

Chapter 2

Can Property Rights Help Us Understand People's Actions and Even Reduce Conflict?

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. For decades social critics in the United States and throughout the Western world have complained that “property” rights too often take precedence over “human” rights, with the result that people are treated unequally and have unequal opportunities. Inequality exists in any society. But the purported conflict between property rights and human rights is a mirage. Property rights are human rights.

— Armen A. Alchian (2008), “Property Rights,” p. 422.

How property rights reduce conflict

Should restaurants allow smoking or not? Should schools teach evolution or intelligent design or both? Should insurance companies cover contraception? Should we be able to take off our shoes in your living room?

You might think that that last question doesn't belong with the first three. After all, the first three questions are momentous ones about “public policy.” The last one is only about the rules you have for our behaviour in your living room—a “private policy” question. And your answer to that question will depend on how you want to use your property.

But think about what you just read: Your answer to whether we should be able to remove our shoes in your living room depends on how *you* want to use your *property*. What is implicit here, but obvious to all, is that the choice

is *yours*. We have no say in the matter. That doesn't mean you won't take account of our thoughts and feelings. You will. Let's assume that you find it distasteful for us to take off our shoes, but that you like our company. Let's further assume that telling us that we can't get comfortable by taking off our shoes will mean that we won't want to visit you. You will then trade off your distaste at having us shoeless with the pleasure you take from our company. If one outweighs the other, in your subjective estimation, then you'll choose accordingly.

Notice how property rights solve the problem. It's *your* living room and so you get to choose. How your living room gets used is not a public policy problem.

Although Armen Alchian and Harold Demsetz never, as far as we know, used the shoe example, it's a clear example of the way they reasoned to the conclusion that well-defined property rights solve problems and create harmony.

If property rights are respected, none of the other three questions is a public policy problem either. Consider each in turn.

Should a restaurant allow smoking? We have no idea. Neither do you. Who does? The restaurant owner. The restaurant owner knows that if he bans smoking, he will get more business from non-smokers and less business from smokers. He also knows that if he doesn't ban smoking, he will get more business from smokers and less from non-smokers. He will make that tradeoff and, if he has no particular interest one way or the other, will likely do so in a way that maximizes his net income from running a restaurant.

But don't his employees matter? Yes, they do, and the restaurant owner knows they do and has an incentive to take account of their preferences. If his employees don't like working where there's smoke, he will take account of both the extra wages he must pay to get good employees and the higher turnover of employees. These all factor into his decision. Interestingly, though, a former waitress told one of the authors that even though she doesn't like smoke, she and her colleagues had preferred, as waiters and waitresses, to work in restaurants that allowed smoking. Why? Because, she said, people who smoked also had a higher probability of drinking alcohol and, therefore, had higher restaurant tabs and paid bigger tips.

In short, whether restaurant owners should allow smoking is not a public policy problem. It's a totally private issue, and the person who should

make the decision is the owner. The only reason it looks like a public policy problem is that the government has made it one—by increasingly putting its thumb on the scales and forcing restaurants to disallow smoking.

A true story about two well-known economists is à *propos*. Robert Barro, an economics professor at Harvard University, hates smoke. When he was on the economics faculty at the University of Chicago, at a time when smoking was allowed, he had a “No smoking” sign on his office door. But that’s not all the sign said. One of Barro’s colleagues at the time was Robert Lucas, a brilliant economist who, in 1995, won the Nobel Prize in Economics. Lucas was also a heavy smoker. Barro treasured his conversations with Lucas. So, the full text of sign was: “No smoking, except for Bob Lucas.”

In other words, Bob Barro traded off his intense dislike of cigarette smoke for his intense appreciation of his conversations with Bob Lucas. He made a judgment about how to use his property—his office—based on that tradeoff. That’s similar to the story about how you would use your living room if you valued our company but “disvalued” our being shoeless.

Consider the question of whether schools should teach evolution or intelligent design or both. Your first instinct might be to say that the answer depends on which is true: evolution or intelligent design. But what if what one person thinks is true is something that another person thinks is false? Some people are absolutely sure that evolution is true, while others are absolutely sure that intelligent design explains why we we’re here on planet Earth.

