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# ‘The Fugitive’ The figure of the judge in Coase’s economics

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**Abstract:** ‘The Problem of Social Cost’ (Coase, 1960) asserts a normative role for the common-law judge, that of taking into account the economic consequences of his decisions in allocating property rights. This position is often accused of inconsistency: Coase sees the figure of the judge as willing and able to improve economic efficiency, but criticises the actors of public intervention, particularly regulators, for being fallible, vulnerable to political pressures, and lacking information. I shall show that Coase’s giving this role to the judge stems precisely from his criticism of public intervention. This means that his figure of the judge escapes the tenets of the theoretical system that first rendered it necessary. Various reasons could explain this difference of treatment as between the judge and the other figures of public intervention in Coase’s system, but Coase makes too strong an opposition between common law on one side and regulatory and statutory law on the other, and leaves unexplained the motivation of judges.

## 1. Introduction

Ronald Coase’s article ‘The Problem of Social Cost’ (Coase, 1960) is best known for the ‘Coase theorem,’ which George Stigler (1966: 113) derived from it; yet it is also well known that this ‘theorem’ far from exhausts the content of this article. Coase (1960) suggested through examples that, in the presence of externalities,<sup>1</sup> if transaction costs are nil and if property rights are clearly defined and allocated, agents achieve an optimal output that is independent of the initial allocation of rights. Most of his article, however, examines the consequences of the introduction of transaction costs. When they are not nil, the result may no longer be optimal or independent from the initial distribution of rights, which means that other solutions may be

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<sup>1</sup> Although it had existed since the 1950s, Coase does not use the word ‘externality,’ but instead the expression ‘harmful effects,’ in order to stress his questioning of the traditional-Pigovian treatment of this concept (Coase, 1988a: 27).

necessary and that law may have an influence on the economic output. Coase thus brought to light the influence of the initial distribution of property rights on the economic result.

Coase (1960) drew a normative implication from this influence: common-law judges *should* take into account this economic influence of their decisions when allocating property rights. And he couples this normative role of judges to the empirical claim that they actually *do*: they introduce economic efficiency considerations in their deliberations, as several cases analysed in the ‘Social Cost’ article would suggest. This was the very beginning of the debate over the efficiency of the common law, more famously brought to the fore by Posner (1972).<sup>2</sup>

At first sight, there is an inconsistency in Coase’s analysis of externalities. On the one hand, he sees the figure of the judge as willing and able to improve economic efficiency. On the other, he criticises the actors of public intervention, particularly regulators, for being fallible, vulnerable to political pressures, and lacking information. As Simpson wrote, for example, ‘Coase, who on questions of allocation and delimitation of rights has in mind private law, nowhere treats judicial decisions in private law by the courts of the state as a form of governmental intervention or action. Private law, evolving through judicial decisions, is, for reasons never made explicit, privileged against the criticisms he directs against government intervention’ (1996: 61). It would be more accurate to say that Coase prefers one form of governmental intervention (through common law), which he views as more efficient, to the others (through regulatory and statutory law), which he finds less efficient. This preference has been mentioned, at least to some extent, but not thoroughly analysed.

I will substantiate the idea that, in Coase’s economics, the figure of the judge (common law) seems to avoid the failures this author associates with regulators (administrative agency) and legislators (statutory law). Coase often stressed that regulators lack information, and that they are human beings who are fallible and pursue their own interests. But his judge appears as a manifestation of a specific kind of public intervention, paradoxically closer to the price system than to public intervention. His role is not only to make the operation of the price system possible (by defining and distributing property rights), but also to economise on its operation by distributing these rights so as to render it unnecessary. The figure of the judge, therefore, escapes the criticism Coase levelled against public intervention and the view of human nature on which this criticism is based. In this sense, the judge is a ‘fugitive’ in Coase’s economics.

I will show that a judge who tends towards maximising the value of production is logically necessary to complete Coase’s economic theory; but I go on to argue that this figure does not

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<sup>2</sup> For a review of this debate, see, e.g., Rubin 2000.

fit into the overall structure that first rendered it necessary (the view of human nature and governmental intervention). Can this inconsistency within Coase's thought be removed? In other words, can the judge's desire and ability to substitute himself for the market be explained in Coase's theoretical system? We cannot claim that there is an inconsistency without first having tried to make sense of it, i.e. without having first envisaged a possible rationale for it. Hence, I will suggest – and then evaluate – some explanations for the difference of treatment between the judge and the other figures of public intervention, within the structure of Coase's argument. If these explanations are not convincing, the sense of inconsistency will be strengthened by this investigation.

