

MERCATUS POLICY SERIES

P O L I C Y P R I M E R N O . 2

THE ROLE OF PROPERTY RIGHTS AS AN INSTITUTION: IMPLICATIONS FOR DEVELOPMENT POLICY

KAROL BOUDREAUX
Senior Fellow, Mercatus Center

MAY 2005

MERCATUS CENTER
GEORGE MASON UNIVERSITY

ABOUT FREDERIC SAUTET, SERIES EDITOR

FREDERIC SAUTET is a Senior Research Fellow at the Mercatus Center at George Mason University. Prior to joining Mercatus, Frederic was a Senior Economist at the New Zealand Commerce Commission and a Senior Analyst at the New Zealand Treasury where he focused on economic transformation, entrepreneurship, utility development and tax policy. Frederic holds a doctorate in economics from the Université de Paris Dauphine and did the course work for his doctorate at the Institut des Etudes Politiques in Paris. He also studied at New York University as a post-doc. Frederic's current work focuses on entrepreneurship, institutions and social change.

ABOUT KAROL BOUDREAUX, AUTHOR

Karol Boudreaux is a Senior Fellow at the Mercatus Center at George Mason University. She teaches Civil Rights and Civil Liberties at George Mason and hosts the GMU-TV current affairs program "Capital Commentary." Prior to joining Mercatus, Karol was Assistant Dean at the George Mason University School of Law. Karol holds a Juris Doctor degree from the University of Virginia and a Bachelor's Degree in English Literature from Douglass College at Rutgers University. She also did graduate work in history at the University of Georgia. Karol's current work focuses on property rights, human rights, international trade, institutions, and Africa.

For more information about the Mercatus Center's Global Prosperity Initiative visit us online at www.mercatus.org/globalprosperity, or contact Brian Hooks, Director of the Global Prosperity Initiative, at (703) 993-4892 or bhooks@gmu.edu.

THE ROLE OF PROPERTY RIGHTS AS AN INSTITUTION:
IMPLICATIONS FOR DEVELOPMENT POLICY

KAROL BOUDREAUX

EXECUTIVE SUMMARY

After years of overlooking the central role that property rights play in economic development and growth, scholars and policy makers are beginning to recognize that property is a key building block of a prosperous society and must be a part of any sustainable development program.

However, there is a very real risk that reforms enacted in the name of property rights will fail if policy makers employ the rhetoric of property rights, but don't pay careful attention to what makes property regimes function in the real world.

When they are secure and divisible, property rights unleash entrepreneurship and economic prosperity and form the basis for trade and markets. Divisibility means that individuals may trade sticks in their bundle of property rights with others — they are allowed to negotiate and decide how they may or may not use property they hold.

In many countries legislative, regulatory and, at times, customary barriers block the divisibility of rights or fail to enforce rights, creating insecurity for rights holders. Well-intentioned development programs often create similar constraints. Such decisions mute the incentive structure that exists when property rights are robust and contracts are respected. When such barriers exist, economic growth is sacrificed, and human flourishing is constrained.

In order for policies that address property issues to be as effective as possible, they must focus on improving the security and divisibility of property rights to allow members of a society to contract over the sticks in the bundle of property rights as *they* desire. This can be achieved by:

- Decentralizing property-rights decision making;
- Allowing for the evolution of property rights rules; and,
- Developing credible and effective supporting institutions.

THE ROLE OF PROPERTY RIGHTS AS AN INSTITUTION: IMPLICATIONS FOR DEVELOPMENT POLICY

INTRODUCTION

The institution of property rights is increasingly recognized as an essential building block of an economically prosperous society.¹ Property rights, supported by other crucial institutions including contract rules and norms and an impartial judiciary, provide individuals with incentives to create, innovate, and conserve.² They help connect individual effort and reward. As developing nations transition from managed to market economies, clearly defined and effectively enforced property rights will facilitate this transformation and help generate prosperity.³

Property rights do more than promote economic

well-being—they provide the means for individuals to flourish which, after all, is the ultimate goal of development policy and foreign assistance. Flourishing means having the greatest scope for personal agency and self-fulfillment.⁴ It means that individuals are free to pursue their own unique goals and develop their unique talents while allowing others to pursue goals that may, or may not, be different. Flourishing implies that individuals are capable of purposeful choice regarding their well-being and that they will, if empowered to make such choices, respond creatively to challenges and opportunities to fulfill their potential.

Property rights play an essential role in promoting

¹ The World Bank's 2005 *World Development Report* labels property rights as one of the basic requirements for a healthy investment climate and for economic growth. Available at: <http://siteresources.worldbank.org/INTWDR2005/Resources/complete_report.pdf>. The 2005 *Economic Report of the President* devoted an entire chapter (Chapter 5, "Expanding Individual Choice and Control") to the role property rights play in economic development. Available at: <<http://www.whitehouse.gov/cea/erpcover2005.pdf>>. See also, *Land Policies for Growth and Poverty Reduction* (2003) World Bank: Washington, D.C. Available at: <http://econ.worldbank.org/files/27811_ch2.pdf>.

² Effective enforcement is key to the functioning of a property-rights system. As Gerhson Feder and David Feeny pointed out in a 1991 article: "If private property rights are not viewed as being legitimate or are not enforced adequately, *de jure* private property becomes *de facto* open access." Open access property is subject to the overuse and misuse associated with a tragedy of the commons. See "Land Tenure and Property Rights: Theory and Implication for Development Policy," *World Bank Economic Review* 5(1) 135-153.

³ The same issues remain important for developed nations: clearly defined, divisible and vigorously defended property rights will help ensure that these nations sustain their high levels of economic development.

⁴ For a discussion of human capabilities, flourishing and economic development see Martha C. Nussbaum (2001) *Women and Human Development*, Cambridge University Press: New York; and Amartya Sen (1999) *Development as Freedom*, Knopf: New York.

human flourishing: they decentralize political and economic power and decision-making authority over resource use and allocation.⁵ Indeed, property rights may be seen as a prerequisite for flourishing. They empower individuals holding these rights and expand their choice set. As a result, individuals who have secure rights to property are better able to exercise agency and to decide for themselves how to pursue their goals.⁶

For policy makers interested in promoting sustainable economic development, understanding the role property rights play in this process is a necessity. For organizations and individuals concerned with expanding the space for human flourishing—the space in which people are free of abuses of power and free to pursue their own interests in a productive manner—an understanding of property rights is essential.

