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The Coase theorem and idea of transaction costs - their significance for the development of economics

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The Coase theorem and idea of transaction costs – their significancefor the development of economics

Abstract

Ronald Coase drew the attention of main stream economists to the significance of social coordination in the economic system. The key role was played here by much-disputed political conclusions drawn from Coase's idea as well as by his famous theorem and the zero transaction costs theory. The study focuses on the division of labor as a starting point for analysis of zero transaction costs. From this vantage point, the best example of the world of zero transaction costs is Robinson Crusoe's island. However, very often the concept of zero transaction costs is associated with the assumption of perfect information. If we stretch this assumption to its logical limits, then there is no market mechanism and all impediments related to the central planning system disappear. This interpretation is in line with the Hayekian interpretation of the market as a mechanism for acquiring knowledge.

1. Introduction

Ronald Coase is recognized for his contribution to the field of transaction costs economics. He pointed out that transaction costs were the crucial element in explaining why corporations existed and grew. The approach has developed and tested by Oliver Williamson who was awarded the Nobel Prize for Economics in 2009. Despite the fact that Ronald Coase's essay, *The Problem of Social Cost*, is one of the most cited article in the economics, Coase's ideas are often misreported. The aim of this paper is to identify the distinctive features of

Coase's approach and to consider his contribution to development of economic theory.

2. The issue of coordination and transaction costs

Ronald Coase's contribution to the development of economic thought results from his unconventional approach to economic issues and is reflected in posing unusual questions. Why do enterprises and entrepreneurs exist as factors of production if, according to orthodox theory, the price system provides a sufficient mechanism of coordination? How can we reconcile economists' conviction about the role of the price system and the unfeasibility of central planning with the existence of great corporations (such as General Motors) in the market economy? Why would the Soviet economy not work as one huge factory in the way Lenin fathomed it?

In his lecture given on the occasion of being awarded Nobel Prize, Coase said that he had found the answer to the above questions back in 1932. He realized that there are some costs related to the use of the price mechanism. These are the costs of negotiations, contracting, and gathering information which must be incurred in order to "discover prices". The existence of costs related to the functioning of markets justifies an alternative method of coordination – coordination within a company through hierarchic management (Coase 1992, p. 715). The above questions and the idea of transaction costs are included in his famous first article *The Nature of Firm* (Coase 1937).

Coase presented companies and markets as cost-entailing alternative methods of coordination. In this way, he discovered that transaction costs were part of overall production costs and a selection criterion for the mechanism of coordination. In a system based on economic freedom and competition, optimal planning in companies is established as a result of comparison between internal coordination costs and transaction costs arising from using the market. A prerequisite for a company to be "a small planned society" is to provide the coordination function at a cost lower than the transaction costs indispensable to obtain particular goods through the market. The functioning of the market does not occur free of charge and an enterprise is a tool to minimize the cost of market functioning. An enterprise emerges when the internal system of coordination is less expensive than the application of the market mechanism (Coase 1937,1992).

But why does the firm not expand to a full monopoly which internalizes all of its transactions; in other words, why is it not possible for the whole

national economy to merge into one enterprise? This is due to the fact that hierarchic management also entails costs and the function of the entrepreneur is subject to the law of diminishing returns. When a firm grows in size, from a certain point in time the management may no longer be able to control the stream of information. Before information reaches the decision center, it becomes distorted on the various levels of management. The risk of making wrong allocation decisions increases. There is then, an optimum size of an enterprise, which is the volume of production at which internal organization entails the same costs as bargaining. Coase's theory is a specific form of application of marginal calculation. An enterprise internalizes its transactions until the internal marginal costs of management equal market transaction costs.

Orthodox economists regard market mechanism as an optimal mechanism for co-ordination of economic activities and allocation of resources but disregard the costs of this coordination. While analyzing the allocation of production factors, the proponents of market mechanism focused their attention on costs of turning resources into the final product to be placed in the market. They implicitly assumed that the exchange itself does not cost anything and does not engage any resources. R. Coase posed a provocative question: Why do firms exist? He stressed the existence of market coordination costs (Coase[1] which he considered a reason for the existence of alternative coordination, feasible in enterprises, thus indicating another type of transaction costs – management costs in companies. Therefore, an effective system of competition is necessary not only for the markets to exist but also for shaping the right extent of planning within the company, thus minimizing management costs.

