Coase on the nature of economics

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Recent writings on Coase’s methodology largely focus on method, at the risk of under-appreciating his substantive view of economics. That economics has as its subject matter the working of the real world economic system is Coase’s main methodological message and is also the key to understanding Coase’s other methodological concerns. Coase’s methodological position is illustrated in this paper by comparing him with other economists in terms of their differing research programmes informed by their methodological stances. Along the way, this paper outlines the new institutional economics, a research programme inspired by Coase’s methodology.

**Key words:** Coase, Methodology, New institutional economics

**JEL classifications:** B3, B4

I

Ronald Coase has recently interested a circle of scholars as a research subject (Posner, 1993A, B; Foss, 1994; Medema, 1995, 1998A, B; Mäki, 1998A, B). A fair amount of this literature is devoted to Coase’s maverick view on method, particularly realism. Indeed, when writing about Coase, defender and critic alike, no one is likely to fail to recognise his unwavering emphasis on economic theories being realistic (e.g., Medema, 1995; Posner, 1993A, B).

In a recent article ‘Is Coase a realist?’ Uskali Mäki (1998A, p. 6) claims ‘Coase’s methodological main message is that economics has to be made more realistic’. This stylised picture of Coase contains a considerable amount of truth, given Coase (1937, p. 386, 403; 1978, 1984) has consistently criticised mainstream economics for its lack of realism. However, it is an open question whether to characterise Coase’s methodological main message as his call for realism. At the very least, to emphasise realism does not lead us very far. As Mäki (1998A, p. 27) cautiously concludes in his article, if Coase is a realist, Coase’s realism ‘can be understood only in the context of his economics’. There is no fast and firm answer to the question, ‘Is Coase a realist?’ It rather depends on what a realist or realism is. Furthermore, the singular stress on realism readily misleads scholars as learned as Richard Posner (1993A, B) to picture Coase erroneously as anti-theoretical, since in light of Milton Friedman’s (1953) classic article on methodology, theorising proceeds at the sacrifice of realism. Not surprisingly, Coase, who repeatedly emphasises realism, is considered as hostile to theorising.

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*University of Chicago Law School. Without implicating in any ways, I would like to thank Ronald Coase for helpful comments. I am also grateful to two anonymous reviewers for their pressing but constructive criticisms, which have led to a number of improvements.

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This paper advances an alternative approach. It contends that Coase's primary methodological message lies in his heterodox view of the subject of economics. As Coase (1988A, p. 1) realises, 'most economists have a different way of looking at economic problems and do not share my conception of the nature of our subject'. The dominant view sees economics as a subject-free discipline characterised by a specific approach with universal applicability. In sharp contrast, Coase (1998, p. 73) insists that economics has a unique research subject, i.e., the real world economic system. Though this difference is widely recognised (Posner, 1993A, B; Williamson, 1994; Medema, 1998A; Mäki, 1998A), no one has yet emphasised Coase's substantive view of economics as his main methodological message. This paper attempts to show that this emphasis provides a preferable approach to understanding Coase, including his other methodological concerns, such as realism and 'blackboard economics', and his vision of where economics should be going.

II

That economics has a unique subject of research, i.e., the economic system, is not Coase's invention, but a recurring tradition in the profession. In a well-received book on the philosophy of economics, Daniel Hausman (1992, pp. 2–3) observes, correctly, that over time there have developed two competing views of economics, the substantive view and the formal one. The substantive view defines economics in terms of its substantive or material concerns, i.e., the economy. The formal view, on the other hand, pictures economics essentially as a perspective based on the principle of economising. Both views have venerable traditions in the profession. In retrospect, the substantive view can be traced back to James Stuart Mill and Alfred Marshall, while the latter is accredited to Lionel Robbins (Lawson, 1997).

The formal view unquestionably predominates in contemporary economics. Gary Becker (1976, p. 5), who has best defended and developed this approach over the past several decades, believes 'what most distinguishes economics as a discipline from other disciplines in the social sciences is not its subject matter but its approach'. As Becker further explains, 'The combined assumptions of maximizing behavior, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach' (ibid.). Applying this economic approach to the analysis of human behaviour in a conventionally non-economic area, such as the family, the school, the court and the government, has been the most exciting development in economics since the last quarter of the twentieth century.

Coase is a determined believer and staunch practitioner of the substantive view of economics. Coase (1998, p. 73) prefers to define economics by a subject matter: 'the study of the working of the economic system'. This substantive view of economics is consistent with his general position regarding the division of labour among neighbouring disciplines in social sciences. Coase (1994, p. 38) once explicitly states his preference for the subject rather than methodology as the defining feature of a discipline.

The origin of this difference is attributable to the equivocal lexical meaning of 'economic', as pointed out long time ago by Polanyi et al. (1957, p. 243):

The substantive meaning of economic derives from man’s dependence for his living upon nature and his fellows. It refers to the interchange with his natural and social environment, in so far as this results in supplying him with the means of material want satisfaction. The formal meaning of economic derives from the logical character of the means–ends relationship, as apparent in such words as ‘economical’ or ‘economizing’. It refers to a definite situation of choice, namely, that between the different uses of means induced by an insufficiency of those means.
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I need not conceal from you at this stage my belief that in the long run it is the subject matter, the kind of question which the practitioners are trying to answer, which tends to be the dominant factor producing the cohesive force that makes a group of scholars a recognizable profession within its own university departments, journals and libraries. I say this, in part, because the techniques of analysis and the theory or approach used are themselves, to a considerable extent, determined by what it is that the group of scholars is studying, although scholars in a particular discipline may use different techniques or approaches in answering the same questions.

Clearly, Coase puts priority on the subject because he believes that the methodological approach we take in our study crucially depends on the subject matter of our inquiry. To understand what Coase has to say on method, we should begin with his view on this subject matter.

But what is or should be, in Coase’s view, the subject for economic inquiry? Coase is clear on this point: the economic system. Let me quote Coase (1994, p. 41):

What economists study is the working of the social institutions which bind together the economic systems: firms, markets for goods and services, labour markets, capital markets, the banking system, international trade and so on. It is the common interest in these social institutions which distinguishes the economic profession.

If this answer conjures up a view too broadly brushed to be of much practical relevance for our search for the subject of economics, we are better served if we narrow our focus and take industrial organisation as an example.

So far as industrial organisation is concerned, Coase is quite precise on what constitutes the proper subject matter for investigation:

how industry is organised now, and how this differs from what it was in the earlier periods; what forces were operative in bringing about this organization of industry, and how these forces have been changing over time; what the effects would be of proposals to change, through legal action of various kinds, the forms of industrial organization. (1988A, pp. 58–9)

In any industry, as Coase warns us, the players are not just private organisations, but should also include government agencies. As a result,

It should surely be part of the task of studies on industrial organization to describe the economic activities which are performed by government agencies, and to explain why the carrying out of these economic activities is divided up among private organizations and governments in the way that it is. (ibid., p. 59)

This view clearly diverges dramatically from the then dominant research programme, which treats the subject of industrial organisation essentially as applied price theory, without any touch of ‘how industry was organised, in all its richness and complexity’ (ibid., p. 61). What Coase has proposed here is a ‘direct approach’ to the problem, which would concentrate on what activities firms undertake, and it would endeavor to discover the characteristics of the groupings of activities within firms. Which activities tend to be associated and which do not? . . . In addition to studying what happens within firms, studies should also be made of the contractual arrangements between firms (long-term contracts, leasing, licensing arrangements of various kinds including franchising, and so on). . . . The study of mergers should be extended so that it becomes an integral part of the main subject. In addition to a study of the effects on the rearrangement of functions among firms through mergers, we also ought to take into account ‘dismergers’ (the breaking up of firms); the transfer of departments or divisions between firms; the taking on of new activities and the abandonment of old activities; and also—something which tends to be forgotten—the emergence of new firms. (ibid., pp. 73–4)
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Furthermore, to investigate industrial organisation in the real world, Coase (1964, p. 195) urges us to take a comparative institutional approach by studying 'how alternative arrangements will actually work in practice'. Criticising the 'Nirvana approach', i.e., comparing the actual performance of the industry with an ideal derived from the textbook economic theory, Coase tells us that 'until we realise that we are choosing between social arrangements which are all more or less failures, we are not likely to make much headway' (ibid.). When comparing different social arrangements, Coase reminds us, 'what is economically relevant is how the allocation and use of factors of production will change with a change in social arrangements' (ibid.). This feature of Coase's methodology is nicely summarised by Oliver Williamson (1994, p. 202): 'Because hypothetical forms of economic organisation are operationally irrelevant, and because all feasible forms of organisation are flawed, assess alternative feasible forms of organization in a comparative institutional way'.

