RONALD COASE'S VIEWS ON THE CONDUCT OF ECONOMICS

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Introduction

I am delighted to welcome you here today to celebrate the life and works of Ronald Coase, one of the most influential thinkers in economics. I can summarize the essence of his ideas about the conduct of economics, and of research in general, in three words: realism, institutions, and alternatives. I'll explain as I go along what I mean.

Realism

Ronald Coase would often say that if Darwin were to come back to earth today, he would be amazed at how much biology has progressed since *The Origin of Species*. Whereas if Adam Smith came back today and looked at economics, he would be amazed at how little has changed since he wrote the *Wealth of Nations*. Coase believed that the kind of progress that biology had made in explaining and interpreting the world around us should be the goal for economics. The task of economists should be to discover and understand the workings of the economic system: consumers, firms, and institutions. But economists, he said, aren't studying real economic systems. Rather, Coase argued, the entities whose decisions economists are analyzing have no real substance. We are not looking at consumers as human beings, but as a consistent set of preferences. We are not looking at firms as organizations of people making decisions, but at black boxes consisting of cost curves and demand curves. On top of that, when we look at markets, we do not look at the institutions that govern exchanges and affect transaction costs, such as laws and contracts. So what have we got? According to Coase, we have "consumers without humanity, firms without organization, and exchange without markets."

Coase was particularly critical of what he termed "blackboard economics." In blackboard economics, the teacher moves around the factors of production, imposes taxes, grants subsidies, changes prices, and achieves a social optimum, but it all happens on the blackboard.[1] Blackboard economics is misleading because there is no counterpart to the teacher in the real world to create that social optimum, and it ignores market failures, government failures, and the messy role of institutions. To Coase, blackboard economics was a system which lived in the minds of economists, but not on earth, and so had little relevance for policies and practice.

Coase further argued that economists were too enamored of technique. To Coase, technique should not be an end in itself. Technique was of interest only as a tool of analysis, a way of achieving the main goal of understanding the real world. He further argued that economists should be more eclectic in their choice of techniques, rather than focusing mainly on econometrics.

Coase's arguments about theory are probably the most controversial part of his views on methodology. Coase's 1982 lecture, "How Should Economists Choose," led Richard Posner to accuse him of being anti-theory.[2] In that lecture, Coase challenged Milton Friedman's view that the test of a good theory is how well it predicts. Based on his readings as editor of the *Journal of Law and Economics*, Coase maintained that economists were not actually testing rival theories against one another to see how well they predict. Instead, most economists were searching for the statistical results that best fit their theories. They were usually successful, since, as he put it, "If you torture the data enough, nature will always confess." In those rare cases where the statistical results failed to support the theory, then economists didn't usually reject the theory; instead they called for further study.

Now, Coase may have gone overboard in his critique of analytical rigor in economics. Sam Peltzman, for example, in a 2011 article pointed out that by pretending to be a positive science economics gains useful rigor.[3] However, Peltzman, and I think many of us, can be sympathetic with Coase's point of view that economics has overemphasized theory and technique at the expense of better empirical work.

Coase argued that the goal should be to formulate economic theories that are helpful. As he said, "A theory also serves as a base for thinking. It helps us to understand what is going on by enabling us to organize our thoughts" (1994). And he went on to emphasize realism and institutions when he said, "Generalizations are not likely to be helpful unless they are derived from studies of how such activities are actually carried out within different institutional frameworks."

Coase also called for realism in case studies, as famously evidenced in his 1974 paper, *The Lighthouse in Economics* .[4] In that paper, he took to task a number of economists, ranging from John Stuart Mill to Paul Samuelson, for their use of the lighthouse as a classic example of a public good. Economists had argued that since the lighthouse saves lives and money, and since there is no way to prevent free riders because ships that move along the coast benefit from the light even if they have not paid for it, the lighthouse must be publically provided.

Coase studied the history of the lighthouse in the United Kingdom and discovered there was a period when many lighthouses were built and maintained by tolls levied on the ships that came into port, and earned enough money to be able to support private lighthouses. For instance, he found that private organizations built and operated most lighthouses in 1820. Most important to Coase was not the lighthouse per se, but the fact that, "Despite the extensive use of the lighthouse example… no economist, to my knowledge, has ever made a comprehensive study of lighthouse finance and administration… The lighthouse is simply plucked out of the air to serve as an illustration."

Coase was very critical of this approach to economics and called on us to use realistic cases. In doing so, he was not aiming for description for its own sake, but rather to help us understand the important choices and their outcomes.

Institutions

As is already evident from my earlier remarks, institutions were a second central focus for Coase. As he argued, "It makes little sense for economists to discuss the process of exchange without specifying the institutional setting within which the exchange takes place since this affects the incentives to produce and the costs of transacting." [5] And what could be more critical to exchange than the incentives and the costs?

In fact, Coase defined economics as the study of "the social institutions which bind the economic system together."[6] He called on economists to understand the internal operation and decisions of firms, as well as decisions about firm boundaries, the process of contracting, the laws that affect the workings of markets, the costs of government action and the results, and so forth.

Alternatives

The third word summarizing Coase's views, if you remember, was "alternatives." Coase argued that we should analyze alternatives, and I can clarify what he meant with two examples. The first example comes from the paper he did on the Federal Communications Commission on allocation versus auction of spectrum property rights (rights to airways).[7] The second, from *The Problem of Social Cost*, relates to the control of the effects of economic activity that cause harm to third parties, such as pollution, through taxes or other means.[8]

Let us look first at allocation versus auction of radio spectrum. At the time that Coase wrote this paper, the Federal Communications Commission (FCC) allocated most rights to the airways by issuing a license to private operators, resulting in a big windfall profit for the lucky recipient. Coase pointed out that allocations could cause problems besides windfall gains, in particular, censorship. The FCC didn't have to actively censor license holders; it could regulate offensive content through "raised eyebrows." The license holder would be so sensitive to the FCC's reactions that they would self-censor. That, Coase said, threatens freedom of speech. The FCC, however, argued that their control of the licenses was necessary to prevent one segment of spectrum from interfering with adjacent segments.

