The Coase Theorem, Applied to Markets and Government

RANDALL G. HOLCOMBE

The Coase theorem, as commonly understood, says that in the absence of transaction costs, the allocation of resources is independent of the assignment of property rights—or, restated in more descriptive terms, in the absence of transaction costs, resources are allocated to their highest-valued uses.[1] The logic of the Coase theorem is especially straightforward in this second variant. If there are no transaction costs, people who value resources the most will engage in mutually advantageous exchange to maximize the value of resources under their control. This holds true in political transactions as well as in market transactions. In the political marketplace, some people are in a low-transaction-cost group and can bargain with each other to produce policy outcomes that maximize the value of resources to those in the group. Most people face high transaction costs in the political marketplace and are unable to participate in those transactions. Policies implemented by those in the low-transaction-cost group—the people who design public policy—are not necessarily the ones that maximize the value of resources to those in the high-transaction-cost group.

A transaction-cost approach to public-policy analysis shows why some are systematically able to enact policies that benefit themselves, often at the expense of others.

Randall G. Holcombe is DeVoe Moore Professor of Economics at Florida State University.

1. The paper from which the theorem is extracted (Coase 1960) contains no theorems. My paper uses this common statement of the Coase theorem without considering how close the theorem is to what Ronald Coase intended to convey in his article.

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Public-choice theories of rent seeking, regulatory capture, and interest-group politics describe situations in which some are able to use the political system to generate benefits for themselves, but by imposing costs on others that result in an inefficient allocation of resources. Those others are prevented by high transaction costs from bargaining to mitigate the costs imposed on them. The lesson of the Coase theorem is not that resources are allocated to their highest-valued uses but rather that when they are not so allocated, the reason is that transaction costs stand in the way.[2]

The implications of the Coase theorem apply to government allocation of resources just as they do to the market allocation of resources, but market versus government outcomes often differ because markets allocate resources through mutually advantageous exchange, whereas governments allocate resources by a political decision-making process in which the resource-allocation decisions made by the small group of people who design public policies apply to everyone. The very nature of government allows some to impose costs on others.

The Coase theorem offers a good framework for analyzing the nature of these costs and by extension offers some insights about the operation of political systems. In particular, it provides an economic foundation for the elite theory that has been developed by social scientists for more than a century and integrates elite theory into the public-choice framework. A transaction-cost approach to public-policy analysis shows why some—the elite—are systematically able to enact policies that benefit themselves, often at the expense of others. In the context of the Coase theorem, the elite are those who face low transaction costs in the negotiations that determine public policy and so are able to bargain among themselves to maximize the value of public policies to members of the low-transaction-cost group.

Public choice has sometimes been described as analyzing politics as exchange. Exchange can take place only when transaction costs are low enough to allow people to bargain with each other. In politics, some people face low transaction costs and can bargain with each other to design public policy. Other people are excluded from the exchanges that produce public policy because they face high transaction costs. Transaction costs separate the elite from the masses. The Coase theorem provides an economic foundation for the elite theory that has been a part of sociology and political science for more than a century.

The Coase Theorem, Applied to Markets

Resources are allocated in markets through voluntary exchanges that occur when all parties view the exchange as mutually advantageous. The assumption when analyzing market exchange is that property rights are well defined and effectively enforced, so

2. This point is worth emphasizing because both Daron Acemoglu (2003) and Francesco Parisi (2003) refer to a political Coase theorem in their titles, and both use the term *Coase theorem* to mean a situation in which political exchange takes place with no transaction costs.

exchange takes place when all parties to the transaction value what each party receives in the exchange more highly than what each party gives up. This section assumes there are no externalities, which follows from the assumption that property rights are well defined and effectively enforced.[3]

In the absence of transaction costs, resources are allocated to their highest-valued uses because those who value resources most highly buy them. If the transaction costs for a particular exchange are higher than the gains from trade, the transaction will not occur. Although markets may not allocate resources to their highest-valued uses if transaction costs are too high, market exchanges do not result in resources being allocated to lower-valued uses. High transaction costs can prevent mutually beneficial exchanges from taking place, but potentially advantageous exchanges that are prevented because of high transaction costs do not impose costs on anyone. They simply preserve the status quo. When markets are complete, market transactions are always welfare enhancing, even though transaction costs prevent some transactions from occurring when the transaction cost is greater than the gain from trade.