We do not need to go much further to appreciate the far-reaching contribution that this research proposal has made. In the past few decades, the economics of institutions as fuelled by Coase's original idea has become 'one of the liveliest areas in our discipline' (Matthews, 1986, p. 903).

III

Though Coase believes that economists have a defining subject matter, viz., the economic system, he (1994, p. 46) does not think that the economic system can be examined and understood alone, independent of other social systems. It is due to this realisation that Coase supports the 'new institutional economics' (1984, 1998) to investigate the impact on the working of the economic system of various institutions in a society, including 'its legal system, political system, social system, educational system, culture, and so on' (1998, p. 73).

Clearly, Coase's substantive view of economics has in no way narrowed the scope of economics, a common charge laid against the substantive approach. Dissatisfied with the limited scope of economics allegedly confined by the substantive approach, economists have in the past several decades embarked on 'economic imperialism' to march into territories of other disciplines in social sciences, subjecting such traditionally non-market behaviour as crime, marriage, and education in economic analysis. Thanks to the pioneering work and continuous leadership of Gary Becker (1957, 1976, 1981, 1996), this intellectual crusade has been extremely successful in demonstrating the wide applicability of the logic of choice.

That Coase does not endorse and actually remains pessimistic about 'economic imperialism' is widely recognised (e.g., Posner, 1993A; Medema, 1998A). Coase's lack of interest in economic imperialism, becomes 'more puzzling', as Posner (1993A, p. 204) points out, if we bear in mind that Coase initiates the 'economics and law' movement, presumably a child of economic imperialism.

Coase's lack of interest in economic imperialism clearly distances him from Becker. Their difference is certainly not that Coase sticks to a narrow subject as constrained by his substantive view. As we have pointed out, Coase, like Becker, urges us to investigate the social, legal and political systems of a society. However, they hold different views of what purpose such intellectual pursuits serve. For Becker, who believes that economics 'provides the most promising basis presently available for a unified approach to the analysis of the social world by scholars from different social sciences' (1993, p. 403), the main mission is to uncover the universal applicability of the economic approach to human behaviour, not only
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in market situations, but also in family, court, politics and other arenas as well. For Coase, however, the social, legal and political systems are studied to expose their impacts on the economy. Rather than to show that economics as an approach is universal, Coase recommends us to study social institutions ‘to enable us to understand better the working of the economic system’ (Coase, 1994, p. 46). Let Coase speak for himself:

Economists may, however, study other social systems, such as the legal and political ones, not with the aim of contributing to law or political science but because it is necessary if they are to understand the working of the economic system itself. It has come to be realised by many economists in recent times that parts of these other social systems are so intermeshed with the economic system as to be as much a part of that system as they are of a sociological, political or legal system. Thus, it is hardly possible to discuss the functioning of a market without considering the nature of the property rights system, which determines what can be brought and sold and which, by influencing the cost of carrying out various kinds of market transaction, determines what is, in fact, bought and sold, and by whom. Similarly, the family or household and the educational system are of concern to the sociologist but their operations affect the supply of labor to different occupations and the patterns of consumption and production and are, therefore, also of concern to the economist. In the same way, the administration of the regulatory agencies and antitrust policy, while part of the legal system and, as such, studied by lawyers, also provides the framework within which firms and individuals decide on their actions in the economic sphere. (Coase, 1994, pp. 45–6)

Not surprisingly, their differing goals have led them to contrary routes. Becker carries the analytical tools of price theory to enlarge the territory of economics. Coase, on the other hand, explores how the working of economic system is influenced by the social, political and legal systems.

Despite their different emphases, Coase does not deny the value nor versatility of economic theory, as his critics (Posner, 1993A) lead us to believe. On the contrary, the established economic theory, as Coase appreciatively admits, is ‘a towering intellectual achievement and has enduring value’ (1995, pp. 246–7). ‘I am delighted when our colleagues in law use them [economists’ tools of trade] to study the working of the legal system or when those in political science use them to study the working of the political system’ (1998, p. 73). What makes Coase less enthusiastic about economic imperialism is not that economists’ tools of trade cannot apply to other fields—indeed, they ‘may ultimately rejuvenate the study of law, political science, and sociology’ (1988A, p. 3)—but that economic imperialism falls short of shedding light on the working of the economic system, the proper subject of economics, by ‘diverting attention from some very important features of the economic system’ (1995, p. 247). Through demonstrating the wide validity of the logic of choice, the movement of economic imperialism has certainly deepened our understanding of the social, legal, and political systems, the proper domain for sociologists, legal scholars, and political scientists, respectively. To reciprocate intellectual exchange, Coase urges colleagues in these disciplines to join economists to investigate the impact on the working of the economy of social, legal and political institutions, a paramount mission of the new institutional economics.

The new institutional economics is a rich and open research programme to encourage intellectual dialogue between economics and other neighbouring disciplines. What differ-

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1 Economists’ preoccupation with the logic of choice and the following separation of the theory from its subject matter, according to Coase, have led economists away from the very economic entities whose behaviours economists are engaged in analysing, such as the consumer, the firm and the market. As a result, ‘we have consumers without humanity, firms without organization, and even exchange without markets’ (1988A, p. 3).

2 Though these social scientists may not welcome, and have actually resisted, not without justification, the intrusion of economics, economic imperialism does provide a powerful and challenging alternative approach to their subjects. For relevant literature, see Baron and Hannan (1994) and Miller (1997).
entiates it from economic imperialism is its unifying thematic focus, i.e., the working of the economic system. Unlike economic imperialism, which applies analytical tools of price theory to other domains of human life in the hope of uncovering the hidden logic of choice in non-market behaviour, the new institutional economics cooperates with other social sciences to 'study man as he is, acting with the constraints imposed by real institutions' (Coase, 1984, p. 231), with the aim of improving our knowledge of the economic system. If we remember the fundamental principle of economic life, as bequeathed to us by Adam Smith, that the division of labour together with trade improves efficiency, we can detect potential gains of exchange between economic imperialism and the new institutional economics.

