COASE LOOKS AT CHINA

Property rights and transaction costs revisited.

Reducing Ronald Coase's doctrine on the problem of social cost to a so-called 'Coase theorem' does little favor to his outstanding contribution to the theory of market efficiency. Many of us economists have made this mistake when following Stigler's summary presentation of Coase on externalities. I myself have taught year after year that, *given well defined property rights and zero transaction costs, all so-called externalities can be solved by agreement between the affected parties, if one leaves aside changes in distribution resulting from such agreements.*

This reduced form of Coase's structural model (if I may use these concepts taken from econometrics) fails to do justice to his thought. True, there were ambiguities in his presentation that made such a mistaken interpretation possible. But a proper interpretation of Coase's theory will make it much more useful in explaining real problems than his theorem can do.

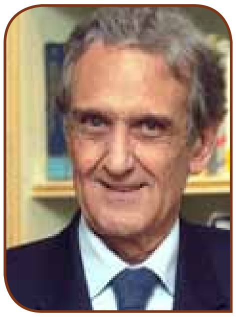
The assumption of zero transaction costs, that of well-defined property rights, and that of ignoring distributional effects, are not necessary for understanding the social forces that Coase uncovered. Indeed, the criticisms of such authors as Cooter or Buchanan lose much of their sting if one does away with those three assumptions. Cooter showed that Coase's theorem is not valid in non-competitive or small number situations. Buchanan objected to the implication of some Coasian formulations that efficient social outcomes could be observed from the outside as if by some neutral all-wise observer. These objections are properly directed to Coase's theorem but not to Coase's theory.

The need for a reformulation of Coasian doctrine becomes evident when one reads the great man on the Chinese economy. When he was celebrating a century of a fruitful life, Coase wrote with Ning Wang a book titled *How China Became Capitalist* (2012). There, Coase and his co-author apply his theory to the extraordinary transformation of the Chinese economy without having to assume well defined property rights, zero transaction costs, or indifference to distribution effects. This book demands giving up the Coase theorem and formulating a more complete Coase theory than is currently taught.

Stigler on the Coase Theorem

In the century following J.S. Mill's discussion of the limits of *laissez faire* in 1848, the economic profession slowly widened the number of cases when a free market failed to deliver efficient outcomes. Pigou's case against free markets was that they were inefficient due to an endless number of external effects. In his study of *The Economics of Welfare* (1920, 1932), he argued that social welfare often did not coincide with the private welfare sought by market participants, as for example happened with the proverbial factory freely belching smoke or Dr. Fleming discovering penicillin. In those cases, the state could impose taxes or grant subsidies to channel private activity fully into maximising social welfare. This idea of Pigou's became the accepted doctrine of the profession in the first part of the 20th century.

Ronald Coase turned the tables on Pigou with three arguments: that people and firms often corrected externalities by mutual



Pedro Schwartz is president of the Mont Pelerin Society, an adjunct scholar of the Cato Institute, and Rafael del Pino Research Professor at the Universidad CEU San Pablo de Madrid.

agreement; that the resulting agreements were not determined by government or in court adjudication of the right to pollute or to be indemnified; and that solutions imposed by government often resulted in worse outcomes than the starting situation.

George Stigler in his *Memoirs* (1988) tells the story of the famous 1960 dinner at the home of Aaron Director to discuss 'how so fine an economist as Coase cold make so obvious a mistake' as to criticise Pigou's theory. Twenty economists, among them Milton Friedman and George Stigler himself, listened to Coase making the heretical proposition that

> Whatever the assignment of legal liability for damages, or whatever the assignment of legal rights of ownership, the assignments would have no effect upon the way economic resources would be used!

In the end Coase changed a minority of one at the beginning of the dinner into unanimity of 21 in his favor.

Coase did not take it for granted that markets functioned perfectly. High transaction costs often made it difficult to come to effective agreements. But he pointed at the often unrecognised government imperfections and at the nugatory effect of sovereign decisions, and concluded that, when markets did not function *and* there was high probability of government failure, then doing nothing could turn out to be the best policy.

Stigler recast these thoughts of Coase's into a theorem by boiling down Coase's theory into a simple model. When remembering the dinner, he said that Coase had asked them to assume zero transaction costs. Though the assumption was heroic in most cases—because transaction costs are never zero in a market—once accepted, the final agreement could be expected to be an optimum. To explain this, Stigler did give a real example of zero transaction costs: if both the polluter (the cattle owner) and the party harmed (cultivating corn in an open field) merged into a single firm. In that case the single owner would organise production so as to maximise the joint product of both activities. That is what in his *Memoirs* he called 'the Coase Theorem'. No formal Coase theorem can be found in Coase's work.

If Coase made the assumption of zero transaction costs at the dinner, it must have been because that was the way his Chicago friends tended to reason. But in the seminal 1959 paper on the Federal Communications Commission where he proposed that radio frequencies be auctioned to the highest bidder and rejected administrative allocation of frequencies, there was no mention of zero transaction costs. And neither is there in Coase and Wang's book on China's road to capitalism.

