Economic Analysis of Law: A Coasean Approach

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I.

Ronald Coase is the most recognized founder of the economic analysis of law. He has almost exclusively been associated with the "Coase theorem", which is based on an assumption of zero transaction costs, while ironically, Coase, the person, insists that the core of economic analysis relies on an assumption of positive transaction costs. It is therefore no wonder that Coase has not toned down his battle cry even after he was awarded the Nobel Prize in Economics in 1991.[1] For him, law is the institution which reduces transaction costs and thus increases the value of social products.[2] Coase claims that "the delimitation of rights is an essential prelude to market transactions".[3] This means that property law determines who the owner is and thus makes it possible for interested parties to identify with whom they should transact. However, Coase further says that if a pure delimitation of rights cannot reduce enough transaction costs in the market, the law should avoid the market and directly assign the property right to the party who produces a higher

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[1] See Interview with Professor Ronald Coase, http://english.unirule.org.cn/Html/Unirule-News/20110101130956819.html, last visited date: 2011/10/14；Why Economics Will Change, http://www.coase.org/coaseremarks2002.htm, last visited date: 2011/10/14。

[2] R. H. Coase, The Firm, the Market and the Law 6-7 (1988).

[3] R. H. Coase, The Federal Communications Commission, 2 J. L. & Econ. 1, 27 (1959).

value of social products. Coase's approach is comparative institutional analysis.

For economists, the Coase approach is revolutionary. Before Coase, the Pigovian approach, which characterized any damage arising from a conflict of activities as an externality, required the government to take corrective measures otherwise the value of social products would not be maximized. By contrast, Coase argues that due to the reciprocity of damages, the party who causes the damage might produce more value than the party who suffers the damage. Therefore, the value of social products may still be maximized even if the party who causes the damage is not liable for the damage.[4] The reciprocity of damages is derived from the scarcity of resources. When there is conflict in the use of resources, A's usage necessarily excludes B's usage. The way to maximize the value of social products is to choose the usage which would produce a higher value at the expense of forgoing the other usage. This is the nature of damages—the concept of opportunity cost. In the natural state, however, this choice would not be made because of the lack of a baseline on which people could rely to bargain. Property law regime arises to facilitate the market transactions which would eliminate this rent dissipation.

In market transactions, if the party who causes the damage is liable, then the damage is his direct cost. However, even if the party who causes the damage is not liable, the damage is still his cost-- opportunity cost. This is because the party who suffers the damage has an incentive to use market transactions to buy off the party who causes the damage to stop the damage-causing activity. If the value of the damage-causing activity

[4] R. H. Coase, *supra* note 2, at 96.

is less than the payment put forward by the party who suffers the damage, the damage-causing activity would stop. Under a property regime, whether the party who causes the damage is liable or not, he has been burdened with the same amount of cost. No externality exists!

Coase attributes this flaw of economists to their ignorance of law. Economists are too occupied with physical objects to see that what are actually being traded in the market are intangible legal rights.[5] Economists see noise, pollution of water or air, or view blocking as externalities -- damages without market transactions. They will usually prescribe taxes or regulations as corrective measures. Lawyers qua lawyers know better.[6] Easements, a part and parcel of property law, have been traded in the market for millennia. Nuisance law does not always make the party who causes the damage liable.

A clarification of the proposition that the delimitation of rights is an essential prelude to market transactions might be needed. Derived from the Coase theorem, some people would say that property law does not significantly affect the value of social products because the only requirement of the courts is to make a judgment, and either way of ruling, liable or not liable, would not make a difference in the resulting value of social products. This is a mistake. A case-by-case approach would not facilitate market transactions because interested parties would have to incur litigation costs to win the case, thereby dissipating the benefits of bargaining. The legal historian A. W. Brian Simpson refuted Coase by putting up evidence showing that in the case of *Sturges v. Bridgman*,[7] the

[5] R. H. Coase, *supra* note 2, at 155.
[6] R. H. Coase, *supra* note 2, at 11.
[7] R. H. Coase, The Federal Communications Commission, 2 J. L. & Econ. 1, 26-7 (1959); The

parties did not reach an agreement either before or after the litigation.[8] Coase responded by arguing that if the value of the subject matter in this case had been large enough, an agreement would have been reached.[9] This dispute seems unnecessary. The result of this case does not undermine the property law proposition. Law as the basis for market transactions needs to have characteristics of normativity and system to channel parties to transact in the market, not to battle in the legal process.

Although a certainty of a property law regime is important in facilitating market transactions, thereby increasing the value of social products, Coase advances a second argument that if transaction costs in the market are too high to prevent agreements from being reached, the law might avoid the market and directly assign the property right to the party who produces a higher value of social products. A liability law with a negligence rule is such a regime because the party who causes the damage is not liable when he is not negligent. This is the legal regime under which there exist damages without compensation.