Take as an example the 'law and economics' movement. Under this broad heading, there exist two overlapping yet heterogeneous sub-trends, as repeatedly underlined by Coase (1993A, p. 251; 1996, pp. 103–4; 1997A, p. 1138). On one side stands the economic analysis of the legal system, commonly known as the economic analysis of law (Posner, 1998), or 'economics of law' as Posner (1987, p. 4) put it. Here, 'economic' or 'economics' is used in a formal or methodological sense, referring to what Becker (1976, p. 5) calls 'the economic approach'. The research programme thus informed uses 'the theories and characteristic empirical methods of economics to increase our understanding of the legal system' (Posner, 1975, p. 757), mainly by illuminating the deep economic structure of the law, which otherwise seemed an assemblage of completely unrelated rules, procedures and institutions (Posner, 2000; see also Cooter and Ulen, 1999). On the other side, the new institutional economics approaches the law to disclose and appraise the economic significance of the legal system. In this case, 'economic' carries a substantive meaning. The focus here is on the profound impacts the legal system has on the economy.1 The law enters into economic analyses, because, as pointed out by Coase (1993A, p. 251), 'in a regime of positive transaction costs, the character of the law becomes one of the main factors determining the performance of the economy'. Rather than bringing economics to bear on the structure of the law, the focal concern here is to discover the role of law in affecting transaction costs and determining the institutional structure of exchange and production.

It is widely recognised that Coase's (1960) remarkable piece on social cost has played a fundamental role in launching the 'law and economics' movement understood as the economic analysis of law. Richard Posner, the most prolific and prominent figure in this movement, and who is not hesitant in expressing his strong disagreement with Coase, credited Coase's 1960 article as 'the most significant for the long-run development of the new law and economics field' (1975, p. 760). The article, he went to say, 'established a framework for analyzing the assignment of property rights and liability in economic terms, thereby opening a vast field of legal doctrine to fruitful economic analysis' (ibid.). The huge impact on legal scholarship that this paper has had was never expected or intended by Coase. His intention, instead, lies elsewhere (1993A, p. 250). 'For me, The Problem of Social Cost was an essay in economics. It was aimed at economists. What I wanted to do was to

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1 It is certainly not true that the economics of law ignores the impact of law. On the contrary, Gary Becker (1968; see also Becker and Stigler, 1974) and William Landes (1971), two Chicago economists and leading players in the 'law and economics' movement, focus their attention on the behavioural impact of law. In this regard, they are quite different from Posner, who is not so interested in 'the behavior of the individuals and firms regulated by the legal system', but rather in 'the (economic) structure of the (legal) system itself' (Posner, 1979, p. 288). At the same time, they are certainly also different from Coase, who is mainly interested in law's impact on economic behaviour. Practising economic imperialism, Becker and Landes extend economic tools to investigate law's impacts on non-economic human behaviour. Nevertheless, what they share with Coase is the focus on the impact of law, rather than the structure of law, which is the main concern of Posner.
improve our analysis of the working of the economic system.' To be more precise, Coase 'used the concept of transaction costs to demonstrate the way in which the legal system could affect the working of the economic system' (1988B, p. 35). As far as its influence on economics goes, however, the article is less successful. Its message, nevertheless, is clear, as Stigler (1972, p. 12) put it.

The Coase analysis has emphasized the urgent need in economics for a general theory of transaction costs. The development of a theory of costs is a task for economists, but an integral part of that task is the understanding of the legal process which may be employed. Economic life requires reliable commitments by the transactors, and economic disagreements call for methods of resolution. The civil law and private arbitration are the peaceable methods by which a society achieves commitments and conciliation. It comes as more of a surprise to the theoretical economists, I am sure, than to his legal brethren that economic order has deep relationships to legal order.

Tensions have certainly arisen between the two diverging directions coexistent in the 'law and economics movement', as the debate between Coase and Posner attests. These tensions, to a large extent, represent the general difference in objectives between economic imperialism and the new institutional economics. Nonetheless, potential gains of exchange exist. The study of property rights has already provided a case in point. Its success is built on two indispensable branches. On the one side, economists such as Armen Alchian (1965) and Harold Demsetz (1968) explain the rise and structure of property rights on economic grounds. On the other hand, Coase and Douglass North (1990) focus on the impact of property rights on the working of the economic system.1

IV

Coase's preoccupation with the working of the economic system on the one hand and his inclusiveness in treating other social systems on the other bring him a fairly large number of intellectual companions, usually not recognised by himself or others. In this context, it is interesting to compare Coase with another Nobel laureate, James Buchanan.

Buchanan is one of the few economists who are sympathetic to Coase's substantive view of economics. First, Buchanan (1989A, p. 81) shares with Coase the same reservation with regard to the received definition of the economic problem. The mainstream economics, according to Buchanan (ibid., pp. 81–2), 'generates intellectual confusion and misunderstanding because it focuses attention inappropriately on scarcity, on choice, and on value maximization, while shifting attention away from the institutional structure of an economy, with the consequent failure to make elementary distinctions among alternative structures'. This critique clearly supports Coase's emphasis on the institutional structure of production.

Second and more importantly, constitutional political economy, a research project launched by Buchanan (1991A), shares a mission similar to Coase's new institutional economics. According to Buchanan (1989B, p. 9):

The analysis of the working properties of alternative structures of an economy, alternative sets of rules and institution that serve to constrain the choice behaviour of participants within that economy, defines the domain for constitutional political economy in its positive aspects . . . the focus is the impact of differing structure of incentives on the choice behaviour of economic actors and, through this impact, on the pattern of aggregative results in an economy.

1 It is not my intention here to delve into the huge literature on property rights. Interested readers could start with Pejovich (2001). To qualify my point made in the text, I should like to point out that Alchian's work actually covers both branches.
Though Buchanan and Coase share their grand view of what economics is, they have nonetheless demonstrated distinctive ways of practising economics. One the one hand, Coase is a hopeless empiricist, preoccupying himself with what’s actually going on in the real world. Buchanan, on the other hand, is best known for his theoretical inquiry.

The positive exercise must precede any normative judgment on structure, on any part thereof, whether directed at the status quo or at any proposed alternative. The only legitimate normative exercise involves institutional–structural comparison. Demonstration of ‘failure’ against some idealised standard (efficiency, justice, liberty) that is not anchored in structural feasibility is irrelevant.

Though the new institutional economics does not have an explicit normative aspect, its empirical comparative analysis as expounded by Coase is essentially what Buchanan means above by constitutional political economy.

Given their similar dissatisfaction with neoclassical economics and resembling visions of what economics is, it is not surprising that there is a family resemblance between the new institutional economics and constitutional political economy. Actually, Buchanan (1991B) clearly endorses the new institutional economics as a part of the emerging ‘new political economy’, an inclusive label also containing constitutional political economy, for its emphasis on institutional constraints in the economy and thus moving economics from its conventional exclusive focus on choices within constraints to choices among constraints. While it is beyond my intention to go further in comparing Coase and Buchanan, even such a brief comparison makes it safe to conclude that Buchanan’s project of constitutional political economy, with its clear differentiation of constitutional and post-constitutional order, provides a promising approach to examining the impact of the changing macro political and legal system upon the working of the economic system, a major concern of the new institutional economics.

Another striking feature of Buchanan’s research programme is also worth pointing out, even at the risk of belabouring the obvious. Buchanan is known for his pioneering work in public choice (1983; Buchanan and Tullock, 1962) and constitutional political economy (1991A). The former, obviously a form of economic imperialism, is to apply the tools of economics to analysing politics; the latter, in line with the new institutional economics, is to investigate the impact of constitutional order on individual choices and the economic system. Buchanan’s original combination of public choice and constitutional political economy constitutes the beauty and strength of his research programme, an exemplar of bridging economic imperialism and the new institutional economics.

