

PROPERTY FROM THE PERSPECTIVE OF TRANSACTION COSTS

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Abstract

In new institutionalists' analysis, the transaction costs are essential in explaining the origin of private property; however, this aspect is not that obvious in old institutionalists' works. But even if they did not emphasize on this issue, they created a theoretical-explanatory background used and enriched with logical arguments and numerous examples by the new institutionalists in order to point out that it is not possible to explain the origin of property rights without taking into account the transaction costs theory.

Key words: institutionalists, new institutionalists, property, transaction costs, allocation, appropriation, exclusion, delimitation, arrangement of rights, externality.

A topic such as the origin of property could not have been overlooked by institutionalists. Indeed, neither the old nor the new institutionalists have avoided it.

Let us take the example of Veblen, from among the old generation of institutionalists. He was first concerned with what others wrote on this subject, and he remarked: “In the accepted economic theories the ground of ownership is commonly conceived to be the productive labor of the owner.” (Veblen, 1898-9, p. 1). “Some writers who have taken up the question from the ethnological side hold that the institution is to be traced to the customary use of weapons and ornaments by individuals. Others have found its origin in the social group's occupation of a given piece of land, which it held forcibly against intruders, and which it came in this way to own” (Veblen, 1898-9, p. 2). Highlights in the text are ours, and we use them to mark the **key points** that Veblen started from, and according to which he is willing to argue. He was familiar with the main “sources” of property from anthropological research: work as such, armed violence, occupation of a plot of land, followed by its defence etc. Each of these possibilities to gain ownership rights as possession implied the consumption of energy, a cost. Veblen does not seem willing to make comments in this direction. Moreover, faithful to his general philosophy, he does not share the idea of work as a source of property. The general view that an institution is, essentially, a cultural fact, a shared belief, is applied in the case of property as well. Therefore, he writes that “ownership is not a simple and instinctive notion that is naively included under the notion of productive effort on the one hand, nor under that of habitual use on the other. It is a conventional fact and has to be learned; it is a cultural fact which has grown into an institution in the past through a long course of habituation, and which is transmitted from generation to generation as all cultural facts are” (Veblen, 1898-9, p. 5). As a supporter of such a point of view, Veblen does not stand in the same line as the institutionalists who explain the emergence and function of property rights starting, essentially, from transaction costs. Commons and Mitchell will not steer away from this stand.

As far as **new institutionalists** are concerned, they start off by acknowledging Marx's merit to have been “... the first to have stated that the specificity of ownership rights can be explained as a response to social problems due to deprivations and that the structure of ownership rights affects economic behaviour in specific and predictable ways” (Pejovich, 1982, p. 383-384). Once this issue has been established, they build a theory of property rights that can be situated on two levels: one of them is the level of **naive** theory, and it concerns the emergence of property rights in State and non-State societies; the other is the level of the **modern** theory of property rights. For the purpose of this article, we are interested in the first level. We

wish to find out what neo-institutionalists think about the **origin** of property rights and how they have influenced the transaction costs of this phenomenon.

The grounds of the naive theory of property rights are laid by Demsetz (1967), Mc Manus (1972), Anderson and Hill (1975), North and Thomas (1977). If Marx analysed the phenomenon of “primitive accumulation” with direct reference to the emergence and development of property in its capitalist form, Demsetz and the other new institutionalists set the original time frame even further back into time: they go as far as approx. 8-10 thousands years. Across such a time span, they are preoccupied with how property rights emerged and what costs this phenomenon involved. They are convinced that throughout this process, the **State** had a major role. What is more, they think that “... a theory of property rights cannot be truly complete without a theory of the State” (Furubotn & Pejovich, 1972, p. 1140). This explains why R. Coase and D. North emerge as two representative figures of the “Property Law School” – Virginia USA –, a school that grounds the emergence of the State, of law and of property, as a process of “social effectiveness”; this is a process based on which a social contract is conceived so as to make cost savings and to find a rule, an institution that, irrespective of whether it is called market, State or property, must allow the passage from a chaotic, collective and inefficient exploitation, to one of clearly determined responsibilities and limits that also generate motivation and, consequently, that allow the efficient use of resources. Within such logics stands the approach of the first neo-institutionalists who tried to understand the origins of property in their connection with the necessary reduction of costs.