Coase in his groundbreaking article defined transaction costs as costs of using price mechanism. Although the term "transaction costs" is regularly used in the literature devoted to new institutional economics, the definition of this notion is still under deliberation (Dollery 2001, Allen 2000). In its broadest sense transaction costs are the costs of social coordination or the costs of the operation of the economic system. Since exercising and transferring property rights form the central issue of social coordination, transaction costs are often referred to as all costs related to the transfer of property rights from one bargaining partner to another. All transaction costs understood as costs of market operation comprise costs of searching for information and partners, costs of negotiation of contract conditions, costs of settling possible claims resulting from implementation of contracts, and also costs related to uncertainty, e.g. change of prices or supplier's bankruptcy.

[1] (R. Coase, The Nature of Firm, [in:] The Firm, the Market and the Law, ed. cit., p. 38-39).

Subsequently, analysis of the transaction cost notion understood as costs of co-ordination led to the identification of political transaction costs. Apart from the costs of particular transactions born directly by partners to bargaining and costs of managing companies there are also costs of creating and maintaining institutional and legal structures, financed by the state budget. The outlays incurred in the process of exercising judicial, legislative, and executive power on the establishment and maintenance of political institutions and organizations which form indispensable conditions for social coordination are referred to as the political costs of transactions. The language of transaction cost economics defines in this manner the costs of institutional and legal functions of the state. The implications of political transaction costs and the issue of market effectiveness were discussed in particular by Douglass North (1990, pp. 47 – 52; Furubotn E. G., Richter, pp. 39 – 54).

Coase further develops his transaction cost theory in his famous second article *Problem of Social Cost* (1960). The notion of transaction costs is presented here in the context of a new approach to social issues and private production costs and a modification of conclusions regarding the involvement of the state in the economic sphere. While questioning the core of Arthur Pigou's welfare economics Coase used, remarkably, the term of zero transaction costs, which became the subject of heated debate and many misunderstandings. Presenting Coase's standpoint, Stiegler formed a thesis which he named the Coase theorem. This theorem contributed to the popularization of transaction costs, new institutional economy ideas and Coase himself[2]. The popularity of Stigler-Coase theorem did not, however, mean that Coase's standpoint and transaction cost economics were properly understood.

3. The Coase Theorem – various formulations

The idea of the so-called Coase Theorem comes from Coase himself, but it was George Stigler who first formulated the theorem criticizing Arthur Pigou's stance against the issue of negative externalities in the 3rd edition of *Price Theory*:

„The Coase theorem thus asserts that under perfect competition private and social costs will be equal [and] the composition of output will not be

[2] Coase himself writes about interest in his ideas and famous theorem. See: *Lives of the Laureates. Thirteen Nobel Economists*, ed. W. Breit, R. W. Spencer, MIT Press, Cambridge-London 2002, pp. 247 – 248.

affected by the manner in which the law assigns liability for damage" (Stigler 1966, p. 113).

Stigler's interpretation made the proponents of free market economy use Coase's views to justify explicit rejection of state intervention in the market and led the economists critical to free market to conclude that Coase's view is nothing more than an attempt to restore the Smithsonian principle of "the invisible hand" of the market. It was so because it was a common practice to focus on the second part of the famous theorem and at the same time to neglect the caveat: "in conditions of perfect competition". In subsequent formulations of the Coase theorem the above-mentioned caveat is replaced by the condition: "in a world of zero transaction costs" or "in the absence of transaction costs".

"In a world of zero transaction costs, regardless of how the property rights are assigned initially, resources will be utilized efficiently in the sense that the value of production will be maximized with transaction costs being interpreted as the costs of search, bargaining, and enforcement of contract" (Hsiung 1999, p.153).