Externalities

Externalities exist because transaction costs prevent some people from negotiating with others to mitigate the effects of actions taken by those others. One of Coase's (1960) points was that if transaction costs are absent, those who bear external costs can bargain with those creating these costs to internalize the externality. Internalization means that resources formerly allocated externally to the market system are now allocated internally to the market system because the recipients of externalities bargain with those who create them. Internalization occurs when transaction costs are low enough to allow the parties to bargain.[4]

Externalities exist because some people in a low-transaction-cost group bargain for their mutual benefit and as a by-product generate costs or benefits external to the market that affect others outside the low-transaction-cost group. Those others face high transaction costs and are not in a position to bargain to internalize the externalities. For

3. Externalities are defined in various and sometimes confusing ways, so the name is often more descriptive than the definitions economists are prone to use. Externalities are often defined as third-party effects: the actions of some impose costs on or confer benefits to others. A definition like this often leads to confusion. A better way to view externalities is that they exist when resources are allocated externally to the market. Dean Worchester (1969) discusses pecuniary versus technological externalities, for example, but pecuniary externalities occur when the third-party effects are internal to the market and so are welfare enhancing (as, for example, when a competing store opens near an existing business, taking customers from the business that was there first). If externalities are defined as costs and benefits allocated externally to the market, pecuniary externalities would not fit the definition.

4. Government policies such as a Pigouvian tax also can create incentives for people to account for the external effects they impose on others, when transaction costs prohibit parties from bargaining with each other. James Buchanan and William Craig Stubblebine (1962) show that when transaction costs are low enough to allow bargaining, the imposition of Pigouvian taxes can result in an inefficient allocation of resources.

externalities to exist, some people must be in a low-transaction-cost group to create them, and other people must be in a high-transaction-cost group and prevented by transaction costs from internalizing them. Consider the classic example of air pollution. Some people, such as steel producers and steel purchasers, participate in the market for steel because they face low transaction costs and are able to bargain to their mutual advantage. People who breathe the air pollution from steel mills are in a high-transaction-cost group and are unable to effectively bargain to reduce the amount of pollution they experience.

The Coase theorem divides people into two groups. Some are in a low-transaction-cost group and can engage in mutually advantageous exchange that maximizes the benefit of their transactions to those in their group. Others are in a high-transaction-cost group and are prevented by transaction costs from bargaining with those in the low-transaction-cost group. Those in the high-transaction-cost group can find themselves bearing costs imposed on them as a by-product the transactions of those in the low-transaction-cost group.

The Coase Theorem, Applied to Government

The Coase theorem applies the same way to government. Some people engage in political exchanges to make public policy. They are in the low-transaction-cost group. Other people are outside the policy-making arena and have no say in the design of public policy. They are in the high-transaction-cost group and must comply with the policies created by the low-transaction-cost group. Following the Coase theorem, those in the low-transaction-cost group who make public policy will bargain to produce public policies that maximize the value of those policies to those in the bargaining group. They are analogous to the steel producers and the steel purchasers. Those in the high-transaction-cost group often bear costs as a result of policies produced by those in the low-transaction-cost group. They are analogous to those who suffer the air pollution created by the steel mills. Just as in markets, those in the high-transaction-cost group bear the external costs of exchanges made by those in the low-transaction-cost group.

Consider the costs imposed on third parties via rent seeking, as described by Gordon Tullock (1967) and Anne Krueger (1974). Those in the low-transaction-cost group are able to compete for rents, which impose costs on the general public. Tariffs and monopolies benefit those who are protected by trade barriers and monopoly privileges, which raise prices and impose costs on those in the high-transaction-cost group, who are unable to bargain with policy makers. Douglass North (1990) clearly recognizes cases like this as the result of transaction costs that prevent political bargaining. As Mancur Olson (1965) describes, smaller groups are able to organize more effectively precisely because they have lower transaction costs and so are able to use the political process to generate gains for themselves at the expense of the general public. Similarly, George Stigler's (1971) regulatory capture works only because of the low transaction costs between the regulators and the regulated firms. Public-choice theory often describes how some can use the political process to impose costs on others.

