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Development and Property Rights

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Abstract

This chapter argues that economic development originates not from the gains from trade and specialization under a division of labor but fundamentally from an institutional framework of property rights which permits the gains from trade and innovation that emerge on a societal wide scale. It is this framework that enables the transition from small-scale trading and capital accumulation to medium-scale trading and capital accumulation and finally to large-scale trading and capital accumulation. All of humanity was once poor; those societies that have been able to escape from poverty are those that were able to get on this development path by adopting the institutional framework of property, contract, and consent. We argue that well-defined and exchangeable private property rights yield economic growth by operating as a filter on economic behavior – the establishment of property rights embedded in the rule of law weeds out unproductive entrepreneurship and the corresponding politicized redistribution of property rights, with rent-seeking and predation as its consequence, and engenders instead productive entrepreneurship and a more efficient allocation of property rights and with that a realization of the gains from trade and the gains from innovation. The fundamental cause of economic development, we argue, is the institution of private property, as it is this institutional framework that results in productive specialization and peaceful cooperation among diverse and disparate individuals.

Introduction

In the introduction to their book, *How the West Grew Rich*, Rosenberg and Birdzell (1986) argue that little controversy exists that institutions, namely, private property rights as well as the rule of law and enforcement of contracts, are the fundamental determinant to economic growth. There is a general consensus among economists that the unprecedented gains in labor productivity and innovation beginning in the nineteenth-century England cannot be attributed exclusively to the proximate causes of growth, such as the expansion of international trade, the accumulation of physical capital, or utilization of the economies of scale, all of which by themselves exhibit diminishing returns to scale (Phelps 2013, pp. 5–8; McCloskey 2010, pp. 133–177). Rather, the fundamental cause of modern economic growth is the institutional framework that makes possible the increasing specialization and widening circle of exchange. The "virtuous cycle" is implied in Adam Smith's famous dictum that the "division of labor is limited by the extent of the market." Increased possibilities of trade result in increasing specialization and a more extensive division of labor, which in turn increases the productive capacity of individuals and leads to great trading opportunities. With specialization and trade, there is also great scope of opportunities for innovation.

An understanding of how private property generates economic development also provides a perspective of the processes that emerge from such an institutional environment, which is necessary

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for prosperity. Observation of countries around the world indicates that those countries with an institutional environment of secure property rights have achieved higher levels of various measures of human well being, including not only higher GDP per capita, but also lower infant mortality rates and higher rates of education. Private property rights structure human interaction by providing individuals three main mechanisms of social coordination and conflict resolution: (1) excludability, (2) accountability, and (3) exchangeability.

Well-defined and exchangeable private property rights yield economic growth by operating as an entrepreneurial filter. By structuring the costs and benefits of exchange, private property rights economize on the emergence of certain patterns of behavior by (1) filtering in productive entrepreneurship, leading to a more efficient partitioning of property rights and technological innovation as its outcome, and (2) filtering out unproductive entrepreneurship that leads to a politicized redistribution of property rights with rent-seeking and predation as its consequence.

The basic thesis of this entry is that the process of economic development goes as follows: the only way to achieve sustained increases in real income is to increase real productivity. Such increases in real productivity come from investments and technological innovation that increase and improve physical and human capital. However, because of the heterogeneity of capital, capital accumulation is a necessary, though not a sufficient, condition for economic growth. Such capital formation can only be undertaken through a decentralized price system, which coordinates the particularized insights of entrepreneurs about opportunities for gains from trade and gains from innovation. This manifests itself in technological change by discovering new and improved combinations of land, labor, and capital to satisfy the most valued consumer demands. The production plans of some must mesh with the consumption demands of others, and this is accomplished through the guiding influence of monetary calculation and the weighing of alternative investment decisions. Moreover, the allocation of entrepreneurship into productive activities that improve productivity and increase real income depends upon an institutional framework that widens the extent of the market for entrepreneurs "where they can take advantage of increasing returns to ability" (Murphy et al. 1991, p. 510). An institutional framework of secure and exchangeable private property rights is sufficient for the emergence of a decentralized price system that provides profit and loss signals to entrepreneurs to discover new technological opportunities, generating economic growth.