"The Coase theorem states that in the absence of transaction costs, an efficient or optimal economic result occurs regardless of who owns the property rights. The free market guarantees the efficient outcome regardless of who owns what, because there will remain incentives to bargain towards the efficient result until it is achieved" (Schafly 2007, p. 45).

The formulations of the Coase theorem based on "a world of zero transaction costs" facilitate understanding Coase's views, since this assumption, in opposition to the principle of perfect competition, directs one's attention to the proper (from Coase's vantage point) aspect of economic issues. Coase frequently explained that the real world is a world of positive transaction costs, and an assumption of zero transaction costs was only a metaphor which was to point out serious drawbacks of orthodox economics, especially that it fails to address the issue of coordination. Therefore, it should be acknowledged that it is the formulation of the Coase theorem made by Steven Medema that brings us as close as possible both to the real world and to Coase's economics. In the formulation suggested by Medema, the costs of coordination are explicitly presented as are the implications of the fact that these are not zero costs.

"…Coase pointed out that, in a world in which coordination costs are zero, externality problems also could be efficiently resolved through either a single-owner firm (which would take all relevant costs into account) or the government, which could employ various "Pigouvian" remedies to internalize the external costs. However, he argued that the reality of coordination costs – costs associated with market transactions, transactions within the firm, and the bureaucratic, legislative, informational, rent-seeking, etc. processes associated

with the Pigouvian remedies – and the fact that these costs differ across mechanisms imply that the final allocation of resources will be impacted by the mechanism employed to resolve externality problems" (Medema 1996, p. 573).

4. The world of zero transaction costs

Transaction costs are often regarded as the result of imperfect information and, accordingly, the world of zero transaction costs is presented as a world of perfect information. Following step by step the logical implication of the assumption of perfect information one may conclude that there are no markets, prices, or money in a society with perfect information. "Since information is complete, the buyer enjoys all the relevant information he needs; therefore he does not have to search in the market. Similarly, the seller does not have to go to the market to attract buyers. As a result, both the buyer and the seller can make their respective decisions and conduct transaction at home" (Hsiung 1999, p. 156). Since there are neither prices nor money, the concept of the value of production loses its basis.

Let us notice that such conception of the world of zero transaction costs is not in line with the conception of Coase who illustrated his reasoning with examples and made references to prices Coase 1990, p. 98, 140, 160)[3]. His insight and numerous examples regarding transaction costs undoubtedly referred to an economy of prices and money. The reasoning which provides full logical implications of the premise of perfect information is, nevertheless, rational and it shows that the world of zero transaction costs is far more extraordinary than Coase himself implied (Hsiung , p. 157).

The world of zero transaction costs interpreted as a world of perfect information has no reference to reality and is even hard to imagine. How can we imagine the results of the fact that everybody knows everything about other people's behavior and knows their future? And if there are no prices or money, how are goods and services delivered to consumers? A possible solution seems to lie in a system in which distribution is effected by means of a central plan. Since we possess full information, there disappears the justification for the market mechanism as a source of information and, on the other hand, there disappears the principal reason for central planning failure. We may emphasize the absurdity of the perfect knowledge thesis if we observe that the situation of

[3] R. Coase, *The Firm, the Market and the Law*, The University Chicago Press, Chicago and London 1990, pp. 98, 140, 160.

perfect knowledge in which everybody knows everything brings about a situation in which there is no place for human freedom or striving for knowledge.

There is, however, an easier way to imagine the world of zero transaction costs – a way which would point out an aspect of the economy which is often disregarded by neo-classical economics, but to which Coase pays attention. The starting point might not be the perfect information but the issue of the division of labor. If transaction costs are cooperation costs, then these costs do not exist if production does not require cooperation between people. Such a situation takes place in the world of Robinson Crusoe with one manufacturer and one consumer; transactions, money and prices are not necessary, and all of this is due to the fact that there is no division of labor. Considering both criteria – perfect information and division of labor – it appears that the real world is a world of positive transaction costs which can exist in various forms of market economy as well as in real socialism (Figure 1).

