
The Economics of Property Rights

BY ANDREW P. MORRISS

Property rights play a critical role in a wide range of economic institutions. From understanding why owners are generally better stewards of property than renters to finding ways to resolve environmental problems, property rights are at the center of the analysis. It is unsurprising, therefore, that economics offers important insights into property rights. The economic approach is not the only way to think about property, and economic analysis is often misused, but it is an important part of understanding why property rights are so important to liberty and human progress. In particular, economics can help us understand two fundamental aspects of property rights: how they change and the types of problems they solve.

A simple example illustrates the evolution of property rights in land. The basic form of property in land in the United States is called the fee simple absolute. The owner of a fee simple absolute has the maximum extent of rights possible in the land under the law; most privately held American land is in this form.

An owner of a fee simple absolute in a plot of land in 1800 and an owner of a fee simple absolute in the same plot in 1900 had different sets of rights because of changes in the law. Between 1800 and 1900 the federal government abandoned a claim it had in mineral rights in private land. Most national governments in 1800 claimed a share of any minerals produced from any land within their boundaries. (Indeed, most national governments still make such a claim today.) Although American law was not completely clear on the subject in 1800, many thought that the federal government had inherited the English government's claim of a share of mineral rights, and such claims were asserted by the federal government a number of times during the first part of the

nineteenth century. By 1900, however, the United States had effectively abandoned its general mineral-rights claim and recognized that private landowners with fee simple title had property rights to both the surface and subsurface of their land. Indeed, the U.S. government went further and through a series of laws in the 1860s and 1870s, culminating in the General Mining Law of 1872, recognized individual claims of ownership of mineral rights and surface rights by those who discovered valuable mineral deposits on federal land.

Now compare the rights held by today's owner of this land with the rights held in 1900. Over the past century or so, various governments took important parts of the property-rights bundle from many landowners. Local governments passed zoning laws, reducing landowners' freedom to use their property as they see fit. State governments adopted a wide range of land-use restrictions. Some, such as Florida, adopted statewide land-use planning programs that imposed major restrictions on how property could be used. Others simply increased taxes on land. The federal government significantly reduced landowners' rights through regulatory statutes such as the Endangered Species Act and the assertion of jurisdiction over a wide range of "wetlands" under the Clean Water Act. As a result, an owner of a fee simple absolute in that same property today has many fewer rights than the 1900 owner did.

At the same time, the rights that remain in that fee simple absolute have evolved in ways that make them potentially more valuable today through private efforts

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at rebundling rights. For example, one of the fastest-growing forms of property ownership today is ownership in communities in which a developer has rearranged the property rights through covenants, easements, and servitudes. One of the best known such communities is the town of Celebration in Florida, constructed by Disney. There restrictions in the deeds govern a multitude of details of the houses constructed on the property. Houses must conform to a particular architectural style, have front porches and white window hangings fronting the street, be painted a color from a specified range, and so forth. While the deeds to the properties Disney sold were notable for the number and detail of restrictions, they were by no means unique. In fact, millions of Americans now own property in which they paid a premium price to receive a deed with many more restrictions on use than was common even 30 years ago. Why?

The solution to this seeming paradox of paying more for less lies in the relative values of the rights lost and gained. Property owners in Celebration did not just give up property rights; they also acquired negative rights in their neighbors' property.

A homeowner in Celebration is limited in her choice of colors for her house—but so are her neighbors. A homeowner in Celebration is limited in the color of blinds she can hang in the windows facing the street—but so are her neighbors. The success of Celebration in boosting property prices in the development over the prices for property in surrounding areas that lack the restrictions tells us that property owners are more concerned with limiting their neighbors' ability to create aesthetic annoyances than they are with maintaining their own ability to do so. Reallocating the property rights among the property owners in Celebration increased the value of the bundle of rights each person purchased because it added rights worth more (the ability to prevent an aesthetic disaster down

the street) than those it took away (the ability to create one's own aesthetic disaster).