The public-choice literature essentially stops at the point where these various theories explain how some people use the force of government to impose costs on others. Applying the Coase theorem, it is easy to see that those who are able to design policies for their benefit must be able to bargain to do so—they are in the low-transaction-cost group—and those who bear the costs of those policies must be unable to bargain to prevent costs being imposed on them—they are in the high-transaction-cost group. Just as with externalities in markets, some people who face low transaction costs are able to strike bargains for their mutual advantage and impose costs on others who face high transaction costs and are unable to bargain to mitigate the costs being imposed on them.

Daron Acemoglu (2003) says that there is not a political Coase theorem, but what he means is that high transaction costs prevent the masses from bargaining with those who create public policy. The implication is that the Coase theorem applies only to situations in which there are low transaction costs and that the low-transaction-cost assumption does not apply to political decision making. The point of the Coase theorem, however, is not to conclude that transaction costs are low and that resources are allocated to their highest-valued uses, but rather that when resources are not allocated to their highest-valued uses, the reason is that transaction costs stand in the way. Acemoglu's (2003) arguments about political decision making are on the mark, but his argument that the Coase theorem does not apply to politics misses the mark because the Coase theorem is not intended to apply to cases where transaction costs are low. Coase's main point is that high transaction costs can prevent resources from being allocated to their highest-valued uses.

In politics, the elite face low transaction costs and can bargain with each other to make public policy for their benefit. The masses face high transaction costs, which exclude them from the political bargaining process. Resources will be allocated to the highest-valued uses for those in the low-transaction-cost group, but costs are often imposed on those in the high-transaction-cost group, who cannot bargain to mitigate them.

Who Is in the Low-Transaction-Cost Group?

The people who make public policy are in the low-transaction-cost group. The core part of this group consists of members of the legislature. Consider the U.S. Congress, which is composed of 435 representatives and 100 senators. The group is small enough that all members know each other, and all are able to bargain so that the legislation they produce maximizes its value for the low-transaction-cost group. The public-choice literature has extensively analyzed bargaining within the political marketplace. James Buchanan and Gordon Tullock (1962) discuss the efficiency of logrolling, vote trading, and political exchange. A substantial subsequent literature (including Weingast, Shepsle, and Johnsen 1981; Koford 1982; Becker 1983; Wittman 1989, 1995; Cardona and Rubi-Barcelo 2014; and others) describes the way political exchanges take place among those in the legislature, depicting politics as exchange. Exchange takes place only among those who face low enough transaction costs to make exchange feasible and cost effective.

Well-placed lobbyists are also in a position to engage in political exchange as a part of the low-transaction-cost group. Sometimes lobbyists are able to use their personal connections. For example, a common profession for former legislators is lobbyist because they know personally the people they will lobby.[5] Lobbyists can also buy their way into the low-transaction-cost group by offering benefits to lawmakers, perhaps in the form of campaign contributions, perhaps in the form of employment for relatives, and perhaps in other ways that can funnel benefits more directly to lawmakers. Peter Schweizer (2013) offers details about actual political exchanges that have taken place between lobbyists and lawmakers and describes how political exchanges between lobbyists and legislators actually take place. He provides examples of what Fred McChesney (1987, 1997) calls rent extraction.

Bureaucrats, agency heads, and legislative staffers may also find themselves in the low-transaction-cost group because of their input in the design of public policy. As with legislators, they can benefit through job offers for themselves and their relatives, through political contributions that may help them if they want to run for higher office, or simply through promotions within the agencies where they work. Similarly, business leaders, such as corporate CEOs, are able to interact with legislators and executive-branch officials because they can provide benefits to those policy makers in exchange for policies that will benefit their firms.

There is a long-standing literature, mostly in political science and sociology, that describes how the political and economic elite are able to design public policy for their benefit (e.g., Bentley 1908; Truman 1951; Mills 1956; Kolko 1963; Bartels 2008; Hacker and Pierson 2010; Gilens 2012; and Holcombe 2015). Joseph Stiglitz says, "It's one thing to win a 'fair' game. It's quite another to be able to write the rules of the game—and to write them in ways that enhance one's prospects of winning. And it's even worse if you can choose your own referees" (2012, 59). Stiglitz uses the Occupy Wall Street language to talk about the way government policy benefits the one percent at the expense of the 99 percent, but the one percent can write the rules of the game and choose their own referees only if transaction costs among policy makers are low enough to facilitate doing so. Similarly, David Stockman argues, "We have a rigged system—a regime of crony capitalism," and goes on to say, "In truth, the historic boundary between the free market and the state has been eradicated, and therefore anything that can be peddled by crony capitalists . . . is fair game" (2013, 560, 606).[6] Cronyism means

5. Sounman Hong and Jeehun Lim (2016) find that a university that selects a former politician as its president receives favorable funding treatment because of the new president's former connections.