Figure 1. The relationship between the world of zero transaction costs and the perfectness of information and division of labor

Division of labor	Perfect information +	Perfect information –
+	Zero transaction costs Ideal system of central plannig	Positive transaction costs Market economy and real socialism
–	Zero transaction costs Ideal Robinson Crusoe island	Zero transaction costs Robinson Crusoe island

Source: Author's own work.

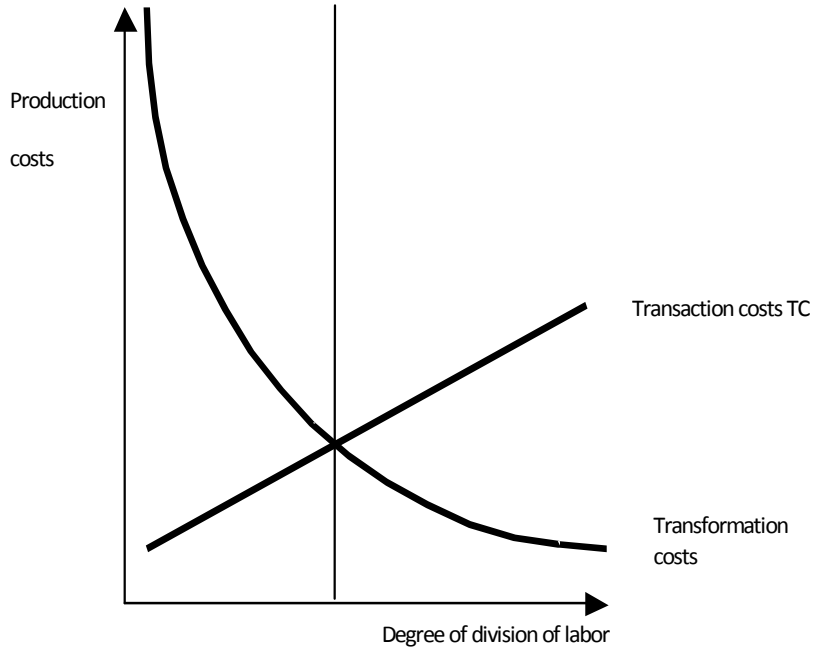
The world of zero transaction costs presented as Robinson Crusoe's island is not only more readily imaginable but also has some important advantages from the vantage point of transaction cost economics. Firstly, as Coase pointed out, it reveals a real problem of neo-classical economics, and secondly, it does not lead to the simple but erroneous conclusion that the lower transaction costs the closer we get to the economic optimum. The conclusion which is often drawn from the Coase theorem that the lower the transaction costs are, the more

effective resource allocation is, is not correct since transaction costs are not only dependent on the quality of institutions but also on the extent of the division of labor. An increase in the division of labor does not unidirectionally affect total production costs; it decreases production costs – the eternal focus point of neo-classical economics, that is, the costs of transforming production factors into final goods, but it entails an increase in the number of transactions, thus provoking an increase in transaction costs. On the basis of transaction cost economics it may only be asserted that **at a given level of division of labor** resource allocation becomes more effective with more effective institutions, more efficient cooperation, and thus lower transaction costs. Research based on this economics also reveals that economic development is related to an increase in the share of transaction costs in the global social product[4].

Given the indisputable importance of the division of labor in improving the conditions of human existence, the premise of absolute minimization of transaction costs is just as absurd as the world of zero transaction costs. The principal direction of the influence of the division of labor on transformation and transaction costs is presented in Figure 2.

[4] The first attempt to measure transaction costs was undertaken by North and Wallis, who divided the structure of national income into the production sector (agriculture, industry, mining, construction, transport, and services) and transaction sector (banking, insurance, real estate market, wholesale and retail trade, administration and public safety, national defense). According to their estimations, the share of transaction costs (services) engaged in the transaction sector in GNP rose from 26% in 1870 to 54.7% in 1970 (Furubotn, Richter, 2000, p. 52). A similar tendency was observed in Australia: transaction costs which in 1911 accounted for 32 % of GDP rose in 1991 to 60% of GDP. This strong upward trend was not confirmed by the research of transaction sector in Argentina, as it revealed that the share of transaction sector in the GDP there slightly changed from 25% of GDP in 1930 to 28% of GDP in 1970, and in the following decade rose to 35% of GDP and remained at that level until 1990 (Wang 2003, p. 4). It should be stressed that research aimed at measuring transaction costs is in its initial stage and the concept of the transaction sector as a means of measuring transaction costs as well as the method of its evaluation might be considered controversial.

