Coase Encounters (Book Review)

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<u>Essays on Economics and Economists</u>, by Rondal H. Coase, Chicago: University of Chicago Press, 230 pages.

Are you looking for an economist who can really write and who has insight after insight on free markets versus government regulation? Would you like it even better if you could get some good laughs from his clever way of putting things? Then Ronald H. Coase's Essays on Economics and Economists is the book for you.

One of the book's best articles is "The Market for Goods and the Market for Ideas." Presented originally in December 1973 at the American Economics Association meetings, it made many intellectuals squirm. In it, Coase notes that intellectuals tend to think government regulation of economic markets improves matters. When it comes to regulating the market for ideas, however, most intellectuals are positive that the government is utterly incompetent. Coase sticks the knife into this inconsistency, and, page by page, cleverly turns it. He points out that, while the press is often quite willing to accept and capitalize on stolen documents (as was the case with the New York Times publication of the "Pentagon papers" in 1971), it castigates others for stealing them. At the time of his speech, the Watergate burglary--an attempt to steal documents--was bringing down Richard Nixon. Quips Coase: "It is hard for me to believe that the main thing wrong with the Watergate affair was that it was not organized by The New York Times."

One of my other favorites is "Economics and Public Policy," based on a speech Coase gave in 1974 at UCLA. I remember the speech; I saw him give it. And it reads as well as I remember it. Coase's main message is that what economists have to say that "is important and true is quite simple--so simple indeed that little or no economics is required to understand it." But what is discouraging is that these simple truths are commonly ignored in economic policy discussions. One such insight is that if the government fixes a price below the market price, it will cause a shortage because at that lower price consumers will want to buy more and producers will want to supply less.

In the early 1970s, Nixon's price controls on gasoline were causing shortages, long lines, and violence. Coase tells of his colleague at the University of Chicago Law School, Edmund Kitch, giving a speech in Washington explaining how price controls were causing a shortage of natural gas. The audience was a typical Washington audience: Washington journalists, staff members of congressional committees, and so on. They showed little interest in Kitch's findings, says Coase, but much interest in who financed the study. Many assumed that it had been financed by the natural gas industry, which was not the case.

Coase writes, "A large part of the audience seemed to live in a simple world in which anyone who thought prices should rise was pro-industry and anyone who wanted prices to be reduced was pro-consumer. I could have explained that the essentials of Kitch's argument had been put forward earlier by Adam Smith--but most of the audience would have assumed that he was someone else in the pay of the American Gas Association."

Who is this guy? Few people outside the economics profession had heard of Coase before he won the Nobel Prize in economics in 1991. But he had a major impact on economics with just two articles, one published in 1937, the other in 1960. In the book's first essay, a reprint of the lecture he gave in accepting the Nobel Prize, Coase explains the significance of the two articles. The 1937 piece, "The Nature of the Firm," was probably the first attempt by an economist to explain why there are firms rather than just autonomous individuals exchanging things. Within firms, he pointed out, the price system--free markets--is rarely used. Coase asserted that firms arise as a way of economizing on the inevitable transaction costs of the price system. Competition ensures that we get the optimal combination of firms and arm's-length market transactions. Coase notes that he had presented the essentials of his 1937 article in a 1932 lecture when he was 21. "It is a strange experience to be praised in my 80s for work I did in my 20s," says Coase.

His other major article was "The Problem of Social Cost" (1960). In it, Coase shows that if property rights were complete and if transaction costs were zero, then problems like pollution would be solved. How so? If the people hurt by the pollution had the right not to be polluted, they could either stop the pollution or sell their right to the person who wanted to pollute. If those suffering from pollution valued not being polluted more than the polluter valued being able to pollute, then the polluter would not be willing to pay enough to pollute and the pollution would cease. If, on the other hand, the person polluting had the right to pollute but valued being able to pollute less than the victims valued being free of pollution, then the victims would be willing to pay enough to get the polluter to stop. Notice something interesting: Whether the pollution occurs does not depend on who has the right. Irrespective of who has the right, the entity that values the right most dominates. The outcome is efficient. The insight was so stunning at the time that George Stigler, Coase's colleague at the University of Chicago, labeled it the "Coase Theorem."

In the same Nobel Prize lecture, Coast outlines the significance of his theorem. He stresses that he is not claiming that transaction costs are zero. Rather, he is saying that if they were zero, there would be no problem; if they are positive, then we have to examine whether government or free markets would do a better job of solving pollution and other problems. The tendency before his article had been to assume that transactions are costly in free markets but that somehow the government could arrange things more efficiently.

A gentle man, Coase is also quite willing to take on some of the giants of economics when he disagrees with them. In one essay, "How Should Economists Choose?," Coase criticizes a famous 1953 article on methodology by Milton Friedman. Friedman had argued that the correctness of one's assumptions is unimportant and that all that matters for an economic theory is that it be capable of accurate predictions. Coase responds with a devastating counterexample.

"We could have predicted," writes Coase, "over the last few years what the American government's policies on oil and natural gas would be if we had assumed that the aim of the American government was to increase the power and income of the OPEC countries and to reduce the standard of living in the United States. But I am sure that we would prefer a theory that explains why the American government, which presumably did not want to bring about these results, was led to adopt policies which harmed American interests. Testable predictions are not all that matters. And realism in our assumptions is needed if our theories are ever to help us understand why the system works the way it does. Realism in assumptions forces us to analyze the world that exists, not some imaginary world that does not."

Or consider how he takes on Austrian-school economist Joseph Schumpeter in an essay on Adam Smith's Wealth of Nations. "Schumpeter," comments Coase, "acknowledges Smith's skill in rather grudging terms: `He disliked whatever went beyond common sense. He never moved above the heads of even the dullest readers. He led them on gently, encouraging them by trivialities and homely observations, making them feel comfortable all along.' What Schumpeter means is the Wealth of Nations can be read with pleasure. It is clear, amusing, and persuasive. Adam Smith's style is, of course, very different than that of most modern economists, who are either incapable of writing simple English or have decided that they have more to gain by concealment."

My favorite part of Coase's Essays is the essays on economics. I found the essays on famous economists making up the book's second half less interesting. Of the latter, the most captivating pieces include an essay on George Stigler, written before Stigler died in 1991, and an essay on the London School of Economics in the 1930s. The piece on the LSE points out what was known at the time, and mainly forgotten now, namely that young economist F.A. Hayek was a major player at the school in the 1930s.

Coase also writes at length on Alfred Marshall, arguably the greatest economist of the late 19th century. The essay's best moment comes when Coase quotes from a letter Marshall wrote to a student about how mathematics should be used in economics: "(1) Use mathematics as a shorthand language, rather than as an engine of inquiry. (2) Keep to them till you have done. (3) Translate into English. (4) Then illustrate by examples that are important in real life. (5) Burn the mathematics. (6) If you can't succeed in (4), burn (3). This last I did often."