

Case Study: The Coase Theorem and Informal Property Rights

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In his seminal paper, Ronald Coase (1960) presented what was later called a “theorem” bearing his name:

“It is always possible to modify by transactions on the market the initial legal delimitation of rights. And, of course, if such market transactions are costless, such a rearrangement of rights will always take place if it would lead to an increase in the value of production.”

One of the most quoted papers in economic history, it opened a flood of research and discussion. Some of it centered on transaction costs and whether these would be sufficiently high or low to inhibit or to allow such market transactions. Among these costs, the very definition of property rights takes an important role. If it is not clear to whom they belong or what use can be made of an asset, a good deal of effort may be needed first to clarify the issue and then to proceed with the transaction.

Nevertheless, if we stick to the subjective nature of value, costs are subjective as well and inimical to the acting individual. Valuation becomes evident only as “revealed preference” in action. Therefore, there is not much that an independent observer can say except that if the transaction was made it must be assumed that the involved parties thought “it would lead to an increase in the value of production” and if not, that the subjective costs were higher than the subjective benefits.

To test this proposition, we conducted a field research experiment in a shanty town in the suburbs of Buenos Aires where there is no formal definition of property rights in housing. Would there be transactions in this case? (Hidding Ohlson & Krause, 2010).

The Neighborhoods of San Isidro

San Isidro is located some 20 miles north of the place where Buenos Aires was founded in 1580, in a border zone between the areas occupied, or rather transited, by the Guaraní and Querandí tribes. Juan de Garay, the founder, distributed parcels on the northern coast of the River Plate among his men somewhere beyond San Isidro. Only two centuries later, a small town to be named San Isidro, Madrid’s patron saint, started to grow. It completed its development thanks to the migration of people resulting from the economic boom of Argentina in the second half of the 20th century.

Large estates were parceled and created the urban downtown with a residential neighborhood of large parcels and houses named Lomas de San Isidro. La Cava is an informal settlement created mainly on government land. In 1946, the state water company, Obras Sanitarias, asked the federal government for this plot of land to use the red soil to filter water and to manufacture bricks, generating a sink or “cava” – from the Spanish word to dig or to excavate – and giving its name to the estate. The digging soon reached groundwater and the project was set aside. The sink was partially refilled and started to be settled by squatters on the 50 acres of its present area. According to different census estimates, there were between 1,700 to 2,100 houses and between 8,000 to 11,000 people, though the area housed a larger population in the past.

In San Isidro, as in most of the other city neighborhoods, the right to property is guaranteed by a title recognized by law, granting its validity to any legal claim, allowing sale and purchase, mortgaging it, and protecting possession against usurpation. Of course, such guarantee is relative considering Argentina’s low institutional quality and the lack of trust in its political and judicial systems. The 2009 *International Property Rights Index*, for example, shows Argentina in position 80 with a total score of 4.3 (on a scale of 1 to 10).

In La Cava, only 16 percent of those polled said they have a property title for their houses. Some even asked what that was. Among the rest, 17 percent said they have an informal document, usually consisting of an informal sale/purchase invoice. Altogether, 84 percent said they do not have formal documentation. On average, they lived 15 years at the same house, which shows low turnover rates. Those who said they have a property title also have lived at the same house 15 years on average. When asked how they acquired their home, 37 percent bought it, while 26 percent built it. In many cases, people added homes as annexes of a family house. Six percent say they got their house from the government.

There are not many problems in the sale/purchase of housing because deals are made with people they trust and payment is in cash at the moment of possession (90 percent of respondents). Only 27 percent said there could be installments but much trust or familiar ties were needed.

We asked La Cava dwellers how they solve problems with neighbors when there is conflict related to continued coexistence, such as negative externalities. As an example, what happens if a neighbor whose home is at a close distance away plays music at a high volume or emits smoke or nasty odors? What if there are problems with the dividing walls or unclear borders between one property and the next, or someone builds a second floor blocking sunlight or damaging the other? Houses are quite precarious, and these are real possibilities.

Confirming conclusions from a subjective cost interpretation of the Coase Theorem, 76 percent said they solve these problems by talking with the other side. They prefer not having intermediaries, either from the same neighborhood or outside, and they avoid violence at all cost. Only in extreme cases do they resort to it. They know they cannot go to the authorities, and starting violence is a dangerous game. Besides, in a place where people live very close to each other, having a good relationship with neighbors is an important asset. Those unresolved cases have to do with the nature of the neighbor; they must evaluate his/her reaction, and sometimes it is better to bear the cost of the externality than the cost of attempting a solution.

As mentioned, one source of high transaction costs is a disagreement over property rights. It makes bargaining costly and prevents a negotiated internalization of the externality. Nevertheless, what really matters to the application of the Coase Theorem does not seem to be just the formal definition of the right to property, but that neighbors know and respect the informal right. This includes not just the definition of the land plot and its borders but also its accepted use and effects on third parties.

The high proportion of answers related to negotiated solutions shows there are common codes of conduct regarding alternative uses of properties, which facilitate negotiations. They are not legal “ordinances,” but they fulfill similar functions. They demand consensus and generalized acceptance to become “social norms.”

The lack of formal property rights does not prevent the transfer of the possession, although it does not allow for the existence of mortgage credit and disincentivizes investment. Acceptance of “informal” rights allows for a solution of negative externalities in most cases. Many “public goods” are supplied voluntarily, others not.

Personal relationships and goodwill are critical when there are no written rules or cases in which different rules apply to different people. It is important who happens to be your neighbor because there are no clear mechanisms to resolve disputes. Regarding security, they are at the mercy of criminals and must rely on their capacity to defend themselves. Houses are bought and sold among known parties, groceries lent to those who they trust, and people are afraid of moving if they do not know who will be their new neighbors.

A lack of formal property rights prevents dwellers of La Cava from accessing credit, some public services, even jobs, and having a sense of security provided by ownership. They cannot appeal to formal authorities to solve problems of negative externalities. The absence of authorities increases subjective transactions costs because residents must evaluate personal reactions among other residents.

In conclusion, the Coase Theorem is verified in such informal settings though it should probably be rewritten to take into account the subjective nature of transaction costs. We offer the following suggested rewrite: “It is always possible to modify by transactions on the market the initial legal or informal delimitation of rights. And, of course, if such market transactions are worth the subjective costs for the parties, such a rearrangement of rights will always take place if it would lead to an increase in the value of production.”

Reference List

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