Coase did not take it for granted that markets functioned perfectly.

Cooter on Coase

One of the most effective critics of Coase on social cost is Robert Cooter in his 1982 article 'The cost of Coase'. He there shows that, from the point of view of 'objective' or 'outside evaluation of' efficiency, Coase's theorem is only valid under conditions of perfect or at least sufficient competition.

The reason why this is so is that the distributive effects of moves to make markets more efficient will give rise to disputes about the sharing of the benefits and therefore to indecisive bargaining. A fully competitive market is a pure cooperation game, where the distribution of gains from moving nearer to a Pareto optimum are nugatory or nil, since participants cannot threaten each other with strategic moves. When numbers are small there always is the danger that the attempt of one party to hog most of the benefit of the proposed move will lead to a breakdown of negotiations and losses all round. The way out from these mutually destructive attitudes is said to be one of two: Coasians will propose that transactions barriers be removed so that the bargaining takes place in as fully competitive a situation as possible; Hobbesians on the contrary will want to create a Leviathan with powers to contain the violence of participants.

Cooter is quite right in saying that a number of elements in bargaining processes are wrongly classified under the rubric of transaction costs:

'Bargaining games have non-cooperative outcomes even when the bargaining process is costless'. He adds that 'it is cheaper to engage in strategic behavior when communication is inexpensive'. Buchanan goes as far as to speak of 'The irrelevance of transaction costs' (the title of a paper of 1984). He even takes up some of Cooter's objections to the *porte-manteau* character of transaction costs. They not only are made to include the prohibitions, such as that of side-payments, often imposed by authorities; they also are presented as including information and communication constraints; and, least acceptable, also free-riding and strategic behavior.

The conclusion of Cooter's critique is that the Coase Theorem has limited applicability, and is valid only for competitive markets. Should we rest content with this negative conclusion?

The notion of transaction costs is not very useful.

Buchanan's Institutional Point of View

The starting point of Buchanan's critique (1984) is that Coase and many Coasians seem to think that there exists a unique efficient allocation of resources in any situation that can be seen as determinate by any external observer. He proposes that the analysis of Ronald Coase be re-interpreted from what he calls a 'subjectivist-contractarian' point of view. He also terms this viewpoint as 'Austrian-Wicksellian'.

He started, as was his wont, by denying that optima were observable. The fallacy in ordinary formulations of the Coase Theorem was that the optimum can be objectively defined. It was wrong to define a situation as beset by externalities because an objective optimum had not been reached. 'It is unfortunate', he said, 'that Coase presented his argument … largely in terms of presumably-objectively measurable and independently-determined harm and benefit relationships'. It was a mistake to think 'that an 'efficient' … allocation exists and becomes determinate conceptually to any external observer'. An external observer could not determine whether a trade fell short of an optimum. Each transactor discovered what was optimal for him or her and accordingly when he came or failed to come to an exchange. Realised trades, whether under conditions of perfect competition or not, must be optimal, though the institutional framework may not be. Whether transaction costs are high or low is irrelevant for the decision to execute or not the trade in question: it will be optimal '*given the institutional setting*'.

Now, this seems to be fiction out of Voltaire's *Candide,* where everything is for the best in the best of possible worlds, be it the rape of Cunegonde or the destructive Lisbon earthquake of 1755. Not so, says Buchanan. When the parties to a transaction discover they are not satisfied with the agreement reached, they will try to change the institutional framework in which they operate, as long as they can negotiate without political interference. 'If the initial [institutional] constraints are deemed to be 'inefficient' potential traders will, themselves, find it advantageous to invest resources in efforts to shift them'.

> Agreement on a change in the rules within which the exchanges are allowed to take place would be a signal that patterns of outcome reached … under the previously-existing set of rules are less preferred or valued than the patterns expected to be generated under the rule-as-changed.

Two unexpected and illuminating consequences can be drawn from this analysis. The first one is that the notion of transaction costs is not very useful, as Cooter had foreseen. These 'objectively observed transaction costs' are a rag-bag of information deficiencies, prohibitions by authorities, voluntary hiding of intentions, strategic behavior, anti-social free-riding—not helpful analytical tools. The second one that these

> so-called 'transaction costs' barriers to 'efficiency' in resource allocation can be more appropriately analysed in the context of hypotheses about institutional reform.

Now, the shifting of the quest after 'efficiency' to the higher plane of institutional reform must again be seen as a subjective affair where groups of people may try to change the rules that irk them. Buchanan explains this with an illuminating reinterpretation of the proverbial 'prisoners' dilemma'. The suboptimal result suffered by the two arrested criminals held *incommunicado*, who will confess to the crime because they cannot rely on the other's silence, is inefficient for the delinquents but perhaps not for society in general. The fraternity of *Mafiosi* may want to impose the law of *omertà* under threat of reprisals, but law-abiding citizens may prefer to make some turn Crown evidence. Different groups in society may have diverse views of 'efficiency' and will pursue them on their own if they find a way. We shall see that this subjective and contrasting way of understanding efficiency throws light on China's progress to capitalism.

