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Ronald Harry Coase: institutional economist and institution builder

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Abstract. This essay outlines the contributions of Ronald Harry Coase (1910–2013) to institutional economics, noting his insistence on the importance of studying real world institutions and his personal contribution as an institution builder.

Ronald Harry Coase (1910–2013) is acknowledged as a great institutional economist; it is noteworthy that he was also a great institution builder.[1] First, Ronald and Marion Coase had a long and successful marriage; second, Coase was also a long-time editor of the *Journal of Law and Economics;* and third, he was a prime mover and first president of the International Society for New Institutional Economics.

There have been many beneficiaries of Coase's editorship of the *Journal of Law and Economics.* A whole new era in law and economics was ushered in by the Coase theorem, but the Coase theorem deals with a fiction, and Coase has had an abiding interest in real world institutions. Coase-as-editor encouraged contributors to the *Journal of Law and Economics* to pay heed to institutions and their consequences.

Training in economics always involves training in the use of technical concepts and apparatus and sometimes involves learning to think like an economist. Usually, but not always, training of the first kind occurs in the classroom – although a few remarkable individuals, such as the great French economist Maurice Allais, have mastered the technical literature on their own. And sometimes, but also rarely, perceptive individuals with an uncommonly keen intuition about complex economic organizations learn to think like an economist. The deeply reflective and subtle mind of Chester Barnard is an example.

Coase was not only formally trained as an economist at the London School of Economics, but he also learned to think as an economist. His remarkable career as an economist is the product of both his formal training and his informal or tacit understanding of what economics is all about. His seminal contributions

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define the man, but much of his influence is due to his ability to help others think like an economist. That is true, moreover, not merely within economics but also extends to the contiguous social sciences. Arnold Plant, who taught at the London School of Economics, played a central role in broadening Coase's understanding of the economic enterprise and in deepening his interests in the importance of property and organization. As they say, the rest is history.

Formal training in economics always entails introduction to core concepts, such as tradeoffs and opportunity costs, and to the use of formal apparatus, to include the use of various optimization techniques and game-theoretic reasoning. The formal apparatus is usually mathematical, often subtle, and sometimes elegant. Sometimes the formal analysis merely provides a logic-check upon the verbal argument. Ideally, however, it goes beyond to discover nuances and qualifications and to work up additional ramifications. But sometimes the formal analysis becomes self-contained and loses contact with the phenomena. Formal analysis becomes in-grown when analytical convenience routinely trumps relevance. Also, formal analysis can be – though it need not be – pedagogically bankrupt. Coase (1988, p. 22) described the last as 'blackboard economics', according to which instructors 'cover the blackboard with [formulas and] diagrams and fill the hour in one's lectures without the need to find anything about what happened in the real world'[1]. It is elementary that the mindless application of technical apparatus to inform public policy can be (and has been) counterproductive.

Coase's work, and much of new institutional economics (NIE) more generally, turns on close reasoning; but much of it has also so far resisted 'full formalization'. This is both a benefit and a cost. The benefit is that NIE has never lost contact with real phenomena. The costs are of two kinds: NIE is more difficult to teach; and the detection of lapses in the logic and/or extensions upon the logic, through the application of formal analysis, go unrealized. Indeed, there may be a third cost: because the profession is 'ruled', as it were, by orthodoxy, those who work out of a non-orthodox setup are more difficult to evaluate for appointments and promotions.

This last, however, should not be exaggerated. Economists, in my experience, are very practical fellows. Tell economists something novel or different about phenomena that they are interested in and show that the data line up: that will get their attention. To be sure, this places an added burden on new institutional economists, but it is a burden that they can accept with alacrity. After all, NIE deals with a wide variety of phenomena and is the source of a huge and growing number of refutable implications, to which the data have been kind – which is to say corroborative. NIE is an empirical success story. Applications to public policy, moreover, are numerous and growing. The upshot is that new institutional economists have an inviting menu from which to choose. Not everyone, of course, will decide to dine at the NIE cafe. But many have and more are in prospect.

