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# COASE AND DEMSETZ ON PRIVATE PROPERTY RIGHTS

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In his seminal work, "The Problem of Social Cost," Coase held that in cases of private property right disputes involving what have been called externalities, "with costless market transactions, the decision of the courts concerning liability for damage would be without effect on the allocation of resources."[1] I shall try to show that this view is mistaken because it does not take account of psychic income. I shall then consider what can only be considered immoral implications Demsetz draws from Coase's view of property.

Let us suppose that the damage to a farmer's crops from a neighboring factory amounts to $100,000; that there is no way that the farmer himself can prevent the damage to his crops; that bargaining transactions between the farmer and the manufacturer are costless; that changes in the distribution of wealth between them can be ignored; and finally, that the manufacturer can stop the crop damage by installing a smoke prevention device (SPD) which will cost him $75,000.

Under these conditions, Coase would argue that whether the court assigns crop damage liability to the manufacturer or not, the SPD will be installed. This means that the allocation of resources between farming and manufacturing will not depend on the court decision. This means, moreover, that the value of production will be maximized, since a $75,000 cost will gain $100,000. How does this work?

If the court finds the manufacturer liable, and grants the farmer an injunction to stop the smoke pollution, the manufacturer is legally bound to install the SPD (or to cease operation). He will not be able to bribe the farmer into allowing him to pollute: The farmer can only be compensated by receiving at least the $100,000 which he would lose in damages and the manufacturer can get away with paying only $75,000 to install the SPD.

If the court does not find the manufacturer liable, then the farmer cannot get an injunction. The manufacturer is not legally bound to install the SPD. But note: The farmer stands to gain $100,000 (in undamaged crops) if he can convince the manufacturer to do something which costs only $75,000 (install the SPD). There will be a bargaining situation where a bribe from the farmer to the manufacturer of something between $75,000 and $100,000 will make them both better off. For instance, a payment of $90,000 will save the farmer $10,000 (the farmer can save $100,000 worth of crops at a cost of only $90,000) and will earn $15,000 for the manufacturer (the manufacturer receives $90,000 for installing a $75,000 SPD). What if the farmer just does not happen to have $90,000 lying around? This is not an insurmountable problem. The farmer does have $100,000 worth of crops lying around, which, presumably, will serve as collateral for a $90,000 loan. The farmer will obtain the $90,000 loan, pay the manufacturer the $90,000, sell his crops for $100,000, and then pay off the cost of the loan out of his $10,000 gain.

Now let us consider a case exactly like the preceding except for one thing: instead of there being $100,000 worth of crops lying around that can be ruined by smoke pollution, there is but one flower bed that can be so ruined. But this a rather special flower bed (to the farmer). Its pecuniary value to other people is nil; however, the farmer's mother, on her death

bed, asked him to care for it. It is so valuable to the farmer in a psychic sense, that only, as it happens, $100,000 would compensate the farmer for the ruination of the flower bed.

If the court finds the manufacturer liable, then the psychic loss case works out as did the pecuniary loss case: the manufacturer will have to install the SPD since he can install for less ($75,000) than what a bribe will cost him ($100,000 or more).

If the court does not find the manufacturer liable, then, as before, a bribe of something between $75,000 and $100,000 (say $90,000) will insure the installation of the SPD. If the farmer has $90,000 with which to save his flower bed, the SPD will be installed.

Coase's view breaks down when we consider the case of psychic income loss where the loser does not have the wherewithal to make a bribe greater than the cost of the SPD ($75,000). All the psychic income in the world may not be enough collateral to support a $90,000 loan to save a flower bed.

In this case, the allocation of resources *will* depend on the decision of the court. If the court holds the polluter responsible, the SPD will be installed; if the court does not hold the polluter responsible, the SPD will *not* be installed.

We now turn to a more realistic example to illustrate psychic income. Demsetz holds[2] that the same citizens would join the military "no matter whether taxpayers must hire military volunteers or whether draftees must pay taxpayers to be excused from service. For taxpayers will hire only those military (under the 'buy-him-in' property right system) who would not pay to be exempted (under the 'let-him-buy-his-way-out' system). The highest bidder under the 'let-him-buy-his-way-out' property right system would be precisely the last to volunteer under a 'buy-him-in' system."

