



## Some uneasiness with the Coase Theorem: Comment

Oliver E. Williamson

*University of California, Berkeley, Berkeley, CA 94720, USA*

That the so-called Coase Theorem has had a huge impact on the way many economists think about their project is beyond dispute. As George Stigler observes (Stigler, 1992), Ronald Coase's 1960 (Coase, 1960) article on "The Problem of Social Cost" became "the most cited article in the literature of the field, perhaps in the entire literature of economics" (Coase, 1992, p. 456). Paul Samuelson complains that the "proposition" has never been explained to his satisfaction. He furthermore believes that it is used as an instrument to defeat activist government regulation by those with *laissez faire* predilections.

I can relate to both of those concerns. As one, however, who has benefitted from many Coasian insights into the economics of organization – including the fiction of zero transaction costs – I will speak to what I regard as the distinctive merits of the Coasian enterprise.

One of these, which goes unremarked by Samuelson, is the importance of "private ordering" as compared with "legal centralism." Indeed, although some legal scholars expressly recognized the limits of legal centralism and the merits of private ordering (Llewellyn, 1931; Galanter, 1981), many legal scholars did not and most economists were content to assume that the courts applied efficacious rules of law to contract disputes in an informed, sophisticated, and low-cost way. To be sure, the omniscient court fiction had analytical advantages. Those advantages, however, came at a cost – in that they obscured the fact that most disputes, including many that under current rules could be brought to a court, are resolved by avoidance and private ordering. That is because in "many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute" (Galanter, 1981, p. 4).

The assumption of zero transaction costs, as applied by Coase to the issue of externalities, effectively substituted comprehensive private ordering for

legal centralism. Given zero transaction costs, private parties will costlessly bargain to an efficient result. That was the “Eureka” proposition to which Stigler referred. Although, on reflection, it is simplistic, it nonetheless surprised many sophisticated economists. Moreover, the zero transaction cost fiction is no more simplistic than the fiction of benign government that was so characteristic of public policy analysis in the 1960s. Wherein are the vulgar Coasians, those laissez faire advocates who invoked the Coase Theorem in support of their preferences, worse than the vulgar Utopians, who worked out of the benign government tradition (and who, for those who keep score, preceded them)?

Better, however, than excesses of either kind – which might be labeled, respectively, Panglossian Economics (everything is fine and unimprovable) and Utopian Economics (government intervention will assuredly improve matters) – is an objective assessment of the strengths and weaknesses of alternative modes of economic organization. That will be promoted by moving into the world of positive transaction costs, which is the central Coasian message.

Although that is unambiguously Coase’s central message (see especially his 1988 book (Coase, 1988) of essays and his 1992 Nobel Prize lecture), that message was slow to register on some of his readers. One of the contributing factors is that his 1959 article (Coase, 1959) on the Federal Communications Commission is very sanguine about the ease of defining and enforcing property rights in electromagnetic spectrum, which turns out to be difficult to implement.<sup>1</sup> Probably more important is the fact that the first 14 pages of Coase’s 1960 article worked out of the zero transaction cost economics fiction. Many early readers did not appreciate that this was merely a device by which to introduce the main arguments, which are developed in the succeeding 30 pages. These are: (1) the assignment of property rights does matter in a world of positive transaction costs; and (2) the study of economic organization is always and everywhere an exercise in comparative institutional analysis.

Implementing that program will be facilitated by recognizing that idealized forms of economic organization (to which Pareto Optimality so often refers) are operationally irrelevant. Instead, because all feasible forms of organization are flawed – market organization and government organization included (Coase, 1964) – alternative feasible forms need to be assessed in a comparative institutional way. Also, because so much of the action resides in the institutional mechanisms (as opposed to the incentive alignment mechanisms) through which alternative modes of governance operate, the microanalytics

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<sup>1</sup> Interestingly, however, spectrum was auctioned off in 1994 – with the benefit of new theory and a very sophisticated set of procedures developed by Paul Milgrom and Robert Wilson.

of contract, contracting, and organization come under review. As R.C.O. Matthews puts it, institutions are not only important but have become susceptible to analysis (Matthews, 1986, p. 903).

That is a very different prescription for doing economics than emerges naturally (or at all) from the neoclassical tradition. And although the New Institutional Economics is, as Samuelson remarks, “in a primitive stage of development” (Samuelson, 1994, p. 7), it has nevertheless made progressive headway in relation to orthodoxy (Matthews, 1986; Arrow, 1987). If, in the end, the best parts of the NIE get subsumed within a unified science of economic organization, that is no cause for regrets. That is progress.

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The author is Edgar F. Kaiser Professor of Business Administration, Professor of Economics, and Professor of Law at the University of California, Berkeley.

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