



School of Business

“The Present State of Economics”
by Professor Ronald Coase
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WINCOTT VISITORS' SERIES

Professor Ronald Coase

Vice Chancellor, Ladies and Gentlemen,

It is a great privilege to welcome Professor Ronald Coase to Buckingham today. The Schools of Law and of Business comprise a rapidly developing part of the University of Buckingham and it seems entirely natural, therefore, that we should honour the work of Professor Coase. For the intellectual contributions which he has made, and for which he was awarded the Nobel Prize for Economic Science in 1991, concern areas of mutual interest to students of business and the law. He has taught economics at Universities in Britain and, after 1951, in the United States, but he is a rarity among economists in finding a congenial home in a Law School - at the University of Chicago - in 1964. There he became a distinguished editor of The Journal of Law and Economics which has become one of the highest ranked economics journals in the world.

It was as a student of Sir Arnold Plant at the London School of Economics in the early 1930s that a young Ronald Coase first became interested in business structure. At that time no satisfactory explanation for differences in structure between business firms existed. He received a scholarship to travel to the United States to study this problem and there he formulated a general approach to the answer which was to have wide ranging influence. In essence, he argued, there are costs associated with transacting and the organisations that we observe are structured to economise on these transactions costs. Later, he was to extend the scope of this insight by proposing that the institutions of the law played an important part in determining transactions costs and hence the allocation of economic resources. Governments too, through their regulatory systems could influence the possibilities for trade by suppressing or creating property rights in resources and by limiting or facilitating their exchangeability.

Over a period of more than fifty years, therefore, Professor Coase has had a profound influence on the way economists think about business organisation, the legal framework and the role of government. His work forms a foundation for what is now sometimes called the New Institutional Economics; it led directly to the establishment of the sub-discipline of Legal Economics - an area of study regrettably more advanced in the United States of America than it is here; and it informs much of the current debate over government regulation in both the economic and social spheres.

Indeed we live in an age in which Coasian questions have become increasingly prominent in academic debate and important in policy formulation. When business gurus investigate what forces lead some enterprises to success and others to failure they will often have been influenced by Coasian reasoning without perhaps recognising their intellectual debt. When economists investigate the relative performance of economies such as Japan and Germany compared with the United States or Britain, they are now likely to pay attention to institutional and transactional considerations rather than the merely technological ones which dominated discussion until fairly recently. When governments consider how the public utilities should be structured - whether they should be permitted to integrate vertically or whether electricity generator should be kept at arm's length from distributor, gas producer from transporter, train operator from track authority, - they are wrestling with the original Coasian dilemma of the appropriate scope of market contract against internal organisation.

Recognition of the importance of Professor Coase's work developed gradually over time. Among the other factors which mark him out as a special case is his distrust of 'blackboard economics' and his rejection of the more rarefied technical and purely mathematical approaches to the discipline. He writes with great clarity using basic economic concepts to make sense of his observations of the world. Unlike the work of many other economists, articles by Ronald Coase seem to become more enlightening the more they are read. Indeed, I have more than my own subjective judgement to call as evidence for this point. A recent study (in 1993) of the influence of economics on law in the United States by William Landes and Richard Posner which attempted to measure the rate at which articles depreciated in their influence over time was forced to conclude that "Coase's citations follow an atypical pattern. .. A human capital regression on Coase alone has the wrong signs - ..indicating that his work may be appreciating rather than depreciating".

Ladies and gentlemen we welcome Professor Coase here today to mark the award of an honorary degree and pay tribute to his great contributions to economics or, as some of my profession might prefer to express it, to his extraordinary ability to confound the econometricians with the wrong signs on the coefficients of his human capital regression equations. I can think of no-one better qualified to address us today on the state of economics.

The Present State of Economics

by Professor Ronald Coase

To have this opportunity of visiting the University of Buckingham is a very happy occasion for me. I was one of the early supporters of the proposal for establishing in Britain an Independent University, as we called it when the idea was first mooted. I remember Ralph Harris bringing me out to Buckingham to see the site. I saw a field in which gypsies were camping and was pessimistic about the future. Ralph Harris ignored the gypsies and saw a University and he was right. Now that I have come here and have seen the transformation that has taken place, I am amazed - and also mortified because I did not see what others did. But economists are notoriously bad as predictors. What has been accomplished here is an extraordinary achievement and we know that the story has only just begun for the University of Buckingham, set, as it is, in this green and pleasant land. We cannot foresee the future but we can await it with confidence.