When the phenomena of psychic income is incorporated into the analysis, however, it is by no means certain that "the highest bidder under the 'let-him-buy-his-way-out' property right system would be precisely the last to volunteer under a 'buy-him-in' system." Consider a died-in-the-wool-pacifist who *would* be the last to volunteer under the 'buy-him-in' system because of the extraordinary sacrifice of psychic values a military life would entail. How can we be sure that he would be "precisely" the highest bidder under the 'let-him-buy-his-way-out' property right system? He might be too poor to pay "precisely" the highest bid. He might be too poor to even pay a bribe that would keep him out of military service at all. His reserves of "human capital" might well be so low so as to be unable to borrow money to bribe his way out even if human beings could be used as collateral. In short, Demsetz is correct only if we may safely ignore psychic losses on the part of people who are unable to afford the bribe. Yet this case is one where this procedure would seem particularly dangerous. Psychic, not (so much) pecuniary, losses are likely to be very important; and draftable men are likely to be at a stage in their lives where they are unlikely to have been able to accumulate much capital.

A few words are in order here on the almost revolutionary changes in moral outlook implicit in this view of property rights. In the traditional moral view of private property rights, the "let-him-buy-his-way-out" property right system would be, if anything, a contradiction in terms, and not really a private property right system at all. According to traditional morality, each person is a self-owner. Any attempt to involve the individual in a "let-him-buy-his-way-out" system would necessarily involve *enslaving* him first. To first enslave a individual and to then offer him the possibility of buying his way out would have been thought of as equivalent to asking the individual to pay ransom to his kidnappers. To say the least, this would be anathema to a system of private property rights. And to further declare that "it makes no difference" whether an individual is kidnapped and then offered the possibility of paying ransom or whether the individual is not kidnapped but rather offered employment on a voluntary basis, would have been thought of as just adding insult to injury.

Demsetz considers another interesting case[3]:

> "Whether or not a new product will be profitable is, in the absence of exchange and police costs, independent of which property right assignment is chosen:

(A) Producers of new products are assigned the right to sell new products without compen-

sating competitors who are injured.

(B) Producers of old products are assigned to retain their customers."

I have already argued that this is correct only if negotiation costs, income or wealth effects, *as well as* psychic effects, can be safely ignored. Here I am concerned to point out the deviation from traditional private property views.

According to the traditional or libertarian view, old producers do not, cannot, must not, have any right to retain their customers, if for no other reason than that they do not *own* their customers in the first place. All they own is what they produce. More exactly, all they own are the *physical goods* that they produce. They cannot own the *value* of what they produce, because the value of a good is determined by other producers and consumers, (as well as by their own valuations), but none of these people are owned by the old producers. It is true that the advent of new producers can lower the value of what the producers own. So can the refusal of old customers to continue patronization. So can weather conditions, etc.

According to this traditional view of the free enterprise system, everyone has a right to try to compete. Likening destruction of physical property to the destruction of the value of property by forbidding the latter as well as the former can only be considered a travesty of the free enterprise, private property system.

Let us now consider non-zero transactions costs. Demsetz has advice to give on the assignation of property rights in the case of high transactions costs, where he concedes that court decisions are relevent to the allocation of resources. Demsetz calls attention to realignment costs and holds that they should have an important part to play in such assignments. Realignment costs are the costs of transacting that occur after the new assignment of property rights.

"For example, let us consider the property right problems associated with the introduction of home air conditioners. The question arises as to whether homeowners should have the right to prevent noise levels from rising above a given intensity or whether air conditioner owners should have the right to run their sets even though noise levels on surrounding land will be raised. If it is generally true that owners operate their sets that they will purchase most of the noise control rights from their neighbors, then exchange costs could be reduced by giving the initial assignment of rights to set owners. If set owners are given these rights, some homeowners will contract to buy them from set owners but, by assumption, the number and presumably the cost of such exchanges would be less than under the alternative assignment of rights. A number of sets that approximates the efficient number would be arrived at with the use of less resources for conducting exchanges if set owners are given the right rather than homeowners.[4]

Consider the case of very rich sadists who have a maniacally strong desire to torture poor people; such a strong desire, it might be added, that most sadists would be able to purchase most of the torture rights from their poorer fellows. According to the criteria of minimizing exchange costs, it would seem that the sadists should be given the "right to torture" in the first place. It need hardly be pointed out, except perhaps to the most thoroughgoing advocate of the "Coase - Demsetz" view[5], that granting rights to torture is incompatible with a free enterprise, private property system.

Coase also gives advice on assigning property rights. He considers the case where negotiation costs are greater than the expected gains to be obtained from such negotiations. He holds that: "In a world in which there are high costs of rearranging the rights established by the legal system, the courts, in cases relating to nuisance, are, in effect, making a decision on the economic problem and determining how resources are to be employed"[6].

An example will illustrate: Assume the previous case where installation of a smoke prevention device will cost $75,000, where monetary harm due to smoke is $100,000, where income effects are insignificant, but where the costs of negotiation are $200,000.

If the judge decides in favor of the farmer, the devise will be installed—not because it will not pay the manufacturer to bribe the farmer into accepting the smoke—but because it will be too expensive to negotiate the bribe.

