Property Rights

Private property was the original source of freedom. It still is its main bulwark.

Walter Lippmann

Importance of Property Rights

One of the most fundamental requirements of a capitalist economic system – and one of the most misunderstood concepts – is a strong system of property rights.

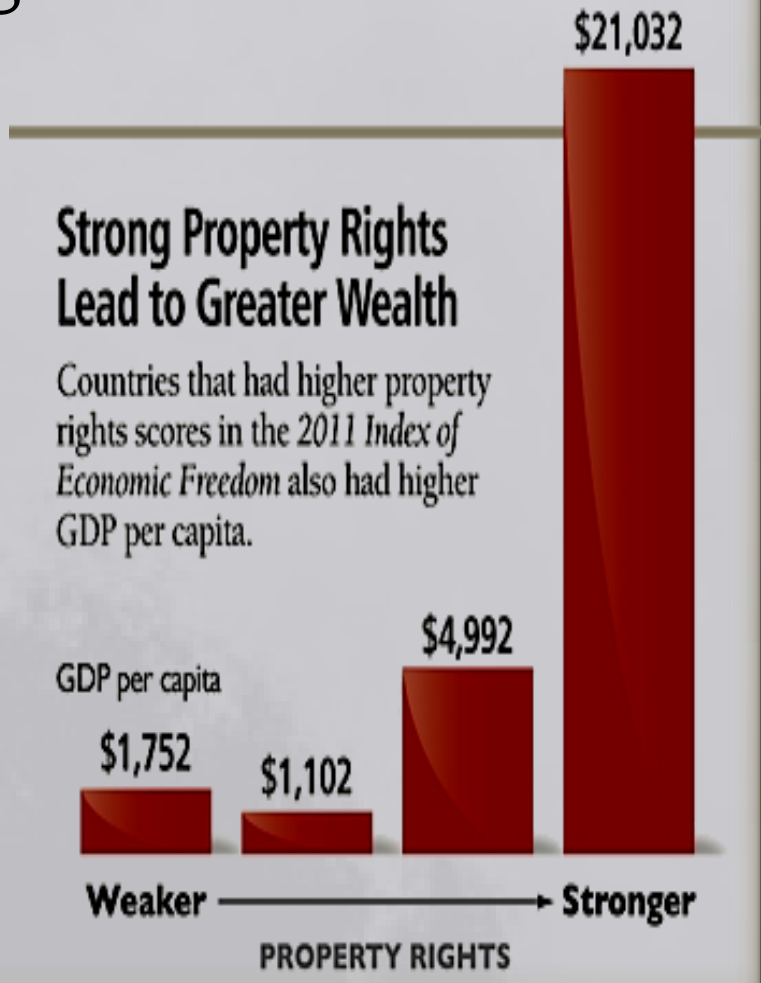
Importance of Property Rights

Economic theory contends that government enforcement of strong property rights is a determinant regarding the level of economic success.

Individuals will create new forms of property to generate wealth only when they are assured that their rights to their property will protect them against unjust and/or unlawful actions by other parties.

Importance of Property Rights

- Secured rights to property and resources trigger a multiplying effect of opportunity:
  - social identification and inclusion
  - economic stability
  - better environmental stewardship
  - responsible and more informed private investment that lowers financial risk



