



KINDERGARTEN COASE

Jeremy Kidd

I. INTRODUCTION

NOBEL PRIZE-WINNING ECONOMIST Ronald Coase passed away on September 2, 2013, leaving behind an impressive record of challenging the conventional wisdom of economics. A founding member of the law and economics movement, Coase's *The Problem of Social Cost*¹ is the most-cited law review article.² And yet, despite having an objectively successful career, Coase may have harbored some regrets for falling short of the goals he set out to achieve in *Social Cost* and other articles: convincing economists that economics should model the real world, not just classroom theory; changing the way economists and lawyers view disputes between parties; and eliminating the mindset that optimal results cannot come about without government action.

To Coase, the doctrines he espoused in *Social Cost* were “so simple . . . as to make [them] fall into the category of truths which can be deemed self-evident.”³ Considering that, even after fifty years, Coase's “truths” are regularly missed by economists and lawyers

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¹ Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960) (hereinafter “*Social Cost*”).

² blogs.wsj.com/law/2012/06/01/the-most-cited-law-review-articles-of-all-time/.

³ RONALD COASE, *THE FIRM, THE MARKET, AND THE LAW*, 1 (1988) (hereinafter, “*The Firm*”).

alike, either the principles are not really “so simple” or something has gotten lost in translation. This essay argues the latter – that Coase’s works are correct but largely misunderstood. The source of the misunderstanding likely comes from the dramatic paradigm shift proposed by Coase, arguing for a change in the way economists thought (and still think) about the nature of conflicts. The leap was simply too great for most rational scholars to make, so some forced Coase’s principles to fit within the dominant paradigm. That led to a conflict of ideas that made it difficult for subsequent generations of scholars to understand the concepts Coase proposed. The end result is that Coase became influential based on theories he never espoused.⁴

A prime example is the “Coase Theorem,” often misunderstood as the proposition that if the cost of arranging transactions were zero, the courts wouldn’t be needed to resolve disputes. It sounds technical and theoretical enough that it could come from an economist, but it is not the point Coase was trying to make. Instead, Coase argued that society is better off when people resolve their disputes without government intervention, so we should find ways to remove the obstacles that get in the way of private resolution of disputes. Many well-meaning scholars, when referencing Coase’s work, cite him for the first, incorrect proposition.⁵ That they do so approvingly lends credence to their misrepresentation. Coase’s goals are further undermined when these well-meaning scholars cite Coase’s work as a theoretical construct, something Coase attempted to minimize in the profession.

If Coase’s work is to be rescued from the artificial obscurity of benign misinterpretation, it must be considered on its own terms,

⁴ See Robert C. Ellickson, *The Case For Coase and Against “Coaseanism,”* 99 YALE L. J. 611, 611 (1989) (“Coase’s name is consistently attached to propositions that he has expressly repudiated. Predictions identified as ‘Coasean’ are predictions Coase would never make.”).

⁵ See, e.g., Gideon Parchomovsky & Peter Siegelman, *Cities, Property, and Positive Externalities*, 54 WILLIAM & MARY L. REV. 211, 221 (2012) (“Coase demonstrated that when transaction costs are sufficiently low – nonexistent in his original analysis – private bargaining will solve the problem of externalities.”).

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not that of the dominant paradigm. Coase challenged the foundations of how economics and economic analysis of the law are taught in classrooms and practiced in the profession. Understanding that challenge requires restating Coase in language that largely eschews economics jargon and technical legal phrases. Some previous restatements have been persuasive and powerful,⁶ but their reach is limited, precisely because they were made in the language of economics. Those who understand economics can be easily misled by the natural tendency to interpret all economic theories in light of the dominant paradigm, and those who do not understand economics will be blinded by the severe opacity of economic jargon to those outside the discipline.

This essay presents Coase's work in language that is intended to be understood by scholars and non-scholars alike, breaking down long-standing confusion and introducing the reader to the world as seen by Coase. Doing so requires presenting his most widely recognized work – the Coase Theorem – and explaining where it fits within his larger project. Section II will present a plain-language explanation of the Coase Theorem. Section III will explain, also in plain language, the larger context of Coase's work.