We Were All Once Poor

Since at least the days of Adam Smith, economists have debated why certain societies have grown rich while others have remained stagnant and poor. Despite the unprecedented economic growth that has transformed the West and more recently China and India, many parts of the world today, particularly sub-Saharan Africa, are still poverty stricken. Many development economists, most notably Jeffrey Sachs, have argued that sub-Saharan Africa has been stuck in a "poverty trap," resulting in unsustainable levels of economic growth that are not robust enough to bring Africa out of poverty. Africa's extreme poverty levels lead to low savings rates, which in turn lead to low or negative economic growth, which cannot be offset by large inflows of foreign capital. Therefore, an investment strategy focusing on specific *interventions*, defined broadly as the provision of goods, services, and infrastructure, would be required, including improved education, which in turn leads to reductions in income poverty, hunger, and child mortality. The concept of a "poverty trap" has been a long-standing hypothesis in theories of economic growth and development (Sachs et al. 2004).

The underlying premise behind the poverty trap hypothesis is that the conditions of poverty are unique to Africa and other developing regions around the world and that the West has been uniquely

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endowed with economic wealth. The poverty trap hypothesis leads to the presumption that the West can save Africa (Easterly 2009), particularly through increasing transfers of foreign aid. However, development economist Peter Bauer, one of the most outspoken critics of modern development economics in the twentieth century, wrote the following:

> To have money is the result of economic achievement, not its precondition. That this is so is plain from the very existence of developed countries, all of which originally must have been underdeveloped and yet progressed without external donations. The world was not created in two parts, one with ready-made infrastructure and stock of capital, and the other without such facilities. Moreover, many poor countries progressed rapidly in the hundred years or so before the emergence of modern development economics and the canvassing of the vicious circle. Indeed, if the notion of the vicious circle of poverty were valid, mankind would still be living in the Old Stone Age. (2000, p. 6)

The engine of growth that transforms a society from "subsistence to exchange" (Bauer 2000, p. 3) is trading activity, leading to what Adam Smith recognized as "the greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which is any where directed, or applied, seemed to have been the effects of the division of labour" (Smith 1776[1981], p. 13). The absence of exchange opportunities precludes social cooperation under the division of labor and the emergence of specialized skills and crafts.

Smith pointed out that the division of labor was limited by the extent of the market. By widening its extent, individuals could capture increasing returns from specialization and trade. While Smith had emphasized the role of international trade in promoting economic growth, Bauer focused on the neglect among development economists of "internal trading activity" which in emerging economies leads to "not only the more efficient deployment of available resources, but also the growth of resources" (2000, p. 4). When individuals exercise their comparative advantage, not only are they able to produce goods and services beyond their subsistence level of consumption, but such surplus consumption can be deferred as savings and investment, not only in physical capital but also in human capital. Through increasing investments in physical and human capital, economies become more productive.

What is lost among First World observers is that in the developing world, much of this investment takes place in nonmonetary forms. As most production in the developing countries is labor intensive and agriculturally based, "these investments include the clearing and improvement of land and the acquisition of livestock and equipment. Such investments constitute capital formation" (Bauer 2000, p. 11). Because much of this investment is not calculated in money prices, these forms of investment "are generally omitted from official statistics and are still largely ignored in both the academic and the official development literature" (Bauer 2000, p. 11).

The fundamental basis of economic development from subsistence to exchange entails well-defined, enforceable, and exchangeable property rights. Most of the developing world today remains poor because governments are predatory or because governments are unable to enforce private property rights, precluding the advance from subsistence to exchange. Just as Bauer pointed out that the "small-scale operations" of trade and nonmonetary investment are required for economic development, analytically speaking, what allowed for the birth of economic development in the West and in those emerging economies embarking in economic growth today was the development of various types of property rights arrangements:

> We ought not to be surprised if we find that in the relatively short history of man, he has already devised, tested, and retained an enormous variety of allocations and sharing of property rights. The history of the law of property reveals an overwhelming and literally incomprehensible variety. (Alchian 1961[2006], p. 33)

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The absence of tried and tested mechanisms of private property rights and their enforcement would have thwarted modern economic growth in the West and those developing countries emerging from poverty today. Within the framework of private property rights under the rule of law, individuals are able to form reliable expectations about how their land, labor, capital, and entrepreneurial talent can be permissibly utilized. In rich countries, property rights provide a framework of rules that provide a degree of legal certainty so that individuals reliably coordinate their actions amid the flux and "throng of economic possibilities that one can only dimly perceive" (Mises 1922[2008], p. 117) over an uncertain economic horizon.

