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Looking For Results

Nobel laureate Ronald Coase on rights, resources, and regulation

When Ronald Coase was awarded the Nobel prize for economics in 1991, many in the profession were stunned. No one could remember a single equation, an estimated parameter, a correlation coefficient--nary a Greek symbol--in any of his articles. How could this poseur--a man who had taught economics at the University of Chicago *Law* School--properly lay claim to that esteemed title?

It was not the first time in his life that Ronald Coase had surprised people. Born in England in 1910, Coase wore leg braces as a youngster and was placed in a school for "physical defectives." It was run by the same organization, Coase remembers, that ran the school for "mental defec- tives," and there was "some overlapping in the curriculum." Coase found himself in (literally) basket-weaving classes, and received virtually no academics until the age of 10.

Even at the London School of Economics, Coase was pretty much on his own. He took only business and accounting--no economics--until a seminar with Professor Arnold Plant in his senior year. The course--no readings--featured a robust discussion of the invisible hand. Coase, then a socialist, grasped as seminal the idea of spontaneous coordination in the marketplace, and his career as a creative and provocative economic thinker was born.

Again, in a most unusual way. He trekked to America in the early 1930s on a scholarship, and wandered about the industrial heartland researching the methods of business firms. Coase's scientific methodology? He asked businessmen why they did what they did. One key question, for instance, involved why firms chose to produce some of their own inputs (vertical integration), and why they sometimes chose to use the market (buying from independent suppliers). He was fascinated by their answers, but even more by their astute calculation: Firm managers were keenly aware of all the relevant trade-offs. In 1937, Coase published his article "The Nature of the Firm," explaining the basic economics of the business enterprise. It became one of the most influential works in the history of the dismal science, outlining the subtle logic of how firms pursue efficiency in a complicated world. The approach was vastly more sophisticated than the ones in vogue in America in the 1930s, which posited that the corporation was simply an accident waiting to self- destruct.

Again, in 1960, Coase rearranged the study of economics with his essay "The Problem of Social Cost." It analyzed what happens when economic actions affect third parties--say, for instance, when a railroad dumps pollution on a farmer's crops. Before Coase, economic analysis maintained that decentralized decision making--the market--in such cases would predictably fail to achieve an optimal solution, because self-interested actors (say, the railroad owners) would fail to take into account the harm imposed on others. That idea had widespread implications for the economy and provided intellectual justification for a wide range of government interventions.

Coase, whose 1959 article on the Federal Communications Commission had led him to realize how property rights could be used to manage the airwaves, saw something different: The problem actually lay in an improper definition of legal rights. He noted that once property was well-defined and easily tradable, the efficient solution would follow. Ironically, the optimal social outcome would obtain no matter who owned the property. For instance, even if the railroad possessed the right to pollute, the farmer could pay it not to. Indeed, the farmer (really the farmer's customers) *would* pay whenever the benefit from mitigating pollution exceeded the cost created by pollution. Hence, whenever someone clearly possessed the right to pollute: Voilà! Social efficiency! This became famously known as the Coase Theorem.

What was perhaps Ronald Coase's most important contribution to economic understanding, however, was not as an author. As editor of *The Journal of Law and Economics* from 1964 to 1982, Coase exercised a huge effect over the sort of topics that economists chose to investigate. Located at the University of Chicago Law School, the journal is written by and for economists, but economists working in areas that were recently the sole purview of lawyers and policy makers. The *JLE* under Coase was relentlessly relevant, dedicated to exploring the actual effects of actual policies. This paddled against the flow of virtually the entire profession, which was drifting to increasing abstraction and formalism. Due to its rigorous analytic standards, as well as to the demand for a reality check on the theories of economic scribblers, the *Journal* led its own paradigm shift in the social sciences. The ultimate success of this bold approach is today apparent, as its pages are cluttered with the writings of many of the Nobel laureates in economics. Just another Coasian demonstration, one might say, that the market works.

Reason: Could you state the Coase Theorem? How do you explain it to people?

Ronald Coase: It deals with questions of liability. Whether someone is liable or not liable for damages that he creates, in a regime of zero transaction costs, the result would be the same. Now, you can expand that to say that it doesn't matter who owns what; in a private enterprise system, the same results would occur.

Take the case of a newly discovered cave. I say, whether the law says it's owned by the person where the mouth of the cave is or whether it belongs to the man who discovers it or whether it belongs to the man under whose land it is, it'll be used for growing mushrooms, storing bank records, or as a gas reservoir according to which of these uses produces the most value. The law of property determines who owns something, but the market determines how it will be used. It's so obvious to me that I couldn't understand the fuss. All it says is that the people will use resources in the way that produces the most value, that's all. I still think it's an obvious point. You wouldn't think there was a need for a Coase Theorem, really.

