

The goal of this introduction will be to give the reader a general introduction to how economics treats property rights and how this relates to intellectual property. Much of the discussion is aimed at summarizing the literature but some commentary is original. The first section aims to give a brief introduction to the roots of the debate and its modern framing. The second section aims to introduce the reader to basic economic notions in a static context and to familiarize the reader with how the Coase theorem is used to discuss property rights. In a third section we will discuss the dynamic aspects of property rights and some literature around incomplete contracts. In a fourth section we will discuss some mechanism design literature that relates to intellectual property rights.

We will then give a brief introduction to each article and attempt to situate them within the notions introduced in the introduction.

The first article aims to show that even if it is desirable to give a monopoly on a good, this does not entail that property rights should also be used against consumers.

The second article uses the Coase theorem but shows that the ability to negotiate for the buyout of innovations causes firms to pursue innovations that increase externalities.

The third article is a general model of discounting, the aim of this paper is to show that it is possible to define discounting as something other than a preference, under this interpretation, the choices entrepreneurs make is not a function of their preferences but a function of their environment.

Finally the fourth model presents a general model of sequential innovation in a network in an aim to show that royalties are in fact subject to Bertrand like competition.

1 The origins of the debate about private property

Plato's most famous work, the Republic, is a treatise on an idealized society, one that has managed to halt to a minimum its own deterioration from the perfect form. Plato's view of property rights is purely instrumental in that it is something that will help maintain the ideal society from deteriorating. Plato views ownership as an important source of corruption that creates clannish self interest and considers the panacea of this influence to be the abolition of private property. In "Politics," Aristotle takes a stand against his mentor and defends private property. Aristotle reasons that without private property people would interfere in each others affairs without being motivated by love. Indeed Aristotle viewed the act of waiving your rights to property against an individual a way to be virtuous, and a limitation of this right would limit the ability to be virtuous. The debate between Aristotle and Plato

has echoed for millennia. With various philosophers taking their sides on this debate. For instance Hegel defended property rights based on his theory of person-hood, stating that people are defined by their will and the only way to manifest their will is through physical objects.

Perhaps the most influential modern non-economic view of property is John Locke's theory of homesteading.¹ Locke's view of property rights is as a method of linking a person who is adding value to that value. This is done by mixing one's labor with the object or land which makes the physical object inseparable from its founder. In other words, this is a theory about the creation of property rights an originalism of sort.

Economics has always focused not on the origins of property but on its effects. Using this lense, perhaps the most famous critic of the Lockean theory of property was Karl Marx who claimed the opposite, that private property is the means by which workers become alienated from their labor. The logic behind this is rather simple, if an employee adds a number of hours worth of labor, he will necessarily be compensated less than that number of hours worth by the property owner otherwise there would be no way of making profit, hence exploitation. This is one of the first views of property which focused on the dynamics of property, specifically here, the dynamics on wealth inequality. However these kinds of interpretations have been superseded as value has been associated not with inputs but by the tastes of agents and the relative scarcity of resources. Similarly profit could be entirely explained by other factors such as the relative advantage firms have in information, whether it be an edge in production, taste, impulses of consumers etc. This does not entail that property is disconnected from value, merely that value is not simply related to labor.

Perhaps the first fully prescriptive system of property was articulated by Henry George², which aims to reduce some of the dynamics described by Marx. Henry George devised a system where property is temporarily allocated to the highest bidder. What is ingenious about the modern version of the Georgist scheme is that it aims to eliminate land rents by making tenants bid for their own rents. This creates a system where people will only earn their labor rent and not the land rent of value. Perhaps the most known response to this view is the view of Hayek³. In this view function of property is not homogenous across individuals and making ownership temporary is prescriptive in not only the system of property but also in what agents should pursue. For instance, an agent may wish to pursue non-monetary goals and the Georgist scheme cannot accommodate such a structure of production.

¹Locke (2014)

²George (1973)

³von Hayek (1991)

1.1 What is a property right?

What is a property right? ⁴ Some possible answers to this question are: Property is simply the default contract, that is, if people do not agree on a contract, property is what is taken as the baseline. 'Property as the default' view is simple enough: Person A can contract with person B that person B will not touch or use item z without A's permission. This in fact requires no property right at all. What does require a property right is that all other people will also not be able to do with z as they please. If agents could all simultaneously consent or if there were but two agents who could contract, there would be no need for property rights. Indeed property rights rely on the inability to contract.

1.2 The language of property rights

Discussion of property rights often suffer from precision. To clarify our definition we use some legal language ⁵.

It is convenient to speak of two categories of rights. First order rights and second order rights. First order rights are what is often called, the right to use or the right to exclude. The right to use is often called a "privilege" and the right to exclude is called a "claim".

Second order rights are rights about first order rights. For instance when one talks of "power" this is in reference to the right to transfer, waive or annul "claim" and "privilege" rights. For instance, the right to transfer property to someone else is a second order right. One can also speak of "immunity", which means that one has the right for his "claim" or "privilege" to something to not be affected by others.

Notice that if an agent has full second order rights over an object, this entails the ability to have first order rights. Both first order and second order rights may be under negotiation in contracts, the possibility space is automatically much narrower without second order rights. The idea of second order rights entirely entails the right to destroy and to abandon, if someone does not have second order rights this entails the agent has no right to destroy or abandon. ⁶

To clarify ideas it useful to know how this taxonomy matches with traditional economic ideas. For instance clearly if there is a law that requires property owners to allow access, this is a limitation of the first order right of "privilege". A regulation stating that one may not consume or use one's land in a specific way is similarly a reduction in "claim" rights. A

⁴The presentation borrows from [Munzer \(1990\)](#)

⁵see [Hohfeld \(1917\)](#)

⁶for an interesting analysis of the right to destroy/abandon see, [Strahilevitz \(2005\)](#), [Strahilevitz \(2009\)](#)

price control is a limitation on what price one can sell their good for, as such it is a "power" limitation. A constitutional constraint is an example of a second order right of "immunity" being increased.

Similarly, the types of arrangements possible (corporations, partnerships, non-profits, licenses, bailments, non-voting common stock, trusts, agencies, employee-employer relationships marriages etc) entirely depend on the above taxonomy. With this in mind we clarify how some property right paradigms fit into this conceptual framework.