Some Development Economics of Property Rights

James Buchanan stated "the economist should not be content with postulating models and then working within such models. His task includes the derivation of the institutional order itself from the set of elementary behavioral hypotheses with which he commences. In this manner, genuine institutional economic becomes a significant and important part of fundamental economic theory" (Buchanan 1968[1999], p. 5). However, throughout most of the twentieth century, neoclassical economists have largely neglected the framework within which exchange and production takes place. In the textbook neoclassical model, individuals are presumed to have perfect information and are able to engage in costless exchange without incurring any externalities, or third-party effects, on other individuals. Property rights are the given background of analysis of competitively perfect markets, but a theoretical framework cannot account for the innumerable contractual arrangements, such as firms and money, that emerge in order to reduce the transaction costs of engaging in market exchange.

However, the economic analysis of property rights, although neglected, was not completely overlooked. Scholars working within the property rights, law and economics, public choice, and Austrian market process perspectives all took property rights out from underneath the cover of the "given background" to analyze the evolution and allocation of property rights and how alternative institutional arrangements of property rights will have different consequences on the pattern of exchange and production. The leading twentieth-century economists who emphasized the importance of private property rights to economic theory were Ludwig von Mises, Friedrich Hayek, James Buchanan, Ronald Coase, Armen Alchian, and Harold Demsetz. Their research emphasized how different delineations of property rights lead to different economic outcomes. Because of scarcity of knowledge and other resources, competition among individuals emerges in all societies. However, the manner in which competition manifests itself was *institutionally contingent* to the cost-benefit structure of property rights. But as neoclassical economics grew increasingly focused on static equilibrium analysis after the 1930s, what emerged was an institutionally antiseptic theory of choice. This preoccupation with the properties of static equilibrium shifted theoretical attention away from the institutional context of choice, namely, how private property rights structure the marginal costs and benefits of choice that generate a dynamic tendency toward equilibrium (Boettke 1994[2001], p. 236). Economist Svetozar Pejovich defines property rights in this way:

> *Property rights are relations among individuals that arise from the existence of scarce goods and pertain to their use*. They are the norms of behavior that individuals must observe in interaction with others or bear the costs of violation. Property rights do not define the relationship between individuals and objects. Instead, they define the relationship among individuals with respect to all scarce goods. The prevailing institutions are the aggregation of property rights that individuals have. (italics original, 1998, p. 57)

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Private property rights structure human interaction by providing individuals three main mechanisms of social coordination and conflict resolution: (1) excludability, (2) accountability, and (3) exchangeability. Excludability means that individuals are free to use and dispose of their property rights over a particular resource and exclude other individuals from utilizing their property rights so long as they do not violate the property rights of other individuals, namely, the physical properties of their body and the resources they own.

Accountability assigns residual claimancy over the costs and benefits of an action initiated by an individual. Without private ownership, when a person uses resources, they impose a cost on everyone else in the society, leading to a tragedy of the commons. Therefore, private property rights provide accountability over the costs and benefits of individual's actions through the internalization of positive and negative externalities (Demsetz 1967, p. 350). Through such internalization, private property rights over resources provide the incentive for individuals to maximize the present value of their resources by taking into account alternative future time streams of benefits and costs and selecting that one which he believes will maximize the present value of his resources. Private property incentivizes individuals to economize on resource use and maintain capital for future production because the user bears the costs of their actions. Poorly defined and enforced property rights lead to overuse and depletion of resources since the decision maker of a particular action does not bear the full cost of his action.

Exchangeability of property rights not only allows individuals to make trades that both parties believe will make them better off. When rights over private property are transferable, it also provides an institutional framework within which a system of money prices emerges. The emergence of money prices provides the information to calculate the relative scarcity of different resources, such that "prices can act to coordinate the separate actions of different people" by communicating the dispersed and particular knowledge of millions of individuals (Hayek 1945, p. 526). People are able to observe prices and determine whether they value the property they have more than the money they could receive for it. Changes in price signals drive the movements in the demand and supply for different goods and services. These price changes provide the information to entrepreneurs as to what products are most urgently demanded and what inputs can be combined to most cheaply produce them. Absent the free exchange of private property rights, this *contextual* information embodied in money prices is not generated (Mises 1920[1975]). Since entrepreneurs have a property right, or residual claimancy, over their profits and losses, they also have every incentive to use resources to satisfy these most highly valued demands.

