

# OTHER THINGS EQUAL

## The So-Called Coase Theorem

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When George Stigler started around 1960 touting an idea he thought he had gotten from his colleague at the Law School at Chicago, Ronald Coase, as a "theorem," Paul Samuelson was not amused. George told the story that he and Coase and Aaron Director and others shuffled chairs around to represent property rights at a dinner party one evening (Chicago in those days was like that: I attended many such parties that evolved into seminars; no longer), at the end of which George went home with what he thought was a new theorem. "Where's the theorem?" snorted Paul Anthony Samuelson of Gary, Indiana. Where is the set of assumptions A implying a set of conclusions C? Or more exactly, where's the *interesting* piece of valid reasoning? As so often, Paul was right and George was wrong. George Stigler was among the worst historians of economic thought in the history of the discipline, mainly because he used the history as an ideological tool and was ruthless in doing so. He read a lot but was defective in paying attention. Thus the Coase Theorem.

The bizarre doctrinal history of the so-called "Coase" theorem is given its most thorough airing in a paper by Steve Medema and Warren Samuels [1994]. I have been worrying about the point ever since first teaching Coase's famous paper on "The Problem of Social Cost" to grad students at Chicago in 1968. I was made uncomfortable with George's strange tale. And gradually I figured out why.

Economists have gotten the "theorem" wrong; in fact, backwards. The reason they have is that they practice blackboard economics and cannot grasp the anti-blackboard economics of the Marshallian sort that Coase (and on a rather lower level, I) practice.

The "theorem" is supposed to be that it doesn't matter where you place the liability for, say, smoke pollution, because in a world of zero transaction costs the right to pollute will end up in the hands that value it the most. If breathers value it most they will buy it. If steelmakers value it most they will keep it. Literally hundreds of articles and expositions in textbooks, beginning with the late George Stigler, have put forward this interpretation of the "theorem" [Stigler 1966, 113, where he calls it "a remarkable proposition to us older economists who have believed the opposite for a generation"]. Thus a fine book by Shughart, Chappell, and Cottle on managerial economics, "In the absence of transaction costs, the allocation of resources is independent of the initial assignment of property rights" [1994].

Something like a dozen people in the world understand that the "Coase" theorem is not the Coase theorem. (I'll adopt the convention of putting quotation marks around the non-Coasean "Coase" theorem.) One of this select group is Ronald Coase himself, so I suspect we blessed few are right.

The "Coase" theorem as advertised by George Stigler or sneered at by Paul Samuelson is actually Adam Smith's theorem [1776]. It is wholly explicit in F. Y. Edgeworth [1881, 30ff, 114]; and with all the bells and whistles in Arrow and Debreu [1954]. Smith, Edgeworth, Arrow, Debreu, with many others, noted that an item gravitates by exchange into the hands of the person who values it the most, if transactions costs (such as the cost of transportation) are not too high. Why a student of economic thought like Stigler would call this oldest idea in economics "remarkable" I do not know, though as I say it is not the only strange reading that Stigler gave. Applying it to pollution rights is unremarkable. Where's the theorem?

Coase's actual point, the core of a Coasean economics, was to note what happens in the many important cases in which transactions costs cannot be neglected. If the situation *does* have high transactions costs, then it *does* matter where the liability for pollution is placed. In consequence, as Coase has stressed throughout his career, the economist's preference for a simple, blackboard solution, taxing the party that "causes" the pollution (as Pigou and Samuelson suggest), is no longer defensible. One could look on Coasean economics as a program for taking seriously Lancaster and Lipsey's "General Theory of Second Best" [1956]—if Coase, also at the London School of Economics, had not started the program twenty years before Lancaster and Lipsey. Coase's work from the 1930s to his Nobel Lecture is one long demurral from the Pigovian and Samuelsonian tradition that dominates modern economics.