6. Holcombe (2014) discusses the books by Stiglitz (2012) and Stockman (2013) in more detail, showing how much their views have in common. Ralph Nader (2014) argues there is an unstoppable coalition from political left to right that will dismantle the corporate state. The problem with Nader's hypothesis about the unstoppable coalition is that although there may be widespread agreement from left to right—Stiglitz and Stockman are examples—on the problems, there is disagreement on the solutions. The Left prefers more government oversight and more government programs, whereas the Right argues that government is the problem and that the solution is less government interference in the market economy. Stockman's description of the growth of crony capitalism fits comfortably within the framework that Olson (1982) describes as the decline of nations.

that cronies know each other, and low transaction costs enable the cronies to rig the process for their mutual benefit.

The terminology varies from author to author and over time, but whether one is discussing the bourgeoisie and the proletariat, elites and masses, or the one percent and the 99 percent, the concepts fit well within the Coasean framework, in which the members of the low-transaction-cost group design public policy and the members of the high-transaction-cost group often find that they bear the costs. The low-transaction-cost group is the aristocracy, the bourgeoisie, the elite—today's one percent.[7] As I have noted elsewhere (Holcombe 2017), those in the low-transaction-cost group capture the regulatory agencies and receive the rents, and those in the high-transaction-cost group—the proletariat, the masses, the 99 percent—are left out of the bargaining process.

Anthony Downs (1957) argues that voters are rationally ignorant because they realize their one vote has no effect on political outcomes, so people who do vote vote expressively (Brennan and Lomasky 1993) or even irrationally (Caplan 2007). The political process described by the public-choice literature is easily organized within this Coasean framework, wherein some people are in the low-transaction-cost group and are able to bargain within the political marketplace for their mutual benefit, but most are in the high-transaction-cost group and are unable to engage in political exchange.

One difference between these groups in markets and these groups in government is that in markets people sometimes find themselves in the low-transaction-cost group and engage in activities that may impose external costs on others and sometimes find themselves in the high-transaction-cost group and bear external costs created by others. People specialize and trade only on those markets they know and for the most part are unaffected by markets in which they face high transaction costs and do not trade. In government, membership in the low-transaction-cost group is more stable, which is why social scientists can identify them as the elite.

The policies designed by the elite do not always impose costs on the masses because some of those policies are good for everybody or for most people. The same is true in markets, where most transactions do not generate externalities. However, in markets and in government, those in the low-transaction-cost group always enact policies that benefit themselves, which sometimes do impose costs on those in the high-transaction-cost group. A major difference between decision making in markets and decision making in governments is that the policies made by decision makers in government apply to everyone, not just to those who are party to the exchange. When markets are complete, so externalities are eliminated, market exchange is always welfare enhancing. In government, policies designed by the elite also apply to the masses, creating a built-in externality.

7. Deirdre McCloskey (2006) has done a lot to promote the term *bourgeois* and to promote bourgeois virtues, so it is worth noting that the bourgeoisie McCloskey promotes is a different group from the bourgeoisie that Marx and Engels targeted.

The Coase theorem provides an economic foundation for the elite theory developed in other social sciences and connects public-choice theory with elite theory. It explains that those who receive the rents, those who capture regulatory agencies, and those whose narrow interests benefit at the expense of the general public are members of a low-transaction-cost group—the elite—who are able to use their elite status to benefit themselves, often at the expense of the masses.

The Coase Theorem and Constitutional Economics

James Buchanan (1990) says that economics typically analyzes the effects of choice subject to constraints, whereas constitutional economics studies the choice among constraints. Economists typically take as given the constraints within which people make choices, but many of the constraints people face are institutional and the result of human design. Those institutions can be modified, sometimes through the decentralized decisions of individuals who operate under them and sometimes through collective decisions, as is the case with government rules and regulations.