In short, "The courts directly influence economic activity...when market transactions are so costly as to make it difficult to change the arrangement of rights established by the law[7]."

Coase then concludes:

"It would therefore seem desirable that the courts should

understand the economic consequences of their decisions and should, insofar as this is possible without creating too much uncertainty about the legal position itself, take these consequences into account when making their decisions"[8].

Coase urges the courts to make "a comparison between the utility and harm produced (as) an element in deciding whether a harmful effect should be considered a nuisance"[9].

In effect, I take Coase to be advising the court to decide in favor of that party which, in the absence of negotiation costs, would be unable to be bribed in the normal course of negotiations. In other words, the court should give the manufacturer the right to belch forth smoke upon the farmer if the monetary costs of installing a smoke prevention device were greater than the resultant monetary harm to crops. And the court should decide in favor of the farmer if the monetary costs of the smoke prevention device were less than concomitant financial damage to crops.

One might fear that such advice is not likely to maximize the value of production; that having the courts "adopt a rigid rule" might well "give economically more satisfactory results" than having the courts follow Coase's advice; that, in reality, it will not be likely for the court to take these economic consequences of their decision into account without creating too much uncertainty about the legal position itself.

First of all, the judges might act "very foolishly" and award the property rights to the wrong person. The task of comparing losses if the externality is allowed to continue, with losses necessitated by the cessation of the externality, is one calling for no mean level of skill. Can it be expected that judges appointed largely through the political process will judge correctly (more than half the time)?

Moreover, there is no market test to ensure that judges who are inept at evaluating relative losses make way for judges who have greater ability.

Even assuming that the courts will not be too inefficient in guessing relative costs, there are still problems with Coase's advice.

Presently, for every legal case that reaches the courts for final judgment, there are hundreds if not thousands of potential disputes that are not tried in the courts. Many cases can be settled out of court based on court precedents. Substituting the "flexible" court judgment of costs for rigid rule will impose extra costs in the form of more cases reaching the courts for adjudication, since precedents are not based on flexible judgments and evaluations.

There is the further problem of added uncertainty and consequent diminished ability to forecast and plan ahead. It is questionable whether it is possible to substitute judgment for rigid rules "without creating too much uncertainty about the legal position itself." The question is a marginal one: at what point do the gains (if, indeed, there are any) of more scope for judgments and evaluations of harm begin to be outweighed by the losses tied to inability to plan ahead?

Two analogies come to mind. One is the concept of "rule of law" associated with Friedrich Hayek. According to this philosophy men are freer contending with publicized rigid laws than with "judgments," "opinions," "estimates." "Laws" that judge "each case on its merits" like this would be more akin to absence of law than to its presence. (One cannot make too much of this philosophy with its emphasis on the *form* of the law and its dis-emphasis on the *content* of law. Laws that sentence all people to death at age forty can be well publicized, rigid, known in advance and are consonant in all ways with Hayek's rule of law; they are hardly conducive to freedom or justice, however.)

The other analogy is from the field of monetary policy. Milton Friedman has long been an effective spokesman for the view supporting monetary "rules" as against monetary "authority." His contention, made famous by the 5% rule, is that it would be an improvement to reduce the myriad activity of the Fed to one of increasing the money supply at a steady 5% per year. The arguments he marshalls are too well known to bear repition here; my point is that these arguments can be seen as defending the view that rigid rules might well be more efficient than allowing judges the "authority" to tinker around and estimate the benefits and harms associated with externalities.

But more important than any of these utilitarian considerations, we must reject Coase's advice because it is just plain downright *immoral*.

It is evil and vicious to violate our most cherished and precious property rights in an ill conceived attempt to maximize the monetary value of production. As the merest study of praxeological axioms will show, it is also *impossible* for an outside observer (the judge) to maximize the psychic value of production. I must conclude, then, with some advice of my own to the Chicagoans, Coase and Demsetz: a study of Austrian economics has great value, apart from its intrinsic merits; it will prevent straying from the paths of righteousness.

## NOTES

1. *Journal of Law and Economics*, (Oct. 1960), page 10.
2. "Toward a theory of property rights" by H. Demsetz in *Proceedings of the AEA*. Spring 1967.
3. "Some aspects of property rights", pp. 62-63. JLE, Oct. 1966.
4. "Some aspects", *op. cit.* p. 66.
5. This is not meant so as to obliterate distinctions in the two men's views. It is meant merely as a shorthand device.
6. See his "The Problem of Social Cost," *J.L.E.*, Oct. 1960, Section VII, pp. 19 - 28.
7. *Ibid*, p. 19.
8. *Ibid*, p. 19.
9. *Ibid*, p. 20.