

# **Alternative Visions of Incomplete Property Rights**

SUZUKI Yasushi

College of Asia Pacific Management

Ritsumeikan Asia Pacific University

Md. Dulal Miah

Graduate School of Asia Pacific Studies

Ritsumeikan Asia Pacific University

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# Alternative Visions of Incomplete Property Rights

Yasushi SUZUKI<sup>1</sup> and Md. Dulal Miah<sup>2</sup>

**Abstract:** This paper attempts to unfold a neoclassical paradox generated by transaction cost and residual right explanations toward a well defined property rights and argues that those received models fail to identify attributes that lead to positive transaction cost. As a result, assigning residual right does not always lead society to be better-off as the model claims. Our examination of some cases from a developing country supports the hypothesis and substantiates that the nature and consequence of property rights of a particular country are mostly determined by the political choices and relative balance of power among conflicting interest groups rather than the spirit of easing transaction costs or economic benefits of the society. The paper also argues that transaction cost is at best necessary but not sufficient for property rights to remain incomplete which is a sharp contrast to the argument put forth by neoclassical model.

**Keywords:** property rights, transaction cost, state failure, social margin of safety

**JEL Classification:** P14, P16, P26

## 1. Introduction

The institution of property rights is crucial for providing rational actors with proper incentives to undertake productive efforts. Perfect delineation property right system is, thus, the first best alternative that through creating sufficient incentive ensures maximum benefits for the society. However, the question emerges: to what extent rights can be delineated? Assigning property right involves with the issue of internalizing the externality. Externalities evolve when there is a divergence between private and social costs. Notwithstanding the possibility that all voluntary

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<sup>1</sup> College of Asia Pacific Management, Ritsumeikan Asia Pacific University. E-mail address: szkya@apu.ac.jp.

<sup>2</sup> Graduate School of Asia Pacific Studies, Ritsumeikan Asia Pacific University. E-mail address: dulamd05@apu.ac.jp.

transactions are facilitated by the market, there still remain some interactions that ought to be internalized which market cannot cope with. The question is why? Coase's (1960) argument or generally known as Coase Theorem first sheds light on the issue bringing transaction costs to the forefront of the mainstream discussion. With costly transaction, some externalities remain. The assumption that property is placed where it takes its maximum value through the market exchange is likely the case when transaction cost remains lower than benefits received from the exchange. In contrast, where cost of transacting remains high, it is unlikely to take by an actor all the effects of resource uses into account. Thus, externality remains. It follows that how well rights to the property are delineated depends on the transaction costs.

In the standard economics literature property rights are defined as a bundle of rights whereas the bundle includes many different attributes of the underlying property. We can reach to the first best alternative if the contents of the bundle are perfectly specified *ex-ante*. This relates to the issues of identifying all the attributes of the property and also foreseeing flawlessly every future contingency that might be generated by the use of property. However, perfect specification of all attributes may not be possible because cost of doing so may outweigh the benefits received and thus actor has no motivation to delineate further. On the other, foreseeing *ex-ante* every bit of future contingencies is unlikely taking human bounded rationality into consideration. These forces compel potential actors to leave some property undefined and thus, first best alternative of wealth maximizing arrangement of property rights cannot be reached.

What are the sources of such contingencies or variations? Or in other words, what causes the variation in future outcome that makes it too difficult to precisely define? Mainstream view of property rights attributes any variation in mean outcome to technical differences generating from technology, human inputs etc. (Cheung 1983, Milgrom and Roberts 1992, Barzel 1997). Since exact distribution of outcome can not be made to input owners according to their respective efforts, perfect delineation of property rights is not feasible. This implies that externality remains and social and private costs do not coincide. Resultantly an input owner can be benefited without bearing the full cost of his actions and Pareto optimality is not attained. From this vintage point, this model argues that attributing ownership to input that effects mostly the variation in the outcome or in the economic parlance assigning 'residual right' is welfare enhancing. Persuasive though, success of the model depends on some important qualifications.

Factors with which the model is preoccupied for output variations can be attributed to sheer technical variations of inputs. How can we get rid of the presumption that output variations are also caused by the disturbance of fundamental uncertainty? Variations in outcome stemming from uncertainty as well as human bounded rationality are not taken into account in this model. Moreover, the efficiency issue with which the model is adhered relies on the assumption that residual claimant is not risk averse. If so, firstly potential residual claimant simply refuses to

become residual right holder, secondly, risk aversion characteristic undermines social welfare because opportunities of benefiting from undertaking some risky but high payoffs projects are forgone. Furthermore, who decides the residual claimants?

Answer of the question relates to the determinants that facilitate the evolution of property rights. In the standard neo-classical model the emergence of property rights is facilitated by some common factors such as technological changes, increased value of the property, innovation (Demsetz 1967). Meaning that evolution of property right relies on the marginal net benefits or greater utility (Pejovich, 1972, Anderson and Hill, 1975). Despite the fact that the model deserves some applicability we are however unable to accept that the proposition is universal. In most developing countries emergence of property rights is lead by some factors which are beyond the contents of that model. Political influence rather than the spontaneous market reaction plays critical rules in the process of allocating property rights in those countries. From this view, if the selection of residual claimants is motivated by the former factor, maximizing social benefits by having residual right arrangement is not materialized.

From this vintage point, this paper aims to argue: first, that variation in outcome is not confined merely to the technical variation of input but also driven by the fundamental uncertainty. As a result, assigning residual claimants does not always ensure maximization of social benefits. Second, complex political interactions influence the emergence of property rights in most developing countries and thus efficiency depends on the nature of that interaction. Third, emphasizing solely on high transaction cost for imperfect delineation of property rights departs the model from the reality because real world is blend with transaction cost and the constraint of human bounded rationality. Neither of them separately is sufficient for property rights to be incomplete. Moreover, a fine-tune nature of property rights is not necessary for welfare enhancing rather incomplete property rights may function as slack which acts as the buffer against uncertainty.

The structure of this paper is: section two critically evaluates the loop between transaction cost and property rights reflected in the neoclassical model. The new institutional perspective in respect of the evolution of property right is taken into account in section three whereas section four illustrates an alternative vision of incomplete property rights which is followed by a brief conclusion.

