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**The Ethics and Economics of Private Property**

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**[excerpted from chapter in a forthcoming book]**

***V. Chicago Diversions***

At the time when Rothbard was restoring the concept of private property to its central position in economics and reintegrating economics with ethics, other economists and legal theorists associated with the University of Chicago such as Ronald Coase, Harold Demsetz, and Richard Posner were also beginning to redirect professional attention to the subject of property and property rights.<sup>1</sup>

However, whereas for Rothbard private property and ethics logically precede economics, for the latter private property and ethics are subordinate to economics and economic considerations. According to Posner, whatever increases social wealth is just.<sup>2</sup>

The difference between the two approaches can be illustrated considering one of Coase's problem cases: A railroad runs beside a farm. The engine emits sparks, damaging the farmer's crop. What is to be done?

From the classic viewpoint, what needs to be established is who was there first, the farmer or the railroad? If the farmer was there first, he could force the railroad to cease and desist or demand compensation. If the railroad was there first, then it might

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<sup>1</sup> See Ronald Coase, *The Firm, The Market, and the Law* (Chicago, University of Chicago Press, 1988); Harold Demsetz, *Ownership, Control, and the Firm* (Oxford: Basil Blackwell, 1988); Richard Posner, *The Economics of Justice* (Cambridge: Harvard University Press, 1981).

<sup>2</sup> Posner, *The Economics of Justice*, p. 74: "an act of injustice (is defined) as an act that reduces the wealth of society."

continue emitting sparks and the farmer would have to pay the railroad to be spark free.

From the Coasean point of view, the answer is twofold. First and "positively", Coase claims that it does not matter *how* property rights and liability are allocated as long as they *are* allocated and provided (unrealistically) that transaction costs are zero.

Coase claims it is wrong to think of the farmer and the railroad as either "right" or "wrong" (liable), as "aggressor" or "victim." "The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is, How should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would be to inflict harm on A. The real question that has to be decided is, Should A be allowed to harm B or should B be allowed to harm A? The problem is to avoid the more serious harm."<sup>3</sup>

Further, given the "equal" moral standing of A and B, for the allocation of economic resources it allegedly does not matter to whom property rights are initially assigned. Suppose the crop loss to the farmer, A, is \$1000, and the cost of a spark apprehension device (SAD) to the railroad, B, is \$750. If B is found liable for the crop damage, B will install an SAD or cease operations. If B is found not liable, then A will pay a sum between \$750 and \$1000 for B to install an SAD. Both possibilities result in the installation of an SAD. Now assume the numbers are reversed: the crop loss is \$750, and the cost of an SAD is \$1000. If B is found liable, he will pay A \$750, but he will not install an SAD. And if B is found not liable, A is unable to pay B enough to install a SAD. Again, both scenarios end with the same result: there will be *no* SAD. Therefore,

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<sup>3</sup> Ronald Coase, "The Problem of Social Cost," in: idem, *The Firm, the Market, and the Law*, p. 96.

The moral perversity of this claim is best illustrated by applying it to the case of A raping B. According to Coase, A is not supposed to be restrained.. Rather, "we are dealing with a problem of a reciprocal nature." In preventing A from raping B, harm is inflicted on A because he can no longer rape freely. The real question is: Should A be allowed to rape B, or should B be allowed to prohibit A from raping him/her? "The problem is to avoid the more serious harm."

regardless of how property rights are initially assigned, according to Coase, Demsetz and Posner the allocation of production factors will be the same.

Second and "normatively" - and for the only *realistic* case of *positive* transaction costs - Coase, Demsetz and Posner demand that courts assign property rights to contesting parties in such a way that "wealth" or the "value of production" is maximized. For the case just considered this means that if the cost of the SAD is less than the crop loss, then the court should side with the farmer and hold the railroad liable. Otherwise, if the cost of the SAD is higher than the loss in crops, then the court should side with the railroad and hold the farmer liable. Posner offers another example. A factory emits smoke and thereby lowers residential property values. If property values are lowered by \$ 3 million and the plant relocation cost is \$2 million, the plant should be held liable and forced to relocate. Yet if the numbers are reversed - property values fall by \$2 million and relocation costs are \$3 million - the factory may stay and continue to emit smoke.

Both the positive and the normative claim of Chicago law and economics must be rejected.<sup>4</sup> As for the claim that it does not matter to whom property rights are initially assigned, three responses are in order. First, as Coase cannot help but admit, it certainly matters to the farmer and the railroad to whom which rights are assigned. It matters not just how resources are allocated but also who owns them.

