Chapter 6

The Economics of Property Law I: Property Rights and Consensual Exchange

This chapter begins the study of property law by describing the nature and function of property rights. It emphasizes how rights are defined, how they emerge, how they are legally protected, and how they influence economic behavior. The analysis then turns to a discussion of how the specific rules of property law facilitate the consensual exchange—or transfer—of property rights.

Key Points

- Property rights are legally enforceable rights to use, exclude others' use of, and profit from, one's assets. The law enforces an individual's property rights up to the point where they become incompatible with another's rights. In the language of economics, incompatible or incomplete property rights lead to externalities.

- Property rights create incentives for efficient exchange and production by assuring that owners have exclusive rights to the resulting profits.

- According to economic theory, property rights emerge when the gains from instituting a system of rights exceeds the costs of enforcement. Private enforcement of property rights often precedes state enforcement.

- Consensual transfers of property rely on legal rules that protect property rights.

- Systems for protecting private property balance certainty of ownership against enforcement costs.

- In the context of land ownership, the recording system, which is the predominant system in the U.S., awards title to legitimate claimants as against current possessors. In contrast, the Torrens registration system certifies the rights of current possessors as against defrauded owners.

- Leases allow property owners to divide their rights to the use of their land (or other assets) over time. Leases have historically occupied the nexus between contract and property law.

- Because leasing arrangements divide ownership and use, they potentially lead to inefficient use of an asset. Economists refer to this inefficiency as the rental externality. Legal doctrines, such as the implied warranty of habitability, the duty to mitigate, and the law of waste, help to alleviate this problem.

- Sharecropping represents a contractual response to inefficiencies associated with divided ownership of agricultural land. One function is to share risks of uncertain output between landlords and tenants; another is to provide both parties incentives to supply inputs into agricultural production.

- Common, or public, ownership may be superior to private ownership when the optimal scale of a given productive activity exceeds that which a single owner can optimally manage. Group ownership can be beneficial in the presence of either cost or benefit spillovers. It can also share risks associated with land ownership such as uncertain crop yield.

- Intellectual property has the characteristic of a public good in that the benefits can be simultaneously used by many. However, if ideas and inventions become public property, innovators will have little or no incentive to create them in the first place. This is called the "appropriability problem."

- The law of intellectual property—encompassing patents, trade secrets, copyrights, and trademarks—deals with this trade-off in various ways. Most notably, patents and copyrights give innovators exclusive rights to profit from their creations for a limited period of time.

- The doctrine of fair use, however, allows some unauthorized copying for educational or private use. The economic justification for fair use is that it allows copying that the copyright holder presumably would have consented to in a world of zero transaction costs.