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Richard A. Epstein

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Introduction to Spontaneous Order and Emergence of New Systems of Property

Yun-chien Chang & Richard A. Epstein***

The Spontaneous Order and Emergence of New Systems of Property Symposium was organized by the Classic Liberal Institute, New York University (“NYU”), and was held on November 14 and 15, 2014, at NYU. We thank the editors of the *Iowa Law Review* for their diligent and able work in rounding out the Essays from the Symposium for publication.

The theme of this Symposium is obviously inspired by Friedrich A. Hayek, a Nobel Laureate in economics and one of the most eminent classic liberal thinkers of all time. Hayek developed the term “spontaneous order” (probably coined by Michael Polanyi)¹ into an elaborate theory,² which he used to explain the social phenomenon of cooperation. The purpose of this theory was to demonstrate how a decentralized system, which relied on local and dispersed information held by a large number of different and unrelated players, could be brought together through the operation of the price mechanism. The genius of this system is that no person who participates in that system has to inquire into the private purposes of his trading partner. It is enough that he knows that the other side thinks that it is better off by the exchange. The system thus produces more reliable decisions at lower cost, from which Hayek deduced that this simple mechanism could outperform a centralized system, which was in vogue after the Second World War, when Hayek developed his theory. As private law scholars, we are interested in how private bargaining, contracting, and local custom shape the property regimes over different types of assets in various legal systems. It is for this reason that the Essays in this Symposium examine the different forms of property rights: those that are legal or customary, formal or informal, and de jure and de

* Associate Research Professor & Co-Director of Center for Empirical Legal Studies, Institutum Iurisprudentiae, Academia Sinica, Taiwan; J.S.D., New York University School of Law, kleiber@sinica.edu.tw.

** Laurence A. Tisch Professor of Law at New York University School of Law, James Parker Hall Distinguished Service Professor Emeritus of Law and senior lecturer at the University of Chicago Law School, and Peter and Kirstin Bedford Senior Fellow at Hoover Institution.

1. See CHRISTINA PETSOUHAS, HAYEK’S LIBERALISM AND ITS ORIGINS: HIS IDEA OF SPONTANEOUS ORDER AND THE SCOTTISH ENLIGHTENMENT 2 (2013).

2. See, e.g., F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

facto. The Essays examine these various permutations in the context of the property rights regimes in the U.S., Europe, and East Asia.

As developed in the Essays collected in this issue, the big picture appears to lend support to Hayek's general approach. Many new property arrangements did arise from spontaneous order, and many of these are efficient. Nonetheless, it is important not to be carried away by the notion that spontaneous order explains the full range of property rights systems. Bottom-up approaches often give us a good first approximation to the basic elements of a property system. But this conclusion does not always hold without qualification, for often times statutory rules are used to supplement and clarify customary rules whose exact parameters may remain uncertain.

Below we group the Symposium Essays, summarize the gist of each, and point out the relations among them.

Two Essays focus on the spontaneous order in the area of natural resources. Bryan Leonard and Gary Libecap provide a framework that enables us to understand the de facto, informal property rights in open-access regimes. They argue that de facto property rights in natural resources spontaneously emerge and maintain when users are heterogeneous and resources are both ample and heterogeneous. These initial conditions create search and production advantage for certain infra-marginal users. The rise of such spontaneous rights causes the open-access regime to persist longer, if the initial de facto property rights cannot be easily converted to de jure property rights. Oil, gas, and fishery offer examples of natural resource regimes used to bolster their claims.

Dean Lueck and Karen Bradshaw Schultz, in their joint work, discuss how landowners use contracts to govern landscape-level resources, such as wildlife habitats, scenic vistas, and fireescapes. The optimal size of managing landscape-level resources is usually larger than individual parcels—thus can also be described as “semicommons,”³ as farming or cattle raising is better conducted separately on individual plots whereas managing wild fire, for example, is more efficient and effective when done collectively. Transaction costs are critical in determining whether private bargaining is capable of leading to some spontaneous order or degenerates into anarchical disorder. More specifically, homogenous land use tends to reduce transaction costs, echoing the conclusion of the Leonard and Libecap Essay.