But the people at the University of Chicago thought it was an error. Some people thought I should delete this section from my article on the FCC. The person who most desired this was Reuben Kessel, who was a very good economist, but he was supported by Aaron Director and George Stigler and others at the University of Chicago. I replied that if it was an error, it was a very interesting error and I would just as soon it stayed in. And it did stay in.

Then George Stigler invited me to do something at a workshop in Chicago and I presented something on another topic. I said I'd like to have an opportunity to discuss my error. Aaron Director arranged a meeting at his home. Director was there, Milton Friedman was there, George Stigler was there, Arnold Harberger was there, John McGee was there--all the big shots of Chicago were there, and they came to set me right. They liked me, but they thought I was wrong. I expounded my views and then they questioned me and questioned me. Milton was the person who did most of the questioning and others took part. I remember at one stage, Harberger saying, "Well, if you can't say that the marginal cost schedule changes when there's a change in liability, he can run right through." What he meant was that, if this was so, there was no way of stopping me from reaching my conclusions. And of course that was right. I said, "What is the cost schedule if a person is liable, and what is the cost schedule if he isn't liable for damage?" It's the same. The opportunity cost doesn't shift.

There were a lot of other points too, but the decisive thing was that this schedule didn't change. They thought if someone was liable it would be different than if he weren't. This meeting was very grueling for me. I don't know whether you've had a conversation with Milton Friedman, but an argument with Milton Friedman is a pretty strenuous affair. He's very good. He's very fair, but he doesn't let you slip up on anything. You're constantly being pressed. But when at the end of whatever the time was--say, an hour--I found I was still standing, I knew I'd won. Because if Milton can't knock you out in a few rounds, you're home.

Reason: The place the Coase Theorem comes into play most often is when talking about pollution. The pollution problem has been seen in a very different light because of the Coase Theorem.

Coase: It should be seen in a different light, but I don't see why you needed the Coase Theorem to do it. The pollution problem is always seen as someone who was doing something bad that has to be stopped. To me, pollution is doing something bad and good. People don't pollute because they like polluting. They do it because it's a cheaper way of producing something else. The cheaper way of producing something else is the good; the loss in value that you get from the pollution is the bad. You've got to compare the two. That's the way to look at it. It isn't the way that people today look at it. They think zero pollution is the best situation.

Reason: The basic idea behind the Coase Theorem is that the market is efficient, that consumers are going to direct the resources to where these resources yield the highest value.

Coase: Roughly speaking, when you are dealing with business firms operating in a competitive system, you can assume that they're going to act rationally. Why? Because someone in a firm who buys things at $10 and sells them for $8.00 isn't going to last very long in that firm. I think that the market imposes a great discipline, and the discipline of the market makes the assumption of rationality in that field correct.

I find that people behave in ways that destroy themselves and their families, produce a lot of hardship, and when it comes to policy do the same thing. I hold the view of Frank Knight: In certain areas rationality is enforced; in other areas it's weakly enforced. You get more irrationality within the family and in consumer behavior than you get, say, in the behavior of firms in their purchases.

Reason: Now, this is a very un-Chicago view. You must've had some arguments with George Stigler or Gary Becker or Richard Posner at some point about this view. They think people are rational in their marriage, their honesty, or their sex life, or in crime and all those social contexts that Gary Becker writes about.

Coase: Oh yes. When you say it is un-Chicago, you mean that it is an unmodern Chicago view. Because Frank Knight was at Chicago, and I was brought up more on Knight than I was on any of the others. And my views were quite consistent with what he says. They're not consistent with what George Stigler, Gary Becker, and Richard Posner say. Posner condemns me because I don't think people maximize utility.

Reason: So you don't think if we doubled the penalty for crime, we'd see less crime?

Coase: Oh, I do. I don't say people are wholly irrational. I have said that almost the only thing we can say about consumer behavior is, if you raise the price of something, people will demand less. And that we know, but it doesn't follow that because a person does less foolishness when the price is high for foolishness that you don't have foolishness. The foolishness follows the universal law of demand. The greater the price you have to pay for being foolish, the less you do.

Reason: Though you are now known as a leading free market economist, you started your intellectual career as a socialist. Why and when did your political views change?

