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1

Contracting for property rights

INTRODUCTION

Property rights are the social institutions that define or delimit the range of privileges granted to individuals to specific assets, such as parcels of land or water. Private ownership of these assets may involve a variety of rights, including the right to exclude nonowners from access, the right to appropriate the stream of rents from use of and investments in the resource, and the right to sell or otherwise transfer the resource to others. Property rights institutions range from formal arrangements, including constitutional provisions, statutes, and judicial rulings, to informal conventions and customs regarding the allocations and use of property. Such institutions critically affect decision making regarding resource use and, hence, affect economic behavior and performance. By allocating decision-making authority, they also determine who are the economic actors in a system and define the distribution of wealth in a society. Because of their important social role, property rights institutions have been the subject of attention by economists and economic historians, as well as by political scientists and sociologists. Surveys of the economics and economic history literature are provided by Furubotn and Pejovich (1972), North (1978), De Alessi (1980), and Libecap (1986). The focus of this literature largely has been on how various property rights arrangements affect behavior, which ranges from the wasteful practices associated with open-access or common pool settings to the wealth-maximizing actions possible with secure private property rights.

Because of the overwhelming advantages of secure property rights, economic agents often are hypothesized to adopt or to modify property

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rights in order to mitigate the losses of the common pool, as soon as the private benefits of so doing outweigh the private costs. Forces that drive these adjustments in property rights include new market prices and production possibilities to which old arrangements are poorly attuned (Demsetz, 1967). Davis and North (1971, p. 39) are explicit in the argument: "It is the possibility of profits that cannot be captured within the existing arrangemental structure that leads to the formation of new (or the mutation of old) institutional arrangements." In other words, it is argued that market forces tend to erode property rights institutions that are ill suited for responding to new economic opportunities. If the existing rights structure limits or blocks reaction to changes in relative prices or technology, the existence of unexploited potential gains will lead individuals to adopt more accommodating property rights.

Despite these optimistic assertions in the literature, the actual process by which property institutions are changed and whether the changes represent an efficient solution to a particular social problem have received much less consideration. For example, a continuing puzzle is why we observe so much variety in the types of property institutions that exist. Some rights arrangements appear to be well structured to allocate resources to high-valued uses and to promote economic expansion, whereas others appear to limit decision flexibility and to instill incentives that retard economic growth. Moreover, historical studies of economic development reveal that differences in property rights institutions across societies with otherwise similar resource endowments have contributed importantly to observed variations in economic performance.

North and Thomas (1973) provide a case in point. They argue that the observed difference in growth rates in the sixteenth and seventeenth centuries between France and Spain, on the one hand, and England and the Netherlands, on the other, were due at least in part to differences in property rights arrangements. According to North and Thomas, in France and Spain absolutist monarchies relied on granting and taxing local monopoly privileges and were fearful of adjustments in property rights that might undermine their political and economic base, even if such changes offered broad economic gains. In England and the Netherlands, where commercial interests were politically stronger, property rights institutions tended to be adopted that allowed for more fluid resource movement to promote and to respond to growing markets.

Although closer examination of property rights in these four countries would be useful for evaluating the North and Thomas thesis, this

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case in European economic history, where property rights were maintained for distributional and political reasons at the expense of significantly greater economic growth, does not appear to be an isolated example. Indeed, North (1981, p. 6), as part of the progression of his thinking on this matter, noted: "But the fact that growth has been more exceptional than stagnation or decline suggests that efficient property rights are unusual in history."

The persistence of seemingly perverse property rights in the face of what would appear to be obvious alternatives recently has led to more attention to the origins of property institutions and to the process of institutional change. This concern with the underpinnings of property rights shares a common research agenda with a broader literature on institutional analysis.

One direction this literature has taken is an examination of the underlying reasons for the emergence of firms, rather than markets, to coordinate certain production activities. Beginning with Coase (1937) and including Alchian and Demsetz (1972), Jensen and Meckling (1976), Williamson (1981), and others, firms are viewed as developing as a means of reducing transactions costs in production and of diversifying risk. The adoption of institutions to reduce transactions costs is also the theme of related analyses of government regulation. Representative is the work of Goldberg (1976) and Williamson (1976), who argue that certain kinds of regulation, at least, can be interpreted as mechanisms for completing long-term contracts when private agreements are not forthcoming.