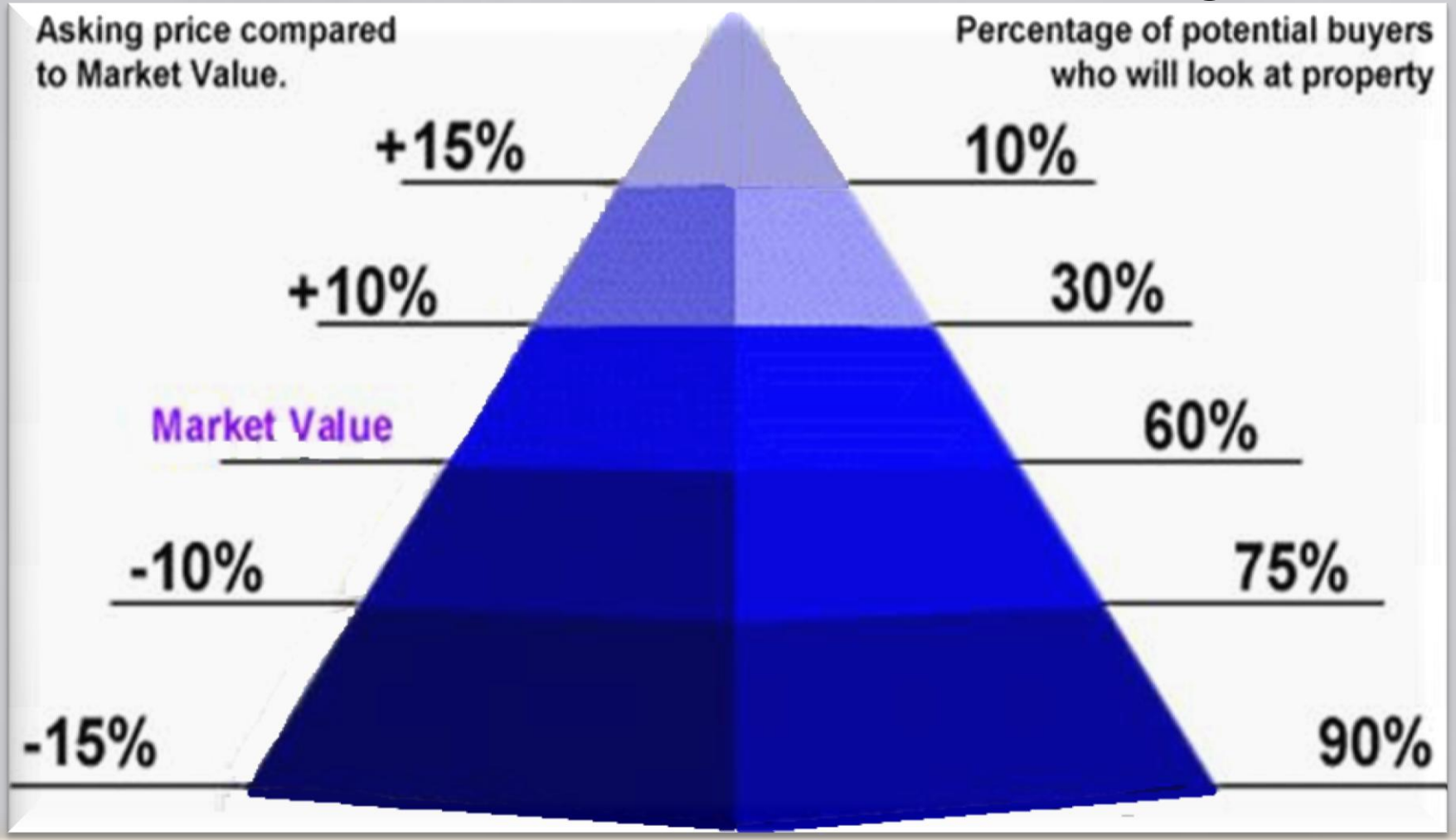
What are Property Rights?

A property right is the exclusive authority to determine how a resource is used, whether that resource is owned by government or by individuals, commonly referred to as excludability.

The market exchange value of the property reflects the preferences and demands of the rest of society. Society approves the uses selected by the holder of the property right with governmental administered force and with social ostracism.

Market Exchange Value

Market exchange value becomes more important than other factors in exchanges.



What are Property Rights?

Private property rights have two other attributes in addition to determining the use of a resource. One is the *exclusive right to the services of the resource* (rent).

A private property right also includes the *right to delegate, rent or sell any portion* of the rights by exchange or gift *at whatever price the owner determines* (provided someone is willing to pay that price).

The Basic Elements of Property Rights

Thus, the three basic elements of private property rights are (1) exclusivity of rights to choose the use of a resource, (2) exclusivity of rights to the services of a resource and (3) rights to exchange the resource at mutually agreeable terms.

Property Rights for *Sesame Street*

Limitations

- The US Supreme Court has vacillated about the third aspect of private property rights but such limitations as price controls and restrictions on the right to sell at mutually agreeable terms <u>are</u> reductions of private property rights.
  - The market values of property reflect the preferences and demands of the rest of society.
  - Property rights eliminate destructive competition for control of economic resources.
  - More complete property rights make discrimination more costly.
  - Restrictions on private property rights reduce competition based on monetary exchanges for goods and services and increase competition based on personal characteristics.

The International Property Rights Index (IPRI), 2014

- Finland leads the 2014 rankings with a score of 8.5 out of 10.
- New Zealand, Sweden and Norway tie for second place at a score of 8.3, followed by Switzerland and Singapore at 8.2, the best score in the Southeast Asia region.
- Canada ranks 9th with a score of 8.0, 0.3 points above the United States (7.7), which ranks 17th.
- On average, countries in the top quintile of IPRI scores (i.e., the top 20%) show a per capita high income (HI) approximately 12 times that of the bottom quintile.

The International Property Rights Index (IPRI), 2014

Rank	Country	Rating (out of 10)
1	Finland	8.5
2	New Zealand	8.3
2	Norway	8.3
2	Sweden	8.3
5	Singapore	8.2
5	Switzerland	8.2
7	Luxemburg	8.1
7	Netherlands	8.1
9	Canada	8.0
10	Denmark	7.9

The Theory of Property Rights

The basic assumption of the theory of property rights is that an efficient result can be achieved regardless of who is the owner of a resource but not *without* an owner.

Goods without private property are often vulnerable to the problem of overuse which leads to market failure (tragedy of the commons).

Property rights is a way to correct market failures.

