Coase Theorem

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> *Forget about the Coase Theorem. It determines the status quo and hinders better designed taxes.*

The Coase Theorem states that if transaction costs are zero, the efficient allocation of resources will occur, regardless of the initial distribution of entitlements, so long as the entitlements are well defined. Many scholars have cited the Coase Theorem as support for various claims—that government regulation is of limited importance, that Pigouvian taxes are ill-advised, and that government should focus on ensuring that property rights are well defined. However, the Coase Theorem does not support these claims or have any useful empirical or normative implications.

One puzzle about the Coase Theorem is what is meant by "transaction costs." A possible interpretation is the physical and opportunity costs of negotiating and drafting a contract. But if this is what transaction costs mean, then the Coase Theorem tells us just that parties will not enter into certain low-value transactions because the benefits are less than the transaction costs. This is not an interesting or useful insight.

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A more common interpretation is that transaction costs mean asymmetries of information. If information costs are zero, parties will bargain to optimal distributions; otherwise, they will or might not.

But if this is the right interpretation, then when transaction costs are zero or low, there is also no need for a market, as Hayek argued. The government can determine efficient outcomes. And if information costs are high, then the Coase Theorem by its own terms has no implications.

Many scholars have claimed that the Coase Theorem implies a specific normative agenda. One is deregulation when transaction costs are low: if the government cannot affect the allocation of entitlements, it should not bother to try. However, there are hardly any cases where transaction costs are so low that government intervention is futile. Even when only two people interact, and both are sophisticated, information asymmetries can block the efficient outcome. The government faces an array of possible property-rights systems that minimize this risk to different degrees. It must choose and enforce the optimal system. An agenda of "deregulation" doesn't tell us which system is optimal.

Other scholars argue that the Coase Theorem indicates that the government can and should help reduce information costs, enabling parties to achieve efficient outcomes, and the government can do this by clearly defining and enforcing property rights. Pigouvian taxation and other forms of regulation are then unnecessary.

However, this argument, like the first, doesn't tell us what it means for the government to clearly define and enforce property rights. Traditional "simple" property rights give owners monopoly power, which interferes with bargaining as long as information is imperfect. The government produces better outcomes by allowing people to violate property rights as long as they pay damages than by enforcing property rights strictly. The damages are roughly the same as a Pigouvian tax—the target of Coase's critique.

Transaction costs can also be high when externalities harm a large number of agents. In such cases, enforcing property rights entrenches the status quo, blocking bargains to efficient outcomes. The Coase Theorem agrees that bargaining cannot solve this problem, but some scholars have taken the Theorem as a rebuke to Pigouvian taxes, which cannot account for the reciprocal nature of harm as well as bargaining can. Be that as it may, the Coase Theorem provides no guidance in such settings. It is an empirical question whether Pigouvian taxes improve over the status quo in many-agent settings; it may also be the case that better-designed taxes can do so.

While there is much of value in Coase's work, which helped stimulate interest in the optimal design of legal and market institutions, the Coase Theorem should be forgotten.