The crucial link between private property rights and such unprecedented economic growth lies with increasing returns to the division of knowledge embodied in entrepreneurial activity. As the extent and complexity of the market widen, so do the complexity and specialization of knowledge within the market. The effective partitioning of property rights enables individuals to specialize in applying their particularized knowledge of time and circumstance in the discovery of previously unnoticed profit opportunities conducive to capital investment and technological progress (Alchian 1965[2006], p. 63). Through this process, entrepreneurship effectively leads to greater productivity, higher real wages, an expansion of output, and an overall increase in human welfare.

Property Rights and Entrepreneurship

Certain institutional frameworks encourage the spontaneous order of the market economy, as well as its entrepreneurial drive towards economic growth, while others erect barriers to growth and pervert the incentives of entrepreneurs towards rent-seeking and predation. Private property rights and their

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exchangeability ensure the emergence of a spontaneous order, in which entrepreneurs are driven by consumer preferences and encouraged to invest in enterprises that spur innovation and create wealth. Through purposeful actions of entrepreneurs, economic resources and knowledge, which are dispersed and particular to time and place, are coordinated through the incentives of the price system. However, how entrepreneurs coordinate economic knowledge and resources depends heavily on the institutional framework, or the rules of the game, that happen to prevail in the economy.

The prosperity or stagnation of societies rests on the allocation of entrepreneurship (Baumol 1990). The institutions that constrain human behavior within a particular society largely influence how entrepreneurial activity will be allocated and the nature of their purpose, which may be productive or unproductive in result. In prosperous societies, in which exchangeable private property rights have prevailed, entrepreneurship has been driven by consumer preferences and led the market process to more efficient outcomes, leading to economic growth. Poor and stagnating societies are characterized by institutions that are interventionist and arbitrary, leading to the politicization of entrepreneurial activity. Such an environment encourages rent-seeking and predation and discourages innovation, capital investment, and economic growth.

It is not only because individuals have limited means to satisfy their innumerable wants that property rights structure the rewards and costs of human interaction but more fundamentally because knowledge about how to *discover* such means is scarce as well. Property rights structure the costs and rewards of utilizing particularized knowledge in the application and specialization of particular forms of entrepreneurial talent, both productive and unproductive.

Moreover, private property rights yield economic growth by operating as an entrepreneurial filter. By structuring the costs and benefits of exchange, private property rights economize on the emergence of certain patterns of behavior by filtering in productive entrepreneurship, leading to technological innovation and enhanced productivity, and filtering out unproductive entrepreneurship, which leads to rent-seeking and predation. In a world of uncertainty, the means by which individuals pursue different economic ends are unknown and must be discovered through entrepreneurship.

According to Israel Kirzner (1988, p. 179), entrepreneurship refers to the process of individuals acting upon profit opportunities “that could, in principle, have been costlessly grasped earlier.” In *Competition and Entrepreneurship*, Kirzner further elaborates on the process of entrepreneurship:

> The entrepreneur is someone who hires the factors of production. Among these factors may be persons with superior knowledge of market information, but the very fact that these hired possessors of information have not *themselves* exploited it shows that, in perhaps the truest sense, their knowledge is possessed not by them, but by the one who is hiring them. It is the latter who “knows” whom to hire, who “knows” where to find those with the market information needed to locate profit opportunities. Without himself possessing the facts known to those he hires, the hiring entrepreneur does nonetheless “know” these facts, in the sense that his alertness – his propensity to know where to look for information – dominates the course of events. (Kirzner 1973, p. 68, italics original)

Kirzner also states “the discovery of a profit opportunity *means the discovery of something obtainable for nothing at all*. No investment at all is required; the free ten-dollar bill is discovered to be already within one’s grasp” (Kirzner 1973, p. 48, emphasis in original). The entrepreneur’s role in the production process is to earn pure profit based on his “alertness” of where to find market data under uncertainty (Kirzner 1973, p. 67). It entails that the entrepreneur possesses the right knowledge at the right time for discovering new combinations of technological inputs for the production of new goods and services to their most valued uses. The entrepreneur does not mechanically respond to profit opportunities as a calculative, maximizing *homo economicus*. Rather, he is “alert” to price discrepancies between existing commodities and to discovering previously unknown opportunities

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for mutually beneficial exchange. It is the entrepreneurial element in each individual "that is responsible for our understanding of human action as active, creative, and human rather than as passive, automatic, and mechanical" (Kirzner 1973, p. 35). It is through the discovery of profit opportunities that entrepreneurs discover how resources must be allocated to satisfy their most valued uses.