Correcting Market Failures

- Externalities occur when property rights are not defined or are not effectively enforceable.
- Negative externalities exist when the costs of producing a good are borne by people other than those who decide how much or whether to produce that good.
  - Negative externalities result in more being produced than would be if the producers and consumers of the good bore all the costs.

Correcting Market Failures

- Positive externalities exist when the benefits of a good or service affect people other than those who decide how much or whether to produce that good.
  - Positive externalities result in less being produced – scenic views, for example – than would result if those who bore the costs could capture all the benefits.
- When property rights are not well-defined, enforceable and transferable, cooperation becomes more costly and markets operate less effectively to allocate resources to their most highly-valued uses.

An Example of Correcting Externalities with Property Rights

In the 18th century, when colonists began to buy beaver furs from the Montagnes Indians, hunting increased to the point that the beaver population declined. (The existence of externalities is evidence of incomplete property rights.)

The Montagnes Indians successfully solved the problem by allocating individual territories to each family (exactly defined property rights), so that individuals had incentives to plan for the long term survival of the beaver population. Consequently the negative externality was remedied and individuals' behavior was purposely changed by property rights.

Types of Property Rights

Property rights may be *private*, *common* or *collective.*

Private Ownership

- Private property ownership allows the owner to exclude others from the use of the resource.
  - Private property creates incentives for conservation and improvement of resources. A stable, dependable enforcement mechanism is essential for these incentives to work.

Private Ownership

Private property rights to a resource need not be held by a single person. They can be shared, with each person sharing in a specified fraction of the market value while decisions about uses are made in whatever process the sharing group deems desirable.

A major example of such shared property rights is the corporation.

Private Ownership

Private property rights are not absolute. The rule against the “dead hand,” or perpetuities, is an example. An owner cannot specify how resources that he/she owns will be used in the indefinitely distant future.

Common Ownership

- Common property is characterized by the inability to exclude users.
  - Common property arrangements – shared ownership arrangements where everyone owns the property together, create incentives for overuse, a phenomenon known as the tragedy of the commons
  - Common property *can* be an effective alternative to private ownership of large-scale resources, *if* access to the resource can be kept closed to outsiders.

Common Ownership

Common ownership of resources – whether in the former Soviet Union or in the US – gives no one a strong incentive to preserve the resource.

A fishery that no one owns, for example, will be overfished. The reason is that a fisherman who throws back small fish to wait until they grow is unlikely to get any benefit from his waiting. Instead, some other fisherman will catch the fish.

The same holds true for other common resources whether they be herds of buffalo, oil in the ground or clean air.

Collective Ownership

- Collective property is similar to common property in that ownership is shared, but it differs in that decision-making is through government and political processes and in that individuals cannot avoid "ownership" without departing from the political jurisdiction.
- Collective property arrangements can be either public or private.
  - A country club swimming pool is an example of a private collective.
  - A city-owned swimming pool is an example of a public collective.