II. KINDERGARTEN COASE THEOREM

Coase wrote *Social Cost* as an analysis of conflicts between individuals or groups and the attempts to resolve those conflicts. The Coase Theorem is commonly stated in the following terms: “When transaction costs are zero, an efficient use of resources results from private bargaining, regardless of the legal assignment of property rights.”⁷ An economist can make sense of this with minimal effort, but the non-economist barely begins before running into the first serious roadblock – “transaction costs,” an opaque word choice, to say the least. Even if that roadblock is overcome, others remain, such as determining what economists mean by “efficient.”

⁶ See, e.g., Ellickson, *supra* note 4; David Friedman, *The Swedes Get It Right*, available at www.daviddfriedman.com/Academic/Coase_World.html.

⁷ ROBERT COOTER, INTRODUCTION TO LAW AND ECONOMICS, 3d. ed., 85 (2000).

A. “Transaction Costs”

Coase’s original explanation was actually easier to understand and subsequent authors have made it less transparent in the interest of brevity. From *Social Cost*: “In order to carry out a market transaction [necessary to modify an initial legal determination of rights], it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on.”⁸

The phrase “transaction costs” is not incorrect⁹ because the costs are those associated with putting together a market “transaction,” but it obscures the full meaning of the phrase. Most lawyers, for example, understand that resolving disputes requires certain obvious steps (negotiations between lawyers, drafting contracts, and so on), each of which costs something. Other necessary expenditures might not be as obvious, such as overcoming the parties’ antagonism towards each other, enforcement of the contract terms, etc. Using the shorthand “transaction costs” leads many readers to conclude that the term has the more narrow definition, but Coase intended the concept to be much broader, covering mechanical costs of negotiation but also concepts such as uncertainty and risk, costs that can cause the parties to be reluctant to negotiate fully and honestly.

“Transaction costs,” then, represents a comprehensive list of anything and everything that could make it harder for two or more people to negotiate. Its apparent simplicity but broad and unusual definition lead many unsuspecting readers and listeners to oversimplify. There is natural tradeoff between brevity and accuracy and the key is to find the best middle ground. The traditional formulation of the Coase Theorem is so brief that it is usually misunderstood, and even Coase’s formulation leaves some terms undefined. It should be possible to expand the definition slightly with plain-language terms but without requiring a lengthy exposition of

⁸ *Social Cost*, at 15.

⁹ In *The Firm*, Coase himself uses the phrase repeatedly.

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each category of cost. One possible restatement is that a world of low (or zero) transaction costs is a world where bargaining is perfectly cheap and easy, where there are no physical, technological, emotional, or other obstacles to bargaining.

B. "Efficient"

There is no simple answer to what an economist means when using the word "efficient." Part of the trouble is that the economics profession has been quite casual about the use of the word. In most cases, however, efficiency means that resources and goods are held by the individuals who value them most. The best way to help a non-economist understand what is meant by "efficiency" is not by defining it, but by explaining how it is achieved. When two well-informed people get together and bargain voluntarily, they will make a deal only if what each has post-deal is better for them than what they had pre-deal. Every voluntary transaction, therefore, moves stuff in society around to people who want it more than the people who possessed it prior to bargaining. String together millions or billions of voluntary bargains and each item will eventually find a home with the person who values it the most. That outcome is the efficient outcome, and it is the outcome that arguably leads to the highest possible level of satisfaction in society.

Alternatively, imagine a pleasantly dysfunctional game of musical chairs where there is a seat for every participant and every chair has at least some desirable characteristics. The chairs vary in size, color, location, and so on. Once the music stops, players begin claiming chairs, but then any player can exchange chairs with any other player. A more diminutive player who gets cold regularly and ended up in a large chair might exchange chairs with another player who ended up in a smaller chair that also sits in direct sunlight. Both players are happier with their new chairs. However, once in the sun-lit chair, the diminutive player might trade chairs again, this time to obtain a fabric color or design that is more in keeping with the player's tastes. Eventually, every player is sitting in a chair that is the best fit for them out of the available chairs.