This Policy Primer explains the relationship between property rights, economic development, and growth. It discusses property rights as the foundation for trade and markets. It also examines how property rights help alleviate poverty by encouraging entrepreneurial activity. Finally, it explores the important connection between secure property rights and human flourishing.

⁵ Harvard historian Richard Pipes argues that freedom and a rule of law are impossible in the absence of property rights (1999) *Property and Freedom*, Knopf: New York.

⁶ In the extreme case, a slave has limited opportunities to pursue her own goals because she is the property of another. She lacks ownership rights in herself and her labor. Lacking property rights in herself, she faces severe constraints in her ability flourish. She may develop creative strategies for making the best of her situation, but she still lacks opportunities that would come if her property rights in herself were honored. See “Niger: Slavery – an unbroken chain,” *IRINnews.org* March 21, 2005. Available at: <<http://www.irinnews.org/report.asp?ReportID=46200>>.

The key messages of this Policy Primer are that:

- Secure property rights provide the basis for trade and markets. These rights are more likely to promote economic growth and development if broad segments of society are free to hold as many, or as few, secure rights to property as *they* find desirable;
- Economic growth will be hampered if the effective use, transfer, or development of secure property rights is blocked by government policies or institutional weaknesses; and,
- By decentralizing power and decision making, property rights protect individuals against official and traditional abuses and create space in which people may flourish.

This Policy Primer is divided into two parts:

- (1) A discussion of the concept and role of property rights; and
- (2) Implications for development policy:
 - (i) Effective policy reform will decentralize property-rights decision making to allow all individuals to hold securely as many sticks in the bundle of property rights as *they* desire. Reforms should target formal and informal barriers that

limit the divisibility and transferability of property rights. This will provide individuals greater scope for decision making, choice, trading, and entrepreneurial behavior.

(ii) Successful reforms to develop secure, divisible property rights will look to, but also beyond, legal codes to allow property rights to evolve in response to changing conditions. Any such reforms must take the needs of all stakeholders into account.

(iii) Successful property reforms will focus on the need to develop credible and effective supporting institutions that impartially enforce property rules and norms and that allow for continued development of property-rights rules. Freedom of contract and an impartial judiciary are particularly important. Without effective supporting institutions property rights will remain insecure.

I. ANALYSIS

Although property rights provide the basis for trade and a market economy, theoretical work on the central role they play in economic develop-

ment was largely absent from modern economics until the 1960s. Before economists such as Ronald Coase, Harold Demsetz, and Armen Alchian began writing,⁷ property rights were taken as a given; that is, in their analyses, economists assumed that the western-style rules and norms regarding the use and allocation of property were present. While this assumption may be understandable with regard to the developed world, it is often inappropriate in other areas where such institutions may be absent. We now know that the institution of property provides positive incentives that encourage people to invest, save, protect, and conserve what they own. Without these incentives, economic activity will be muted and economic growth and development will lag.

After several decades of work on the economics of property rights, many economists, policy makers, and lawyers recognize the key role these rights play in promoting economic development and human flourishing. Despite this, official policies often constrain, or block, this vital institution. By limiting the abilities of individuals to use their property in creative ways and to engage in voluntary exchanges, such constraints limit economic growth. These constraints also reduce the scope

⁷ Seminal work on the role of property rights as an institution includes: Ronald H. Coase (1960) “The Problem of Social Cost” *Journal of Law and Economics* (3) 1-44; Harold Demsetz, (1967) “Toward a Theory of Property Rights” *The American Economic Review* 57(2) 347-459; and Armen Alchian (1977) “Some Economics of Property Rights,” 127-149 in *Economic Forces at Work*, Liberty Fund: Indianapolis, IN.

of individual agency and limit the ability to flourish. This analysis explains how property rights promote the twin goals of economic prosperity and human flourishing.

A. THE CONCEPT OF PROPERTY

A.1 A DEFINITION OF PROPERTY RIGHTS

Property rights are the social institutions that define and limit the privileges individuals hold with regard to specific resources, such as a parcel of land or an automobile.⁸ Property rights develop when a social consensus exists to support particular allocation/use/transferability decisions. These rights can be formal (i.e., captured in constitutions, statutes, or regulations) or informal (i.e., norms of behavior).⁹ So long as people respect them, both formal and informal property rights work effectively. They encourage the adoption of particular behavioral norms with respect to the use of things (i.e. “don’t take what doesn’t belong to you”). They also specify the costs involved in breaching these norms.¹⁰ The cost of breaching a formal property right might be a fine or time in jail, while the cost of breaching an informal right might be ostracism or loss of reputation. In either case, the key role of property rights is to permit decision making about the

use and allocation of resources.

Lawyers often resort to the following analogy when they discuss property rights: property rights consist of sticks in a bundle. The bundle, as a whole, represents the set of rights associated with a particular place or thing. Each stick in the bundle represents one of the discrete ways in which property may or may not be used. In a robust property-rights environment, these sticks are separable and can be traded or given away. What is important from a development perspective is that individuals be empowered to decide which sticks to retain and which to trade away or purchase.

There are many sticks in the bundle that make up property rights. Some important ones include:

- The right to own property, jointly or individually;
- The right to sell or transfer property during one’s life and upon death;
- The right to exclude others;
- The right to use of property (by actively using or by pledging/mortgaging);
- The right to leave property unused (for conservation purposes, for example);
- The right to generate and keep the profits that flow from the use of property;

⁸ See Gary D. Libecap (1989: 1) *Contracting for Property Rights*, Cambridge University Press: New York.

⁹ Property rights institutions consist of formal rules contained in constitutions, legislation, or court cases, as well as informal custom and convention. Libecap (1989: 1).

