Nobel Laureate: Ronald Coase and Methodology

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Nobel Laureate
Ronald Coase and Methodology

Richard A. Posner

"Coase will never win the Nobel Prize for Economics."
Stewart Schwab (1989, pp. 1190)

When the name Ronald Coase comes up in conversation, the economists and economically minded lawyers who follow his work are apt to say: He has written very little, but his percentage of "hits" is very high. In particular, he has written two great theoretical articles, published a quarter of a century apart but thematically continuous, which earned him the Nobel Prize: "The Nature of the Firm" in 1937 and "The Problem of Social Cost" in 1960 [1, 4]. The latter article, which is widely believed to be the most frequently cited article in all of economics, introduced (though it did not name) the Coase Theorem: If transaction costs are zero, the initial assignment of a property right—for example, whether to the polluter or to the victim of pollution—will not affect the efficiency with which resources are allocated. The major significance of the theorem has been to focus economists' attention on a neglected but very important facet of the economic system, the costs of market transacting. Restated as a hypothesis—if transaction costs are low, the law's assignment of rights and liabilities is unlikely to affect the allocation of resources much—the Coase Theorem has guided important empirical research. For example, consistent with the Theorem, no-fault divorce does not appear to have increased the divorce rate (Peters, 1986).

The impression of a lifetime's work compressed into two articles is not dispelled by the elegant address that Coase gave upon receipt of the Nobel

1 As is conventional for this journal, the references to Coase's work are to the numbers of the articles appearing in Table 1. All other citations are by the author (date) system to the reference list at the end of the article.

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Prize [14]. For he discusses only those two articles, remarking modestly that he has "made no innovations in high theory" (p. 1) but adding quickly that he believes that the ideas in these articles, once they are absorbed into mainstream economic analysis, will "bring about a complete change in the structure of economic theory, at least in what is called price theory or microeconomics." So they must be contributions to theory, and indeed fundamental ones: more than enough for a lifetime. Because these two articles were singled out by the Royal Swedish Academy in its award of the Nobel Prize to Coase, it is natural that he should have made them the focus of his prize lecture, but it was not inevitable that they should be the only work that he discussed in it. The impression of a life work's compressed into two articles that are really one is reinforced by his remarking that the "essentials" of his argument about the importance of transaction costs, which he regards as the point of both articles, had been presented in a lecture that he gave in 1932, when he was only 21 years old; "and it is a strange experience to be praised in my eighties for work I did in my twenties" (p. 6). At the end of the Nobel lecture he explains that since the articles demonstrate the centrality of transaction costs in the operation of markets, the next stage in research is to study contracts empirically because they are the method (more precisely, a method) by which business firms minimize, overcome, or adjust to transaction costs.

If his work is destined to bring about "a complete change in the structure of economic theory," and to do this by the creation and study of "large-scale collections of business contracts" ([14], p. 12), Coase must believe that the dominant tendencies in modern economics are unsound. He does not say this in so many words in the Nobel lecture, but he has not been reticent on the subject elsewhere and I do not think that he has changed his mind about it. He has repeatedly made clear his "dissatisfaction with what most economists have been doing... This dissatisfaction is not with the basic economic theory itself but with how it is used. The objection essentially is that the theory floats in the air. It is as if one studied the circulation of the blood without having a body" [12, p. 230]. In a splendid article on The Wealth of Nations he asks, "What have we been doing in the last 200 years? Our analysis has certainly become more sophisticated, but we display no greater insight into the working of the economic system and, in some ways, our approach is inferior to that of Adam Smith" (Coase, 1977, p. 325).

Both the conventional impression of Coase's work (which may well have been shared by the Swedish Academy), and Coase's own take on his work,

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2A shorter and less revealing version of the lecture is [15]. The original version may be found (under a slightly different title) in [16], but my page references are to the pamphlet published by the Nobel Foundation.

3See also [13], especially ch. 1, which reprints several of Coase's articles, including "The Nature of the Firm [1], "The Problem of Social Cost [4]," and "The Marginal Cost Controversy [2]," together with some additions. It is the best introduction to Coase's work and to his distinctive point of view. Two reviews of the book also provide good introductions to Coase: Schwab (1989) and Williamson (1989).
Table 1
Some Works by Ronald Coase


which (as revealed by the quotations that I have just given) reflects a methodological preoccupation ignored in the conventional appraisals of his contribution to economics, seem to me interestingly wrong. To begin with, it is not true that Coase has written only a few papers. His curriculum vitae lists five monographs and 75 papers. These works fall into three groups. One is theoretical and includes besides the two articles on transaction costs a series of very fine articles on public utility pricing (the most important is [2]) and an important article on the monopolization of durable goods [6]. The second group consists of a number of case studies of particular institutions, mostly public, such as the British Post Office, the British Broadcasting Company, and the Federal Communications Commission. The third consists of articles dealing with the methodology of economics, often in the setting of a discussion of a particular economist, such as Adam Smith or Alfred Marshall, and, as the title of this paper will have revealed already, this series of articles will be my particular focus.