Coase (1994, p. 38) believes that the subject of a discipline greatly influences its research method. Since he sees the working of the economic system as the subject of economic science, distancing himself from the mainstream, Coase approaches economic problems in his distinctive way. The case study, a method that has almost disappeared from the repertoire of contemporary economists, is Coase’s favourite. For example, ‘Bacon Production and the Pig-Circle in Great Britain’ (1935) (with R. F. Flower), ‘British Broadcasting’ (1950), ‘The Federal Communication Commission’ (1959), ‘The Lighthouse in Economics’ (1974), ‘Payola in Radio and Television Broadcasting’ (1979), and ‘The Acquisition of Fishery Body by General Motors’ (2000) are all well-conducted case studies. These empirical case studies have exemplified Coase’s way of doing economics. That is, the economic research always starts from detailed knowledge of the issue at hand, and proceeds to

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propose some general theoretical arguments, which then are applied back to the real world to illustrate other relevant economic issues.

Clearly, Coase sees economic research as essentially containing three critical processes. First of all, economic research begins with ‘the careful collection of detailed information and its assembly’ (Coase, 1988A, p. 57). This process always requires laborious work and may often lead to nowhere. In collecting facts, both qualitative and quantitative data are desirable. The conventional image of Coase, who is described as hostile to quantitative data, is far from the truth. As a matter of fact, most of Coase’s early work is of econometric study. As Aaron Director reminded us, Coase is ‘one of the pioneers of the quantitative method in economics’ (Kitch, 1983, p. 219).

Second, data collection is expected to lead to theoretical arguments consisting of ‘formal relations that are capable of being conceived exactly’ (Coase, 1988A, p. 34). Theorising is indispensable for economic research. Coase’s emphasis on theorising is well expressed in his critique of the old American institutionalists:

All it (American institutionalism) had was a stance of hostility to the standard economic theory. It certainly led to nothing . . . The American institutionalists were not theoretical but anti-theoretical, particularly where classical economic theory was concerned. Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire. (Coase, 1984, pp. 229–30)

Though Coase does not invent any ‘high theory’ dressed in mathematical language, there is no doubt that Coase is a theorist. As Guido Calabresi tells us, Coase is ‘the highest level of theoretician, trying always to be an empiricist’ (Medema, 1998B, p. xliii). However, Coase is not a blind theorist. His following quotation from Marshall applies equally well to himself.

In my view ‘Theory’ is essential. No one gets any real grip of (on) economic problems unless he will work on it. But I conceive no more calamitous notion than that abstract, or general, or ‘theoretical’ economics was economics ‘proper’. It seems to me an essential but a very small part of economics proper: and by itself sometimes even—well, not a very good occupation of time . . . general reasoning is essential, but a wide and thorough study of facts is equally essential . . . a combination of the two sides of the work is alone economics proper. Economic theory is, in my opinion, as mischievous an imposter when it claims to be economics proper as is mere crude unanalyzed history (italic original, Coase, 1994, p. 172)

This leads us to the last point, that the theory is expected to explain certain aspects or parts of the real economic system, that is, to help us ‘to understand what is going on by enabling us to organize our thoughts’ (1994, pp. 16–17). The ultimate purpose of theory is to serve as ‘a base for thinking’ and to provide a new and presumably informative way of looking at the real world. Coase categorically opposes theoretical abstraction for its own sake, without real world relevance. He insists that the abstraction or theoretical model should apply back to the real world, speaking to and shedding light on relevant economic problems. Coase

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1 Coase’s critique of American institutionalism may seem too harsh. Coase criticises American institutionalists as ‘anti-theoretical’ because they failed to engage in classic economic theory. This does not mean that they did not have any theory at all. As pointed out by a reviewer, the old American institutionalists had their own way of theorising, see Hodgson (1998) for example. Given the limited space here, I would simply mention that theoretical formulations of American institutionalists were closer to macro sociological analysis than to marginal analysis as identified with economics. For an interesting view on the similarity between Coase and old American institutionalists, see Stinchcombe (1997).

2 In another case, Coase (1997A, p. 254) quotes Ernest Rutherford approvingly that science is either physics or stamp collecting. Here, however, Coase’s view of theory comes close to what Popper (1979, pp. 341–61) has called the ‘searchlight’ view of knowledge.
nicely embodies what Frank Hahn (1990, p. 539) describes as the British tradition of economics.

(1) The study of economics is not to be regarded as an end in itself. It lacks the beauty of mathematics or art or the possibilities for precision and prediction of physics. The main motive for its study must be the improvement of the condition of mankind . . . (2) While certain aspects of the subject require precision and rigour it does not lend itself to the formulation of a general 'system'. A good economist is a pragmatic economics. (3) Economic phenomena are only a part of the phenomena of importance to the study of society. While *ceteris paribus* concerning all the non-economic variables may often be legitimate, explanation and understanding is often impossible without a knowledge of the history, mores and social norms of the society concerned. It is the duty of the theorist who has arrived at a formal result to consider whether it is robust when applied to different societies and particularly when it is applied to his own society. (4) It is pretentious to use mathematics when words will do and it is equally pretentious to use 'highbrow' mathematics when more elementary methods will do almost as well. (5) As far as possible, (given (1)), the economist should attempt to communicate with the educated non-expert.

Clearly, Coase's way of doing economics, i.e., beginning with empirical information, then moving towards theoretical abstraction, and coming back to the real world, is in sharp contrast to the received axiomatic approach, which, as characterised by Brian Loasby (1976, p. 13), is a research programme that 'seeks to emulate the mathematicians by the careful construction of watertight logical systems from a brief but comprehensive axiom set'. This axiomatic approach, as recognised by Friedrich Hayek (1937, p. 35) long ago, is 'to turn economics into a branch of pure logic, a set of self-evident propositions which, like mathematics or geometry, are subject to no other test but internal consistency’. This approach never appealed to Coase. As Coase remarks decades (1988A, p. 71) ago,

An inspired theoretician might do as well without such empirical work, but my own feeling is that the inspiration is most likely to come through the stimulus provided by the patterns, puzzles, and anomalies revealed by the systematic gathering of data, particularly when the prime need is to break our existing habits of thought.

It is undeniable that this empirical approach as embraced by Coase has fewer practitioners than the axiomatic one (but see Summers, 1991; McCloskey, 1991). However, if economics could learn something from biology, an intellectual trade Coase (1978, 1998) has consistently urged us to engage in, we should not be content.

The path to success in theoretical biology is thus fraught with hazards. It is all too easy to make some plausible simplifying assumptions, do some elaborate mathematics that appears to give a rough fit with at least some experimental data, and think one has achieved something. The chance of such an approach doing anything useful, apart from soothing the theorist’s ego, is rather small, and especially so in biology. (Crick, 1988, pp. 113–14)

VI

After the above exposition of Coase's way of practising economics, we are better positioned to judge whether Coase is anti-mathematics and anti-theoretical, two widely circulated charges against him.

The well-known witty quotation from Coase (1988A, p. 185) is usually invoked to convict Coase as anti-mathematics: ‘In my youth it was said that what was too silly to be said may be sung. In modern economics it may be put into mathematics.’ But does this piece of evidence carry sufficient weight?
Mathematics enters into economic research at two stages, data-collection and theory-construction. In the process of data-collection, Coase is an early practitioner himself. Yet, we cannot conceal Coase’s deep concern about the abuse of mathematics, as the above quotation indicates. A careful reading of Coase makes it clear that his caution and scepticism concerning the use of mathematics come from his two beliefs, which, as we shall see, are solidly founded and widely shared. First, the preoccupation with quantitative data tends to make economists blind to certain aspects of the economic system that are not easily quantifiable.