As I put it once :

I should report my long-standing conviction that "Coase's theorem" is not the point of Coase's article in 1960 (see McCloskey 1985, 335-340). Coase's article was not meant to show that we live already in the best of all possible worlds (as Stigler was inclined to assume in this and other cases) but on the contrary that if we did there would of course be no need for policy; and that in fact, as Coase argued also in the 1937 article, transaction costs push our world unpredictably far from the blackboard optimum [thus second best]. But I have given up hope of persuading any other economist of this interpretation, since the only economist who shares it is R. H. Coase (Coase 1988a, pp. 15, 174), and we know how unpersuasive he has been [I would add now "and a bare dozen other economists, equally unpersuasive"]. Coase's actual contribution to economics has been to make a point he made in 1937 about some of Kaldor's early writing: Kaldor assumes "all relevant prices" are known, "but this is clearly not true of the real world" (Coase 1937 [1988a], p. 38n18; [compare the critique of socialism by Mises a decade earlier]). The misunderstanding of the Coase theorem arises from economists thinking that Coase is trying, like them, to flee the world. [McCloskey 1993, footnote 2]

Some years ago I had an e-mail conversation about the actual and ersatz Coase theorems with Tom Weisskopf at the University of Michigan. Tom, you know, is a well-known Marxist economist; unlike most economists, Marxist or otherwise, he's willing to listen, and not just to me:

Weisskopf: *I have been reading Bob Cooter's piece on the "Coase theorem" in The New Palgrave. It strikes me as . . . quite consistent with the view that whether externalities can best be addressed by state action or private market transactions is always an empirical issue. I take it we agree on this. [Yes, we do, and with Ronald Coase.] I was just wondering . . . whether you would include Cooter among the dozen or so in your corner.*

McCloskey: *No, Bob gets it wrong, with the other N - 12 folks. He gets it wrong also in his book with Tom Ulen, Law and Economics (p. 5; in a Stiglerian vein they call the "Coase theorem" = Adam Smith's theorem a "remarkable conclusion," echoing Stigler). Dick Posner gets it wrong in his book, The Economic Approach to Law (4th ed., pp. 8, 22, 285, most egregiously on p. 636, and then throughout; he gets it right once, on p. 50f). These excellent scholars get it wrong for the same reason. They do not appreciate the doctrinal history from which Coase was writing [and which Medema and Richard Zerbe illuminate in a recent article about Coasean economics (1997)], and in particular they do not appreciate Coase's distaste for blackboard economics, Pigou / Samuelson, and easy solutions to difficult problems. The so-called "Coase theorem" is framed in a Benthamite spirit wholly obnoxious to Coase.*

Weisskopf: [I here put words into Weisskopf's mouth]: *Can that be right? They all got it wrong?*

McCloskey: *I don't expect you to believe it, since no one does except the Blessed Dozen, and Ronald Coase himself. In Coase's introduction to his little collection of substantive articles, The Firm, the Market, and the Law (1988), you can find statements that sound like the "Coase" theorem, but more that sound like the Coase theorem, no scare quotes, the actual theorem. If you read all of Coase's works you will see that the actual theorem, besides being the prose meaning of the last few pages of "The Problem of Social Cost" (which most economists appear not to have read), is consistent with the rest of Coase's views. Coase's second published paper, the famous one in 1937 on the firm, says that transaction costs matter. So have all his papers, over and over again. The version of the "Coase" theorem that Stigler popularized says the opposite.*

Weisskopf: *If I understand your point, the true Coase theorem implies that one cannot in general efficiently internalize an externality by taxing / subsidizing whoever is generating the negative / positive externalities, because (in light of transactions costs) this would generally not result in the right to the resource affected going to the person who values it the most.*

McCloskey: *Yes, that's right. Another way of putting it, as Coase does, is to point out that "whoever is generating the externality" is not a meaningful notion. Coase has the famous, and confusing, railway / farmers example: who "causes" the burnt fields of corn, the railway which makes the sparks, or the farmers who plant impru-*

dently close to the line? [The question arises naturally in the common law; on a blackboard by contrast you can't see it: equalize marginal private and social cost, that's all]. A better example is noise pollution around airports. We usually think of the airplanes as the cause. But wait. Suppose that there were no ears close to the airport. (Or that the ears were easily protected from the noise.) In that case the noise would be harmless, and it would be silly to curb it. So the presence of ears is just as much a "cause" as the vibrations in the planes' motors. Where then should the Pigou/Samuelson tax be placed?