¹⁰ See Eirik G. Furubotn and Svetozar Pejovich (1972) “Property Rights and Economic Theory: A Survey of Recent Literature” *Journal of Economic Literature* 10(4) 1138-1162.

- The right to lease, sublease, and otherwise extend temporary use rights to others;
- The right to protect the property from misuse or abuse; and,
- The right to seek redress for harms.

To the extent that a person holds a thicker bundle of secure, divisible property rights—one with many sticks to be traded—her property is likely to be more valuable.¹¹ A thicker bundle gives the property owner greater say over use, allocation, and exclusion decisions. An owner with a thick bundle of secure property rights is empowered to make a wide range of decisions about how, when, and if to use the property. If individuals are free to contract and trade sticks in their bundle of rights (or, are free to create new sticks), they are better able to take advantage of entrepreneurial opportunities. Thick bundles of secure rights provide individuals with numerous opportunities to use the property, or parts of the property, in creative ways, and to flourish through such creative use.

An owner with a thick bundle of rights is more likely to be rewarded for exerting effort to care for the property because she will directly benefit or suffer from the decisions she makes. People who hold single sticks, or who have thin bundles in

“If individuals are free to contract and trade sticks in their bundle of rights (or, are free to create new sticks), they are better able to take advantage of entrepreneurial opportunities.”

particular property, often don’t have the right to sell or lease or otherwise transfer property. This means they are less likely to directly benefit from taking care of the property. However, the owner of a thick bundle usually does have such rights, which provide her with incentives to make careful decisions about the property’s use or allocation—decisions that improve her well-being.

Consider the example of homeownership in the United States. A homeowner has a fairly thick bundle of rights in both the land and the physical structure of the home. Typically, a homeowner has broad (though by no means unlimited) rights to use the house.¹² If her property is large enough, she might plant an apple orchard. If she covers costs associated with maintaining the orchard and selling the fruit, she can keep the profits and do what she wishes with them. If she prefers her

¹¹Note, however, that if these rights are not effectively enforced—if they are insecure—they will be less valuable, a common problem in the developing world. See Alston and Mueller (2002) “Property Rights in Land: An Historical Overview.” Available at: <http://esnie.u-paris10.fr/pdf/textes_2002/Alston_mueller_2002.pdf>.

¹² Zoning ordinances, building codes, restrictive covenants in deeds of sale, and historic preservations laws are all examples of statutory laws that limit the ability of homeowners to use their property as they might wish. For example, if a city has a zoning ordinance that prohibits commercial activity in single-family homes, then a pediatrician will not be able to use her home as an office. One stick in her bundle of property rights has been removed, and she may suffer. Her neighbors, however, may have been granted a benefit by the local government.

property in an undeveloped state, she can choose to leave it that way and enjoy the beauty of nature. She can use the property as collateral for a loan which, in turn, she can use to expand her apple business or fund her children's education.

She can typically sell use rights to others: she can sell and convey an easement to a neighbor who wants to build a driveway over a portion of her land; she can lease a room in the house to a tenant; for a fee, she can allow another apple grower to harvest and use some of her apples, etc. When it comes time to transfer the property she can, if she wishes, give her house to her children. She can sell it to a stranger for market value or sell it for a reduced price to her pastor. She might also place her land in trust, so that future development is limited.

Importantly, she can keep others off her property. If someone trespasses on her land she can call the police and will be assisted in removing the unwanted person. If a neighbor begins dumping trash on her land, she can bring him to court and seek redress. Finally, if the government regulates the use of her land, or takes the property, she can challenge either act and she will be compensated in the case of the physical taking.¹³

Precisely because the owner of a thick bundle of

property rights directly benefits, or suffers, from her efforts to maintain or improve her property, she is more likely to take good care of it than is someone with a thin, or non-existent, bundle. She is more likely to invest in, improve, and protect her property from the predatory acts of others.¹⁴ She is also more likely to take care to avoid harming others, because she is liable for such harm and liability puts her property at risk.

Conversely, people who hold thin bundles of rights are less likely to invest in property, to take good care of it, or to protect it from the misuse of others. People with thin property rights are less likely to personally benefit from taking good care of property, so it makes sense for them to expend less effort in caring for it. A city dweller who rents a car for the weekend has few incentives to change the car's oil, but this is precisely why, in many situations, people voluntarily choose to hold thin bundles: they would rather not expend

“Decentralizing decision making about how and when to use property gives individuals greater scope to trade their rights and to engage in creative, entrepreneurial behavior.”

¹³ Whether or not she will be compensated in the event of regulatory taking is another matter.

¹⁴ Feder and Feeny (1991: 135-153); *Land Policies for Growth and Poverty Reduction* (2003) World Bank. Available at: http://econ.worldbank.org/files/27811_ch2.pdf.

resources caring for a particular piece of property, though they may choose to expend resources caring for other pieces. So long as people are empowered to make these decisions for themselves—so long as they are not constrained by formal or informal barriers limiting this trade—they will be better off. Decentralizing decision making about how and when to use property gives individuals greater scope to trade their rights and to engage in creative, entrepreneurial behavior.

A.2 KINDS OF PROPERTY

Property takes a number of different forms and exists in a variety of different ownership patterns. There are three major types of property. These include:

- Real property, by which we mean land, houses, and other buildings attached to the land;
- Personal property, by which we mean moveable goods (as opposed to immovable real property); and.
- Intellectual property, by which we mean the goods or services produced by human creativity, such as copyrights, patents, and business processes.¹⁵

Property may be tangible, like a bicycle, or intangible, like an author's copyright for his novel. In a system of secure, thick property rights, both the bicycle's owner and the writer can defend their rights in their property against anyone who harms the property. Similarly, both should be held liable for harms they impose on other people's property.¹⁶

The three basic types of property may be broken into four different ownership categories:

- Open-access resources, which are owned by no one person or group. The high seas are an example of an open-access resource;
- Public, or government, property. Use of this property is controlled by political actors;
- Communal property, which is owned jointly by members of a group, sometimes members of a kinship, or family group; and,
- Individual property, which is owned by a single individual.¹⁷

Creating property rights is costly. People must devote time and effort to define what a right consists of, to identify who may, and may not, hold such rights and, importantly, to enforce and

¹⁵ Another common form of property might be called “conventional” property. Conventional property is created by informal social norms, is often recognized as being legitimate, but is enforced by means of social pressure, rather than by formal channels. An example of conventional property rights is placing one's bag or backpack on a chair in a public space. By placing your bag on the chair you create a temporary property right in the use of the chair. This claim cannot be enforced in a court of law but, because of social norms, it is recognized as legitimate.