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4A representative such study is [3], where the "Coase Theorem" was first adumbrated.
Defending Markets Against Economic Theory

One cannot understand the character or the limitations of Coase’s overall economic position without viewing the corpus as a whole. One cannot for example otherwise understand why he is so critical of modern economics.5

Consider first the series of papers on the marginal-cost controversy. That controversy is largely forgotten today but it was very much alive a half century or more ago and it has cropped up from time to time since. Harold Hotelling and other high-powered economists used to argue that if a service was produced under conditions of declining average cost—transportation over a bridge assumed to be in no danger of congestion was the standard example, although the analysis was assumed to be applicable to all services produced under conditions of declining average cost, such as gas, electric, telephone, and water service—it had to be provided by a public entity. Only a public entity could charge a price equal to marginal cost even if marginal cost was zero yet stay in business by making up the deficit with taxation. A private firm would have to charge a price higher than marginal cost, and this would cause inefficient substitution away from the bridge. Coase pointed out that with price set equal to marginal cost, there would be no way to discover whether the public actually valued the bridge more than it valued substitutes that, not being produced under conditions of declining average cost, would have to pay their way in the market, without the help of a tax subsidy. The problem would disappear if government were omniscient, as implicitly assumed by Hotelling, but government is not omniscient6 and throughout his career Coase has insisted very sensibly that in evaluating the case for public intervention one must compare real markets with real government, rather than real markets with ideal government assumed to work not only flawlessly but costlessly.

Hotelling was one of those innovators in “high theory” that Coase has told us he is not; and like so many economic theorists Hotelling was led by his theorizing to propose a socialist solution to an economic problem that, as Coase showed, could be handled (not perfectly of course) by private alternatives, such as two-part or multipart pricing, once the ridiculous though analytically convenient assumption of omniscient government was dropped. Many years later some distinguished economists would oppose pay television on the ground that it would make the price of television programs to the viewer higher than the programs’ marginal cost, which was zero (the cost of adding one more viewer).7

5Here is a representative quotation [13, p. 85]: “In my youth it was said that what was too silly to be said may be sung. In modern economics it may be put into mathematics.” And recall the passage that I quoted about the bodiless character of modern economic theory.

6If it were, moreover, as Coase also pointed out, it could charge the users of the bridge directly; there would be no reason for the taxpaying public as a whole to subsidize that use.

7See the exchange among James Buchanan, Paul Samuelson, and Jora Minasian in volume 10 of the Journal of Law and Economics (1967).
The socialist pitfalls of high theory are a constant refrain in Coase's work. For the first 40 years or so of his professional life microeconomists were preoccupied with what he has derisively termed "The Problem of Monopoly" [11, p. 22]. They saw monopoly everywhere—"monopolistic competition" and "oligopolistic interdependence" were the theoretical constructs that extended the monopoly concept beyond classic single-firm monopolies and cartels—and they were quick to recommend government intervention by means of antitrust suits or other regulatory devices. They were apt for example to regard vertical integration as a monopolizing device, one that employed "leverage," or created "barriers to entry," to extend or protect monopoly power.

Coase's article "The Nature of the Firm" had offered an alternative, nonmonopolistic explanation of vertical integration, or, as Coase termed it, the firm. Businessmen bring a part of the process of production within the firm, rather than arranging for it by contract with other producers, when the costs of coordinating the firm's inputs by market transactions exceed the costs of coordinating them hierarchically. The hierarchy is itself, of course, a contractual one. But employment contracts that entitle the employer to direct the employee's work are importantly different from contracts with outside suppliers (independent contractors) for outputs specified as to price, quality, quantity, date of delivery, and the other dimensions of performance, but with control over inputs left to the supplier.

Coase's hostility to monopoly explanations, a hostility that the waning of interest in antitrust policy appears to have vindicated, created a certain awkwardness for him when he wrote his appreciation of George Stigler upon the occasion of the latter's receipt of the Nobel Prize. Much of Stigler's work had consisted of exploring monopoly problems, and in addition much of it was theoretical, even mathematical. Much consisted of regression analyses; and Coase is suspicious of econometrics just as he is of mathematical economics. It should not be a surprise, therefore, except for those who lump all economists at the University of Chicago into an undifferentiated "Chicago School," that the essay on Stigler seems rather strained [11].