To illustrate, consider the following question: Does the Coase theorem imply that markets allocate resources efficiently or that market allocation of resources is inefficient? In the standard economic framework, transaction costs are real costs, so the standard economic answer is that making an exchange when the transaction cost from doing so is greater than the gain from trade would be inefficient. The Coase theorem implies that resources are allocated efficiently, even though some resources are not allocated to their highest-valued uses.

When transaction costs are greater than the gain the parties would realize if the exchange were made, it is efficient to leave resources allocated to less-valuable uses rather than to reallocate them. If, for example, person A values an object at $100, and the object is owned by person B, who places a $90 value on it, and if the transaction cost to make the exchange would be $20, the transaction cost would be greater than the value gained by making the exchange, and the efficient outcome leaves the object in the possession of the person who places a lower value on it.

Taking a constitutional approach, institutions can be modified to lower transaction costs, and a major part of the constitutional project is to look for ways to modify constraints—redesign the institutional framework—to lower transaction costs and facilitate mutually advantageous exchanges.[8] The Coase theorem implies that resources are being allocated efficiently if constraints are taken as given but also implies that

8. Constitutional economics is a part of the new institutional economics. For a good discussion that differentiates the new institutional economics from neoclassical economics, see Williamson (1990). Acemoglu's (2003) pessimistic view is that transaction costs are too high for the high-transaction-cost group to bargain with the low-transaction-cost group to allocate resources more efficiently. The more optimistic constitutional approach looks for ways to redesign constraints to lower transaction costs to facilitate such exchanges. The theoretical possibility that such exchanges could take place does not necessarily say that Acemoglu's pessimism is unwarranted.

resources could be allocated more efficiently if constraints can be modified to lower transaction costs by changing institutions.[9]

In the previous example, if institutions can be modified to lower the transaction cost to $5, then the gains from the exchange would be larger than the transaction cost, and the exchange can profitably be made. How property rights are defined and enforced is a constitutional issue, and some types of institutions are more productive than others. The constitutional approach would say that resources could potentially be allocated more efficiently if the owner of an object places a value of $90 on it and someone else values it at $100, and constitutional economics looks for ways to alter the constraints facing individuals to lower transaction costs.

Constitutional economics looks for ways to redesign constitutional rules to lower transaction costs so that more mutually beneficial exchanges can take place. In this sense, the Coase theorem points toward a constitutional approach to evaluating the efficiency of resource allocation by looking for ways to modify institutions to lower transaction costs.

Buchanan and Tullock and External Political Costs

Buchanan (1962) and Buchanan and Tullock (1962) call costs that democratic governments impose on some parties external political costs, but the external costs they describe are different in small but important ways from the externality that Coase is analyzing. Buchanan (1962) notes that majorities can impose costs on minorities and calls these costs external costs because they are imposed on some (the minority) by others (the majority). Buchanan and Tullock refer to as external costs the costs people bear because political decisions impose costs on them greater than the benefits they receive (1962, chap. 6), but in their framework people willingly accept those external costs in exchange for lower decision-making costs. In both cases, they are correct to observe that some bear costs as a result of the political decisions of others, but in neither case does the way they use the term *external costs* directly parallel the way external costs are generated in markets.

Within the context of the public-choice literature, the low-transaction-cost group is not a majority, as in Buchanan (1962). Olson (1965) explains that well-organized minorities are often able to use the political process to benefit themselves at the expense of the poorly organized general public for exactly the reason implied in the Coase theorem. Well-organized minorities face low transaction costs and can bargain to create policies that impose costs on the poorly organized majority that faces high transaction

9. Parisi (2003) analyzes constitutional decision making under the assumption that there are no transaction costs, developing what he calls a political Coase theorem. This analysis is consistent with Buchanan's (1975) constitutional framework, but I explicitly recognize here that there are transaction costs that prevent some parties from entering the political bargaining process.

costs. This is not the same thing as the majority that Buchanan (1962) describes as imposing costs on a minority.

