PROPERTY, MARKET STRUCTURE AND EFFICIENCY

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My argument is elementary, fundamental and unoriginal. I would not repeat it, but for the fact that it seems often to be ignored. Let me summarize it in one paragraph.

Summary of Argument

I will argue that policies designed to influence market structure and conduct involve changes in property rights. And, that the economic efficiency criteria of welfare economics based upon the competitive model are inappropriate for judging changes in property rights. And, in addition, there is no support in welfare economics for assuming a desirable outcome from changes in property rules designed to alter the structure of the market to make it conform more closely with the purely competitive model. The concern of economists with the optimum allocation of resources, allocative efficiency, has at any rate been misplaced. A more proper concern is with the consequences of alternative property rules as they influence behavior in the evolving market process. Finally, I suggest a list of potentially relevant questions concerning changes in property rules which may be useful to the applied economist in a policy advisory role.

Nature of Property

By property, I mean the sets of rights and obligations established by law, custom, and covenant which define the relations among members of a community in respect to their control over the resources of the community. Property derives from the community, for no person or group can have property in anything except as it is acknowledged by the relevant community. In this sense, property is never private. 1

Property is an organic part of a social economy. As the economy changes, property changes, and changes in the community's concept of property alter the economy. The change from an agricultural subsistence economy to a complex industrial economy requires significant changes in the property concept and failure of the community to adjust its property rules may be a major obstacle to the transition. 2

The property rules and covenants of a community prescribe the means of access and control of the assets of the community. Such rules affect both the performance of the economy and the distribution of its

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fruits. To change the property rules is to change both the value and the distribution of the ownership of assets within the community. Since control of the means of production confers power and prestige upon its holder, it may be desired beyond the value of the capitalized expected earnings of the asset. Thus, compensating individuals for losses resulting from changes in property rules may be beyond the capacity of the community.

The effective property rules of the community describe its concept of what is fair and equitable in cooperation and competition among members in the use of the resources of the community. The concept of what is a fair game in this respect is an important characteristic of a community.

Market Structure

Property rules cannot be said to specify market structure. Rather, they circumscribe the structure. However, a set of property rules could be specified which would prescribe a particular market structure. Rules designed to alter the market structure alter the distribution of the assets of the community and are property rules.

The characteristics of the market most often identified as strategic aspects of market structure are the degree of seller or buyer concentration, the degree of product differentiation and the conditions of entry to the market. 3

Buyer and seller concentration is limited and encouraged by a variety of property rules. For example, the anti-trust laws specify conditions for limiting the extent of assets allowed under the control of a single management unit. The thrust of these property rules is directed at limiting extreme concentration. If my understanding of the origins of the Sherman Act is correct, the arguments concerned fair game or equity and growth issues, but were devoid of references to the optimum allocation of resources as presented in the competitive model.

At the same time, a set of property rules which legitimizes control through the corporation fosters concentration. The corporation as a means of control seems to have contributed greatly to our industrial development. However, anti-trust laws might not be needed if the community did not sanction the corporate form of control.

Product differentiation depends to a large extent on property rules. These include rules establishing exclusive rights to trademarks, brand names, written materials, and "inventions." Product differentiation as we know it would be improbable without instituting these as property, the business firm would be less able to capture the rewards for the benefits of quality control and real product differences, and would, therefore, be less likely to engage in product improvement. At the same time, these property rules facilitate the exploitation of advertising and minor product differences. Rules and government activities designed to reduce the effectiveness of these devices as means of product differentiation, reduce the value of the holder's assets. These are the bases of the issue between the majority and minority of the "Food Commission" regarding the introduction of compulsory government grade labeling. Such changes certainly are not Pareto-better and, thus, involve an ethical or equity question. Note this says nothing of the merits of the two positions, but simply makes the point that the proposal alters the value and distribution of assets.

The conditions of entry are also significantly related to property rules. Product differentiation represents an important barrier to entry and, thus, all of the property rules just discussed are significant in terms of entry. For example, government grade labeling would facilitate entry. Similarly, the protection of patents, enforcement of some types of contracts, and sanctioning franchise agreements provide established firms with cost advantages over most potential entrants. In addition, the community
grants a number of special privileges directly related to entry. These include licenses, often under the control of a special interest group, and exclusive franchises granted to utility and broadcasting companies.

Zoning is a property rule which may limit entry. The use of zoning to control undesirable entry has received little consideration. An example of such possible use is suggested by the problems of the tart cherry industry. The major problem of this industry is identified to be chronic fluctuations in supply. One of the causes is that a number of orchards are planted on land which will produce cherries only under favorable weather conditions. The physiology of the trees is such that failure to yield one year adds vigor for the next crop year. The result is that orchards on poor locations contribute very large quantities of cherries in years of favorable weather, causing the value of the crop to be very low, and produce few cherries in the unfavorable years. The planting of orchards on poor locations is financially disastrous not only for such growers but for all growers. A zoning ordinance restricting plantings of cherries to acceptable locations could significantly reduce the chronic variations in supply.