Private property grants all of the above rights. Private property gives the right to use, the right to exclude, the right to transfer/waive the exclusion and immunity from someone others altering one's claim. *Private property* has been defined as the ability to use one's property in any way one wishes as long as the *physical* characteristics of others private property is not affected ⁷. This definition of private property has the advantage of setting an objective standard and requires no reference to subjective clauses. To see an example of the issues with defining private property rights as "the right to do with your property as you wish as long as nobody else is harmed by it," one need only notice how ambiguous this standard is if the question is about the right of someone to build a skyscraper given that it blocks the view of a neighbor.

Communal/Public/ property on the other hand gives all agents in society the right to use but not the right to exclude. ⁸. Communal property gives second order rights to the state. In practice, the distinction between communal and public ownership is whether the state exercises its second order rights. If it exercises it for setting up things such as a military reservation, then we call it "public". Communal property is technically a first come first served type of property. It has been said that agents with communal rights tend to ignore the cost of use ⁹.

Georgian system of property. The Georgian system of property is a system which temporarily grants first order rights to individuals. The system does not have discretion like public property has, however, second order rights like power and immunity are still in the hands of the state, as such it is merely about how the state decides to use, which is simply to create an auction for temporary rental.

The language presented is especially useful for the analysis of intellectual property. Whilst each physical property can be seen as a list of rights and the matching of those rights to individuals or groups of individuals the concept of intellectual property is qualitatively different.

⁷Alchian (1965)

⁸what is deemed the right of the absentee owner see Alchian (1973)

⁹Alchian (1973) mentions how the Canadian government in 1970 set an upper limit to the number of seals to be clubbed which caused speed of hunting to be the competitive trait

The notion of intellectual property is a limitation of the first order right of "privilege" on physical property. That is, if one has intellectual property on the concept of a wooden chair, this is in fact the limitation on the use rights of all owners of wood. Alternatively, there are instances where the law permits copying but not commercialization, in these instances the first order rights are not affected but the second order rights of "power" are limited conditional on the use of the asset.

Is the change in allocation of rights substantive? In other words is this whole exercise just a redefinition but does not imply any changes in resulting actions? Well the nice thing about this taxonomy is that the proposition that both systems work identically is the proposition that second order rights do not matter. In theory, public and private property can both pursue the same kind of goals, profits/charity, in practice, once the incentives of the agents are taken into account the theory of property rights becomes descriptive. For example, a price control or a "power" limitation, as it restricts the conditions of transfer an owner can make, this can lead to the agents choosing differently. For instance, an agent renting out an apartment may prefer childless/petless adults to avoid noise or damage to his property, in other words, leading to both investment and allocation differences.

2 The static economics of property rights

Much of economics treats law as merely instruments to utility maximization. Where each branch of law, tort, contract, is aiming to create rules that increase utility and each branch captures new elements. Discussion of property rights can be broken down into four distinct questions. 1) What are the assets that property rights protects? 2) From who is the property protected? 3) What is the content of property protection. 4) What is the enforcement mechanism by which property is to be protected. The economics way of answering these questions generally leans on two kinds of efficiency: allocative efficiency and investment efficiency. Allocative efficiency means either to give it to the agent who values it the most or the agent who has the lowest cost to operate it. Both of these dynamic notions require the static concepts of value. Value in economics is usually broken down into two components, market value and subjective value. These notions are important in that the whole framework of analyzing property rights leans on their interaction. We quickly analyze some cases of how these notions interact. One of the achievements of economics is the deduction of the market value of an asset by the description of the subjective value. Note that a positive market value does not imply that exchange occurs, indeed subjective value is key to whole framework of the optimal allocation of property rights. When discussing numerous independent assets the above logic holds, however when the utility of assets is not independent then additional notions enter into the framework. Independence of assets simply means that each asset is to be valued separately and does not depend on whether other assets are acquired with them.

2.0.1 Identical and strictly positive subjective value for all agents

If an asset has an identical positive value for all agents then it has a positive market value but no exchange occurs.

2.0.2 Identical and null value for all agents

Suppose an asset has zero subjective value for all agents, then it also has zero market value because nobody is willing to buy it.

2.0.3 Identical and negative value for all agents

Then the market value is negative and the allocation of property rights just means, "who will be targeted to receive this asset". In such a case, there is a demand for abandonment or destruction. The decision whether to force the ownership of the asset to occur should

depend on whether the asset is best left abandoned or destroyed, if the optimal use of the asset is its destruction then ownership should be forced, if its optimal use is abandonment then no property right is necessary. Of course there may also be a situation when one requires someone to own something without giving that person the right to abandon or destroy(keys).

2.0.4 Variable and weakly positive value for all agents

Suppose now that we introduce variance into the mix. If agents have differential positive value for the asset, then a positive market value exists and an exchange occurs unless the highest value user is one who is allocated the property.

2.0.5 Variable and weakly negative value for all agents

Hot potato: Similarly if all agents have a differential negative value of the good then there is still a value market value to the good unless the highest value user owns it. This is because if anyone other than the highest value user owns the good, they would be willing to pay the highest value user to own it. In this case they would consider the lowest cost alternative between subsidizing the highest value user to own it versus destroying it or abandoning it.

2.0.6 Variable, positive and negative value

Some difficulty arises when we mix the cases, for instance if the distribution of subjective value include both positive and negative values, then clearly if transaction costs are zero then there will occur a trade if the good is given to anyone but the highest value user.

2.1 Coasian paradigm

A *transaction cost* can be defined as the cost of accessing the market value. So by definition, if an agent owns an item at equilibrium and has a lower valuation of it than the market value of the object, this must be because of the transaction cost. In other words the broad category of transaction cost can include, psychological, institutional, physical factors etc, anything that prevents an entailment of the form "If this individual owns it then this individual has the highest value". From the point of view of efficiency(to be defined in the next paragraph), the question of making destruction or abandonment illegal becomes relatively more important as transaction costs increase due to the risk of over-destruction or over-abandonment. A liquidity constraint(also called a pecuniary externality) is also a

sort of transaction cost, if agents cannot buy a good whose market value is lower than their subjective value then we have a reason for allocational inefficiency. Similarly, if an agent does not know of the market price or say is ethically against using the market mechanism, these are both types of transaction costs. There are many things in society which are either naturally or legally inalienable(kidneys, votes, future labor, historically important, etc), and to the extent that inalienable endowments exist these can be interpreted as exorbitantly high transaction costs. From the framework examined above, a transaction cost is usually a function of a lack of second order rights, one can only transact on the rights they have.