In Buchanan and Tullock (1962), people agree to bear external costs because on net they benefit from a combination of lower external costs and decision-making costs. Everyone is in the low-transaction-cost group in the Buchanan and Tullock (1962) model because they unanimously agree to constitutional rules that make them all better off. In the Coasean framework, the high-transaction-cost group is not agreeing to bear external costs as compensation for lower decision-making costs, as is the case in Buchanan and Tullock (1962). They have no choice because transaction costs prevent them from participating in the decisions that impose costs on them, and, unlike in Buchanan and Tullock (1962), those in the high-transaction-cost group often are not better off bearing those external costs. Everyone agrees in Buchanan and Tullock (1962), whereas in the Coasean framework high transaction costs prevent some people from being a part of the political bargaining process.

Although Buchanan (1962) and Buchanan and Tullock (1962) apply the concept of external costs to politics, the parallel to externalities generated by market exchanges is not exact. In Coase's framework, externalities, in markets and in government, are produced when people who face low transaction costs strike bargains that benefit themselves but impose costs on those who face high transaction costs and are unable to bargain to mitigate those costs.

Transaction Costs and the Political Marketplace

Scholars have depicted differently the role of transaction costs in the political marketplace. At one extreme, Donald Wittman (1989, 1995) provides a long list of reasons and examples to argue that political institutions minimize transaction costs and facilitate political exchange, so that democracies produce efficient outcomes that rival the market's allocation of resources. Wittman's approach is essentially what Acemoglu (2003) calls the Coase theorem applied to politics. Political institutions place everyone in the low-transaction-cost group.

Gary Becker (1983, 1985) has a more nuanced view of efficiency in political exchange. His argument is that whatever the policy goal, policy makers have an incentive to accomplish it in the least-cost manner, and he would recognize that transaction costs could prevent some potentially profitable political exchanges. Resources are then allocated efficiently, given transaction costs. Actors in his framework have an incentive to look for ways to facilitate political exchange to provide greater net benefits that can be divided among everyone. Political entrepreneurs have the incentive to expand the low-transaction-cost group so that, at the limit, the efficient results depicted by Wittman are produced.

This stands in contrast to Olson (1982), in which members of the low-transaction-cost group are increasingly able to strengthen the division between themselves and members of the high-transaction-cost group, leading to increasing political benefits going to the elite at the expense of the masses and eventually to the decline of nations. Many public-choice models are more static in nature, but the literature on rent seeking depicts one group of people who receive rents and another who bear the costs as well as one group of people who capture regulatory agencies and another group of people who bear the costs.

The importance of transaction costs to political outcomes has been discussed for decades in the public-choice literature, although not in these terms. Wittman presents a framework in which political institutions mitigate transaction costs; Becker presents a framework in which political actors have an incentive to look for ways to minimize them; but much of the literature simply divides people into two groups: one group benefits from government policies, whereas another bears the costs of those policies. Applying the Coase theorem, those who benefit are in a low-transaction-cost group and those who bear the costs are in a high-transaction-cost group. Transaction costs divide people into elites and masses.

Consider the degree to which transaction costs hinder mutually advantageous exchanges in general. It would be rare to find someone who would argue that transaction costs really are absent in markets and do not stand in the way of some mutually advantageous exchanges. The general opinion is that transaction costs are an impediment to more efficient resource allocation and that externalities are a source of inefficient resource allocation in markets. Based on the recognition that external costs result from transaction costs in markets, it would seem reasonable to conclude that in government, as in markets, transaction costs are high enough to exclude some people from the low-transaction-cost group and that government resource allocation results in costs imposed on a high-transaction-cost group by the policies designed by the low-transaction-cost group.

If one recognizes that transaction costs stand in the way of internalizing external costs in markets, there seems to be no good argument that transaction costs are lower when resources are allocated through government. Arguments that voters are rationally ignorant (Downs 1957) and that concentrated interests are able to use the political system to benefit themselves by imposing costs on diffused groups who find it difficult to organize (Olson 1965) point the other way and give reasons why transaction costs are more of a factor in generating inefficiency in government than they are in generating inefficiency in markets. If externalities remain a problem in markets, there are reasons to believe that they are more of a problem in government. Indeed, many of the core theories in public choice are built on the idea that members of a low-transaction-cost group can use the political process for their gain by imposing costs on a high-transaction-cost group. This idea permeates public choice even though the transaction-cost language has not been employed.