Substantiating the thesis of inconsistency regarding Coase's role for the judge calls for a detailed analysis of the roles of this judge, leading to a theoretical reconstruction of Coase's analysis. Consequently, the present paper focuses on only one aspect of this analysis, and it must be remembered that Coase does not give an optimal and universal solution to externalities but rather offers a way of designing specific solutions, when needed. Nor do I propose to study Coase's judiciary thought in its context: the legal background of 'The Problem of Social Cost' is still to be explored. The present paper rather provides an interpretation and evaluation of his thought on the relative merits and demerits of common law on the one hand and regulatory and statutory law on the other. It reconstructs Coase's position in this debate, in the history of which it is often mentioned as a precursor of Posner's, but seldom analysed in and for itself. Moreover, if the inconsistency was removed, this would strengthen his argument in favour of the superiority of common-law solution to externalities, over other governmental solutions. However, unearthing the implicit beliefs that underpin his argument in fact contributes to illustrating one of its weaknesses and so brings to light that his confidence in common-law solutions is presupposed rather than established.

The following section details Coase's view of the common-law judge, and section 3 contrasts it to his view of other governmental agents (regulators and legislators). In section 4, I shall make explicit, and call into question, some of the reasons that could explain this difference of treatment in Coase's framework. Section 5 concludes.

## **2. The roles of the judge in Coase's analysis of externalities**

The roles that Coase gives to the common-law judge are determined by the conjunction of three claims – theoretical, normative and empirical – which closely interact with each other.

*Theoretical claim: the initial distribution of property rights influences the economic result*

‘The Problem of Social Cost’ starts with distinguishing the ethical problem of responsibility from the economic one, which is reciprocal (Coase, 1960: 2). If a policy protecting her is instituted, the presence of the ‘victim’ harms the person ‘responsible’ for the nuisance, *i.e.* imposes a cost upon him. Reiterating his prior analysis (1959: 26–27) of the *Sturges v. Bridgman* (1879) case, which concerned a doctor who could no longer practice because of the noise generated by his confectioner neighbour, Coase writes: ‘To avoid harming the doctor would inflict harm on the confectioner. The problem posed by this case was essentially whether it was worth while, as a result of restricting the methods of production which could be used by the confectioner, to secure more doctoring at the cost of a reduced supply of confectionery products’ (1960: 2).

The reciprocal nature of the economic problem is therefore tightly linked to the criterion of economic efficiency: ‘To avoid the harm to B would inflict harm on A. The real question that has to be decided is: should A be allowed to harm B or should B be allowed to harm A? The problem is to avoid the more serious harm’ (*ibid.*: 2). The aim is to reach economic efficiency, defined as the maximisation of the value of production (*ibid.*: 15).<sup>3</sup>

If the pricing system operated without costs, the role of the judge would just be to define property rights, no matter how, but in a definite and predictable way:<sup>4</sup> ‘all that matters (questions of equity apart) is that the rights of the various parties should be well-defined and the results of legal actions easy to forecast’ (*ibid.*: 19). Exchanges on these property rights (including those whose use implies effects on others) could then take place and yield an optimal result, independent from their initial allocation: this is the idea Stigler named ‘the Coase theorem.’

However, transaction costs may prevent some exchanges of rights, and, when this is the case, the initial allocation of rights is not modified or, at least, not until the optimal allocation is reached:

In these conditions the initial delimitation of legal rights does have an effect on the efficiency with which the economic system operates. One arrangement of rights may bring about a greater value of production than any other. But unless this is the arrangement of rights established by the legal system, the costs of reaching the same result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved. (*ibid.*: 16)

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<sup>3</sup> Though Coase (1960: 43) mentioned the necessity of an ethical evaluation, he never even started it (Pratten, 2001: 620).

<sup>4</sup> Following Coase (1960), I will not distinguish liability rules and property rights in this analysis (see Calabresi and Melamed 1972).

Coase did not aim to demonstrate the neutrality of law or the independence of the economic result from the property rights allocation; on the contrary, it is the thesis of the economic influence of law that is important: ‘with positive transaction costs, the law plays a crucial role in determining how resources are used’ (Coase, 1988a: 178).

