Review of R.H. Coase
The Firm, the Market and the Law

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Economic analysis of law, which uses economics to analyze and explain legal doctrines, may well be the most important innovation in legal scholarship in the past fifty years. Ronald Coase is the economist most responsible for this innovation. His essay, "The Problem of Social Cost," which first appeared in the Journal of Law & Economics nearly thirty years ago, is the single most influential paper in the brief history of law and economics. This paper together with Coase's famous papers on the firm and marginal cost pricing are the core essays in The Firm, the Market and the Law. The volume also includes an introductory essay, a paper that responds to the criticisms made of the social cost paper, a paper on the provision of lighthouse services in England, and an article surveying the field of industrial organization in 1972 and proposing areas of research.

That "The Problem of Social Cost" became the principal building block for economic analysis of law is one of the ironies of legal scholarship. Coase did not intend it so. Coase had little interest in educating lawyers about economics (in contrast to his predecessor at the law school, Aaron Director) or in using economics to illuminate legal doctrines. Coase wrote for other economists. He hoped to persuade them to change the way they approached traditional subject matter areas of economics such as social cost, the firm and markets. Thus, the term "the Law" in the title of this volume does not refer to economic analysis of law. Rather, it refers to the study of how laws and legal institutions constrain and influence economic behavior and how the failure by economists to examine these constraints systematically leads to faulty policy conclusions. A good example is the lighthouse. Economists commonly use the lighthouse to illustrate the proposition that charging a fee for a service that has important public goods aspects (i.e., A's use of the service does not prevent B from also using it) is incompatible with economic efficiency. Private provision would yield too small an output and so the service should be provided by the government and financed from general taxation. In the essay "The Lighthouse in Economics," Coase points out that economists have reached this policy conclusion without ever studying the relevant legal constraints that governed the actual operation of lighthouses. Coase showed that lighthouse services in England were provided by private organizations, that tolls, which varied with the size of ships and the number of lighthouses passed, were collected from ships that docked at British ports, and that the system was better adapted to the needs of shipowners than a tax supported system would have been.

"The Problem of Social Cost" is best known for the Coase Theorem. Although Coase did not originate the term "The Coase Theorem," he defines it in the essay "Notes on the Problem of Social Cost," which was written for this volume, as "...with zero transaction costs, the value of production would be maximized." A more familiar definition in law and economics is that the efficient allocation of resources is unaffected by the assignment of property rights or liability rules, provided transaction costs are zero. Suppose locomotives emit sparks that damage the farmer's crops and the only way to reduce the amount of crop damage is by running fewer trains. If the railroad is liable for damage to the farmer's crops, crop damage becomes a cost to the railroad, so it will run the number of trains that maximizes the joint value of the two enterprises. Prior to Coase, economists believed that in
the absence of liability, the railroad would run too many trains. Although the railroad's profits would be higher, the joint value of railroading and farming would be lower because of greater losses to the farmer. Coase showed that this view was wrong. In the absence of transaction costs, the farmer would offer to pay the railroad to reduce the number of trains. Negotiations would continue until the same number of trains were run as in the case of railroad liability for crop damage.

In the real world, transaction costs are not zero. It is costly to acquire information on the attributes of products to be exchanged, to bargain over the terms of exchange and to write and enforce contracts. Sometimes these costs are so large relative to the gains from exchange that no transaction takes place. Then the initial assignment of rights will be the final assignment. Positive transaction costs occupy a central place in Coase's article on social cost although economists have focused mainly on the Coase Theorem and the zero transaction cost world. In contrast, transaction costs play a central role in economic analysis of law in two ways.