The works of the above mentioned institutionalists reference concrete examples in the history of the emergence of private property; Indian castor hunters in Western Canada, farmers and cattle growers in the West American fields, fishing in the waters of the global ocean etc. Their writings lead to the conclusion that the first form of exploitation of any resource was common ownership. The passage from common to private ownership did not manifest itself as a bloody, “primitive” and gross process, in the Marxist version, but as a process in which **hedonistic calculation** played an essential role. As long as land or wild animals were plenty and enjoying full freedom, their value equalled zero. With the introduction of exclusive property rights, the value of these first primordial resources became positive. The appropriation process occurred in two forms. In pre-State phases there occurred a **self-attribution** of exclusive rights. Once States were formed, a process of **ownership establishment** was registered. In this latter case, the State is the master and the warrantor of common property. Yet in both cases, the passage from common to private is determined by similar reasons. The forceful idea and the common denominator of all arguments is that the acquisition of exclusive rights occurs only when potential future owners expect net gains from exclusivity.

In **pre-State** times, studied by North, Gluckman (1956), Bates (1983), Umbeck (1978) and others, it seems that **force**, **violence** and **coercion** were major players in determining the limits of property. Whether land, gold mines, or fish lakes were concerned, the avoidance of chaos in exploiting these resources depended on the force mechanism between potential owners; the mechanism translated in a kind of contract via which a principle was acknowledged and respected, according to which each individual’s acknowledged wealth is the same that he would have gained by violence. In other words, the potential threat by force delimits things and establishes the proportions according to which goods are owned. Commenting on the writings of anthropologists that dealt with this subject, Thrainn Eggertsson concludes: “Violence takes the form of the use of work so as to exclude others from a piece of land. If two individuals of equal violent potential compete over a marginal piece of land, then the person who is ready to allot more work hours to conquer it will obtain it” (Eggertsson, 1999, p. 310). What is at stake here, of course, is a “**primitive cost**”, as a sum of time and energy allotted to violence. Such costs determined the initial distribution, by self-attribution, of property rights; a distribution based on the power and status of individuals in the social group to which they belonged. What was acquired and gained by force had to be **defended**. Umbeck also considered the creation of some “revenge groups” that invite to non-aggression anyone who is tempted not to observe what has already been established. Their intervention would reduce profits expected after attacking a certain property. Obviously, these groups, whose role was to “guard” property, involved some costs. The same author also analyses the possibility that instead of counter-offensive of “pressure groups,” what should be effective was the fear of the misfortunes that a potential infringement of the rights of another person could bring about. Witchcraft or cursing function according to the same algorithm. To this we should add “compensation”, by virtue of which whoever has caused damages must cover them. All these actions are backed by customs, traditions, primitive “institutions”, initiated and accepted by the individuals of a human community. We can ask if under such circumstances, it was hedonist calculations or habits and

customs that were mainly operative. Karl Polanyi, for instance, doubts the capacity of individuals in antiquity to calculate in terms of gains-losses, just like he finds it equally doubtful that exchange can shape society and bring benefits. “Contrary to what Smith believed, writes he, the inclination to make an exchange with a view to obtaining gains is not natural. Numerous examples, passing through ... the New Egyptian Empire... or Bergdama in South-West Africa show that, as long as the market has not become a central institution of society, humans envisioned their life according to their social status and not according to their personal economic interest. The forces that acted then in society were reciprocity and redistribution. Reciprocity was ensured ... by the symmetry of primitive societies that guaranteed partners that exchanges should unfold on grounds of reciprocity. Redistribution was done via a central authority (total production was entrusted to the chief who performed redistribution among his subjects)” (Polanyi, 1983, p. 2).

Irrespective of whether habit, custom or rational calculation were primordial, one thing is certain: once a resource was taken in property (to be used, since buying and selling were not known yet) this very fact offered some extra motivation to the new owner. He was willing to consume time and energy, to resort to violence, to make friends or relatives etc. so as to defend his rights. Briefly, he was willing to **support costs such as price of the quality of an owner**. And nothing can explain that these costs were worth the trouble but the reason (that one was or not aware of) that what could be obtained by exploiting the property was worth the effort. The effort was first consumed to make provisions against hunger and then to go beyond the stage of equal wealth and reach differentiation; to obtain gains by exploiting the right of use, a primal form of property right.