The Smithian growth process that was described above rests not only on passive capital accumulation but more importantly on the increasing returns to knowledge that enlarge the extent for entrepreneurial activity. The emergence of knowledge externalities through the entrepreneurial pursuit of pure profit opportunities links the fundamental relationship between private property rights and economic growth (Holcombe 1998, pp. 51–52). Demsetz states that:

> Property rights develop to internalize externalities when the gains of internalization become larger than the cost of internalization. Increased internalization, in the main, results from changes in economic values, changes which stem from the development of new technology and the opening of new markets, changes to which old property rights are poorly attuned. (1967, p. 350)

Following Kirzner, Holcombe goes further to state that entrepreneurship drives the changes in relative prices and technology, from which:

> Knowledge externalities occur when the entrepreneurial insights of some produce entrepreneurial opportunities for others. Increasing returns occur because the more entrepreneurial activity an economy exhibits, the more new entrepreneurial opportunities it creates. (Holcombe 1998, p. 58)

The key to understanding the engine that drives the market economy towards efficient outcomes is the fact that today's inefficiencies are tomorrow's profit opportunities for entrepreneurs to seize upon such externalities of knowledge. However, this entrepreneurial market process requires that private property rights assign to entrepreneurs residual claimancy over the costs and rewards of their actions in the form of monetary profits and loss. The consequence of poorly defined property rights will be the destruction of wealth. Without secure property rights, economic calculation will break down, as money prices will not reflect the relative economic profitability of using different quantities and qualities of scarce inputs, such as land, labor, and capital. As a result, insecure property rights will shrink the extent of the market for productive entrepreneurship. Murphy et al. (1991) also point out that unproductive entrepreneurship is more prevalent in countries with poorly defined property rights since the market for rent-seeking is larger and more lucrative there. As they argue, "rent seeking pays because a lot of wealth is up for grabs," (1991, p. 519) particularly for those entrepreneurs who are successful at defining property rights through bribery, theft, or litigation. Such entrepreneurial activity is wasteful since entrepreneurs are committing their time, knowledge, and resources not to creating more efficient ways of producing goods and services but in transferring wealth or resisting other entrepreneurial competitors from capturing their rents (Tullock 1967, p. 228).

Conclusion

Economic development originates from trading activity, specialization, and social cooperation under a division of labor. But the *cause* of economic development is inextricably linked with a framework of well-defined, enforceable, and exchangeable private property rights. Economic growth and development, driven by entrepreneurship, cannot be explained independent of its institutional context, namely, private property rights. Entrepreneurship by itself cannot be the fundamental cause of economic development, since scarcity, competition, and entrepreneurship exist in all

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societies. Rather, the manner in which entrepreneurship manifests itself is a *consequence* of the structure of property rights (Boettke and Coyne 2003). The fundamental cause of economic development is the adoption of well-defined and exchangeable private property rights, which incentivizes entrepreneurship to act on profit opportunities that facilitate increasing gains from exchange and specialization, spurring capital investment, increased labor productivity, and higher real income.

Recognizing the link between property rights, entrepreneurship, and economic growth has important implications not only for economic theory but also for economic policy as well. Assuming away the institutional differences in property rights arrangements across countries leads to misleading policy advice about how poor nations can emerge from poverty. In the wake of the fall of the Berlin Wall and the collapse of communism in Eastern Europe, Peter Murrell asked whether neoclassical economics could underpin the reform of centrally planned economies. As he wrote, "reformers need a filter that interprets the experience of capitalist and socialists systems" (Murrel 1991, p. 59). Such a filter refers to a comparative institutional analysis of property rights that have emerged to fit the historical and cultural context of a particular time and place.

By focusing on the accumulation of production inputs, such as physical and human capital, to increase productivity and real income, economic policymakers have focused on investment as well as research and development to spur economic growth. However, failing to take account of the framework of property rights misleadingly places factor accumulation as a fundamental cause of economic development, rather than as a proximate cause. Capital investment by itself does not cause economic growth but emerges in response to productive entrepreneurship incentivized by a framework of private property.

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