the costs of their actions. It is precisely these extra constraints that make public ownership a higher cost, thus a less efficient, ownership form than private ownership.

III. Ownership Rights and The Firm

Does it mean that private ownership has no problem on its own? Alchian and Demsetz (1972) shows that the nature of a classical capitalist firm, as a proxy of private ownership, creates a critical problem of control:

"*...The presence of different owners of the several jointly used inputs in the team production process heightens the problem of shirking-i.e., the undetected marginal productivities of each input that are reduced below the payments for their services. In sum, the information, detection, and transmission is more expensive*."

To control team members from shirking, someone must have the right to monitor and an incentive not to shirk. According to Alchian and Demsetz, that someone must posseses a bundle of *ownership* rights of a clasical firm: (i) the right to receive residual claims, (ii) the right to terminate or revise the membership of the team, and (iii) the right to sell those rights mentioned under (i) and (ii).

Furubotn and Pejovich (1972) look at the changes of these rights and see how the attenuation of the rights affect decision makers, and hopefully it can give us an insight into the behavior of various types of firms: corporation, regulated firm, not-for-profit firm, and socialist firm.

In a modern corporation, a dispersion of stock ownership and a proxy fight reduce ability of the owners to revise and terminate the membership of managers. This causes an attenuation of the stockholders' bundle of property rights in the firm.

The attenuation of a regulated firm takes a different form: a *legal restraint on the owners' right to the residual* (Alchian and Demsetz, 1972). With a regulated price, and an upper limit of profit, the manager can reap the benefits of higher profit and conceal the true profits from the regulatory agency by reporting higher cost of doing business.

The problem with a not-for-profit firm is that *no one can claim the right to appropriate the residual* (Alchian and Demsetz, 1972). This allows the managers to use potential profits to obtain their non-pecuniary incomes (e.g. big office building) at the expense of the firm's customers and patrons.

In a socialist firm, the content of ownership rights are significantly similar to a modern corporation. But the costs of the state to detect and enforce a desired behavior of the manager can be substantial. Therefore, the managers gain some room for an independent policy making in order to improve his personal position (e.g. request for larger allocations of labor by understating plant's efficiency).

IV. Summary

We understand that property rights play an important role in a resolution of externalities based on an assumption of positive transaction costs. The resolution may

involve changes of property rights from public to more efficient private ownership. But private ownership has to deal with its problem of the attenuation of ownership rights.

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