The Efficiency Norm

Efficiency has come to be used in diverse ways even by economists. My use of the word is in the sense of a social norm. In this sense, it is tied to the perfectly competitive model as a norm. Thus, we say that resources are not allocated efficiently if there are imperfections in the market. And, resources are efficiently allocated when the marginal conditions of the perfectly competitive model are obtained. "However, because practically all modern industrial markets seriously violate the assumptions of pure competition, the competitive norm becomes an unattainable ideal." 4 While recognized as unattainable and even as something less than the desirable social choice, the model retains an extensive influence as a norm or ideal.

The necessity of adjusting the structural criteria to the realities of scale economies is well recognized, but those of us of a structural persuasion give a strong inference that the structure of the economy should conform with the ideal to the extent consistent with achieving the productivity advantage of scale. The significance of externalities is also generally recognized and, where measurable, modifications in structure or conduct rules to take them into account are acceptable to most economists. The difficulty is that externalities are difficult or impossible to measure and the tendency is to assume they cancel out. Making the life of the applied economist even more difficult, the theorists now tell us that we can no longer assume with certainty that the simple directional rule, "expand activities which yield external benefits," will necessarily move an economy in the direction of improved welfare. 5 My own belief is that externalities are much more extensive and important than implied in economic literature. For example, the most important product of a new enterprise in a developing economy may well be the training received by those engaged in the enterprise—yet almost none of this enters the profit account of the firm. And, the costs of providing necessary public services to a new enterprise either in a large city or in an unpopulated area may exceed the profits of the firm; yet, never enter the profit account of that firm, and thus not be considered in its decisions. It may be that one of the important functions of the applied economist is to devise changes in property rules which would put more of the costs and benefits within the profit or utility accounts of the individual firm or household.

Others of us are prone to argue that while it is impossible or undesirable to replicate the structure of the competitive
model, conduct should be regulated to conform with that which would be expected given an ideal structure. This is the approach taken by Lerner in the Economics of Control where the management of each firm is directed to act in such a way that the marginal conditions of the ideal model are met. Note, however, that this is a radically different property system than ours, for private ownership and control of the means of production are absent.

Still others of us emphasize industry performance. While other criteria are introduced, and importantly so, the competitive model remains significant as a norm. For many of the performance criteria are in terms of allowable deviation from that expected from the ideal model. This seems not to recognize that the outcome of the competitive model in any real situation would depend upon the property rules of the community. One of the policy difficulties with the performance approach is that performance cannot be directly legislated and attempts to regulate in response to observed performance of particular firms or industries often results in "locking the barn door after the horse has been stolen."

The difficulty with the use of the competitive model as a norm for judging changes in the property rules designed to create greater conformity to the competitive model is that such changes create and destroy non-compensable assets—it is not a Pareto-better situation and cannot be judged within the context of welfare economics. The model essentially takes property rules as given and cannot consistently be used to evaluate changes in them.

A community is unlikely to restrict itself to changes in property rules which are Pareto-better in each application, for it is clearly in each individual’s long-run interest not to have the community so restricted. The Pareto-better concept is a political paradox; for the decision to adopt a Pareto-better voting rule (one requiring 100 percent agreement) could be vetoed by a single member of the community and if so vetoed then no action under the rule could be considered Pareto-better. Can a social science discipline which restricts its application to Pareto-better situations serve its community?

The notion that implementing measures to make an existing market conform more closely to the purely competitive ideal is further questioned by the Lipsey-Lancaster second-best theorem. Baumol has recently discussed the implications of this theorem for public policy, and I will follow his argument.

Briefly, the theorem of second-best states "that in a concrete situation characterized by any deviation from 'perfect' optimality, partial policy measures which eliminate only some of the departures from the optimal arrangement may well result in a net decrease in social welfare." This is precisely the situation when recommendations are made concerning policy to alter the structure or conduct of the market.

For example, this theorem appears to mean that, given the existence of monopolistic elements in industry and labor, there is no theoretical basis for arguing that policies designed to alter the structure of agriculture in such a way that output is restricted would necessarily result in inefficient use of resources.

Even without the property argument and the second-best theorem, the policy belief that altering the structural anatomy or conduct rules of the economy to more nearly match the ideal model would necessarily enhance welfare is theoretically unsound. For example, there is no theoretical basis for arguing that an economy with more homogeneous products would provide a better allocation of resources than one with less. As Chamberlin points out "...wherever there is a demand for diversity of product, pure competition turns out to be not the ideal, but a departure from it. Marginal cost pricing no
longer holds as a principle of welfare economics: nor is the minimum point on the cost curve for the firm to be associated with the ideal." 7 The theory does seem to show that consumers in a static economy would gain a larger number of units of homogeneous products than units of heterogeneous ones from an industry for a given cost, but there is nothing to indicate that consumers would be better off with or prefer a larger, less heterogeneous output to a smaller more heterogeneous one.