Not everyone wants to live in Celebration, or even in a community with fewer restrictions, such as the one in Yuma, Arizona, where my parents live and all houses must be painted a shade of sand color. Enough people do, however, that property owners and entrepreneurial developers have discovered that they can increase the value of some properties by incorporating such restrictions into their deeds. Property law makes such transactions possible by providing a mechanism for embedding such reallocations in deeds and so binding future purchasers of the property. It also provides a way out of deed restrictions that become obsolete, as a future entrepreneur could change or abolish restrictions by reuniting the parcels benefited and burdened by them.

There's an important difference in how property rights changed in these examples. In the expansion of property rights to include subsurface rights between 1800 and 1900, rights became more secure as the result of government's limiting its claims against individuals. In the rearranging of rights

involved in creating developments with a particular aesthetic, private entrepreneurs used contracts and deeds to increase their property values through voluntary transactions. In the contraction of property rights from 1900 to the present through regulatory statutes, however, interest groups used the power of the state to forcibly redistribute property rights. (Anyone who doubts the "forcibly" portion of the preceding sentence need only speak to one of the landowners criminally prosecuted for violating federal endangered-species or wetlands laws and regulations.) Unfortunately, the value created by the combination of property rights and voluntary transactions all too often makes property rights a tempting target for expropriation.



In Celebration, Florida, there are restrictions in the deeds that govern a multitude of details of the houses constructed on the property, including architectural style.

Property Rights Evolve

The first key economic insight is thus that property rights are not static. They evolve. How does this evolution work? As a type of property becomes more valuable, people are willing to invest more in efforts to define rights to it. Property rights thus naturally evolve in response to changes in technology, changes in costs, changes in tastes, new discoveries, and other changes in individuals' preferences. A critical role in this evolution is played by entrepreneurs who identify opportunities to increase value by rearranging property rights.

How do property rights evolve? It is useful to think about five different ways in which they regularly change:

- (1) The subject of property rights changes, making new things property that were not previously considered property.
- (2) The bundle of rights changes, making it possible to divide property rights in new ways and trade those rights.
- (3) The method of establishing property rights changes, making the cost of establishing property rights different.
- (4) The method of protecting property rights changes, making the cost of securing property rights different.
- (5) The method of stealing property rights changes, making property rights more or less secure.

Property rights can evolve to include new subjects. A classic example is the development of water rights in the nineteenth-century American west. Settlers from the more humid east found that the water-law institutions they brought with them, derived from English law and custom, were inadequate. Eastern water law gave riparian rights to landowners adjacent to bodies of water. These rights generally included the right to use water but not to diminish its flow for downstream users. In the west, where water was scarcer, however, the right to divert water for irrigation or mining was valuable. Western states and territories quickly recognized a doctrine of prior appropriation, whose essentials came out of the practice of early miners and farmers in the region. Under prior appropriation, water users had the right to divert water, with users' rights ranked in the order in which it was originally appropriated.

Unfortunately, western water rights subsequently

became the subject of a massive resource grab by the federal and state governments. Wyoming initiated the process by asserting a claim of state ownership to all surface water in its 1889 state constitution and placing the state engineer's office in charge of water allocations. The federal Bureau of Reclamation built massive water projects across the west with tax dollars, further distorting water rights. The combination made western water rights less secure and limited their evolution in response to changes in technology and demand for water. Today, however, many states have loosened their control of water rights and are beginning to allow markets to emerge.

Rights also evolve into different bundles through voluntary transactions that benefit both parties. As discussed earlier, entrepreneurs in the United States discovered that reallocating the rights to make aesthetic decisions about the appearance of homes could increase the value of properties in some cases. Other examples include sale of easements to neighbors that allow an adjacent property owner to guarantee the preservation of a desirable view and conservation easements that allow a property owner to sell development rights to a preservation group while continuing to use his land.

The method of establishing rights also evolves in response to demand. Creation of an easy-to-use title system increases the value of all property, facilitating transactions by making it inexpensive to determine who owns a particular piece of land. The development of title insurance facilitated property transactions by reducing the risks for buyers. More recently, the securitization of mortgages in the United States has vastly increased the financial resources available to prospective property owners by making it possible for investors to buy diversified portfolios of mortgages. What all these examples share is that they are the result of entrepreneurs identifying an opportunity for profit and using the tools provided by the law to create a means of earning that profit.

