

Chapter 4

When Do Property Rights Come About?

A primary function of property rights is that of guiding incentives to achieve a greater internalization of externalities. Every cost and benefit associated with social interdependencies is a potential externality. One condition is necessary to make costs and benefits externalities. The cost of a transaction in the rights between the parties (internalization) must exceed the gains from internalization.

— Harold Demsetz (1967), “Toward a Theory of Property Rights.”

In the early 1960s, the parents of one of the authors left him, his brother, and his sister a lot. Such situations, with one pre-teen (the author) and two teenagers, can lead to a lot of conflict. On one issue, the three siblings figured out how to reduce conflict to zero by defining property rights. The family had a corn popper and all three liked popcorn. But there was a problem. Even when the three agreed on who was to pop the corn and who was to wash the resulting dishes (leaving no unwashed dishes was a strict household rule), each of the three had an incentive to eat quickly out of the common popcorn bowl so that he or she would get the popcorn ahead of his or her siblings. After only a few times in which all three ate popcorn more quickly than they ideally wanted to, they devised a solution. They poured the popcorn from the corn popper in equal amounts into three bowls. Then each had a bowl that was his or hers and each could take his/her sweet time eating. Problem solved. Tragedy of the commons averted. Harold Demsetz would have been proud.

When and why do property rights come about? It’s an important question but it was relatively unstudied by economists before the UCLA School

got its hands on the issue. A pathbreaking article that gave an answer was Harold Demsetz's 1967 "Toward a Theory of Property Rights" published in the *American Economic Review*.

Although economists are known to make unjustified fun of anthropologists, Demsetz took them seriously and read their literature. The specific area Demsetz studied was the development of property rights, or the lack of their development, among Aboriginal Canadians and native Americans. Anthropologist Frank G. Speck, wrote Demsetz, had "discovered that the Indians of the Labrador Peninsula had a long-established tradition of property in land." The Speck article that Demsetz cited had been published way back in 1915. His finding was at odds with what anthropologists knew about Indians in the American Southwest. Anthropologist Eleanor Leacock, noting that difference, inquired further into the situation of the Labrador Indians and wrote up her findings in 1954. According to Demsetz, "Leacock clearly established the fact that a close relationship existed, both historically and geographically, between the development of private rights in land and the development of the commercial fur trade" (1967: 351).

Reading Leacock's article gave Demsetz his "aha" moment. He noted that although the factual basis of the correlation was solid, no theory that he knew of had related private property in land to the fact of the fur trade. But to Demsetz it seemed obvious. And in laying out his insight, Demsetz made a further contribution: he analyzed the tragedy of commons a full year and a half before the famous *Science* article, "The Tragedy of the Commons," by biologist Garrett Hardin. The Hardin article had introduced the concept of the tragedy of the commons. The core idea is that if a commons, that is, an area that no one owns, is unmanaged, people will overuse it. If, for example, no one owns land on which cattle graze, and no one manages the land, cattle owners will overgraze the land and reduce its value. The Hardin article is one of the most-cited *Science* articles ever.

In his version of the idea published earlier in relation to the fur trade, Demsetz wrote:

Because of the lack of control over hunting by others, it is in no person's interest to invest in increasing or maintaining the stock of game. Overly intensive hunting takes place. Thus a successful hunt is viewed as imposing external costs on subsequent hunters—costs

that are not taken into account fully in the determination of the extent of hunting and of animal husbandry. (p. 351)

Later in his article, Demsetz wrote:

It will be best to begin by considering a particularly useful example that focuses our attention on the problem of land ownership. Suppose that land is communally owned. Every person has the right to hunt, till, or mine the land. This form of ownership fails to concentrate the cost associated with any person's exercise of his communal right on that person. If a person seeks to maximize the value of his communal rights, he will tend to overhunt and overwork the land because some of the costs of his doing so are borne by others. The stock of game and the richness of the soil will be diminished too quickly. It is conceivable that those who own these rights, i.e., every member of the community, can agree to curtail the rate at which they work the lands if negotiating and policing costs are zero. Each can agree to abridge his rights. It is obvious that the costs of reaching such an agreement will not be zero. What is not obvious is just how large these costs may be. (1967: 354)

Notice how this anticipates Hardin's later article in *Science*.

Demsetz wrote, "The geographical or distributional evidence collected by Leacock indicates an unmistakable correlation between early centers of fur trade and the oldest and most complete development of the private hunting territory" (p. 352).

Tribes agreed to hunt in their own well-defined areas. Since furry animals aren't migratory, the agreed-upon territorial rights had value. Conversely, grazing animals in the Southwest wandered all over the land, so territorial rights there didn't have as much value. Put differently, in the Southwest, the costs of enclosing grazing animals in a specific geographical area were prohibitively high. Recall that this was many decades before the post-Civil War invention of barbed wire. The lower costs of husbanding fur-bearing forest animals together with the higher commercial value of fur-bearing animals made it productive to establish private hunting lands.

Demsetz summed up the situation of the American Southwest:

Hence both the value and cost of establishing private hunting lands in the Southwest are such that we would expect little development along these lines. The externality was just not worth taking into account. (p. 353)

What is particularly interesting in the hunting example is that the property rights arrangement in Quebec that Demsetz cited arose voluntarily in response to circumstances that made the arrangement efficient. Property rights did *not* come about by government fiat. In furthering their economic interests, people typically choose the property rights regime that best promotes their economic interests.

Interesting also is the fact that Demsetz didn't have the attitude that many people had about American and Canadian First Nations people, namely, that their culture was such a sharing culture that they didn't need or value private property. He noted one clear finding of the anthropological literature that showed the importance of private property in items that were easily claimed and easily protected. He wrote:

Among wandering primitive peoples, the cost of policing property is relatively low for highly portable objects. The owning family can protect such objects while carrying on its daily activities. If these objects are also very useful, property rights should appear frequently, so as to internalize the benefits and costs of their use. It is generally true among most primitive communities that weapons and household utensils, such as pottery, are regarded as private property. Both types of articles are portable and both require an investment of time to produce. (p. 353)