Similarly the notion that advertising and other selling costs are wasteful or represent an inefficient use of resources cannot be proven by the theory. The fact that advertising would not exist under perfect competition derives from the assumption of perfect knowledge. But, knowledge is not perfect. And, there is no basis within the theory for judging that a bundle of unadvertised homogeneous products is more desirable or preferable to another bundle of advertised heterogeneous products. Is it possible the performance norm specifying that selling costs should be low is based upon the relevancy that advertising would not be needed under the perfectly competitive ideal?

Also, there seems to be no basis for believing the set of prices consistent with the marginal conditions of the competitive model would be consistent with the community's feasible desired growth rate. Nor does there appear to be any unique set of prices which will clear a market if selling efforts and cost reducing innovations are allowed. A price set which yields a "surplus" will stimulate selling and cost reducing efforts and thus tend to reduce the surplus and clear the market. Conversely, a price set which yields a "shortage" discourages selling and cost reducing efforts and thus tends to eliminate the shortage. 8 If the market clearing price is not unique, and if tastes and preferences are not independent of production and producer activities, how can any particular market clearing set of prices be argued as optimum?

The Policy Problem

What are the implications of these theoretical developments to the applied economist interested in contributing to policy decisions? It seems to me we have lost one of our most obvious guideposts. Applied economists of a previous period have been able to believe, with certain limited exceptions, that an improved allocation of resources would result from amendments to market structure and conduct to make it approximate more closely the competitive ideal. They recognized other social objectives as desirable, that pure competition was not feasible and might well not be desirable if reached, but nevertheless felt rather secure in the belief that reducing "imperfections" in the market would improve it. We can have no such faith.

Unfortunately, theorists are much better at telling us what we cannot do than what we can. 9 This is inherent in the logic of theory. But, as applied economists, we are obligated to look for useful solutions.

I wonder if Buchanan 10 is not correct in arguing that the economists have misplaced their emphasis on the theory of markets? Perhaps the most significant insight in economics is the fact that in a voluntary exchange each party benefits. Is it not also clear that the amount of the gain and the division of the gain is rooted in the property rules of the community and exchange cannot be dealt with independent of these rules?

Could we develop a theory of market behavior explaining the evolving processes of exchange--the bargaining, the trading, the agreements, the conflicts, the attempts to coordinate activities and control uncertainty? Certainly economics is a long way in this direction already.
Is the theoretical question of economics then--How do people behave in a market context?--How do they compete and how do they cooperate in their attempt to achieve their ends?

And, is the appropriate applied question--How can members of the community control the system to achieve their purposes whatever these may be? If this is the legitimate question, property rules or the rules of the market cannot be taken as given, for they are the means the community has for controlling the system. The relationship of the property rules to behavior in the ordinary business of making a living would be the major empirical content of market economics. Is a clinical approach appropriate to the applied problem? 11

Can we incorporate such concepts as ethical competition, fair games, liberty, community, covenant, just profit, fair price, and equitable salary into our analysis? These concepts seem to be related to property and relevant to questions concerning changes in property rules.

Would it not be desirable to direct analysis at the fundamental issues of property--rather than deal with it indirectly through policies related to structure, conduct and performance?

Can we formulate a list of questions which are analytically relevant to the issues of changing property rules, the answers to which would provide useful information for the political process of actually changing the rules?

Do the following questions have utility for that purpose? Concerning a specific change in a property rule:

1. Does the change facilitate or hinder exchange?

2. Is opportunity for individual expression fostered or restricted?

3. Is coordination of activities in the vertical production process improved or impeded?

4. How is the distribution of income and assets affected?

5. In what way is control or management altered?

6. How will incentives, motivations and innovations be affected?

7. Does it change the ability of an economic actor to capture the benefits of his activities or the accounting of the costs?

8. Does it change the level of conflict within the community?

9. How does it interact with the ethical system of the community?

10. How does it change the balance of political power?

11. As the effects of the change in property work out in the process of the evolving market system, how will it affect preferences, attitudes and personality of the participants?

Perhaps this seems destructive and negative. The tentative list of questions above do not offer norms. For each question the normative criteria would have to be supplied. But, my point is just that--the tough judgments must be made in any case. And, intelligent judgment will involve a variety of dimensions, conflicts of interests, and judgments of value. But, will it not be to our advantage to avoid the myopic consequences of the dead hand of perfection.

Economists have, of course, been so engaged from the beginning. To some extent, they have dealt with all of the questions I have listed and their analytical tools have much to offer in answering these kinds of questions. My concern is our preoccupation with the optimum allocation of resources.
or the efficiency of the system which diverts attention from what I believe to be more productive activities. In other words, we could be more efficient. Habits of thought are, obviously, difficult to change.

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Notes


4. Ibid., p. 523.


6. Ibid.,


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