The notion of efficiency in economics has a static and a dynamic dimension. Static efficiency is usually termed *allocationally* efficient, this simply means that the set of actions which maximize the total payoffs is taken. When the question being posed is related to ownership of an asset, allocational efficiency simply means that an asset is owned by its highest subjective value user. When discussing assets allocational efficiency generally does not make reference to pareto efficiency but to Kaldor Hicks, which says that enough value has been created that the sum of values is greater than before.

The dynamic notion of efficiency used in economics is the notion of *investment* efficiency, this notion of efficiency brings attention to growth. The idea behind investment efficiency is that the allocation that results will lead to the highest amount of growth and hence eventually, the highest long run payoff eventually. The two notions are sometimes in conflict in that static efficiency is not necessarily good for growth. The interaction between these two ultimately depends on the discount rates of agents, when the agents don't discount the future, the two are perfectly compatible.

The Coase theorem is fundamentally about static efficiency. The theorem states that if transaction costs are zero, the result of the market interactions is allocationally efficient. This can also be interpreted from an action standpoint to say that the actions which maximize total payoffs are undertaken. If on the other hand there are non-zero transaction costs we can only discuss constrained efficiency in the sense "of those who entered the market, the highest subjective value will receive it". There has been a reading of Coase where a zero transaction cost world implies no firms, this reading however depends on not having gains from specialization [Demsetz \(2011\)](#)

The Coase theorem is of direct relevance to most analysis of externalities. Externality is often a poorly defined concept ¹⁰, one temptation is to define it as effects on non-consenting parties, however this is too large of a conception since competition is all about negative externalities between firms. Instead externalities are best defined as effects on non-consenting

¹⁰for details about why it is a poorly defined concept see [Cheung \(1970\)](#)

parties which do not pass through the market mechanism. The theorem was initially framed with externalities in mind, perhaps it's most counterintuitive result is that it implies that externalities become internalized if there are sufficiently low transaction costs.

The theorem also describes the kind of effects the legal system can have. Take a problem situation where there is an infringer and the owner of the property that is being infringed. If owner has veto capacity on his property and others can only use it with his permission, this is called a property rule. If on the other hand there is fixed or court determined cost associated with infringement this is called liability rule. The theorem states that when transaction costs are sufficiently low, both liability and property rules will result in an allocationally efficient outcome. This has sprouted a rich literature on choosing the legal rules as a function of transaction costs.¹¹ For instance, the liability rule may be preferred due to: the holdout problem; free riders; accident situations; if the infringer is better informed; if the infringer has less liquidity; etc etc. Alternatively, if transaction costs are deemed to be sufficiently low, the legal rules can be chosen for other criteria than allocational efficiency, for example, distributional considerations.

¹¹Theoretical: [Calabresi \(1972\)](#) Empirical: [Kaplow \(1995\)](#)

3 The Dynamic creation of property rights

Once we introduce time into the picture a few things become more complicated. Time may create new property in one of two ways, either because the actual material goods have increased or because new information has led to an increase in property, for example, the discovery of existing assets. New property creates questions about how to allocate property that previously had no owner. In other words, time gives rise to questions about property allocation before it exists, *ex-ante*, and whether property is allocated after it exists, *ex-post*.

There are *ex-ante* rules one could adopt that solves property allocation problems. For instance if all surface area is fully allocated, then new physical property will just be allocated to whoever owns the surface on which it is discovered. Full geographical rights in this manner give rise to questions of volume rights, such as air or underground, one has to decide if land property expands into the sky via cone shape or just a tower like rectangle, these kind of questions can determine the operating costs of underground facilities or the cost of flying overhead due to air rights. *Ex ante* fully allocating surface area rights is difficult, mainly because agents are often not interested in allocating property before it has a value, instead property rights emerge naturally as the value of assets increases, at some point there will be demand to create rights ¹².

An *ex-ante* regime of property can apply to both physical and biological property. For instance, if a piece of land is found to contain oil, it would go to its owner. Similarly for organisms, if a pet is owned, one usually owns its offspring.

Consider an asset that creates new assets and is owned *ex ante*. If the production of future assets is independent of usage then the owner need only consider the demand side of the market. If on the other hand the production of future assets increases with use the tendency will be for use to be maximized. If on the other hand the generation of future assets decreases with use, then the optimal extraction rate will depend on the discount rate of the owner. In these cases the concepts of allocational and investment efficiency are unclear concepts, mostly because there is no clear question as whose discount rate matters. Nevertheless, if it happens that the discount rate of the owner is somehow identical to some broader notion of discount rate, the owner will have the incentive to harvest at optimal rate. For the case of fisheries this just means the owner will tend to calculate the optimal rate of fishing per period, if the demand for fish is more or less constant per period, this harvest rate will correspond to the long run maximum number of fish rules.

The cost of *ex-ante* allocation is an important factor in determining the regime that will

¹²for details about the emergence of property rights see [Alchian \(1973\)](#)

be adopted. For animals there are times when ex ante allocation can be cheap (branding, collars, microchips, etc) and times when it can be expensive (fish, birds, etc). If it is difficult to create ex ante allocation then there will be difficulties which depend on the ex post regime adopted.

The basic problem of dynamic property rights is conditionality. That is, property that is only allocated conditional on some effort. A potential normative role for the economist is to judge if the effort in question is desirable. It seems clear that if the effort is investment in some socially desirable good, then the conditionality is positive. However conditionality can also cause negative effects.

Consider the case where animals move between properties. The ex ante ownership of the animals would result in Coasian bargaining, in this case investment efficiency may look like an oasis or fences.

If it is costly to create an ex ante allocation on animals a number of ex-post conditional property regimes may arise each with its own effects. If the animals are only owned conditionally on being on the land, this creates incentives for fencing as long as the wild animal has higher subjective or market value than zero. If the animal is only owned if killed, then this creates an incentive to kill it. If land is lost (re-possession) conditionally on having deer on it, then this creates an incentive to kill/abandon or sell the deer. In other words, the conditionality of property rights can have a plethora of effects. Notice that the fence may emerge in both the ex-ante ownership and the conditional on land ownership, however in the latter case, the presence of the fence is not necessarily efficient (in the Kaldor Hicks sense).