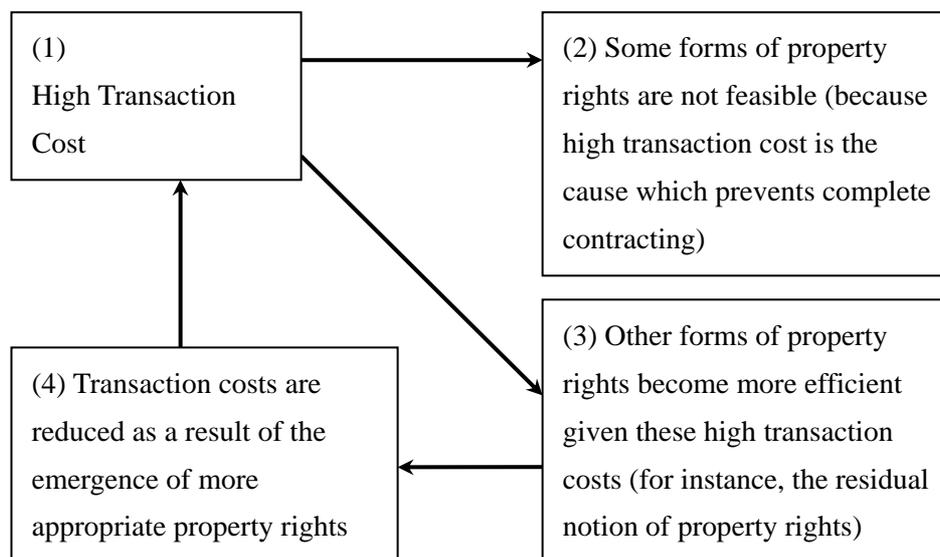
## **2. Mainstream Argument on the Loop between Property Rights and Transaction Costs**

Mainstream theories place *transaction cost* at the centre for analysing property rights. They assume it as the only reason for externality to exist and thus any solution for optimum use of

scarce resources or perfect delineation of property rights evolves with the notion of transaction costs. In his celebrated article *'The Problem of Social Cost'* Coase (1960) stated that in the absence of transaction cost, efficient allocation of resources will be adopted by the competing parties regardless of initial assignment of property rights. They reach a mutually agreed upon bargain because affected interacting parties have economic incentives to come into negotiation which leads to Pareto Optimality. However, this bargaining process might cease to exist, for instance, when an individual's action generates some externalities which he or she cannot be made liable to or compensated for, or when there are free-riders who intentionally shirk compensating. Perfect delineation of property rights for completely resolving these externalities or free-riding problems is not feasible because the nature of the associated transaction cost is prohibitive and problematic.

Indeed the loop between property rights and transaction costs has potentially many layers as property rights continue to evolve in response to transaction costs so we have to be very careful in setting up the problem and not confusing cause and effect. We would say that, on the one hand, extremely high transaction costs are themselves the "cause" which prevents complete definitions of rights (see vector 1 to 2 in Figure 1).

Figure 1 depicts the loop between transaction cost and the delineation of property rights



On the other hand, property rights will evolve in response to this problem and may once again become well-defined, despite the existence of high transaction costs (vector 1 to 3). For instance, Milgrom and Roberts (1992) have residual right explanation which states that yielding residual control and return rights to the same hands facilitates the evolution of more efficient form of property right. In this sense, the powerful explanation of transaction costs theory of property rights loses its supremacy to the residual rights model because the reason which the transaction costs

theory attributes the cause to imperfect delineation of property rights are the reason for emergence of more appropriate form of property rights according to residual rights theory. Or in other words, since well-defined property rights are well-defined rights over the residual control, residual right model becomes more important when transaction cost rises. When it is overly costly to monitor and check output variation caused by input owners, simply allocating residual rights to them resolve the problem and society is made better off. This implies that assigning residual control rights and returns to a single hand eliminates the necessity for writing a precise and complete contract, or to incur additional costs for overseeing so that there is no mismatch between the share of input employed and the output received. In this sense, transaction costs are reduced as a result of the emergence of more appropriate forms of property rights (vector 3 to 4). For the same reasons Barzel argues “making the person who can affect the flow bear full responsibility for his or her actions ensures that ownership becomes secure” (1997: 9). Since the cost of acquiring information would be much lower once rights are assigned and the assessment of the effects would be much easier, delineation of property rights would automatically lead to reduced transaction costs and thus prevalent structure of property right is the one that minimizes the cost of transacting. However, the prevalent efficient property right structure may transform into an inefficient one if some changes in economic circumstances take place. This implies that in dynamic economies, we go to the next round for responding to increasing transaction costs by emergent exogenous factors<sup>3</sup> such as technological changes (vector 4 to 1).

The received model is persuasive; however, its success depends on some important qualifications. It is probable that every right arrangement generates some residual claimants in one way or the other which might not be the efficient one. For example, the model assumes that person that greatly affects the outcome enthusiastically accepts the residual control rights. This assumption, however, falls into the crisis of empirical validity because if that is so, we can expect all types of firms are owned and managed by the same entity. But the reality is different because an individual is likely to assume ownership simultaneously rejecting controlling right and the

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<sup>3</sup> For example, private property rights on wild animal which was previously infeasible because of high transaction cost might have been possible with the invention of barb wire. Similarly, implementation of patent rights on genetically modified seeds was extremely costly to producers because once the seeds have been sold farmers can preserve and use for the subsequent period. Since producers cannot prevent farmers reproducing seeds some attributes of property remain unspecified but society is well-off. However, with the invention of built-in-obsolence in which the seed’s reproductive power is automatically terminated after first use, the existing property rights has transformed into an inefficient one. This means that exogenous changes in economic activities have led more efficient form of property rights which reduces transaction cost.

vice-versa. That is, an individual, preferable to become the residual claimant, just simply refuses to become so because of his risk-averse character. Thus, until we examine the risk preference of a potential residual claimant we are in the dark to conclude that merely assigning residual rights construes that rights are well-defined.

Moreover, who selects the residual claimants? According to the received model the process is spontaneous. Market forces automatically lead to bind the rights to the person who can best use of resources. If we take the "functionalist" approach, we have the danger of falling into a paradox that any property right structure which exists is the one which is the most appropriate for reducing transaction costs on the one hand, and at the same time residual rights emerge to reduce transaction cost on the other (vector 3 to 4). To resolve this puzzle we raise two explanatory hypotheses. First, the neoclassical paradox can be avoided if we introduce distributive conflicts in the process of moving from phase 3 to 4 that conflates with politics. That is, some disturbance may arise in the process which averts the emergence of the most appropriate forms of property rights. Secondly, the existing property right structure that is efficient may transform into an inefficient one if some changes in economic circumstances take place. The neoclassical model has failed to explain properly the causes of such changes no surprise because of its overly concern about transaction cost. In this model the variability of output is attributed merely to internal forces such as technical ability, shirking behaviour of input owner due to incomplete contracting and the like. However, political forces which have an overwhelming influence on output variability remains untouched. Politics, most often than not, is placed at the centre point for crucial state's decision including allocation of rights. In this sense, any prescribed model that excludes political force as a crucial factor for the evolution of property rights might not be compatible with welfare enhancing hypothesis and also deserves restricted applicability .

Critics may counteract that countries with matured democracy judiciary will safeguard not only undesirable political interference that causes outcome variability but also redress already misallocation of rights and hence constraint its adverse effects to the society. It is arguably the fact that the perception that judges deliberately or at least impulsively understands efficiency consideration is not true because of at least two reasons, bounded rationality as well as associated information imperfection, and the existence of uncertainty. Judiciary system in most developing countries is not free from political bias, especially countries where judiciary is not functionally and administratively separate from executive, politics can exert considerable power on it and prevents emergence of more efficient property rights system. Consequently, the ensuing system of formal rules and actions could be cumbersome and unreasonable. From this vintage point we argue that the neoclassical assertion that given high transaction cost assigning residual rights to person who mostly affect the mean outcome would automatically lead to reduced transaction costs is not universal. The model is incomplete because it does not take institutional constraints that cause

output variability into account.