Coase begins by saying that Stigler is "seen at his best" [11, p. 21] in his work on the history of economic thought—a subject that has virtually ceased to exist in economics. A science tends to forget its founders: physicists don't read Newton, or for that matter Einstein. Coase, however, seems not to believe that economics has made much progress since its founding; he regards Adam Smith as almost the only economist worth reading. So it is natural that he should have a high regard for studying the history of economic thought; nevertheless, it seems rather a backhanded compliment to suggest that Stigler's work in this

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8 In a striking passage in "The Problem of Social Cost," Coase appears to be blaming all pollution on government (4, p. 26).
9 Ironically, Coase's own contribution to the analysis of monopoly—his article on the problem of monopolizing durable goods [6]—has spawned a large literature.
10 If you torture the data enough, nature will always confess" [10, p. 16].
esoteric and declining field is his best. Stigler's writings on monopoly are passed over quickly because Coase believes (as I have already noted) that "by concentrating on the problem of monopoly in dealing with an economic system which is, broadly speaking, competitive, economists have had their attention misdirected and as a consequence they have left unexplained many of the salient features of our economic system or have been content with very defective explanations" (p. 22). He singles out for praise, as had the Swedish Academy in its Nobel citation of Stigler, Stigler's paper on the economics of information, because it offers a nonmonopolistic explanation for a variety of business arrangements, such as advertising and department stores. The Swedish Academy had also emphasized Stigler's theory of regulation, which Coase summarizes accurately as "treating political behavior as utility-maximizing [and] political parties as firms supplying regulation, with what is supplied being what is wanted by those groups (or coalitions) which are able to outbid others in the political market" (p. 24). Coase is skeptical, because he doesn't believe that political behavior "is best described as rational utility-maximizing." Elsewhere he has described the standard economic assumption of man as a rational maximizer as "unnecessary and misleading" even as applied to market transactions [12, p. 231], and we shall see that he will have no truck with applying economics outside its conventional domain of explicit markets.

Besides the phenomena of declining average cost and of monopoly, externalities whether negative or positive are standard theoretical grounds for public intervention in markets (and both declining average cost and monopoly problems can be restated in terms of externalities). Coase took a bead on them in "The Problem of Social Cost" and in a later article on lighthouses [7], where he showed that this classic (perhaps hackneyed would be a better term) example of a public good had in fact long been provided privately. Although the lighthouse article is not one of Coase's better-known works, he reprinted it in The Firm, the Market, and the Law, I assume because it makes one of his central antitheoretical points so effectively: that economic theorists use stock examples to illustrate their theories without bothering to inquire whether the examples are correct.

The anti-interventionist point of "The Problem of Social Cost" is not, as it is sometimes taken to be, that the Coase Theorem (a term coined later, by Stigler) shows that markets will internalize pollution and other negative externalities. Coase believes that we live in a world of positive transaction costs: otherwise, "The Nature of the Firm" would have had no subject. The point is that intelligent intervention requires more information than governments are likely to have. Pigou's assumption that the way to deal with a polluter is to tax or regulate him is, as Coase showed, superficial. For the victim of pollution may be able to reduce or eliminate the cost of pollution at a lower cost than the polluter. Suppose the cost of the pollution to the victim is $50 but he can

11"There is no reason to suppose that most human beings are engaged in maximizing anything unless it be unhappiness, and even this with incomplete success" [13, p. 4]. As an ironic comment on the human condition, this has some bite. But as an economic proposition, it is difficult to know what to make of it.
eliminate the cost completely by moving somewhere else at a cost of $10, whereas the polluter would have to spend $20 to abate the pollution. If the polluter is forced by taxation or regulation to do so, on the ground that the cost of the pollution ($50) exceeds the cost of abatement ($20), the result will be suboptimal. Pigou’s approach can be patched up by pointing out that the cost imposed by the polluter is really only $10—the cost of the resources required to eliminate the pollution—and is less than the cost of abatement to the polluter, so the tax should be zero; then the polluter will not stop polluting and the victim will move away, which is the optimal result. But this point was not noticed until Coase’s article on social cost.

