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A Tribute to Ronald Coase: A Legend Misunderstood

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A TRIBUTE TO RONALD COASE: A LEGEND MISUNDERSTOOD

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Ronald Coase, the Nobel Prize–winning economist known for his founding contributions to the field of law and economics, passed away on September 2, 2013, at the age of 102.[1] Coase is best known in the legal community for his 1960 *Journal of Law and Economics* article, *The Problem of Social Cost*,[2] which ranked as the most-cited law review article of all time as of 2012.[3] The article first articulated what fellow Nobel Prize–winning economist George Stigler would deem "The Coase Theorem."[4]

The Coase Theorem, as it is typically understood in the legal community, states that "if transaction costs are zero, the initial assignment of a property right . . . will not affect the efficiency with which resources are allocated."[5] This articulation of the Coase Theorem has been criticized by legal scholars as unrealistic because transaction costs are rarely ever low enough to allow for efficient bargaining,[6] and because it does not account for psychological factors after the initial allocation of resources—specifically that people will

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1. Jacob Gershman, *Ronald Coase, Author of 'Most-Cited Law Review Article,' Dead at 102*, WALL ST. J. L. BLOG (Sept. 3, 2013, 1:09 PM), http://blogs.wsj.com/law/2013/09/03/ronald-coase-author-of-most-cited-law-review-article-dead-at-102/.

2. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

3. *See* Fred R. Shapiro & Michelle Pearse, *The Most-Cited Law Review Articles of All Time*, 110 MICH. L. REV. 1483, 1489 tbl.I (2012) (showing *The Problem of Social Cost* as the most-cited law review article of all time).

4. *See* GEORGE J. STIGLER, THE THEORY OF PRICE 113 (3d ed. 1966) ("The Coase theorem thus asserts that under perfect competition private and social costs will be equal."); *see also* Deirdre McCloskey, *Other Things Equal: The So-Called Coase Theorem*, 24 E. ECON. J. 367, 367 (1998) (describing how Stigler coined the term "Coase theorem").

5. Richard A. Posner, *Nobel Laureate: Ronald Coase and Methodology*, J. ECON. PERSP., Fall 1993, at 195.

6. *See, e.g.*, Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1096 (1972) (discussing how the Coase Theorem is only a starting point since "no one makes an assumption of no transaction costs in practice"); *see also* Daniel Q. Posin, *The Coase Theorem: If Pigs Could Fly*, 37 WAYNE L. REV. 89, 92 (1990) (noting that critics have raised issue with the transaction cost–free assumption).

always offer less to acquire something and demand more to sell it.[7] Law and economics scholars of the "Chicago School,"[8] by contrast, have defended the Theorem.[9]

The unfortunate truth is that Ronald Coase is remembered in the legal community for something he did not believe. As Coase has stated, "The world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave."[10] This is obvious to anybody familiar with Coase's work, as his initial contribution to economics offered an explanation for why individuals choose to form partnerships, companies, and other business entities: because transaction costs are lowered by these institutional arrangements.[11]

So who is the real Ronald Coase, and why did he write *The Problem of Social Cost*? The real Ronald Coase was a man whose views on the nature of firms were influenced by the economic insights of Friedrich Hayek, Lionel Robbins, and Arnold Plant in their calculation-based criticism of socialism.[12] He was also a man whose views on political economy were influenced by James M. Buchanan and public choice theory.[13] So, contrary to popular perception, Ronald Coase was not a typical Chicago School

7. *See* Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387, 401 (1981) (critiquing the Coase Theorem using the "offer-asking problem," which observes that asking prices are normally higher than offer prices).

8. The term "Chicago School" generally refers to a school of thought in both economics and law and economics that adheres to neoclassical price theory and free market, efficiency-based solutions. *See* Maurice E. Stucke, *Money, Is That What I Want?: Competition Policy and the Role of Behavorial Economics*, 50 SANTA CLARA L. REV. 893, 896–97 (2010). The school attempts to analyze law through simplified and assumption-filled economic models. *See* Mark Tushnet, *"Everything Old Is New Again": Early Reflections on the "New Chicago School,"* 1998 WIS. L. REV. 579, 586. It has been given the name "Chicago School" because its proponents, including Milton Friedman, George J. Stigler, and Judge Richard Posner, are largely centered at the University of Chicago. *See* Robert Van Horn, *Chicago's Shifting Attitude Toward Concentrations of Business Power (1934–1962)*, 34 SEATTLE U. L. REV. 1527, 1527 n.1 (2011).

9. *See, e.g.*, DAVID D. FRIEDMAN, LAW'S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS 42 (2000) ("[T]he range of problems to which the Coasian solution is relevant may be much greater than many would at first guess."); Posner, *supra* note 5, at 195 (citing the fact that "no-fault divorce does *not* appear to have increased the divorce rate" as empirical evidence of the Coase Theorem).

10. R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 174 (1988); *see also* McCloskey, *supra* note 4, at 368 ("Something like a dozen people in the world understand that the 'Coase' theorem is not the Coase theorem.").

11. *See generally* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). In fairness, Professor Daniel Posin, perhaps Coase's most frequent legal critic, recognized this. *See* Posin, *supra* note 6, at 92 n.16 (stating that Coase himself recognized the deficiencies in a transaction cost–free model).

12. *See* Peter Boettke, *Ronald Coase and Comparative Institutional Analysis*, COORDINATION PROBLEM (Sept. 3, 2013, 10:16 AM), http://www.coordinationproblem.org/2013/09/ronald-coase-and-comparative-institutional-analysis.html (discussing Coase's formative intellectual background at the London School of Economics).

13. *See id.* (discussing parallels between Buchanan's idea of political economy and Coase's work).

economist.[14] In fact, with *The Problem of Social Cost*, Coase was trying to change the views of the Chicago School, and modern economics as a whole, by showing Chicago and modern economists the absurdity of their transaction cost–free and institutionless models.[15] His goal was ultimately to create a "genuine institutional economics" by enlisting the help of social scientists to uncover and examine real-world institutional designs.[16] In the words of Coase himself:

> [W]e know that the costs of exchange depend on the institutions of a country—the legal system (property rights and their enforcement), the political system, the educational system, the culture. These institutions in effect govern the performance of the economic system. This is the basic reason why the New Institutional Economics is so important and why, if we are to achieve our objective, we have to enlist the help of lawyers, political scientists, sociologists, anthropologists and other social scientists. . . . The entry of economic analysis into the other social sciences has been termed economic imperialism. We are engaged in a completely different enterprise—enlisting the help of those in the other social sciences to enable us to understand better how the economic system works.[17]

With that, I say goodbye Ronald Coase, rest in peace, and may your vast contributions to the world of political economy one day be properly understood.

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14. *See id.* ("While many younger readers will associate Coase with the University of Chicago and what they understand the field of Law and Economics to be, Ronald Coase didn't join the staff at the University of Chicago Law School until 1964.").

15. I do not mean to suggest that Coase's affiliation with the University of Chicago Law School and Chicago School economists like Judge Richard Posner, George Stigler, and Milton Friedman should be forgotten. I simply make the point that Coase's analytical method was very "un-Chicago" in that he was highly critical of the use of—what he deemed unrealistic—mathematical models in economics. *See* COASE, *supra* note 10, at 185 ("In my youth it was said that what was too silly to be said may be sung. In modern economics it may be put into mathematics.").

16. *See* Boettke, *supra* note 12.

17. Ronald Coase, Speech to ISNIE: The Task of the Society (Sept. 17, 1999), *available at* http://www.isnie.org/coase-isnie-speech.html.