### **3. Emergence of Property Rights: The New Institutional View**

Perfect delineation of property rights lies at the nexus between economics and politics in the sense that property rights may evolve in response to some economic opportunities but may end up with merely *de jure* right if enforcement authorities through their credible commitment do not shape it into *de facto* right. Current commitment is not sufficient to enforce credible property rights rather credibility of their persistence in the long run is also required for growth enhancing property system to exist. It is of instituting credible formal rules and their effective enforcement that brings politics to the forefront of property rights analysis (Diermeier *et al*, 1997). In the same token, Umbeck (1981) asserts that protection of property rights is not an economic good and thus, stable property rights require enforcement agencies with outright dominion which allows them to use force to those who have violated the rights of others. Where there is the necessity of force or dominion there needs a government (Scott, 1983).

In the frictionless market, government or central enforcement authority is simply neutral arbiter if not redundant institution. As a result, it is ubiquitous that emergence of more efficient form of property rights that reduce transaction cost is automatic. The fact to note is that the real economic activity is not only heavily entangled with politics but political choices most often than not precede economic considerations in most developing countries. In this sense law and government have much to do with the origin of property rights. This implies that there is no scope without deficiency to deny the existence of government of some sort (Riker, and Sened 1991). Bates (1995) argument is a clear manifestation about the presence of state in defining and protecting property rights. He contends ‘property rights, contract law, the power to regulate the production, and exchange of commodities – these and other economic institutions are created by the state’ (1995: 42). If the evolution of property rights is facilitated by some common determinants we would expect more uniform nature of property rights and North’s humanly devised constraints have a very little room to influence economic performance. North (1990) notes that scarcity and the needs to internalize the externalities, or reduced transaction cost, is neither necessary nor sufficient for the emergence of property rights. But rather they can still be emerged because of such determinants as political boundaries, charismatic leaders, and psychological reactions (Levmore, 2002).

Given the fact that government is an important player in the evolution of property rights, variability of outcome in the production process also results from government intervention which the received model fails to contemplate. Khan maintains “the result of such interventions in property rights has only been destructive. Unstable property rights have often been associated with

predation and plunder” (2004a: 30). A strong government can provide congenial institutions to fulfil market requirements but the same government is strong enough to change the rules further for its own interest. Once we assume utility maximizing individuals we have to accept that government is also utility maximizing entity like any other agent in the society. Thus, a theory of property right must describe the strategic behaviour of individual agents of society vis-à-vis the institutions that characterizes the polity in which they live (Sened, 1997).

Government’s utility maximizing propensity may take such form as tariffs and quotas, monopoly franchises and government licenses and any other arbitrary restrictions on market freedom created through government auspices. Transaction costs are increased when weak state as a problematic institution fails to enforce rights toward productive use (Khan, 1995). For Khan, transaction cost is the gap between the neoclassical production function and the real production function and these two do not coincide because there is resistance to change stemming from incumbent rent-seekers. In the weak state this results to structural failure because property rights that reduce transaction costs do not emerge. Just as efficient institutions can provide an enabling environment which enhances competitive behaviour and efficient growth path, an inefficient institution can persist because of their symbiotic relationship between them and the states. There is a contestation for any initial right allocation or reallocation of existing right between the interacting parties. In this contest, it is not guaranteed that rights will be allocated to those who can best use of resources rather balance of power between contestants determines the possessors of rights or whether rights will be defined at all (Libecap 1989, Firmin Sellers 1996). Khan (1995) therefore, argues “the net effects of an institution depend not just on the institutions and the production technologies it coordinates but also and critically on the balance of power between the classes and groups affected by that institutions, that is, on the *political settlement*”<sup>4</sup> (1995:77). In this process private property may emerge not because they economize on transaction costs but instead, because some of those who can mostly gain from restricted access can not restrict participants but they have strong influence on government and thus, encourage it to restrict the access on their behalf. Stiglitz’s (1994) objection on privatization perhaps, emanates from this fear that the decision to establish private rights on state property may be strongly influenced by interest groups rather than economic viability. Perpetuation of such tendency leads to state failure in the long run.

### **3.1. Type 1 State Failure**

Khan (1995) refers type 1 state failure, also called structural failure, to an institutional setting where social net benefits are lower than net benefits achieved by an improved institutional

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<sup>4</sup> Emphasize on original.

structure. In this sense, the point to note that if better institutions which bring improved performance cannot be attained the problem of type 1 failure is absent. This implies that some artificial obstacles are created in the society to use productive resources to an unproductive manner where state willingly or unwillingly intervene to create such rent for the benefits of some interest groups and thus society as a whole gets worse-off and resulting structural failure.

#### *State failure from inappropriate state intervention*

State failure can be attributed not only to state's doing of wrong things but to state's intervention either too little or too much about the right things. Too little intervention is followed where potential rent seekers seek inappropriate form of property rights which state cannot prevent because of its lax controlling power over them which we term '*failure of omission*'. On the other hand, in case of any attempt to rectify the decaying institution by the emergence of more productive and efficient one, too much intervention is noticed which we call '*failure of commission*'. State failure both from failure of omission and failure of commission are pervasive and severe in many developing countries. The following case has been drawn from Bangladesh to exemplify how inappropriate state intervention generates and sustains inapt property rights.

Recent Supreme Court verdict on *A Rouf Chowdhury and another vs. Bangladesh and Others (RAJUK)*<sup>5</sup> reflects this predisposition of inappropriate state intervention. The plaintiff is the owner of 'Rangs Bhaban', a 22-storied shopping-cum office building situated nearby an airport which was built upon receiving appropriate approval from the concerned authority, City Development Authority (in Bengali it is abbreviated "RAJUK"). The case was particularly important because it was one of the widely discussed notorious examples where RAJUK power was overly neutralized by rent-seeking propensity of the influential quarters. In a sense, Rangs Bhaban in the public perception comes to be a towering reminder of the intrinsic inadequacies of the law-enforcement system, the systemic mismanagement, ineptitude and corruption of the city development authorities and, most importantly, the apparently persistent pro-rich bias of successive governments and the state.

While Rangs Bhaban was completed up to 16<sup>th</sup> floor objection was raised by Bangladesh Air Force Head Quarter requesting RAJUK to demolish any adjacent high-rise construction beyond the permissible height certified by Civil Aviation Rules. Accordingly, RAJUK issued an order to the plaintiff to demolish the construction beyond 6<sup>th</sup> floor, permissible limit, within 10 days at the cost of the plaintiff, failure of which would constitute the building as unauthorized and illegal. The plaintiff did not response and resultantly RAJUK rebuked the plan on June 1999. The plaintiff then

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<sup>5</sup> DLR 52, 2000, (HD).

filed a suit in the High Court Division of the Supreme Court against the order. The Court on May 2000 in its verdict rejected RAJUK order to demolish the building but also asked the plaintiff to stop all sorts of obstruction on the suit property. The judges in their verdict stated that the concerned authority actually neglected the question of legality and/or propriety while adopting decision of cancelling the permission of constructing the building. Judges emphasized that the construction undertaken so far spending several millions of monetary costs and also as per plan duly approved by RAJUK must be held to be a property lawfully vested to the plaintiffs. RAJUK appealed to the Supreme Court against High Court verdict and won. Eventually, Rangs Bhaban was demolished