So, if violence, even in its brute form, is present in the new institutionalism’s explanatory environment, the picture that they depicted is different from Marx’s. Aggression means are not used until the moment when some individuals are totally deprived of their goods and forced to sell their labour force. Genetic adaptation, as well as cultural adaptation, operated in each case. Each was given the chance to choose. The one who had chosen to spend more gained more. His consumption of energy, time, products, etc found their compensation. His property title had a price. He deserved to be paid because he had brought the chance of progress.

It was not only the founders of the naive theory of property rights that dealt with pre-State times. Other economists wondered about the origins of property too. Hayek is one of them. He has had a more significant contribution to the modern theory of property rights. Yet we mention him here as well because his perspective is interesting. He argues that “... the idea of individual property must have emerged at a very early stage, and that the first **fabricated** tools represent, perhaps, a good example” (Hayek, 1990, p. 61 – our emphasis). Therefore, not any kind of tools are linked with the origins of private property. It is only **fabricated** tools that can enjoy this status. The idea of work, of a cost incorporated in the fabricated goods, is implicit. Hayek does not stop here. He thinks that not only work, but **skill** also contributed to the division between common and private property. But, although work and skill have always been spoken about, more or less deftly, the concept of property does not go back that late in time. “Such a concept, he argues, could not have had too much of a signification among the groups of hunters and fishermen among whom the discoverer of a source of food or of a good shelter was obliged to share his discovery with his fellows” (Hayek, 1990, p. 61). Some time had to pass until the idea of property gained meaning and that “fusion between the inventor and ‘the rightful owner’ was produced” (Hayek, 1990, p. 61), between the creator of a product and the one who remains its rightful owner. The appropriate time was needed for the passage from natural “tools” to man-made tools. And, once produced, they “were attached to their makers probably because they were the only ones who knew how to use them” (Veblen, 1898-9, p. 61). In other words, lack of skill was taxed. Here lies the seed of a modern idea; production factors move on the market before they reach the hands or the minds that best know how to use them. Indirectly and deeply, Hayek talks about a cost: the cost of “skilful” use, of maximal efficiency of that which constitutes the body of individual property. In the same line of thought but at its other end, present day liberals will argue that “property does not mean ‘the right to do what you want with what you have’ but the right to decide freely on how to use resources on condition that, by so doing, the similar rights of others are not infringed upon” (Lepage, 1989, p. 324). Infringing upon the rights of others does not necessarily mean plunder, theft or trespassing but also the inefficient, “unskilled” use, of the goods that one owns.

What happens, though, in the age of the **State**, where the State is invested, at least initially, with the prerogative to administer and take responsibility for the management of common goods? The passage from

common to private property is done here with the “consent” and support of the State; or outside the State, and in this case a **cost of exclusion** is present. The circumstances that determine it vary.

Delimitation and application activities, such as putting up fences, building a dam, introducing and using barbed wire, lockets, alarm systems or watchdogs have mostly attracted attention. The achievement of “local voluntary agreements and of some extra-legal institutions” (Anderson&Hill, 1975, p. 169) out of the need to face a high rate of criminality and abuses of all sorts also meant costs. The first economic revolution, the **passage from hunting and fishing to agriculture** supposed costs as well. Determined as it was by the **pressure of an increasing population** and, therefore, by the need to obtain extra food, the new occupation, agriculture, although based on exclusively common ownership of land, led to compulsory expenses; to costs for the learning of the new “trade,” for the acquisition of new knowledge and techniques (North & Thomas, 1977, p. 240-241).

New costs have also emerged as a result of a cumulative process of training by passing from common to private ownership. Communities’ attempt to maximise wealth found their solution in the passage from common property rights to individual property rights. The latter proved to bring supplementary profits to their owners, and this was enough reason to delimit plots and establish boundaries. Exclusion, made out of reasons of efficiency and in order to prevent theft of harvest increases the value of land. A higher value means, implicitly, the increase of the exclusion profit as well as of the temptation to trespass property. Increasing theft and abuses increase future delimitation and application costs, and so on.