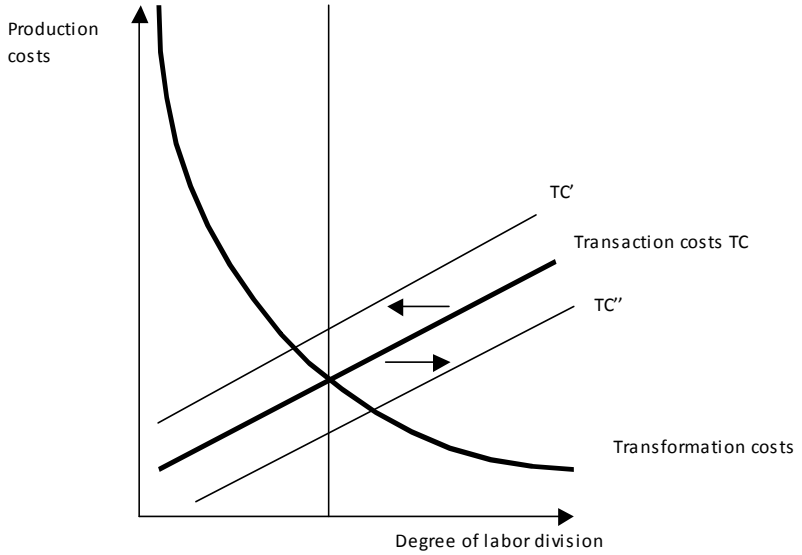
Figure 2. Relationship between transformation and transaction costs on division of labor



The intersection of the curve of transformation costs, diminishing with rising division of labor, with the upward transaction costs line depicts a state of economy in which the share of transaction costs in overall production costs reached 50%.

Source: Author's own work.

Figure 3. Relationship between transformation and transaction costs on division of labor and quality of institution



Transaction costs increase with the growth of division of labor, but depending on the quality of institutions (both formal and informal) transactions with an equal degree of division of labor may engage different amounts of resources. The TC curve depicts an economy in which the higher quality of institution ensures better coordination of activities and lower transaction costs. The shift of the TC curve to TC' illustrates a higher level of transaction costs at each level of division of labor which is a consequence of less effective institutions and the resulting poor cooperation. The problem of choosing optimal proportions between using the market or state regulation is in fact the problem of transaction costs optimization. The problem is even more complex than suggested by the graph below, since institutional solutions affect not only the level of transaction costs but also the level of transformation costs.

Source: Author's own study.

5. The significance of the Coase theorem

The significance of the Coase theorem does not result from its truth but from drawing the attention of economists to the quality of coordination of activities in economic processes. The significance of coordination which depends on the institutional structure of the society is revealed through its impact on production costs, which are termed transaction costs. These costs, thanks to the famous theorem, became a subject of heated dispute and exerted

immense influence both on the development of economic theory and on its ensuing conclusions regarding the choice of a resource allocation mechanism and economic policy. Due to the manner in which the issue of transaction costs was introduced into economic dispute, it seems appropriate to start the presentation of its significance with questions regarding state intervention into the market mechanism.

5.1. The nature of negative externalities and the significance of the law

The Coase theorem and thereby the significance of the transaction costs emerged in the context of negative externalities. First, in *The Federal Communications Commission* (Coase 1959) and then in his famous *The Problem of Social Cost* Coase questioned Arthur Pigou's acclaimed view that market failures displayed in the form of negative externalities absolutely justify state intervention into the market mechanism. Coase suggested two theoretical innovations: to consider bilateral character of origins of negative externalities and to extend the notion of production factor.