There are many objections that can be raised to this way of looking at bargaining, including that bargains in the real world aren't always voluntary or well-informed, so there is no guarantee that everyone will be better off post-bargaining. However valid those objections might be, they are not relevant to the Coase Theorem because it proposes a world where there are absolutely no barriers to bargaining, including the barriers of imperfect information and coercion. This type of purely theoretical construct also seems to be a direct contradiction of Coase's stated goal of getting away from purely theoretical analysis, but as will be discussed at greater length below, it was merely a baseline that would allow Coase to show how similar principles work in the far-more-complicated real world.

C. "*Regardless of the legal assignment of property rights*"

Some disputes are resolved simply by having the parties talk about it and come to an understanding. Other disputes end up in front of a judge, a legislative body, or a regulatory body. In the latter case, the law may not be clear and the parties may be trying to see who is "right," from a legal perspective. Alternatively, the law may be clear but one or both of the parties think that they could do better if the law were changed.¹⁰ Having a government official declare one party to be "right" can make a big difference in how much that party takes away from the bargaining table.

So, the parties to a dispute care very much about what the government has to say regarding who is right and who is wrong, since it can affect their ultimate bottom line. The Coase Theorem says that *society* has no *economic* reason to prefer any particular outcome. Government interventions can make individuals or groups better off (to the corresponding detriment of other individual or group),¹¹ but an

¹⁰ Coase argues that if the legal rights of the parties were clearly defined and the government's decision were easy to predict, no one would ever ask the government to get involved; they would simply begin bargaining. *Social Cost*, at 19.

¹¹ Coase does argue that, in the long run, there will be no difference in the distribution of wealth between general classes of individuals who are impacted by the court's decision. Once the legal rule has been stated by the court, prices in society

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economic-minded society cares only about picking rules that, if followed, will consistently lead to the best outcomes over time. In Coase's analysis, letting individuals bargain with each other leads to the best outcomes, so government does best when it stays out of the way. Of course, just because society doesn't have an economic reason to prefer one party over another does not mean that everyone should or will be indifferent to the outcome. Society may have other norms which it will want to advance, and those will likely impact the government's decision.¹²

D. The Coase Theorem, Plain-English Version

Putting these pieces together, we can restate the Coase Theorem in a way that gets closer to the simple principles that Coase, himself, envisioned:

In a world where bargaining can occur without any costs or effort, voluntary bargains between individuals lead society to the best possible outcome. When there are disputes between parties in this easy-bargaining world, government involvement can change the relative bargaining strength of the disputing parties, but not the ultimate outcome for society; the bargaining process will pick up where the government leaves off and continue along the same path as before until society reaches its ideal destination.

Returning to our pleasantly dysfunctional game of musical chairs, the Coase Theorem says that government can mandate that specific

will begin to change to reflect the payments that the losers will have to pay to the winners. Those prices will change according to a wide range of bargains that will be struck between members of society, and as long as the world is still one in which bargaining is cheap and easy, prices will balance out and any change in wealth distribution will be negated. *The Firm*, at 170-74.

¹² Those norms may be ones generally shared by society, such as norms regarding justice, fairness, ethics, etc., or they may be political norms, where powerful interest groups are successful in what public-choice economists call "rent-seeking." See, e.g., Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 WESTERN ECON. J. 224 (1967); Anne Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291 (1974).

players claim certain seats when the music stops, but bargaining will still lead all players to sit in the same chairs as they would have if the government had stayed out of the way. Phrased this way, the Coase Theorem is closer to being self-evident – if people will bargain when there are opportunities for improvement in their situation, and if bargaining requires no effort or cost, then how the bargaining table is set initially is irrelevant to what individuals will achieve through bargaining.

Making the Coase Theorem understandable is important but not enough. For Coase, the Coase Theorem was merely a way of setting the stage for understanding how things work in the real world, where bargaining is often costly and difficult. The following section will address Coase’s larger and broader theory of bargaining in a costly-bargaining world, using plain language in an attempt to bring Coase’s insights out of obscurity and into the light.