In the case of public property rights often the conditionality is on geography. For instance, if some property's fruits are shared based on some geographical specification, this incentivizes entering the geographical area in question. In a sense the only way to sell one's share in the property is to move. This often has the effect of involuntary dilution of one's share due to new entrants.

In the case of private property a similar dilution may occur in the case of stock ownership, but it is usually for an associated sum with the idea of increasing the value of the shares held by investors by more than their dilution. In other words, when production plays a role, property is best attributed more directly to the people who are responsible for the production, this could be because they have knowledge of how to use it, or because they have some characteristics, such as risk bearing ability which would create higher productivity.

A specific case of this conditionality are conditions on labor. Firms decide to reward employees based on their production, based on the assumption that agents put in effort as a

function of the compensation conditional on that effort. For instance if there is a set of agents and a set of assets, and each agent can only work on a single asset, then it is simple to show that more production will be achieved in the case where agents own a higher fraction of the assets they work on than if their ownership was more distributed. This basic logic has led to the development of the modern theory of the firm due to Hart and Moore.

Conditionality can shed new lights on the normative theories of property rights. For instance, Locke's theory that something is owned conditionally on mixing one's labor with it, whilst a moral theory, from the point of view of economics has descriptive content in the sense that such a property rights paradigm incentivizes people to put their labor into things.¹³ From the economic point of view this is not necessarily efficient relative to ex-ante ownership because this creates an over-incentive for labor instead of output. However if we consider that there is uncertainty about the creation of investments and a general unforeseeability, yet we also think that labor has positive upside, then the regime of labor mixing may be superior for output.

The idea that property is granted conditional on some actions is a simple way to frame numerous concepts in economics. The questions of allocation and investment efficiency are both dependent on the conditions under which new property is distributed. For instance, take an example of the tragedy of the commons, overfishing. The issue with fishing is generally that all agents have the privilege of fishing the fish without actually owning them. The specific conditionality is that the fish is only owned once fished out of the water, which creates an incentive to overfish. The tragedy of the commons arises when first order rights and second right order rights are granted conditionally. Of course if there are no conditional property rights at all, even conditionally, then the only action the economic agent will undertake is direct pleasure and survival.

The tragedy of the commons disappears with a number property right regimes, what they have in common is elimination of some sort of conditionality. For instance if fishing does not give you the right to sell(power) the fish but gives you the right to use it(privilege), then the level of fishing depends entirely on the cost of fishing and the demand for fishing, the problem then becomes purely a problem of population, clearly as the population increases it causes increases in fishing. Note however that this outcome may not be efficient in the Kaldor Hicks sense since some agents may have a lower cost of fishing.

In general we may say that if there are full unconditional property rights, and the transaction costs are low, the allocational and efficient outcomes are achieved. On the other hand conditional property rights give rise to overuse(relative to the unconditional case) and no

¹³Nozick, Anarchy State and Utopia

property rights gives rise to underusage.

When numerous effort levels are possible it is also possible to talk of the strength of the conditionality. That is, the more effort, the more rights, this gives rise to an analysis of the connection between effort and distribution. In the incomplete contracting approach the new property is created conditional on some effort, but distributed as a function of ex-post bargaining power. While in the static Coasian view, the ex post distribution does not affect decisions, in an incomplete contract world, the distribution matter. This basic tension motivates some general results on private property.

The general motivation for property rights in the incomplete contracting literature is that property rights allow for investments to be undertaken before a contract is signed. Why is there a need to give negotiating power ex-post? Because ex-post, the other the other party has no reason to compensate for more than the value added to the transaction. In other words, other parties have no need to compensate agents for their fixed costs which were undertaken before the contract was signed.

Why can't contracting be done ex-ante? There are two commonly given reasons, either contracting a priori is not profitable or because the future states cannot be described [Hart \(1999\)](#). The foundations of incomplete contracting have often been criticized because firms can just contract on outcomes instead of states and this can be equivalent to the first best contracts.¹⁴ This is part of a setup for a larger problem in economics, the *hold-up* problem, which says that if agents cannot use their sunk costs in the first period to negotiate in the second period, they will always underinvest.

The justifications often go very far to explain something that can have quite a common sense foundation. Why can't agents contract ex-ante? Because they are not agents ex-ante. For instance, if we imagine an individual throughout their life, some of their choices will be decided by those around them, either because of the cultural atmosphere or because they are not capable of making decisions. In a family structure, a parent may wish to invest for their child but they cannot contract long term on the child's behalf (this would be a form of slavery). Instead the parents can optimize ex-ante investments for their children without committing them to long term contracts.

Incomplete contracts imply a number of things about the theory of the firm. The theory of the firm is often framed as being about whether to outsource or insource production. The problem with insourcing is that agents will be less motivated to put in effort, the problem with outsourcing is that agent ex-ante investments cannot be recovered later on. This reasoning has been used by economists to explain why innovation often occurs in small firms, in large

¹⁴see [Maskin \(2002\)](#) and [Maskin \(1999a\)](#)

firms workers have an incentive effort that is observable to the owner. [Holmstrom \(1989\)](#).

The mechanics of the model are simple. In a first period firms can undertake ex-ante unobservable investments, in the later period they can try to sign a contract with some other party that owns the asset that makes the investment useful. The problem is that the investment has already been undertaken by the time they are re-negotiating with the other party and the other party has no reason to compensate them based on their past investment, this will then lead to firms underinvesting. If there is only one firm that can undertake the investment, then the solution is simple, the firm need only ex-ante buy the asset it needs from the other party and then invests and reaps the profit on its own.

However if both firms can undertake investments, there is larger issue. The party that does not own the asset will underinvest. There is no notion of equal ownership possible because the asset is indivisible. Fortunately there is a solution to this, however, it requires more time periods. First one of the firms owns the asset and invests on the asset, it then sells the asset to the second firm which then undertakes its own investment, this can be setup ex-ante by giving second firm an option contract to buy the asset. Since both firms will fully reap the benefits of their investments this will not lead to underinvestment. This same logic can be interpreted through re-negotiation, instead of buying the asset that has been worked on, the parties just bargain after the investment, but all the bargaining power has to be given to the party that invested. This sequential logic has limitations if there is uncertainty about what the optimum is ¹⁵

Note that the ownership of the asset itself is not the causal factor. What is important is that a firm that is not needed has veto power. The framework is interesting because it does not identify the source of the value of a transaction but instead merely states the necessary conditions for the value to be created.