Coase: They changed gradually. What was most important was the work I did on the economics of public utilities at the London School of Economics. I studied the results of municipal operation of utilities and the effects of nationalization, particularly in the post office. This led to grave doubts about nationalization. It didn't produce the results people said it did. My views have always been driven by factual investigations. I've never started off--this is perhaps why I'm not a libertarian--with the idea that a human being has certain rights. I ask, "What are the rights which produce certain results?" I'm thinking in terms of production, the lives of people, standard of living, and so on. It has always been a factual business with me. I discovered that municipal operation didn't work as well as people said it would, and nationalization did not either.

Reason: You said you're not a libertarian. What do you consider your politics to be?

Coase: I really don't know. I don't reject any policy without considering what its results are. If someone says there's going to be regulation, I don't say that regulation will be bad. Let's see. What we discover is that most regulation does produce, or has produced in recent times, a worse result. But I wouldn't like to say that all regulation would have this effect because one can think of circumstances in which it doesn't.

Reason: Can you give us an example of what you consider to be a good regulation and then an example of what you consider to be a not-so-good regulation?

Coase: This is a very interesting question because one can't give an answer to it. When I was editor of *The Journal of Law and Economics*, we published a whole series of studies of regulation and its effects. Almost all the studies--perhaps all the studies--suggested that the results of regulation had been bad, that the prices were higher, that the product was worse adapted to the needs of consumers, than it otherwise would have been. I was not willing to accept the view that all regulation was bound to produce these results. Therefore, what was my explanation for the results we had? I argued that the most probable explanation was that the government now operates on such a massive scale that it had reached the stage of what economists call negative marginal returns. Anything additional it does, it messes up. But that doesn't mean that if we reduce the size of government considerably, we wouldn't find then that there were some activities it did well. Until we reduce the size of government, we won't know what they are.

Reason: What's an example of bad regulation?

Coase: I can't remember one that's good. Regulation of transport, regulation of agriculture-- agriculture is *a*, zoning is *z*. You know, you go from a to z, they are all bad. There were so many studies, and the result was quite universal: The effects were bad.

Reason: What was the idea of *The Journal of Law and Economics*?

Coase: I wanted to find out what the effects of regulation actually are, to make factual studies so that we didn't have all these general discussions. I wanted to find out what effect different legal rules had on the economic system.

Reason: Isn't it shocking that economists didn't spend more time doing this kind of work before 1964?

Coase: Well, I'm not that easily shocked. Economics has been becoming more and more abstract, less and less related to what goes on in the real world. In fact, economists have devoted themselves to studying imaginary systems, and they don't distinguish between the imaginary system and the real world. That's what modern economics has been and continues to be. All the prestige goes to people who produce the most abstract results about an economic system that doesn't exist.

Reason: You began teaching at the University of Virginia in the late 1950s, and by the early 1960s the administration there was not impressed with the work being done by yourself, Warren Nutter, James Buchanan, Gordon Tullock--four of the most famous and influential economists in the post-war era, two of whom [Coase and Buchanan] went on to win Nobel prizes. Yet the University of Virginia was not happy with what was happening in their economics department.

Coase: 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.

Reason: In 1991, you won the Nobel prize in economics. How has that changed your life?

Coase: It has made it very difficult. Now it takes me a day a week just to read my correspondence, longer to reply to things. It's a great burden, this Nobel prize. I get letters from all over the world. People writing, sending materials they've written, wanting comments on it. But what do you do? You reply when you have a special obligation--you know the person or the person has done something for you. Businessmen, scholars, journalists, students--all write me. Occasionally I get letters from people who argue that they can prove that the Coase Theorem is wrong because the Earth is going to end on the year 2003--which, I might say, is an actual case. He's found the error in the Coase Theorem.

Reason: You're a man who likes to look at the facts, so it's going to take us another few years to check out his theory. You don't wish that you had gotten the Nobel prize any earlier?

Coase: Oh yes I do, because I could have handled this situation much better. At my age it's very difficult. I get invitations to go all over the place. I largely refuse them. But if I were younger and more energetic and so on, I would handle these things better. I would have done more. Getting it so late means that I have very little time left, even though a lot of research is now going on influenced by the fact that I got the Nobel prize. It encourages other people working in the field. A lot more work, I think, is now going on because the field has been recognized, and I want to take part in it, and I don't have very long to do it.

Reason: What led you to study the Federal Communications Commission?

