The Coase Theorem: The Greatest Economic Insight of the 20th Century

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The most-cited paper in all of economics[1] is "The Problem of Social Cost," published by Professor Ronald H. Coase in 1960.[2] It describes what later became known as the "Coase theorem," a fundamental conservative insight about entitlements and property rights. Though criticized for thirty years by academics who disliked its implications, this theorem was finally recognized by the 1991 Nobel Prize in Economics, of which Professor Coase was the single recipient.

Very few economics courses even mention the theorem, and those that do, teach distorted interpretations of it. Professor Coase himself has endured unfair academic disdain and criticism, including being called a "dinosaur" by one colleague.[1] One not-too-kind remark by another colleague was that Coase's idea can be understood by a tenth grader.[1]

Out of millions of published federal opinions, only three, two of which were by the same judge, have acknowledged his theorem. Not a single published federal opinion has mentioned it in nearly a million opinions since 1997. Coase's monumental intellectual achievement remains largely hidden from students, lawyers, economists and the American public.

But truth is not so easily denied. As politicians and professors propose shifting entitlements to address economic and social ills, the Coase theorem demonstrates the folly of their exercise.

The Coase Theorem Explained

Like Isaac Newton, who invented calculus in order to do his work on physics, Ronald Coase first invented a new concept of "transaction costs" to lay the groundwork for his insight. "Transaction costs" consist of the time, money, and effort someone loses in obtaining what he wants. The libertarian law professor Richard Epstein tersely summed up the meaning of "transaction costs" in one word: "friction."[1] Coase's Nobel Prize was based on his discovery and development of this new concept, and the committee conferring the prize (the Royal Swedish Academy of Sciences) likened this to the discovery of a new set of elementary particles.[3]

Once "transaction costs" were discovered and described, Coase's insight became possible. The Coase theorem states that in the absence of transaction costs, an efficient or optimal economic result occurs regardless of who owns the property rights. The free market guarantees the efficient outcome regardless of who owns what, because there will remain incentives to bargain towards the efficient result until it is achieved. This is true even for activities that generate "negative externalities" (harm to others); freedom to negotiate will enable all affected to bargain towards the most efficient output.

Restated another way, if property rights are well-defined and transaction costs are zero, then the most efficient or optimal economic activity will occur regardless of who holds the rights, because negotiation and market transactions will ensure the optimal allocation and use of property in a free market.

Chicago federal trial judge Milton I. Shadur explained the legal meaning of this theorem. "So long as the rule of law is known when parties act, the ultimate economic result is the same no matter which way the law has resolved the issue."[4] Whether the law gives an entitlement to a rich man or a poor one, the economic activity will be the same, assuming people can bargain freely with each other.

An oversimplication of this concept is Ralph Waldo Emerson's famous statement that if a man can "make a better mouse-trap … [then] the world will make a beaten path to his door."[5] Assuming people can deal without regulatory or other barriers, it does not matter who invents the mousetrap or who obtains legal rights to it. The free market will ensure that the better mousetrap is sold to the public for the benefit of all involved.

But an entire educated class—including lawyers, accountants, and politicians—makes a very good living from transaction costs. Leading academics build their life's work on the claim that "reforming" legal entitlements and property rights will somehow improve society. The Critical Legal Studies movement, started in 1977 at a conference at the University of Wisconsin at Madison, asserts that the upper class manipulates the law in order to perpetuate oppression of the lower class. The Coase theorem, however, disproves all that. Unchanging legal rules have no effect on economic activity, in the absence of transaction costs.

The meaning of Coase's insight for government regulation was unmistakable. A society is better off by simply assigning property rights, reducing transaction costs, and getting out of the way so that the market process can reach its most efficient result. Government regulations that add transaction costs hurt efficiency and prosperity. In response to the question "What's an example of bad regulation?," Coase replied, "I can't remember one that's good."[6]

The Most Famous Dinner in the History of Economics[7]

Initially Professor Coase's theory was not well-received, even by economists. In 1959 Coase, then in the economics department at the University of Virginia, published an early version in a paper concerning allocation of the radio frequency spectrum. Coase proposed that the Federal Communications Commission reject its then-current bureaucratic procedures for assigning licenses and simply sell frequencies in the spectrum to the highest bidders.

Coase elaborated on his theory in his paper, and every economist at the University of Chicago objected. Even though the Chicago economists were predisposed towards free markets, they thought Coase had erred.[8]

But these economists wanted the truth, and they invited Coase to a friendly dinner at the home of the great conservative economist Aaron Director. Milton Friedman and George Stigler were among those in attendance who thought Coase had erred. As the hors d'oeuvres were served, the vote was 20 against Coase's theory and only Coase in favor of it.[6] But as the two-hour discussion proceeded, it became like a scene from the famous movie *12 Angry Men.* One by one, bit by bit, the great economists came over to Coase's side as their objections were resolved. By the end their leader, Milton Friedman himself, heroically admitted that he had been wrong and Coase was right. To his enormous credit, Professor Friedman then became an energetic champion of Coase's theory.

The dinner attendees thanked Coase and invited him to write up his theory more fully for the new *Journal of Law and Economics*, and that version became by far the most cited paper in all of economics.

