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# Ronald Coase

## *An Appreciation*

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JOHN V. C. NYE

### The Mainstream Iconoclast

The death of Ronald Coase (1910–2013) at 102—almost certainly a record for any economist of note—put an end to one of the longest and most illustrious careers in academia. Not only had Coase received the highest accolades of the profession—headed by the Nobel Memorial Prize in Economics, of course, but also multiple honorary doctorates from leading universities, fellowships in the American Economic Association and the American Academy of Arts and Sciences, the first presidency of the International Society for New Institutional Economics, and more—but he was widely regarded as among the greatest and most influential economists of the past century. This was a stunning achievement, considering the fact that Coase had never received a doctorate in economics. Furthermore, Coase—whose work as a scholar and as a journal editor helped to establish the new legal discipline of law and economics—spent half of his life as an economist on the faculty of the University of Chicago Law School, not the Economics Department. Even a cursory examination of Coase’s biography will underline how unorthodox his path to eminence was and how amazingly successful he was at unearthing the most profound truths while often marching out of lockstep with the profession and, indeed, the world at large. Though Coase’s fame and influence were enormous, his reputation did not really peak until very late in his life. I can recall, just a year or two before he received the Nobel, a conversation I had

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with a distinguished economist who scoffed at the suggestion that Coase was a worthy future laureate. After all, hadn't Coase written only "two good papers"?

Such underestimation of Ronald Coase, both of his abilities and his accomplishments, seems to have been a marked aspect of much of his life.

As a youngster in England, he had suffered problems with his legs that caused him to be schooled at a boys' institute for "physical defectives." Coase quipped that it shared grounds with the school for "mental defectives" and, perhaps he thought, even some of the curriculum. Remarking on economists' frequent classroom use of basket weaving as an example of a low-skilled activity, Coase said, "I *did* study basket weaving. It's not simple at all. In fact, it's rather more complicated than economists expect."

As an undergraduate at the London School of Economics, Coase began the work that would eventually lead to "The Nature of the Firm" (1937)—one of the most highly cited papers in economics and the social sciences. Starting from the simple question "Why do firms exist?" Coase came up with the profound insight that although the market price mechanism is best at allocating resources, having to obtain market prices and make use of them is not costless, and therefore the existence of the firm owed much to the problem of transactions costs and the need even in the most highly developed, free-market economies for organizations to arise that can economize on such costs by producing some items within the firm through hierarchy and planning. At the time, economists had no answer to the conundrum that if the market pricing mechanism is so efficient and market economies so productive, why are all the leading-edge firms in the most successful and advanced industrial economies marked by hierarchy and command rather than by the use of internal prices? Coase was the first to claim explicitly that all firms have to balance the advantages and disadvantages of obtaining goods from an external market that might or might not exist for any given items against the advantages and disadvantages of producing those products internally. Because both the institutions of the firm and the legal and political institutions outside the firm condition many of the transactions costs that determine the scope of markets and hierarchies, the insight contained in Coase's earliest paper has served as a foundational idea for work in industrial organization, law and economics, and the new institutional economics.

In 1951, Coase first moved to the United States to teach at the University of Buffalo and then subsequently was hired away by the Jefferson Center at the University of Virginia (UVA), where he worked alongside such future luminaries as James Buchanan and Gordon Tullock from 1958 to 1964. While at UVA, Coase produced his famous papers "The Federal Communications Commission" (1959) and "The Problem of Social Cost" (1960), which established the ideas that George Stigler later christened the "Coase Theorem."

The Coase Theorem has been one of the most widely cited and most commonly misunderstood ideas in economics and the social sciences. In its simplest and

most common version, it states that where property rights are well defined and transactions costs are negligible, the initial allocation of rights will not impede people from coordinating and trading so that those with the highest valuation of those rights will come to own them, thus maximizing efficiency. Correcting for externalities, such as pollution, by taxing them (as first taught by Arthur Pigou and widely endorsed by mainstream economists) is therefore often inferior to allowing parties to work out trades that will maximize joint product when such trades are feasible. This understanding has sometimes been used to suggest that property-rights allocation is irrelevant to efficiency (and only matters for distribution), but as Coase emphasized, he wished to make a rather different point.

