Remembering Ronald Coase's Legacy

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Article at a Glance:

- Ronald Coase pioneered the work on transaction cost, which was transformative to economics at large.
- The International Society for New Institutional Economics (ISNIE) continues Coase's work and celebrates his legacy.
- Oliver Williamson commemorates Coase, who was known for generously sharing credit for his work.

This article is based on a speech presented on March 27, 2015 in Washington, DC at a conference titled "The Next Generation of Discovery: Research and Policy Change Inspired by Ronald Coase." *The conference was co-hosted by the Ronald Coase Institute and the Center for International Private Enterprise (CIPE) to pay tribute to Ronald Coase and celebrate his legacy.*

Coase's Education in the Early Years (1930-37)

Sidney Winter and I were both at Yale in 1987, which was the 50th year after Coase published his 1937 paper on the nature of the firm. We thought 1987 was a noteworthy event and contacted Coase to see if he had an interest in organizing a conference to revisit the issues. Coase not only expressed interest in it but furthermore proposed to prepare three lectures: the first on the origin, the second on the meaning, and the third on the nature of the firm.

His first lecture concentrates on the complications he encountered when he was seeking to define a research program upon which to base his dissertation. There were obstacles. Part of the difficulty was that by reason of lack of Latin and mathematics, Coase was unable to qualify for a science degree. Such a degree being out of reach, he decided to work on a commerce degree. One such possibility was to take up what he referred to as group D (industry) courses as part of the bachelor of commerce, which he described as recommended to those wishing to enter the engineering and metal trades, distributing trades in certain instances, and generally for those engaged in works and factory management. It was a choice of occupation for which Coase described himself as, "singularly ill-suited, but what else was there for someone to do who did not know Latin and did not like mathematics?"

Grim, but not as bad as it seemed. For one thing, Coase had considerable perseverance upon which he could call. Also, a new teacher, Arnold Plant, had terminated his teaching at Cape Town and accepted an appointment at the London School of Economics. Plant had long taken the subject of economics seriously and he communicated that attitude to

Coase. Also Coase and his fellow student Ronald Fowler perceived the common need to develop a deeper understanding of contract and its relation to economics.

Qualifying as he did for a Cassel Traveling Scholarship, Coase decided to spend the next year in the United States, mainly to examine the purposes served by various forms of organization, and he described it as follows: "The route which was ultimately to take me to a theory of integration is a curious one, and the more so because it came about in part as a result of examining the role in promoting vertical integration of what is now called asset specificity. (1988, p. 12)

Chapter 1 of Coase 1989 is summarized as: "I cannot say exactly how I came to hit upon the solution. Getting an idea is the kind of process in which you don't know what you're doing until you've done it. The solution was to realize that there were costs to making transactions in a market economy, and that it was necessary to incorporate them into the analysis. This was not done in economics at that time, nor I may add is it in most present day economic theory. However, once taken into account, everything falls into place." (p. 17)

'Falls into place,' however, is a vague claim. What exactly are the mechanisms? It is noteworthy that this would remain a vague claim even after Coase's paper, "The Nature of the Firm," was published in 1937 by *Economica.* Most certainly one of his insightful observations is that "Outside of the firm price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production." He observes that we have to explain the basis on which in practice the choice between alternatives is effected.

Coase's Insights on Externalities

Although Coase's 1937 article was for many years ignored, his 1960 paper on the problem of social cost received immediate attention. Kenneth Arrow's remarks were especially instructive. "Current writing has helped bring out the point that market failure is not absolute. It is better to consider a broader category, that of transaction costs, which in general impede and in particular cases completely block the formation of markets. It is usually though not always emphasized that transaction costs are costs of running the economic system. An incentive for vertical integration is the replacement of the costs of buying and selling in the market by the costs of intrafirm transfers; the existence of vertical integration may suggest that the costs of operating competitive markets are not serial, as is usually assumed in our theoretical analysis." This was stated back in 1968, and things have changed since. The new science of comparative institutional analysis would eventually take hold, albeit gradually.

Public Policy Disarray, and Efforts in the 1970's to Break Away from Orthodox Public Policy

Ronald Coase and I were two among four economists who were invited by the National Bureau of Economic Research to participate in the November 1970 panel on policy issues and research opportunities in industrial organizations. Victor Fuchs as moderator opened the discussion as follows, “Wither industrial organization…(A)ll is not well with this once flourishing field.” (1972, p. xv)

And that was exactly right. The fact is that industrial organization for the most part was content, and was not about to be changed. Between Coase and me, Coase was the more skeptical of the two of us, yet Fuchs also recorded similarities (1972, p. xv-xvi). “Both Coase and Williamson stress the need to study why firms are formed and why they assume certain activities and not others. According to Coase, ‘The source of the gain from having a firm is that the operation of a market costs something, and that by forming an organization and allowing the allocation of resources to be determined administratively, these costs are saved.’ In a similar vein, Williamson concludes that, ‘…the question of organizational design is intrinsically interesting and inseparably associated with efficiency considerations… The study of firm and market structures …can benefit from more systematic examination of the sources and consequences of market failure, and by a fair assessment of the powers and limits of internal organization.’”