¹⁶ For example, if the author “steals” the words from another writer's book and uses them in his own book, he should be liable for violating the other author's rights in intangible property—her copyright.

¹⁷ Public corporations, the most visible economic actors in the modern economy, are “owned” by individual shareholders or by groups such as pension funds. Corporate ownership is unique in that liability of each owner is limited. However, the corporation itself is given a legal status similar to that of an individual, so that each corporation is liable for harms it imposes.

“To the extent that women are barred, either formally or informally, from owning, using, or transferring property, they are more dependent on male authority figures and are more likely to be subject to exploitation.”

defend rights. Generally speaking, the more specific the right, the more expensive it is to create and enforce. However, as a particular resource becomes scarcer, and hence more valuable, it becomes more worthwhile to expend the necessary resources to create property rights.¹⁸

For example, in some developing countries land is still owned communally, but the tools used to work land, or cook food, or produce clothing, are owned individually.¹⁹ The explanation for this ownership pattern is that in such societies land is relatively abundant, so the society devotes fewer resources to defining and enforcing individual

rights to real property.²⁰ When land is relatively abundant, the cost of defining and enforcing rights may be greater than the value of the land itself—so there tends to be less specificity of rights to land.

On the other hand, personal property, such as tools, are relatively scarce and, hence, more valuable. These societies create rules of individual ownership for relatively scarce goods. By developing specific rules about personal property that are costly—in that they require definition and enforcement—developing societies lessen conflict over this type of property. These rules make it clear who owns what and what consequences will follow for violating ownership rules. These rules also provide incentives for individuals to maintain and protect their personal property. Finally, property rules provide incentives to some community members who are particularly good at crafting tools or cloth to specialize in this task and trade with others.

Robust private-property rules also play a role in

¹⁸ In his 1967 article Demsetz explains how property rights create incentives that help individuals to internalize externalities. In discussing how property rights emerge, he draws on work by Eleanor Leacock on Montagnes Indians of Canada, who established property rights in land after the development of a commercial fur trade. Before this trade, there was no private ownership of land because the value of the land was relatively low. After the trade began, the value of furs to Indians rose dramatically at the same time that the extent of hunting fur-bearing animals increased. In this case, it became worthwhile to develop property rules to lessen conflict and reduce the chance for over-hunting (1967: 351-353).

¹⁹ John W. Bruce, “Country Profiles of Land Tenure: Africa, 1996,” No. 130 1998 *Land Tenure Center*. Available at: <<http://www.ies.wisc.edu/ltc/rp130.html>>. See also *Land Policies for Growth and Poverty Reduction* (2003: 2).

²⁰ See David E. Ault and Gilbert L. Rutman, (1979) “The Development of Individual Rights to Property in Tribal Africa,” *Journal of Law and Economics* 163-182 and Richard Barrows and Micheal Roth, (1990) “Land Tenure and Investment in African Agriculture: Theory and Evidence,” *Journal of Modern African Studies* 265-297.

limiting political authority.²¹ Effective property-rights rules are likely to reflect a social consensus that favors individual decision making about property allocation, use, and exclusion. To the extent that a society favors private decision making over public decision making, property is less likely to be subject to arbitrary seizure or destruction by traditional or political forces. In a society where public authorities are willing and able to protect these individual decisions, property owners are less fearful of expropriation and extortion. In this way, private property is a bulwark against exploitation.

This role of private property is particularly important for those concerned about women's rights and gender empowerment.²² To the extent that women are barred, either formally or informally, from owning, using, or transferring property, they are more dependent on male authority figures and are more likely to be subject to exploitation. They are forced to hold only thin bundles of property rights and these mandatory thin bundles provide less protection against coercion and fewer

opportunities to trade and invest in their human capital.

A.3 PROPERTY RIGHTS EVOLVE

As noted, as resources become scarcer and their value rises, or as technologies change, people are more likely to expend valuable time and effort defining and enforcing rights—building property-rights institutions. The people who respond creatively to these challenges and develop new property-rights mechanisms can be thought of as “property-rights entrepreneurs.”²³ They develop innovative norms, rules, or approaches for solving property-rights problems. When they are free to innovate and contract, these entrepreneurs push the property-rights regime in new directions. Their actions are vital to the institution of property rights because they better ensure that the institution remains relevant to local needs.

This suggests that the institution of property rights evolves over time: it changes to meet a community's changing needs. If the community's needs remain constant, the set of property rights

²¹ See Roy L. Prosterman and Tim Hanstad, (2003: 5) “Land Reform in the 21st Century: New Challenges, New Responses,” *RDI Reports on Foreign Aid and Development* #117.

²² Property rights protect all individuals against arbitrary use of power by those in authority. Minorities, repressed majorities, as well as women all benefit from the decentralizing powers of property rights.

²³ The idea of a property-rights entrepreneur comes from the work of Terry L. Anderson and Peter J. Hill (2002) “Cowboy and Contracts” *Journal of Legal Studies* (31) 489- 514. Note that property-rights entrepreneurship might be either positive—rent creating, or negative—rent-seeking.

in use is likely to remain constant. If the community's needs or circumstances change, say, as a result of rising population, a newly discovered use for a resource, or resource depletion, individuals will define or create new rights, or develop new methods for allocating property or excluding others *so long as this evolutionary process is not blocked or hijacked* by government action or predatory private coercion.²⁴ Governments block the evolution of property rights when they legislate or regulate to limit the transferability of property, or when they limit the ability of certain members of society to own or use property. For example, when governments legislatively block the sale of land they limit the ability of communal property regimes to evolve towards individualized tenure.