Aspects of the economic system which are difficult to measure tend to be neglected. It diverts attention from the economic system itself to the technical problems of measurement. I do not mean to suggest that we should avoid quantitative work. But it is well to remember that there is no such thing as a free statistic. (Coase, 1994, p. 58)

In his presidential address to the American Economics Association, Gerald Debreu (1991, p. 5) expresses the same concern:

In the past two decades, economic theory has been carried away further by a seemingly irresistible current that can be explained only partly by the intellectual successes of its mathematization. Essential to an attempt at a fuller explanation are the values imprinted on an economist by his study of mathematics. When a theorist who has been so typed judges his scholarly work, those values do not play a silent role: they may play a decisive role. The very choice of the question to which he tries to find answer is influenced by his mathematical background. Thus the danger is ever present that the part of economics will become secondary, if not marginal in that judgment.

Second, Coase worries that the use of statistics in economic analysis, with the advent of high-power computers and statistical packages, makes it vulnerable to manipulation: ‘if you torture the data enough, nature will confess’. This concern is not unfamiliar to any veteran in the field.

The computer has made it easy to fish for results. If the statistical analysis does not come out ‘right’ the first or the twentieth time, one can drop a year from the data, add a new variable to explain contradictions, take the logarithm of another variable, and so on until, lo, the desired answer appears—all in just a few minutes. (Stigler, 1988, p. 16)

Coase is more concerned with the role of mathematics in constructing economic theory. With few exceptions, economic theories have been increasingly dressed in mathematical language. The use of mathematics has made theory highly formal and precise, but, according to Coase (1994, p. 94), without making much substantial headway. Furthermore, economic theory becomes less accessible to those who cannot speak the language of mathematics. This criticism is usually construed as Coase’s denial of the progress of economics, and hostility to economic theory and neoclassical economics in particular (e.g., Posner, 1993A). However, Coase’s diagnosis of the current state of economics is not idiosyncratic. In the centennial issue of *Economic Journal*, the title of the piece by Milton Friedman (1991), ‘Old Wine in New Bottles’, sounds disquieting. And it reads:

The substance of professional economic discussion has remained remarkably unchanged over the past century while at the same time the language in which economic analysis is presented has changed so drastically that few economists who contributed to the early volumes would have been able to read most articles in recent volumes. (p. 33)

1 It is beyond the purpose of this paper to review the hot debate in economics regarding the use or misuse of mathematics in theory construction. See Mayer (1993B) for a flavour of this literature.
Against the trend to mathematisation, Coase’s continuous use of non-technical language in the exposition of theoretical arguments is characterised as ‘the most unusual feature of Coase’s writings’ (Posner, 1993A, p. 203). When the whole profession accepts that ‘if it isn’t mathematics it isn’t economics’,¹ it is indeed unusual for Coase to continue to write prose-like theoretical articles. Yet, Coase becomes less uncommon when we read Robert Solow (1985, p. 329):

The true functions of analytical economics are best described informally: to organise our necessarily incomplete perceptions about the economy, to see connections that the untutored eye would miss, to tell plausible—sometimes even convincing—casual stories with the help of a few central principles, and to make rough quantitative judgments about the consequences of economic policy and other exogenous events.

When economic theorising becomes a branch of applied mathematics, economics gradually turns more rigorous but with less substance: it even becomes ‘mathematics without number’ (McCloskey, 1991, p. 9). It is this preoccupation with formalisation at the expense of practical relevance that worries Coase, a practice he calls ‘blackboard economics’. This infamous term figures prominently in Coase’s writings. Indeed, it is this feature of the mainstream economics that Coase disapproves of emphatically. All Coase’s criticism against neoclassical economics is crystallised in this notation. Hence, it behoves us to find out what it means.

In his article, Mäki (1998A, p. 11) complaints ‘the notion of blackboard economics is far from a clear one’. A substantial part of his article is devoted to clarifying this concept from the perspective of realism. This exercise can be largely saved or at least made easier if we remember Coase’s primary methodological message, i.e., economics should investigate the real world working economic system. If economic inquiry losses its touch with and relevance to the real world, it falls into blackboard economics, in which ‘what is studied is a system which lives in the minds of economists but not on earth’ (Coase, 1994, p. 5).

Bearing this in mind, we can better understand why Coase regards the Coase Theorem—when conventionally formulated as the following: in a regime of zero transaction costs negotiations between the parties would lead to the efficient use of economic resources independent of the initial assignment of property rights—‘as a stepping stone on the way to an analysis of an economy with positive transaction costs’ (Coase, 1994, p. 11). This is not because Coase dislikes economic theory, as Posner (1993A, p. 205) accuses, but rather that the assumption of a world of no transaction costs hinders, rather than facilitates, our understanding of the economic system.

Though Coase repeatedly emphasises that economic theories should be realistic, realism, as Coase sees it, is a means, not an end in itself.

Realism in our assumptions is needed if our theories are ever to help us understand why the system works in the way it does. Realism in assumptions forces us to analyze the world that exists, not some imaginary world that does not. (Coase, 1994, p. 18)

At the same time, Coase is fully aware that any theory cannot and should not be completely realistic. We should have justifiable reasons to leave theories or their assumptions unrealistic. Let me quote Coase again.

There are factors we leave out because we do not know how to handle them. There are others we exclude because we do not feel the benefits of a more complete theory would be worth the costs

¹We have recently began to witness reactions against mathematisation in some elite economics departments; see Blaug (1998) for example.
involved in including them. . . . Again, assumptions about other factors do not need to be realistic because they are completely irrelevant. . . . There are good reasons why the assumptions of our theories should not be completely realistic, but this do not mean that we should lose touch with reality. (ibid.)

However, when the quality of economic theory is highly, if not solely, judged by its mathematical vigour, economists are lured away from doing empirically relevant studies, which are time consuming and less respectable. It is for this reason that Coase is cautious of mathematisation. In a recent interview with *Reason*, Coase states (1997B, p. 43)

Economists have been becoming more and more abstract, less and less related to what goes on in the real world. In fact, economists have devoted themselves to studying imaginary systems, and they don’t distinguish between the imaginary system and the real world. That’s what modern economics has been and continued to be. All the prestige goes to people who produce the most abstract results about an economic system that doesn’t exist.

This attitude toward mathematisation makes Coase easily misunderstood as anti-theoretical (Posner, 1993A, B). Though Coase (1993B), Scott (1993) and Mäki (1998B) have clarified this misunderstanding, it is important to re-emphasise that the reason Coase dislikes mathematical theory is not because it is mathematical or theoretical, rather because it is ‘blackboard economics’, pure mathematical exercise out of touch of the real world.

Coase’s emphasis on the empirical relevance of economic theory is actually not as peculiar as we might think. The Nobel lecture of Maurice Allais (1990, p. 5) reads:

When neither the hypotheses nor the implications of a theory can be confronted with the real world, they are devoid of any scientific interests. Mere logical, even mathematical, deduction remains worthless in terms of an understanding of reality if it is not closely linked to that reality.

To pursue theoretical abstraction for a better understanding of the real world characterises Coase’s view toward economic theory. What Duncan Black has said about Coase is worth repeating:

He wanted an Economics that would both deal with the real world and do so in an exact manner. Most economists are content to achieve one or other of these objectives and to my mind the distinguishing mark of Coase’s work in Economics is that, in a fair measure, it achieves both objectives. (quoted in Coase, 1995, p. 235)

VII

When encountering the following quotations,

Biology, even modern molecular biology and modern evolutionary biology, is not governed by a few overarching laws. Biologists are accustomed to expending enormous labor collecting facts. They theorise about facts, but they do not theorize without facts. You do not get praise from biologists for theorizing without facts.