Individualism and Elites

The political science and sociology literatures have long recognized this division between elites and masses—the low-transaction-cost group and the high-transaction-cost group—but have not described the mechanisms by which the low-transaction-cost group exercises its power. The public-choice literature describes those mechanisms. It recognizes that some receive rents, whereas others pay the cost; some capture regulatory agencies, whereas others pay the cost; concentrated interests use the public-policy process for their benefit at the expense of others. But public choice has not recognized what puts the beneficiaries in a position to benefit. The beneficiaries are members of the low-transaction-cost group. And the public-choice literature has not recognized that the low-transaction-cost group has a very stable membership.

In part, this oversight is due to the individualistic mindset that underlies the economic approach to understanding behavior. Kenneth Arrow notes this connection: "It is a touchstone of accepted economics that all explanations must run in terms of the actions and reactions of individuals. Our behavior in judging economic research, in peer review of papers and research, and in promotions, includes the criterion that in principle the behavior we explain and the policies we propose are explicable in terms of individuals, not of other social categories" (1994, 1). Buchanan and Tullock emphasize that economic approach, saying they "reject any theory of conception of the collectivity which embodies the exploitation of a ruled by a ruling class." They go on to say, "Collective action is viewed as the action of individuals as they choose to accomplish purposes collectively rather than individually, and government is seen as nothing more than a set of processes, the machine, which allows such collective action to take place." They emphasize that they take a "purely individualistic" approach to analyzing political decision making (1962, 12, 13).

This individualistic approach that underlies public choice weighs against analyzing individuals as members of groups, but it is not inconsistent to recognize that as individuals they may be able to bargain in some situations but are prevented from doing so because of high transaction costs in others and that those who design public policy consistently find themselves in a low-transaction-cost group that can design policy for their benefit while imposing costs on members of the high-transaction-cost group, who are prevented by transaction costs from entering into the bargains. Whereas Buchanan and Tullock rule out any theory that "embodies the exploitation of a ruled by a ruling class," the Coase theorem provides an economic rationale for understanding that some people are members of an elite class and are, in fact, in a position to exploit the masses.

The Distribution of Political Power

Many public-choice theories show how some individuals can use the political process to gain at the expense of others—through rent seeking, regulatory capture, interest-group politics—and those theories do identify gainers with groups to an extent. Gainers are those who get rents, capture regulatory agencies, and are in concentrated interest groups. But public-choice theory has not looked at these various theories as a whole to point out that in all cases the gainers gain because they are in a low-transaction-cost group that can make public policy, and the masses, because they face high transaction costs, are not in a position to negotiate with the elite to mitigate any costs that public policies place on them.

To the extent that membership in these groups is relatively stable, the same people always find themselves in the group of gainers, and other people always find themselves in the group of those who bear the costs of the public-policy measures designed by the elites. Martin Gilens and Benjamin Page (2014) note that not all public-policy measures impose costs on the masses, but they assert that public policies always work to the interest of the elite even when they do not impose costs on the masses. This process is analogous to market exchange: not all market exchanges generate externalities, but whether externalities are generated or not, those who participate in the exchange benefit. Similarly, not all public policies impose costs on the masses, but whether they do or not, those who design the policies design them for their own benefit.

In markets, people are not forced to engage in exchanges when they face high transaction costs. Some people specialize in trading precious gems, others in fine art, and most people trade in markets for groceries, but only if they choose to. In government, those in the high-transaction-cost group are forced to pay their taxes and abide by government regulations designed by those in the low-transaction-cost group.[10] Because most people—those in the high-transaction-cost group—are forced to abide by those policies even though they have no say in their design, members of the low-transaction-cost group are always in a position to produce policies for their benefit even if those policies impose costs on others. The distribution of political power is unequal because the same people are always in the low-transaction-cost group that produces public policy.

Conclusion

The transaction-cost framework offers a considerable amount of insight into the characteristics of the political marketplace. The idea of a political marketplace is more than just an analogy. Policy outcomes are produced by actual exchanges made by individuals who, because of low transaction costs, are able to enter into bargains with each other to produce public-policy outcomes. Policy makers themselves form the nucleus of the low-transaction-cost group.

Applying the Coase theorem, political exchange produces outcomes that are most highly valued by those who are in the bargaining group that produces them. Just as with externalities in markets, the policies produced by the low-transaction-cost group may and often do impose costs on those in the high-transaction-cost group who do not participate in the political bargaining process. Just as with externalities in markets, how the high-transaction-cost group is affected by the political bargaining of those in the

10. The public-choice literature has long observed other differences between markets and government. See, for example, Buchanan (1954) and Wagner and Yazigi (2014).

low-transaction-cost group is irrelevant to the outcome. The low-transaction-cost group produces the outcomes that are most highly valued to its members, regardless of whether those policies benefit or harm members of the high-transaction-cost group.

