Boston/Dordrecht/London: Kluwer Academic, 1997.

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12 THE GOOD OLD COASE THEOREM AND THE GOOD OLD CHICAGO SCHOOL: A COMMENT ON ZERBE AND MEDEMA

Deirdre N. McCloskey

Dick Zerbe and I were together at Chicago back in the 1970s, during the creation of law and economics. The point of Dick and Steve's paper is that law and economics as it has developed in, say, Richard Posner's work and as it has been absorbed into the mainstream of economics is not the same thing as what might be called a "Coasean" approach. Coase and Posner, though often treated as identical, represent different views on how to conduct economics. The Medema-Zerbe paper identifies the difference, namely, that Coase follows the British tradition of commonsense empiricism as found in Adam Smith while Posner follows the French (and, in Bentham, the uncomfortably British) tradition of rationalism. The one mucks about in the world as it is. The other, finding such an approach tedious, retires to the study and the blackboard. In all his work from the 1930s onward Coase has attacked this rationalist tradition of what he calls "blackboard economics," as for example Jeremy Bentham, or A. C. Pigou, or Paul Samuelson, or Richard Posner.

The best example of the difference is the bizarre doctrinal history of the so-called "Coase" theorem (the doctrinal history is given its most thorough airing in another paper by Steve Medema, with Warren Samuels 1997; Medema and Samuels anticipate much of what I say here). 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 (and now we know from Zerbe and Medema the Hewinsian sort).

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, p. 113, where he calls it "a remarkable proposition to us older economists who have believed the opposite for a generation"). Thus the fine book by Shughart, Chappell, and Cottle on managerial economics, p. 577: "In the absence of transaction costs, the allocation of resources is independent of the initial assignment of property rights."

The half-dozen people in the session in which the Zerbe and Medema was first presented, including Zerbe and Medema, are among the handful who 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 understood by George Stigler or Paul Samuelson is actually Adam Smith's theorem (1776). It is wholly explicit in F. Y. Edgeworth (1881, pp. 30ff; p. 114); and with all bells and whistles in Arrow and Debreu (1954). Smith, Edgeworth, Arrow, Debreu, with many others, noted that an item tends to gravitate 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 old idea in economics "remarkable" I do not know, though it is not the only strange reading that Stigler gave. Applying it to pollution rights is unremarkable. As Paul Samuelson said sneeringly about the "Coase" theorem: 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 can*not* 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 simple, blackboard solutions by way of 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 in a recent article (McCloskey, 1993, footnote 2):

> I should report my long-standing conviction that "Coase's theorem" is not the point of Coase's article in 1960 (see McCloskey 1985, pp. 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 half-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. 38, n. 18; [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.

Some months ago I had an e-mail conversation about the actual and ersatz Coase theorems with Tom Weisskopf at the University of Michigan:

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 half-dozen or so in your corner.

McCloskey: No, Bob gets it wrong, with the other N - 6 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"). 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 Zerbe and Medema have illuminated in their article], 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 Half 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 [and with the Hewinsian method that Zerbe and Medema identify]. Coase's second published paper, the famous one 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 imprudently 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 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 [consistent with Hewins] 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."

So I agree with Zerbe and Medema that Coasean economics follows an old-fashioned method, outlined by Hewins. Coase, as they say, is "not a modern economist." 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 Courbusier 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, pp. 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.

One of the reasons it did not work very well is that it was self-contradictory. The ambition of prediction and control, as Tom Sargent and Robert Lucas and other inadvertently *post*modern economists can tell you, is self-contradictory. ("Postmodernism" is a scarey word, but in essentials it merely opposes the mechanical modernism about which Larkin complains; call it "anti-modernism," refusing to elevate modernity to a religion (McCloskey 1995].) The Austrian economists understood the criticism of modernism long ago. The ambition in the positivism of Comte to predict and control — "savoir pour prévoir, prévoir pour pouvoir," he said, "know in order to predict, predict in order to control" — runs up against the knowledge that people have. In 1929 the University of Iowa economist Frank Knight noted the rhetorical contradiction in the idea that we can be helped by social engineers: "natural science in the 'prediction-and-control' sense of the laboratory disciplines is relevant to action only for a dictator standing in a one-sided relation of control to a society, which is the negation of liberalism — and of all that liberalism has called morality" (1929, 38; Stigler, incidentally, misrepresented Knight, too).

To put it another way, the utilitarianism so typical of the French Enlightenment, which diverted economics from its Scottish and commonsense roots, was a noble attempt but flawed. Certainly Coase thinks so. The late utilitarianism of Pigou and Samuelson or Stigler is anathema to him, as Zerbe and Medema (and at the session Thráinn Eggertsson) have pointed out. Friedrich Hayek said it this way: "I believe I can now . . . explain why . . . [the] masterly critique by Mises of socialism has not been really effective. Because Mises remained in the end himself a rationalist-utilitarian, and with a rationalist-utilitarianism, the rejection of socialism is irreconcilable . . . . If we remain strictly rationalists, utilitarians, that implies we can arrange everything according to our pleasure . . . . In one place he says we can't do it, another place he argues, being rational people, we must try to do it" (Hayek 1994, p. 72-73).