While property-rights regimes share many general features across time and cultures, they may differ in specifics. What worked to define rights to water in the American West 100 years ago may or may not work effectively in modern southern Africa. Property rights reflect community-specific concerns and circumstances. As a result, it is essential to understand the actual, informal property rights in a given community before attempting property or land reform. A familiarity with the on-the-books, formal property rules may not

tell policy makers enough about the actual rules and norms people follow to use and manage property in their daily lives. Therefore, it is essential that policy makers identify a credible baseline, or starting point, for reforms.²⁵

It is also important to recognize that informal rules may be quite difficult to change. They reflect community preferences regarding methods for resource allocation—preferences that have developed over time and as a result of the interactions and experiments of many citizens. To implement policies that disregard these informal rules is to disregard the locally specific knowledge embodied in these rules and thereby risk policy irrelevance.

Having said this, policy makers should identify which stakeholders do, and importantly do not, take part in the process of creating and defining property rights. It is important to understand who has voice in this process and who is, or has been, voiceless. Property reforms that continue to leave segments of society voiceless (or property-less) may perpetuate harmful inequities and limit flourishing. Therefore, it is essential that policy makers understand the actual process involved in creating or modifying property rights

²⁴ Not all evolutionary moves are positive—it is certainly possible, for example, for interest groups to successfully lobby for changes to the property rights regime that favor small groups over the interest of the general public. See Libecap, (1989) 11-12.

²⁵ See Frederic Sautet (2004) "The Role of Institutions in Entrepreneurship: Implications for Development Policy," *Mercatus Policy Series*, Primer No. 1. Available at: <<http://www.mercatus.org/pdf/materials/1053.pdf>>.

before they attempt property-rights reform. Informal norms may impose harms on particular segments of society, but before these norms are rejected or replaced, it is important to understand their function and how one might build coalitions to limit any harm they impose or, at the very least, to target reform efforts to generate the highest level of policy buy-in.

B. THE ROLE OF PROPERTY RIGHTS

Property rights are often controversial. Why, for example, should anyone, or any group, own *anything*? French philosopher Pierre-Joseph Proudhon famously argued that “property is theft.” Throughout history, many groups have sought to abolish individual property rights.²⁶ Few have advocated a wholly open-access property regime, preferring instead some method for centralizing the ownership and control of property. Yet property rights—private, communal, government—remain an essential feature of modern societies. Why?

B.1 PROPERTY RIGHTS HELP INDIVIDUALS ALLOCATE RESOURCES

Individual property rights provide the institutional basis for trade and a market economy.

“If the community’s needs or circumstances change, say, as a result of rising population, a newly discovered use for a resource, or resource depletion, individuals will define or create new rights, or develop new methods for allocating property or excluding others so long as this evolutionary process is not blocked or hijacked by government action or predatory private coercion.”

Individuals who own their labor and other resources are empowered to decide how to use and allocate these things. When individuals hold secure rights to self-ownership, and to ownership over the goods and services they produce with their labor, they are able to trade voluntarily with others. Secure property rights give them this power. If someone else holds these rights (say, a slave master or an authoritarian government) the individual cannot trade with others—this right rests with the person or institution holding the rights. Individuals living under such circumstances are more likely to be subject to the predatory actions of the physically or politically power-

²⁶ For example, when the Bolsheviks took control of the Russian government they abolished the private ownership of property. This shifted decision-making power about the allocation of scarce resources from private individuals to political actors. The latter group also determined how any revenue from the use of resources would be managed. Concentrating allocation and use decisions as well as revenue in the hands of political actors proved hugely troublesome from an economic perspective and from a human-rights perspective. As the example of the Soviet Union showed, in a society where only a limited number of people control resources and revenue there are significant opportunities for misuse and abuse. See Peter Boettke and Gary Anderson (1997) “Soviet Venality: A Rent-Seeking Model of the Communist State,” *Public Choice*, 93, (1-22) 37-53.

ful, who may appropriate or destroy the possessions of weaker people at will.

Property rights permit voluntary trading because people are willing to reallocate property to individuals who value it more highly. In the example of our homeowner, if she has the right to rent or lease her home, she can offer to exchange some sticks in her bundle to a willing renter. The trade will not take place unless the homeowner values the rent she can earn more than she values the house without a renter and the renter values the space more than he values the money he must pay to use the space. Similarly, the homeowner is unlikely to sell her house unless she values the income from a sale more highly than she values remaining in the house. If she chooses to sell, cash flows to its highest value user: the homeowner, while the physical house is transferred to its highest valued user: the buyer.

If formal or informal barriers existed that barred our homeowner from renting space in her house or from selling it, both she and a willing renter/seller would be worse off, and a trade that otherwise would have taken place would be forgone or moved to the black market.

Individual property rights allow people to trade what they own—their time, their creativity, their

“Entrepreneurs could not trade with consumers if they lacked property rights over their goods or services.”

skill, and the products that flow from these—with others. The possibility of gains from this trade provide individuals with incentives to become entrepreneurs and to act entrepreneurially by keeping alert to opportunities to meet the felt needs of others. Entrepreneurs could not trade with consumers if they lacked property rights over their goods or services. In conjunction with contracting rules and norms which provide guidelines for socially acceptable exchanges, this trade gives rise to markets: markets which are the basis for economic growth.

B.2 PROPERTY RIGHTS CREATE POSITIVE INCENTIVES

Property rights create positive incentives to create, innovate, conserve, and protect property. As Acemoglu, Robinson, and Johnson say: “Without property rights, individuals will not have the incentive to invest in physical or human capital or adopt more efficient technologies.”²⁷ Property rights provide these incentives by tying investment and other effort with reward. People who are free to trade their property and retain the profits are more likely to maintain and improve

²⁷ See Daron Acemoglu, James Robinson and Simon Johnson (2004) “Institutions as the Fundamental Cause of Long-Run Growth,” *NBER Working Paper* No. 10481. Available at: <<http://papers.nber.org/papers/w10481.pdf>>.

their property because they are more likely to be rewarded for their efforts. Conversely, property owners who neglect what they own are less likely to be rewarded. By linking reward, or penalty, with creative effort, property rights promote creative, entrepreneurial behavior at all levels of society.

