CHAPTER 3

PROPERTY

This chapter begins our examination of the common law—a term that like many legal terms is ambiguous. It is variously used to mean: (1) the body of principles created and applied by the royal law courts of England (thus excluding equity and admiralty law but including most of criminal law); (2) the fields of law that have been created largely by judges as the by-product of deciding cases, rather than by legislatures (thus including equity and admiralty as well as the common law fields in the first sense); (3) or any field of law shaped largely by judicial precedents (thus including large swatches of intellectual property as well as the fields in [1] and [2]). This part of the book concerns the common law mainly in its second sense (though veering sometimes into the third), but excludes two important areas of (largely) judge-made law, procedure and conflict of laws, both discussed in Chapter 21.

Common law in the second sense, when viewed economically, has five parts:

1. the law of property, concerned with creating and defining property rights, which are rights to the exclusive use of valuable resources;
2. the law of contracts, concerned with facilitating the voluntary movement of property rights into the hands of those who value them the most;
3. the law of torts, concerned with protecting property rights, including the right to bodily integrity;
4. criminal law, which in economic analysis is a backup to tort law; and
5. remedial and ancillary doctrines, such as damages, restitution, and injunctions (as well as criminal punishment).

§3.1 The Economic Theory of Property Rights: Static and Dynamic Aspects

To understand the economics of property rights, we must first distinguish between static and dynamic analysis. Static analysis suppresses the time dimension of economic activity: All adjustments to change are assumed to occur instantaneously. The assumption is unrealistic but often fruitful; the attentive reader of Chapter 1 will be undisturbed by a lack of realism in assumptions.

Dynamic analysis, in which the assumption of instantaneous adjustment to change is relaxed, is usually more complex than static analysis. So it is surprising that the economic basis of property rights was first perceived in dynamic terms. Imagine a society in which all property rights have been abolished. A farmer plants corn, fertilizes it, and erects scarecrows, but when the corn is ripe, his neighbor reaps it and takes it away for his own use. The farmer has no legal remedy against his neighbor's conduct because he owns neither the land that he sowed nor the crop, where ownership implies the legal right to exclude. Unless defensive measures are feasible (and let us assume for the moment that they are not), after a few such incidents the cultivation of land will be abandoned and society will shift to methods of subsistence (such as hunting) that involve less preparatory investment.

Although the value of the crop in our example, as measured by consumers' willingness to pay, may have greatly exceeded its cost in labor, materials, and forgone alternative uses of the land, without property rights there is no incentive to incur these costs because there is no reasonably assured reward for incurring them. The proper incentives are created by parceling out mutually exclusive rights to the use of particular resources among the members of society. If every piece of land is owned by someone—if there is always someone who can exclude all others from access to any given area—then individuals will endeavor by cultivation or other improvements to maximize the value of land. Land is just an example. The principle applies to all valuable resources.

All this has been well known for hundreds of years. In contrast, the static analysis of property rights is little more than 80 years old. Imagine that a number of farmers own a pasture in common, meaning that none has the right to exclude any of the others and hence none can charge the others for the use of the pasture. We can abstract from the dynamic aspects of the problem by assuming that the pasture is a natural (uncultivated) one, so that there is no question of improving it by investment. Even so, pasturing additional cows will impose a cost on all the farmers. The cows will have to graze more in order to eat the same amount of grass, and this will reduce their weight. But because none of the farmers pays for the use of the pasture, none will take this cost into account in deciding how many additional cows to pasture, with the result that more cows will be pastured than would be efficient. (Can you see the analogy to highway congestion?)

The problem would disappear if one person owned the pasture and charged each farmer for its use. The charge to each farmer would include the cost he imposes on the other farmers by pasturing additional cows, because that cost reduces the value of the pasture to the other farmers and hence the price they are willing to pay the owner for the right to graze. (Notice the analogy to a toll road.)