III. MORE KINDERGARTEN COASE

Coase wrote *Social Cost* to answer Arthur C. Pigou, an economist who argued that the efficient response to externalities – the good and bad things that spill over onto “innocent bystanders”¹³ – is to tax people whose actions inflict harms on bystanders and subsidize people whose actions benefit bystanders. Coase did not disagree that society should pursue a goal of fewer actions that impose external costs on bystanders,¹⁴ but he argued that Pigou’s easy solution was an illusion. For one thing, Coase believed that it is far more difficult in real life to determine who is to blame. He also believed that there is no single “right” solution for achieving the best outcome for society in the wake of a dispute.

¹³ See ARTHUR C. PIGOU, *THE ECONOMICS OF WELFARE* (1920). For example, a smoker who makes breathing harder for the asthmatic standing nearby creates a negative externality, and a homeowner who increases the property values of her neighbors by removing broken-down cars from the front yard creates a positive externality.

¹⁴ *Social Cost*, at 32.

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A. It Takes Two (And Sometimes Three) To Tango

Coase offered an observation that would sound familiar to any parent who has more than one child. It is that when two individuals (children) squabble, the truth of who is to blame is likely to be more complicated than either party will admit outright and probably includes some contribution from both sides. In policy debates about pollution, for example, it is easy to point to the factory emitting smoke, agree that smoke is bad, and move immediately to the question of how much the factory should pay bystanders who are impacted. Coase, however, emphasized that society, if it hopes to achieve the most efficient outcome, should consider the contributions of all sides to the dispute. Coase also pointed out that government is often one of the parties whose actions lead to the dispute.

This may seem odd, because one party may clearly be wrong from a moral or ethical point of view, but Coase argues that the *economic* nature of the problem requires a more impartial perspective.¹⁵ To illustrate, imagine a paper mill sets up shop in the middle of a barren wasteland and avoids creating any negative externalities because there are no bystanders.¹⁶ Now imagine a poor resident of a nearby community that finds she can only afford to live in a house constructed in the wasteland. Pigou would see a negative externality to be eliminated but the paper mill hasn't changed any of its behavior. When the homeowner arrives, the presence of a bystander fulfills the last remaining criterion for an externality, but it is the *combination* of paper mill and homeowner that causes the problem; remove either one and there would be no dispute.

This simple insight by Coase – that there are always two sides to a dispute – encourages us to consider additional options for resolving the dispute, including requiring the homeowner – the traditional “victim” in such cases – to take specific actions. A traditional nuisance claim would normally mandate that the paper mill: (1) cease

¹⁵ *Social Cost*, at 13 (“Judges have to decide on legal liability, but this should not confuse economists about the nature of the economic problem involved.”).

¹⁶ The paper mill still emits a foul stench into the surrounding air, but there are no bystanders to be harmed.

production; (2) take costly steps to mitigate the smell; and/or (3) make payments to the homeowner. If we consider ways in which the homeowner might resolve the dispute, we increase our chances of finding the solution that makes everyone as well off as possible.

To use a numerical example, assume that the paper mill's foul odor causes \$500,000 worth of damages over a 30-year period. Ceasing production would cost \$5 million in lost profits, and installing filters to eliminate the smell would cost \$1 million. The Pigouvian solution would be to have the paper mill write a check for \$500,000 because that is the cheapest option under discussion. But that ignores actions the homeowner might take. One possibility is that the homeowner could relocate to a much nicer neighborhood for only \$400,000, saving the parties and society at least \$100,000 over the traditional solutions.

Society achieves the \$100,000+ savings regardless of who actually pays the cost of relocation, but other criteria – fairness, justice, equity, legal precedent, and so on – can and arguably should inform that decision. Coase's important contribution is to point out that these are two separate questions: the legal, moral, and ethical determination of who is responsible for the harm; and the economic determination of how to resolve the dispute in a way that wastes as few resources as possible.¹⁷ The nation's courts can use any legitimate criteria (including economics) when choosing legal rules, but the economist then must figure out how to implement the rule in a way that keeps costs low and makes everyone as happy and wealthy as possible.

