3. Property rights theory

Property rights theory is an exploration of how providing stakeholders with ownership of any factors of production or goods, not just land, will increase the efficiency of an economy as the gains from providing the rights exceed the costs.

3.1. Origins: Early Literature

For the present purpose of analyzing property rights theory within the context of strategic management, we take Coase (1937, 1959, 1960) as the conceptual starting point. Neoclassical economic theory portrays the market as an economic system where the price mechanism, Adam Smith's 'invisible hand,' efficiently and costlessly coordinates economic activities. Thus, resources are put to their most productive uses, and thereby the market arrives at an optimal output level (a Pareto optimal outcome). In the world of neoclassical economics theory, the existence of the firm is a paradox, since there is no compelling reason for the firm to exist if it is posited that markets function flawlessly and costlessly to reach an optimal output level. The economic reason the firm exists as a viable alternative to the price mechanism, of course, is because the price mechanism does not function flawlessly and costlessly.

There are strong parallels between Coase's 'Nature of the Firm' (1937) transaction costs paper and his 'Social Cost' (1960) property rights paper. In the 'Nature of the Firm,' because of the costs of operating the market, there are alternative modes of transacting. In the 'Social Cost' paper, (both positive and negative) externalities impede efficient market transacting, with the theoretical emphasis placed on how difficulties in perfectly delineating private property rights (i.e. positive transaction costs) imply different contracting outcomes. Therefore, the theoretical insight that is common to both Coase (1937) and Coase (1960) is that in a world of positive transactions costs a comparative assessment of different modes of organizing economic activities is needed. Or put differently, in a world of positive transaction costs, governance structures matter for efficiency outcomes according to transaction costs theory (Coase, 1937) and legal rules matter for efficiency outcomes according to property rights theory (Coase, 1960). Following Coase's seminal works, a comparative economic approach has been incorporated into subsequent theoretical and empirical developments in property rights theory (Demsetz, 1967, 1969, 1988) and transaction costs theory (Williamson, 1975, 1985, 1996).

Another important theoretical point in Coase (1960) and emphasized subsequently in Alchian (1965), Demsetz (1967), and Davis and North (1971), among others, is the dynamic (evolutionary) nature of institutional responses to

new contracting situations. Early property rights scholars have argued that economic institutions tend to move toward more efficient economic solutions through negotiations between the interested contractual parties. In a world of zero transaction costs, this economic process would be immediate and efficient. However, if transaction costs are positive and non-negligible, this economic process may be more gradual, and in some economic cases may result in failure to reach contractual agreement. Often, vested interests and existing political, social, and economic positions of contracting parties lead to inefficient economic outcomes. Indeed, North argues that no student of economic history can deny that efficient economic outcomes are the exception, rather than the rule.

3.2. Property Rights definition

Property rights define the theoretical and legal ownership of resources and how they can be used. These resources can be both tangible or intangible and can be owned by individuals, businesses, and governments.

In many countries, including the United States, individuals generally exercise private property rights or the rights of private persons to accumulate, hold, delegate, rent, or sell their property.

In economics, property rights form the basis for all market exchange, and the allocation of property rights in a society affects the efficiency of resource use.

3.3. Benefits of implementing property rights

- Opportunism is discouraged as it is harder to exploit a good protected by enforced property rights. For example, a song can be easily pirated from purchased copies and, with no punishment, this form of the free-rider problem likely occurs. This causes the price mechanism to be less effective at finding the true market equilibrium and hurts the owners of the good who did not get it through opportunism.
- The moral hazard is less likely to influence the actions of consumers, meaning they will be less likely to exploit resources unsustainably or inefficiently as property is protected. This will lead to a lower group cost overall as people will not be able to exploit these resources as easily, causing less inefficiency issues. For example, if a person's car doesn't have property rights, people will be more likely to mistreat it or steal it for a drive, as there are no real repercussions for doing so.
- Property rights are also believed to lower transaction costs by providing an efficient resolution for conflicts over scarce resources. Empirically, using historical data of former European colonies, Acemoglu, Johnson and Robinson find substantial evidence that good economic institutions – those that provide secure property rights and equality of opportunity – lead to economic prosperity.