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One of the giants

Ronald Coase, the economist who explained why firms exist, died on September 2nd, aged 102

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"I HAVE made no innovations in high theory," was how Ronald Coase modestly summed up his life's work. "My contribution to economics has been to urge the inclusion…of features of the economic system so obvious that…they have tended to be overlooked." Attention to the overlooked helped Mr Coase transform both law and economics.

Born in the London suburb of Willesden in 1910 to working-class parents, Mr Coase had an academic temperament and an interest in science but lacked a taste for mathematics, a flaw that might have kept him out of economics in later decades. He studied "commerce" at the London School of Economics (LSE), a course tailored to those destined for middle management ("a choice of occupation for which I was singularly ill-suited").

The degree included instruction in economics, and he quickly fell for the dismal science. A one-year travelling scholarship gave him the chance to apply what he had learned. He chose to tour America's industrial cities in the hope of answering a question that troubled him: why did companies exist?

Economists of the time were enthralled by the special magic of the price mechanism. In a free market prices should adjust to allocate resources where they are most valued. A certain price for wool, for example, encourages farmers to raise sheep and bring wool to market to meet consumer demand. As more is produced and demand is sated the price falls, discouraging farmers from wasting time and resources producing unwanted goods. Yet whereas some parts of the economy rely on prices to guide materials and labour to their best uses, others do not. Within firms tasks are doled out by fiat and strategies are set by the Politburo of the corporate board. Mr Coase wanted to know why.

As he watched American car plants in action, he realised that the existence of the firm compensated for a critical flaw in the price-setting mechanism. In the real world it is often costly for buyer and seller to arrive at a final price. "Transaction costs", like the need to negotiate or draw up contracts, prevent the price mechanism from working smoothly. Firms would exist, he reckoned, when it was cheaper and easier to co-ordinate activity within a centrally planned organisation than to spell out contract details for every step in the production process. Mr Coase first presented his proposition in a lecture in Dundee in 1932, at the tender age of 21. In 1937 he published “The Nature of the Firm”, an article based on the Dundee lecture.

An entire field of research would eventually be built on this paper, but it garnered scant attention at first. Mr Coase bounced around British academia in the 1930s and 1940s, from Dundee to Liverpool and back to the LSE, researching the workings of public utilities as he went. In 1951 he migrated to America and proved similarly itinerant, until an article on radio-spectrum property rights caught the eye of scholars at the University of Chicago.

In 1959 he was invited to Chicago to air his views. His audience included future Nobel prizewinners like George Stigler and Milton Friedman: confident, room-commanding men sceptical of Mr Coase’s conclusions. Over the course of a two-hour discussion the measured Mr Coase won them around. He was asked to write up his arguments and in 1961 produced “The Problem of Social Cost”, another landmark text. By 1964 Mr Coase was on the University of Chicago’s faculty.

His debates with the Chicago academics centred on market “externalities”: economic choices that impose social costs or benefits on others. Factory pollution may disturb or poison nearby residents, for example. Earlier generations of economists diagnosed a market failure that governments could set to rights. The polluting factory does not face any costs from spouting black smoke over a town: the costs are “external” from its perspective. A tax on pollution would internalise the cost, however. The price mechanism would work once more, as the tax encouraged the factory’s managers to reduce pollution to socially optimal levels.

Coase was clear

Mr Coase’s work suggested another answer. In the world of theory, without transaction costs, no government intervention would be needed to address externalities. The factory owners and the residents could work out side-payments on their own. Residents might pay the factory to emit less or the factory might pay the town for leeway to pollute more. Either way an efficient outcome should result without government help. This Panglossian view became known as the Coase Theorem. (Post-Soviet “shock therapists” who supported rapid privatisation in the belief that markets would reallocate resources handed to oligarchs were sometimes accused of “vulgar Coase-ism”.)

Yet Mr Coase himself recognised life is more complex than theory. Neither private bargaining nor a pollution tax can make a market perfectly efficient given transaction costs like the expense of monitoring a factory’s emissions. Mr Coase reckoned the law had a critical economic responsibility: to minimise the disruptive effect of these costs on markets. A system of clear and easily transferable property rights (in this case, the right to pollute) can play a role like that of the firm, allowing useful economic activity to take place that might otherwise be gummed up by the hassle of negotiating and enforcing contracts. His insight revolutionised policy. Tradable emissions permits, which helped eliminate acid rain as an environmental problem in America, are a direct application of his work.

Almost 70 years after that first Dundee lecture Mr Coase won the Nobel prize for economics. “A scholar must be content with the knowledge that what is false in what he says will soon be exposed,” he noted in his speech. “As for what is true, he can count on ultimately seeing it accepted, if only he lives long enough.”

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