Coase also pointed out that while government can play a role in resolving disputes, previous government actions often give rise to future disputes or preclude easy resolution of the dispute:

The kind of situation which economists are prone to consider as requiring corrective governmental action is, in fact, often the result of governmental action. Such action is not necessarily unwise. But there is a real danger that extensive government intervention in the economic system may lead

¹⁷ *Social Cost*, at 14-15.

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to the protection of those responsible for harmful effects being carried too far.¹⁸

In the paper-mill example, government zoning may have caused an unnecessary increase in housing costs, effectively forcing the homeowner into the wasteland where the paper mill's foul odor would cause injury. Remove the zoning and the dispute disappears as the homeowner relocates back to more hospitable neighborhoods. Similarly, if government regulations require paper mills to install specific equipment to reduce the odor, those regulations might preempt any claims by the homeowner and make the paper mill far less likely to bargain, knowing it has the upper hand. In these cases, both parties would be better off without government involvement.

Identifying and overcoming obstacles to bargaining, whatever form they take, becomes the central question of a Coasian analysis. Remembering that some obstacles are neither natural nor insurmountable is the key to moving forward into a world where bargaining, not government intervention, leads to the best outcomes. Understanding how requires us to leave the theoretical world of the Coase Theorem and enter the real world, where bargaining can be hard.

B. What To Do When Bargaining Isn't Easy?

Many people dismiss the Coase Theorem as an academic oddity and Coase's work, generally, as having little practical application because the real world doesn't look like the world described by the Coase Theorem. There are obstacles to bargaining, the critics say, so the rest of Coase's conclusions about the potential of voluntary bargaining to solve disputes are overstated and government intervention is required.

The unspoken assumption appears to be that if there are obstacles to bargaining then bargaining loses its effectiveness, but that is both inconsistent with what we see in the real world and a misinterpretation of Coase's actual conclusions. It is also based on flawed

¹⁸ *Social Cost*, at 28.

logic because bargaining isn't impossible just because it isn't costless. Simply because a road is not perfectly smooth does not mean that it is impassable, and the existence of obstacles to bargaining does not mean that bargaining is impossible.

Contrary to the way he is often portrayed, Coase spent most of *Social Cost* expressly discussing how bargaining occurs in spite of the obstacles. Specifically, Coase discussed how bargaining will occur whenever the benefits of completing a bargain are greater than the costs of bargaining. Bargains that can happen with few obstacles should happen frequently but even more significant obstacles will not necessarily stop bargaining because the benefits from bargaining can be quite high. At some point, the obstacles to bargaining could be so high that bargaining would cease, but that is not the world we live in.

We live in a world dominated by voluntary bargains. Every day, we bargain with merchants for food, entertainment, and everything else we buy. We also bargain in less-obvious ways, such as determining where to eat out as a family or group of friends. Some of these bargains are relatively cheap and easy (buying a loaf of bread) while others are more costly (buying a house), and Coase appears to be empirically correct in concluding that less costly bargains will occur more frequently.

Just as important, the profits to be gained from bargaining create strong incentives for individuals and businesses to innovate in ways that reduce or eliminate obstacles to bargaining. For example, the amount of international trade in fresh produce has increased dramatically in the last century as technological innovations have made it easier to communicate, verify the quality of the produce, and transport it so that it arrives while still fresh. Innovations occur at every step of the supply chain between international produce farmer and domestic consumer, so that where a consumer would have needed to bargain directly with the farmer, now he need only bargain with his local grocer. Similar innovations across society will continue to lower the costs of bargaining, increasing the number of disputes that voluntary bargains can resolve without government intervention.

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Yet, it cannot be ignored that any obstacles to bargaining will render imperfect those solutions achieved through bargaining. Voluntary bargaining may get closer to the ideal than government intervention in most cases, but it will still fall short. Many believe that government must intervene when voluntary bargaining (a.k.a. the “market”) falls short of the ideal, but there are additional concerns associated with government intervention. Greater obstacles will mean greater imperfections from voluntary bargains, but also that any mistakes made during government interventions will be harder to undo, so the harm to individuals and to society will be far more lasting. In short, as bargaining becomes more difficult the potential good that government can do increases, but only if it can get closer to the right economic solution than perfect private bargaining would have achieved.

