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## Ronald Coase (1910-2013)

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## Ronald Coase (1910-2013) *By David A. Westbrook*

Ronald Coase, professor of economics at the University of Chicago Law School and winner of the Nobel Prize in Economics, died on September 2, 2013, at the age of 102. The influence of Coase's work is difficult to exaggerate. In academic economics, he is credited with founding institutional economics. In law, he is credited with founding the most influential movement in the US legal academy, law and economics, and his article "The Problem of Social Cost" (1960) is far and away the most cited text in the academic literature. More importantly still, because his work was so influential among policy makers trained in economics and/or law, Coase's work can be said to have shaped political economy itself over several decades.

I want to suggest that Coase's texts were so influential because they worked in essentially poetic ways -- he was probably the most powerful mythmaker in political economy since Marx. Despite his intentions, Coase's work presented a way of seeing the world that make great sense not only to professors of economics, but also to capitalists (and hence lobbyists and politicians), and to law professors, who should have known better. But I am getting ahead of myself.

In awarding the Prize, the Swedish Royal Academy of Sciences cited two articles: "The Nature of the Firm" (1937), which was ignored for many years, and the aforementioned "The Problem of Social Cost."

"The Nature of the Firm" begins with an observation: the business world is composed of any number of relations that do not operate through a price mechanism. As he makes clear in his Nobel lecture, this is a problem that goes to the root of economics, which since Adam Smith has argued that decentralized actors, coordinated by prices, can make socially beneficial decisions. Moreover, Smith argued, efficiency (and hence competitiveness) lay in specialization -- so why aren't most relations governed by price? Why do firms exist? Or, since we observe firms, why isn't economic life conducted by one big firm, i.e., why don't we have a planned economy? Why do we observe substantial, but incomplete decentralization of social decision making? Coase argued, as most of readers of this newsletter know, that contracting, operating in a market, was itself expensive. Finding willing buyers, haggling, and so forth imposes "transaction costs." Of course, management imposes its own costs. Therefore, argued Coase, societies use "private" hierarchical relations, paradigmatically master/servant (now renamed, in agency law, employer/employee) where transaction costs of contracting are thought to be higher than the analogous costs of managing. Sometimes we buy, sometimes we build.

"The Problem of Social Cost" also turned on the concept of transaction costs. Coase began a rather broad inquiry into the nature of welfare economics by focusing on the ancient doctrine of nuisance, or what would later



David Westbrook

be called the negative externalities of an activity. Coase pointed out that labeling an activity "a nuisance" was to give neighbors a right to be free of the nuisance, that is, was to create an entitlement on behalf of the neighbors. But one man's nuisance is often another's livelihood. In Coase's example, we may ask whether a rancher has the right to let his cows roam, or does a farmer have the right to have fields unmolested by cows? Hurting one will help the other. (The reciprocal nature of rights was a big point made by the Yale legal scholar Hohfeld almost half century earlier.)

Coase argued that, in the absence of transaction costs, the farmer and the rancher would bargain to reach an allocatively efficient solution: "the ultimate result (which maximises the value of production) is independent of the legal position if the pricing system is assumed to work without cost" (Coase, 1960, p. 8) If the rancher had the right to let the cows roam, and farming was more valuable than cows, then the farmer would pay the rancher to fence the cattle in. If ranching was more valuable, then the farmer would take the loss, or perhaps abandon the land and do something else. If the farmer had the right to keep the cows out, and ranching was more valuable, then the rancher would pay the farmer to waive his right to exclude the cows. Conversely, if farming was more valuable, than there would be less ranching. Thus, it was argued -- more laboriously, of course -- that in a costless environment, the original placement of entitlements did not matter, because the parties would contract to reach the economically efficient result. The economist George Stigler named this proposition "the Coase Theorem," and so it came to be called.

It is important to note that for Coase, the case of bargaining in the absence of transaction costs was something of a thought experiment, used to clarify thought, and perhaps a model. Transactions costs are always positive, indeed were ordinarily significant, and therefore it is generally necessary to create entitlements -- this is the role of the law. The question for the law, then, is to establish the optimal set of social arrangements:

in choosing between social arrangements within the context of which individual decisions are made, we have to bear in mind that a change in the existing system which will lead to an improvement in some decisions may well lead to a worsening of others. Furthermore we have to take into account the costs involved in operating the various social arrangements (whether it be the working of a market or of a government department), as well as the costs involved in moving to a new system. In devising and choosing between social arrangements we should have regard for the total effect. (Coase, 1960, p. 44)

As I read him, Coase thought he was mapping the boundaries of markets, and in doing so, expanding the domain of economic thinking to society writ large, where markets were but one mode of ordering.