The article suggests that the English common law judges were quicker than the economists to recognize the reciprocal character of pollution—the sense in which pollution is as much “caused” by the victim as by the polluter, although the better way to approach the question is to forget about causation and simply ask which party to a harmful interaction should be induced to change his behavior (maybe both should be) to maximize the social product. From this suggestion stems the positive economic theory of the common law, which argues that common law judges have tried, whether consciously or not, to assign property rights and fashion liability rules in such a way as to prevent or at least minimize misallocations due to the presence of prohibitive transaction costs.\(^\text{12}\)

Hostility to public intervention in markets beyond what is defensible in strict wealth-maximization terms is thus a leitmotif of Coase’s work. The relation between this hostility and his doubts about modern economic theory is this: so many economic theorists in this century have been interventionist that economic theory itself has become dominated by concepts, such as “perfect competition” (the conditions for which are never satisfied in the real world), “externality,” “public good,” “social welfare function,” and “market failure,” that seem like invitations to interventionist prescriptions. These terms and the vast bodies of formal theory that they conjure up assume the fragility of markets and the robustness of government, whereas Coase believes that careful observation of markets and government discloses the robustness of markets and the fragility of government.

I think his observation is correct\(^\text{13}\) but that in trying to explain the blindness (as it seems to him) of interventionist economics he has got the causality backwards, because he has the intellectual’s propensity to assign intellectual causes to opinions, here the opinions of professional economists. It is not that formal economic theory inherently favors public intervention; it is that economists predisposed by temperament or life experience to favor a large and aggressive government will be inclined to formulate theories congenial to

\(^{12}\)See, for example, Posner (1992), pt. 2. I quote the critical passage from “The Problem of Social Cost” on page 203.

\(^{13}\)Though it is arguable that he exaggerates the robustness of markets by disregarding the cumulative economy-wide effects of minor-seeming distortions in individual markets. See Greenwald and Stiglitz (1986).
their preferences. Eventually their theories will collide with reality and be overthrown, as I think has now happened to a considerable extent with collectivist or interventionist economic theories.\textsuperscript{14} Even before it happened, the bias in these theories had been exposed—notably by Coase himself, in his attacks on the Pigouvian tradition.

Of course there is an equal and opposite danger that economists inclined by temperament or life experience to favor a weak and passive government will overlook real opportunities for fruitful government interventions.\textsuperscript{15} It is difficult to believe for example that the entire problem of pollution can be left to be sorted out by the market, or even by the market plus the common law of nuisance. And the role of regulation in creating markets, for example markets in pollution rights, must not be overlooked. Coase is well aware of all this. He is not a doctrinaire adherent of laissez-faire. He merely insists that the costs of government intervention be compared with the benefits rather than assumed to be zero. He cannot fairly be criticized for having emphasized in his work the downside of government intervention in the economy, given the excessive faith of so many modern economists in the beneficent efficacy of that intervention.

I have pointed out that Coase considers the theoretical and empirical tools required for the study of markets and their regulation to be intellectually modest. In fact they are the tools bequeathed us by Adam Smith. Coase has explained [8, p. 313] that the “extremely difficult question” that Smith posed for himself was “how is the cooperation of these vast numbers of people in countries all over the world, which is necessary for even a modest standard of living, to be brought about?” This sounds much like the question: how are the suppliers of inputs into a productive process to be coordinated? There are two possibilities—contracts with independent contractors (sometimes these contracts are standardized and pooled in formal markets) and contracts with employees—and whichever is cheaper will be the one adopted.\textsuperscript{16} Thus, “there would be an optimum of planning since a firm, that little planned society, could only continue to exist if it performed its co-ordination function at a lower cost than would be incurred if it were achieved by means of market transactions and also at a lower cost than this same function could be performed by another firm” [14, p. 6]. So in 1969, Coase predicted that if the conglomerate enterprise turned out not to be an efficient method of organizing production within a firm, these enterprises would spin off some of their divisions, so that less activity would be coordinated by the firm and more by the market [5]. Which appears to be what happened following waves of conglomerate mergers in the 1960s and 1980s.

When the costs of private coordination are prohibitive, the law may step in by specifying property rights or imposing liability, and again the analytic task

\textsuperscript{14}Of course, it is a fragile victory. Regulation is a Hydra, and there are growing signs that, in this country anyway, reregulation is becoming the order of the day.

\textsuperscript{15}Greenwald and Stiglitz (1986) is again relevant.

