

## The Importance of Property Rights

By Daniel K. Benjamin

Political and economic institutions—the rules, laws, and customs that guide behavior—help determine living standards around the world. New research by Daron Acemoglu and Simon Johnson (2005) reveals that among these institutions well-defined and enforced property rights are most important in shaping long-run economic growth and thus prosperity.

In any economy there are two key rules of the game: property rights institutions, which include protections against expropriation by the government, and contracting institutions, which facilitate private contracts between citizens. Acemoglu and Johnson find that, when property rights institutions protect people from expropriation (for example, via high taxes, price controls, or outright confiscation), individuals can profit from investment in both physical and human capital. This investment produces higher rates of growth, which eventually yield much higher living standards.

In contrast, the authors find that contracting institutions (such as those determining how difficult it is to resolve contractual disputes through the legal system) have little effect on measures of long-term prosperity. Instead, when contracting institutions are weak or flawed, but property rights are protected, individuals seem to simply alter the terms of their contracts to avoid most of the adverse effects of such flaws. In contrast, the only sure way to avoid predation by the state in the face of weak property rights is to refrain from investing in the first place—which yields poverty in the long run.



The authors' conclusions result from their empirical estimates of the impacts of alternative patterns of European colonization. They show, for example, that the legal systems brought by the colonists interacted with pre-existing conditions of the lands they colonized to shape the long-term institutions of each colony. Some nations happened to colonize prosperous lands where population densities were high, as Spain did in Mexico and Peru. These colonizers imposed legal institutions that would facilitate the exploitation of indigenous peoples. This yielded short-term riches for these colonial powers, but discouraged long-term investment. Other nations, such as England in colonizing North America, settled lands with few local inhabitants, and thus had to rely on investment and voluntary exchange to survive. This required strong property rights institutions, which promoted investment and yielded long-run prosperity.

These forces were amplified by local disease conditions. In locales such as sub-Saharan Africa, where settler mortality rates sometimes exceeded 50 percent per year, colonizers created legal institutions that enabled them to extract resources quickly, without regard for protecting long-term investments. This was an understandable short-term strategy. But its long-term legacy has been legal systems with weak property rights that even today enable governments to extract resources at will from their citizens.

In contrast, settlers in low mortality colonies, such as North America, opted for property institutions that would protect their investments from predation by others, especially the state. These decisions of 400 years ago have produced dramatic differences in long-term prosperity. Per-capita income levels today can differ by a factor of fifty across nations with different property rights institutions, and the people who live where property rights are strongest are the richest.

Today's contractual institutions also reflect the legal systems of early colonists' countries of origin. English colonists brought with them English common law, which made possible a wide range of relatively inexpensive means of settling contract disputes. Colonists from France, Spain, and Scandinavia imported civil law systems, which rely on cumbersome, highly formalized means of settling contract disputes. The difference in legal systems has meant considerably higher costs of creating and enforcing private contracts for citizens of civil law nations. By any of a variety of

measures, the red tape that must be endured to enforce a private contract in a civil law nation is roughly double that experienced in a common law country.

The authors find, however, somewhat surprisingly (in their view and mine), that this difference in legal formalism has little impact on current standards of living. They suggest that this may be because wherever there are strong private property protections, people are ingenious in writing contracts that will (mostly) keep them out of cumbersome regulatory and judicial systems.

This explanation is consistent with the work of Ronald Coase (1960), which showed that if property rights are defined, secure, and transferable, individuals will ensure that resources go to their highest valued uses. But there may be another (albeit complementary) explanation: Standard measures of real income treat legal fees as equivalent to, say, vacation expenditures. The results of this paper thus do not rule out the possibility that citizens of civil law nations spend their time in court, while those of common law nations spend it at the beach.

Apart from its general message on the long-term importance of social and legal institutions, this paper has an encouraging yet chilling message. Equipped with systems of well-defined and enforced property rights, humans can prosper anywhere on the earth. But if these institutions are lacking, any prosperity is likely to be short-lived, at best.

#### REFERENCES

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