Coase on Capitalist China

Towards the end of his life, Ronald Coase started to take an interest in China's evolution towards capitalism. The result of this new interest is the book he wrote with Wang Ning, *How China Became Capitalist*, when he was 102. I warmly recommend Coase and Wang's book for the extraordinary tale they recount. From the outside, China's transformation is astounding; from the inside, as told in this book, it is nothing short of miraculous. There was not a moment when it could be taken for granted. The freeze after the Tiananmen massacre in 1989 seemed to put the whole process in danger.

Neither is the future free of danger, especially in view of the parlous state of Chinese banks—and that is aside from the difficulties of moving towards more personal and political freedom. The authors underscore

> the lack of a market for ideas which is directly responsible for the lack of innovation in science and technology, the Achilles' Heel in China's growing manufacturing sector.

From the point of view of this article, the interest of the book lies in its thesis: that the transformation of China from a socialist tyranny into a *sui generis* capitalist economy was not planned by the Communist Party and the different governments that ruled the country after Mao. It was the unintended result of a policy aiming at the preservation of socialism by fostering growth.

It was the consequence of the unexpected expansion of what the authors call 'the four marginal forces' —marginal in the sense that they gathered strength below the horizon of the government's radar, so to speak. The Chinese leaders were content to tolerate a measure of private activity as long as they kept control of state enterprises; and thus 'private farming, township and village enterprises, individual entrepreneurship, and the Special Economic Zones' enjoyed an increasing degree of economic freedom, as long as they did not threaten official socialism.

These new freedoms evolved unwittingly. They were not the consequence of a previous definition of property rights by Chinese central authorities or Chinese courts. Neither was there a concerted government plan to remove administrative barriers or reduce transaction costs.

> The transformation of China from a socialist tyranny into a *sui generis* capitalist economy was not planned.

The transaction costs for individual entrepreneurs in a communist society must have been almost insurmountable, especially in the beginning, when downright corruption and capitalist business were almost indistinguishable. Market solutions were discovered and applied through agreements between private people. The state and local authorities were then called in to redefine property rights so as to accommodate new business arrangements. As the authors underline,

> China did not first delineate property rights, specify other relevant institutional rules and then allow market forces to allocate rights to the highest bidder. … During the first two decades of reform, as

> China remained committed to socialism and against outright privatisation of state assets, what rights private actors obtained from the state were subject to individual negotiation.

Change was speeded up because the state followed the promptings of private business and did not have 'to get the rights right before their economic values were revealed in competition'

> as economic conditions changed over time … [The] state was thus frequently called to revise and redefine the structure of rights.

There was no need for perfect competition to avoid conflicts over the sharing out of the new wealth.

No Need for Perfect Competition

The advantages of moving from an ill-functioning socialist economy to productive capitalist markets thus happened spontaneously. There was no need for perfect competition to avoid conflicts over the sharing out of the new wealth. Neither was there need for a Leviathan to stop conflicts over the distribution or sharing of the proceeds of greater productivity. There were conflicts but mostly these were caused by unwanted state interference rather than by capitalist growth but 'Corruption' was a way of sharing the proceeds of improvement more widely than political planning and interference would allow. The growth in wealth was so large that there was room for the bettering of all—except when politicians tried to stop change.

It is here that Buchanan's reformulation of the prisoners' dilemma comes in handy. We saw that this model is usually presented as a failure of the free market because the two prisoners, by following their interest, land themselves in a worse position than they would wish. Buchanan split the social group into two: criminals and honest people. Holding the delinquents *incommunicado* was against their interests but could be favored by the rest of society, as helping curb crime. The criminals, however, could find ways of ensuring that no prisoner deserted his mates by some enforceable contract or agreement.

China's social reality leads me to invert Buchanan's analysis. The state and its rulers might prefer to control and even stop the disobedient minority. But the ingenuity of the innovators slowly forced the authorities to allow more innovation. Individuals took matters in their own hands, sometimes with considerable danger to themselves. It is here that we must apply Buchanan's reformulation of the prisoners' dilemma.

'Private business in cities was most vulnerable to the accusation of 'economic crime',' write Coase and Wang, but individuals could always be found who beat the system. The authors tell the charming story of Nian Guangjiu in the Anhui province: Illiterate and unemployed, Nian found a special way to bake watermelon seeds that made them the favorites of passers-by in the streets of Wuhu. In 1980, people were queuing to buy them and Nian started employing people outside his family—a case of capitalist exploitation. Nian's wife worried that he would be taken to prison, as had happened under Mao. But the case was taken to Deng Xiaoping, who was inclined to wait and see, as was his pragmatic habit. By 1980, Nian had turned his delicacy into a household name, 'The Fool's Watermelon Seeds'. Still, Deng had to intervene in 1984 and 1992 to save Nian from arrest.

By introducing spontaneous institutional evolution and forsaking the concept of transaction costs and initial property rights delimitation, Coase turned the 'theorem' that goes under his name in to a theory of how capitalism seeps through the cracks of command economic systems.