The key difference between economic power and political power is that government uses force to impose its policies on everyone. In markets, people obtain resources from others only if those others agree, unless there are poorly defined property rights that enable some to impose external costs on others. One role of government (in theory) is to control and limit externalities, but government is designed to create them because government policies are designed by a small group and are imposed on everyone. The only reason to have a government is to force people to do things they would not otherwise choose to do.[11] If people would voluntarily pay for public goods, there would be no reason to force them to pay taxes; if people would voluntarily act as government regulations command, there would be no reason for government to force compliance.[12] This power creates an opening for those who make government policy to impose costs on those who are forced to comply with that policy.

This framework presents a vision of public-sector resource allocation that differs from some of the classic ideas in public choice. The median-voter model has often been interpreted to say that the public sector produces the output the median voter prefers (Holcombe 1989). Downs (1957) and Black (1958) provided a foundation for the development of public choice based on the median-voter hypothesis, and Borcherding and Deacon (1972) and Bergstrom and Goodman (1973) provide early examples of empirical work that assumes, based on the median-voter model, that the public sector produces what the median voter demands. The transaction-cost framework describes a different type of political equilibrium that leads to policies that maximize their value to those who are able to engage in transactions to produce them rather than an equilibrium determined by aggregated voter preferences.

Tullock (1982) evaluates a literature initiated by R. D. McKelvey (1976) and others that concludes there is no unique stable political equilibrium. Preferences in political issue space always are such that there is some other political outcome that is preferred by a majority to the status quo. Voter preferences can lead to cyclical majorities, although it has been argued (Shepsle and Weingast 1981; Weingast, Shepsle, and Johnsen 1981) that institutions can produce stable outcomes even when preferences by themselves might lead to cycles. The transaction-cost framework points toward institutions that maximize the value of political outcomes to those who work together to produce them. Whether voter preferences in an issue space can produce cycles is

11. This point is forcefully made in Yeager (1985, 2001).

12. It is possible that people might agree to be coerced, as Harold Hochman and James Rodgers (1969) suggest, but this line of reasoning involves some degree of wishful thinking. As Joseph Schumpeter states, "The theory which construed taxes on the analogy of club dues or of the purchase of the services of, say, a doctor only proves how far removed this part of the social sciences is from scientific habits of mind" (1950, 198).

irrelevant because members of the low-transaction-cost group bargain to maximize the value of policies to themselves. The outcome of exchange in the political marketplace is stable for the same reason that a market equilibrium in any market is stable.

The elite theory that has been a part of other social sciences for more than a century has not made much inroads into economics or public choice, but the transaction-cost framework provides an economic foundation for integrating this theory into public choice. If membership in the low-transaction-cost group is relatively stable, elites are those who are in the low-transaction-cost group. Although elite theory has distinguished elites from masses, it has only imprecisely described the mechanisms by which the elite exercise their power. Public choice describes those mechanisms with its theories of rent seeking, regulatory capture, and interest-group politics. Meanwhile, public choice has not identified the mechanism that distinguishes those who benefit from government policies from those who pay the costs. Elite theory fills this gap. The transaction-cost framework provides a bridge between public-choice theories and elite theory and in the process gives both more explanatory power.

Applying the Coase theorem to government decision making does more than just add insight to existing public-choice analysis. It ties together previously unconnected ideas to paint a clearer picture of the nature of the political marketplace and calls into question some well-established theories about how the political decision-making process allocates resources.

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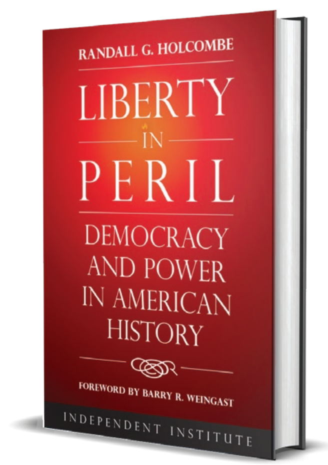

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