Finally, property rights evolve in response to changes in how they can be defended. Property owners often play a critical role in physically defending their rights, as anyone knows who has seen the broken-glass-topped walls, gates, and razor wire routinely used by property owners in countries where land is vulnerable to invasion. New technologies can repeat the role of barbed

wire on the American Great Plains, making it possible to cost-effectively control access to resources that cannot be safeguarded today. For example, in the not-too-distant future we may see a combination of GPS and DNA-testing technologies provide a means to create property rights in migratory sea animals, such as whales.

The evolution of property rights is a remarkable phenomenon. In the United States and elsewhere, positive developments have produced better-defined, more secure, and more valuable bundles of rights over time. That evolution has occurred as the result of individuals' seeking to fulfill their own plans, to earn profits, and to use their property to serve their own needs. In short, the voluntary transaction-driven evolution of property rights is a Hayekian spontaneous order.

At the same time, however, there have been value-destroying, liberty-restricting developments in property law. The widespread adoption of central-planning methods for land-use control, the seizure of private property to redistribute it to favored interest groups masquerading as "economic development," and regulatory restrictions on property owners in pursuit of special interests' agendas, as has happened with laws such as the Endangered Species Act and Clean Water Act, are the result of the combination of an unconstrained state and the attraction of the wealth individuals create through the trade made possible by property rights.

Property Rights Solve Problems

There are two fundamental problems solved by property rights: (1) how to exchange goods in the course of trade and (2) the commons problem.

The problem of how to exchange goods in trade is a serious one, although not one we often consider today. If goods belonged to whoever happened to pick them up, there would be little reason for me to trade with you. I could simply wait until you fell asleep or were distracted and take the goods without giving you anything in return. Even if you and I agreed between ourselves, or if all the people in our neighborhood or even our town agreed on who owned what, we would still not be close to unlocking the potential value made possible by a system of well-defined property rights.

To take but one example, many new businesses in the United States are started by entrepreneurs using their

homes as collateral. If a bank could not be sure who owned the property offered as collateral, it would not be willing to lend the money. Similarly, if the bank thought that it could not collect on the collateral, it would be unwilling to lend. When banks can rely on clear titles, however, they are willing to advance money, holding the titles as collateral. When property rights are sufficiently clear and markets well-enough developed, bundles of security interests in land can be combined and turned into new investment securities. These securities then make it possible to expand the pool of money invested in real estate, and so enabling even more, even cheaper loans. The economic power of property rights in such cases is so extraordinary that they almost seem to be alive with energy. Indeed, Peruvian economist Hernando de Soto refers to property in societies where rights are so poorly specified that using it as collateral is impossible as "dead capital" because it cannot be used to produce new value in this way.

This critical feature of property rights—that they permit trade and so permit the creation of wealth—is central to the economic case for them. It provides the solution to some thorny philosophical issues as well. Philosopher David Schmidtz suggests that the solution to the problem of the Lockean Proviso—the requirement that "enough and as good" be left for others in a just system that includes original appropriation—is that allowing the original appropriation produces more for those who come after by permitting trade to take place. In his essay "The Institution of Property," Schmidtz points out that "Philosophers are taught to say, in effect, that original appropriators got the good stuff for free. We have to pay for ugly leftovers. But in truth, original appropriation benefits latecomers far more than it benefits original appropriators. Original appropriation is a cornucopia of wealth, but mainly for latecomers. The people who got here first never dreamt of things we latecomers take for granted."

The second important problem property rights solve is the tragedy of the commons. Made famous by Garrett Hardin in his 1968 article in *Science*, a tragedy of the commons occurs when there is no means to exclude others from a resource. Under these conditions, the resource will be overused to the point of destruction so long as each user gains more benefits than the costs he



The commons is a problem only for societies that lack property rights.

bears as a result of his actions. In Hardin's example, villagers shared access to a common field. Each could put as many cattle on the field as he desired since no one had the right to exclude another. As a result, each villager added cattle so long as the last cow he added benefited him more than it cost him. Since a portion of the cost created by the additional cow was the reduction in grass available to the cows owned by others, no villager took into account the total cost to the village of the additional cows. Unsurprisingly in Hardin's example, the field ended up with so many cattle grazing on it that it was overgrazed and destroyed. All the villagers were worse off, yet no one had had an incentive to stop the overgrazing. Why?