In the case of our hypothetical homeowner, she is more likely to spend resources putting a new roof on her house if the current one leaks than is a non-owner because an undamaged home is more valuable than one that has suffered water damage, and she will capture that value if and when she sells her home²⁸. For the same reason she is more likely to fix the plumbing, the hot water heater, the furnace, or add landscaping than is a non-owner. Because her bundle of property rights is relatively thick she directly benefits from these acts of preservation and enhancement, so she has a powerful incentive to engage in these acts. By decentralizing decision making about which sticks in the property-rights bundle to hold and which to trade, to as many individuals as possible more trade and investment in human and physical capital can take place.

The positive incentives created by the institution of property rights apply primarily when property is owned individually or, to a somewhat lesser extent, communally. Under individual and communal ownership patterns, some one or some group, is the residual claimant of property and has the power to make use and allocation decisions, as well as decisions to exclude others from the property. As a result, individual owners and communal owners face incentives that tend to preclude overuse. As Elinor Ostrom has amply documented, groups often cooperate to solve “commons” problems—so long as they develop rights and norms that allow individuals within the group to effectively manage and benefit from the resource.²⁹ When either individuals or groups of individuals own something, they tend to take care of it, so long as they are able to capture the benefits that flow from wise use.

However, when property is owned by no one, or by society at large, people tend to take less care of it. The result is the now-famous “tragedy of the commons” in which resources are overused, misused, and abused because no one owns them.³⁰ Few non-owners invest in protecting open-access

²⁸ In our hypothetical, the homeowner is the “residual claimant” of the property: she has the claim to any profit, or loss that occurs when she transfers the property or makes use of it.

²⁹ See Elinor Ostrom (1990) *Governing the Commons*, Cambridge: Cambridge University Press.

³⁰ Garrett Hardin’s famous 1968 article “The Tragedy of the Commons” (*Science*, 162, 1243-1248) explains what happened to pasture land in a “commons” ownership pattern. Assume everyone in a particular town was able to graze his/her cow on the commons for free. As a result, each individual had incentives to put more and more cows on the commons, so that he could maximize his personal gain. Precisely because each individual had the same incentive, each cow owner put more and more cows on the commons until it was overgrazed, with the result that cows on the commons went hungry. As Hardin says: “Freedom in a commons brings ruin to all.” The tragedy can be avoided if those who have access to the commons can create rules to limit access and overuse.

or government property because they know that they will not benefit directly from their actions.

For example, imagine that our homeowner *does* plant an apple orchard. Because she holds the stick that allows her to profit from the sale of apples she is likely to nurture her trees, prune them carefully, and do her best to keep them free from pests and disease. Would our homeowner's neighbors behave the same way? Would they expend resources taking care of trees they did not own? And what would happen if this orchard was located on public property rather than on private land? Would passersby expend their resources to care for the apple trees? It seems unlikely. What's more likely is that these passersby would pick these "free" apples and soon, the trees would be bare. If a person has no prospect of recouping expenses required to care for property she is less likely to go to the effort.

Under open-access and government-property ownership, property users have incentives to take all they can, as fast as possible, otherwise they will "lose out" to others. The result, which we see all around us, is that both open-access and govern-

ment-property resources *tend* to be overused and under-maintained. Whether the example is fish stocks in the high seas, national parks, or elephants in Kenya, the lesson is the same: if no one owns it or, if there are no effective residual claimants, a resource is not likely to be well cared for.

B.3 PROPERTY RIGHTS PROMOTE ECONOMIC DEVELOPMENT AND POVERTY ALLEVIATION

What is the relationship between property rights and economic development? As discussed above, markets evolve when individuals are free to develop and use property and contract rights. Strong evidence indicates that open trade within a free-market economy promotes economic growth.³¹ Evidence also indicates that people invest more in property when their rights are secure.³² Societies that allow for trade and an expansive division of labor—supported by a rule of law and the enforcement of contractual obligations—experience economic growth and prosperity.³³ The standard of living and average income in these societies rises, the health of citizens improves, literacy rates tend to increase and individuals have more opportunities to flourish.³⁴

³¹ See James Gwartney and Robert Lawson *Economic Freedom of the World 2004 Annual Report*, (The Fraser Institute and Cato Institute: Vancouver, Canada) available at: <http://www.freetheworld.com> and *The Heritage Foundation/Wall Street Journal 2005 Index of Economic Freedom* available at: <http://www.heritage.org/research/features/index/>.

³² *Land Policies for Growth and Poverty Reduction*, (2003: 11-18).

³³ See Douglass North and Robert P. Thomas (1973) *The Rise of the Western World*, Cambridge: Cambridge University Press.

³⁴ Acemoglu, Robinson and Johnson (2004: 16-17) and their subsequent discussion of the two Koreas and western colonies.

One reason why trade-friendly societies prosper is that members of these societies create relatively few roadblocks on the path to prosperity. Individuals living in these societies create institutions that protect property rights and that allow for relative freedom of contract. They find ways to limit corruption and predation and, in turn, promote creative entrepreneurial efforts from the very lowest to the highest rungs of society. They also find ways to limit expropriations, arbitrary government actions, and excessive regulation. In other words, they tend to create environments in which *individuals* are empowered to make decisions about how to use and trade their property instead of creating environments in which property-rights decision making is centralized and people hide or otherwise disguise valuable resources.

Because it provides the basis for trade and markets, the institution of property rights is a key ingredient in the fight to alleviate poverty. Without the critical combination of property rights, rule of law, and contract rules and norms, a society is unlikely to experience economic growth.

B.4 HUMAN FLOURISHING AND EMPOWERMENT DEPEND UPON PROPERTY RIGHTS

Human flourishing depends upon empowering individuals to decide how best to realize their unique capabilities. If we believe that individuals should be permitted to live the best life they can, then we must recognize that this is impossible in the absence of individual property rights.

“Because it provides the basis for trade and markets, the institution of property rights is a key ingredient in the fight to alleviate poverty.”