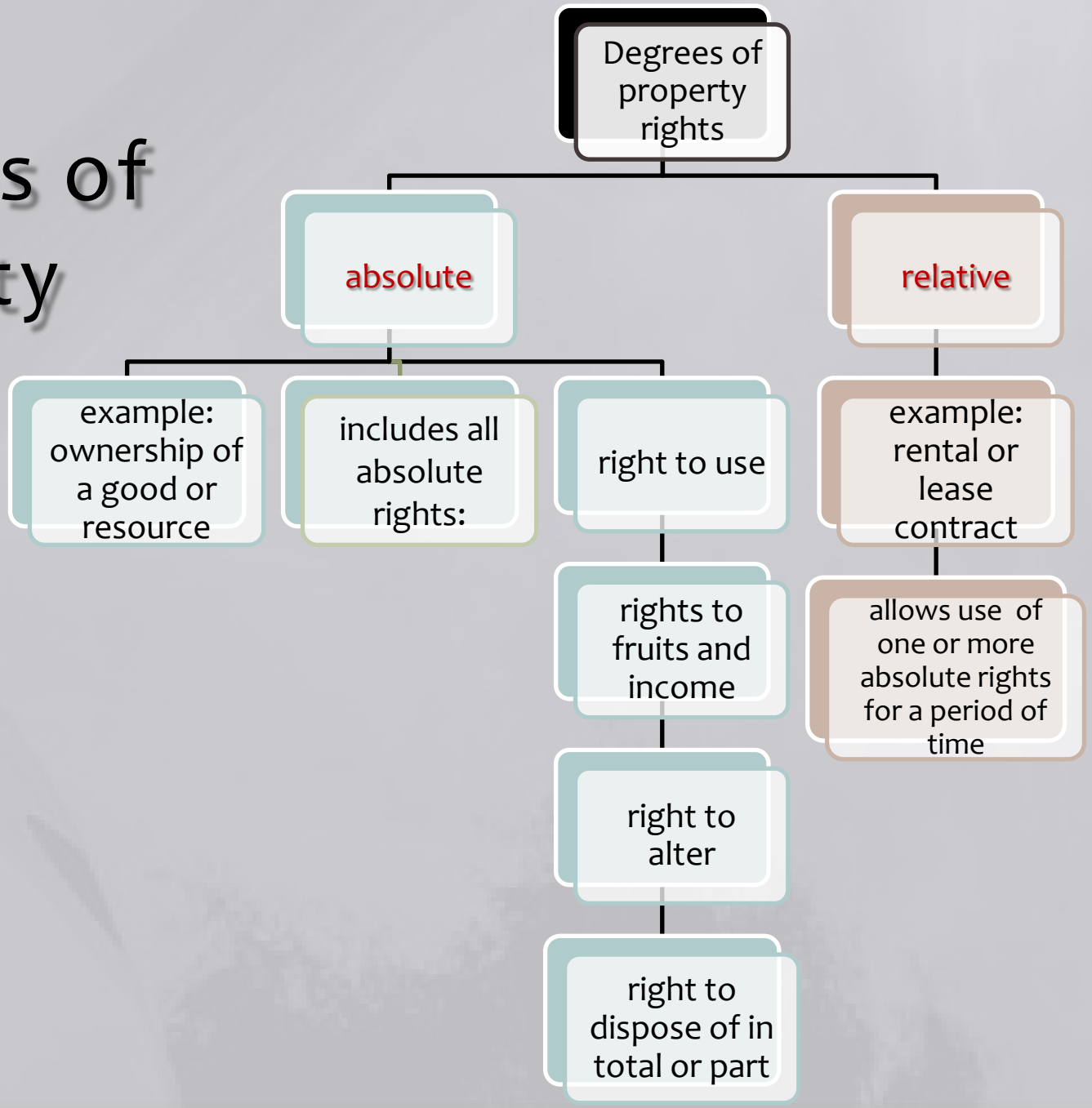
Collective Ownership

- Because users cannot be excluded, collective ownership creates incentives that lead to the tragedy of the commons.
- If effective *exclusion* is feasible, common and collective ownership arrangements can avoid the tragedy of the commons.
  - *Community* run fisheries in the coastal waters off New England and Newfoundland, for example, have effectively solved the problem of depleted fish stocks that resulted from over-fishing in common waters.

Collective Ownership

- Collective ownership (and sometimes common ownership) also creates incentives for *political* allocation of benefits and rent-seeking behavior.
  - rent-seeking behavior - expending resources on political activity to increase one's share of existing wealth without creating wealth
  - For example, lobbyists are hired to sway public policy to benefit their companies and punish their competitors. Although hiring lobbyists clearly benefits the company they represent, the work of lobbyists does not add value to the larger marketplace.
  - The effects of rent-seeking are reduced economic efficiency through poor allocation of resources, reduced wealth creation, lost government revenue, increased income inequality and, potentially, national decline.

Degrees of Property Rights



Complexity

While more complete property rights are preferable to less complete rights, any system of property rights entails considerable complexity and many issues that are difficult to resolve.

If, for example, I operate a factory that emits smoke, foul smells or airborne acids over your land, am I using your land without your permission?

Absolute Rights

Property rights theory focuses on absolute rights. It attempts to answer in which way absolute rights should be distributed to solve negative externalities and thereby increase efficiency.

Points Important to Efficiency

For efficiency, four key points are important.

Points Important to Efficiency

- Universality: Security … All scarce resources should belong to someone. This right must be clarified unambiguously and guaranteed by the state.
- Exclusivity: All property rights should be allocated exclusively so that *one* owner can exclude others from the good. This increases the interest for sustainability.

Points Important to Efficiency

- Sustainability: Permanence … Property rights theory only works when there are absolute rights of disposal.
- Transferability: Marketable … Property rights should be transferable. Thereby a bad producer can transfer his property to a more talented one. The owner here has a strong incentive for the efficient use of a resource.

Ronald Coase

Property rights theory is based on the ideas of Ronald Coase, who theorized that economic efficiency is achieved best by the full allocation of, and completely free trade in, property rights.

The Coase Theorem states that what really matters is that *every*thing is owned by someone and that, initially, who owns what doesn't matter. It's based on two main ideas – freedom of individual choice, and zero transaction costs (expenses associated with the process of buying and selling).

Coase Theorem

- The *Coase Theorem* provides insight into how the definition of property rights can facilitate "willing seller – willing buyer" exchanges that enhance environmental quality.
  - When property rights are well-defined, enforceable at low cost and transferable, property rights to resources will be traded in the market until they reach their highest-valued use – that is the use that maximizes net benefits, taking into account *all* of the costs and benefits of their use.