Related, but at a more abstract level, Lee Anne Fennell studies the establishment and sustainability of spontaneous order in managing commons and preventing rent dissipation. Fennell argues that resource needs to be properly segmented—or, divided into appropriate units—to reduce

3. See, e.g., Lee Anne Fennell, *Commons, Anticommons, Semicommons*, in RESEARCH HANDBOOK ON THE ECONOMICS OF PROPERTY LAW 35 (Kenneth Ayotte & Henry E. Smith eds., 2011); Henry E. Smith, *Semicommon Property Rights and Scattering in the Open Fields*, 29 J. LEGAL STUD. 131 (2000).

governance burden and produce convergence between private and social cost–benefit calculus. Property features can be lumpy⁴—or, discrete rather than continuous—and thus certain externalities can be irrelevant, as divergence of private costs/benefits from social ones may still produce efficient results. With the proper segmentation of a given resource, its most efficient use may emerge spontaneously. In the two Essays related to natural resources, resource segmentation, such as setting the limit for the minimal size of land, is crucial in facilitating private bargaining and transformation of de facto property rights to de jure property ones.

Several Essays, not surprisingly, touch on the *numerus clausus* principle⁵ and related issues. The *numerus clausus* principle states that numbers of property forms in any given asset are found on some closed list, such that it falls on the legislature to create new forms. This principle, when interpreted and enforced in its strictest sense, impedes the spontaneous emergence of new property forms, which are then ratified by judicial decision. In this Symposium, Yun-chien Chang and Henry Smith revisit the economic theory of the *numerus clausus* principle in order to lay new foundations in favor of optimal standardization. But they also caution against total rigidity, noting as their reference point that the civil law jurisdictions, which introduced the *numerus clausus* principle, tend to have too few property forms. After elaborating an information cost theory of property custom, Chang and Smith connect these two separate literatures together and thereafter point out that customary properties could be a safety valve when the *numerus clausus* principle confronts an inactive legislature. Drawing on the examples of customary properties in East Asia, especially those in Taiwan, they specify the underlying conditions for the emergence of new property forms.

A strict form of the *numerus clausus* principle is explicitly adopted in China. Shitong Qiao and Frank Upham, however, offer convincing evidence based on field work that, notwithstanding this apparent prohibition on the informal creation of new forms, an important de facto property right, “small property,” emerges nonetheless. More specifically, they show that residential buildings have been constructed in violation of building code and zoning law, which renders them non-registrable. Nonetheless, the want of an official legal pedigree has not stopped high volumes of transactions in these units, even though purchasers cannot receive legal title to buildings that under the formal law may be torn down anytime. Indeed, about half of the buildings in

4. For more discussion on this idea, see Lee Anne Fennell, *Lumpy Property*, 160 U. PA. L. REV. 1955 (2012).

5. See, e.g., Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373 (2002); Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000); Henry E. Smith, *Standardization in Property Law*, in RESEARCH HANDBOOK ON THE ECONOMICS OF PROPERTY LAW, *supra* note 3, at 148.

Shenzhen, China (the fourth largest city in China) are small properties.⁶ Qiao and Upham also challenge the central role that the law and economics approach gives to the right to exclude, by proposing instead a relational theory of property. Their relational theory defends an *in personam* bundle-of-rights conceptualization of property that emphasizes the key role of social norm and social practice—a spontaneous order—in establishing property rights, particularly in developing countries.

Lee Alston and Bernardo Mueller's Essay, titled *Towards a More Evolutionary Theory of Property Rights*, pays homage to Harold Demsetz's seminal 1967 article.⁷ Their work takes Darwinian "evolution" theory seriously. The unit of selection in their analysis is the design of property rights⁸ (i.e. the bundle of rights⁹) and the fitness refers to the perpetuation of this bundle design over time.¹⁰ The potential combinations of sticks in any potential bundle are essentially infinite. The original set of rights in a practical bundle is likely to emerge spontaneously. Property rights with sticks that operate independently of each other tend to yield optimal results. While the authors do not explicitly discuss the *numerus clausus* principle, it nonetheless works in the background as a way to greatly limit the possible combination of sticks that are observed in practice. That is, the workable bundles of rights¹¹ are limited in ways that might shape the evolution of property rights.

Richard Epstein then seeks to link the notion of spontaneous order to the emergence of natural law, that is, law that emerges without the conscious guidance of the state. In dealing with these rules, Epstein notes that the want of centralized enforcement tends to limit customary rules to one of two forms: either individuals share with each other on a pro rata basis, as open access to rivers and waters or the creation of riparian water rights. Alternatively, the law can gravitate toward systems of absolute priority, as with ownership in land, under which prior in time is higher in right. But as resource use becomes

6. See Shitong Qiao, *Small Property, Big Market: A Focal Point Explanation*, 63 AM. J. COMP. L. (forthcoming 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2399675.