Transaction costs were used in the one case [in Theory of the Firm] to show that if they are not included in the analysis, the firm has no purpose, while in the other [in "The Problem of Social Cost"] I showed, as I thought, that if transaction costs were not introduced into the analysis, for the range of problems considered, the law had no purpose. (Coase, 1993, p. 62)

In one of the ironies of recent history, however, Coase became famous for the Coase Theorem itself, understood as a fair description of a wide range of human relations. If there were no barriers to contract, then social outcomes could be presumed to be the result of explicit or implicit bargains, and hence efficient. If transaction costs were in fact significant, government action (notably regulation and judicial decision) might be taken to create situations for which marketplace actors would have bargained, thereby replicating the optimal allocation of costless markets. Doing this sensibly required (deeply speculative) analysis of various alternative uses of the factors of production. In light of the fact-intensive and open-ended nature of such inquiries, it was perhaps unsurprising that, at least in the United States, markets would be presumed to pose no substantial barrier to socially beneficial contracting. And given the costs of bureaucratic regulation, and the risk that government would abuse its monopoly of legitimate force, many in the United States were quite inclined to agree with Coase that often the best response to social cost "was to do nothing about the problem at all," i.e., deregulate. Thus was law and economics born.

It is important to emphasize that the misreading of Coase is a matter of degree rather than of kind; converts tend to zealotry. But Coase himself believed that the price mechanism was the fundamental, and indeed preferred, mode of social ordering. In his Nobel acceptance speech, Coase said:

The economy could be coordinated by a system of prices (the "invisible hand") and, furthermore, with beneficial results. . . . Economists have uncovered the conditions necessary if Adam Smith's results are to be achieved and where, in the real world, such conditions do not appear to be found, they have proposed changes which are designed to bring them about. . . . What I endeavoured to do in the two articles cited by the royal Swedish Academy of Sciences was to attempt to fill these gaps or more exactly to indicate the direction in which we should move if they are ultimately to be filled. (Coase, 1991)

For Coase, markets were presumed, raising questions why other forms of social ordering were necessary, and insofar as they were, how to make their operations as socially productive as possible. From this perspective, it is unsurprising that, generally, Coase was unsympathetic to regulation. Sometimes it is better to do "nothing about the problem at all." More specifically, in somewhat less famous work, on matters like lighthouses and

the distribution of the radio spectrum, Coase insisted that markets could work quite well in lieu of government action.

The stir raised by the (mis)reading of "The Problem of Social Cost" led to a resurgent and vastly increased interest in "The Nature of the Firm." And so, approaching his eighties, Coase was hailed as a sage. Fame is a strange thing: authors do not get to decide if, when, or how their ideas will be received. For his part, Coase spent another (!) generation arguing, most notably in his Nobel Prize acceptance speech, that (i) he was a rather simple mind and not a great economist, and (ii) he had been substantially misunderstood. He found almost no agreement for either proposition.

Both Coase's career and our fascination with prizes illustrate how deeply we remain influenced by the idea of genius, and how problematic it is to talk about intellectual influence or even greatness as a property of an individual mind. Thoughts are taken up, or ignored, or (de)formed to fit the interests of their times. For purposes of intellectual history, the fact that Coase was somewhat misread is both easily overdone and irrelevant, as are substantial objections to Coase's ideas in both theory and practice. At the end of illustrious lives it is appropriate to ask after historical questions, e.g., why did Coase's work so powerfully strike a chord when it did -- which brings me back to the assertion that Coase was, in spite of himself, a mythmaker.

Transaction costs preserve the anthropology of economics: individuals are still the basic unit of social life (regardless of what other disciplines may say), and individuals contract to get things done. Thus the social is a product of individual action), which feels more scientific (since called methodological individualism). When the social stubbornly reappears in firms and other hierarchical settings, and ordering cannot plausibly be ascribed to contract or price, then the social can be explained as an artifact of implicit bargaining over implicit costs. More ambitiously still, the distribution of rights and the correlative imposition of constraints are understood not as artifacts of power or belief or history, but as legal approximations to negotiations only imagined. Thus both social organization and law (and presumably government) are understood as if they were contractual in origin. The market is ubiquitous, and economics remains the queen of the social sciences, even in the absence of actual transactions with real money. Or, to put it differently, Coase rearticulates the Hobbesian social contract for those trained in economics.