II.

In the paper entitled "The Nature of the Firm",[10] Coase argues that the firm is created because transaction costs are high in the market. Being a general contract, the firm replaces many spot contracts in the market. The scope of a firm is determined such that the costs of organizing an

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Problem of Social Cost, in *supra* note 2, at 105-7.

[8] A. W. Brian Simpson, *Coase v. Pigou* Reexamined, 25 J. Legal Stud. 53, 85-87 (1996).

[9] R. H. Coase, *Law and Economics and A. W. Brian Simpson*, 25 J. Legal Stud. 103, 109 (1996).

[10] R. H. Coase, *supra* note 2, at 33-55.

additional transaction in the firm do not exceed the transaction costs in the market or the organization costs of another firm. In a later paper entitled "The Problem of Social Cost", Coase says that the state is a super-firm. Within a firm, top-down directives replace the pricing system in the market to allocate resources. The law and the government also have such power -- and much more. The basis of the firm is contractual choice, which is also the basis for the law or the government.

Coase once said:

> In such cases, the courts directly influence economic activity. It would therefore seem desirable that the courts should understand the economic consequence of their decisions and should, insofar as this is possible without creating too much uncertainty about the legal position itself, take these consequences into account when making their decisions. Even when it is possible to change the legal delimitation of rights through market transactions, it is obviously desirable to reduce the need for such transactions and thus reduce the employment of resources in carrying them out.[11]

James Buchanan challenged this. Buchanan argued that the courts should only apply clear legal rules and should not take into account the economic consequences.[12] Both Coase and Buchanan hold the concept of law based on contractual choice. Buchanan, however, would not give courts "discretionary power". This view of the courts is too restrictive. In common law systems, the courts both apply and make laws. Even in continental law, the courts are required to fill in legal gaps. Furthermore,

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[11] R. H. Coase, *supra* note 2, at 119.

[12] James M. Buchanan, *Rights, Efficiency, and Exchange: The Irrelevance of Transaction Cost* (1984), in Steven G. Medema ed., The Legacy of R. H. Coase in Economic Analysis II 175-190 (1995).

when taking into account the differences between common law and continental law concerning the role of the courts, the last quoted passage of Coase can explain the codified law. A negligence rule in liability law is such a case.

On the assumption of positive transaction costs, Guido Calabresi carried Coase even further to argue that any law making or change necessarily involves not only efficiency, but also issues of distribution.[13] Coase would not totally deny this. He once said:

> In this article, the analysis has been confined, as is usual in this part of economics, to comparisons of the value of production, as measured by the market. But it is, of course, desirable that the choice among different social arrangements for the solution of economic problems should be carried out in broader terms than this and that the total effect of these arrangements in all spheres of life should be taken into account. As Frank H. Knight has so often emphasized, problems of welfare economics must ultimately dissolve into a study of aesthetics and morals.[14]

However, the comparative advantages of divisions in a legal system and a lack of criteria for determining distribution would limit Calabresi's claim.

III.

For Coase, it is ironic that the unintended Coase theorem casts

[13] Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 Yale L. J. 1211-1237 (1991).
[14] R. H. Coase, *supra* note 2, at 154.

doubt on the "externality" solution, while the intended transactional cost analysis on less careful hands unfortunately revives it. The rights *in rem* externality problem is one such example. Thomas Merrill and Henry Smith, in a paper entitled "Optimal Standardization in the Law of Property: The *Numerus Clausus* Principle",[15] claim that informational externalities result in the creation of new types of rights *in rem* because third parties and parties who trade in assets not subject to this type of right *in rem* would have to incur measurement costs to avoid infringing on others' rights or to clear titles, respectively. They argue that the *Numerus Clausus* as a form of Pigovian tax would internalize these measurement costs by increasing the frustration costs of the parties who create new types of rights *in rem*.