\textsuperscript{16}“We had a factor of production, management, whose function was to co-ordinate. Why was it needed if the pricing system provided all the co-ordination necessary?” [14, p. 5].
according to Coase is simply to compare the costs of alternative methods of
copying with transaction costs. The necessary comparisons are made by exam-
ing the operations of particular institutions through the lens of the case
study, using interviews, judicial records, newspaper articles, and like sources of
qualitative data. There is no great need for formal quantitative methods of
empirical investigation, about which, as I have noted, Coase is skeptical. He had
taken some law courses as an undergraduate, and in “The Problem of Social
Cost” he examined several areas of common law, particularly nuisance law,
which he commended for not always placing liability on the injuring party.
Summarizing, he said [4, pp. 27–28] that “in a world in which there are costs of
rerranging the rights established by the legal system, the courts, in cases
relating to nuisance, are, in effect, making a decision on the economic problem
and determining how resources are to be employed...The courts are con-
scious of this and they often make, although not always in a very explicit
fashion, a comparison between what would be gained and what lost by prevent-
ing actions which have harmful effects.”

It is easy to understand why Coase would regard his Adam Smithian
approach as immensely fruitful. It has been, in his hands and that of like-minded
economists,17 and I think it will continue to be. A lot can be done with simple
economic theory combined with historical or even journalistic methods of
empirical research as distinct from regression analysis and other methods of
empirical research that use random sampling and statistical inference rather
than anecdote and narrative. But this only begins to explain the most unusual
feature of Coase’s writings, which is the narrowness of his conception of the
domain and methodology—and hence of the past, present, and future—of
economics.18 I have mentioned that he considers his approach not only fruitful,
but destined to transform economics, and that he thinks that the two centuries
since the publication of The Wealth of Nations have been largely wasted in
economics and we must turn now to the study of large-scale collections of
business records.

Then there is the insouciance with which Coase appears to regard one of
his most signal achievements. The “new” (that is, post-antitrust) law and
economics movement of the last quarter century, probably the most influential
movement in American legal scholarship during this period, has been im-
mensely influenced by “The Problem of Social Cost,” for many doctrines,
procedures, and institutions of law can fruitfully be viewed as responses to the
problem of transaction costs—as designed either to reduce those costs or, if
they are incorrigibly prohibitive, to bring about the allocation of resources that
would exist if they were zero. Characteristic of Coase’s attitude toward the law

17A few examples (not all of which, by the way, were actually influenced by Coase’s work) are
Crocker and Masten (1991), Demsetz (1967), Kitch (1977), Klein and Murphy (1988), Peterman
(1975), Siegan (1972), and Telser (1960, 1981).
18A thumbnail sketch of my conception of and reservations concerning Coase’s methodology drew a
reply from him to which I have in turn replied. For the complete exchange, see Posner (1993a, b)
and [17].
and economics movement is his comment in the Nobel lecture [14, p. 8]: “I will not say much here about its [the article’s] influence on legal scholarship, which has been immense, but will mainly consider its influence on economics, which has not been immense, although I believe that in time it will be.” Between 1976 and 1990, more than a third of the citations to Coase’s entire corpus, as recorded in the Social Sciences Citation Index, appeared in law journals rather than in economics journals (Landes and Posner, 1993). It is possible that, despite the Nobel Prize, Coase looms larger in law than in economics (Schwab, 1989)—an ordering with which he would not be at all happy. It must quickly be added that as director of the Law and Economics Program of the University of Chicago Law School and as editor of the Journal of Law and Economics, Coase was immensely supportive of William Landes, myself, and other practitioners of economic analysis of law. But this just makes all the more puzzling his lack of interest in this movement that he has done so much to nurture.

Englishness

I will risk startling the reader by suggesting that the key to understanding Coase’s methodological stance, and indeed his overall strengths and weaknesses, lies in his Englishness. Although he has lived in the United States since the middle 1950s and wrote “The Problem of Social Cost” here, he is as much an American as a nineteenth-century Englishman in the Indian Civil Service was an Indian. There is no evidence that he has been influenced by any American economist, with the possible exception of Frank Knight. He rarely writes about any American institution other than the Federal Communications Commission, the functions of which in regard to telephone companies and broadcasters have direct counterparts in English institutions studied by Coase before he came to the United States.

His Englishness expresses itself in a number of ways, one superficial: the wit, feline in its subtlety and sharpness, that he occasionally turns on his fellow economists is vintage English academic acid, as in “The clumsiness of his [Adam Smith’s] treatment and its lack of finish have been strongly criticized by some economists, so strongly, indeed, as to suggest that if only these writers had been around in 1776 Adam Smith would not have been necessary” [8, p. 317].¹⁹ The other aspects of Coase’s Englishness have a deeper significance. He writes in an English economics tradition shaped by Smith and Marshall and by Coase’s teacher Arnold Plant (and perhaps also by the nineteenth-century laissez-faire tradition, invented in England); and although he has written against Hotelling and other non-English economists, in particular Paul Samuelson, his major target remains Pigou.²⁰ The mathematical and statistical movement in eco-

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¹⁹ See index references to Pigou and Samuelson in [13, pp. 216–17]. It would be more precise to speak of a “British” than of an “English” economics tradition, since Adam Smith was Scottish, as was David Hume, a seminal figure in the broader “English” scientific tradition that I also discuss.
nomics, which is primarily American (or at least primarily non-English), has passed Coase by and indeed has become an object of his scorn. He writes the beautiful simple prose of the accomplished English essayist. Its self-conscious plainness and modesty and commonsensicality and rejection of high-falutin' theory make Coase the George Orwell of modern economics.