Rangs Group of Companies is a large consumer Electronics Company registered under the Companies Act of 1913 and was incorporated in Bangladesh in 1984. The original plan for a 10-storey shopping-cum-office complex on the eastern side of Airport was submitted to RAJUK on December 1988 for approval. RAJUK approved the plan on July 1989 keeping aside the permission of the Civil Aviation Authority. However, the plaintiff was directed to obtain permission from Civil Aviation Authority of Bangladesh (CAAB) to fulfil the requirements of building codes for any construction undertaken nearby an airport. The plaintiff instead of doing so took an initiative to construct a 22-storey complex on the same land and submitted a revised plan on January 1990 which was also approved by RAJUK on May 1990 again without permission of CAAB. Needless to say that RAJUK has strongly entangled with bureaucratic politics and thus, it has transformed into a highly bureaucratic organ of the country representing the interest of each government in power. RAJUK spontaneously confessed its mistake for granting the permission to build the building, but asserting the phenomena as merely a mistake hides the real scenario. Rather powerful rent seekers strained RAJUK to perpetrate this mistake.

On February 2007, during the time of a non-party interim government, a four-member committee was formed to unfold relevant facts and to examine the legality of the construction. After careful scrutiny of all data and records the committee came into conclusion that the land on which the Rangs Bhaban located belongs not to its owner. He has no legal entitlement on the property. Rather a substantial part of the said property is Wakf Estate (Charitable property) and the remainder belongs to department of Roads and Highways (R&H). The report also revealed that the R&H department planned to build a road across the land where the Rangs Bhaban was located but due to the existence of some privately owned land which the department of Roads and Highways was supposed to acquire, the plan could not be executed instantly. The then ruling government was a military dictator who was typified having strong bond with business elites to strengthen his tenure. Those business elites were granted enormous opportunities in exchange for their unprecedented support to the dictator undermining social benefits.

The plaintiff was a powerful businessman who allegedly had positive connection with an

influential cabinet minister of the government. Mobilising this political capital he desperately lobbied to secure the ownership of the suit land and finally managed to acquire the rights to construct the building illegally. RAJUK asserted their concern on that issue but was bound to retreat because of the forceful interference by the minister. This rent-seeking tendency during the dictatorial regime was the rule rather than an exception. However, the CAR was a big trouble for the construction and the saddest episode of the tale was that the airport then declared abandoned by the then autocratic president to save the building. Although both international and domestic operations of the said airport shifted to a new place in 1981, the airport has been continuing to be used as an operational base for the Air Force and oftentimes as a domestic airport.

The fall of dictatorial regime in 1990 and the emergence of democracy subsequently helped curtail widespread corruption to a certain extent but apparently failed to bring the Rangs Bhaban episode to an end because the state was still weak with immature democracy. Thus, the fortune of the Rangs Bhaban remained unchanged even democratically elected government superseded the dictatorship in 1991. Since then several attempts were made during the last three democratic tenures to demolish the building, but none of them were executed because behind the scene transactions between concerned interested parties thwarted all endeavour. Specially, the housing Minister of the 1991 BNP-lead government was adamant about the issue and he intensely wanted to see an end. Again, he was tamed afterwards allegedly arranging some incentives by the plaintiff. After seven years of continuous battle between the plaintiff and RAJUK, Supreme Court on August 2007 declared the construction illegal overturning High Court's decision. Social consequence of such a tendency is critical which in turn creates myriad problems and hinders economic development of the country.

Rangs Bhaban is not a unique case rather countless examples of such ill practices of property rights are found which can be attributed to country's weak legal system and its lax enforcement. Lax enforcement stems from the inability of country's judiciary system to work independently on the one hand and political appointment in the critical judiciary position on the other. Judiciary is assumed as a prime source of institutional change: it revises existing formal constraints where they act as a constraint on welfare-enhancing activities. Such revisions help facilitate economic progress. In Bangladesh the judiciary is separated from executive neither functionally nor administratively which means that legislatures have influencing power on judiciary and thus neutralize its capability towards better administration. Interestingly, every democratic government reiterated their promise to separate those two vital organs from each other. However, no significant progress has been achieved after almost two decades of promise. No surprise because political organs derive their strength from the current institutional arrangements and thus any change will just jeopardize their self-sanctuary of expropriating state property through enacting inappropriate property rights leading to the transition failure or type II state

failure.

### 3.2 Type II state failure

The basic function of institutions is to facilitate efficient market transactions so that individuals can not maximize their welfare without making other worse off. Institutions determine the nature of the game and where bad institution drives good one out of the game, transition failure is inevitable. Transition failure or type II state failure refers to a situation in which the existing structure of institutional change is not efficient enough to accelerate the changes compared to alternative processes. For Khan, transition failure “occurs when the process for changing the structure of institutions attains a lower cumulative set of net benefits for society compared to an alternative process over a given period” (1995: 73). Although Khan attributes the reason of type II failure to several possible explanations he stresses on the possible resistance to change by potential losers. He argues “some powerful potential losers may block socially desirable reforms that threaten to hurt them” (Khan, 2004b: 93). They fear the change because under the decaying institutional settings they are capable of harvesting higher pay off making the society worse off. In such an uncertain environment resources are spent to capture rents which are not only social waste but also those artificial impediments that blockade successful transition prolong the survival of inefficient institutions. For instance, even though it is pronounced that private property and the resulting economic well-off is better protected in the functional democratic regime than do in the dictatorial rule, a move from the latter to the former is not smooth nevertheless.

#### *Transition failure results from interlocking inefficient structure of rights*

Transition failure in most developing countries is interlocked with their political and institutional structure. Political institutions are featured as clouded with patron-client relation which means that weak state frequently compromises with clients in the question of shifting towards better institutions. In the process, the degree of competition among alternative institutions is effectively curbed imposing high political transition costs. Resultantly transition to more efficient form of institutions is severely undermined. Recent judicial verdict on *Dr. Chowdhury Mahmud Hasan and Others v. Ekushey Television*<sup>6</sup> reflects the state’s tyranny for assigning rights to a private entity for airing its program using state-owned frequencies in Bangladesh.

Ekushey Television (ETV), a private television channel, went off air in 2002 after losing its prolonged battle over broadcasting rights when Appellate Division of the Supreme Court upheld

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<sup>6</sup> Writ petition no. 5050 of 2001 (HD), 54 DLR (2002).

the High Court Division's judgment that the process by which ETV obtained license was illegal. Even though ETV was private entity, the terrestrial system it used to air its programs originally owned by Bangladesh Television (BTV) the only state-run television channel having sole right over the terrestrial transmission system for over three decades. Furthermore, ETV was granted the right to use BTV premises for key installation stipulating that ETV would pay a certain amount to BTV when both channels simultaneously would be on the air. The plaintiffs in their writ petition at the High Court Division of Supreme Court questioned the legality of ETV's license and the contract with BTV to use BTV's technical support and premises.