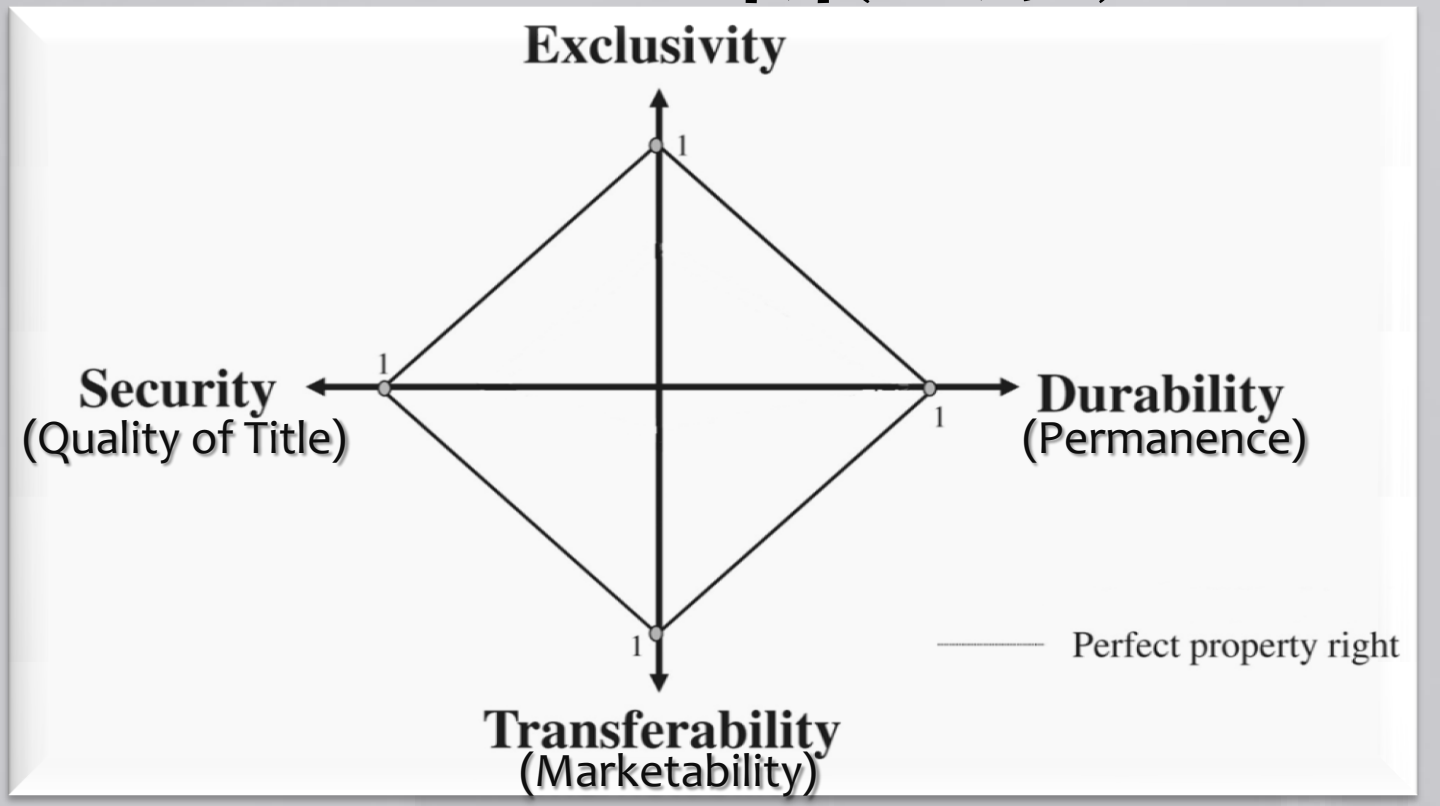
Benefits and Transaction Costs

Property rights theorists propose that rights systems emerge and evolve when resources become scarce. However, the transaction costs of establishing a system of rights can be considerable, particularly where the resource users are dispersed and heterogeneous.

When the benefits of establishing rights exceed the transaction costs of doing so, things should start to happen, as long as the costs can be shared appropriately. The activity undertaken by potential beneficiaries to have rights established is called contracting.

