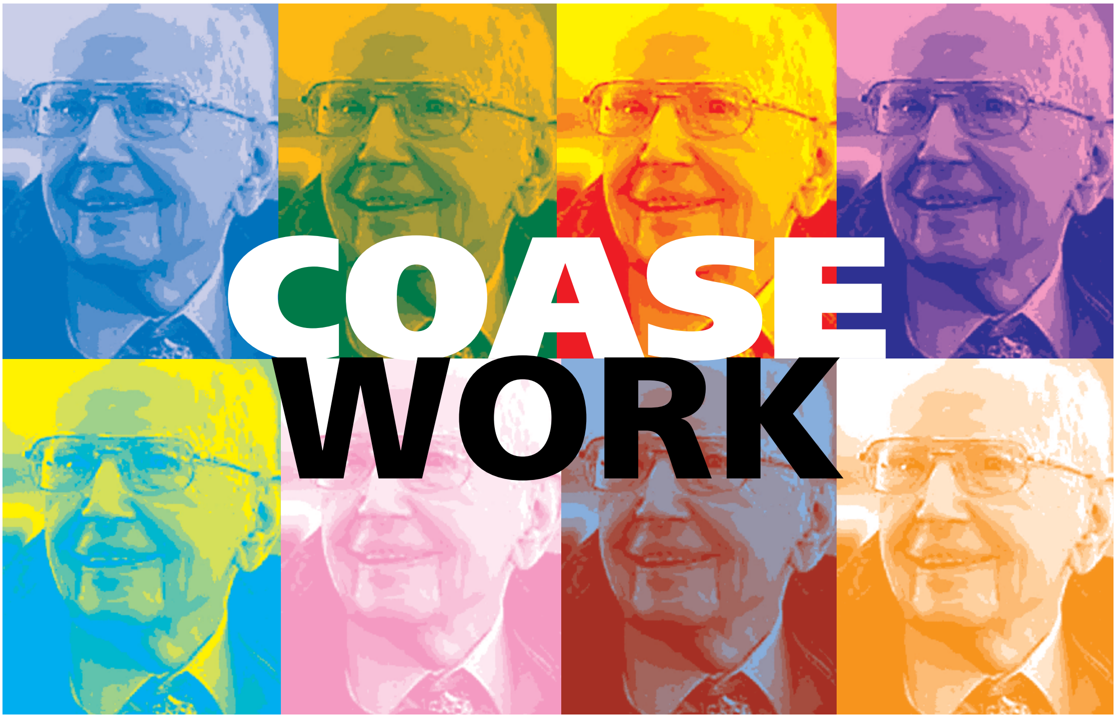


COASE WORK

In the first of a series of introductory articles, IEA Education Director STEPHEN DAVIES profiles a man who made a giant contribution to the world of economics

Ronald Coase died last year at the age of 102. Arguably he is one of the greatest economists in the history of the discipline.

He was only in his early twenties when he presented the lecture that ultimately led to him winning the Nobel Prize in economics.

Though Coase's most important ideas were developed decades ago and have influenced economic policy enormously, perhaps their most profound influence on policy will be in the 21st century. His work is highly relevant to the core topics on current A-level economics and undergraduate economic and social policy syllabi.

The area where Coase first made an important contribution to economics was that of industrial organisation.

In his article, "The Nature of the Firm", he looked at a simple but profound question: why do firms exist? Classical economic theory would lead us to expect an economy made up of many self-employed people all contracting with each other. But this is not what we see.

Instead, much economic activity is organised through firms of various sizes with the majority of people as employees. What makes a company, for example, have an accounts department rather than contracting with self-employed accountants?

Coase's great insight was to realise that economic transactions such as trading or making contracts are not costless.

There are what we now call transactions costs, things such as the cost of making and agreeing the contract and of supervising their work, which might be more or less difficult if people are not employed by a firm. In a world without these costs we would not have firms.

However, because transactions costs do exist there is an incentive to reduce them by having a single transaction (the employment relationship) rather than a whole lot of separate costly ones.

Much standard economics and business studies teaching assumes the existence of firms but does not explore why they exist.

It is only when you realise that the critical explanation is the nature and level of transaction costs that you will understand better not only why firms exist but also why at any time there is a predominant form of industrial organisation, with variations between sectors.

It is transactions costs that will determine how much outsourcing – including to developing countries – takes place. If transactions costs decline then there will be a rise in outsourcing whereas a rise in transaction costs will lead to larger and more integrated firms. It is also the level of transaction costs that will determine how large firms become on average.

And crucial issues in the policy debates about the energy and railways industries can only be understood if we think about transactions costs.

Was railway privatisation a mistake, or was it just foolish for the government to split the train companies from the company that operates the track?

Should energy companies be vertically integrated or should they split up? One course of action might lead to more competition but it may also lead to much higher costs.

