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Comment
On Hodgson on property rights

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Abstract. Geoffrey Hodgson has a number of criticisms regarding the 'economic approach to property rights' that has been mostly championed by members of the UCLA and Washington departments of economics during the 1960s–1990s. In this short note I address these comments and point out that most are simply a matter of nomenclature. When there are disagreements they stem from Hodgson's failure to account for positive transaction costs and this literature's emphasis on operational explanations of organization.

1. Introduction

Geoffrey Hodgson is perturbed by the 'economic approach to property rights' (EAPR), and he opines that this line of theorizing has wrought more harm than good because it ignores traditional legal theory, downplays the importance of the law and the state, and mischaracterizes human motivation to the point that it snubs our moral nature. Therefore, he alleges, the approach is incapable of understanding a modern economy, let alone the role of property in such matters as collateralized loans and development.

Ironically, Hodgson, who is well versed in the history of economic thought, ignores the context within which the EAPR developed and exists, and therefore he fails to offset his costs with any benefits. More to the point, however, most of what bothers him amounts to little more than semantics and focus. When more than mere words are involved, however, his train falls off the track.

2. Legal *versus* economic property rights

The EAPR, first and foremost, is a literature founded and sustained by the desire to *understand* organization behavior. In this process, it has been discovered that the concept of 'property rights' has no behavioral meaning absent the concept of 'transaction costs'.[1] Nine times out of ten in a discussion of rights, the transaction cost idea is implicit: sometimes identified as enforcement or

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Thanks to Georffrey Hodgson for requesting this comment.

1 The older I get the more I feel like a broken record on this point. I first pointed this out in my 1988 dissertation, but published it in Allen (1991, 1997, 2000, and 2014).

measurement, sometimes assumed to be zero, sometimes assumed as a mere friction. When the transaction cost assumption is implicit, the concept of rights becomes a ship with a name but no rudder. Unfortunately, Hodgson's discussion of property lacks any reference to the cost of property, and so his argument drifts around; sometimes it makes sense, sometimes it does not.

Elsewhere, I have specified this relationship as: *transaction costs are the costs of establishing and maintaining (economic) property rights*, where 'economic property rights' are the 'ability to freely exercise a choice'. This notion is distinct from what the EAPR literature refers to as 'legal property rights' which are one's rights under the law to freely exercise a choice.

Recognizing this role of transaction costs leads to the first critical point: if transaction costs are zero, then there is no behavioral distinction between legal and economic property rights.[2] Here the set of choices under the law are identical to the actual set of choices. Yet in the real world this is practically never the case, and this distinction between these two concepts of rights was an early contribution of the EAPR. It forces an understanding that if transaction costs are positive, there is a difference between rights specified in the law and rights that actually matter for behavior. Therefore, since transaction costs are ubiquitous, considerations of *only* legal property rights will be inadequate for understanding behavior.

Thus, someone walking down a city street late at night might consider taking a short-cut down a dark alley. If, after three steps into the darkness the pedestrian sees the shadow of a shady character lurking up ahead, the fact that he has the legal property right to walk through the alley is quite irrelevant for what he does next. The explanation for why the walker turns around and spurns the alley for a longer route rests on the set of realistic choices held at that moment. The economic rights count for behavior.[3]

Contrary to Hodgson's claim that 'It is impossible to understand capitalism ...without an adequate conception of [legal] property' (2015), it is quite the opposite. Without an appreciation of the *distinction* between legal and economic rights it is unlikely that any real understanding of behavior is possible.[4] In the writings of Alchian, Demsetz, Cheung, and Barzel there is a long journey to this realization. Indeed, a full understanding of Coase's famous 1960 paper on social costs requires this distinction.[5] Hodgson's call to adopt a purely legal concept of property, amounts to abandoning this important distinction.

2 For much of his paper, this is the implicit assumption that Hodgson is making.

3 Which does not mean, as Hodgson often infers, that the EAPR assumes legal property is irrelevant.

4 For example, a full and adequate conception of legal property in the Soviet Union would still leave one baffled by why such well-specified rights failed to produce much output or happiness. There can be legal rights without economic ones. And as every crook knows, there can be economic rights without legal ones.

5 Any attempt to define the 'Coase Theorem' simply in terms of legal property rights, quickly leads to either nonsense or refutation. For example, see Cooter (1982).