What would be the result if we auctioned off property rights to spectrum, as suggested by Coase? Instead of the license holder reaping windfall profits, the government would earn significant revenues from the sale. There would be less scope for government censorship of content, protecting freedom of speech. Interference between spectrums might still occur, but the owners of the property rights would have every incentive to try to prevent it, and to challenge it in court, if necessary. Moreover, property owners would have more incentive to invest and adapt to changes, resulting in new technology and other benefits.

When Coase presented this paper, the FCC commissioner asked, “Is this all a big joke?” The auction proposal was received with incredulity and Coase was laughed at for making such a suggestion. It took 34 years for auctions to be implemented in the United States; they began in 1994 and are now used in over 30 countries. Hazlett and others have estimated that the revenues from auctions in the United States from 1994 to 2009 were over $53 billion, with avoided welfare losses of $17 billion.[9] Not all of the spectrum is auctioned, mainly the part used for cell phones, but auctions have been a success story in many respects.

My second example of comparing alternatives looks at what many economists call “externalities,” when an economic activity has a harmful effect on someone else. For example, when an airport’s noise annoys its neighbors, the standard advice of economists at the time of Coase’s article was to impose a tax as advocated by famous economist Arthur C. Pigou. Coase pointed out that Pigovian taxes ignored the reciprocal nature of these harms. For example, it is not the airport alone, but the interaction between the airport and the neighbors that creates the problem.

What are some of the alternatives to Pigovian taxes? One, of course, is to regulate airport noise: to prohibit it, to make the airlines fly quieter aircraft, or to make planes follow a particular flight path. If you have flown into Reagan National Airport, you know that you follow the Potomac River in a serpentine flight path to avoid flying over houses. Another alternative, given that it is a reciprocal problem, is to prohibit houses from being built in or near the airport’s flight paths. Alternatively, you could grant clearly defined property rights and if there are clear liability laws, then you create incentives for both parties. In that case you could have lawsuits by property owners to object to noise in their neighborhood.

If you allow bargaining and incentives – and again, a lot depends on the institutional framework, the property rights, and liability rules –the airport might pay households to induce them to soundproof their homes or even wear earplugs. Or the neighbors might pay the airlines to change their flight paths or use quieter planes, or close the airport after 10:00 p.m.

Coase pointed out that all remedies have costs. He argued that a satisfactory analysis of policy requires patient study of how markets, firms, and governments handle the problem of harmful effects in practice. In comparing alternatives, the goal should not be to compare a “state of laissez faire and some kind of ideal world,” but to “start our analysis with a situation approximating that which actually exists.” A realistic assessment would analyze the effects of proposed remedies throughout the economic system and take into account the possibility that in some cases the cure may be worse than the disease. In effect, Coase was not advocating a specific policy, but an approach: the analysis of the “total product yielded by alternative social arrangements.”

Now, I realize that not a lot of economists follow this approach. One reason, of course, is that it is very difficult to do. Another reason is the profession may not reward you for all that hard work.

Conclusion

So what was Coase's advice? Realism, institutions, and alternatives. Study the real world. Focus on the institutions – do not assume them away. And analyze the practical alternatives.

But what about getting published and getting tenure? What are the incentives for young economists to follow Coase's advice if they can't get published and are denied tenure? That is a continuing problem and not one that Coase himself really addressed. Coase's goal was to "understand the economic system to get to the truth." He believed that economics should be useful, and during this conference we are going to present some examples of insightful papers that follow in that tradition. We are also going to discuss how we can motivate young scholars to follow Coase's lead and analyze the economic system in order to get to the truth.

Thank you.

To view a video of the full two-day conference visit http://www.cipe.org/coase-conference.

Endnotes

[1] Coase, R. H. (1990), *The Firm, the Market, and the Law*, Chicago: University of Chicago Press (paperback edition).

[2] Coase, R. H. (1994), 'How Should Economists Choose?', in R.H. Coase, *Essays on Economics and Economists*, Chicago: University of Chicago Press, 15-33.

[3] Peltzman, S. (2011), 'Ronald Coase and the Methodology of Economics', *Journal of Law and Economics*, 54 (4), S15-S29.

[4] Coase, R. H. (1974), 'The Lighthouse in Economics', *Journal of Law and Economics*, **17**(2):357–376.

[5] Coase, R. H. (1992), 'The Institutional Structure of Production', *The American Economic Review* **82** (4), 713-719. Lecture delivered in Stockholm, Sweden accepting the Alfred Nobel Memorial Prize in Economic Sciences, December 9, 1991.

[6] Coase, R. H. (1990), 'Economics and Contiguous Disciplines', in R. H. Coase (ed.), *The Firm, the Market, and the Law,* Chicago: University of Chicago Press (paperback edition): pp. 34–46.

[7] The Federal Communications Commission. R.H.Coase. *Journal of Law and Economics*, Vol.2, (Oct., 1959), pp. 1-40. http://www.jstor.org/stable/724927

[8] The Problem of Social Cost. R.H.Coase. *Journal of Law and Economics.* Vol. 3, (Oct., 1960), pp. 1-44.http://www.econ.ucsb.edu/~tedb/Courses/UCSBpf/readings/coase.pdf

[9] Hazlett, T.W., D. Porter, and V. Smith (2011), 'Radio Spectrum and the Disruptive Clarity of Ronald Coase', *Journal of Law and Economics,* **54** (4), S125-S165.

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