That disdain for theory, so closely linked to the plain style (it is difficult to express complex theory plainly), is the key to Coase's methodological Englishness. Hostility to theory is a bright thread in the carpet of English thought. Of course it is not the only thread, for one is speaking of the nation of Newton and Darwin, not to mention of Adam Smith himself, the creator of economic theory. But I am thinking here of the common sense, empiricist, anti-theoretical tradition in English philosophy that runs from Samuel Johnson and Locke and Hume to Moore, Ayer, and J. L. Austin and that is so different from the dominant tradition in Continental philosophy. I am thinking also of the empiricist, anti-theoretical tradition of the common law that is so different from the abstract, a priori, systematizing cast of continental jurisprudence. Even within theory there often are differences between Englishmen and others. One of the striking features of Smith's "invisible hand" and Darwin's theory of natural selection is that, despite their generality and subtlety, they are extremely simple, nonmathematical concepts that, once grasped, seem (though not to everyone) completely intuitive and obviously correct. (Compare Cournot with Smith, and Mendel with Darwin.) Coase's theory of transaction costs is in this tradition of simple theory, for after disclaiming "innovations in high theory" he explains in the next sentence of his Nobel lecture: "My contribution to economics has been to urge the inclusion in our analysis of features of the economic system so obvious that, like the postman in G. K. Chesterton's Father Brown tale, 'The Invisible Man,' they have tended to be overlooked" [14, p. 1]. But Coase's theory, not only the part that goes by the name of the Coase Theorem but also (and related) the part that questions whether liability should always follow causality, is not obvious, is in fact counterintuitive, and required an intelligence of a very high order, whether or not mathematically gifted, to discover (or create)—though it is true that, partly because of its simplicity, it is easy to understand, especially for people too young to have been brought up in the Pigouvian tradition. It can be proved mathematically but the elementary arithmetical "proofs" that Coase presents in "The Problem of Social Cost" using locomotive sparks and straying cattle are completely adequate. One is put in mind of an aphorism of Whitehead's: "It requires a very unusual mind to undertake the analysis of the obvious."

The Economy vs. Economics

Coase's dislike of theory is not, I think, a mere pose. For him the significance of the Coase Theorem is "as a stepping stone on the way to an analysis of an economy with positive transaction costs" [14, p. 9]. And that is a
study to be conducted he believes without fancy tools either theoretical or empirical but by means of case studies guided by “basic economic theory.” The basic theory, as we have seen, does not (or at least pretends not to) include the concept of maximization. It may not include the concept of equilibrium. In Coase’s eyes one of the great strengths of Adam Smith’s view of economics is that he “thought of competition . . . as rivalry, as a process, rather than as a condition defined by a high elasticity of demand, as would be true for most modern economists. I need not conceal from you my belief that ultimately the Smithian view of competition will prevail” [8, p. 318]. This approach furnishes ammunition for the enemies of free markets. The idea of competition as a process, as rivalry, rather than as the state of affairs in which sellers do not have monopoly profits, because each faces a highly elastic demand for its product or service, is a source of much of the unsound thinking about “The Problem of Monopoly” that Coase decries. If a market contains few firms, or if all the sellers of a product charge the same price, the naive see a weakness or absence of competition and begin talking about “oligopolistic interdependence” and “conscious parallelism.”