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The second critical point is that there is a functional relationship between economic and legal property rights. The ability to make choices depends – sometimes critically – on the delineation of the legal rights. One cannot, in general, speak of economic rights without having some understanding of the legal consequence. This understanding may be implicit in many analyses, but it must be there nonetheless.

Hodgson goes back and forth on the role the law plays in the EAPR. On the one hand he acknowledges that the writers in this field accept the law's importance (e.g., 'Barzel did not argue that the law does not matter'. (2015)), but he repeatedly claims things like 'The mistaken removal of legal rights from the definition of property cannot be justified ...' (2015). No one is removing the law from property rights. Rather, the EAPR is interested in the functional relationship.[6]

3. Just semantics?

Hodgson makes a distinction between 'possession' and 'property'. He explicitly defines possession as the '...control or possible use of an asset or resource, irrespective of any assumed or decreed right to do so' (2015); and property as the '...the right of the owner or owners, formally acknowledged by public authority, both to exploit assets ...and to dispose of them by sale or otherwise' (2015, citing Pipes). He goes on to state 'The crucial difference [between possession and property] concerns the granting of formal rights by public authority. Hence property in its truest sense has another prerequisite – the political authority of the state'.

In earlier comments I suggested that there is an affine relationship between the four concepts. That is, 'possession' is essentially another term for 'economic property rights', and 'property' is essentially another term for 'legal property rights'. The proof of this is found in various claims in Hodgson's paper that are in agreement with the EAPR. Consider:

> The crucial difference [between possession and property] concerns the granting of formal rights by public authority
>
> [2015]

6 In discussing Barzel's notion that individuals maximize the value of economics rights, Hodgson states: 'These exclude "legal rights",.... individuals are indifferent to "legal rights", and act solely to maximize their enjoyment of assets under their control'. Since economic rights depend on legal rights, individuals who maximize the value of their economic rights must consider the legal rights. In failing to recognize the functional relationship, Hodgson arrives at a false conclusion.

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> Property is 'a creature of ...the legal system'.
>
> [2015]

> ...through social interactions involving authority and expectations it [property] also reinforces *de facto* ability to use and hold onto the asset.
>
> [2015]

> But the establishment of legal rights, ...can affect intentions or behavior. An economy involving mere possession is very different in nature and outcomes from one that has institutionalized rights of property.
>
> [2015]

In each case, a switch of 'possession' with 'economic property right' and 'property' with 'legal property right', would lead to no change in meaning.

Likewise, there is mostly agreement in conclusions. Consider

> ...there are good reasons to confine the definition of law to circumstances where there is a state with and institutionalized judiciary and legislature. This does not mean that custom is unimportant, but that law is more than custom alone.
>
> [2015]

> ...it is important to understand extra-legal enforcement mechanisms ...but we should not pretend that might and right are the same.
>
> [2015]

Once again, no one using the EAPR would disagree with either statement. Much of Hodgson's paper boils down to these distinctions without a difference. When there is a difference, it often comes down simply matters of emphasis.[7]

Hodgson rejects the 'merely semantics' comment for three reasons: using the word 'right' to describe matters of 'control' is misleading; it diverts attention away from moral duties to obey authority; and the EAPR would still have an 'inadequate treatment of (legal) property rights as collateral to obtain loans' (2015). The first reason is as compelling as saying Fahrenheit is misleading because some freezing temperatures are positive numbers.[8] The second reason is a matter of opinion, and unlikely in any event (the question of moral duty is dealt with below). Finally, the third reason is a non-sequitur: if there is just an affine transformation, then Hodgson's nomenclature must also be inadequate.

7 For example, his discussion of von Mises, Marx, Demsetz, Posner, Alchian, Barzel, and Allen is reasonably accurate. Most of his criticism is only that too much of their work is centered on possession, customs, and other non-legal matters. However, one cannot conclude from this that the EAPR is incapable of analyzing the law. Indeed, there are thousands of examples of such work, and many papers by Posner, Barzel, and Allen deal specifically with the law.

8 If either terminology is confusing, it is Hodgson's. Consider 'The exchange of property involves a minimum of not two parties but three, where the third is the state...' (2015). At first glance this seems nonsensical. Crusoe and Friday engaged in trade without the state, institutions like marriage predate the state, and bitcoin was created to have exchange *without* the state; how can exchange require the state? Nonsensical, that is, until one realizes that 'property' is 'legal property rights' and so the statement is true by definition.