But the only reason this appears to be a public policy problem is that with a prior intervention, governments have made it one. How so? By taxing people, some of whom believe in intelligent design, some of whom believe in evolution, and some of whom don’t know what they believe, to pay for other people’s schooling. In other words, it appears to be a public policy problem because of a prior restriction of people’s right to keep their own property. That’s why there is conflict. People who argue that they shouldn’t be forced to subsidize the teaching of intelligent design have a point. So do those who argue that they shouldn’t be forced to subsidize the teaching of evolution. Thomas Jefferson put it best: “To compel a man to furnish contributions of money for the propagation of opinions which he disbelieves and abhors is sinful and tyrannical.”

If the government got out of schooling and let people choose how and where to spend their money on their children’s schools and on other children’s

schools (we are assuming that, consistent with history, many relatively affluent people who are free to choose how to spend their money would willingly subsidize the schooling of those who are less affluent),² the problem would go away. Those who want to finance the teaching of evolution would do so; those who want to finance the teaching of intelligent design would do so. The conflict would disappear.

Of course, there would still be people who are upset that a school teaches something they disapprove of, but that doesn't mean that there would be conflict. If everyone's property rights were respected, there would be no conflict. There would simply be people who are upset by others' choices.

Consider, finally, a hot-button issue that came up in the United States during the last decade: Should insurance companies cover contraception? That's for each individual insurance company to decide. In making that decision, will they consider the interests of their customers? Absolutely. It's in the insurance companies' interest to do so. How will they think about it? Companies whose owners or managers think it's immoral to cover contraception probably will not cover contraception. They have the right not to do so and their rights should be respected. Most companies will probably think about it the standard way they think about these things: How much are customers willing to pay to get coverage for contraceptives? And how much will it cost the insurance company to provide such coverage, taking account of the fact that covering contraception might save the insurance company money that it would have spent on abortions and on pregnancies brought to term? The insurance companies probably have a lot of information on these issues. We can tell them little that they haven't thought of. But it's not a public policy issue unless the government makes it one. It's a matter for the insurance company to decide. Then customers can decide whether to deal with that company.

This is just a small list of the problems that are apparently "public policy" problems only because the government has chosen to make them so. Private property solves people's problems every day.³

² For a look at how schooling was almost universally provided in England in the mid-nineteenth century (when almost everyone was much poorer than people are today and there was virtually no government involvement), see West (1965/1994).

³ This section is adapted from Henderson (2012).

Using property rights to explain behaviour

Property rights are the core concept underlying most of the major intellectual contributions of the UCLA School. In particular, Alchian, Demsetz, and others emphasized how the existence and strength of private property rights affect economic behaviour.

Walter Williams (2018), a widely published author and professor who studied under Armen Alchian, stated that private property rights contain three components: (1) the owners' rights to make decisions about the uses of their own property; (2) their right to keep and dispose of their property; and (3) their right to enjoy the income, as well as bear the losses, resulting from their decisions. Alchian (1965) defines a system of property rights as a method of assigning to particular individuals the authority to select, for the goods or services owned, any use from a non-prohibited set of uses. Having a property right, therefore, means that the owner enjoys protection against other people acting against the owner's will.

Consider an example that most of us take for granted but that illuminates the point. You regularly take your nice clothing to a dry cleaner that you have come to trust. One day, you go to pick up your best shirt, which you had bought for \$100 just a few weeks earlier. Your tag says the dry cleaner has the shirt, but the employee can't find the shirt. You ask for \$100 in cash so that you can buy a new shirt. The employee refuses. What do you do? We all know the answer. You ask to speak to the manager. But why do you do that? Because the manager has more power over the decision to reimburse than the employee below her has. Chances are that the manager will give you the \$100. But what happens in the unusual case that she doesn't? You then say the magic seven words: "I need to talk to the owner." We all understand, even if only at an intuitive level, why those are the key words. But an understanding of property rights helps us move beyond intuition to a clear theoretical understanding. The reason to talk to the owner is that the owner has the most to gain by keeping his reputation intact or to lose by not being accountable to the customer. The owner is what Alchian calls the "residual value claimant." Economists have shortened the term to "residual claimant." The owner is the residual claimant because he gets all the difference between revenues and costs. This gives him an incentive to care strongly not only about current revenues and costs but also about future revenues and costs.