More generally, the model has a few conclusions: 1) If only a single agent can make asset specific investments, then allocative efficiency says that that agent should own all the assets; 2) All assets should be controlled by a single person at a time; 3) No more than a single agent should have veto power over an asset; An explicit assumption of this model is that assets only have value on the ultimate coalition that ends up using them. While this may be true in physical property, it is probably false for intellectual property.

Conceptually we can imagine the effort as flowing towards three different components. The three components are, either the effort flow directly into the agent putting in the effort(human capitalish), either into an asset(physical capital), or into another party. The question of

¹⁵for designing the option contract see, [Nöldeke \(1998\)](#), for sequential investments with complementary assets see, [Zhang \(2014\)](#),[Bessen \(2009\)](#) , for the breakdown of conditional contracts see, [Maskin \(1999b\)](#)

private property has to do with how many parties should have veto power over the use of the asset, and how should the veto power be distributed. In general, the presence of the veto power is a disruptive force so it is best to give it to the party whose non-participation would already be most disruptive or whose participation is already necessary. ¹⁶

Specifically if the effort(s) flows directly into either the agent(s) putting in the effort or directly into the asset, it is best to minimize veto power. When the effort flows directly into it's own agent, then it is best if no veto power exists at all. If on the other hand the effort flows directly into the asset, then it is best if the asset is given to a single agent, the agent who is most productive with the asset. ¹⁷

On the other hand if effort flows into other agent's(perhaps we can imagine agent's funding each others education) then we no longer minimize veto power. If only one agent exerts the effort then he should own the asset. If both agents exert effort that flow into the other, then both agents should have veto power. ¹⁸

Some additional results from the incomplete contracts literature are highlighted below: Agents can also endogenously decide between them who will own the asset, this will depend on their relative marginal contributions to the asset and their ex-post bargaining power, or if there are liquidity constraints, they may prefer a third party to own the asset; The framework can also be used to discuss the narrow incentives of the firm that will potentially integrate as opposed to the broader incentives of the firm being bought over in a scientific vs commercial payoff context; In the context of innovation, the incomplete contracts framework implies that for ex ante contracts to be less restrictive, a larger amount of liability is required, to weed out bad inventors; If there is also asymmetric information between the two parties, it can also be shown that joint ownership with veto power is optimal, this induces parties to share their information; ¹⁹

The setup of veto power given to unnecessary members is especially suited to analyzing intellectual property. The kind of situation described where, where a party is in a coalition for the sole purpose that they have an asset is, in fact, the norm in intellectual property regimes. The contracts framework is interesting because the value created between parties in the original work is not the price of the good but the value of the transaction. To render this point clear, suppose there is only one coalition using intellectual capital, now a different

¹⁶the original model was intended for human capital only, created by [Hart \(1990\)](#) which builds on the work of [Grossman \(1986\)](#)

¹⁷For efforts flowing to assets, see [Schmitz \(2013\)](#), [Gattai \(2016\)](#), [Schmitz \(2017\)](#).

¹⁸see [Hamada \(2011\)](#)

¹⁹see respectively, [Aghion \(1994\)](#),[\(Lerner and Malmendier, 2010\)](#),[\(Anton, 1994\)](#), [\(Rosenkranz and Schmitz, 1999\)](#)

coalition without any intersecting members may adopt this good without decreasing the value of the first coalition.

Notice that the notion of value being used here is not profits but subjective value. That is, while it is true that being the second firm to use an intellectual asset may mean a firm reaps less profits, in the subjective value sense this is not correct. That is, it is not because one agent figured out how to use his assets better first that the second agent will be less happy about discovering the same method. The framework of [Anton \(1994\)](#) use the profit notion of value and not the subjective notion of value because they assume that as knowledge leaks from the intellectual asset occur, eventually the asset becomes worthless.

Depreciation in use is the most natural way to conceptualize the quantitative differences between physical and intellectual capital. In a model one can say that assets are used sequentially and that transactions which use physical assets lose value the later they are in the sequence, whilst transactions that use intellectual capital do not lose value with use. you could just assume that as the asset is used, its knowledge leaks out into other users and eventually becomes worthless. The value of intellectual property only decreases because of copies or leakage.

4 Intellectual Property

Intellectual property is the broad term used by economists to refer to Patents, Copyright and Trademarks. Patent's generally being protection of non-digital technologies, copyright being the protection of digital technologies, and trademarks being protection of a specific image or logo with which companies identify themselves. When economists discuss intellectual property they usually only encompass patents and copyright. The question of trademarks, whether consumers can identify a specific producer is generally uncontroversially considered as an ability to monetize reputation.

The general goal of intellectual property is to increase innovation. Whilst many believe that the purpose of the intellectual property system is to protect inventors, the economics approach attempts to follow the legal imperative, which is that the system is about incentives. In other words, in theory, if it can be shown empirically that the intellectual property law inhibits innovation, the legal system should theoretically abolish the rights altogether. Much of the problem with this stance is that the legal system imposes a system and asks for evidence that it is not necessary, when in most traditions of common law, the approach is the opposite, the legal system will intervene if there is evidence to support a certain claim. This implies that there is a shift in the burden of evidence, whilst most common law starts with a problem

and gives a solution to it, the intellectual property rights approach gives a solution and then asks for evidence that the problem does not exist.

Economists often group patents and copyrights because the market structure justifying intellectual property is similar advocates describe. To balance incentives/deadweight loss of intellectual property, economists focus on the ratio of the cost of discovery to the cost of copying. If the cost of development is immense but so is the cost of copying, then there is no need for IP since an entrant cannot come in to reap the profits. Similarly the case where the cost of copying and the cost of innovating are both low also implies there is little need for protection.