A Tool to Measure the Quality of Property Rights

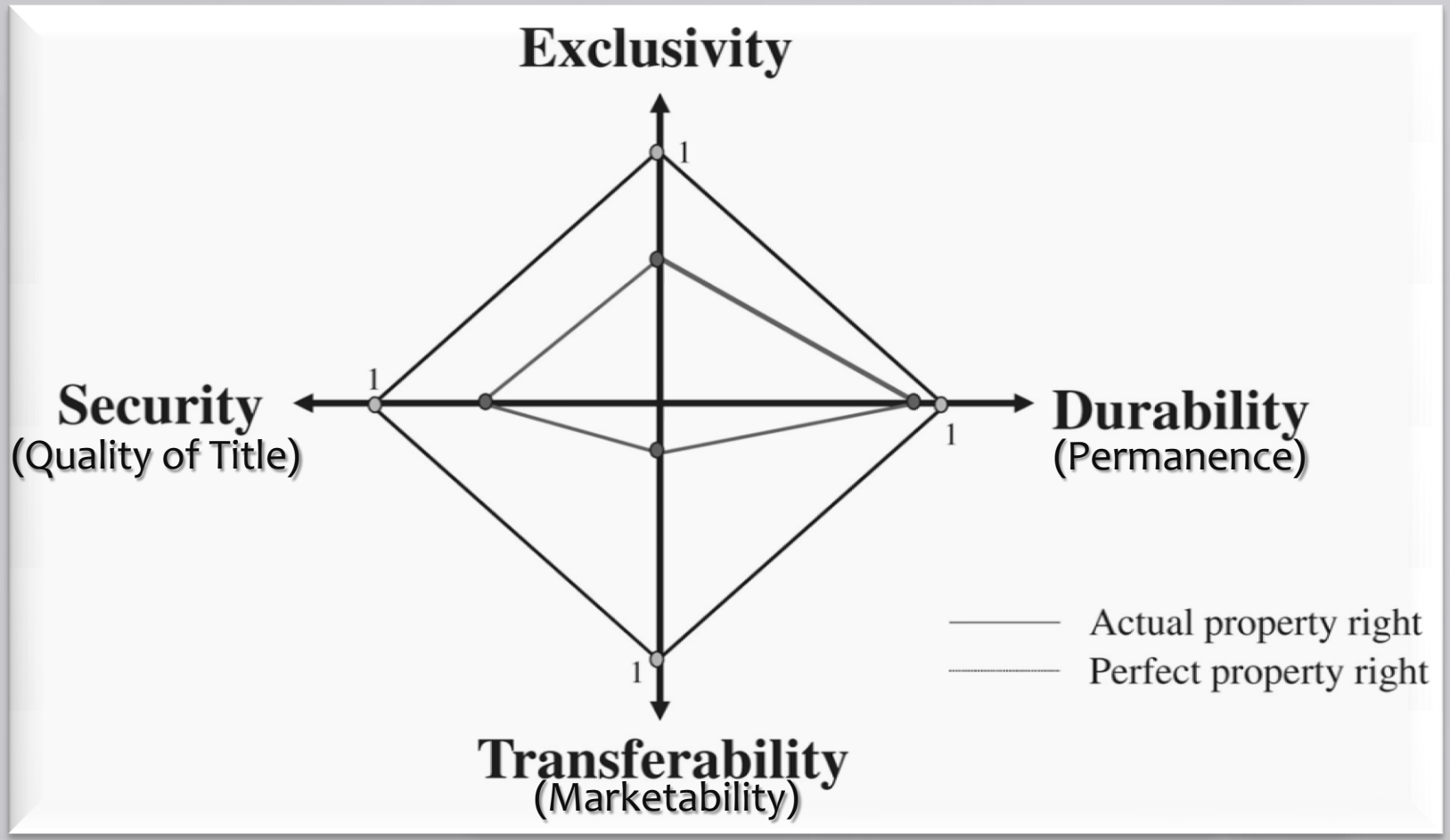
The perfect property rights, with quality values at 1 for each characteristic, have the highest quality and the largest characteristic footprint possible. Their extent is measured on a scale from 0 to 1, with 0 meaning none and 1 meaning full extent of the characteristic. In the diagram below the extent of each of the four characteristics is measured along an axis over the interval [0,1]. (Scott, 1988)