Alchian (1965) used this focus on property rights to explain the difference between a privately-run and a government-run enterprise. He gave the example of garbage collection. A government bureaucrat is not a residual claimant. If he inefficiently manages a municipally owned garbage collection service, he suffers no direct financial loss other than possibly being fired. But because he is a government official working for a government agency, his boss or bosses, who are also government officials, don't have a strong incentive to fire him. His and his bosses' actions would have to be so egregious that voters demand that their elected officials fire him. But this threat is likely to be much less effective than that faced by the owner of a privately-owned service who would suffer substantial and direct financial losses if the city terminated its contract for the service. And the incentive for good performance would be even stronger if garbage collection companies sold their services directly to customers. In other words, efficient performance is more likely when the property right to the rewards for efficient garbage collection is held privately rather than held collectively by a municipal government.

In *University Economics*, Alchian and co-author William R. Allen used property rights to explain the underpricing of tickets to the Rose Bowl. They noted that every year there is a large shortage of tickets to this event. Many people who want them at the face price can't get them. Why does that happen? At the time they wrote, the Rose Festival Association, which sold the tickets, was not privately owned. One third of the ticket receipts went to the association and one third went to each of the participating universities and their athletic conferences. But, they noted, "no person can claim any pro rata part of the proceeds as being 'his.'"

This simple fact, they noted, had huge implications. Why should the decision-makers price higher to reduce or eliminate the shortage when they don't get the gains from that action? Why not instead price low so that they can pay a lower price than otherwise for their own tickets and sell tickets to their friends and associates who are given first dibs? By doing so, they can be "invited to the best places, clubs, and circles."

If this analysis were useful only for analyzing pricing of Rose Bowl tickets, it might be only an amusing example. But, as Alchian and Allen understood, it has far more widespread implications.

Thomas W. Hazlett, a UCLA graduate who studies telecommunications markets and who was for a while the chief economist at the Federal

Communications Commission (FCC), used the “Rose Bowl” analysis to understand the behaviour of a particularly powerful Congressman, John Dingell, a Democrat from Michigan. For many years, as chairman of the House Commerce Committee, Dingell opposed auctioning off valuable electromagnetic spectrum. Instead, he wanted the FCC to give away the licenses for specific uses and for limited time periods. Why? Dingell had a lot of power over the FCC. But if the spectrum were auctioned off, the FCC’s power would be less and so, therefore, would be Dingell’s power. As Henderson put it in discussing Hazlett’s point:

When something is allocated to the highest bidder, the bidders, not the auctioneer, determine who gets it. Therefore, Dingell, who had a big oversight role over the FCC, would find his power over allocation dropping to zero also. Without that power, people wouldn’t invite him to dinners and hunting parties as frequently, would contribute less to his campaign fund, and would return his calls less quickly, if at all. In short, he would be a less important man in Washington, and probably a less wealthy one. (2001: 65)

One of the ideas that comes across loud and clear in Alchian’s writing is the idea that property rights and the whole system of incentives that go along with property rights can explain behaviour of people around the world. In a 1960 article, Alchian and co-author William H. Meckling wrote:

And the men of Kharkov and Karachi are not different from the men of Kalamazoo. The specific objects of wealth and power may differ between Kalamazoo and Kharkov. But if Kalamazoo teems with thieves and brigands while Karachi is serenely industrious, the explanation lies not in differences in goals. Differences in goals will not explain differences in the way individuals pursue those goals. (Meckling and Alchian, 1960: 55-61)

What explains the different ways people pursue goals, Meckling and Alchian pointed out, was the system of incentives, which depends on the system of property rights.