In all these circumstances individuals can use, or not, the State to their advantage and interest. Usually, the appeal to the State aims to adopt rules, when local and community rules are not enough to ensure the firm enforcement of property rights.

R. Coase, in his celebrated article *The Problem of Social Cost* (1960), offers an example of State-private arbitrage and of the emergence of some exclusion costs. His work has remained special for our topic and also because in the process of exclusion he introduces a new variable – the effect de **externality**. The example offered by him, of the two neighbors of whom is a farmer and the other is a cattle-raiser, has remained a classic. In this example, starting from the hypothesis that the two plots of land are not enclosed, the cattle of the cattle-raiser can enter the farmer’s land. Hence, a negative externality via the damage caused. Without resorting to the State’s arbitrage, the two neighbors will look for a solution that would eliminate their conflicting situation. The nature as such of the solution depends on the existence or non-existence of property rights. A first option is that in which the farmer is the owner of exclusive rights, well-defined. In such a case, the cattle-raiser is obliged by law to pay damages. In order to avoid this situation he will take the initiative to enclose the land of his neighbour. The cost of the fence is an opportunity cost. It will be supported since it is smaller than the “fine” for trespassing. When the farmer does not have exclusiveness ensured by property rights, the relationship between the two changes. The cattle-raiser has a “right of free use” of his neighbour’s land, since it is not the object of a clearly defined property. The initiative of the solution comes, this time, from the farmer. He will be interested to “regain” his right of use. Therefore, he will fence the tract of land on his own expense.

In either case, exclusivity, even as right of use, has a **cost**, that is covered as long as benefits obtained after gaining exclusive rights will be bigger.

Coase’s “theory” functions under the circumstances where there is the possibility of a negotiation. In other words, it functions when there is a **market** on which costs connected to information, monitoring, negotiation and application of the agreement or of the contract can be noticed and quantified. It is possible however that the place and role of the market to be taken over by the **State**. Just like transactions and the acquiring of exclusivity on the market imply costs, similarly “...But the governmental administrative machine is not itself costless. It can, in fact, on occasion be extremely costly” (Coase, 1960, p. 9), warns the same Coase. Yet he is not the only one who warns against the fact that State patronage in the exclusion process is not for free. Libecap and Johnson (1979, p. 137) highlight the costs engaged by the criminal character of some transfers under State patronage even. What they have in mind is the bribe paid to public officers who are authorised to deal with such issues as de transaction cost, data gathering and “investigation” of the problem; fees for free access to a source etc. Thrainn Eggertsson reminds us the significant example that 289 days were necessary in a bureaucratic process to obtain from the State the necessary approvals to set up a clothing factory in Peru in the fist half of the 20th century and 200 stages to go through, take would take at least 7 years, in order to obtain the necessary licences to buy plots owned by the government that had never been private property (Libecap & Johnson, 1979, p. 293). It is precisely

excessive bureaucracy and costs, occasioned by faulty, inquisitorial management, that damaged not just the individual's pocket but also his health, entitled some persons to believe and to write that in many places, the Mafia is more productive than the State.

What needs to be remembered is that also, in the case of the State as an "organiser of exclusive rights bidding", what is always aimed for is hedonist balance; one calculates if net profits obtained after the acquisition of exclusive rights are higher than transactional costs. If the terms of this equation are reversed, the "privatisation" process does not take place. It stops or the goods simply return to the common property fund. There are quite few examples of non-attractive resources to be the object of exclusive rights in individual property. Hard to delimit and apply, exclusive fishing rights in the planetary ocean have featured, for instance, this specificity. The true owners have remained the national States; it was only the temporary use and exploitation that have made the object of exclusion. Anyway, it is well known that a rule did not exist back then, in the "primitive" or naïve stage of the emergence of property rights, just like it does not exist today, a rule that should establish fixed norms according to which a resource or a good must pass from common to private ownership. It is generally acknowledged that the cost-benefits balance, even in its naïve form, operated then just like, given the necessary exceptions, it operates even today. The Eiffel Tower is an exceptional example.

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