Property Rights and the Coase Theorem

Recall the basic Coase Theorem: once property rights are established, the allocation of resources will be Hicks-Kaldor Optimal.

The crop loss will be non-optimal if property rights are unclear.

Recall the basic Coase Theorem

• The simple version of the Coase Theorem holds that economic output will be the same no matter what the property rights are.
• A more general version says the outcome will be efficient.

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The Coase Theorem

Number of Steers | Annual Crop Loss (Tons) | Crop Loss per Incremental Steer (Tons)
--- | --- | ---
1 | 1 | 1
2 | 3 | 2
3 | 6 | 3
4 | 10 | 4

However, this principle does not hold if transaction costs are high.

Think of the resort and the railroad. Whichever way we assign the property rights will influence income and hence the demand for (say) coal. In turn, the spillover effects will be non-optimal seen throughout society.

The Coase Theorem

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Some authors talk about social norms as a way of obtaining efficiency without the use of bargaining or property rights. For example if we all obey the commandment “Thou Shalt Not Steal” on moral or religious grounds, the problem with Farmer A and Farmer B disappears.

Transaction Costs
- We want to allocate resources to their best use, and property rights will help us do that. However, there are Transactions Costs
  - Search Costs
  - Bargaining Costs
  - Enforcement Costs

• If Transaction Costs ≈ 0
  – Allocation of property rights irrelevant.
  – Simply allocate property rights and let the bargaining process allocate the property
• If Transaction Costs >0
  – Allocation of property rights matters. We want to get it right.

• Can we lower Transaction Costs?
Transaction Costs

- Can we lower Transaction Costs?
  - To some extent.

The size of transaction costs depends on whether we are talking about a homogenous or heterogeneous good.

- Homogenous Good: one where there are many similar items. (A share of IBM stock or a can of soda).
- Heterogeneous Good: one where each item is unique. (A house or a piece of land).

The Coase Theorem and Transaction Costs

- Can we lower Transaction Costs?
  - To some extent.
- Can we “lubricate” the bargaining process?
  - To some extent

Smith owns a piece of land that is worth $100 to him and $150 to Jones. Efficiency requires that Smith sell to Jones.

Alas, they despise each other.
The Coase Theorem and Transaction Costs

- Can we lower Transaction Costs?
  - To some extent.
- Can we “lubricate” the bargaining process?
  - To some extent.
- Can the legal system get it right when the bargaining system fails?
  - To some extent.
The Coase Theorem and Transaction Costs

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We call this the Wisdom of Solomon. Today, information costs are lower. A modern Solomon would simply order a DNA test.

And to some extent, the courts should not try.