In this case, since the legal distribution influences the economic result, what should be done?

***Normative claim: the judge should take this economic influence into account***

Coase answers this question in two steps. He first assumes that the initial delimitation of rights is given and inefficient, and that negotiations are too costly (Coase, 1960: 16). It is here that he makes his comparative institutional approach explicit: the economist or the policy-maker must compare the values of production yielded by different institutional arrangements and choose the one in which it is the highest, taking into account the costs of operation of these arrangements and the costs of changing from one to another.<sup>5</sup> The arrangements that have to be compared are the market, the firm, direct regulation (e.g., zoning), and ‘to do nothing about the problem at all’ (*ibid.*: 18). The necessity of the comparative institutional approach is one of the most important messages of Coase’s 1960 article (see Veljanovski 1977 and Medema 2014). Coase’s observation that ‘[a]ll solutions have costs’ (Coase, 1960: 18) implies that no solution is optimal, even those towards which Coase seems to incline.

In the second step (section VII of ‘The Problem of Social Cost’), Coase wonders: when property rights are not yet allocated, how are we to allocate them most efficiently? From the theoretical claim that the initial distribution of rights influences the economic result, he immediately infers a normative claim about the common-law judge:

when market transactions are so costly as to make it difficult to change the arrangement of rights established by the law [...], the courts directly influence economic activity. It would therefore seem *desirable that the courts should* understand the economic consequences of their decisions and should, insofar as this is possible without creating too much uncertainty about the legal position itself, *take these consequences into account* when making their decisions. Even when it is possible to change the legal delimitation of rights through market transactions, it is obviously *desirable to reduce the need for such transactions* and thus reduce the employment of resources in carrying them out. (*ibid.*: 19, my italics)

We see here that in Coase’s thought, ‘taking the economic consequences into account’ means aiming at diminishing costs, *i.e.* at increasing the net value of production. Limiting the need for exchanges entails distributing, right from the start, the property right to the person who values

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<sup>5</sup> On Coase and the comparative institutional approach, see Medema and Samuels 1998, Medema 1996, Bertrand 2014b.

it the most, that is to say, imitating the result of the market. If exchanges cannot take place, this could improve efficiency. Even when transaction costs do not prevent exchanges of the right, limiting the need for exchanges economises on these costs. Coase asserted this rule again in his ‘Nobel Prize’ speech: ‘It is obviously desirable that these rights should be assigned to those who can use them most productively’ (1992: 718).<sup>6</sup>

From the discovery of the positive influence of the property-rights distribution, Coase (1960) inferred the prescriptive rule according to which this influence should have to be taken into account by the courts when distributing property rights, although it does not exhaust all of what the judge has to take into account. It is one of the roles of the judge to somehow apply the comparative institutional method: she has to compare the values of production yielded by alternative allocations of a right, and consider distributing it to the person who will use it in the way that maximises the output value.

***Empirical claim: the judge does take this economic influence into account***

‘The Problem of Social Cost’ also asserts that judges are, at least partly, aware of the reciprocity of the problem, and of the economic consequences of their decisions.<sup>7</sup> Immediately after asserting that judges have to take these consequences into account, Coase examines a series of nuisance cases. The empirical claim indeed follows the normative one: ‘it is clear from a cursory study that the courts have often recognized the economic implications of their decisions and are aware (as many economists are not) of the reciprocal nature of the problem. Furthermore, from time to time, they take these economic implications into account, along with other factors, in arriving at their decisions’ (Coase, 1960: 19).

Regarding reciprocity, he had already argued earlier in his text that judges understand it. Concerning *Bryant v. Lefever* (1878–1879), in which the plaintiff’s chimneys begun to smoke after his neighbour rebuilt his house with higher walls, Coase insists that ‘[t]he smoke nuisance was caused both by the man who built the wall *and* by the man who lit the fires’ (*ibid.*: 13, his italics). And he argues that the judges’ treatment of this case exhibits that their understanding was the same (*ibid.*: 13).

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<sup>6</sup> This normative rule to be followed by judges was also taken up in 1977: ‘I have argued, in my “Problem of Social Cost,” that rights to perform certain action should be assigned in such a way as to maximize the total wealth (broadly defined) of the society’ (Coase, 1977a: 32). For criticisms of this rule, see, e.g., Samuels 1974, 1981; Schmid 1989; Simpson 1996; Medema and Samuels 1997, 1998.