It was Coase's view that economists were ignoring their own teaching that voluntary trade is mutually beneficial when thinking about property rights, regulation, and pollution while also assuming away transactions costs. In the standard model, the supplier arbitrarily produces pollution as an unwanted by-product of his trade, and it is the state's job to step in and tax away this externality. But Coase first observed that if transactions costs—which play no role in either the Pigouvian analysis or the proposed solutions—are truly zero, then there is no impediment to both the creators of pollution and the affected parties working out an efficient compromise. A regulator establishing a corrective Pigou tax has the burden of identifying not only the harm caused by pollution, but also the exact opportunity cost of preventing the producer from engaging in valuable activity that has the unfortunate by-product of undesirable pollution. Only a full accounting of all costs and benefits after taking into account possible trades will allow us to justify an intervention.

A lively literature in law and economics has sprung up to debate the various ramifications of the so-called Coase Theorem (Coase never phrased it in a mathematical fashion, nor would he have been interested in demonstrating his ideas in axiomatic form) to argue about when it is or is not appropriate and what implications it has for the relevance of law and institutions to the problem of externalities.

In fact, Coase was rather unhappy about Stigler's dubbing his idea the "Coase Theorem." He felt that this name overemphasized the special and mostly unlikely case of zero transactions costs and turned his work into caricature. As Coase always insisted, transaction costs are usually not negligible, so deciding what the appropriate course of action should be depends entirely on the trade-offs involved in choosing the initial allocations of rights, the costs of bargaining, the costs of obtaining information, and the incentives provided to all parties to change their behavior. For Coase, the pervasiveness of real-world transactions costs justifies paying less attention to pure theory and exerting more effort on empirical research to classify, categorize, and analyze a variety of legal, regulatory, and administrative transactions costs that will determine in each specific case whether corrective taxes or regulations are necessary, desirable, or even feasible. Coase had no patience for the dichotomy that said that zero transactions costs imply that

regulation is pointless, whereas positive transactions costs mean that regulation or other interventions are obviously required.

Although these two papers were to trigger the interest in his work that would also lead to a renewed attention to his earliest work on the firm, all did not go well for Coase at UVA. In hindsight, one would assume that a second-tier economics department at a leading state university that had successfully attracted Ronald Coase, James Buchanan, and Gordon Tullock (two of whom were to receive the Economics Nobel) would have rejoiced at its immense good fortune, especially as these men were starting to receive national attention for their work. This period was exactly when Coase produced his work on social cost and contributed to founding law and economics, just as Buchanan and Tullock (who had written *The Calculus of Consent* [1962]) founded the fledgling area of public choice. In fact, rather than be grateful for its good fortune in having these scholars, the university—more precisely, Dean of the Faculty Robert Harris—actively worked to push them out through conscious policies of selective nonpromotion and unwillingness to match outside offers from other leading universities. All of this would have remained a rumor had a secret report on the UVA economics faculty not fallen into the hands of a UVA economist by sheer accident. The net result was that Coase left UVA for Chicago in 1964, and Buchanan and Tullock decamped a few years later.

The full story of this rather sad affair is examined in great detail in David Levy and Sandra Peart's unpublished article "How the Virginia School Got Its Name: Documents of the Controversy of the Thomas Jefferson Center" (2013). University officials felt that the Economics Department was one-sidedly attached to an outlook "described by its friends as 'Neo-Liberalism' and its critics as 'Nineteenth-Century Ultra-Conservatism'" (Levy and Peart 2013, 55).

Coase himself described this period in an interview with *Reason* magazine, in which he said: "They thought the work we were doing was disreputable. They thought of us as right-wing extremists. My wife was at a cocktail party and heard me described as someone to the right of the John Birch Society. There was a great antagonism in the '50s and '60s to anyone who saw any advantage in a market system or in a nonregulated or relatively economically free system" (Hazlett 1997).

The so-called "Secret Report" or, officially, the "Self-Study Report, University of Virginia 1963," spoke of the need to hire "additions to the staff . . . of different, 'modern' outlook—by no means an easy assignment given the [Economics] Department's present reputation; but urgently to be attempted in order to introduce an element of pluralism into an otherwise closed society. Care should be taken in making or renewing non-tenure appointments, as well as those of higher rank to avoid further recruitment from the Chicago School, now sufficiently represented by able staff members" (qtd. in Levy and Peart 2013, 56).