The proposition that enforcing property rights will lead to a greater output is questioned by Frank I. Michelman in Ethics, Economics, and the Law of Property, 24 N.Y.U. L. Rev. 3, 25 (1952). He suggests that the farmer who knows that half his crop will be stolen may just plant twice as much. This suggestion overlooks (1) the added incentive to theft created by planting a larger crop and the resulting likelihood that more than one-half the larger crop will be stolen; (2) the unlikelihood that farming would be so much more profitable than substitute activities not entailing preparatory investment as to keep people in farming in the face of rampant theft; and (3) the likelihood that the farmer, if he did remain in farming, would divert some of his resources from growing crops to protecting them with walls, guards, etc.

2. See Frank H. Knight, Some Fallacies in the Interpretation of Social Cost, 38 Q.J. Econ. 582 (1924).
The creation of individual (as distinct from collective) ownership rights is a necessary rather than a sufficient condition for the efficient use of resources. Suppose the farmer in our first example owns the land that he sows but is a bad farmer; his land would be more productive in someone else’s hands. Efficiency requires a mechanism by which the farmer can be induced to transfer the property to that someone else. A transferable property right is such a mechanism. Suppose Farmer A expects that his farm will yield him $1,000 a year above his labor and other costs, indefinitely. Just as the price of a share of common stock is equal to the present value of the anticipated earnings to which the shareholder will be entitled, so the present value of a parcel of land that is expected to yield an annual net income of $1,000 can be calculated and is the minimum price that A will accept in exchange for his property right. Suppose that present value is $20,000. If B believes he can use A’s land more productively than A, the present value of B’s expected earnings stream will exceed that calculated by A. Suppose it is $30,000. Then at any price between $20,000 and $30,000 both A and B will be made better off by a sale, and so there are strong incentives for a voluntary exchange of A’s land for B’s money.

The discussion to this point may seem to imply that if every valuable (meaning scarce as well as desired) resource were owned by someone (call this the criterion of universality), if ownership connoted the unqualified power to exclude everybody else, from using the resource (exclusivity) as well as to use it oneself, and if ownership rights were freely transferable or, as lawyers say, alienable (transferability), value would be maximized. This leaves out of account, however, the costs of a property-rights system, both the obvious and the subtle ones.

Suppose a farmer thinks he can raise a hog with a market value of $1,000 at a cost of only $500 in labor and materials, for a net of $500, and that no alternative use of the land occupied by the hog would yield a greater net value—in the next best use, his income from that land would be only $200. He will want to raise the hog. But now suppose his property right is qualified in two respects: He has no right to prevent an adjacent railroad from accidentally emitting engine sparks that may set fire to the hog’s pen, killing the hog prematurely; and a court may decide that his raising a hog on this land is a nuisance, in which event he will have to sell the hog on disadvantageous (why disadvantageous?) terms before it is grown. In light of these contingencies he must reevaluate the yield of his land: He must discount his original $1,000 estimate to reflect the probability that the yield may be much less, perhaps zero. Suppose that, after this discounting, the expected revenue from raising the hog (market value times the probability that it will reach the market) is only $600. He will not raise the hog. The anticipated profit from raising the hog is now only $100, since the farmer’s costs remain at $500. The next best use, we said, would yield a profit of $200. He will put the land to that use even though it is a less valuable use ($200 versus $500) and so the value of the land will fall.

But the analysis is incomplete. Removing the hog may increase the value of surrounding residential land by more than the fall in the value of the farmer’s parcel. Alternatively, the cost of preventing the emission of engine sparks may exceed the reduction in the value of the farmer’s land when he switches from raising hogs to growing, say, fireproof radishes. But, the alert reader may interject, if the increase in value to others from a different use of the farmer’s land exceeds the decrease in value to him, let them buy his right. The railroad can purchase an easement to emit sparks; the surrounding homeowners can purchase a covenant

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3. Discounting to present value is discussed in greater detail in §6.13 infra.
from the farmer not to raise hogs; there is no need to limit the farmer's property right. But as we shall see in §3.8 infra, the costs of effecting a transfer of rights—transaction costs—are often prohibitive, and when this is so, giving someone the exclusive right to a resource may reduce rather than increase efficiency.