Without the power to exclude, any grass left for tomorrow would be eaten by someone else's cow today. Even if the villagers had all recognized that there were too many cows on the land, no one would rationally agree to reduce his herd because any grass "saved" would be eaten by someone else's cow.

As Hardin recognized, in a passage rarely cited by those eager to use his work as an excuse for state intervention, the commons is a problem only for societies that lack property rights. The tragedy, Hardin declared, is solved by "private property, or something formally like it." And in fact there was no tragedy of the commons in

medieval English common fields, the case Hardin used as his example, precisely because there were property rights in them, known as "stinting," that limited the ability to add animals. Stinting rights were based on the amount of property in the private fields each villager held.

By making it possible for a property owner to gain from good stewardship, private property creates an incentive to invest in maintaining and improving resources. Just as important, if someone is not engaged in good stewardship, whether due to ignorance, indolence, or idiocy, private property rights make it possible for someone who is able to engage in good stewardship to offer a premium

over the value of the property to the current owner. By buying the property and improving its management, the new owner can generate enough income to pay the higher price. (Of course, not every owner will sell when offered more money than he is getting from his property, but many will.)

Government-Caused Problems

Economics can also shed light on how governments can cause problems with property rights. Two problems are particularly acute today. The first is that governments may impede efforts to create tradable property rights by attempting to steal resources for themselves. The second is that governments may fragment property rights into so many small bundles that the cost of reassembling them into useful arrangements is too high to be worthwhile.

The problem of predatory states is as old as the state itself. Simply taking property without compensation is of course possible, but predators that engage in such naked aggression kill the goose that lays the golden egg. More common are efforts to chip away at property rights on the margin, transferring specific rights from property owners to favored interests. For example, local governments often attempt to condition construction permits on grants of easements or restrictions on use of

the property in question. Similarly, “regulatory takings” are a major area of concern, as property rights become entangled in a web of regulatory restrictions. Unfortunately, the American courts have been even less protective of property rights in the face of regulatory takings than they have been with respect to outright takings.

The problem of fragmentation of property rights is particularly acute in countries attempting to privatize state-owned property. In some instances, rather than decide to whom to award a particular property, officials simply gave it to everyone. As a result, there were multiple “owners” able to veto any particular use of a property. Professor Michael Heller termed this the “tragedy of the anticommons” after observing it in post-Soviet Russia. Heller wondered why so many Moscow storefronts were empty while businesses occupied kiosks on the sidewalks in front. He discovered that the reason was that granting of rights to the former employees of the stores so fragmented ownership that reaching an

agreement on a use of the property was virtually impossible. The tragedy of the anticommons is a creature of the state. Overcoming it is largely a matter of preventing fragmentation of property rights in privatization efforts.

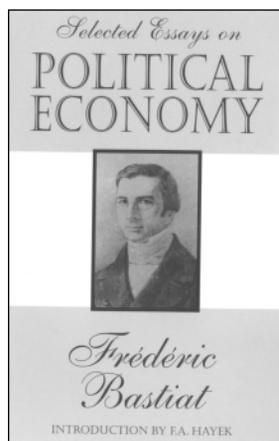
In his history of property rights and civilization, *The Noblest Triumph*, Tom Bethell concludes that private property makes possible liberty, justice, prosperity, and peace. Secure property rights make liberty possible because they fence off a private domain out of the reach of the grasping hand of the state. They make justice possible because property owners reap the rewards and suffer the losses caused by their actions, linking reward to merit. They make prosperity possible because they allow trade. Finally, secure private property rights make peace possible because they enable each individual property owner to pursue his or her own plan, free from the interference of others and without interfering with others.



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