7. See Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347 (1967).

8. An alternative way of testing the evolution theory of property law is to use "property forms" as the selection unit. Certain ancient forms, first championed by the Romans, such as ownership, usufruct, servitude and mortgage, withstand the challenge of 2000 years, while fading away are forms such as fee tail and *dian* (an ancient Chinese property form that is now rarely used Taiwan and was intentionally left out of the China Property Law of 2007). The former groups of rights can be characterized as survival of the fittest (they tend to be general and flexible).

9. For a recent defense of property as a bundle of rights, see Richard A. Epstein, *Bundle-of-Rights Theory as a Bulwark against Statist Conceptions of Private Property*, 8 ECON. J. WATCH 223 (2011).

10. For related discussions of why "styles" in common and civil property law persist, see Yun-chien Chang & Henry E. Smith, *An Economic Analysis of Civil Versus Common Law Property*, 88 NOTRE DAME L. REV. 1 (2012); Yun-chien Chang & Henry E. Smith, *Structure and Style in Comparative Property Law*, in RESEARCH HANDBOOK ON COMPARATIVE LAW AND ECONOMICS (Giovanni B. Ramello & Theodore Eisenberg eds., forthcoming 2015).

11. See Yun-chien Chang, *The Economy of Concept and Possession*, in LAW AND ECONOMICS OF POSSESSION 103 (Yun-chien Chang ed., 2015).

more intensive, often more complex systems of rights emerge, but these require the formation of a given state regime that should seek to strengthen the rules of acquisition, protection, and transfer that emerged in the early common law systems.

Two Essays demystify common belief or conjecture regarding certain spontaneous orders. Emily Kadens's Essay explains the operation of the extended credit network that emerged in pre-modern Europe. Kadens contends that reputation is not always sufficient to form sustainable credit arrangements, as the prior literature has assumed. To be sure, transparency and honesty of the debtors and the confidence of the creditors motivated much of the lending for a few centuries. But another mechanism—the setoff of accounts moving in opposite directions among traders—was operative as well. Every person in the pre-modern society was a creditor and a debtor at the same time, throughout his or her life. Government intervention through traditional legal remedies increased in importance as the size of lending transactions, and the communities in which they were made became too large for these control mechanisms to work without supplementation.

Ruoying Chen demonstrates that new property arrangements can emerge spontaneously in the most unlikely field of eminent domain. Chen describes the rise of an idiosyncratic phenomenon in China—invited takings. That is, the government would not make an offer to purchase real properties owned by private citizens, unless a supermajority (often 90%) of property owners in a community had invited the government to condemn their properties. The government is not bound to make offers to purchase a call option from these property owners, and these owners are not committed to accept the offers. The amount of compensation is standardized and formulaic, thus avoiding corruption. The invited takings regime in China in many ways resembles the land assembly district design advanced by Michael Heller and Roderick Hills in the U.S.¹² Chen's detailed description of the institutional details in China and careful theoretical analysis demonstrate that a spontaneous voluntary takings regime can work under certain institutional conditions.

Finally, Georg von Wangenheim and Fernando Gomez make the case for complex rules in nuisance law. Since Guido Calabresi and Douglas Melamed's seminal 1972 article,¹³ many writers have sought to figure out the best way to allocate and protect entitlements from these nontrespassory invasions. The two of us in our separate writings have generally preferred simpler rules, including a legal regime that makes injunctive relief the primary remedy in property law.¹⁴ In their Essay, Wangenheim and Gomez contends that their

12. See Michael Heller & Rick Hills, *Land Assembly Districts*, 121 HARV. L. REV. 1465 (2008).

13. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

14. See RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* (1995); Richard A. Epstein, *A Clear View of the Cathedral: The Dominance of Property Rules*, 106 YALE L.J. 2091 (1997);

more complex rules do better to regulate nuisance law as it develops in Spain, Germany, and the U.S.

It should be evident that these Essays look at many different facets of property law, and often approach them from many different points of view. But throughout the effort is to figure out the correct mix of entitlements and remedies that allow us to shape profitable interactions both among ordinary individuals and with government in a way that works to raise the overall standard of living and liberty for all persons.

Richard A. Epstein, *Protecting Property Rights with Legal Remedies: A Common Sense Reply to Professor Ayres*, 32 VAL. U. L. REV. 883 (1998). See generally Yun-chien Chang, *Optional Law in Property: Theoretical Critiques and a New View of the Cathedral*, 9 N.Y.U. J.L. & LIBERTY 459 (2015). One of us, however, recognizes that complex rules in certain contexts are more efficient than the property rule. See Yun-chien Chang, *Access to Landlocked Land: A Case for a Hybrid of Property and Liability Rules* (July 26, 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1986739.