Interestingly enough, Coase was always quite adamant about separating himself from those who were too strongly motivated by political ideology and took

great pains to disavow any ties to either of the leading American parties as well as to smaller movements. Though he was a firm believer in the virtues of markets and was skeptical of much government regulation, he disavowed any strong beliefs that were simply derived from philosophical principles—such as libertarianism. He was quick to emphasize that he favored a pragmatic, empirical approach to questions of regulation or policy and that only further detailed research would help reveal which specific approaches or policy tools were more effective. Nonetheless, he was of the opinion that most of the cases of regulation that he had studied or that had been studied by others were failures and argued against the effectiveness of intervention. He surmised that this record of failure was perhaps because the state had grown so large that it was dysfunctional at the margins. When once asked at a public lecture in St. Louis how large the state should be, Coase answered: “If you see a man who weighs over 400 pounds, and you ask me how much he should weigh, my answer would be . . . *less*.”

Fortunately for Coase, the move to the University of Chicago Law School was fortuitous and allowed him to exercise influence on both economists and lawyers. Indeed, one might plausibly claim that the Coase Theorem has been more intensely studied and debated in law schools than in economics departments. The latter have yet to incorporate the most basic insights of Coase’s 1960 paper in the most prominent writings on pollution and externalities. Even those leading scholars at elite universities who now profess to admire Coase’s work still tend instinctively to reach for variants on Pigouvian taxes as the natural solution to problems of pollution and global warming without giving full consideration to figuring out how to correct for unobserved Coasian adjustments (on the latter, see Nye 2008).

Though Coase is best known for his work on the theory of the firm and on telecommunications and the problem of externalities, he also authored a number of papers that have been widely cited and quite influential in rather different areas.

For example, despite his lack of interest in formal theory, one of his most celebrated essays is “Durability and Monopoly” (1972). In it, he observed that even a perfect monopolist who is totally free from the threat of outside competition might have to fear competition from itself if that firm’s production is of durable goods. The knowledge that previously sold goods can be resold on the used market would serve as sufficient competition for the firm because customers might wait to buy them instead of new product. This would force monopolies to take this into account and lower their prices. This idea, known as the Coase Conjecture, has inspired a number of important papers both in formal economic theory as well as in the economics of networks and regulation.

Coase was also well known for a famous exercise in *reductio ad absurdum* when he wrote “The Market for Goods and the Market for Ideas” (1974b), in which he took his economist colleagues to task for their enthusiasm in advocating the regulation of goods on externality grounds while shying away from wishing to

regulate ideas that he said exhibit more clearly the problem of beneficial or invidious externalities used to justify regulation and taxation. Coase felt that a consistent approach to the theory of externalities means that one can advocate for regulating both goods and ideas or neither, but not just goods rather than ideas. This assertion created enough of a stir that it drew the attention of *Time* magazine. Noting that regulation of ideas does exist, albeit in limited form, Coase explained the asymmetry in attention to the two types of regulation by noting that “[t]he explanation of the paradox is self-interest and self-esteem. Self-esteem leads the intellectuals to magnify the importance of their own market. That others should be regulated seems natural, particularly as many of the intellectuals see themselves as doing the regulating. But self-interest combines with self-esteem to ensure that, while others are regulated, regulation should not apply to them” (1974b, 386).

Coase was fond of criticizing blanket statements in economics that ignored the historical reality of institutional evolution. The most famous example of his invocation of economic history to refute theory is in his highly cited paper “The Lighthouse in Economics” (1974a). Arguing against the view that public goods that are nonrivalrous and nonexcludable have to be financed by the state out of general revenues because government cannot charge individual users fees, Coase used the historical example of British lighthouses in the nineteenth century to demonstrate that such fees can in fact support a private system. This argument has sometimes been interpreted as a straightforward claim of private versus public provision, but both a careful reading of the original Coase paper and further discussion by later scholars suggest that the problem is more nuanced. Coase’s main intention seems to have been to contradict the overly simplified accounts in the existing economics literature, but not to replace these accounts with new claims about the equivalence of private provision. Once more we see the conflict between academics’ desires to produce simplified theories to codify reality and Coase’s inherent antipathy to overly abstract reason not grounded in institutional and historical reality.