The justification for intellectual property has been changing ever since its inception but they can be separated into two categories, ex-ante and ex-post. Ex-ante reasons, that is, to justify what would occur by the presence of protection *before* an asset exists. These reasons are about creating the incentives so that the asset/innovation will be created. Ex-post reasons on the other hand are justifications for protection after the asset exists. Ex-post justifications are about ensuring that the asset is optimally used, in both an investment efficiency sense and an allocational efficiency sense. ²⁰

The origin of copyright in England is particularly interesting because it gave rise to the arguments in favor of intellectual property. Stationers' Company, a publishing house, petitioned parliament for the first copyright laws in 1643 making a number of arguments, the most economically important being: 1) Books are a luxury good and demand for it is elastic, therefore it cannot harm the public; 2) A monopoly would create a safer environment for sales and increase both the number of books and decrease their sales; 3) Would reward the book authors; After almost two centuries of copyright it was noticed that there was a divergence between American book prices and English book prices, so the arguments in parliament changed. The new emphasis was on emphasizing how poorly publishers could predict the sales of books. The poor ability to forecast future sales implied a need for higher prices so that the publishers to recuperate their costs. Interestingly this argument did not justify the divergence in prices between US and UK prices, and as Plant points out, the firms likely understated their ability to predict sales. ²¹

The alternatives to intellectual property can also be separated into ex-ante or ex-post. Innovation can be undertaken by seeking funds before it is undertaken. Patronage was historically the main source of funding for music, architecture, books, etc, whether this be patronage for pleasure or for profit. In the modern world, in addition to patronage there is equity finance,

²⁰for a discussion of ex-ante versus ex-post justifications [Lemley \(2004\)](#)

²¹[Plant \(1934\)](#)

debt financing or crowdsourcing (examples are Kickstarter, gofundme, Patreon, etc). The advantage of patronage and crowdsourcing is that they do not rely on a future stream of revenues since the funding arrives directly from the consumer. Ex-post financing is often what the economics arguments are targeting as infeasible because once an innovation exists other agents can also use it. Ex post financing usually means services or products that use the innovation in some way. ²²

Reverse settlements, the practice of extending patents by paying other firms not to use a technology imply a few things about market structure. The simplest implication is that transaction costs are not very high, so it is possible for firms to strike Coasian bargains. Since these contracts are firm specific, the empirical implication is that smaller firm's don't matter enough to change the profitability of such arrangements. The scope of reverse settlements is unknown, but if these contracts are possible before the creation of an innovation, it may imply that a large segment of the patent system is unnecessary since firms can just negotiate a priori with the limited number of firms who could use it. The ability to patent could then be interpreted as an increase of the bargaining power of the first firm?. This kind of reasoning implies that patents should only be granted to radical innovations because they would be ineffective otherwise, this is because if the innovation does not have sufficient profits in a fixed time period, it would not be created at all. ?. ²³

An alternative explanation for reverse settlements is that patents are, in practice, probabilistic, and firms don't want to take the risk of the court failing to validate their patent. This probabilistic feature can have two effects, it protects innovations which upon closer scrutiny, would not be protected, and will favor that firms pursue secrecy strategies. ²⁴.

Intellectual property is subject to a unique asymmetry in legal enforcement. In a normal property trespassing dispute, if the trespasser is found to be in the right without mention of his idiosyncratic attributes or circumstances this would create a general free access to the property, the total value of this free access would be naturally bounded due to the scarcity of the property, there can only be so many resources to extract. On the other hand, if the asset is an intellectual asset, if the court denies the intellectual property, the potential user base is virtually boundless due to the non-degradability of an idea. In other words there is a structural asymmetry in patent law, where patent validations are private goods and patent negations are public goods. This means that unless the public goods problem is overcome the

²²this has a number of assumptions: perfect information, no reputational mechanism, no developed expertise, etc

²³this class of models is presented with probabilistic enforcement by ?

²⁴For details about probabilistic enforcement see, [Lemley \(2005\)](#), to see how reverse settlements can signal invalid patents see: [Dolin \(2011\)](#)

regime may consistently not take into account the proper costs and benefits of intellectual property.

4.1 Assumptions of intellectual property

There are two fundamental assumptions that underlie the theoretical justification for intellectual property. These are the assumption of foresightedness and the assumption of a weak first mover advantage.

Perhaps the most commonly ignored in the economics literature is the assumption of foresightedness. Since the argument for intellectual property is that after the innovation exists, there will be no rents possible on it, agents won't invest to make this innovation occur. This fundamentally implies that innovation is directed, that is, that there is an agent who will invest based on his expected future payoff.

There are alternative to innovation through investing in foresightedly profitable projects. Why might an agent take on a costly project that is not foreseeably profitable? One simple answer is that the agent is a hobbyist, that is someone who enjoys the prospect of discovery. There is also perhaps an inbuilt assumption in the question, that is, do agents undertake on projects that have known outcomes? Clearly the answer is no, whilst there are areas where the agents know the result they want, they do not know which method the given outcome will occur.

What force matters if foresightedness is not possible? The behavior of agents can be said to be determined by two forces, incentives and evolutionary. If there is thick fog of unknowability in the most radical sense, the long term behavior of agents will be entirely determined by evolutionary forces, these forces in an economic context would be the market structure. If for instance the market environment is such that it gives rise to specific business practices, then those business practices that will emerge in the long run would be maximizing the probability of finding things out.

Another answer to why agents innovate perhaps a more controversial one from an economic point of view is to view agents not as calculating but as heuristic creatures and discovery is made serendipitously. This is not as rare as it appears, in fact it seems like a development through accident without a clear direction is the norm rather than the technology. Specifically for medicine, it seems there is a long list of breakthroughs which was not directed, but discoveries through learning by doing: Periwinkle, Platinum, Aspirin, Thalidomide, Librium, Valium, Thorazine, etc . Similarly the Jet Engine seems to have been developed without a clear sense of the developmental process without a very limited background in physics.

Similarly the modern understanding of Cybernetics through formalized by Wiener in 1948 was just an ex-post formalization of existing systems. Perhaps most noteworthy is how the processes of development in fields such as architecture was itself the cause of developments in the structure of mathematics. The general takeaway is that the ideal of "theory to practice" often is contradicted by evidence, indeed, the practice is often what leads to the theory. ²⁵

The idea that innovation occurs due to heuristics does not imply that the rate of innovation is policy invariant. Indeed the competitive environment can matter a great deal since for innovation to occur at the evolutionary stable state it should increase the probability of survival of agents who innovate, nevertheless the returns to imitation will be bounded and in equilibrium, innovation will occur. Winter (1993)