There existed a market niche to be served, no doubt. Before ETV went to air, BTV was the only television channel with huge investment for its Key Point Installation (KPI). In a country like Bangladesh, private investment with such a colossal amount to established terrestrial frequency is unexpected. Uncertain nature of institutional characteristics imposes prohibitive risk and thus cost benefit analysis does not yield attractive payoffs on investment. Thus, terrestrial facility belongs only to BTV which unanimously has ceded it a natural monopoly. Since BTV is not an autonomous body up until now, relevant ministry is vested with enormous controlling power and thus every successive government has exercised undue influence to squeeze benefits utilizing the facility for their greater interest.

In 1998 the ministry of information invited tenders requesting proposals from local and foreign firms individually or under joint venture to install and operate a private television channel. This invitation for bid *per se* generated host of interesting questions. Firstly, the purpose that was intended to serve by establishing a private television channel could be satisfied by BTV. It was quite capable to telecast what a private channel could do since newly installed channel (ETV) was allowed to use BTV's KPI rather than investing by its own. Secondly, if there is any inefficiency entangled with BTV, ultimate responsibility rests on respective ministry. It is arguably the fact that institutional maladjustment of BTV can be attributed to unwarranted political influence. Weeding out those inefficiencies was the priority agenda for government rather than allocating broadcasting licence to a new one if the government really wished to cater social needs. This could be done easily by privatizing BTV or if government ownership was warranted considering the benefits of public goods, at least BTV's autonomy should have been the prior agenda.

Seventeen companies participated with their proposals in the tender which were sent to Technical Committee to screen and evaluate based on certain pre-set criteria where one application declared commercially unsuccessful. Remaining sixteen companies divided into three distinct categories: top three enterprises were classified as satisfactory whereas second category included three enterprises whose proposals might be considered and the last ten enterprises were categorized unsuccessful in which class the defendant belonged to. The report was then forwarded to Ministry of Information for further processing. Subsequently, the technical committee came

under serious pressure by an interest group allegedly affiliated with the then ruling party and was compelled to make another report in such a fashion that the defendant became the first and foremost to acquire the right and applicant that was declared unsuccessful earlier, placed second following the defendant in the new list. Moreover, Multimode Transport Consultant Ltd. securing the top place in the first report was placed at the last position. In the changed report it was mentioned that eight enterprises' proposals out of seventeen can be considered with some conditions. Surprisingly, the conditions were not sent to all participants and also it was blurred who set those conditions and even why those conditions were set out even though three proposals were found satisfactory. Through this shady and obscure dealing the interest group conjured granting the rights to ETV.

In their writ petition, the petitioners raised the issue involving with breaches of constitutional obligations and statutory duties in dealing with public property. It was, nevertheless argued that the decision to grant broadcast license to defendant was made based on this *mala fide* report. In the proceedings, the High Court Division of the Supreme Court affirmed plaintiff's claim valid.

Our concern is about the way, manner and the procedure which were followed to come to a decision by the technical committee...we are of the view that there was something wrong somewhere which the respondents...very carefully and consciously tried to keep out of the knowledge of the Court. On this ground, we are of the view that the whole transaction and evaluation is *mala fide*

The Court also questioned the transparency with which the government pursued the recommendations of the report-

We are further of the view that the action taken by the Ministry of Information on the basis of the second report is also not transparent. The ministry considered this report as 'final', but we have found that it is not at all a final report, it is an incomplete and conditional report. The ministry processed only the case of ETV (defendant) without trying to know from the evaluation committee as to what are the conditions required to be fulfilled, the ministry itself determined those conditions required to be fulfilled, the ministry did not inform the other 7 parties as to whether they are ready to fulfil the conditions. It is not known how and why... the ministry came to the conclusion that only the ETV was agreeable to fulfil he conditions and the other 7 parties were not agreeable.

The court thus, concluded

In the result, the Rule is made absolute. It is declared that the act of acceptance of the proposal of ETV as most responsive and granting of licence to ETV by the Ministry of Information was done without any lawful authority and is of no legal effect.

The defendant appealed to the Supreme Court against High Court's verdict but the division bench concurred with the High Court's decision. The defendant then appealed for a review petition but

the original verdict was upheld by the Review Bench and finally the defendant's rights to air as a first private terrestrial TV channel had rebuked.

*Transition failure resulting from insufficient collective actions for public interests*

In his book *The Logic of Collective Action* in 1965, Mancur Olson challenged the traditional thinking that group with common interest would tend to form and take collective action whenever they are jointly benefited. Instead, Olson (1965, 1982) argues that self-interest individual hardly takes such step to further the group interest even though cost of such actions is offset by the benefits derived. He further points out “*the larger the group, the farther it will fall short of providing an optimal amount of a collective goods*” (1965: 35). This argument was later known as “zero contribution thesis” (Ostrom, 2000). Following this thesis we like to argue that in case of collective action problem, rent seekers organized in a small group with few members possess competitive edge to easily overthrow any attempt by a group formed with many individuals to overcome collative action problem. The problem again arises because of differential bargaining power of the groups. It is seemingly the fact that market cannot clear demand and supply for public goods like air because transaction is prohibitively costly and thus government intervention is *sine quo non* to correct this failure. However, government may not have good willing to response quickly to this problem unless a group with profound bargaining power pressure to go ahead. The following case drawn for Bangladesh demonstrates how rent-seeking by the public to remove inefficient rents from a particular beneficiary fails.

Dhaka, the capital city of Bangladesh, is a notorious example of air pollution.<sup>8</sup> The polluters are many and free riding problem is perverse when any individual or group of individual tries to curb pollution by buying the rights of fresh air. Given the initial rights to motor vehicles which pollute the most, Coase Theorem suggests that internalizing the externality at individual level is infeasible because too many transacting parties are involved with this negative externality. However, government may acquire the rights<sup>9</sup> prohibiting operation of certain vehicles, which are liable for pollution, with strict enforcement. In such a situation, interest group theory rather than transaction cost is more powerful explaining what type of property rights rearrangement will emerge.

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<sup>7</sup> Emphasize in original.

<sup>8</sup> Air pollution level in Dhaka is considerably higher than Bangladeshi standards or World Health Organization guidelines.

<sup>9</sup> Rights on property may take such form as private, communal, state, or open depending on who has the power to exclude nonpayer.

Among the vehicular pollutants, two-stroke engines were estimated to emit about 35 percent of particles and more than half of the hydrocarbons emitted by all vehicles. Initially it was considered that banning the operation of those vehicles can save Dhaka from severe pollution. Even though the crying need for the change alteration was felt at the beginning of 1980s, it was not until 2002 that such rights rearrangement for narrowing down social loss from smoke emission took place

Fresh air resulting from banning certain vehicles is obviously a public good for which individual cannot be charged in congruent with their consumption level. Thus, the task relied ultimately to state, and individuals pressures on government was negligible because the initiative requires some cost for which they receive some benefits which non-subscribers can also enjoy without paying. On the other hand, a large number of people were employed in the sector and thus, banning the operations of responsible vehicles meant to slap their direct interest which motivated them to organize together and opposed the proposed modification of rights. During the autocratic regime (1981-1990), the feasibility of banning two-stroke vehicles was not affirmative for at least two reasons. First, an alternative to substitute for the existing two-stroke was not much obvious. Second, autocratic regime was marked with severe political instability and thus any change of rights might have exerted a serious threat to the authoritarian government. So the right alteration was obscured keeping forward other issues at the agenda.

