

Chapter 1

Institutions, Property Rights, and Transaction Costs

In fact, a large part of what we think of as economic activity is designed to accomplish what high transaction costs would otherwise prevent or to reduce transaction costs so that individuals can freely negotiate and we can take advantage of that diffused knowledge of which Hayek has told us.

—Coase (1992), p. 716

In all of his work Coase emphasized the importance of incorporating *institutions* into economic theory and empirical economic research. Institutions are the arrangements, the “rules of the game,” that structure social interactions. They vary from informal social norms about acceptable conduct to formal law enshrined in precedent or legislation. Institutions structure social interactions in the sense that they shape the incentives that individuals face as they make decisions, decisions that can affect their own outcomes and the outcomes for other people.

One important institution for economic activity is understanding what property rights are, how they are defined, and how they are enforced. Human societies have long developed concepts of what is “mine” and “not mine” (Wilson 2020). That concept of having property in an item specifies what a property owner can do with that item—use it, change or improve it, loan it, lease its use to someone else, let it lie unused, give it, sell it. A property right is a right to take particular actions or make certain decisions about the use of a resource.

A property rights framework reflects the activities that are and are not permissible for property owners to do with their property. That framework

affects their incentives to use the resource productively over time. For example, rent control restricts how someone uses their property, which affects their incentives. Limiting the rent owners can charge limits their revenue and thus their incentive to improve the property, which is why properties often fall into disrepair under rent control. In situations where rent control legislation is very onerous or burdensome, that legislation can even induce owners to stop renting, thereby reducing the supply of rental housing and contradicting the policymaker's original intentions.

In general, a property rights framework in which rights are defined clearly and transparently, and where rights can be enforced at reasonable cost, is an institution that creates incentives for the efficient use of resources and for efficient production, consumption, investment, and innovation. Coase's insights on property rights sparked a new literature that further developed the concept of property rights theory and applying it to a variety of situations (see, for example, Demsetz (1967), Libecap (1989), and Barzel (1989)).

Another important implication arising from the property rights framework concerns transaction costs. Coase defined transaction costs as consisting of all costs of using markets, contracts, and the price system. Allen defines transaction costs as the costs of "establishing and maintaining property rights" (1999: 898). Transaction costs affect the distribution of property rights across all types of governance structures and organizations. Coase never defined transaction costs explicitly, relying instead on examples to illustrate how they affect contracts, incentives, and outcomes.

Much of a society's property rights framework depends on its formal legal institutions because legal definitions and enforcement of property rights are inputs into the specifics of property rights. Some aspects of property rights emerge out of more customary norms and conventions that societies form around property over time, but the bulk of Coase's work focuses on legal institutions, the effect of the law on economic decisions, and the role of the judicial system and legal precedent in defining property rights. Importantly, Coase stressed that various forms of government regulation, including state-owned property, are alternative ways of performing the coordinating tasks of property rights and entail their own transactions costs. Chief among these transactions costs are the barriers that regulation often puts in the way of firms that wish to

reorganize to operate more efficiently or to introduce new innovations. These costs are often unseen and, more dangerously, ignored in traditional economic analyses.

Formal legal institutions and a property rights framework affect market institutions by enabling exchange and supporting the formation of firms that will subsequently produce and offer their wares for sale in markets. Well-defined property rights are often essential precursors to mutually beneficial market exchanges, because a buyer is less likely to purchase from a seller, and an investor is less likely to put resources into perceived opportunities, to the extent that uncertainty exists about whether the seller has the right to sell or develop the item. Indeed, in the abstract, market transactions are really exchanges of rights over the use of items, as anyone who has bought or sold a house or a car realizes.

With respect to firms, one way to think about the management and organization of firms is as markets for corporate control, which uses a property rights approach to describe what firms do. The extent to which markets can emerge, can operate, and can enable participants to create value through mutually beneficial exchange, depends on whether or not the formal, informal, and property rights institutions introduce higher transaction costs or reduce them. For example, well-functioning stock markets enable firms that wish to expand to easily obtain the necessary funds by selling additional shares of ownership. In addition, share prices set on stock markets convey a great deal of information about how well or how poorly firms are currently being managed. Shares of corporations that are poorly managed will be priced lower than they would were these corporations better managed.

This institutional framework is a combination of legal institutions, a property rights framework, and market institutions, within a context of informal social norms and conventions. A society's institutional framework determines the transaction costs that citizens confront. These costs, in turn, are an important part of the incentives that individuals confront when engaging in economic activities. Whether as a producer or consumer, we can think about those outcomes as net value realized from a transaction. In this sense, institutions matter for shaping the transaction costs and incentives that lead to specific outcomes.

Institutional frameworks don't always generate beneficial outcomes; often people can attempt to improve on realized outcomes by experimenting with different actions or rules. Over time there are feedback effects from the profits and losses realized. If an institutional arrangement embeds high transaction costs that thwart potential gains, people may use that feedback to change the institutional arrangement to be more conducive to welfare creation. In many cases that reform does not happen, and those cases are important to study and understand.

Figure 1 Institutional Frameworks

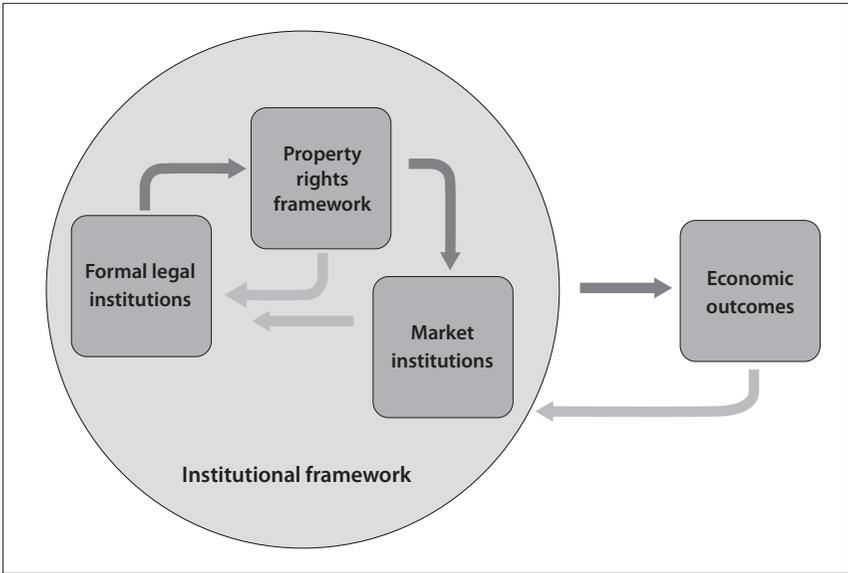


Figure 1 represents institutional relationships and consequences. The dark arrows represent how the legal institutions influence the property rights framework, which shapes market institutions. Together that institutional framework affects market outcomes. The light arrows represent how the experimentation, learning, and feedback effects from market outcomes flow back into the components of the institutional framework.