There are differences, though, between this institutional analysis literature and recent historical work on the development of property rights. As with earlier examinations of property rights, the institutional analysis literature tends to be the more optimistic one, viewing the design of various governance structures as maximizing decisions to economize on transactions costs. A problem with such claims, however, is the general failure to specify the size of the net benefits achieved from the adoption of a particular institutional form relative to the returns offered by its alternatives. This failure to identify the range of institutional options confronting decision makers and the likely costs and benefits associated with each one, makes it difficult to evaluate the maximization claims.

Regardless of whether observed institutions represent the most efficient responses to particular social and economic problems, both economic theory and history provide reasons for believing that the net social gains from changes in property rights at any time will be quite modest. This is because it is difficult to resolve the distributional conflicts in-

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herent in major changes in ownership arrangements.[1] The nature of these conflicts and the problems they present for institutional change are the focus of this volume.[2]

THE IMPLICATIONS OF THEORY FOR SUCCESSFUL INSTITUTIONAL CHANGE

Throughout this volume, the term *contracting* is used to describe efforts by individuals to assign or to modify property rights. In this context, contracting includes bargaining among private claimants within groups to adopt or to change group rules and customs regarding the allocation and use of property. It also includes lobbying and political negotiations among private claimants, bureaucrats, politicians, and judges to implement or to alter more formal property laws and administrative rulings.

Because certain property rights arrangements can reduce transactions costs in exchange and production and encourage investment in order to promote overall economic growth, they have public goods aspects. As with all public goods, though, there are hazards in attempting to change in property rights. For example, there may be shirking and noncooperative behavior among the bargaining parties that will affect the institutions that can be established. In bargaining over creating or modifying property rights, the stands taken by the various bargaining parties, including private claimants, bureaucrats, and politicians, will be molded by their *private* expected gains, as well as by the actions of the other parties.[3]

Property rights institutions are determined through the political process, involving either negotiations among immediate group members or lobbying activities at higher levels of government. The political process of defining and enforcing property rights can be divisive because of the distributional implications of different property allocations. Although the aggregate gains from reducing common pool problems or from promoting economic growth through the definition or redefinition

[1]There are historical examples of changes in rights arrangements, such as the enclosure movement in England, that were accompanied by significant increases in the value of production (McCloskey, 1972). Nevertheless, the argument made here is that because of the complexity of contracting, most adjustments in property rights at any time will be quite limited in scope with various close alternatives possible. This points to the problems in developing a theory of institutional change that offers predictions regarding the particular type and impact of property rights that will be adopted.

[2]Successful institutional change is defined as changes in governance structures that promote economic growth.

[3]Binger and Hoffman (1989) rely upon the theory of repeated games and the existence of multiple Nash equilibria to argue that predictions regarding the development of particular institutions will be extremely difficult.

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of property rights are unlikely to be controversial, the distribution of wealth and political power that are part of the transition to the proposed rights structure will be a source of dispute. In political bargaining over institutional change, each of the parties attempts to maximize his or her private net gains. These private net gains, which mold bargaining stands, are determined by the individual's anticipated share in the aggregate or social benefits resulting from modification in property rights institutions. However, both the aggregate benefits that are possible and the individual's position within them depend upon the share formula that is inherent in the proposed allocation of property.

In bargaining over changes in property rights, disagreements can occur over the nature of either the aggregate benefits or the shares, but the heart of the contracting problem is devising politically acceptable allocation mechanisms to assign the gains from institutional change while maintaining its production advantages. Because property rights involve the assignment of exclusive decision making over valuable resources, some parties will be harmed by the new definition of wealth and political power. Compensating those potentially harmed in the proposed definition of rights and increasing the shares of influential parties may produce a political consensus for institutional change. Those share concessions, however, necessarily alter the nature of the property rights under consideration and the size of the aggregate gains that are possible.

If influential parties cannot be sufficiently compensated through share adjustments in the political process to win their support, beneficial institutional change (even as modified through contracting concessions) may not occur, and the potential economic gains fostered by the proposed arrangement will be forgone. Even though society would be better off with the public goods provided by the new property rights, the distributional implications lead influential parties to oppose institutional change.[4] Accordingly, examination of the preferences of the individual bargaining parties and consideration of the details of the political bargaining underlying property rights institutions are necessary for understanding why particular property rights are developed and maintained, despite imaginable alternatives that would appear to be more rational.[5]

[4]Distributional concerns also appear as fairness considerations. For a discussion, see Hoffman and Spitzer (1985).

[5]For example, Libecap and Wiggins (1984) explain why prorationing was adopted in Oklahoma and Texas between 1926 and 1933 with individual production quotas that encouraged overdrilling. Although Adelman (1964) has criticized prorationing for leading to unnecessary wells, Libecap and Wiggins argue that per well quotas were adopted to build political consensus for prorationing. Although overdrilling resulted, prorationing provided some relief from common pool oil production.