A similar conflict can be seen down at the level of practice in the Chicago School. There are two Chicago Schools, identified with Friedman on the one side and Stigler on the other. One is the Good Old Chicago School to which Knight, Hayek, Friedman, Coase, Buchanan, Schultz, Demsetz, Alchian, Fogel, Zerbe, Medema, and I belong. The other is Nouvelle Chicago, the Benthamite and Samuelsonian Chicago that has made the place into a University of Minnesota South.

It must have been around 1968, in the coffee room of the Social Science Building at Chicago, that Friedman and Stigler had a jovial and public conversation about being economists. It made a big impression on me. Milton was lamenting the stupidity of tariffs, to which George broke in, from a foot above, saying something like this: "Milton, you're such a preacher! If people want free trade they'll get it. If they don't want it, no amount of jaw-boning by economists will change their minds." "Ah: that's where we differ, George. We admire markets, but you think they've already worked." "And why not? People are self-interested, voting their pocketbooks — that's enough to make the market work. The people bought the tariffs; tariffs must be what they want." "No: they pursue their interests but often do not know what the interests are. People need education. The average citizen has no idea that a tariff hurts him." "Education! Try educating a lobbyist for the textile industry." "As I said, that's where we differ: I'm a teacher, and think that people do *some* things because they are ignorant." "And I'm a scientist, an economic scientist: people do what they do because they are wise."

Stigler believed with Dr. Pangloss that we are in the best of all possible worlds. The Friedmanites believe that we *could* be in it if we would only stop to think. The Stiglerites assume rationality; the Friedmanites teach it. The Stiglerites want to praise the world; the Friedmanites to change it. The Stiglerites detest policy; what is, is. The Friedmanites embrace it; what might be, can be. The Stiglerites are pessimistic, in the manner of the master. The Friedmanites are optimistic, in the manner of their master, reckoning that we are at present in a second-best world, in which people need some education before the Second Coming of the market. It will come, we Friedmanites say. If I forget thee, o free society, may my math coprocessor lose its cunning. But we disagree with George, who came to believe that it had already come. There must have been sects like his in orthodox Judaism and Christianity. The difference in economics is that the we-are-already-in-heaven sect on the whole won out.

Ronald Coase represents, then, one side of the culture of economics, and of the modern world: Friedman against Stigler, Smith against Bentham, understanding against prediction, induction against deduction, empiricism against rationalism, postmodernism against modernism.

I think Zerbe and Medema would agree. For this reason I doubt they will continue to think of Kahneman and Tversky as the way forward (like Coase's paper on social cost, the papers on rules of thumb by these two psychologists are more cited than read: for years I couldn't spell their names). My colleague at Iowa, Lola Lopes, has written devastatingly on their experiments (Lopes 1991; 1992; Lopes and Oden 1991). The main error was to ask the question in ways that forced people to use rules of thumb, and then triumphantly conclude that in fact people are stupid because they use rules of thumb. "The idea that people-are-irrational-and-science-has-proved-it is useful propaganda for anyone who has rationality to sell" (Lopes 1991, p. 78). As an economist I would add the Chicago-School criticism of such expertise on the make: if you're so smart, why aren't you rich? If as Zerbe and Medema say in reporting Kahneman and Tversky, the decisions of people are "not consistent with standard economic models," I have a proposal for them to make fortunes in hedged futures.

In any event, fixing up modern economics by tweaking the assumptions about maximization is not Coasean. It's more from Bentham-Samuelson-Stigler, more utilitarianism not touching the earth. Kahneman and Tversky offer an alternate modernism, not the anti-modernism of Coase.

Similarly, I do not agree with Zerbe and Medema that modernist rules of Method can tell us whether or not we should drop the idea of utility. Coase's paper on lighthouses, which takes a historical and legal approach, asking questions an economist would ask and seeing ways to answer them, says more about the utility of a utilitarian economics than the top hundred papers since 1881 about the utility function. Economists have wasted a lot of time making blackboard arguments about whether a blackboard economics was possible or not — think of the waste of first-rate minds ruminating on whether or not utility is measurable, from Edgeworth to Houthakker, and now the larger waste of first-rate minds ruminating on whether or not bargaining can be solved as a game (for a sceptical view, see Fisher 1989).

Recall Hayek's argument that Mises contradicted his commitment to freedom by being also committed to utilitarianism. It turns out that Hayek's argument is the same as what literary people call "the aporia [the indecision, the dilemma] of the Enlightenment project." We economists find it in the imperatives of rational expectations and the free society. We note that prediction is inconsistent with free behavior. In the postmodern idiom, utilitarian rationalism is selfdeconstructing. It's what's wrong with one side of modern economics, such as Stigler's political economy as against Friedman's, or Richard Posner's law and economics as against Ronald Coase's.

Utilitarianism is the French element in British thought, contrary to British empiricism. Jeremy Bentham was the problem. Knight and Hayek and Ronald Coase were in this respect two centuries behind the times, products not of the French Enlightenment but the quite different Scottish Enlightenment, spiritual residents of Edinburgh rather than Paris, exponents of bourgeois virtue rather than aristocratic expertise. By the end of the twentieth century they became old-fashioned enough to be postmodern. Hayek and Coase and Lucas have more in common with Derrida and Rorty and Kristeva than with Bentham and Comte and Samuelson.

I commend Coase for his old-fashioned ways. I only add to Zerbe and Medema's commendation that the old-fashioned ways have become the latest fashion. You read it here: Ronald Coase is a postmodernist.

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