I am pleading here for an economics that seeks out facts of how people do react to situations and tries to base economic theories on these effects rather than on speculations made in armchair.

we may reasonably feel that we are reading Coase. Yet, it turns out that both quotations are from Herbert Simon (1997A, p. 20, p. 26, respectively). Unlike Coase, who is a big hedgehog of economics, if we can borrow Isaiah Berlin’s legendary terminology, Simon’s extraordinary contribution in many contiguous disciplines qualifies him as a fox. Despite their differing interests in substantive subjects (even here they share a deep interest in
business organisations), both are staunch empiricists. What interests me in juxtaposing Coase and Simon is to flesh out the compatibility between their visions.

Simon shares a deep commitment to empirical work and realism, as was made abundantly clear in the preceding quotations. In studying business organisation, Simon (1991, p. 63) comments:

If we are managers, or if we are giving advice to managers, we need a theory of firms that encompasses a great deal of detail about their operation. And it must be a theory that describes them realistically, not an ‘as if’ theory.

This is a position congenial to Coase.

Besides methodology, more promising compatibilities between Coase and Simon lie in substantive matters. When reaching out to other disciplines, Coase is always interested in knowing what they can contribute to better our understanding of how the economy works. In this regard, Simon is certainly one of the few scholars whose pioneering study of human thinking and decision-making has greatly advanced our empirical knowledge of the human actor, his/her limited capacity in acquiring and processing information as well as in making decisions (1997A, B).

Simon’s concept of ‘bounded rationality’ is assimilated into the new institutional economics by Oliver Williamson. Deeply suspicious of any concept containing ‘rationality’, Coase, however, does not think ‘bounded rationality’ does a better job in capturing human psychology (1993B, p. 98). This comes as no surprise, given Coase’s general attitude toward rationality: ‘Most economists make the assumption that man is a rational utility maximizer. This seems to me both unnecessary and misleading’ (1984, p. 231). As Coase explains, it is misleading because we do not know what is being maximised; it is unnecessary because the market structure forces economic actors to behave the way they do.1 When Coase (1978, 1988A, p. 4) reads psychology and sociobiology, he anticipates progress in these disciplines can improve our knowledge of human preference structure, in the hope of replacing the widely used but empty concept of utility and rationality (1978, p. 244).

Nonetheless, Simon’s emphasis on human psychology has at least made economists aware that the real world is populated by Homo Sapiens instead of Homo Economicus (e.g., Thaler, 2000). As a result, the process of decision-making has become an exciting research topic (e.g., Kahneman and Tversky, 1979; Denzau and North, 1994; Selten, 1998), instead of being mechanically simplified as constrained maximisation under the usual rationality assumption. Moreover, when economists realise that what they model is Homo Sapiens rather than ‘rational utility maximisers’, utility or the preference structure itself becomes open for investigation (e.g., Becker, 1996). After this paradigm shift, economists are increasingly appreciative of the non-budgetary constraints imposed by social institutions (e.g., Akerlof, 1984). Both trends of development have added a considerable amount of realism in the study of decision-making, a feature certainly welcome by the new institutional economics.

In the meantime, Simon (1991) is highly sceptical of the new institutional economics, particularly Williamson’s transaction cost economics, which, as he criticises, ‘has not drawn

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1 Coase’s well-articulated critique against ‘rational utility maximizers’ demonstrates to us, so Posner (1993A) claims, his hostility toward neoclassical economics. This misunderstanding is reasonable given the prominent role played by ‘rational utility maximizers’ in textbook economics. However, Arrow (1986) expresses the same scepticism against the received view that economic theories must be based on rationality, see also Becker (1962). In Becker’s (1971) textbook, the most part of consumer theory is presented without the assumption of rationality.
heavily from the empirical work in organisations and decision-making for its auxiliary assumptions' (p. 27). According to Simon (ibid., p. 42),

The attempts of the new institutional economics to explain organizational behaviour solely in terms of agency, asymmetric information, transaction costs, opportunism, and other concepts drawn from neoclassical economics ignore key organizational mechanisms like authority, identification, and coordination, and hence are seriously incomplete.

In his study of ‘organizational economy’, Simon places more emphasis on organisation rather than market (1991). Given the ubiquity of organisations in any modern society, Simon’s stress on organisation is indeed commendable. According to Simon (ibid., 29)

An organizational economy poses the questions of why the larger part of a modern economy’s business is done by organizations, what role markets place in connecting these organizations with each other, and what role markets play in connecting organizations with consumers. Moreover, the boundary between markets and organizations varies greatly from one society to another and from one time to another. What mechanism maintains the highly fluid equilibrium between them?

This research project, as readers can readily see, is consistent with Coase’s proposal on the study of industrial organisation, which we have described in Section II. More specifically, the new institutional economics is not inherently incompatible with those organisational mechanisms as identified by Simon. For example, Coase’s classic, 1937 article, unlike the contractual view of the firm, which obliterates the boundary between the market and the firm, clearly acknowledges the existence of authority within the firm. Moreover, employees’ loyalty to and identification with the firm certainly help to reduce management costs, and hence increase the survival chances of the firm. As a matter of fact, the impact of social relations on the working of the economic system properly lies in the purview of new institutional economics (e.g., Greif, 1994).

VIII

When criticising Coase, Posner (1993A, p. 199) asserts that it is erroneous to associate Coase with the Chicago School, ‘except for those who lump all economists at the University of Chicago into an undifferentiated “Chicago School”’. So admits Steven Medema (1998A, p. 3), an economist with recognised expertise in and high regard for Coasean economics. Does Coase belong to the Chicago School?

To answer this question directly requires us to delimit what the Chicago School is, a task I do not feel comfortable to perform. An indirect approach, as taken here, is to compare Coase with Milton Friedman and George Stigler, the Mr Macro and Mr Micro, respectively, of the Chicago School. This approach is further justified because the reason why Posner disassociates Coase from the Chicago School is the alleged difference between Coase and Friedman and Stigler.

Defining economics by its subject matter clearly distances Coase from other Chicago economists, who largely endorse the dominant view of economics as a science of choice.¹ However, the difference between Coase on the one hand and Friedman and Stigler on the other is somewhat exaggerated and their deeply shared commitment obscured.

¹ Even on this point, Coase is actually not so distanced as appeared. As pointed out by Coase (1994, p. 41), Stigler (1952, p. 1) defines economics as ‘the study of the operation of economic organisations’. This view is clearly indebted to Frank Knight (1967, p. 6) who believes ‘economics deals with the social organization of economic activity’ (italics in original).
The difference between Coase and Friedman is exposed by Coase (1994, pp. 15–32). While Friedman (1953) regards prediction as the sole criterion for judging the merit of a theory, Coase lays much more emphasis on the role of theory in providing a new way of looking at things.

The view that the worth of a theory is to be judged solely by the extent and accuracy of its predictions seems to be wrong. Of course, any theory has implications. It tells us that if something happens, something else will follow, and it is true that most of us would not value the theory if we did not think these implications corresponded to happenings in the real economic system. But a theory is not like an airline or bus timetable. We are not interested simply in the accuracy of its predictions. 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. Faced with a choice between a theory which predicts well but gives us little insight into how the system works and one which gives us this insight but predicts badly, I would choose the latter, and I am inclined to think that most economists would do the same. (Coase, 1994, pp. 16–17)

However, this difference between Coase and Friedman is greatly inflated. As Coase rightly points out (ibid., p. 16), Friedman’s general view toward methodology does not square well with this methodological article (1953). A recent book-long examination of Friedman’s methodology has confirmed Coase’s reading of Friedman’s methodology (Hirsch and de Marchi, 1990).