Property rights decentralize power, creating autonomous space in which individuals can pursue their interests and live their idea of a “best life.” A broad political franchise is essential in order to limit tyranny; similarly, a broad property franchise is essential to restrain oppression and empower individuals.

If an individual holds no property rights, he or she is at the mercy of an authority figure who will decide what resources he or she may, or may not, access. Property rights shift the locus of decision making from a central authority to property owners. This shift makes property owners less beholden to either traditional leaders or political authorities. Instead, it empowers individuals or groups to decide how and when to use or trade their sticks in the property-rights bundle.

For example, our homeowner has increased abilities to flourish as a result of her homeownership. She is empowered to choose how, when, and if to use her property. She has the power to accumulate capital if she uses her property in ways that others value. She has access to capital markets and can seek credit using her home as collateral. She can make decisions about her home environment that she might not be empowered to make

if she lived there as a non-owning family member or as a guest (i.e., should she *really* plant an apple orchard or would she be better off raising sheep?). She has some scope of dominion over the property. This power may make it easier for her to both avoid and leave abusive situations, to fund educational or business ventures, or allow her to invest in herself or other causes and people she favors.

Compare our female homeowner in the U.S. to a woman living in rural Zimbabwe. Even though the constitution of Zimbabwe prohibits discrimination based on gender, customary law allows such discrimination—it limits her right to own and inherit property.³⁵ As a result, if she was married under the customary law and her husband dies, she can be disinherited and evicted from the land she has worked. To remain on the land she has worked and relied upon for her livelihood, she will be beholden to community leaders and her relatives. If they choose to allocate this land to someone else they may, and she will be forced to leave. Without property she has limited

“Without the critical combination of property rights, rule of law, and contract rules and norms, a society is unlikely to experience economic growth.”

³⁵ “Zimbabwe – Feature – Calls for review of inheritance laws” *IRINnews.org* Nov. 3, 2004. Available at: <http://www.irinnews.org/report.asp?ReportID=43985&SelectRegion=Southern_Africa&SelectCountry=ZIMBABWE>.

access to credit and limited abilities to invest in her human capital or that of her children. Without independent rights to property women are forced to rely upon men—a situation that limits their agency and leaves them too often at the mercy of others.

An individual who *does* have property rights has the power to make decisions about how to use that property in ways that promote his or her flourishing. People who have secure property rights often respond to this challenge by finding creative, perhaps previously unappreciated, ways to use property. They are more likely to invest in themselves and to pursue opportunities to improve their lives. They are more likely to flourish than are people who lack such rights.

II. IMPLICATIONS FOR DEVELOPMENT POLICY

This analysis leads to important conclusions about the role that property rights play in promoting economic development and in generating greater levels of human flourishing. Property rights help direct human action towards purposeful, positive outcomes. In order to generate the results discussed above, individuals should be empowered to hold securely as many sticks in the

“Property rights decentralize power, creating autonomous space in which individuals can pursue their interests and live their idea of a “best life.””

bundle of property rights as *they* choose. Decisions about how to separate and transfer property rights should be decentralized to the greatest extent possible and should be held by as broad a segment of society as possible. Reforms should work to remove formal and informal barriers that limit the transferability or divisibility of property. Additionally, property rights must be supported by a rule of law, contracting rules and norms, an impartial and effective judiciary, and a restrained and impartial police force. Without the support of these associated institutions, property rights simply will not be secure. Insecure property rights do not provide the kinds of incentives discussed above.

Effective policy should aim to decentralize property-rights decision making and increase the security of those rights. Sustained economic growth requires clearly defined, divisible, secure property rights.³⁶ Secure property rights also help ensure that individuals are less subject to oppression, either by traditional forces or by political leader-

ship. Property rights are what allow marginalized members of society to create “a room of one’s own.” The more people who have this opportunity, the more benefits should flow from secure property ownership.

This final section offers three suggestions for policy makers working in the area of property rights generally, or land-tenure reform more specifically. The key idea of all the suggestions is that a strong property-rights regime will provide an array of positive incentives that will help address economic growth, poverty alleviation, and issues related to human flourishing.

A. POLICY IMPLICATION #1: DECENTRALIZE PROPERTY- RIGHTS DECISION MAKING

In order to generate the greatest benefits from the incentive structure created by the institution of property rights, broad segments of society must be empowered to choose which rights *they* prefer to hold in a given piece of property. Some people will choose to hold thick bundles; some will choose to hold thin bundles. Just as a broad political franchise is thought to be essential for the political health of a society, broad-based property ownership is essential for the economic health and well-being of a society. To the greatest extent

³⁶ See generally, (2005) *World Development Report* Chapter 4 “Stability and Security.” Available at: http://siteresources.worldbank.org/INTWDR2005/Resources/complete_report.pdf.

possible, these voluntary, individual choices should be honored and protected. Reforms should concentrate on removing or limiting formal or informal barriers to separating and trading property rights, and on increasing the security of property rights. While it may be tempting to limit property reforms to particular groups, or to limit the sticks in the bundle of rights, either strategy necessarily results in individuals being *forced* to hold thinner bundles of rights—thinner bundles that may generate fewer benefits for a society.³⁷

In practice, this means policy makers should focus on: (a) understanding the current property-rights environment so that they can accurately establish a credible baseline of existing rights and (b) once this baseline is established and the property-rights environment is mapped, policy makers should first aim to remove top-down legislative and regulatory barriers that limit property-rights decision making and/or the number of people in society who have rights to property.

It is essential to distinguish between legislative and regulatory barriers that have been imposed, top-down, on a community and barriers that result from bottom-up social norms and belief systems. Policy makers may be more successful in

removing the first set of barriers and so should focus on removing these barriers first. While the second type of barrier is capable of modification, changing belief systems and social norms related to property use is likely to be vastly more difficult. If social norms exist that resist the extension of property rights to particular groups or in particular ways, then policy makers must work to build effective coalitions for change before implementing property reforms, otherwise these reforms are likely to meet resistance or simply be disregarded.