I would describe my 1971 paper on the vertical integration of production market failure considerations as follows. One, it examines economic organization through the lens of contract rather than through the orthodox lens of choice. Two, it provides for bonded rationality on which account all complex contracts are incomplete. Three, it makes provision for a strategic behavior (defection from the spirit of cooperation) if an outsourced good or service experiences disturbances for which the stakes are great. And four, it distinguishes between investments in generic assets and specific assets where a bilateral dependency relation between buyer and seller is ascribed to the latter. Taken together the arguments come down to this: whereas efficient intermediate product market exchange is usually well-served by a simple market exchange if the assets are generic, the advantage shifts to hierarchy as bilateral dependency builds up by reason of asset specificity and outlier disturbances.

While these views were taking shape for some of us, public policy toward business remained, for the most part, in this structure-conduct-performance camp. Indeed Industrial Organization in this “structure, conduct, performance” tradition was confident that this framework was all together efficacious, both as it relates to textbook Industrial Organization and for anti-trust enforcement purposes. Minority challenges, however, were beginning to appear. The new economics of organization was asking “what is going on here,” and pressing the issue. Ronald Coase contributed to this through his micro-analytic motive analysis in which transaction costs were both important and susceptible to analysis. Thus, although textbook industrial organization and anti-trust enforcement agencies, and I emphasize agencies because there were anti-trust specialists out there that were beginning to become cautious, appeared to be content t things would soon be taking a turn as Coase (1972, pp. 63, 67), Williamson (1972, pp. 16-17), Fuchs, and others who participated at the National Bureau of Economics Program made their case. For many of us, a New Economics of Organization would be soon upon us – where infirm and market were alternative modes of governance, to be aligned with transaction in an economizing way.

International Society for New Institutional Economics (ISNIE) and Coase's Legacy

The New Institutional Economics was taking on an identity of its own as a growing number of researchers made their interests known. A meeting was held at Washington University and a decision was made to organize the International Society for New Institutional Economics, the first three presidents of which would be Ronald Coase followed by Douglass North, and the third being myself. There were to be sure a lot of startup costs and controversies indeed. There have been continuing controversies and reforms. Passing on the gavel to a series of confident young leaders from North America, Europe, and spreading out to include Asia will be transformative.

'As if' discussion between Coase and Williamson

Many of my colleagues and students organized a 70th birthday party for me in the year 2002. Coase did not attend that party but he sent me a letter on October 23rd that reads in part as follows.

"Oliver, all economists who have an interest in transaction cost economics owe an immense debt to you. Indeed, transaction cost economics is to a large extent your creation. Seventy is no age at which to stop this important work and I know that you won't. While I hope to benefit from some of the work you will be doing in the next 30 years, most of that benefit will inevitably go to others. I envy them. With all good wishes, Ronald Coase."

Several things from this note bear remark. For one, I am prepared to take some credit for transaction cost economics, but I have grave doubts that I would have started down this track but for the earlier work of Coase (1937, 1960) and Arrow (1968). I also, moreover, am of the view that my three years of training at the Graduate School of Industrial Administration at Carnegie Mellon University were foundational for me and others in interdisciplinary respects.

Economics to be sure was central, but interdisciplinary social science was crucially important. Also, I do not want to omit the years from 1988 to 2004 when I was teaching economics at Berkeley. My graduate students were extraordinary, both in the classroom and in the workshop. They were for me a teaching experience beyond belief.

Now I come to the last exchange between Ronald and myself, and how we are related. Much of Ronald's work predated mine. To repeat, I have grave doubts that my work on the theory of the firm and applied welfare economics would have materialized had I not read Coase and Arrow, both of them generous in recognizing my work and making provision for it, as witnessed in the remarks of Kenneth Arrow elsewhere, but Coase in the context of my earlier remarks.

Coase actually sent me the following material. "Although attention given to my argument on the nature of the firm in the 1970s and the 1980s derived in part from the interest in my views generated by the social cost article," and this is Coase describing himself here now, "and the greater appreciation of the importance of transaction costs which brought it about, the writings of Williamson must have had the same effect. His work, *Corporate Control and Business Behavior*, published in 1970, and especially his *Markets and Hierarchies* published in 1975 must have made many economists aware that there was an approach to industrial organization different from that commonly espoused."

"The alternative approach that Williamson presented depended on the distinction between markets and hierarchy, and incorporated transaction cost into the analysis, and examined in much greater detail than is usual with economists, the problems of the internal organization of the firm. His approach is broadly consistent with "The Nature of the Firm" to which he refers, and must have led some economists to examine or reexamine that article. Williamson ascribes the non-use of my thesis to the fact that it had not been made 'operational'. As he said in 1975, 'Transaction costs are appropriately made the centerpiece to the analysis but these are not operationalized in a fashion which permits one to assess the efficacy of completing transactions between markets and hierarchies in a systematic way.' Williamson has reaffirmed this view in 1985 and 1986. I think it is largely correct."

No question that Coase, both on his own and through his influence on others, will be with us forever. One of the ways he will be remembered is that he shares credit so generously.

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

Oliver Williamson is a 2009 Nobel laureate in Economic Sciences. Williamson earned a bachelor's degree in management from the Massachusetts Institute of Technology Sloan School of Management, a master's degree in business administration from Stanford University, and a Ph.D. in economics from Carnegie Mellon University. He was an assistant professor of economics at the University of California in Berkeley until 1965, when he began teaching at the University of Pennsylvania. In 1983 he was named the Gordon B. Tweedy Professor of Economics of Law and Organization at Yale University, and at Berkeley, served as professor of the graduate school and the Edgar F. Kaiser Professor of Business, Economics, and Law in the Haas School of Business.[1] He is considered a pioneer in the field of New Institutional Economics.

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[1] http://www.britannica.com/biography/Oliver-E-Williamson

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