Note, moreover, that I refer to dining at a cafe, rather than a three star restaurant. New institutional economists are the blue-collar guys with a hearty appetite for reality. As Coase (1984, pp. 231) put it, modern institutional economics 'should start with real institutions ... [and] with man as he is' . To be sure, there is a need to abstract the core purposes and central features of both – which is to say that analysts need to simplify. That does not, however, imply a casual disconnection with reality. Always and everywhere, real human actors are deploying feasible economic, political and social institutions to solve problems.

The study of economic organization becomes both more complex and more interesting as a consequence. Getting in touch and staying in touch with phenomena pushes new institutional economists to go beyond the accustomed limits of economics to draw selectively upon the contiguous social sciences. Aspects of law, organization theory, sociology, evolutionary psychology and cognitive anthropology are all relevant – although economics is and remains the queen of the social sciences.

On my reading, the essence of Coase is this: (i) push the logic of zero transaction costs to the limit; (ii) study the world of positive transaction costs; (iii) because hypothetical forms of economic organization are operationally irrelevant, and because all feasible forms of organization are flawed, assess alternative feasible forms of organization in a comparative institutional way; and (iv) because the action resides in the details, study the microanalytics of contract, contracting and organization. That is a subtle and powerful combination of ideas and turns out to be difficult to implement. Although much of it goes against the main tradition, it has nevertheless made progressive headway in relation to, and parts have been incorporated within, orthodoxy.

The imperative to study the world of positive transaction costs is the most important message, but the concept of zero transaction costs helps to set this up. Specifically, the hypothetical condition of zero transaction costs helps economists to 'think the unthinkable' with reference to contract and organization. If a purported inefficiency is ascribed to an exchange relation between A and B (a 'market failure' is observed), and if A and B are apprised of this condition, then zero transaction costs will permit A and B costlessly to remove the inefficiency, thereby to realize a mutual gain. That, of course, is the message of the famous Coase theorem, according to which the assignment of property rights one way rather than another is irrelevant in a world of zero transaction costs. A similar irrelevance result, moreover, applies to organization: organization is irrelevant in a world of zero transaction costs, because any mode of governance can costlessly replicate the properties of any other.

Coase (unlike some of his early followers) was not content with such a contrived result. He viewed the fiction of zero transaction costs merely as a device by which to set up the analysis of positive transaction costs, where many of the lessons of zero transaction cost reasoning carry over. Specifically, the positive transaction cost version of the Coase theorem is this: if a purported inefficiency is ascribed to an exchange relation between A and B, and if A and B are apprised of this condition, then A and B have an incentive to correct this condition, thereby to realize mutual gains, *in cost-effective degree*. The move to positive transaction costs thus introduces the test of cost effectiveness. This both eliminates the irrelevance results, it no longer being the case that the assignment of property rights does not matter or that any mode of governance can costlessly replicate the features of any other, and presents the need to examine alternative modes of governance with reference to their distinctive strengths and weaknesses.

Upon recognizing that each mode of governance is a syndrome of related attributes – a combination of strengths and weaknesses – efficiency analysis undergoes a transformation. In contrast to second-order efficiency analysis, which entails adjustments at the margin, first-order efficiency analysis entails choice among governance structures – markets, firms, bureaus – which differ in discrete structural ways. Orthodoxy is concerned predominantly with second-order efficiency. NIE is concerned predominantly with first-order effects. The analysis of both is needed, but priorities also matter.

The proposition that inefficiency invites its own demise (in cost-effective degree) still comes hard to some economists and to many academics, but businesspeople have known this in their bones. The Rudolf Spreckels move applies: 'When I see something badly done, or not done at all, I see an opportunity to make a fortune'. Most academics are ill-suited to (or have taken themselves out of) the fortune-making business. There is academic gold to be mined, however, whenever a condition of inefficiency is displayed.