Negative externalities result not only from one party's actions (traditionally regarded as the perpetrator), but they emerge due to the other party's (traditionally regarded as the victim) actions as well. If we adopt Pigou's vantage point and in advance charge the party regarded as the unilateral perpetrator with all costs of the conflict then the party regarded as the victim has no stimulus to seek measures to minimize losses. On the contrary, if the party regarded as the victim receives compensation for the losses incurred, it has a stimulus to maintain the existing solution irrespective of possible alternative solutions. Coase proved therefore that optimal solutions may require a change of conduct on the part of the victim party and asserted that solutions suggested by Pigou's economics are not optimal since they exclude adaptation on the part of those who are regarded as the victims of negative externalities. As Coase proved in his well-known article, paying compensation to the owners of farmland along railway tracks may lead to decreasing numbers of trains and passengers while encouraging people to continue farming in the area threatened with fires caused by sparks from coal-burning steam locomotives. Coase pointed out to the possibility of an alternative, socially more desirable solution: to move part of the farming activity to other places, thus maintaining a greater number of trains and passengers. It follows from Coase's reasoning that intervention instruments proposed by Pigou may lead to a situation in which the interest of the owners of farmland along the railway are furthered not only at the cost of the railway operator but also passengers and that there is always the necessity to compare

advantages and costs related to the activities of both sides of any conflict which emerges on the grounds of negative externalities. It cannot be assumed in advance that the optimal solution is the one that assumes the status of one party (arbitrarily considered as the victim) as the *status quo*.

At the same time it should be stressed that it does not follow from the Coase theorem that state intervention is always harmful or unnecessary. Rather, the presence of negative externalities does not justify making state intervention a rule of thumb. Coase explains that every case should be considered separately and that adopting one principle (intervention or non-intervention) is not correct as it does not lead to optimal solutions. The more general notion that can be drawn from Coase's deliberations on negative externalities regards the significance of the law in economic processes. Contrary to what some may infer from the concise formulation of the famous theorem, Coase does bring our attention to the immense role of the law in the economic system. The law is important because the real world is a world of positive transaction costs and the level of these costs is to a large extent dependent on legal regulations which may facilitate or hinder contracting or transfer of property rights.

"The same approach which, with zero transaction costs, demonstrates that the allocation of resources remains the same whatever the legal position, also shows that, with positive transaction costs, the law plays a crucial role in determining how resources are used. But it does more than this. With zero transaction costs, the same result is reached because contractual arrangements will be made to modify the rights and duties of the parties so as to make it in their interest to undertake those actions which maximize the value of production. With positive transaction costs, some or all of these contractual arrangements become too costly to carry out. The incentives to take some of the actions which would have maximized the value of production disappear. What incentives will be lacking depends on what the law is, since this determines what contractual arrangements will have to be made to bring about those actions which maximize the value of production. The result brought about by different legal rules is not intuitively obvious and depends on the facts of each particular case" (Coase 1990, p. 178). The latter belief underlies Coase's appeal to economists for empirical research. "My conclusion: let us study the world of positive transaction costs"– repeats Coase in his Nobel Prize lecture (Coase 1992, p.717).

5.2 Planning and the market system

Hayek's epistemological perspective on the market system and central planning as alternative mechanisms of resource allocation is proven correct in view of analysis of the Coase theorem and the zero transaction cost assumption. An ideal system of central planning is possible in perfect information conditions. At the same time, perfect information causes such market institutions like prices or money to disappear along with economic calculus and choice constrained by this economic calculus (when the premise of perfect information is pushed to its logical limits the right solutions become self-evident and the individual does not have to chose, or, actually, cannot choose).

However, when we exclude the unrealistic assumption of perfect information we will arrive at a world of positive transaction costs, in which in fact there does not exist choice between government planning and something which would be its complete opposite. Medema is right when he asserts that in fact we face a choice between various types of planning that in a different way affect both economic effectiveness and the interests of groups and individuals. This standpoint means that we treat the law that governs economic activity and regulates various spheres of individuals' behavior as a sort of planning. Through its institutional and legal functions the state always performs its planning function. There always occur problems of coordination and its costs contribute to the costs of production. There is no perfect system of coordination, and in reality there are imperfect markets, firms and governments. The problem is that one has to constantly choose from among imperfect alternatives to the coordination mechanism that would be the most suitable in particular conditions for a particular group of transactions (Medema 1996, p. 576).