THOUGH HIS MOST IMPORTANT IDEAS WERE DEVELOPED DECADES AGO…PERHAPS THEIR MOST PROFOUND INFLUENCE ON POLICY WILL BE IN THE 21ST CENTURY

Coase made perhaps his greatest contribution in his 1960 paper, "The Problem of Social Cost". This dealt with one of the central ideas of modern economics, one that pervades the A-level syllabus: the problem of externalities. In standard contemporary economic thought, externalities occur when economic activity leads to costs or benefits for third parties not involved in the original activity or transaction.

Because these costs and benefits are not internalised (i.e. borne by the party responsible for creating them) the price system does not do its work properly and resources are not allocated efficiently. Some goods will be over-produced and others under-produced. The solution in standard A-level thinking is government action, usually through taxes, subsidies or regulation.

Coase showed that it is not clear where the blame for creating the externality lies and that in many cases the way to maximise efficiency is not through government action but through private bargaining.

Coase used a real life case of a dispute between a farmer and a rancher over the damage done by the rancher's cattle to the farmer's crops. Provided the property rights to land, crops and cattle are clear and the transactions costs of negotiation are low enough then the fence will be built, as long as the cost of building the fence is less than the value of the damaged crops. If the crop farmer has a property right not to have his crop trampled, the rancher will build the fence rather than pay compensation to the farmer. If the farmer has no such right, he will build the fence to keep the cattle out. Crucially, the initial allocation of the property rights does not matter for efficiency, though it may for fairness.

What this means is that when there are externalities there may not be a need for government regulation or taxes as the problem can be resolved through what has now come to be called Coasean bargaining.

However, if the transactions cost of bargaining are very high then a bargain may not be possible. For example, the transactions costs involved with compensating people living below sea level who may be affected by the externalities of

RONALD COASE: KEY INSIGHTS

- When transactions costs change – for example because of changes in communications technology – industrial structure could change radically
- If the wrong structure is imposed on an industry (for example, in railways in the UK) this can be very costly.
- Bargaining between affected parties can often overcome the problems caused by externalities. Governments should not get in the way of such bargaining.
- Public goods can often be provided privately by tying their use to private goods.

carbon emissions or compensating those affected by green-field property development in the south-east of England might be too great to get an efficient outcome using markets alone.

In these cases we may have to resort to legal rules, but very much as a second best option. Crucially, the legal rule should aim not at achieving an outcome designed by planners but at achieving the outcome that people themselves would have wanted if they had been able to bargain efficiently.

HIS GREAT INSIGHT WAS TO REALISE THAT ECONOMIC TRANSACTIONS SUCH AS TRADING OR MAKING CONTRACTS ARE NOT COSTLESS

In practice, we can try to solve these problems by making property rights more extensive or by trying to mimic market mechanisms (for example, by carbon trading or agreements between developers and parish councils that can help compensate people affected by housing development). Technological innovation may well play a large part in reducing transactions costs in these areas in the future.

Coase was very much a realist. He realised that in many cases government action may lead to higher levels of social cost (due to a misallocation of resources) than if the original externality had been left unaddressed. The burden of proof for the need for regulation has to be put on the government or agency making the regulation to show that their action will indeed increase welfare on balance.

The third example of Coase's originality was in the area of 'public goods'. These are another example of what is seen as a 'market failure' in economics courses.

The consumption of a public good is non-excludable so, once they are provided, they bring equal benefit to both those who pay for them and those who do not.

The result, in standard theory, is that there will be a strong incentive for people to not pay and to "free ride" on those who do. The good will then be supplied sub-optimally.

One classic example of a public good of this kind suggested in the literature is a lighthouse (others include national defence). In his 1974 article "The Lighthouse in Economics", Coase used empirical economic history to show that private action had successfully produced public goods including lighthouses. In this case privately owned ports paid for lighthouses in order to increase their own income.

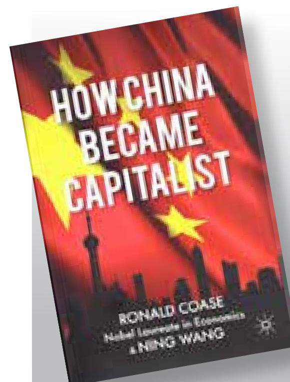
The crucial thing was the ability of people to find ways to co-operate for mutual benefit and find ways to connect non-excludable goods to excludable ones (in this case the use of the port). Subsequent work has shown that almost all the classic public goods can be and often are provided privately.

Coase's work had important practical applications in many areas of public policy. It led, for example, to a change in broadcasting policy with the creation of tradable property rights in the electronic spectrum rather than licences granted through a political process.

Later in his life he did important work on entrepreneurialism and the way industrial production was organised.

His last major book (with Ning Wang, and published by the IEA when Coase was 101) looked at how China had become a broadly capitalist economy and argued that this was due mainly to action by ordinary people in China, rather than by government policy.

Coase's work was creative, original and full of insights that should lead us to question many of the complacent assumptions of much contemporary economic and political thinking.



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