ftp://ftp.fao.org/docrep/fao/009/x7579e/x7579e01.pdf, p.19

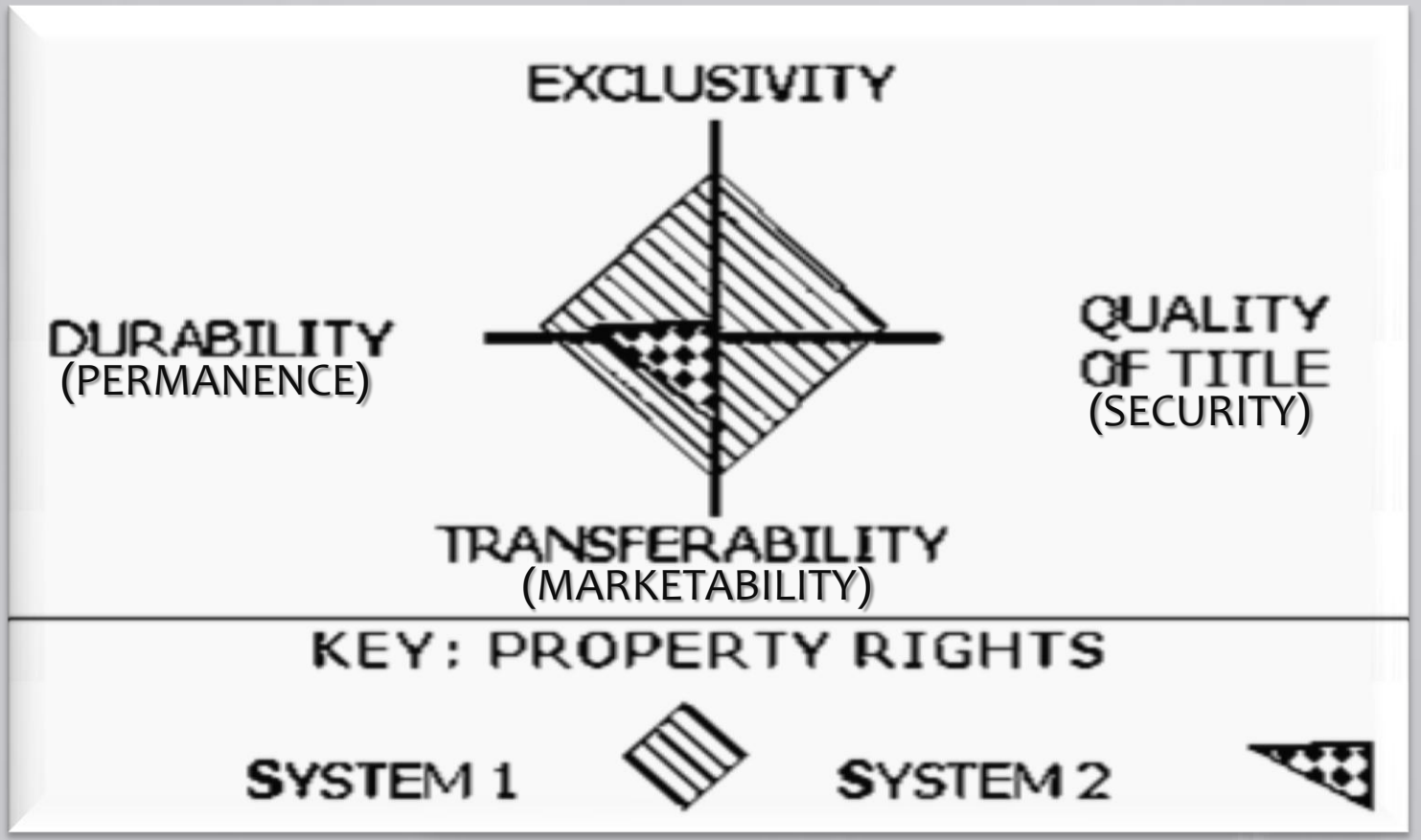
Measuring the Quality of Property Rights

The diagram below presents the characteristic footprints of perfect property rights and less than perfect property rights, labeled "actual property right."



Measuring the Quality of Property Rights

The diagram below presents the characteristic footprints of perfect property rights (system 1) and less than perfect property rights (system 2), shown differently than the previous slide.

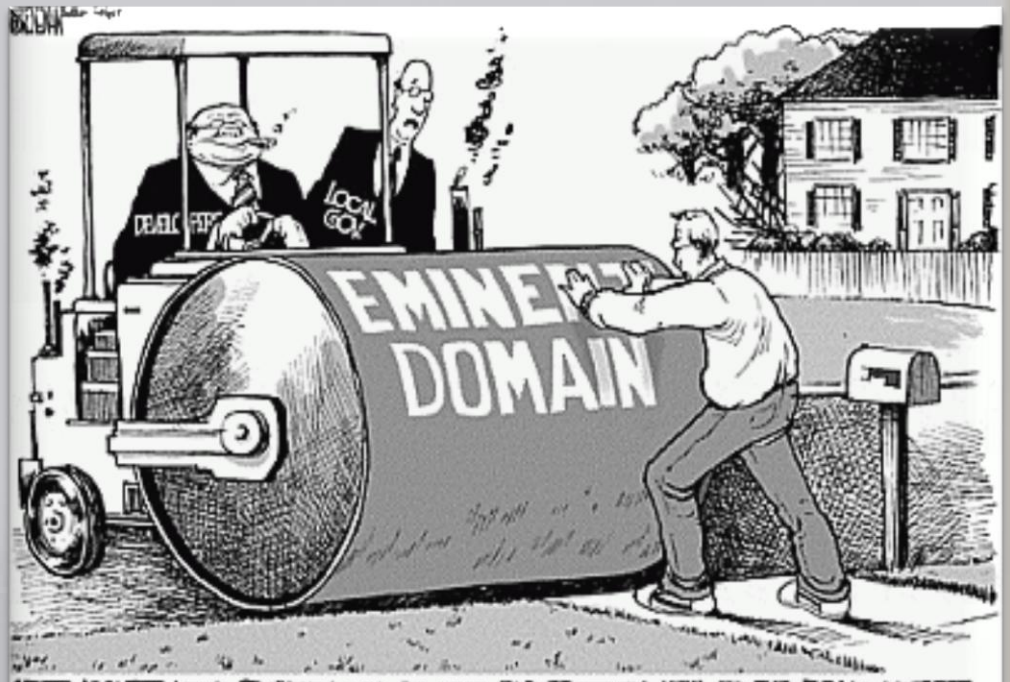


Weakened Property Rights

- Occur in command/socialist economies.
- Government agents exercise control.
- Decisions are highly restricted.
- Right not for sale at any price.
- No incentive to heed to market changes.
- Use of resource influenced by personal choices of agent.
- No incentive to preserve resources.