The second fundamental assumption of intellectual property is that being first to market has a very limited effect on profits. This assumption can seemingly manifest in economic models in one of two ways. The common way is to assume that the structure of the market is such that once an innovation is created at some cost, F_1 , the next person to enter the market can freely use it and pays less than the initial creator to use it, $F_1 > F_2$ whilst having at least the same revenue as the initial firm, R . The specific description of this market structure is then $F_1 > R > F_2$. That is the revenue of the first firm is between the fixed costs of the first and second entrant. The argument against intellectual property then can take three forms: 1) the interval between the fixed costs is minimal(both firms entering does not affect whether the innovation is undertaken); 2) The revenue of the second firm is lower than its fixed cost(second firm will not enter); 3) The revenue of the first firm is not sufficient(innovation would not have taken place anyway)

Using this second assumption as their baseline, one of the first formalization of the model is due to Loury (1979). The general results are that 1) as the number of firms increases, equilibrium investment decreases. 2) If increasing investment of a single firm decreases investment of all other firms by a smaller amount then increasing number of firms decreases expected invention date. 3) Profits go to zero if technology for innovation is concave only as number of firms to goes to infinity 4) If technology is convex then profits may go to 0 with finite number of firm. However this kind of model is fundamentally fragile to the cost structure of the firms, for instance if innovation is not a fixed cost but a variable cost through time, Lee and Wilde (1980) show that the equilibrium investment is increasing with the number of firms. Additionally if firms decide when to enter the market, this kind of framework can imply that it is optimal for firms to delay when they invest. ²⁶

²⁵Medicine: Meyers (2007), Jet engine: Scranton (2006),Cybernetics: Mindell (2002), Architecture: Unguru (1992)

²⁶Weeds (2002). Uses investment under uncertainty framework of Dixit and Pindyck (1994)

Fundamentally, if the assumptions that patents induce innovations are correct, patent length and patent breadth are the key policy tools. In an industry where products are substitutable and where the rate of new innovations is high, it is optimal for policy to focus on patent breadth, that is, to ensure that similar products cannot enter the market. If on the other hand the market structure is such that there are not many new innovations then it may be optimal to focus on patent length. Essentially, the cost of innovating must be repaid, this can be done either by having the profits done early in high amount(breadth) or over time(length). ²⁷

Even if the two market structure assumptions are true, this does not entail that patents are in fact an optimal policy tool. Even if it is true that a patent will create innovations earlier, the same policy tool may delay later innovations, this is specifically if the latest innovation is required to innovate to the next stage. That is, if the innovation created from the first stage is a required input for potential innovation in a second stage then follow on innovations will be more delayed by a patent system. ²⁸

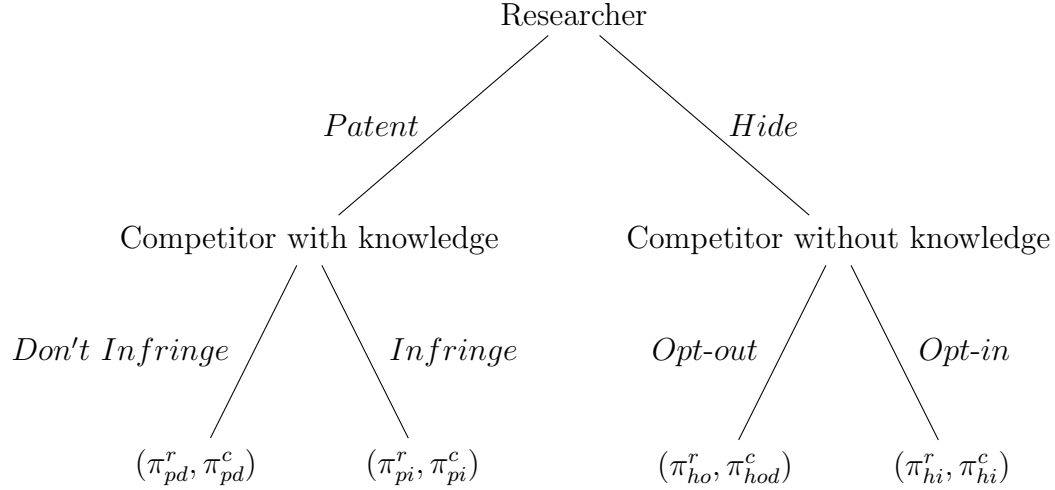
Will a firm that can patent always patent? The general economics view is that firms will not patent either due to the fixed cost of patenting or because they have to disclose information about their invention. The fixed cost from patenting(including the document drafting and the application itself) implies smaller firms may have less of a reason to do so. The information disclosure is related to the broadness of the patent, if the patent is not broad, disclosing how an invention works can be sufficient to help competitors make a competitive product. If a firm chooses not to patent, then specific nuances of the patent system such as "first to file"(European Patent office) or "first to invent"(United States patent and trademark office) can play an important role, for instance, the first to file rule can over-incentivize patenting over secrecy.

Models that formalize this choice takes the form of a researcher choosing whether to hide or patent, then a competitor choosing whether to infringe or not to in the case of patenting and choosing whether to compete even without the knowledge if no patent is present. ²⁹If there is significant overlap between innovations, the disclosure aspect of patenting may be the most important to avoid wasted effort from re-discoveries of existing technologies [Kultti et al. \(2007\)](#). These practical difficulties have often been used as justifications for the common practice of *reverse settlements*. The practice can be described

²⁷This is formalized by [Takalo et al. \(2001\)](#)

²⁸This was first shown by [Bessen \(2009\)](#) and generalized by [Bryan \(2017\)](#)

²⁹for a survey of these models see, [Hall et al. \(2014\)](#), for a model that discusses first to file and first to invent see, [Scotchmer \(1990\)](#)



The choice between patenting and secrecy can depend on the degree to which the innovation is radical. For instance firms will prefer to patent less valuable innovations and keep secret the more valuable ones [Anton \(2004\)](#), this is for the simple reason that not disclosing a radical innovation offers more potential for a larger gap between the secret owner and competitors. However if there are costs to renew the innovation and the degree of innovativeness of the innovation can affect the probability of receiving the patent, the opposite may be true, high quality projects get patented and lower quality projects do not [Mose \(2011\)](#). The decision to patent also depends on the competitive gap between the potential patent owner and potential competitors, if the gap is already large, patenting is attractive. If the degree to which the innovation is radical depends on the firms investment, then weak patents are important but stronger patent protection does not necessarily increase innovation [Kultti et al. \(2006\)](#).