Alchian and Demsetz (1973) even applied basic property rights analysis to explain the barbaric killing of baby seals on the ice floes off Prince Edward Island. They pointed out that Canada’s government “permitted no more than 50,000 animals to be taken.” That was a set-up for a catastrophe. Each hunter knew that once the 50,000 number was reached, he couldn’t take any more. So, each hunter then had the incentive to kill as quickly as possible. They wrote:

The first 50,000 animals are offered on a first-come, first-served basis, a system that is bound to encourage rapid hunting techniques to make a condition for success the degree to which the hunter can be ruthless. (p. 20)

Neither Alchian nor other members of the School claimed that a socially beneficial system of private property rights means that people can use their property in *any* way they deem fit. In particular, their use of property should not physically infringe upon the “legitimate” rights of others to use and benefit from their property.

Consider Alchian’s example of someone who opens a restaurant near an already established restaurant. If the owner of the new restaurant pours smells and smoke into the nearby established restaurant, he violates the property rights of the owner of the established restaurant. The new restaurant’s operation reduces the ability of the incumbent restaurant owner to use his property to its maximum advantage, in this case, serving customers food in an environment free from smoke and foul smells.

But, even aside from smoke and odours, doesn’t the owner of the new restaurant harm the incumbent restaurant’s owner simply by competing for customers? Likely so, although Alchian argues that this apparent intrusion on the incumbent owner’s property right is legitimate. Although private property rights protect private property from physical interference, no immunity is implied for the commercial value of anyone’s property. No one should expect the profits or other benefits he receives from his property to be protected from other peoples’ use of their own private property when the latter usage does not physically limit the former’s use of his or her private property.

Similarly, if your use of your personal property does not physically interfere with the use or sale of our private property, a socially efficient system

of private property rights would not allow us to constrain your use of personal property simply because we find your use objectionable on moral or emotional grounds. Imagine that your neighbour strongly objects on aesthetic grounds to a lawn ornament that you placed outside your house. Should your neighbour enjoy a legal right to have your lawn ornament removed, by force if necessary? What if other neighbours actually enjoy viewing the lawn ornament on their walks past your house?

It is easy to see how objections to other peoples' behaviour based on emotional or aesthetic grounds would lead to the exhaustion of the capacity of regulators and courts to determine legal property rights. The costs to society associated with resolving disputes about property rights based on emotional or aesthetic grounds are likely to far outweigh any benefits to people who feel better off because specific uses of property, such as displaying specific types of lawn ornaments, are banned. Moreover, if specific uses of property are especially objectionable to small groups of individuals, they are free to negotiate with the property owners whose behaviour is objectionable. For example, there may be things you can do for your neighbours who object to your lawn ornaments in return for their "tolerating" those ornaments. This would be a far cheaper way of dealing with property rights disputes than invoking regulatory or legal procedures.⁴

Alchian stresses that individual property rights are supported not only by the states' power to make and enforce laws but also by the "force of etiquette, social custom and ostracism." That's why many potential disputes about specific exercises of property rights are avoided even when laws and regulations do not clearly delineate which specific uses are inconsistent with the public interest. Laws distinguishing between acceptable and unacceptable lawn ornaments are largely unnecessary because society accepts freedom of expression within wide limits as a legitimate right.

The kinds of expression people accept vary over time as social customs change. For example, health experts and others have criticized advertisements lauding specific body types, and the criticism has led many companies to change how they promote their products. No laws or regulations were required to bring about the change. The shareholders of companies affected by

⁴ For the seminal article on how private transactions can resolve disputes about property rights in an efficient manner, see Coase (1960).

the change in society's views about advertising had and have a strong financial interest in acknowledging and acting upon changes in social attitudes. This is a key point in the UCLA School's depiction of property rights. When owners of property rights bear the full, or close to full, benefits and costs of their actions, they have strong incentives to act in the social interest, whether those interests are codified in laws and regulations or in social customs. This is because the failure to do so will usually have adverse financial or other consequences.