Second and more importantly, for the value of social production it matters fundamentally how property rights are assigned. The resources allocated to productive ventures are not simply given. They themselves are the outcome of previous acts of

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<sup>4</sup> See also Walter Block, "Coase and Demsetz on Private Property Rights," *Journal of Libertarian Studies*, Vol.1, no. 2, 1977; idem, "Ethics, Efficiency, Coasian Property Rights, and Psychic Income: A Reply to Harold Demsetz," *Review of Austrian Economics*, Vol. 8, no. 2, 1995; idem, "Private Property Rights, Erroneous Interpretations, Morality and Economics," *Quarterly Journal of Austrian Economics*, Vol. 3, no. 1, 2000; Gary North, *The Coase Theorem: A Study in Epistemology* (Tyler, Texas: Institute for Christian Economics, 1992); idem, "Undermining Property Rights: Coase and Becker," *Journal of Libertarian Studies*, Vol. 16, no. 4 (forthcoming).

original appropriation and production, and how much original appropriation and production there is depends on the incentive for appropriators and producers. If appropriators and producers are the absolute owners of what they have appropriated or produced, i.e., if no liability vis-à-vis second- or third-comers arises out of acts of appropriation and production, then the level of wealth will be maximized. On the other hand, if original appropriators and producers can be found liable vis-à-vis late comers, as is implied in Coase's "reciprocity of harm" doctrine, then the value of production will be lower than otherwise. That is, the "it doesn't matter" doctrine is counterproductive to the stated goal of wealth maximization.

Third, Coase's claim that the use of resources will be unaffected by the initial allocation of property rights is not generally true. Indeed, it is easy to produce counterexamples. Suppose the farmer does not lose \$1000 in crops because of the railroad's sparks, but he loses a flower garden worth \$1000 to him but worthless to anyone else. If the court assigns liability to the railroad, the \$750 SAD will be installed. If the court does not assign liability to the railroad, the SAD will *not* be installed because the farmer simply does not possess the funds to bribe the railroad to install an SAD. The allocation of resources is *different* depending on the initial assignment of property rights.

Similarly, contra the normative claim of Chicago law and economics that courts should assign property rights so as to maximize social wealth, three responses are in order. First, any interpersonal comparison of utility is scientifically impossible, yet courts must engage in such comparisons willy-nilly whenever they engage in cost-benefit analyses. Such cost-benefit analyses are as arbitrary as the assumptions on which they rest. For example, they assume that psychic costs can be ignored and that the marginal utility of money is constant and the same for everyone.

Second, as the numerical examples given above show, courts assign property

rights differently depending on changing market data. If the SAD is less expensive than the crop damage, the farmer is found in the right, while if the SAD is more expensive than the damage, the railroad is found in the right. That is, different circumstances will lead to a re-distribution of property titles. No one can ever be sure of his property.<sup>5</sup> Legal uncertainty is made permanent. This seems neither just nor economical; moreover, who in his right mind would ever turn to a court that announced that it may re-allocate existing property titles in the course of time depending on changing market conditions?

Finally, an ethic must not only have permanency and stability with changing circumstances; an ethic must allow one to make a decision about "just or unjust" *prior* to one's actions, and it must concern something under an actor's control. Such is the case for the classic private property ethic with its first-use-first-own principle. According to this ethic, to act justly means that a person employs only justly acquired means - means originally appropriated, produced, or contractually acquired from a previous owner - and that he employs them so that no physical damage to others' property results. Every person can determine *ex ante* whether or not this condition is met, and he has control over whether or not his actions physically damage the property of others. In distinct contrast, the wealth maximization ethic fails in both regards. No one can determine *ex ante* whether or not his actions will lead to social wealth maximization. If this can be determined at all, it can only be determined *ex post*. Nor does anyone have control over whether or not his actions maximize social wealth. Whether or not they do depends on *others'* actions and evaluations. Again, who in his right mind would subject himself to the judgment of a court that did not let him know in advance how to act justly and how to

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<sup>5</sup> Posner, *The Economics of Justice*, p. 70-71, admits this with captivating frankness: "Absolute rights play an important role in the economic theory of the law. ... But when transaction costs are prohibitive, the recognition of absolute rights is inefficient. ...property rights, although absolute, (are) contingent on transaction costs and subservient or instrumental to the goal of wealth maximization."

avoid acting unjustly but that would judge *ex post*, after the facts?

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