**B. POLICY IMPLICATION #2:
LOOK TO AND BEYOND LEGAL
CODES TO CREATE SECURE,
DIVISIBLE BUNDLES—ALLOW
PROPERTY RIGHTS TO EVOLVE**

Successful property-rights reforms must look to, but must also look beyond a nation's written legal code: successful reforms should allow for the creative evolution of property rights.³⁸ For example, a nation's written legal code should allow individuals to hold as many, or as few, secure sticks in any given bundle of property rights as *they* choose. Legislative changes that might promote this goal include revisions that allow for greater freedom of contract, a statute of frauds, the addition of titling

³⁷ An example would be providing title to land to poor farmers, but limiting their ability to sell or mortgage the land out of fear that they will be taken advantage of by lenders and lose their property. This restriction necessarily limits the thickness of their property-rights bundle, makes the land less valuable to the farmer, and also makes it more difficult to secure loans.

³⁸ See Andrew P. Morriss, (2005) "Hayek and Cowboys: Customary Law in the American West," *New York University Journal of Law and Liberty*.

statutes (with provisions for titling insurance), constitutional rules or statutes prohibiting expropriation, and requirements for just compensation for public takings, among others.

Any formal legal rules enacted to promote property ownership should allow for the possibility of property-rights entrepreneurship—the creation of new sticks in the bundle of property rights or new methods for allocating property rights. Individuals should be encouraged to respond to increasing scarcity of a resource or changing technology by developing new property rights, as property-rights entrepreneurs did when they created exclusive rights to URLs on the World Wide Web. This evolutionary process allows for the creative solutions to problems of changing needs.

The policy implication is that property-rights decision making will not be effectively extended merely by drafting legal codes. Unless prevailing social norms support the extension of such rights, efforts to generate top-down reforms may be ineffective or irrelevant. Policy makers need to understand the process involved in creating property rights, identify stakeholders in that process and, where needed, work to build coalitions to support a broader property-rights franchise. While it may be important to capture some property rights rules in the form of legal codes, statutes, or regulations, it is also important to allow existing customary rules and norms to evolve over time to meet the specific local needs of a community. If all property rules are confined to statute or code books, there will be little space

available for property-rights entrepreneurs to craft new solutions to changing local conditions.

C. POLICY IMPLICATION #3: BUILDING SUPPORTING INSTITUTIONS IS ESSENTIAL

Property rights will not be secure and will likely be less divisible if enforcement institutions and other essential supporting institutions are ineffective. For example, when societies allow individuals greater freedom of contract they have more opportunity to create new sticks in the bundle of property rights and new methods of allocating property rights. The institution of property rights depends upon a robust contractual environment, so policy makers should be aware of possible barriers to property ownership or property divisibility created by contracting rules.

Policy makers interested in the role property rights play in promoting economic development and human flourishing *must* also consider the accountability and transparency of judicial proceedings, as well as the accountability of police activities. Any efforts to build a more vigorous property-rights regime must be accompanied by efforts to improve judicial and police accountability. These efforts must also involve a review of a community's contracting law, to ensure that it allows for the greatest scope of entrepreneurial activity with regards to property. Property reforms that ignore these essential complementary institutions will not be as effective as they might otherwise be.

CONCLUSION

The institution of property rights serves several vital roles in society. Property rights define or limit the privileges individuals hold with regard to specific resources. They allow people to allocate scarce resources, to trade with others and generate economic prosperity, and they limit political and traditional oppression. Property rights align expectations and actions in ways that promote exchange, economic growth, and the creative use of resources.

The result is that effective property rights, supported by the related institutions of a rule of law, contracting rules, and an impartial judiciary and police, are a key element to the puzzle of poverty alleviation and economic development. These rights also decentralize power, resulting in a more open, dynamic society that recognizes the talents and contributions of many members—not just the politically or traditionally powerful. As a result, property rights do more than just promote economic growth, they promote human growth and flourishing.

Many developing countries limit the ability of

individuals to make choices about which property rights to hold and/or they lack essential supporting institutions that bolster property rights. The aim of policy reforms must be to provide secure, divisible bundles of rights to as broad a segment of society as possible. This Policy Primer offers three policy implications:

- 1) Decentralize property rights decision making to allow as many individuals as possible to hold as many secure sticks in the property rights bundles as *they* choose;
- 2) Look to and beyond legal codes to create secure, divisible bundles—allow property rights to evolve; and,
- 3) Work to create vigorous supporting institutions, otherwise property rights will remain insecure.

Secure, divisible formal and informal property rights are vital to the economic well-being of society. These rights also allow for a greater degree of human flourishing. If development policy is to succeed in its ultimate goal of alleviating poverty and helping people to thrive, it must recognize the foundational role property rights play in these processes.

ABOUT MERCATUS

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society. Mercatus's research and outreach programs, Capitol Hill Campus, Government Accountability Project, Regulatory Studies Program, Social Change Project and Global Prosperity Initiative, support this mission.

Mercatus is a 501(c)(3) tax-exempt organization.

ABOUT THE MERCATUS POLICY SERIES

The objective of the Mercatus Policy Series is to help policy makers and those involved in the policy process make more effective decisions by incorporating insights from sound interdisciplinary research. By complementing the standard empirical approaches with on the ground and in depth field work conducted by Mercatus scholars, the Series is designed to provide an analysis rooted in the local institutional context in which entrepreneurs and economic actors make decisions.

Overall, the Series aims to bridge the gap between advances in scholarship and the practical requirements of policy. The Series includes three types of studies:

- **POLICY PRIMERS** present an accessible explanation of fundamental economic ideas necessary to the practice of sound policy;
- **POLICY COMMENTS** present an analysis of a specific policy situation that Mercatus scholars have explored, and provide advice on potential policy changes;
- **COUNTRY BRIEFS** present an institutional perspective of critical issues facing countries in which Mercatus scholars have worked, and provide direction for policy improvements.

MERCATUS CENTER
GEORGE MASON UNIVERSITY

3301 North Fairfax Drive
Arlington, Virginia 22201
Tel: 703-993-4930
Fax: 703-993-4935