Property rights and pollution

Demsetz (1967) was one of the first economists to explain how weak or attenuated property rights can lead to water pollution. A primary function of property rights is to guide incentives to achieve a greater internalization of what economists call externalities. When externalities are internalized, people take account of how their actions physically interfere with other people's property. To illustrate, imagine that there is a chemical plant on one side of a body of water and a fishing lodge on the other side. The chemical plant releases emissions into the water that harm the reproduction of fish, so the lodge cannot offer the same opportunities for successful fishing to its customers as it could if the chemical plant reduced its emissions. If the body of water creates the greatest economic value as a location for fishing resorts, the emissions externality is a source of economic inefficiency. The failure of the chemical plant to take account of the physical damage it imposes on the fishing resort results in an inefficient use of a scarce resource, i.e., the body of water. The externality, in turn, reflects the fact that property rights to the body of water are shared in common by the chemical plant and the fishing lodge.

As noted earlier in the discussion of a neighbour objecting to another neighbour's lawn ornament, if operating a fishing camp is the most valuable use of the body of water, the owners of the fishing camp have an incentive to negotiate with the owners of the chemical plant to get the plant to stop or reduce its emissions. At the extreme, the owners of the fishing resort might simply buy out the owners of the chemical plant and dismantle the plant. Either way, the owners of the fishing resort are either indirectly or directly converting a property right held in common into a property right effectively held by the fishing resort. The outcome is that the body of water will be dedicated to its highest-valued use. What if, on the other hand, the chemical plant's use was the highest-valued use? One might feel uncomfortable with

this result, given the effect on the lake. But even in this case, property rights help. If the chemical plant has full rights to the lake, then it has the incentive to take account of the cost of its damage, not just in the current year, but also in future years. If fishing were to become much more popular in future years, then at some point, it could make sense for the chemical plant to turn the lake over to fishing—and reap the rewards. One might worry that the lake is finished for good. But as anyone knows who followed the evolution of Lake Erie from a highly polluted lake in the 1960s to a very clean lake today, pollution is not forever.

Demsetz recognized that in some circumstances, the costs of transacting may make it uneconomical to convert commonly held property into a private property right so that externalities are “internalized.” As Demsetz puts it, the costs of transacting in the rights between the parties (internalization) may exceed the gains from internalization. In such cases, government regulations on how commonly held property can be used might improve economic efficiency if those regulations are guided by considerations of the economic value of the property in its alternative uses.

Property rights within firms

Demsetz also applied property rights analysis within firms. Large companies rely on managers to operate those organizations in the interests of the owners, who are often a relatively large number of individuals and institutional investors. Shareholders are the property right owners inasmuch as they bear the financial consequences of the decisions made by managers. Therefore, shareholders have an incentive to hire managers who have the specialized knowledge needed to operate the business efficiently. However, shareholders face relatively high costs of monitoring the actions of the managers who run the company, especially when the knowledge needed to run the company is specialized. One way to reduce the need for close monitoring of managers is for shareholders to transfer some of their ownership rights to managers.

Demsetz (1983) noted that one way to align the incentives of managers with the interests of shareholders is to grant stock options to managers or to pay them partly with shares in the company. In this way, managers are made more responsive to the interests of shareholders.

Critics have argued that rewarding managers with claims to partial ownership of the companies they manage, through stock options, creates

incentives for managers to make decisions that increase the short-run profits of those companies at the expense of long-run profits, since the latter might well be realized after current management is no longer employed. This argument assumes that stock markets overvalue short-run profits and undervalue long-run expected profits, a belief for which there is little justification. This view of the inefficiency of stock markets has led many politicians and would-be advocates of “improved” corporate governance to call for limiting or even eliminating the use of stock options as a means to compensate managers.

But Demsetz replied that owners have an incentive to make an efficient tradeoff between doing more active monitoring of managers hired to run the businesses they own and tying management compensation more closely to performance outcomes preferred by the shareholders. Regulatory limits on stock options or other forms of managerial compensation tied to corporate profitability would require owners to do more indirect managing, which would limit the specialization of roles between owners and managers. The net outcome would likely be fewer efficient and profitable companies and greater difficulty in raising financial capital to fund start-ups and help small- and medium-sized companies grow.