However, this last point is simply false, the EAPR can and has provided explanations of collateral.[9]

4. The heart of the matter

If the dispute Hodgson raises is simply over terms, emphasis, and subjects of research, there's little to write home about. However, I believe what really upsets Hodgson is found in Section 3 where he discusses issues of motivation, utility, and instrumentalism. There is no question that the EAPR is instrumental and unabashedly interested in operational explanations of human behavior. Though many in the field *believe* that the rubber meets the road at the level of the transaction, and that observable constraints are where all the action lies, this religious element is of secondary importance. Hodgson, on the other hand, *believes* that a true theory of human understanding must have a set of true assumptions – mere explanation be damned. But how well does Hodgson make his case?

Not well. His first problem is that he confuses 'motivation' with 'objectives'. Every economic argument assumes a motivation of maximization; indeed, this is what makes it 'economic'. However, that says nothing about what the objective is or what is contained within the objective. For Hodgson, 'moral sentiments' are considered a motivation, which is simply wrong. Moral sentiments are elements of a utility function and likely part of one's personal constraints.[10] As Hodgson accepts, however, claims about '*utility* maximization are strictly unfalsifiable' (2015, emphasis added).[11] Adding morality or anything else into the utility function is a game often tried, and always failed. In the words of Stigler and Becker:

> No significant behavior has been illuminated by assumptions of differences in tastes . . . such theories have been a convenient crutch to lean on when the analysis has bogged down . . . [giving] the appearance of considered judgment, yet really have only been ad hoc arguments that disguise analytical failures.
> [1977]

Further to this, Hodgson also confuses moral behavior with constraints. He suggests that citizens obey laws because they recognize 'legal authority'. But why obey authority? He claims because in democracies there is a belief that state

9 See Barzel (1997), chapters four and five, for example.

10 Even in a post-Christian world it is probably still safe to assume that Jesus was moral. On the one hand, Jesus did what He wanted, he was self-interested. On the other hand, He did the will of the Father, namely his objective included the utility of the Father, and he was therefore moral. Likewise, throughout the New Testament, Christians are called to throw off their old set of ...preferences, and act on a new set of preferences. The objective function changes for the righteous man, not the motivation.

11 Hodgson's quotes of Coase in the section are misleading. Coase never objected to the motivation of self-interest. Rather he found the concept of utility and the calculus around it sterile.

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authority is 'legitimate'. But what makes it legitimate? Could it be that we play some type of social repeated game that reduces the transaction costs of dealing with each other? Claiming unobservable beliefs as the source of obedience might be true, but it is still subject to the Stigler and Becker critique. Hodgson goes on to say that obedience might occur because 'it is believed to be moral'. But are violations of moral laws not enforced by God? Perhaps it is not the utility function that needs adjusting, but rather the set of relevant constraints for those who hold these moral values? Yet, if the matter is just one of a missing constraint, then where is the problem with the EAPR? Go ahead, add the constraint.

5. Conclusion

There is one final reason for rejecting the Hodgson's argument: at the end of the day it leads him to a wrong conclusion. By *modus tollens*, a false conclusion means there must be something wrong with the case made.

Section 5 is called 'Property rights and economic development' and for Hodgson this is the last nail in the coffin for the EAPR. It is an ironic subject not just because modern economic development got its start with the EAPR, but because he also uses the example of China. Cheung might be considered the father of modern development economics given the publication of his watershed book *The Theory of Share Tenancy* in 1969. His most recent book on the economic development of China (2009) makes a nice book-end. From North, Acemoglu, and the emerging work of many institutional economists in China, progress has been made on the nature of growth and development mostly based on the fundamental ideas found in the EAPR. This literature does not 'overlook' the legal aspects of property rights, indeed it is an integral part (e.g., see Cheung (2009)). Reading Section 5 was like listening to someone describe the house I live in, and not being able to recognize the house.

Academics should worry about terminology once they have solved all of the problems in their discipline. The EAPR has, and is, making advances in understanding the world around us. But we're just getting started, and perhaps Hodgson is correct that not enough attention is directed at the law itself. However, rather than discard productive and hard fought ideas, let us use them to carry on the good work of seeking operational explanations.

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