The Man Behind the Coase Theorem

Who is the man behind this revelation? It took an unconventional education to bring forth this unconventional work. Professor Ronald Coase, born in 1910 in England, suffered from a physical handicap as a youngster and thus could not attend regular school. He had to wear leg braces and was eventually enrolled in a school for "physical defectives." But that school was managed by the same organization that ran the school for "mental defectives," and Coase later explained that there was "some overlapping in the curriculum."[7] As a result, Coase spent his days in basket-weaving classes, and was deprived of any formal academic instruction until age 10.[7]

He eventually found his way to the London School of Economics, where he remained a socialist until his senior year, when he landed in a seminar taught by Professor Arnold Plant. That course was devoted to the "invisible hand" and featured stimulating discussions without any readings. It changed Coase's life, as he embraced the power of the free market.

Later he immigrated to the United States and eventually earned a faculty position at the University of Chicago. His work almost never included a mathematical equation or formula, contrary to the modern trend in economics. To this day many in the field of law and economics, which Coase helped found, pursue quantification that he would never have done himself.

Professor Coase's breakthrough was analogous to that of mathematician Kurt Gödel. Both proved startling limits on their colleagues' ability to achieve, and as a result both received a chilly reception from their peers. Coase and Gödel took the wind out of their colleagues' sails, so to speak, by demonstrating what *cannot* be done.

In Gödel's case, he showed that continuing efforts to prove the consistency and completeness of mathematics were utterly futile and demonstrably impossible.[9] Coase's insight was similar: economists, lawyers, judges, politicians and academics of all types can best promote efficiency and prosperity by reducing their interference and leaving the market alone. Coase's reward for this was a "too-long-delayed Nobel Prize"[10] and hostility in academic circles. He remains an advisor to the Ronald Coase Institute in St. Louis (www.coase.org) which focuses on international projects and failures of institutions. In universities and law schools, Coase's work is either ignored or distorted so badly that he would barely recognize it.

Implications of the Coase Theorem

In public policy, the Coase theorem implies that greater efficiency and prosperity can be obtained by reducing and eliminating transaction costs. Bureaucratic hurdles erected by government and the legal system increase transaction costs and reduce efficiency and prosperity. Society as a whole would be better off if transaction costs were minimized. Wealth is lost by impeding the ability of people to negotiate private contracts among themselves. The role of government to increase prosperity should focus on *lowering* transaction costs, not raising them.

Often the best a court can do to maximize prosperity is to minimize transaction costs that impede negotiations between parties. But in 1970, as the legal profession ignored Coase, the Warren Court expanded regulatory burdens on state administration of welfare in the mistaken view that more regulations would help the poor.[11] In 1996, the Republican Congress enacted welfare reform that superseded that decision,[12] conservative legislation that was "the greatest social policy success of the 1990s" and that "reduced the states' welfare rolls an average of 60 percent."[13]

In no industry are the transaction costs greater than in medical services, where patients and physicians must waste massive amounts of time determining how much a procedure costs, whether a third party will pay for it, and obtaining payment from that third party. In some cases the transaction costs are even infinite, as bureaucrats try to prohibit entirely private contracts with a physician who has not opted out of Medicare.

The Coase theorem demonstrates that these transaction costs can only detract from overall wealth and efficient economic behavior. Legal impediments to private contracting for medical services should be removed, as such interference frustrates the ability to reach economically optimal results. The best that government can do in controlling medical costs is simply to remove the transaction costs and get out of the way so that the parties—patients and physicians—can negotiate optimal arrangements.

The Coase theorem also provides economic justification for adhering to Rule of Law, and rejecting an "evolving" Constitution. As Judge Shadur observed above, as long as there is a rule of law it does not matter to prosperity where that rule assigns the rights. Legal theorists or litigants cannot devise a new allocation of rights or entitlements that would increase prosperity. Often the best courts can do is embrace the Rule of Law, and then get out of the way. Changing rules midstream, as in arbitrarily taking one's property,[14] is economically harmful.

There are also mind-bending implications of this theorem. Money itself is a property right, and that property will also be allocated to its most efficient uses regardless of who controls it, assuming rational behavior and no transaction costs. Judge Shadur explained above that the Coase theorem means "the ultimate economic result is the same no matter which way the law has resolved the issue," and likewise the economic result is the same no matter which rational person has the property right to the wealth. Bill Gates may control $200 billion or so, but his only rational influence over investing that capital is the same as that of a rational homeless man: allocate it towards the greatest demand in the market. Of course, Gates could choose to dispose of his wealth irrationally, but that would be even less meaningful to our economic future. Simply put, the annual list of the Forbes 400 is no more meaningful to economics than an annual list of a "homeless 400" would be, though a story about the latter would not play on readers' envy as well.

The Coase theorem even justifies the famous observation by Jesus that we "will always have the poor among" us.[15] Misguided governmental attempts to reduce the gap between the rich and the poor require injecting transaction costs into the system to restrain the successful and help the unsuccessful. These transaction costs include taxes and, in the case of medicine, medical boards, auditors and prosecutors that curb the innovators and achievers. But the more transaction costs are injected into the system, the more inefficient it becomes.

Government cannot reduce the gap between rich and poor without detracting from overall efficiency and prosperity. In other words, the only way government can eliminate the poor (relative to the rich) is by imposing transaction costs that make everyone poorer.

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