1. When transaction costs are small, legal rules should encourage parties to engage in voluntary or market transactions. For example, if A desires to park his car in B's garage, B should be able to enjoin A's activity; this will encourage A to negotiate with B to rent his garage. If the negotiation succeeds, this means the garage is more valuable to A. If it fails, this means it is more valuable to B. Granting a property right to B yields the value-maximizing outcome and is preferable to a rule that allows A to park in B's garage but holds A liable for damages, because a market transaction is less costly than adjudicating the dispute in the legal system. To take another example, rules for breach of contract will promote efficiency if they reproduce what the parties would have agreed to had they considered the various contingencies at the time the contract was signed. It would be futile and wasteful of resources for contract law to impose a different solution; the parties will simply contract around the law and there will be fewer value maximizing transactions. Thus, contract law that follows the parties' intentions saves transaction costs and promotes economic efficiency.

2. When market transaction costs are prohibitive, liability rules play a crucial role in allocating damages and creating incentives for efficient behavior. This is the focus of economic analysis of tort law. Suppose it is too costly for the railroad and the farmer to transact because there are too many potential parties to deal with and there are serious free rider or hold-out problems. Or, in the case of automobile accidents, assume it is prohibitively costly for all drivers and pedestrians to agree in advance on levels of care. More generally, if A harms B and transaction costs are prohibitive, legal rules matter and liability rules are preferable to property rights. Liability rules allow "transactions" to take place, but shift them to the legal system because the cost of market transactions is prohibitive. Under a system of liability rules, the driver does not (and can't) negotiate with a pedestrian to acquire the right to run him down, but if the driver is negligent, he will be liable for the victim's injury. The efficient liability rule depends on the costs and benefits of accident prevention and the costs of using the legal system. For example, if the least costly way to avoid an accident is for the victim to alter its activity level, the efficient liability rule is one of no liability. This encourages the victim to alter its activity and saves the costs of using the legal system. On the other hand, if there are significant benefits when both parties take care, a negligence rule is likely to be more efficient.

The importance of the Coase Theorem to economic analysis of law is that it provides a framework for examining legal rules in the context of both low
and high transaction cost settings. The best way to explain legal rules in the
former case is to view them as devices
that shift transactions into the market
and away from more costly legal pro-
cedings or, in the case of disputes aris-
ing out of contracts, to economize on
the costs of contracting. In the high
transaction cost setting, the market is
no longer a cost-justified alternative.
In this setting, common law rules of
liability are best explained as efforts by
judges to fashion rules that promote
efficient allocation of resources—i.e.,
to create incentives for outcomes that
correspond roughly to that of a zero
transaction cost world. The economic
analyst does more than develop
abstract models. He treats cases and
legal doctrines as data to be explained
by systematic application of economic
analysis. The success of economic
analysis of law lies in the fact that it
appears to explain the “data” better
than ad hoc explanations or competing
theories.

Whether Coase was successful in
altering the way economists think
about traditional economic problems
is debatable. Coase is not optimistic on
this point. In his introductory essay, he
states that “My point of view has not
in general commanded assent, nor has
my argument, for the most part, been
understood.” Even a cursory glance at
the leading economic journals will
bear out the first half of this assertion.
Economists study firms as abstract
entities that transform inputs into out-
puts or engage in game theoretic stra-
tegies to impose costs on their rivals.
Markets are analyzed as “shadowy fig-
ures” that facilitate exchanges. This is
not the economic world that Coase
inhabits. His consists of real firms
where the cost of market transaction
determine the boundaries between
activities carried on within and outside
the firm, and where markets require
formal and informal rules that depend
on the nature of the goods transacted
to facilitate and expand the volume of
exchanges.

I do not mean to suggest that Coase
has not influenced economists. By one
objective measure—the citations of
one’s work in the work of others—
Coase has had a spectacular influence.
His articles on the firm, monopoly of
durable goods (not included in this vol-
"me), and social cost are among the
most widely cited articles in econom-
ic. What troubles Coase is that he has
not influenced economists in the way
he would have liked. For the most part,
the articles citing Coase are indistingui-
shable from other articles in econ-
omics. These articles develop formal
economic models and work out mathe-
atical solutions to abstract problems
but have little to say about the actual
behavior of firms and markets.