Coase has warned, however, in the second paragraph of the conclusion of "The Problem of Social Cost":

> A second feature of the usual treatment of the problems discussed in this article is that the analysis proceeds in terms of a comparison between a state of laissez faire and some kind of ideal world. This approach inevitably leads to a looseness of thought since the nature of the alternatives being compared is never clear. In a state of laissez faire, is there a monetary, a legal, or a political system, and if so, what are they? In an ideal world, would there be a monetary, a legal,

[15] Thomas W. Merrill and Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 Yale L. J. 1-70 (2000), in Robert Cooter and Francesco Parisi ed., Recent Developments in Law and Economics (I) 214-283 (2009)。The following critique of this paper is an extraction of Tze-Shiou Chien, The Problem of Right *in rem* externality, Academia Sinica Law Journal v.8, p.227-257 (2011/3) 簡資修，〈物權外部性問題〉，《中研院法學期刊》，8 期，頁 227-257（2011 年 3 月）。

> or a political system, and if so, what would they be? The answers to all these questions are shrouded in mystery and every man is free to draw whatever conclusions he likes. Actually, very little analysis is required to show that an ideal world is better than a state of laissez faire, unless the definitions of a state of laissez faire and an ideal world happen to be the same. But the whole discussion is largely irrelevant for questions of economic policy since, whatever we may have in mind as our ideal world, it is clear that we have not yet discovered how to get to it from where we are. A better approach would seem to be to start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one. In this way, conclusions for policy would have some relevance to the actual situation.[16]

As this quoted passage shows, the problem with the arguments made by Merrill and Smith is that they compare an ideal *Numerus Clausus* principle with a no-law world. The property rights regime arose to overcome the tragedy of commons. This is a process of internalization developed by institutions to reduce transaction costs, thus reducing "externalities". Systems of notification and protection of good faith transactions are such regimes, under which informational externalities become irrelevant. The burden borne by third parties to find out where the rights are would not increase because they would not be required to know exactly who the owners are—they would only need to know that

[16] R. H. Coase, *supra* note 2, at 154.

the property does not belong to them. The parties who trade with clear titles would also not have to incur higher costs to check because the law protects good faith transactions. No informational externality would exist! Furthermore, resources are usually not monopolized by one person, so why would people create an externality in one case and have to accept it in many other cases? Lastly, how can the legislator be imputed omniscience as assumed by the *Numerus Clausus* principle?

Merrill and Smith have further tried to take advantage of "Coaseanism"[17] to criticize Coase's concept of property rights. In a recent paper entitled "Making Coasean Property More Coasean",[18] they declared a "Coase corollary", which states that in a zero transactional cost world, the nature or scope of the property right would not make a difference in the value of social products. They claimed that due to the positive transaction costs existing in our world, the nature and scope of property rights have an effect on the value of social products. This is a logical inference. Merrill and Smith, however, without any empirical evidence, jumped to conclude that Coase's concept of property rights as "a bundle of rights" is not adequate and that their concept of property rights as a "power to control" is better. Coase would not agree.

The reason why Coase chose the concept of property rights as "a bundle of rights" is to demonstrate that intangible damages such as noise or other pollutions can be traded separately from ownership in the market.

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[17] *See* Robert C. Ellickson, The Case for Coase and Against "Coaseanism", 99 Yale L. J. 611 (1989).

[18] Merrill, Thomas W. and Smith, Henry E., Making Coasean Property More Coasean (February 9, 2011). Journal of Law and Economics, Forthcoming; Harvard Law and Economics Discussion Paper No. 688; Columbia Public Law Research Paper No. 11-262. Available at SSRN: http://ssrn.com/abstract=1758846

The image of "a bundle of rights" helps the understanding of the concept of the reciprocity of damages. By contrast, although the concept of property rights as a "power to control" would give a clear physical boundary, which would not be inconsistent with "a bundle of rights" concept and would therefore cost less to operate, the benefits forgone would be too great. Under the "power to control" concept, there would be no rights *in rem* without physical possession. In a modern society with advanced technology and urbanization, the "power to control" concept does not hold. Harold Demsetz says that this is the origin of property rights—in order to reduce rent dissipation when resources become more valuable, a more expensive but efficient institution would arise.[19]

At the beginning of the conclusion of "The Problem of Social Cost", Coase said:

> It is my belief that the failure of economists to reach correct conclusions about the treatment of harmful effects cannot be ascribed simply to a few slips in analysis. It stems from basic defects in the current approach to problems of welfare economics. What is needed is a change of approach. Analysis in terms of divergences between private and social products concentrates attention on particular deficiencies in the system and tends to nourish the belief that any measure which will remove the deficiency is necessarily desirable. It diverts attention from those other changes in the system which are inevitably associated with the corrective measure, changes which may well produce more harm than the original deficiency. In the preceding sections of this article, we have seen many examples

[19] Harold Demsetz, Toward a Theory of Property Rights, 57 Am. Econ. Rev. 347-59 (1967).

of this. But it is not necessary to approach the problem in this way. Economists who study problems of the firm habitually use an opportunity-cost approach and compare the receipts obtained from a given combination of factors with alternative business arrangements. It would seem desirable to use a similar approach when dealing with questions of economic policy and to compare the total product yielded by alternative social arrangements.[20]

[20] R. H. Coase, *supra* note 2, at 153-4.