Afterwards, the endeavour to replace four-stroke compressed natural gas engine (henceforth CNG) for two-stroke diesel-fuel auto rickshaw was laudable as well as economically viable. On the other, the number of two-stroke vehicles was gradually increasing which exacerbated the situation. Different stakeholders such as NGOs and international political bodies pressed government to go for tough action on the issue. But their pressure was not strong enough to offset dangers emanating from the fear of losing political support coming from those losers. Thus, no party on power was willing to assume the risk of right alteration even though the social net benefit from rights rearrangement was positive. On the other, the opportunity stemming from alteration created another interest group who favoured rights rearrangement due mainly to capture the monopoly right to import four-stroke engines from India and the right to establish CNG filling station. High expected gain from acquiring rights facilitated latter group organized strongly and pressed government to modify rights into their favour. Resultantly, through a parliamentary resolution two-stroke engines were banned.

Initially the right to import CNG engines was allocated to Bangladesh Road Transport Authority (BRTA), a government wing under the auspices of ministry of communication. Obviously the rent seekers were many under this right allocation and thus, redirecting the rights to capture rents by some concentrated groups was expected. This right was nullified by the pressure of minister in charge of the Communication Ministry and granted a private dealer, Uttara Motors, the monopoly right to import CNG engine from India. The rent seeking output was so lopsided that

the matter was subsequently discussed in the parliamentary standing committee blaming the minister in charge. The cost of monopolistic right could not be precisely estimated, but the committee's estimation that an engine was priced almost three times of its cost of sale to the dealer, sheds light on the magnitude of rent seeking cost.

The committee also came into conclusion that some government lands for setting up CNG filling station were allocated receiving financial benefits from the rent seekers. Moreover, institutions are set in such a way that any potential investors who are not directly linked with ruling government find it extremely difficult to fulfil the procedure to invest in the sector. For example, establishing a CNG filling station requires approval from about eight government agencies that are highly bureaucratic and thus for common people it is better to restraint desire from investment rather than bearing such hassles. Estimation shows that 170 plots for setting up CNG stations on government lands were allotted in 2003 and until the first quarter of 2007, only 24 of them were executed. Most of remaining plots were allotted to politically affiliated persons including more than dozens of former parliament members who are making money through different means using those lands. This substantiate that the entire process of rights reallocation was influenced by two interest groups as much as it was influenced by Demsetzian changes in technology or price of the resources. Precisely, market forces alone cannot successfully enable property rights to emerge at least for common pool resources (Ostrom, 1990).

Because of its inability to explicitly model social or political institutions, Eggertsson (1990) refers neoclassical theory of property rights as 'the naïve theory'. In contrast, the 'interest group theory' captures the essence of this form of property rights arrangement and explains that much of the structure of property rights is the consequence of monopolist rent seeking. This leads Levmore to argue "... private property rights may emerge not because they are more efficient but rather because they are more attractive to a self-serving, forceful ruler, or because they serve the interests of some well-organized group at the expense of others..." (2002:S432). This, thus, postulates that it is unlikely we can avoid government as definer and enforcer of property rights at least from the perspective of developing countries. Moreover, government involvement increases transaction costs resultantly rights are incomplete. This is obvious, but is transaction cost the only reason for property rights to remain incomplete? We turn to the next section for an elaborate discussion to answer the question which differs from the argument put forth by the neoclassical model.

## **4. Alternative Visions of Incomplete Property Rights**

### **4.1. Incomplete property rights**

Neoclassical model has clearly envisaged the incompleteness of property rights results from the existence of high transaction cost. Those transaction cost can roughly be divided: transaction cost

related mainly to the initial defining of property rights, and transition costs incurred to shift to a more efficient form of property rights. In this circumstance, incompleteness of property rights results from either defining or transition problem. From this view, property rights are complete when defining right as a 'bundle' covers full contents of the bundle and clearly specifies attributes of those contents. In this sense, allocation of property rights is the one which is most efficient. However, the situation might not sustain because some changes in economic circumstances may turn the existing right into an inefficient one and the need to shift to a more efficient form emerges. In this sense, rights on property are complete when the cost of transition is also zero. This situation is depicted below with the help of a matrix.

Figure 2: Relationship between transaction cost and incompleteness of property rights

		Transition cost	
		Zero	high
Transaction cost	Zero	Complete property rights	Well-defined property rights but not always smoothly responding to the change in economic environment
	High	Rights are not well defined initially but can be fairly easily corrected	Rights are inevitably incomplete

Assume no transaction cost involves both with defining ex-ante or tradability ex-post, we ultimately reach to complete state of property rights (1, 1). This is the neoclassical frictionless market. Here, a property right *per se* is considered an economic good and as long as markets are perfect, rights to property is inevitably complete. In the standard Coasean model, given zero transaction costs ex-ante, rights are well defined but again might be incomplete depends on the transition costs when economic changes require to shift to more specified rights assignment. As such if further tradability requires substantial costs, rights are still incomplete even though well defined initially (1, 2). Similarly, with the presence of ex-ante high transaction cost right are incomplete because it is not well-defined (2, 1). But it is unlikely to hamper Pareto optimality because transition to alternative system of property rights can be accomplished fairly easily given zero transition costs. Once we account for positive and substantial costs of transition we enter into the paradigm of practical world which means that rights are inevitably incomplete (2, 2). In this

sense, what matters for property rights to be incomplete is the existence of high transaction costs ex-ante for initial allocation or transition costs of shifting to more efficient one if the initial allocation is imperfectly delineated or economic changes turn it into inefficient. According to this simplistic view, if a legal system performs well, there is no island of uncertainty in the ocean of perfectly excludable property rights and also no island of political influence.

Thus, it is postulated from the standard neoclassical model that elimination of both ex-ante defining cost and ex-post transition costs would lead property rights to be perfectly delineated. From this context, Barzel (1997) argues that given zero transaction cost rights are assigned to those where value is maximized meaning that property right approaches to full specification. However, the probability of zero transaction cost is also zero not because of the sheer presence of market failure ex-post but because of the limitation of human capability to foresee future uncertainty. This implies that attributing the determinant of incomplete property rights to mere transaction costs implies that instrumental view has apparently failed to identify the sources of positive transaction costs.

It is of particular interest that the neoclassical model attributes the genesis of incomplete contract to human bounded rationality, and uncertainty besides transaction cost. In the same token, it can be concluded that once we take those aspects into account rights on property can also be incomplete no matter the residual right allocation is advocated towards searching a fine-tune nature of property rights. Sources that are liable to make the contract incomplete, can rightfully be applied to be the sources of incomplete property rights. As such disregarding this aspect leads economic analysis somewhat inconsistent with the assumption made in other domain of institutions i.e. contract (Nicita, 2007). As a result, it is inevitable that property rights are incomplete not because of only the presence of high transaction cost but also because of human bounded rationality and uncertainty.