When Professor Ricketts broached with me the question of the topic for my talk, I suggested "The Present State of Economics", which seems to have satisfied him, and certainly did me. As no-one would expect me to discuss all aspects of economics in a short talk, I was left free to discuss whatever took my fancy. I should explain that I will largely be concerned with what is happening in the United States. But given that the United States is now the premier country in economics, just as England was in the 1930's, this is not much of a limitation. Of course, what I will be giving you, and I emphasize this, is a very personal view and it is by no means shared by the majority of economists in the United States or elsewhere, many of whom are hostile or at the best, indifferent. I will, of course, be dealing with those parts of economics in which I am particularly interested and in the development of which I have played a part.

I believe that economics as a subject is about to change radically. I say this with some confidence since the changes I have in mind are already beginning to occur. Let us first consider what it is that in my opinion is going to change. Adam Smith in *The Wealth of Nations* gave economics its shape.

What he discussed, we discuss. But as well as giving us our subject, he also gave us our way of looking at the working of the economic system. He argued that the productivity of the system depended on the division of labor, or specialization as we would say. Adam Smith told us that in his day to be able to have even a very modest standard of living required the cooperation of thousands in many different trades in different places. Of course, to enjoy our present standard of living involves the cooperation of millions in all corners of the world. How is this cooperation to be secured and maintained? And how is this to be done in such a way as to make sure that resources are employed in the most valuable way? Adam Smith's answer was that the actions of all the participants in production in the economic system are coordinated through the operation of the pricing system, the invisible hand, and that this operates in such a way as to maximize the value of production. Anyone with any acquaintance with economics knows how the argument is presented in the textbooks. Producers decide how much to supply of their products and on how they are to be made, taking into account the prices at which they can sell the products and on what has to be paid for the resources used to produce it. Consumers, in deciding what to buy, take into account the prices at which the products are sold. The interaction of the activities of producers and of consumers results in resources being used, so it is claimed, to produce those goods and services that consumers value most highly. Economists, and this includes some of the best minds in the profession, have devoted themselves, over the last 200 years and particularly in recent years, to formalizing this proposition of Adam Smith and they have tried to uncover the conditions necessary to produce his result. And where these conditions did not exist, they spoke about "market failure" and gave the function of correcting the situation to the government, without giving much thought to another part of Adam Smith's work and considering the possibility that there might be "government failure". The result of this process of formalizing has been to produce an economic analysis that is highly abstract. One consequence is that many economists seem to live in this abstract world. If they can think it, it can be done. And this has encouraged economists to consider the role of government, as I have indicated, to be to put things right whenever the invisible hand did not do its job. All this is beginning to change. For one thing, economics is becoming an empirical science. One group of studies has involved investigating the

results of government regulation in the United States, a large number of which was published in the *Journal of Law and Economics* while I was editor, studies that were often initiated or at any rate encouraged by me. The result of such studies was to suggest that such regulation was commonly ineffective, in that it left the situation essentially unchanged or where it made a difference, that this was often to make things worse, in that prices were higher and the product less well adapted to the wants of consumers than would have been the case without regulation. As a result, it has become difficult to ignore the existence of "government failure" when discussing economic policy and in fact these studies played their part in the recent and continuing deregulation movement in the United States. However, most of the empirical work in economics carried out in the United States, of which there has been a vast amount, has, of course, been concerned with other matters. The National Bureau of Economic Research, which has long been involved in empirical research, conducts extensive research, usually quantitative in character, and work of this character is being undertaken in many universities and research centers throughout the United States. Most, however, of this research has been concerned with the measurement of the magnitudes of relationships, the general nature of which were already known, and has commonly concentrated on what are essentially price relationships, which are, of course, central to mainstream economic theory. A recent example of such studies relates to the effect on government revenues of changes in rates of taxation. Such research does not change our vision of the way the economic system works. Its consequence is that we see the same things but we see them more clearly. Valuable though this may be, I do not think that this is all that is required.

I will now speak of the change that I think is required in the way we analyze that part of economics in which I am particularly interested. The first effects are already being seen in the theory of industrial organization but I think they will ultimately affect all of microeconomics and even, I believe, that part of economics on which I have never worked, macroeconomics. I have spoken of the abstract character of modern economic theory and of its concentration on price relationships. This has led to a situation similar to what it would be if the circulation of the blood was studied without a body. This way of thinking has been strengthened as a result of the general