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In principle, it is possible to construct a side payment scheme that would compensate those who otherwise would oppose a desirable change in property rights. But in practice, the devising of perfectly compensating side payments to bring agreement encounters formidable obstacles, including questions of who should receive payments, who should pay, what should be the size of the compensation, and what should be its form. All of these issues will be subject to intense dispute, so that outcomes are difficult to predict. Conflicts over distribution will be intensified, if there are important heterogeneities among the bargaining groups and if information problems restrict the bases for negotiation over shares. In the absence of compensating side payments, some parties may see themselves made worse off by the proposed change, while others will benefit. Distributional conflicts and efforts to address them can block institutional change or so mold the rights arrangement that ultimately emerges that it bears little resemblance to that which was initially proposed.

Time and precedent play important roles in determining the range of feasible contracting outcomes. As a legacy of past informal or formal agreements on property rights, some parties will have a vested interest in the status quo and can be expected to oppose institutional change unless they can be made better off. However, it may not be possible to achieve such an improvement and still maintain the character of the proposed change. Groups with vested interests may have advantages in political bargaining relative to other groups through lower costs of collective action. Their current position in the system binds them together to make them a relatively cohesive bargaining group. They also will have beneficial ties to established political processes and leaders. These advantages will make vested interests effective political lobbyists, biasing institutional change toward maintenance of the status quo.

Legal precedent also will have an impact on how property rights are changed in response to new economic conditions. Precedents set expectations among the various parties for successful institutional change. If the political and economic systems are reasonably open to new entrants and there is a history of routine adjustments in property rights, then institutional change to meet specific economic problems is more likely. In this case, as pressures from new market conditions mount, interest groups will mobilize to lobby for adjustments in property rights, drawing upon the history of past changes. On the other hand, in less open societies where the status quo has been maintained by influential parties, new external market conditions will not bring the same expectations for institutional change. Depending on the size of the market pressures, the lack of expectations for change will limit the expected

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returns from forming interest groups within established political structures to lobby for new property rights structures.

The roles of time and precedent suggest that there may be an historical path dependence for institutional change. How constraining past decisions are for shaping the subsequent range of feasible property rights and economic activities over time in a society is an empirical question. It is unclear whether generalizable predictions regarding these effects can be made. It seems clear, though, that past property rights decisions will serve to limit the menu of possible institutional solutions to varying economic problems.

THE IMPLICATIONS OF HISTORY FOR SUCCESSFUL INSTITUTIONAL CHANGE

Recent historical investigation also suggests that a less optimistic view of property rights change is in order. This conclusion is based on examination of the role of interest groups and conflicts among them over the distributional effects of property law and government regulation. Hurst (1960, 1964), Scheiber (1973), Hughes (1977), and Friedman (1985) view the early nineteenth-century American legal environment as one that largely promoted economic development by supporting an expanded market and by providing an infrastructure for investment, production, and exchange. Inherited doctrines that seemed to clash with the needs of a growing economy were cast aside by courts and legislatures.

In the late nineteenth century, however, for uncertain reasons, the law became less promotional. Instead of a focus on aggregate economic expansion, the law became more directed to the concerns of particular interest groups and their share of national income. Vested interests and distributional conflicts assumed greater importance. According to Friedman (1985, pp. 339, 340): "These interest groups jockeyed for position and power in society. They molded, dominated, shaped American law. . . . These laws cemented (or tried to cement) the economic position of the people that lobbied for them in the first place: the organized trade group." In an effort to better understand the preoccupation with distributional concerns in the late nineteenth century, Scheiber (1981, p. 108) called for detailed studies of legal change to identify the winners and losers "when the law was used to allocate advantages and liabilities." Additionally, Hughes (1977) commented that the political maneuvering over economic gains makes sense as history, law, and sociology, even though it makes no sense as economics, narrowly defined.

Olson's (1982) examination of the varied success of western economies in the post–World War II period also emphasizes the im-

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portance of distributional conflicts among interest groups in shaping the institutional structure in ways that determine the pace and level of aggregate economic performance. He argues that those economies that performed less well–the United States, Great Britain, Canada, and Australia–were constrained by powerful interest groups who successfully obtained controls over work rules, production practices, the adoption of new technology, and entry into new markets. Unions and trade associations, according to Olson, relied upon monopoly power and trade restrictions for income and political power and had little incentive to support adoption of institutions that would provide greater flexibility in the economy. Established interest groups with the costs of organizing behind them formed powerful cohesive lobbyists relative to newly emerging groups who might support changes in the status quo. Only the catastrophic effects of World War II in Germany, Japan, Italy, and France on the structure of interest groups allowed for those economies to reorganize and to be relatively more responsive in the adoption of new technology and improved production methods.