Uncertainty makes our decision processes complex and volatile. Since the consequences of actions extend into the future, accurate forecasting is essential for making objectively rational choices. But in the real world, most choices take place under conditions of uncertainty. The fundamental implication of Keynes's uncertainty is that all economically meaningful behaviour derives from agents' efforts to protect themselves from uncertainty. Keynes defined what he meant by "uncertain" knowledge;

"By uncertain knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years

hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to do our best to overlook this awkward fact and to behave exactly as we should if we had behind us a good Benthamite calculation of a series of prospective advantages and disadvantages, each multiplied by its appropriate probability waiting to be summed (Keynes 1937; see also Minsky 1975; 66).

Uncertainty often encourages agents to adopt rules of thumb because standardization and coordination may be more effective than individual prediction. Herbert Simon developed a more realistic description of human bounded rationality, and considered to what extent the limited capability for analysis that is provided by bounded rationality can meet the needs for reason in human affairs. In practice, economic actors are *intendedly* rational but *limitedly* so, because of information problems and the complexity of computing best strategies. In the real world, instead of trying to work out Nash equilibrium or solve optimization problems, individuals follow *rules of thumb*. Simon himself treated the use of rules of thumb as short-cut devices for decision-making. This is not because they are irrational, but it is simply that they economize on a scarce resource, the brain's limited computational capacity. However, such standardized rules of thumb can themselves become constraints on our decision-making: if they acquire the status of norms, they can reduce us to mere engines of procedural rationality (see also Suzuki 2005).

Williamson (1985) stresses the importance of opportunism in the face of bounded rationality. He asserts that assuming unlimited calculative power of the human brains, problems arising from opportunism can be tackled by writing a comprehensive contract ex-ante and thereby ex-post opportunism can be averted by taking every bit of contingencies from which opportunism may likely be the result into account ex-ante. Similarly, admitting human bounded rationality but given non-opportunism, contracting problems arising ex-post can be overcome since parties have agreed to cooperate and disclose all the relevant information generated once the events occurred. In this sense, admitting one ignoring the other creates a problem that can be resolved easily. However, the true nature of human interactions is not reflected recognizing only one dimension of the problem. From this vintage point Williamson argues that the existence of both bounded rationality and opportunism conforms to the reality where incompleteness is of more serious concern.

We construct a similar matrix as that of Williamson to stress the importance of uncertainty to the incompleteness of property rights paradigm. In the functionalist model uncertainty or bounded rationality is simply viewed as an element to increase transaction cost. In so doing, the contribution of the determinant to incomplete property rights is not properly emphasized. We stress that the presence of uncertainty appears to be of more serious concern than it is figured out in the simplistic view.

Figure 3: Matrix showing nature of incomplete of property rights

		Bounded rationality/Uncertainty	
		Absent	Admitted
		Bliss	Based upon “slacks” or “general clause” in terms of incomplete property rights, we can always reach to the near optimal structure of rights
Transaction and transition cost	Absent	A comprehensive set of property rights is expected: biased by political influence (but expected to be finally rectified to a better structure of rights)	
	Admitted		

Assume human beings possess unbounded rationality and face no fundamental uncertainty. What is relevant for defining property rights is sheer transaction cost. In this situation, if transaction cost is insignificant we reach to a situation of perfect delineation of property rights. Human unbounded rationality and zero transaction costs combined help forestall externalities that may arise in the use of resources. On the other, assuming unbounded rationality but in the presence of high transaction costs, a comprehensive set of property rights are expected even though the rights allocation may initially be politically biased. A fine-tune property right rearrangement is possible since no uncertainty is involved with the issues and human brain’s calculative power can flawlessly calculate cost and benefits of future actions.

Now let us now drop the assumption of the absence of fundamental uncertainty and also human unbounded rationality. With the assumption of zero transaction costs, we can reach to a near optimal level of property rights because incompleteness in rights delineation can be overcome ex-post. This means to say that when any new use of the underlying property is figured out ex-post that generates externality, parties can define rights on it since they enjoy the advantage of zero transaction costs. However, admitting both transaction costs and bounded rationality directs us to

come back to the reality under which rights allocation takes place. This is the zone of serious difficulty on the question of assigning property rights. From this vintage point it can be said that mere existence of transaction cost is not relevant for property rights to be complete, rather we cannot ignore without great risk the fundamental uncertainty prevalent in the process of defining it which can prevent the emergence of more efficient form of property rights. Thus, we argue that emphasizing both on transaction cost and on fundamental uncertainty we accord with the true nature of incomplete property rights. To what extent incomplete property rights relates to efficiency issue?

#### **4.2. An alternative vision**

As we have mentioned uncertainty transforms the possibility of taking all valuable attributes of property into account ex ante impractical. Thus, transaction is governed by the existence of some costs and hence rights are incomplete. Does this incompleteness of property rights undermine economic efficiency? Firstly, as long as a world of zero transaction cost cannot be attained, perfect delineation of property rights is just an ideal situation. Intuitive sense of all rational individual supports the idea "...that maximum efficiency is achieved through ideal allocation of allocable resources [but] that no individual achieves this maximum..." (Knight, 1956:167). Knight attributes the genesis of this fact to "...some chance of error and some actual errors" (Knight, 1960: 72). Since an abstraction from the probability of error makes explaining reality unbelievable, a world of positive transaction cost is, thus, the natural consequence.

Relying on Cheung's (1983) postulation that an organization might be as big as the whole economy we can hypothesize that elements that affect an organization might have great influence on the performance of an economy. Hirschman (1970) introduces 'slack' as a cushion to which firms can resort during its unpleasant day. Similarly, existence of some sort of slack in an economy is rather necessary for responding to uncertainty. At organizational level, slack consists of payments to members of any entity in excess of what is required to maintain it (Cyert and March, 1992). It absorbs a significant portion of the variability of the firms' environment especially threats emanating from external environment propelled by various institutional changes. For example a precipitating change in demand of the product of a firm might throw it at the brink of extinction, which may cause it to go burst when operating at equilibrium. Slack that can be called in when it is in need to firm, plays a crucial role to provide firms with supportive means. In recognizing the importance and pervasiveness of slack, Hirschman argues

It assumes not only that slack has somehow come into the world and exists in given moments, but that it is *continuously being generated* as a result of some sort of entropy characteristic of human, surplus-producing societies.... Firms and other organizations are conceived to be permanently and randomly subject to decline and decay, that is, to a

gradual loss of rationality, efficiency, and surplus producing energy, no matter how well the institutional framework within which they function is designed ( 1970: pp. 14-15).<sup>10</sup>

The notion of general equilibrium or Pareto optimality implies that there should be no slack in organization. Thus, entrepreneurs should not earn abnormal profit in the long run. However, slacks at both organization and economic levels exist for responding to uncertain economic conditions. For example, organizations do have employees more than optimal level, firms maintain cash more than immediate necessity. In accordance with this presumption, the degree to which a really attainable level of property rights deviates from a perfectly delineated or Pareto optimal structure of rights arrangement can be marked as slack that acts as buffer against uncertainty. From this vintage point, we argue that perfect delineation of property rights is not always the goal and thus economies can maximize its goal without undermining efficiency issues. It is beyond the doubt that economies working at equilibrium with perfectly delineation of property right would be more efficient but inability to reach unto that level is not equivalent to inefficiency, “in the Pareto optimum not all externalities, whether marginal or inframarginal, should be reduced to zero: we are better off keeping some of them at a positive level” (Dahlman, 1979: 152-3). Even if it is seemingly a case of loosely defined property rights, apparently it is necessary like a surplus producing society that cannot squeeze production function further to reduce surplus because “social behaviour is as simply and as rigidly prescribed and constrained as it is in a no-surplus, bare subsistence situation” (Hirschman, 1970:9). Similarly, the provision of slack for uncertainty is adhered with the system which cannot be eliminated unless the nature of uncertainty changes. This compels not to ask whether there should be any buffer in the delineation of property rights rather the question is, what should be the magnitude of optimal level of slack beyond which inefficiency is the likely consequence.