Thus suppose that a sociologist of organization discovers that a standard practice, say an effort to exercise control, gives rise to a hitherto neglected 'unanticipated consequence' to which an inefficiency can be ascribed. This is an important finding with which students of organization should be apprised. But it is merely the first step. Economists and others who view inefficiencies as opportunities will take three additional steps. Upon being apprised of the inefficiency, they will seek to *explicate* the factors that are responsible for this condition, work out the organization *design* ramifications, and thereafter *fold* these into the *ex ante* design. All elements of the triple to which John R. Commons referred – conflict, mutuality and order – are thus engaged. Specifically, governance becomes the means by which to produce order, thereby to relieve conflict and realize mutual gains. This is different from the orthodox conception of the problem of economic organization, in that economizing, rather than monopolizing or strategizing, becomes the 'main case'.

The third lesson of Coase – that all feasible forms of organizations are flawed – has special relevance for public policy analysis, in that the mere display of a 'market failure' no longer warrants government intervention. Instead, a parallel analysis of 'government failures' (of regulation, nationalization, taxation and the like) is also needed (Coase 1964, pp. 194–7). Again, the Coasean view enlarges the study of economic organization – with more-informed and better public policy in prospect.

This third lesson is also in the spirit of what Harold Demsetz (1969, pp. 1–22) has named 'Nirvana economics' and I have examined with reference to the remediableness criterion, to wit: an extant form of organization for which no feasible superior form of organization can be described and implemented with expected net gains is presumed to be efficient (Williamson 1985, p. 1951). One advantage of the remediableness criterion is that it does not confer wisdom on academics and bureaucrats while casting politicians and businesspeople as weak things (if not poor fools).

In as much as the Rudolf Spreckels move is assumed to be continuously operative, businesspeople are presumed to be alert to non-trivial inefficiencies. If, therefore, such an inefficiency persists, the question needs to be posed as to what are the obstacles to efficient adaptation. Possibly this is due to ignorance or myopia, but might there be more fundamental difficulties? Are the costs of orchestrating collective action prohibitive? Is the proposed corrective action lacking credibility, and hence will not be believed? Because those who would reform extant practice must describe a feasible superior alternative, armchair optimality with reference to a hypothetical ideal falls out of fashion. Comparative institutional analysis supplants it, and better public policy results.

This last brings me to lesson four: because the action resides in the comparative institutional details, analysts must examine the mechanisms of contract, contracting and organization. Although the spontaneous mechanisms of textbook economics remain important, students of NIE make provision for and explicate *intentional mechanisms* as well. This can be tedious, in that there is a need to work these out in the manner of Charles Peguy, which is to say in a 'modest, slow, molecular, definitive' way. The study of intentional mechanisms pushes the NIE beyond economics to include the study of law, especially contract law, and the study of organization.

This complicates matters, and some worry that NIE, like older-style institutional economics, will become engrossed in details and run itself into the sand. That, however, has not materialized. As R.C.O. Matthews put it in his 1986 Presidential Address to the Royal Economic Society, new institutional economics has become one of the most exciting fields in economics. That was over a decade ago and it has continued to flourish since then. By contrast with older-style institutional economics, NIE employs a *logic of organization* in which the institutional environment sets the rules of the game and the governance of contractual relations works out of variations on a few key themes – of which economizing, incomplete but farsighted contracting, discriminating alignment, credible commitment and remediableness are five. In addition, NIE has become and will remain a very empirical enterprise.

We have every reason to celebrate Coase's intellectual leadership and the course of events that he set in motion. George Stigler once distinguished between

BC and AC, where BC refers to 'before Coase' and AC refers to 'after Coase'. Imagine, if you will, a third category, WC, where WC refers to 'without Coase'.

No one would dispute that economics would be impoverished were it not that Coase appeared on the scene and had the insights, aptitude and courage to contest orthodoxy. To be sure, some Coasean ideas are so fundamental that someone, sooner or later, would stumble upon them. It is our good fortune that we did not have to wait. Professor Coase worked these out for us in a modest, slow, molecular, definitive way. The course of economics, and of the contiguous social sciences, has been advanced by decades and vastly changed as a consequence.

It has been my pleasure to have had the benefit of Coase's research. This millennium will witness further developments in new institutional economics – of conceptual, theoretical, empirical and public policy kinds.

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