Transaction costs are thus deeply speculative, indeed subjunctive, treated as if they had happened in fact, when, quite simply, they have not. It is important to remember that there is neither a transaction nor, therefore, a cost to doing the transaction. The "cost" is an assigned value, not an observed price. Coase's great metaphor relies on a deep comfort, widespread in a commercial society, with both the idea of money as a unit of account and the arithmetical consequences of accounting. So we unselfconsciously speak of the negative value of a company; we may assert that, if one share

is worth \$100, then the owner of ten million shares has a billion dollar stake; we may ascribe the difference between book value and price to "goodwill" and be done. The arithmetic is sound, but we are not talking about money in use, transactions, or the world. Similarly, with transaction costs, the difficulties of doing that which is not done are "priced," or more commonly, it is asserted that their price would be higher than the course of action taken (the formation of a firm, the granting of an entitlement).

After Coase, there is a "price" for what is purchased, and a price for what is not purchased or even offered. By way of analogy, consider how the natural numbers, which count what is, imply negative numbers, which quantify what is not. To shift metaphors slightly, transaction costs "balance the books" on social life, much as the concept of equity balances a balance sheet. Such concepts flow from the structure of formal thought, and so are convincing, but are also deeply, profoundly, unempirical. And it is another irony of intellectual history that throughout his life Coase insisted on the importance of empirical work in economics.

After transaction costs, the domain of economics is not the study of actual transactions, or even of plausible transactions on real goods and services, but of conceivable transactions, i.e., social ordering that might be described transactionally. Some things have prices; other things have transaction costs. Thus money goes from being an asset class, situated in a social and institutional matrix, to a symbol for universal value. That accomplished, everything could be articulated in terms of contract, even when no contract was to be seen. Thus transaction costs make economics capable of articulating most all of social life, adjudicating "social arrangements."

This view is both profoundly reassuring (it reassures us of our liberal autonomy) and powerfully conservative (this is the world, more or less, for which we have bargained.) To be more specific, Coase, especially as radicalized by Stigler, appeals to several elites. For academic economists, transaction costs vastly extend the reach of their discipline, and more delightfully still, make economics logically prior to law (and by extension, culture itself), which fit nicely with the traditional aspiration to speak with the a priori imperiousness of a natural science. Coase was aware of this: "it is my view that the approach used in that article ["The Problem of Social Cost"] will ultimately transform the structure of microeconomics -- and I will explain why." This expansive notion of transactional costs had serious downsides. It ap-

peared empirical, but licensed raw speculation. It turned on a frivolous notion of money, but then again, money has always been something of an embarrassment to microeconomics.

For capitalists, transaction costs provided both an apology for the status quo and, more importantly, a political economy for which regulation was always a second-best solution. The financial deregulation of recent years would not have been imaginable without great faith in the ability of sophisticated, and not so sophisticated, actors to reach socially beneficial agreements regarding things like default risk.

The appeal of the Coase theorem, and to lesser extent the "Theory of the Firm," to legal scholars is somewhat puzzling. While many law professors resisted the impulse to explain the world in terms of implicit contracts and around alleged costs (the even more speculative reliance on alternative uses of factors of production has been, to my knowledge, ignored), more subscribed. This is odd. One might have thought that lawyers would viscerally sense the importance of history, of power, of institutional arrangements -- of lots of things besides contract, implicit or not, to understanding social privilege. And surely lawyers should emphasize the difficult and uncertain and hence very partial nature of contracts, which they are taught in their first year of law school? It is something of a mystery, but I think Coase's texts suggested a very appealing vision of social order, in which property entitlements, civil institutions, marketplace action, and law itself make sense in terms of one another, and where the comfortable individual retains his sense of self-worth. Under the spell of such a vision, law could allay its ancient anxiety of being groundless, illegitimate, faithless. This is not the place to develop such speculations about the spiritual history of my profession. For now, it is worth commemorating a marvelous mind if an accidental poet, and also remembering that there are reasons Plato cautions against poetry.

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Coase, R. H. (1993). The nature of the firm: Influence. In O. E. Williamson & S. G. Winter (Eds.), *The nature of the firm: Origins, evolution, and development* (pp. 61-89). New York, N.Y.: Oxford University Press.

## INET event of interest to PhD students

The **Winter School on Law and Finance** includes a 4-day course on the legal theory of finance taught by Katharina Pistor, Brigitte Haar, and Dan Awrey. The school takes place in Paris on January 6-9 and the application deadline is November 18.

<http://ineteconomics.org/ysi/events/winter-school-law-and-finance>