acceptance of Lionel Robbins' definition of economics as expressed in his book, The Nature and Significance of Economic Science. I would not wish to continue without first saying that Robbins was my chief in the economics department at the London School of Economics for many years, that he was a wonderful human being and it is always a matter of regret for me when I feel obliged to disagree with his views. Robbins' definition of economics is this: "Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternative uses." Notice what this makes economics. It is the study of a relationship. Robbins' view of economics is often rephrased by saying that economics is the science of human choice. Robbins' view of economics has turned microeconomics into a kind of logic, by means of which economists are able to deduce what prices and output will be given certain basic assumptions concerning human behaviour and the world. It is an approach that discourages empirical research since the basic assumptions can hardly be questioned. The version of this approach that makes economics the science of human choice, although it also uses the Robbinsian analytical system, results in a greater emphasis being laid on techniques of analysis since economists who think in this way have a great need of methods that can be used to analyze all human choices. For this kind of work, the very generality of economic theory resulting from its abstract character becomes an advantage. Such a view of the task of an economist does not discourage empirical work - indeed in many ways it encourages it - but not having a well-defined subject, the empirical work lacks focus.

All this is very different from my notion of what economics should be. I believe that there is an economic system, that it is within this system that people earn their incomes and spend them and that its performance is determined by the character of the institutions that make up the system, institutions whose influence is largely absent from mainstream economic theory. To me, what we should study is something very real whose operations we can observe - in microeconomics, the operation of firms and markets. Of course these words appear in the textbooks but there is very little examination of how these institutions actually operate or how they come to be created. Their behaviour is deduced rather than observed. It is, I think, this belief in the importance of the institutional structure and the need to

study it that distinguishes the view I espouse from those held by most contemporary economists. But if views similar to mine are held by only a minority of economists in the United States and, I believe, elsewhere, it is a minority that is increasing rapidly (as I have learnt from my correspondence and from other sources) and much interesting work is now being done in the United States but also in countries all over the world. At the same time it is worth nothing that by and large this work is not being done in economics departments but in Business Schools and Law Schools. I was asked about this during the question and answer period after my Nobel Prize lecture in Stockholm. I answered that it seemed probable that like theology departments, economics departments would continue to exist but that the interesting scientific work would take place elsewhere.

How I came to have this view is a curious story which itself throws some light on the present state of economics. In the beginning of 1931, as a student at LSE studying for the B. Com, I attended Arnold Plant's seminar. I was a Socialist at the time and what Plant told us was a revelation. He introduced us to Adam Smith's invisible hand. He explained how the economic system can be coordinated by the pricing mechanism and how a competitive system leads to the production of the goods and services that consumers value most highly. All this was very exciting to me. But I also attended Plant's lectures on Business Administration and there he explained how management coordinated the use of factors of production within the firm. As a student, this presented me with a puzzle. If the pricing mechanism could provide all the coordination needed, why did we need management? Or, put the other way round, if management was able to provide all the coordination, why do we have to rely on the pricing system? At that time, this question presented itself to us in a very concrete form. The Russian Revolution had taken place only a few years before, in 1917, and had been followed by civil war and social upheavals, so that the communist system had only just settled down when I went to LSE in 1929. The first five-year plan was not promulgated in Russia until 1928. We really had no idea of how a communist system would actually operate. Lenin had said that the Russian economy would be run as one big factory. Many western economists maintained that this was impossible. Yet, some of the factories in the west were extremely large. Why couldn't the Russian economy be run as one big

factory. There was, after all, the undeniable fact that in the West, the employment of factors of production was often determined by administrative decisions as within a firm, which is, in effect a little planned economy. Why wasn't the pricing system used or the market as we would say today, and if, as, in fact, we observe, both methods of coordination were used, what determined which means of coordination was employed in any particular case?

I then had a great stroke of luck. I was awarded a Sir Ernest Cassel Travelling Scholarship, mainly I assume due to Plant's influence, and I set out for the United States in 1931, aged 20, to find the answer to these puzzles. I soon found that academic economists had little to offer me - they had difficulty in understanding what my problem was. So I spent most of my time visiting businesses and factories. The businessmen were not, of course, interested in my general problem - but they were interested in the question of whether to make or buy something needed in their business, the problem, that is, of whether to undertake the production within their own organization (their little planned economy) or to use the market. Out of my discussions with these businessmen and my own pondering over the problem, by the Summer of 1932, I felt that I had found the answer. What had not been taken into account in our thinking was that there were costs of using the pricing system (or the market as we would tend to say today). These costs had not been included in the economists' analytical system (and, to a large extent, still are not). They have come to be known as "transaction costs". I have described them in the following words: "In order to carry out a market transaction, it is necessary to discover who it is that one wishes to deal with and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed and so on." I added that these "operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost." Recent studies have confirmed this. It has been estimated that transaction costs represent more than 40% of all costs. Whether the allocation of resources would be made administratively within the firm or through market transactions depended on whether management costs were greater or less than the transaction costs that would be incurred in

using the market - and when they were greater, this set a limit to the size of the firm. Since even the largest firms in a western economy were very small relatively to the size of the economy of which they were a part, this suggested that to attempt to organize the economy as if it were one large factory without recourse to the market would result in a failure to use the resource of the country in the most productive way. In a competitive free enterprise system, there is an optimum amount of economic planning (and we know that this results in widely diffused planning).