Why won’t Coase allow a place for formal theory in economics? Why does he see himself locked in a struggle with economic formalism, indeed with the whole of modern economics outside the pale of that rather small though gallant band of “new institutional economists” of which he is the guru?21 It is mainly, I think, because of what I am describing as his very English mistrust of abstraction. People are not in fact rational maximizers, prices do not in fact equal marginal cost, markets are never in equilibrium. The formal models of economics hold only as approximations. Coase is not interested in approximations. He is interested in observable reality. For him the value of Smith’s “invisible hand” is that it directs our attention to visible phenomena, namely economic practices and institutions that can be observed, described, compared. Of course the “Chicago School” economists to whom Coase is often but erroneously compared, economists such as Friedman, Becker, and Stigler, also believe that theory is valuable only insofar as it guides investigation of the visible world; that is a hallmark of the Chicago School. But they think that formal theory is valuable in that respect, while Coase believes that no theoretical apparatus more elaborate than that of Adam Smith is needed or even helpful (or even harmless). Yet the invisible hand is after all invisible—a part of the theory world, not of the real world—and mathematics can lend precision to theory, can uncover inconsistencies, can generate hypotheses, can promote brevity and

21“Modern institutional economics should study man as he is, acting within the constraints imposed by real institutions. Modern institutional economics is economics as it ought to be” [12, p. 231]. Yet Coase (p. 230) has criticized the original institutionalists, John R. Commons and the like, for their hostility to classical economic theory, because “without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire.” (The acid wit again.) By “theory” Coase means Adam Smith’s view of economics. The modern institutionalists to whom he refers include Thráinn Eggertsson, Victor Goldberg, Benjamin Klein, Douglass North, and Oliver Williamson.
even intelligibility, and can sort out complex interactions, while statistical analysis can organize and interpret voluminous data. It is unlikely that the study of transaction costs will eschew the formal methods that Coase dislikes and content itself with paging through business records. In fact the guiding theory for that study is, increasingly, game theory, which is as formal a body of theory as any in widespread use in economics. Coase’s influence in economics has been diminished by the fact that his articles do not speak the language of modern economics, which is mathematics, and by the fact that he has not attempted to develop a theory of transaction costs.\footnote{In the words of another of his ardent admirers (for I count myself as such), “Coase has been misunderstood because he did not make his argument as accessible as it might be, and because the operational content of transaction costs is obscure. Coase eschews geometry and mathematics . . . and instead uses ponderous arithmetic examples to explain his theories. Although this does not prevent Coase from recognizing and discussing the nuances present in those theories, many readers would benefit from having his arguments, once conceptualized, translated into a more formal language. . . . Coase . . . makes no such efforts and does not acknowledge efforts at translations that have been done by others. A chronic problem with Coase’s work has been that the concept of transaction costs is vague . . . . Although Coase evidently acknowledges the need for operationalization, he has yet to address himself to this in a systematic way” (Williamson, 1989, p. 229 [footnotes omitted]). Whether anyone has made much progress in operationalizing the concept of transaction costs may be doubted.}

Hostility to theory is especially salient in Coase’s discussions of what economics is. It is not, for him, a body of theory, approaches, or techniques. It is least of all the science of rational choice. It is merely “a common subject matter,” namely “the economic system,” more specifically “the working of the social institutions which bind together the economic system: firms, markets for goods and services, labour markets, capital markets, the banking system, international trade, and so on. It is the common interest in these social institutions which distinguishes the economics profession” [9, pp. 204, 206–207]. We now can understand better Coase’s skepticism about Stigler’s application of the economic model to the political process and his lack of interest in the lawyers’ appropriation of the Coase Theorem. Coase deprecates the efforts of economists such as Stigler and Gary Becker—the greatest practitioner and exponent of nonmarket economics—to push economic theory into other disciplines, such as law, sociology, biology, education, health, demography, and politics. The acid wit is much in evidence here. “The reason for this movement of economists into neighbouring fields is certainly not that we have solved the problems of the economic system; it would perhaps be more plausible to argue that economists are looking for fields in which they can have some success” (p. 203). Coase allows that the generality of economic theory facilitates its application to other fields. But since in his view the binding force of a field is the subject matter rather than theory, the practitioners of those other fields will learn the bits of economic theory from the economists and, thus equipped, will enjoy a decisive advantage over them: knowledge of the particular subject matter of the field in question. He allows too that economics is the most advanced social science but he attributes this not to any theoretical sophistica-
tion but to the happenstance that the economist has a convenient measuring rod—money—which enables his observations to be more precise than would be possible otherwise. That measuring rod is absent (or largely so) when economists move into disciplines that do not study explicit markets. In Coase's view the expansion of economics into other fields signifies the abandonment of economics. Theory, by its very power, formality, and resulting generality which tempts economists to seek easy victories over weak disciplines, threatens to ruin economics.