Eminent Domain

Eminent Domain – the right of the state to take private property for public use … The 5th Amendment to the US Constitution requires that "just compensation" be made.



"REST ASSURED, YOUR PROPERTY WILL BE USED FOR PROJECTS VITAL TO THE PUBLIC INTEREST. ESPECIALLY THE PUBLIC INTERESTED IN A NEW MINI-MALL."

Eminent Domain

Eminent domain, broadly understood, is the power of the state to seize private property without the owner's consent. Historically, the most common uses of property taken by eminent domain are public facilities, highways and railroads.

Eminent Domain

Traditionally the power of eminent domain has been exercised for the construction of large public projects, but in the US its use is beginning to be broadened to projects involving not public *use*, but *public benefit*.

The decision in *Kelo v. City of New London*, a case that came before the US Supreme Court in 2004, set a precedent for property to be transferred to a *private* owner for the purpose of *economic development*.

Eminent Domain

In *Kelo v. City of New London (2004)* the US Supreme Court found that if an economic project creates new jobs, increases tax and other city revenues and revitalizes a depressed or blighted urban area it qualifies as a public use.

In this case the city was allowed to take private homes and sell the property to a developer.

Eminent Domain

Susette Kelo with a "Not For Sale" sign on her little pink house, formerly located at 8 East Street in New London, CT.

Demolition of homes taken by Eminent Domain in New London.

Before Kelo's house was demolished, it was deconstructed, rebuilt, and transformed into a museum.

Kelo v. City of New London

"Petitioner Susette Kelo was living in the Fort Trumbull area since 1997. She has made extensive improvements to her house, which she prizes for its water view."
Kelo v. City of New London, 545 U.S. 469 (2005) (Stevens, J.)

Susette Kelo lived in a modest pink cottage in the city of New London, Connecticut. All she wanted was to be left alone, to enjoy her home's idiosyncratic hue and water view. But the City Council had other plans. Anticipating the nearby construction of a major pharmaceutical research facility, it approved a redevelopment plan for the Fort Trumbull area: marinas, a Coast Guard museum, commercial shops and restaurants, all intended to revitalize the city and improve the local economy. Of course the existing structures would have to be demolished first. Susette's property was to be used for office space, or maybe for parking. She, however, did not want to be paid off; money is no substitute for a home. So Susette sued.

The Supreme Court concluded that the city could use its power of eminent domain to perform a forced-sale of Susette's property. The Fifth Amendment authorizes the government to take private property "for public use" and, for a majority of the Court speaking through Justice John Paul Stevens, economic development approved by local democratic bodies evinces enough of a public purpose to satisfy that broad standard. Four Justices disagreed, seeing the city's redevelopment plan as a way to take land from one private party in favor of a preferred other. A far cry from taking private property for a fire station, or for railroad tracks, or even to clean up a blighted neighborhood, and a dangerous precedent to set.

The aftermath of the dispute? Well, the city eventually agreed to move Susette's home, intact, to another neighborhood. Popular outrage against the Supreme Court's decision sparked dozens of states to cut back on their own eminent domain powers by enacting legislative reforms. Meanwhile, back in New London, the much vaunted pharmaceutical facility closed its doors in 2009, and Susette's property is now a vacant lot (*pictured to the right*). Whether any public purpose has truly been served by this affair remains an open question.

Photographs courtesy of Krissy Keys, Institute for Justice

A Solution to Environmental Problems?

The creative extension of property rights to ecological resources could help address many environmental problems. Particularly in the case of natural resources, property rights are a viable and demonstrated means of enhancing sustainability, particularly when compared to the available political alternatives.

A Solution to Environmental Problems?

There is increasing evidence that a *failure to respect and protect property rights undermines environmental stewardship*, particularly on private land.

This is important in a country like the US in which a majority of land is privately owned.

This problem is most evident in the context of endangered species.

A Solution to Environmental Problems?

A majority of those species listed as endangered or threatened rely on private land for some or all of their habitats. If these species are not saved on private land, they may not be saved at all.

Yet the Endangered Species Act, in effect, punishes private landowners for having maintained their land in a way that is beneficial for listed species.

The end result, as empirical research has shown, is a decline in endangered species habitats on private land. Greater protection of property rights could actually enhance species conservation.

Free & Green: A New Approach to Environmental Protection

Back to the Future of Conservation: Changing Perceptions of Property Rights and Environmental Protection

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