C. So, What Should Government Do?

This makes it sound pretty gloomy for the government. At best, government intervention is irrelevant; at worst, it is harmful. Is there really nothing that government can do to aid the governed in resolving disputes?

In *Social Cost*, Coase appears to be of two minds regarding the role for government. Coase was skeptical of the ability of government regulation to arrive at the right answer. Governments are subject to political pressures from various special interests, so it is difficult for governments to make decisions based solely on what is best for the parties and society. To the extent that governments do not have to worry about losing customers when wrong decisions are made, the lack of competition will make many government decision-makers less careful. Finally, governments tend to establish broad rules designed to apply to a wide range of circumstances, but that means that the rule is unlikely to be a good fit for any given circumstance. Combine these concerns and Coase believed that “direct governmental regulations will not necessarily give better results than leaving the problem to be solved by the market or the firm.”¹⁹ However,

¹⁹ *Social Cost*, at 18.

Coase also conceded that, “on occasion,” government decisions might be able to get closer to the ideal solution than the market.²⁰

In many cases, government actors²¹ will find it politically necessary (or otherwise mandatory) to intervene in resolving disputes. When the government feels that it must intervene, what role should it play and what issues should be most important to it? Coase argued that, when there are no obstacles to bargaining, governments should just clearly define the parties’ rights. When there are obstacles to bargaining, however, “courts should understand the economic consequence of their decisions and . . . take these consequences into account when making their decisions.”²² In other words, government officials have an obligation to make an honest effort to get both the legal and the economic questions correct. Even if future bargaining can fix any flaws in the government’s decision, a better up-front decision can limit the bargaining costs to follow.

With a few notable exceptions,²³ most courts seem to ignore the economic question when resolving disputes, but Coase believed that most courts exhibited “some recognition, perhaps largely unconscious and certainly not very explicit, of the economic aspects of the question at issue.”²⁴ Legislative and regulatory efforts²⁵ at resolving disputes are likely guided, in limited fashion, by economic considerations. And yet, those considerations do not typically lead government officials to efficient solutions. In part, as illustrated by the earlier paper-mill hypothetical, this is because government officials are usually unwilling to consider disputes as conflicts between competing interests, focusing instead on punishing polluters and other ostensible

²⁰ *Id.*

²¹ Coase typically referenced judicial intervention, see *id.*, at 19, but the principles apply broadly to all government intervention.

²² *Id.*

²³ Seventh Circuit battles between Judges Easterbrook and Posner being an obvious example.

²⁴ *Id.*, at 22.

²⁵ Executive Order 12866 made some economic considerations mandatory for regulatory efforts.

wrongdoers rather than on of finding the least-costly resolution to the conflict.²⁶ Another reason is that government officials are unlikely to recognize when the current dispute was actually caused by previous government intervention.²⁷

So, what should government do when there are obstacles to bargaining? First, establish rules that are clear and predictable, so that the costs of bargaining post-intervention are lower. Bargaining can be difficult enough without having to spend time and money determining where everyone stands. Second, where obstacles to bargaining are high, government should stay out of disputes whenever possible, unless there was a specific reason to believe that the government could get closer to the ideal outcome than bargaining. Third, if intervention is absolutely necessary, the economic question of achieving the best result for society at the lowest cost must be taken seriously.

IV. CONCLUSION

Coase wrote *Social Cost* to challenge the dominant paradigm in economics. That challenge largely failed, and most of most of what Coase proposed went unnoticed.²⁸ And yet, Coase's writings remain influential, if not entirely understood, so Coase's challenge may yet succeed. This essay has attempted to explain Coase in a way that makes it accessible to a larger audience while retaining the "simple" and "self-evident" truths that Coase believed would revolutionize the way we think about the law and about economics. It is not clear that Coase's theories will win the day, but by explaining them to a larger audience, it can now hopefully be a fair fight.

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²⁶ *Social Cost*, at 27.

²⁷ *Id.*, at 28.

²⁸ As shown by the abundance of citations to the "Coase Theorem" and relative paucity of citations to the rest of *Social Cost*.