Weisskopf: Rather than implying that the state ought to get out of the business of dealing with externalities, doesn't this imply that the state ought to concentrate on defining and transferring property rights instead of taxing/subsidizing [in the Pigou/Samuelson way] . . . getting the entitlements right rather than getting the prices right?

McCloskey: Yes, it certainly does, which is why the notion that Coase justifies doing nothing is wrong. Coase, who emphasizes transaction costs, says in effect: "Because the transaction costs are high it matters where the resources start out. Pigovian taxes are not going to get the right solution, except by happy accident. Face up to the hard facts of life: transaction costs are high." [Which is another way of saying that Second Best sometimes applies.] Amazingly, economists have understood him to be saying, "Transaction costs are low. Relax." [Which is another way of saying that First Best always applies.] But there's a further point that Coase makes in every paper he's written, which may explain why people such as George Stigler think he is saying that we do already live in the best of all possible worlds. The point is that "getting the entitlements right" is devilishly difficult with the governments we actually have. Coase is forever saying that this or that proposal for a public policy entails knowing things that no economist can in fact know. He claims, with considerable empirical evidence, that in many cases laissez faire will be in practice better than what we will get from actual governments—though neither is perfect (we live in a second-best world, that is, a world of transaction costs). The methodological point is that Coase does not claim to have proven laissez faire on a blackboard. He says in effect, "If you look at the FCC or the lighthouses or the law of liability you see that governmental attempts to guide things minute-by-minute—as you say, Tom, 'getting the prices right'—don't work very well. Maybe it's better to just deal the cards and play. But in this veil of tears there are no guarantees. It may not work like some curves you have drawn. Life is hard. Knowledge is scarce. Grow up and admit that you can't extract policy from a couple of lines on a blackboard."

To put it in a wider context, Pigou and Samuelson and Stigler were "modernists." "On or about December 1910," wrote Virginia Woolf, "human nature changed." The modernism of Woolf and Picasso, Russell and Le Corbusier has ruled intellectuals since then. The anti-modernist English poet Philip Larkin complained in the 1960s about the "irresponsible exploitations of technique in contradiction to human life as we know it. This is my essential criticism of modernism, whether perpetrated by [Charlie 'Bird'] Parker, Pound or Picasso." (Or, a Coasean economist would add,

perpetrated by the Fourth P, Paul [Samuelson].) Larkin explained the reference to Parker (1920-1955), an innovative saxophonist, in one of his columns on jazz:

[Said another jazz critic] "After Parker, you had to be something of a musician to follow the best jazz of the day." Of course! After Picasso! After Pound! There could hardly have been a conciser summary of what I don't believe in art. . . . The artist has become over-concerned with his material (hence an age of technical experiment), and, in isolation, has busied himself with the two principal themes of modernism, mystification and outrage. [Larkin, 1985, 22-25]

Modernism has had some good moments, such as the Ronchamp Chapel by Le Corbusier or *The Foundations of Economic Analysis* by Paul Samuelson. It was worth a try, though on the whole it did not work very well. Have a look at economic policy; or, if that doesn't appall you, then look at the average academic article in economics, pure theoretical modernism, blackboard economics gone loco.

I commend Coase for his old-fashioned ways. The old-fashioned ways have become the latest fashion, actually. You read it here: Ronald Coase is a postmodern economist. And his theorem, a post-modern one, is about the difficulty of knowing what is to be done.

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