4.2 Mechanism Design

Mechanism design is a natural way to study intellectual property because the system is entirely designed by a legal system instead of emergent. Indeed the concept of a patent race, where firms invest to achieve a certain technological breakthrough and then only the will gain the patent, is equivalent to an all pay auction second price auction, a war of attrition.

³⁰

Above all, intellectual property is a monopoly, and as monopoly it can induce deadweight loss there are a number of tentative solutions to this. Suppose a system was instituted where all patents and future patents were bought over by the government at a fixed price. Due to the variety of project values, two issues would arise. One would be that projects worth less

³⁰[Heidrun C. Hoppe and Baye \(2003\)](#)

than the value would be over-rewarded, this would naturally create incentives to maximize the number of patent and not maximize the value added of each invention. The second issue is that projects which are worth more than the posted price would not be undertaken. The second issue would entirely disappear if the consent of the patent owner was required, these payments would be bids.

A method of alleviating the issue of overpayment would be choose prices by creating a price system for each patent. This would be done by allowing firms to bid for each patent³¹. Once the price of the patent is established, the government would then pay that price for the patent. The issue is then, why would a firm bid truthfully if it will not receive the patent? It could perhaps just overbid and then split the surplus with the patent owner, or in the language of game theory, it is not coalition proof. A partial solution to this problem would be that instead of the government buying out the patent deterministically, it would buy it out with some probability, unfortunately this does not alleviate the problem because the firms could still make a positive coalition profit in expectation and if the probability of gaining the asset is low enough, then there would be very little incentive to participate in the mechanism.

Although generally alleviating the monopoly problem is too difficult, it is possible to play with the time dimension of patents to reduce it. To avoid the coalitional problems one could devise a mechanism where a patent owner simply bids on its own patent and depending on the amount of the bid, the patent becomes longer. This mechanism is that different R&D have different productivities and it would result in lower productivity sectors having longer patents and higher productivity sectors shorter patents because if an industry is innovative the value of the patent will quickly depreciate as more innovative products take over, this means that it would be worthwhile to increase the cost per unit of time for less productive sectors relative to more productive sectors so that the mechanism becomes more truth revealing.³²

Mechanism design can also shed some light on when it may be optimal not to assign property rights. If agents have private information in a bilateral transaction, Coasian setting, the agent with the property right will have an incentive to overstate his cost or value because the other party will have no option to go the courts, but when it is unclear who will win in court, parties will have an incentive to tell the truth³³.

³¹this method was first suggested by [Kremer \(1998\)](#) and was generalized by [Weyl \(2012\)](#)

³²The mechanism was created by [Scotchmer \(1999\)](#) and built upon [Cornelli \(1999\)](#)

³³[Schmitz \(2001\)](#)

4.3 The scale of the IP problem

There is also some interesting work on how IP rights should change. Suppose we buy the premise that it is difficult to make sufficient profits from an innovation in some given market, it is perceived that some level of reward, say x , balances the losses from the patent system and the incentives for innovation. Now suppose that through time, the market has expanded so that it is easier to gain large portions of profits in a quicker period of time, if the cost of creating new innovations has remained the same after the market expansion, then the optimal patent system would be to decrease the reward.³⁴ The intuitive implication is that as the world becomes more globalized, the requirement for patent protection is decreased because the potential payoffs of projects increase.

While it is easy to imagine that policy maker optimizes a social welfare function, in practice, the system itself relies on a bureaucracy. From an institutional point of view, balancing out incentives is crucial, if there is not sufficient incentive to reject bad projects, an issue of over-patenting emerges.³⁵

To take an example, suppose that some person can produce k units if he were to work on a specific asset. Suppose there are 10 assets and 20 citizens. The citizens own assets equally, so each citizen owns 5%. If a citizen can work on a specific asset to produce 20 units of a good, then he will only receive 1 of those goods in the end. Which means his willingness to expend effort is 1. If on the other hand, the assets are redistributed in such a way that every citizen still owns 5% but the citizens own higher shares of the assets they work on, if for example that same citizen had 10% share of the asset he worked on then, his willingness to expend effort had doubled. In other words, we can say that the distribution of ownership does NOT matter if every citizen works on every asset and their productivity of every citizen is the same.

To make ownership of an asset illegal is to make its market value zero or negative.

The Coasian view of property rights claims that allocative efficiency is in fact irrelevant as long as there are no transaction costs and bargaining is possible.

The question of what assets property rights protects can be quite complex. Some possible categories to consider, are tangible vs intangible; the ratio of subjective value to market value. One could also have alienable versus inalienable. Or one could define assets as having market value, in this formulation an asset only acquires property rights when it has

³⁴this kind of model is presented in [Boldrin and Levine \(2009\)](#)

³⁵see [Caillaud and Duchène \(2012\)](#) for a model with pooling equilibria with good/bad projects and separating equilibria where only good projects are accepted

accumulated sufficient components to acquire either subjective or market value. The market value component could also be used to justify the scope of protection.

Note that positive market value exists only if at least one non-possessor of the good has a subjective value for it. If the only person with positive subjective value of the good acquires it, then by definition the good no longer has market value. It is also possible for a good to have negative market value or subjective value. If the possessor of the good has a negative subjective value of the good AND no property rights to it, then the person is likely to either destroy it or abandon it.

If a good only has value for a single person, then it has no market value. If it has value for more than a single person then it does have market value. ue

4.4 Externalities

To define the Coase theorem we need the concept of externalities. Externalities are usually defined on a set of actions, it is when an action of A, has an effect on anybody else but A. Contracts can be framed as trying to create incentives for positive externalities, in other words to increase the payoff of an agent by A by taking a specific action.

If an agent tries to

4.4.1 Coasian

The coasian view of property rights aims to explain or justify property through two categories. Transaction costs and negative externalities. The Coasian approach has a simple statement of the form: externalities will only matter if transaction costs are large.

If ownership and possession are not identical, this creates the possibility of temporary transfer of assets to higher value users or to lower cost producers. Similarly there is the investment efficiency from stable ownership, this is asset related skills.

The value of assets is not only direct, it can be expected to increase the value of other assets that are complementary to the asset itself.

There is also of course a subjective value from ownership. For instance, suppose an owner who does not intend to use the asset but intends to rent it forever. If this owner discounts, the asset merely represents a series of cash flows, for which he should be able to exchange a lump sum for. If we suppose that someone prefers to own rather than rent, liquidity is only a constraint for transfer to occur.

Economies of scope between monitoring and apprehension.

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