5.3 The development of economic theory

The influence that the idea of transaction costs and the Coase theorem exerted on the development of contemporary economics cannot be overestimated. These concepts, thanks to their intellectual potential and an appealing form decisively contributed to drawing the attention of orthodox economists to problems which had pushed beyond the borders of mainstream economics due to fascination with the Walrasian concept of the general equilibrium. It was mainly due to the interest excited by Coase's ideas that the issues of coordination of economic activities came under deliberation, which means that the social side of production became the subject of analysis. Drawing attention to transaction costs was tantamount to undertaking comparative

analysis of alternative mechanisms of resource allocation and their institutional determinants.

Coase decisively contributed to the development of new institutional economics which rejected the neo-classical theory of growth and the vision of economics as a theory of rational choice – a theory independent of the institutional system. Through the concept of transaction costs, the most important idea of the new institutional economics, Coase followed by North showed that economic success does not only depend on technological progress but also, equally, on tha ability of the society to utilize available technologies. What is characteristic is Coase's reply to a question about the significance of progress in electronic communication systems. "People talk about increases in improvements in technology, but just as important are improvements in the way in which people make contracts and deals. If you can lower the costs there, you can have more specialization and greater production. So that's what I'm interested in now. By improving the way the market works, you can produce immense benefits, not because it invents new technologies, but because it enables new technologies to be used." (Coase 1997). Coase stressed the role of the law in the process of improving conditions of exchange, while North extended his analysis of the society's ability to utilize technologies to area of culture, ideology and politics.

6. Summary

The idea that the economic process is not autonomous is not new. The social character of economy was noted by Adam Smith, and later it used to be the domain of schools regarded as heterodox. Furthermore, thanks to Coase, the approach to economic issues, typical for heterodox economics became a point of interest for mainstream economists. It happened so probably due to three reasons. First, the term "transaction costs" is perceived as a technical term which is ideologically neutral like production costs. The notion of transaction costs, although controversial, is for economists an appealing means of expressing the costs which are the result of the social determinants of the economic process. The interest in the world of transaction costs was enhanced by the intriguing concept of "zero transaction costs". Establishing economic effectiveness as the final criterion of analysis was the second factor promoting the acceptance of the paradigm of transaction costs.

The third aspect of the attractiveness of the paradigm of transaction costs was related to the controversies around the political conclusions. The new approach to the issue of negative externalities, the enhancement of arguments of

the pro-market orientation and finally, the issues which emerged in relation to the crisis of the central planning system – all of these raised interest and growing recognition for this institutional research perspective.

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Streszczenie

ZNACZENIE TEOREMATU COASE'A I IDEI KOSZTÓW TRANSAKCJI W ROZWOJU EKONOMII

Ronald Coase skierował uwagę ekonomistów głównego nurtu na znaczenie społecznej koordynacji w systemie ekonomicznym. Kluczową rolę odegrały tu zarówno kontrowersyjne wnioski polityczne wyprowadzane z idei Coase'a, jak i słynny teoremat i koncepcja zerowych kosztów transakcji. W artykule uwaga skoncentrowana jest na podziale pracy jako punkcie wyjścia do analizy zerowych kosztów transakcji. Z tego punktu widzenia najlepszym przykładem świata zerowych kosztów transakcji jest wyspa Robinsona. Najczęściej jednak koncepcja zerowych kosztów transakcji wiązana jest z założeniem doskonałej informacji. Jeżeli założenie to doprowadzamy do jego logicznych granic nie ma mechanizmu rynkowego oraz znikają wszelkie trudności systemu centralnego planowania. Ta interpretacja jest zbieżna z hayekowską interpretacją rynku jako mechanizmu odkrywania wiedzy.