The key aspect of Friedman’s methodology is his differentiation between the Marshallian and Walrasian methods and his identification with the former (Hirsch and de Marchi, 1990, p. 119; Mayer, 1993A, p. 216). Friedman (1953, pp. 282–3) puts the Marshallian approach this way

The theorist starts with some set of observed and related facts, as full and comprehensive as possible. He seeks a generalization that will explain these facts; he can always succeed; indeed, he can always find an indefinitely large number of generalizations. The number of observed facts is finite, and the number of possible theories is infinite; infinitely many theories can therefore be found that are consistent with the facts. The theorist therefore calls in some arbitrary principle such as ‘Occam’s razor’ and settles on a particular generalization or theory. He tests his theory to make sure that it is logically consistent, that its elements are susceptible of empirical determination, and that it will explain adequately the facts he started with. He then seeks to deduce from his theory facts other than those he used to derive it and to check these deductions against reality. Typically some deduced ‘facts’ check and others do not; so he revises his theory to take account of the additional facts.

What is emphasised here is ‘the ultimate check of deduced against observed facts’ (ibid., p. 283).

Clearly, this Marshallian view of doing economics brings together Friedman and Coase. Though Friedman, a monetary theorist, and Coase, a price theorist, have little in common in terms of subject matter, they clearly share an empirical way of doing economics. This is clear from Friedman’s pioneering study of the monetary history of the United States. The methodology employed in this work reflects the Marshallian way of doing economics. Though econometrics is heavily utilised, Friedman is deeply suspicious of sophisticated econometric techniques in generating any theoretical or substantive insight (Friedman 1953, p. 282–3).

Moreover, the difference in emphasis, i.e., Coase on explanation and Friedman on prediction, does not distance Coase from the Chicago School. On this matter, Stigler is closer to Coase than to Friedman. In his Nobel lecture, where Stigler (1983, p. 552) examines ‘the market for new ideas in economic science’, he claims ‘Economists seldom choose between directly rival theories on the basis of critical empirical tests’. Accordingly, ‘economists have therefore generally chosen to decide between the alternative theories by the process of using each to explore a variety problems’ (ibid., p. 542). ‘The central task of an empirical science such as economics is’, as Stigler continues, ‘to provide general understanding of events in the real world, and ultimately all of its theories and techniques must be instrumental to that task’ (ibid., p. 533).
Coase on the nature of economics

According to David Colander (1998, p. 89), 'the Friedman methodological approach is to concentrate on real problems, continuously test one’s theory against the empirical evidence, and not to bother with highly abstract theory except as a backdrop for developing a testable theory'.

At the same time, Friedman’s (1953, p. 283) characterisation of Walrasian economists reminds us Coase’s critique of mainstream economists.

[He] largely dispenses with the initial step—a full and comprehensive set of observed and related facts to be generalized—and in the main reaches conclusions no observed facts can contradict. His emphasis is on the formal structure of the theory, the logical interrelations of the parts. He considers it largely unnecessary to test the validity of his theoretical structure except for conformity to the canons of formal logic. His categories are selected primarily to facilitate logical analysis, not empirical application or test. ... The theory provides formal models of imaginary world, not generalizations about the real world.

It thus becomes clear that Coase’s Englishness (or more specifically, Marshallianess)1 does not distance him from the Chicago School, as both Posner (1993A, p. 204) and Zerbe and Medema (1998) charge. On the contrary, defending and exemplifying the Marshallian way of doing economics emphatically makes Coase a Chicago economist.

As we have pointed out, another major reason Posner (1993A) exiles Coase from the Chicago School is Coase’s alleged hostility toward the use of mathematisation or formalism in economics (Posner, 1993B, p. 75). This allegation, however, has little relevance, even if it is true. As Posner (1993A, p. 206) admits, a defining characteristic of the Chicago School is that it keeps high theory in low profile and grants high priority instead to understanding concrete economic problems. It is this feature that distinguishes Chicago from Harvard or MIT. As Friedman (Hammond, 1992, p. 110) tells us:

The fundamental distinction is treating economics as a serious subject versus treating it as a branch of mathematics, ... at Chicago, economics was a serious subject to be used in discussing real problems, and you could get some knowledge and some answers from it. For Harvard, economics was an intellectual discipline on a par with mathematics, which was fascinating to explore, but you mustn’t draw any conclusions from it. It wasn’t going to enable you to solve any problem, and I think that’s always been a fundamental difference between Chicago and other places.

Stigler (1988, p. 71) has similar remarks:

At leading centers of economic theory, such as MIT, it has been the practice to ask, Is the new theory logically correct? That is a good question but not as good as a second question. Does the new theory help us to understand observable economic life? No one will deny the desirability of eventually asking the second question, but many economists prefer to leave the question for a later time and a different person to answer. That division of labor is quite proper, but until the second question is answered, a theory has no standing and therefore should not be used as a guide to public policy.

But how can we make economics helpful to understanding the real world economic system?

In his presidential address to the American Economic Association, Stigler (1965, p. 2) reminds economists that their comparative advantage lies in their competence in ‘understanding how an economic system works under alternative institutional framework’. Based

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1The Coasean approach to economics actually resembles, if not continues, what Macfie (1967) called ‘the Scottish tradition in economics’, a rich and powerful line of thought that can be traced back to Francis Hutcheson, David Hume and Adam Smith and was kept alive until Alfred Marshall. In this tradition, economists ‘are typically curious about people, men at work, about comparative institutions and what we could call “social statistics”. They are not concerned with logical processes or sequences, or the framing of abstract hypotheses and their analysis to their utmost limits. They wish to build a truly balanced picture of social life as they found it and the forces which controlled it’ (p. 29).
on this fundamental insight, Stigler goes on, ‘[t]he basic role of scientist in public policy, therefore, is that of establishing the costs and benefits of alternative institutional arrangements.’ Stigler’s emphasis on facts and analyses of comparative institutional arrangement echoes Coase’s methodological message and is certainly in line with the Marshallian approach as described and endorsed by Friedman. Indeed, it is their shared emphasis on empirical facts, on the practical relevance of economic inquiry, and on comparative institutional analysis as the way to do economics that bring Friedman, Stigler and Coase together.

IX

For one reason or another, Coase is apt to be received as someone who accepts uncritically the primacy of market over government and is hostile to public intervention (e.g., Posner, 1993A, p. 201). This impression is too simplistic, to say the very least, and indeed, plainly inaccurate.

True, profoundly influenced by his teacher Arnold Plant at the London School of Economics (LSE), Coase was convinced quite early on, indeed while still a young socialist, that the economic system works itself.1 The intellectual faith in the ‘natural economic order’ made Coase deeply cautious about government intervention. This caution has grown deeper and firmer after his teaching of the Economics of Public Utilities at LSE and careful investigation of British public utilities.

These researches taught me much about the public utility industries and they certainly made me aware of the defects of government operation of these industries, whether municipal or through nationalization. These researches were interrupted by the war, when I joined the civil service, at first, for a short period, in the Forestry Commission, then responsible for timber production, and for the rest of the war, in the Central Statistical Office, one of the Offices of the War Cabinet. This war-time experience did not significantly influence my views but I could not help noticing that, with the country in mortal danger and despite the leadership of Winston Churchill, government departments often seemed more concerned to defend their own interests than those of the country. (1996, pp. 106–7)

Nonetheless, Coase (1937) was too keen an observer to overlook the prevailing existence of economic planning in both capitalist and socialist economies. Indeed, in most firms, the coordination of various factors of production is normally carried out without ‘the intervention of the price mechanism’ (p. 388). It is certainly not true that economists before Coase were blind to the coexistence of the price mechanism and firm as alternative ways of organising exchange and coordinating economic activities. On the contrary, they were aware of ‘islands of conscious power’ in the ‘ocean of unconscious co-operation’ (ibid.). It was Coase, however, who first detected its simple and fundamental economic significance. The coexistence of the firm and market propelled Coase to ‘explain the basis on which, in practice, this choice between alternatives is effected’ (ibid., p. 389). This simple yet powerful view is later gradually developed into his distinctive methodology of comparative institutional analysis.