FOUR AMERICAN EMPIRICAL CASES REGARDING PROPERTY RIGHTS

The four empirical cases of property rights change examined in this volume illustrate the contracting complexities described above. They reveal very different levels of success in mitigating the losses of the common pool, despite large aggregate gains from agreement. Moreover, each has a rich, but different history of private and political contracting behind the observed property rights arrangement. This diversity is surprising, because all of the property rights examined involve ownership of natural resources in the United States, which ostensibly offers a very positive environment for private property rights. The cases cover a variety of contractual outcomes regarding the assignment of property rights, ranging from relatively uncontroversial and unabridged private mineral rights, assigned in the mid-nineteenth century; to more limited, attenuated property rights to federal range and timber lands, assigned in the late nineteenth century; and to chronic common pool fisheries and crude oil reservoirs, where under the rule of capture, private property rights are assigned to fish and to oil only upon extraction. Typically, in these two cases, property rights are not assigned to the resource stock, but instead are granted only as a right to extract.

There is a progression across the cases in the complexity of contracting the degree to which clearly defined exclusive rights were assigned to individuals. For example, agreements on private mineral rights were made quickly with periodic adjustments in the law to reduce ownership

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uncertainty and to correspondingly promote investment and production. Subsequent allocation of federal agricultural land in the nineteenth century was much more controversial, and the conflicts among competing claimants helped to mold the land policies that were adopted. The assignment of private property rights was delayed and in some cases blocked. In the cases of fisheries and crude oil extraction, property rights agreements have been limited both by the nature of the resources and by conflicts among claimants over the distribution of the gains achieved by mitigating common pool losses. For both fisheries and crude oil, costly regulatory arrangements have been instituted, but many margins have remained for dissipation of resource rents. The focus of analysis in this volume for these four cases varies. For the first two cases, which address efforts by various claimants to devise property rights to land and to obtain federal government recognition of those claims, attention is directed to political maneuvering among competing private claimants, politicians, and bureaucrats in shaping federal legislation. The goal is to explain why private property rights to federal mineral lands were established rapidly and endorsed unabridged by the federal government, while private property rights to federal range and timber land were much more difficult to establish politically. For the remaining two cases, involving regulation of fishing and crude oil extraction, the focus is directed more to the problems encountered in negotiations among fishermen and oil producers to devise rules for reducing rent dissipation. In the latter cases, the contracting history is very rich so that an analysis of the bargaining stands of the competing parties is possible.

In Chapter 2 an analytical framework is presented to examine contracting for property rights. The framework isolates the determinants of the aggregate benefits and costs of institutional change, the contracting parties involved, and the factors underlying the calculation of individual private net gains. In this way, the framework provides a basis for determining whether or not parties have incentive to support adjustment in property rights at any point in time to mitigate common pool losses and the political conditions under which contracting is likely to be successful. It shows that efforts to resolve disputes over the allocation of the gains from new property rights arrangements will not only prolong contracting, but mold the agreements that can be reached, with important implications for economic behavior.

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2

Analytical framework

INTRODUCTION

The nature in which property rights are defined and enforced fundamentally impacts the performance of an economy for at least two reasons. First, by assigning ownership to valuable assets and designating who bears the rewards and costs of resource-use decisions, property rights institutions structure incentives for economic behavior within the society. Second, by allocating decision-making authority, the prevailing property rights arrangement determines who are the actors in the economic system.

Because of these very basic and critical roles in influencing economic activity and the distribution of wealth and because of the wide variety of property rights arrangements that exist, it is important to analyze how various property institutions emerge. Although these issues have been introduced in Chapter 1, to go further a framework for analyzing the development and modification of property rights institutions is necessary. In this chapter, a conceptual framework is outlined to analyze four different property rights solutions to common pool problems encountered in exploiting natural resources in the United States. While addressing these four cases, the approach taken here can be generalized for examining other property rights issues.

The analytical framework is a very microoriented one. It focuses on the political bargaining or contracting underlying the establishment or change of property institutions, and it examines the motives and political power of the various parties involved. This approach is taken because ownership structures are politically determined, and they assign both wealth and political power in a society. Property rights are viewed here as being more than remnants of past legal and social traditions, although they are affected by them, and as being molded by political maneuvering and bargaining among many competing interest groups. The stands

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