Coase: It started with my study of public utilities in Britain. I studied the British Broadcasting Corporation and how it developed and its policies, and I wrote a book called *British Broadcasting: A Study in Monopoly* [1950]. I explained how it came to be a monopoly, how it was justified, what were its results. It came to be a monopoly because--and this is rather strange--the telegraphs had been nationalized under the post office. A telegram was defined as a message conveyed by electricity. So broadcasting was considered a telegram. Therefore, the powers to control broadcasting lay with the post office. They were very anxious to have a monopoly of broadcasting. People in some of the firms in the industry wanted it, and people who had visited America and heard about the chaos in broadcasting there decided the only thing that you could do to get rid of all this chaos was to have a monopoly.

I showed that all the arguments for a monopoly were invalid. But it was established, and then it was justified far more by the idea that you needed a monopoly in order to control programming, because competition would result in people producing programs which, although perhaps popular, should not be broadcast because they were bad for people.

Reason: So, you studied the BBC and then you came to the United States and began also taking a keen interest in the FCC.

Coase: Yes, that was really a continuation of my work on broadcasting. Having studied what happened in Britain, I was carrying out a study called *Political Economy of Broadcasting*. My study of the FCC was a natural result of doing this.

Reason: What were you surprised by when you studied the Federal Communications Commission?

Coase: I don't know that surprise is the right word. I looked to see what happened, and I discovered that the FCC was extremely inefficient, that the choices it made could not easily be justified, that a lot of the activities in which it engaged [were] an absolute charade. I was a little doubtful about pure markets for the use of the radio frequency spectrum at first, because there are a lot of things that we can imagine for which we can't have markets because the transaction costs are too high. I thought that perhaps the transaction costs were too high in this case. But then I discovered from the early history of broadcasting that property rights were being established, and it struck me that left alone they could have solved the problem with [signal] interference, which was the main problem they talked about. The period of broadcasting chaos arose because people didn't have well-defined property rights. So I saw no difficulty in bringing about a market in this area.

Reason: Were you ever interested in Hayek's thesis about the road to serfdom?

Coase: I read the book, of course. I knew Hayek and I knew the British response to it. In Britain it was a success, but much less than in the United States, because the general thesis was that socialism would inevitably lead to a totalitarian society, totalitarian state, or suppression of freedoms in other areas. In Britain, living in what is a very tolerant society, few people could imagine that this was going to be the result. I remember Lionel Robbins saying to me this is a very fine book from the continental point of view. It just wasn't British. Once, after I'd come to America, when visiting England I ran into someone I knew. We chatted a few minutes in a very civilized way (he had been a student of mine), and he went on and I went on. This person was a prominent member of the British Communist Party. I'd never imagined that he would have sent me to a Gulag. You know, if the communists had come to power, life would have been much worse. But that these sort of horrors would happen in England....

Reason: Well, the Russians were obviously more serious about their socialism. And in fact, they got much more severe decay of the economic system.

Coase: They got much nearer to serfdom, but the thing that stopped the system was not the fact that human liberties were trodden on, but that they didn't produce. It was a failed economic system.

Reason: How surprised were you by the collapse of the Soviet Union?

Coase: Very surprised. Nothing I'd read or known suggested that the collapse was going to occur.

Reason: What can you tell us about lighthouses?

Coase: Economists had always used this as a service that had to be provided by government. How could a private provider ever be paid for it? So without government operation you wouldn't get lighthouses. My usual practice is to look into what actually happens, and if you look into what actually happens you discover that there's a long period in which lighthouses were provided by private enterprise. They were financed by private people, they were built by private people, they were operated by the people who had the rights to the lighthouses, which they could bequeath to others and sell.

Some have said what happened in lighthouses wasn't really private enterprise. The government was involved in some way in setting the rights and so on. I think that's humbug because you could say that there's no private property in houses by that logic, since you can't transfer your rights to a house without the examination of title and registration and without obeying a whole series of regulations, many enforced by government.

Reason: I thought it was interesting that the shippers were the ones that lobbied to get the toll because they wanted the incentive for the private investor to build the lighthouse. What reaction have you had over the years when Paul Samuelson or other economists would use this example of the lighthouse as a necessary government function?

Coase: Samuelson says I was wrong and he was right, and he froths at the mouth when people talk about the lighthouse example. He says Coase is wrong; he doesn't overcome the free rider problem. Who are the free riders? The foreign ships going past the British coast which do not call at a British port. Using Samuelson's approach, what do you do? Do you ask the foreign governments to give you a subsidy? Do you tax people in Britain because the foreign ships are getting help without paying for it? What do you do?

My approach is to compare the alternatives. People like Samuelson like to set up a perfect world and say that the market does not bring us to this point and imply that the government should do something. They stop their analysis at that point.