Obviously, any one with such a balanced view of the market and firm would find it difficult to accept uncritically the primacy of the market. This becomes abundantly clear if

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1 Remembering his mentor, Plant, Coase has the following to say:

He thought of the consumer as the ultimate employer, with competition as the mechanism through which the consumer exercised his control. Monopoly he considered to be transitional and usually unimportant. The state had a legitimate role in providing law and order and preventing misrepresentation and fraud. But state intervention was commonly designed to help special interests, did not promote competition but monopoly, and imposed economic regulation which often made matter worse. (1994, p. 181)
we examine in detail Coase’s attitude toward government regulation as represented in The Nature of the Firm and The Problem of Social Cost.

First of all, the State, just like the businessman or firm, can and indeed does coordinate economic activities, as a replacement to the market mechanism. This similarity is recognised in a footnote in Coase (1988A, p. 37).

It is easy to see when the State takes over the direction of an industry that, in planning it, it is doing something which was previously done by the price mechanism. What is usually not realised is that any business man in organising the relations between his departments is also doing something which could be organised through the price mechanism.

Second, the state, the firm and the market are three alternative ways of undertaking economic coordination. In theory, none is more or less efficient than the other. It is important to emphasise here that Coase does not believe that government regulation necessarily generates inefficiency. ‘The government has powers which might enable it to get some things done at a lower cost than could a private organization’ (1988A, p. 117). But nor does Coase believe, as most economists did then, in the supremacy of government regulation.

Direct governmental regulations will not necessarily give better results than leaving the problem to be solved by the market or the firm. But equally, there is no reason why, on occasion, such governmental administrative regulation should not lead to an improvement in economic efficiency. (ibid., p. 118)

Therefore, ‘[s]atisfactory views on policy can only come from a patient study of how, in practice, the market, firms, and governments handle the problem of harmful effects’ (ibid.). In his study of British Broadcasting, since ‘the alternative methods of organization have never been set out and their advantages and disadvantages appraised’, Coase realised that it is ‘almost impossible for anyone who has not himself undertaken a study of the probable results of alternative arrangements to come to any definite conclusion as to whether a monopoly is desirable’ (1950, p. 179).

If government regulation is not necessarily inefficient, what then makes it generally so? Coase clearly rejects the possibility that ‘the costs of government are always greater than they would be for the market transactions that would accomplish the same result’ (1994, p. 62). Instead, the answer lies else where. Primarily, the government is simply attempting to do too much. ‘It operates on such a gigantic scale that it has reached the stage at which, for many of its activities, as economists would say, the marginal product is negative’ (Coase, 1994, p. 62). Indeed, this point was long hinted out in The Nature of the Firm.

A further question naturally arises, ‘Why do we have too much regulation in the first place?’ Two factors are relevant here. First, the government as ‘a super-firm’ differs from the ordinary firm in that the latter is subject to the competition of other firms as well as the market, while the government can abolish the market altogether (ibid., p. 117). This unique feature of government, not shared by private firms, makes it over-expand easily. At the same time, economists have also played their part. Whenever the market fails to do its job satisfactorily, government regulation is usually called for as a remedy. This unexamined confidence in government regulation, without empirical comparison of the actual performance of government versus the market or private firms, as Coase (1994, pp. 62–3) points out, has been largely responsible for the over-growth of government regulation.
If there is some truth in the conventional reading of Coase that he is hostile to government intervention, he is not hostile to government regulation per se, but rather its uncritical acceptance among economists and policy makers.

In this context, we should also qualify a related interpretation of Coase, as clearly exposed by Calabresi (1991). As Calabresi (ibid., pp. 1211–12) puts it, Coase, as a young socialist, emphasised the cost of the market in *The Nature of the Firm*, while twenty-five years later and as a middle-aged libertarian, he emphasised the possible benefits of the market in *The Problem of Social Cost*. This contrast between the earlier socialist and later libertarian Coase, and the implied link between the shift of political belief and economic thinking, is as perceptive as it is deceptive. The thematic continuity, i.e., the common emphasis on transaction costs, between the two pieces, has been emphasised by many scholars, including Coase (1988B) himself. It is misleading to suggest a shift of position from stressing the cost of the market in *The Nature of the Firm* to stressing the benefit of the market in *The Problem of Social Cost*.

First, *The Problem of Social Cost* does not naively emphasise the potential benefits of the market, as is usually understood. Coase (1994, p. 11) has the following comments on the Coase Theorem.

It does not imply, when transaction costs are positive, that government actions (such as government operation, regulation or taxation, including subsidies) could not produce a better result than relying on negotiations between individuals in the market. Whether this would be so could be discovered not by studying imaginary governments but what real governments actually do. My conclusion: Let us study the world of positive transaction costs.

Second, this reading of Coase becomes more problematic if we examine *The Nature of the Firm* carefully. Though the cost of market is emphasised, which might be influenced by his then political belief in socialism, as Coase admits (1996, p.106), this article actually advances a non-monopolistic, efficiency-enhancing explanation of the firm. The firm helps to improve economic efficiency if we take into account the cost of using the price mechanism. Without the concept of transaction costs, many business practices, including the rise of firms in replacing the market mechanism, are commonly regarded as monopolistic in nature and thus inefficient, which presumably justifies, and opens the door for, government regulation. Highlighting the cost of using the market mechanism, this article ironically protects a large territory in the economy from governmental intervention, since the realisation of transaction costs strengthens rather than weakens the argument for the limited use of governmental intervention in economic activities, given that the government agent is far less knowledgeable than individuals, and less motivated to acquire relevant information, a point long ago stressed by Hayek (1945).

In choosing the topic for economic inquiry, Coase (1994, p. 175), following Marshall, urges us to ask, ‘Do we concern ourselves not with the puzzles presented by the real economic world but with the puzzles presented by other economists’ analysis?’ In this regard, this paper falls short. It is not directed at real world economic problems, but to other economists’ analysis. By doing so, however, this paper hopes to dispel some of the widely held misunderstanding of Coase, and, more importantly, to suggest a research programme informed by Coasean economics.

In 1980, when Coase was honoured as Distinguished Fellow by the American Economics Association, the praise reads:
Coase on the nature of economics

In a generation that will be remembered for its introduction of logical rigor into economics and for its refinement of quantitative empirical tools, a few economists have steadfastly practiced economics as a social science, a study of relationships between men mediated by the social institutions through which they deal with one another.

Ronald Coase stands in the forefront of these economists. . . . Antaeus lost his strength when his feet left the ground. We honor Ronald Coase for keeping his feet always grounded in the realities of economic-social life, and for reminding us, by demonstrating the strength so gained, that that is where our feet belong also.

Comparing economics with biology, a discipline dealing with an equally complicated organic system, Coase (1998, p. 73) sets a high long-term goal for economics. ‘Biologists now have a detailed understanding of the complicated structures that govern the functioning of living organisms. I believe that one day we shall have similar triumphs in economics.’ To stand on a firm and realistic ground, with eyes open on the working of the real world economic system, sets us on a right track to this destiny.

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