In the last two decades of his life, Coase worked to nudge the economics profession in his preferred direction. He felt that economists had become too obsessed with mathematical abstraction and technical perfection. He thought that institutions had been abandoned as a major subject of research and that deep empirical inquiry had given way to needless flash. Taking full advantage of both his influence in the profession and the prestige of the Nobel Prize, Coase helped to found the International Society for New Institutional Economics in 1997, and he served as its first president. I was privileged to be part of the small group of men and women who organized and helped create the society, and I was always struck by how important it was to Coase to open up the society to a variety of approaches from all the social sciences. Although “Economics” was part of the new society’s name, Coase insisted that interesting work in law, political science, business, psychology, and sociology should be encouraged at the annual meetings.

Some have argued that Coase's critique was passé and that he had lost touch with the trends in contemporary research since mathematical formalism had reached a peak in the late 1980s or early 1990s, being replaced by interest in labor, development economics, political economy, and even institutional economics. But Coase had decidedly mixed feelings about this development: for him, empirical work was still too dominated by the fashionable technical tools of the day, and the leading journals remained hostile to the methodologies he favored. He wanted to encourage work based on case studies, in-depth firm-level comparisons, and even plain taxonomy. He thought that medicine or botany, not physics, with their emphasis on list making and enumeration of pertinent detail rather than on theory development, were better models for economics research. He thought that economists still had much to learn from the study of the law itself rather than from the creation of theories to explain legal behavior in the abstract. Similarly, he thought that the economics of contracts placed too much emphasis on abstract ideas and not enough about actual contracts themselves.

Finally, he felt that one of the best ways to grow the profession was to encourage the work of young institutional scholars, especially those living and working abroad. To that end, he aided in the founding of the Ronald Coase Institute, which since 2001 has run regular workshops and conferences to bring together senior scholars in the profession with small, select groups of younger researchers in the new institutional economics. The institute continues to flourish and seeks to promote ideas in the spirit of Coase to this day.

In the last decade of his life, Coase became interested in China, and in cooperation with Ning Wang he wrote *How China Became Capitalist*, which was published in 2012, just a few months after he turned 101. Their view was that the Chinese reforms did not stem from a well-thought-out plan to change from a socialist to a capitalist economy, but rather from piecemeal reform that allowed enough changes so that China can now be said to have gone quite a ways down the path to a fundamental though incomplete transformation of its economy. Coase's views on China and its recent achievements reflect his own preference for gradual, piecemeal change based on pragmatic reasoning as a basis for longer-term success. Shortly before he passed away, he was still planning his first visit to China and had helped to found a new journal there, *Man and the Economy*, which he was coediting with Ning Wang. Hearing of Coase's new book and new journal last year inspired many a colleague to say that they suddenly felt guilty for being so lazy and needed to get back to work.

Coase managed to remain extraordinarily influential in and simultaneously apart from the profession. He gave the impression of being unable to communicate fully with the younger academic elite, whose attention was drawn to topics and methods that he often found difficult to support or relate to. Yet having lived most of life somewhat out of step with everyone else did not seem to deter Coase from working doggedly and steadily or, in the end, from succeeding. He had a Platonic

belief that there was good work and there was bad and that in the long run good would prevail. He thought that scholars who worked honestly and sincerely on topics of importance to the world would in time be recognized for their accomplishments no matter how unfashionable their methods might be. He did not think of himself as much of a rebel and was serene in his conviction that the study of economics was a great and noble calling. He also felt it had great practical value. He once said that if an academic's work causes a good policy to be implemented a few months earlier than otherwise or else retards the arrival of a bad law by an equal amount of time, that person will have earned his lifetime salary many times over.

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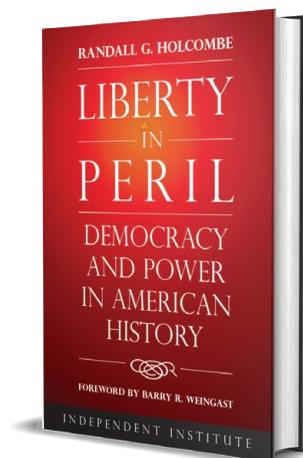
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