Reason: Certainly if the government builds the lighthouses and operates them at a zero price to the shippers, there's a huge free rider problem there, free riding on the taxpayer. But you had to go back to the early days to find the private ownership?

Coase: Yes, that's right. From 1838 or some such date, I can't remember it, the lighthouse people were bought out and compensation was given. Samuelson says that no one would build a lighthouse with the idea of making a fortune. Actually, people did build lighthouses and did make a fortune.

Reason: What about your article on the market for goods and the market for ideas in the *American Economic Review* in 1974? You created quite a stir with this and were interviewed by *Time* magazine. What did you say in that article, and why was it so controversial?

Coase: It was controversial because I said that the arguments for regulation of the market for goods and the regulation of the market for ideas are essentially the same, except that they're perhaps stronger in the area of ideas if you assume consumer ignorance. It's easier for people to discover that they have a bad can of peaches than it is for them to discover that they have a bad idea.

Reason: So if you think that the consumer, ignorant as he is, ought to be protected by a government regulator, then you should really believe that the government regulator ought to step in and police the speech of professors or politicians or pundits.

Coase: That's right. If the government is competent to do the one, it's competent to do the other.

Reason: Then there ought to be a federal philosophy commission.

Coase: That's right. The press was horrified by the idea. If the argument is exactly the same for regulating the press as for regulating peaches, this meant that I was arguing for regulation of the press.

Reason: You have to be careful with reductio ad absurdum arguments.

Coase: As they assumed that all regulation in the market for goods was fine, it never struck them that the argument was really the other way around.

Reason: You wrote another influential article called "The Nature of the Firm" in 1937. Explain what you found in that article.

Coase: I discovered there was something economists left out of their analysis of market competition, namely the costs of using the market, something which has become known--although I didn't invent the term--as "transaction costs."

Reason: Where you have transaction costs, you don't automatically get the invisible hand diverting resources where they do the most good?

Coase: That's right. People adopt other forms which they hope will produce the right result. They change the forms of contracts, taking account of it. They do lots of things. The firm itself is a response to that, but lots of contracts are as well. Even the form of markets, what you can trade: The rules and regulations of the submarket or produce exchange are designed to reduce transaction costs. You see these pictures of the way they do things: You wiggle your hands and this means you want to buy half a million tons of something for delivery in May at a certain price. And a person wiggles their hands, and the trade has gone through. You couldn't do this without having a terrific body of laws or regulations behind you so that people know what they're doing when they wiggle their hands. It can only happen quickly because the law has developed in such a way--in this case it's largely private law--so as to make transactions possible. You've got to be able to carry out transactions at costs less than the benefit which you are going to get. Every time people lower the costs of carrying out transactions, you get these extra benefits. How do we do it? That's what I'm interested in exploring now, and getting others to explore, of course.

Reason: People are very excited that transactions are taking place much more efficiently than ever before through new electronic means and better communication systems. Are you excited about these trends?

Coase: Yes, because I don't understand them. People talk about increases in improvements in technology, but just as important are improvements in the way in which people make contracts and deals. If you can lower the costs there, you can have more specialization and greater production. So that's what I'm interested in now. By improving the way the market works, you can produce immense benefits, not because it invents new technologies, but because it enables new technologies to be used. Without the ability to make efficient contracts, you can't use these new means. And a lot of effort is going, at the moment, into devising new ways of handling the problems, mainly by the lawyers.

Reason: Some people would say that it's just paper transactions, that all the efforts of the lawyers are a waste, a mess, a scourge on society. You have a slightly different view.

Coase: Lawyers do a lot of harm, but they also do an immense amount of good. And the good is that they are expert negotiators, and they know what is necessary in the law to enable deals to be made. Their activities are designed, in fact, to lower transaction costs. Some of them, we know, raise transaction costs. But by and large, they are engaged in lowering transaction costs. People talk about the information age and how large numbers of people are engaged in information activities. Well, gathering information is one of the difficulties when you're in a market. What is being produced, what are the prices of what is being offered? You've got to learn all these things. You can learn them now a good deal more easily than you could have done before; you don't have to search. If you've ever tried to buy anything, you know how much time goes into finding out what's available and all the alternatives.

Reason: That search cost is going to be much lower as information technologies lower the cost of finding out what's out there and take people all over the globe and put them next to each other.

Coase: That's right. You don't necessarily have to go to Singapore or somewhere to find out what's available there.

Reason: So would you think we are embarking on a golden age of economic expansion?

Coase: I think we could be. Whether we'll mess things up is another thing. There are more wrong ways of doing a thing than right ways. But I really think that one can be optimistic now.