When I came back to Britain in 1932, I had another piece of luck. 1932 was the worst year of the Great Depression. I obtained a position as Assistant Lecturer at the Dundee School of Economics. In my first lecture in a course on "The Organization of the Business Unit" in October, 1932, I presented the approach to the problem that I have just outlined to you. It was essentially the argument that was to be published as "The Nature of the Firm" in 1937. I know that this was so because I gave a detailed account of my 1932 lecture in a letter I sent at the time to my friend, Ronald Fowler, a letter that he, a careful as well as an able man, had preserved. The ideas in my 1932 lecture became one of the major reasons why I was awarded the Nobel Memorial Prize in Economics in 1991. One might be inclined to think that the reason this public recognition took 50 or 60 years was that the Prize in Economics was not created until 1969. But this would be wrong - and it is the real reason for the lack of appreciation of the worth of this article that throws light on the present state of economics. "The Nature of the Firm" when it first appeared in 1937, was, apart from my friends, received with complete indifference. It wasn't that it was considered to be wrong but that it seemed to have no importance for economics, just as knowing that Adam Smith liked strawberries, though true and not without interest, does not add to our understanding of *The Wealth of Nations*. The article may have explained why there are firms but what happened within firms was not a concern of most economists. A firm was an organization that bought inputs and sold outputs and it was the markets for inputs and outputs that it was the task of economists to analyze. What happened in between was not part of economics even though most resources used in a western economy are employed within firms. The publication of "The Problem of Social Cost" in 1960 had a different result. It excited great interest and inspired an immense literature. But what

brought this about was Stigler's formulation of the Coase Theorem, the criticism of Pigou's analysis, the use of legal cases to illustrate the argument, and its emphasis on the role of the legal system in affecting the performance of the economy but there was no general appreciation of the significance of transaction costs for the structure of economic theory. It was not until the 1970's and still more, the 1980's that it began to be seen, largely as a result of the writings of economists like Williamson, Demsetz and Cheung that the ideas in these articles, "The Nature of the Firm" and particularly "The Problem of Social Cost," were going to change economic theory. At least this was the opinion of this small but growing minority to which I have referred.

As a result of the publication of "The Problem of Social Cost" and the work that followed, what happened is that there has been a change in the way that we think about transaction costs. In "The Nature of the Firm", I used this concept to explain why firms or organizations exist. The problem was posed in the following way: given the level of transaction costs, what organizations would emerge because management costs were less than transaction costs. After "The Problem of Social Cost" and the work of Williamson, Demsetz, Cheung and others, we no longer thought of transaction costs as a given factor but we considered these organizations and other institutions, above all the legal system, as positive factors determining the level of transaction costs. The firm by taking within itself those transactions for which transaction costs would be high, lowered the costs of transacting on the market and this process was greatly facilitated by a structure of firms transacting with each other. The legal system, through the way it defined property rights and the legal requirements for the transference of these rights clearly had an enormous effect on transaction costs. People began to realize that markets, the *raison d'être* of which was to reduce transaction costs, were creations except for extremely primitive markets. Looked at in this way, Adam Smith's doctrine of the division of labor came alive. As I said earlier, Adam Smith argued that the productivity of an economic system depends on specialization. But specialization is only possible if there is exchange and a highly specialized market economy such as those found in a western economy requires a most elaborate system of exchanges. High transaction costs would make this impossible. But for transaction costs to be low, sufficiently low to make exchange profitable, it is necessary to have the

right organizations, the right laws and legal system and people who know how to operate in a market system. What we need to do is to pay less attention to the invisible hand and more attention to the visible hand.

If we wish to uncover the factors determining economic growth, it is the institutional structure that we should study. In fact, research on contracts, on the activities of firms, on the relations between firms through contracts and outside contract and on the new subject of law and economics is now going on apace in the United States, in Europe and elsewhere. But we remain appallingly ignorant and there is a vast amount of work that needs to be done.

Nonetheless, I have high hopes for this new subject, which, like a new University, will be able to move forward, unencumbered by the cobwebs of ancient lore, I feel confident about the future of the New Institutional Economics just as I do about the future of the University of Buckingham. And now that the University has thought me worthy of receiving an honorary doctorate, as a graduate of the University, I will be able to share your pride in its accomplishments.