The differing objectives of government and private ownership

The main lesson the UCLA School taught in the context of property rights is that legal and regulatory constraints on the ownership and exercising of private property rights are likely to result in inefficient behaviour and outcomes that make society worse off. This is not to say that the School believes that a system of strong private property rights is always preferable to alternative arrangements. Whether it is preferable depends strongly on people’s objectives. Alchian (1965) acknowledged that government and private ownership often have different objectives. In particular, government ownership is focused primarily on redistributing income among individuals, while private ownership is focused on producing and distributing output efficiently. Alchian offered state parks and municipal golf courses as examples. State and local governments that own and operate them typically make them available to patrons at relatively low prices and make the facilities available on a first-come, first-served basis. As a result, willingness to pay does not play the prominent role it ordinarily does in determining who gets the good or service.

Government ownership allows cross-subsidization whereby higher-income taxpayers and non-users subsidize the consumption of lower-income people, since the costs of operating state parks and municipal golf courses are not fully covered by the low prices charged by the relevant government agencies managing those facilities. The residual costs of operating the facilities must be covered through revenues raised by taxes and fees levied on residents, many of whom do not use the facilities. Alchian was careful to note that if cross-subsidization is a more prominent social objective than efficiency, economists cannot say that government ownership of parks and golf courses is inferior to private ownership.⁵

More generally, private property rights may occasionally be costlier to enforce than the benefits of relying upon them would justify. Equivalently, the costs associated with relying on government property rights might be lower than the costs of implementing private property rights. An example is public sidewalks. In major cities, public streets for pedestrians are often extremely crowded during business hours, causing discomfort and delays for users of the streets. A private owner might charge pedestrians to use the streets with prices calibrated to deter peak levels of crowding. However, charging for street access and denying access to non-payers might be prohibitively expensive if major pedestrian thoroughfares and the streets accessing those thoroughfares were operated as privately owned pedestrian “highways.”⁶

In some circumstances, the costs of relying on private property rights to allocate access to and use of streets and roads can be small relative to the benefits of having private owners determine how the assets involved are used and maintained. An example is gated communities, where the use of streets and roads is reserved for use by members of a community association who pay dues to maintain the assets and arrange for managing the assets. Because access to the community’s infrastructure is restricted to members

⁵ An important caveat here is that some forms of cross-subsidization are likely to be more efficient than other forms. For example, government-financed education has traditionally been delivered through government-run public schools that are paid for through tax revenues. However, the use of vouchers, paid for through tax revenues and made available to low-income families, allows lower-income people to pay for their children’s education at privately owned and operated schools. Many economists believe that children from low-income families would receive a better education through a cross-subsidization system that relies on vouchers rather than through the conventional public-school system.

⁶ For an alternate view, though, see Powell (2009, May 4).

of the community association and their approved guests, it is economically feasible to govern the use of the association's assets, including streets, through private ownership. In this case, ownership is shared, much as in a public company, and the arrangement is, in effect, a private club. Usually, a board elected by the association ensures that people pay their dues and obey usage rules.

It is easy to see the advantages of having a relatively small and physically contained community of roads and related infrastructure governed by a system of communally shared private property rights with a relatively small number of owners. It is easier to make decisions about infrastructure than when government owns the infrastructure because private communal ownership avoids the need to petition, and often fight, city hall. Also, members of the community association who are unhappy with how the communally owned property is managed can sell their ownership rights, for example, by selling their houses. They can then relocate to a different gated community rather than having to move out of a city or municipality entirely.

The UCLA School's teachings on property rights are simple, yet profound. Property rights are important for how our scarce resources are used. Different assignments of property rights result in more or less efficient outcomes. Participants in private markets have a vested financial and sometimes social interest in assignments of property rights that result in efficient economic outcomes. Hence governments and regulators should tread carefully lest they intentionally or unintentionally constrain or alter private property rights in the ostensible pursuit of the "public interest."