There must be something wrong with this view. Sociologists, psychologists, Marxist political theorists, historians, anthropologists, and even classicists (such as the late M. I. Finley) also study the economic system, yet they are not economists. The root fallacy is the tenacious belief that every word has a correct definition and it is the task of understanding to find that definition and to act in accordance with it. Nineteenth-century legal thinkers thought that the meaning of contract was a meeting of minds and therefore if one posted a reward for finding one's lost cat, and someone found and returned it but hadn't seen the notice, the finder couldn't claim the reward. This was an unhelpful way of approaching the question of whether a finder should be allowed to claim a reward of which he had no knowledge, a question the answer of which ought to depend on the impact on finding and the costs of using the legal system, rather than on the definition of the word "contract." Likewise the question of what economists ought to be doing is not profitably pursued by inquiry into the meaning of economics, especially given the circularity of defining economics in terms of the economic system.

When Coase predicts that economists will in the end fall flat on their faces in competing with practitioners of other disciplines, he is implicitly conceding that the boundaries of a discipline are set by practical considerations rather than by definitional ones. This is a step in the right direction—and incidentally one that might be illuminated by the theory of the firm, which Coase invented. But the reason he offers for thinking that these incursions will fail is that a discipline is defined by its subject matter rather than by its theories or methods, and this begs the question of what the subject matter of economics is. It is inconsistent with his own powerfully argued view [10], similar to that of Thomas Kuhn, that within a science (including economics) the acceptance of a theory is determined by a competitive process rather than by the theory's conformity to some a priori criterion of theory soundness, such as predictive success. Even if Coase could be persuaded, in accordance with the theory of comparative advantage, to change his definition of economics to what economists do better than other people, this would not help much because it would beg the question of who or what an economist is. Is a lawyer who studies law as a method of economic optimization, perhaps using economic techniques unknown to Coase, a lawyer or an economist, or both, or neither? Perhaps (though I greatly doubt it) economics departments will become exclusive preserves of "high theory," and the kind of economics that interests Coase will be done in business schools, law schools, public policy schools, political science
departments, and departments of sociology, public health, and education (Gary Becker has a joint appointment in economics and sociology), perhaps by people with two degrees. Why should anyone other than a university bureaucrat, which Coase emphatically is not, care?

Much of the exciting work done in economics, not least by Coase himself, over the last 30 years, has been, it seems to me (I admit to bias), in areas usually thought to belong to the economics of nonmarket behavior, such as the economics of education, the family, the political process, health, and law. Because of the success of this work, many economists now think of these as areas of "market" behavior. If little or none of that stuff is really "economics," one can understand the disquiet with which Coase contemplates the present state of economic theory and the urgency with which he calls for "a complete change" in it. For in economics proper as he would regard it, it is possible to argue that the dominant movement has been as he says toward greater formalization of economic theory rather than toward greater understanding of the economic system. The dominant, perhaps, but not the only movement, because labor economics, for example, which Coase acknowledges as part of economics, has made great strides in this period and so too the theory of finance, which deals with capital markets—markets that are a part of the domain of economics as Coase understands it. And so too the economics of regulation (as Coase acknowledges in [10], p. 19); and the economics of information when applied to market phenomena, such as the dispersion of prices for the same good, rather than to (say) marital search, a subject that for Coase is outside economics. Economics has not stood still for 30 years, let alone for 200. But once one understands Coase's very narrow definition of the subject and his dislike of theory, it becomes possible to understand how such an intelligent person can hold so questionable a view.

Yet, having been proved right in so much else, maybe Coase will in the end be proved right in this too. We should in any event judge a person by his best work, and Coase's best is very good indeed. We should recognize too that people have the weaknesses of their strengths, and that the eccentricity of genius, and the occasional cantankerousness that it breeds, is another name for intellectual independence. It is a condition encouraged by a protracted and brooding intellectual isolation. "Many of his main ideas were conceived very early in his life... He thought about these ideas and enriched his analysis by reading and observation for about thirty years. His life included long periods... in which he worked out his position completely alone, with little or no contact with others interested in economic questions... There can be no doubt that he enjoyed his own company and could work well on his own without requiring any stimulus from others" [8, p. 310]. That is Coase, perhaps the finest English economist of this century after Keynes, writing about Smith, his greatest predecessor. But it describes Coase equally well. "The Problem of

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23One review of The Firm, the Market, and the Law remarks that it has a "querulous" tone in places. "The message is 'I am misunderstood'" (Munger, 1990, p. 296).
Social Cost" was published approximately 30 years after Coase began work in economics. We need not accept Coase's methodological prescription in order to understand that it has served him well and in serving him well has served the economics profession—and allied disciplines, such as law—very well indeed.

I thank Gary Becker, David Friedman, William Landes, Lawrence Lessig, Carl Shapiro, Joseph Stiglitz and Timothy Taylor for many helpful comments.

References