Alchian and Demsetz (1972) elucidate two problems, metering input productivity and metering rewards, in explaining why some activities are organized within firms. Those problems arise because it is practically impossible to exactly determine the rights on rewards or outputs in accord with the efforts devoted by individual inputs. They also argue that what markets value is not the marginal product of each individual input but marginal product of team. Thus, market can not resolve those problems due not only to cost of detecting but also because information is asymmetric. In this circumstance, a member from the team who is specialized in monitoring will emerge whose entitlements would be to enjoy residual benefits. Specialization in monitoring implies that he has the capability to manage uncertainty stemming from variability of the efforts of team members among other things. However, it is not likely the case that the residual benefits is exactly such an amount that are required to keep him in the function of organizing and monitoring.

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<sup>10</sup> Italics in original.

Meaning that there exist some slacks since exact delineation of rights of each member in the team is impossible. Every structure of property rights has some slacks or flexibility partly for creating an appropriate incentive to potential residual claimants who could well manage uncertainty.

What should be the system of reward on innovation that maximizes social value, patent right which confers exclusive rights to the innovators to market the goods or the reward paid by the government and hence place the innovation immediately at the public domain? Drawbacks involve with both of the cases. In the former case, the innovator's incentive would be the monopoly price they charge. However, investment in research and development in this system are inadequate because monopoly profits are less than the social surplus created by the innovation and the model suffers deadweight loss emanating from the fact that too little are sold at monopoly prices (Shavell and Ypersele, 2001). On the other hand, if reward system is the chosen alternative, it can reduce deadweight loss to zero. But deviation from the best fit may happen on the ground that if reward does not commensurate with the expectation, incentive to invest for innovation may reduce. Nevertheless, patent right is assumed as most compatible incentive system even though it necessitates some welfare loss.

In most developed economies, patent rights are granted for 20 years. How can we justify longitude of that time frame and why it is not set any longer or shorter? Specifying a time period for which patent rights is issued is hardly consonant with the neoclassical prescription of delineating property rights because it is extremely difficult to define how long an innovation should survive with patent rights. Some flexibility or slack, thus, exists which are necessary to create incentive on the parts of innovators. Moreover, if reward system is the chosen option, innovation is placed at the public domain but can successfully avoid deadweight welfare losses. This postulates that, incompleteness of property rights creates buffer to respond to uncertainty without undermining efficiency in resource distribution.

Hirschman advocates for "surplus above subsistence" or "slacks" to be preserved for responding to uncertainties surrounding the production function whereas Alchian and Demsetz's argument of "team spirits" are addressed primarily to the same economic agent, firms. In the similar fashion Minsky (1977) argues for 'margins of safety' for the financial system with the implication that financial fragility can be avoided because markets are rarely equipped with sufficient cushion to absorb financial shock while working at rigidly prescribed and constrained equilibrium. From a broader economic perspective it can be argued that "social" slacks or "social" team spirits which can contribute to responding to fundamental uncertainties associated with the changes in economic circumstances needs to be preserved. We exemplify that a cushion for safety as "social margins of safety" in terms of how a society or a country or a structure of property rights can bear the associated transaction and transition costs. What constitutes "social margins of safety" is the issue of our future research; however, sufficient ground has been laid to conclude that most

of developing countries may not maintain the social margins of safety sufficiently to respond to the complex institutional failure, partly due to less developed legal system, less developed technology and lack of fundamental accumulation.

## **5. Conclusion**

Bringing transaction costs to the discussion of property rights has undoubtedly opened new avenues to look for efficient allocation of scarce resources. This theory suggests that emergence of property rights follows strict rule of cost benefits analysis that is where the costs of defining or altering rights outweighs the benefits, perfect delineation of property rights is the likely result. The problem arises when the allocation of rights is not the one that maximizes total welfare of the society as well as shift to a more efficient form is not possible because of the presence of high transaction cost. The model is, thus, in tension how to reduce transaction costs. Towards this, they find the concept of 'residual right' as a solution to the problem. Once the residual right is assigned in congruent with tightly-knit cause-effect relationship, property rights is the one which is the most efficient. This paper, in contrast, has argued that in the developing countries evolution of property rights is neither automatic nor always leads to efficiency.

The more we emphasize on transaction cost for determining the problem of inefficiency in resource allocation, the more we are prone to neglect numerous aspects of the problem. We have argued that slack is reserved to respond to uncertainly. We also like to argue that the nature of uncertainty does not remain same at all times. The fundamental uncertainty that is adhered with almost every economy takes different shapes at different point in time. Events that are construed as uncertainty today may be reduced to risk tomorrow because of the advent of more appropriate mechanisms such as technology, institutions, political structures etc. Resultantly, an efficient structure of the institution of property rights is the one which promptly responses to the changes of the structure of uncertainty. Countries that provide sufficient cushion for such a structural change are deemed to have efficient structure of property rights. Conversely, failure to do so can be attributed to transitional failure by which many developing countries are characterized today.

For empirical underpinnings we have examined cases that support our hypothesis and also substantiate that evolution of property rights is mostly determined by the political choices rather than strict cost benefits analysis. Moreover, in order to reach a consensus on a proposed change in property rights negotiating side payments for influential parties is crucial which changes the timing of institutional change. History is replete with examples of societies failing to change property rights at the optimal times in response to changing scarcity and thus rent dissipation is the result. Moreover, the granted right is not even secured for long since change in political environment is associated with the change in relative distributive pattern of the property rights. Rights which are secured in one political

regime are easily invalidated by a shift of the regime which accounts for a huge loss to the society. From this vintage point we argue that without considering government as a crucial player in the equation of demand and supply, property right analysis is incomplete.

To understand the evolution of property rights in most underdeveloped countries, we need to carefully examine the interplay between social demand and supply of property rights. Most often than not both demand and supply of property rights is driven by a complex interaction between political clans and capitalist groups. Balance of power between them loosens the structure of dominion any single side possesses over the other. As a result, both seek supports from each other where property rights are granted outright or side payment is made by the state to the capitalist groups in exchange for their instinctive supports. Thus, neither potential net gain from a change in property rights is materialized nor efficiency is ensured because the costs of making all the appropriate side payments to parties dissipate the potential gains. The ubiquities of poor economic performances of economies throughout history and also at present suggest that such outcomes are common. Perpetual persistence of such tendency leads a country to the gradual decay which we call institutional failure.

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