<sup>7</sup> This would explain the need for economists to study judges’ decisions – which manifest a better understanding of the economic problem – as does Coase 1960. For an example of criticism leveled at Coase’s interpretation, see Liebhafsky 1974.

As evidence that judges take the economic influence into account, Coase puts forward the following elements. Regarding the United States tradition, he relies on Prosser (1955: 398–399, quoted by Coase, 1960: 19): ‘It is only when [a person’s] conduct is unreasonable, *in the light of its utility and the harm which results* [italics added – RHC], that it becomes a nuisance.’ In contrast, says Coase, British writers are less explicit,

[b]ut similar views, if less strongly expressed, are to be found. The doctrine that the harmful effect must be substantial before the court will act is, no doubt, in part a reflection of the fact that there will almost always be some gain to offset the harm. And in the reports of individual cases, it is clear that the judges have had in mind what would be lost as well as what would be gained in deciding whether to grant an injunction or award damages. (1960: 20)

His examples are borrowed from certain English nuisance cases: *Webb v. Bird* (1861 and 1863) regarded the construction of a school which obstructed currents of air near a windmill; *Adams v. Ursell* (1913) had to do with a fried fish shop; *Andreae v. Selfridge and Company Ltd* (1938) was related to the damages imposed on a company demolishing buildings that surrounded a hotel. But most explicit are his comments on the quotes from the *Sturges v. Bridgman* case, in which judges insisted on the fact that what will be defined as a nuisance depends on the neighbourhood, so that ‘[w]hat has emerged has been described as “planning and zoning by the judiciary”’ (*ibid.*: 21, quoting Haar, 1959: 95). To Coase, ‘[i]t was of course the view of the judges that they were affecting the working of the economic system – and in a desirable direction’ (1960: 10).<sup>8</sup> But he adds that ‘the judges seem to have been unaware’ (*ibid.*: 10) of the necessity of comparing gains and benefits from the protection of such-and-such a use of the concerned neighbourhood. This does not prevent him from concluding from these cases that the courts ‘often make, although not always in a very explicit fashion, a comparison between what would be gained and what lost by preventing actions which have harmful effects’ (*ibid.*: 27–28). The words ‘not very explicit’ are to be given their full meaning. Coase insists on this implicit aspect: ‘The courts do not always refer very clearly to the economic problem posed by the cases brought before them but it seems probable that in the interpretation of words and phrases like “reasonable” or “common or ordinary use” there is some recognition, perhaps

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<sup>8</sup> For a discussion of Coase’s interpretation of this case, see Simpson 1996. Moreover, this praise for zoning by the judiciary may be opposed to Coase’s criticism of regulatory (Pigovian) zoning, illustrating once again the difference between the judge and the regulator. The ‘Pigovian’ rule would be too general and neglect the cost-benefit analysis: ‘I need not devote much space to discussing the [...] error involved in the suggestion that smoke producing factories should, by means of zoning regulations, be removed from the districts in which the smoke causes harmful effects. When the change in the location of the factory results in a reduction in production, this obviously needs to be taken into account and weighed against the harm which would result from the factory remaining in that location’ (Coase, 1960: 42).



largely unconscious and certainly not very explicit, of the economic aspects of the questions at issue' (*ibid.*: 22).

According to Coase, judges compare costs and benefits – of course implicitly, and of course among other factors, but we have this general idea that efficiency enlightens the judge's path. And Coase would stick to the empirical claim that judges often take into account the economic consequences of their decisions, repeating it thirty years later in almost the same terms, commenting on his 1960 article: 'I pointed out that the judges in their opinions often seemed to show a better understanding of the economic problem than did many economists even though their views were not always expressed in a very explicit fashion. I did this not to praise the judges but to shame economists' (1993: 251). And he used the work done by legal scholars on this subject since then to confirm his interpretation.<sup>9</sup>

As has already been noted (by, e.g., Simpson 1996), but neither expanded upon nor explained, the judge is not perceived by Coase to be like the other figures of governmental intervention, and escapes the criticisms he levels at regulators and legislators.

### **3. Judge-made law v. Regulation**

In 'The Problem of Social Cost,' Coase criticises the regulation solution for externalities, whether it be issued by regulatory or statutory law.<sup>10</sup> His aim is to stress that Pigovian governmental solutions are costly and non-optimal. When property rights are given and when the market and the firm are too costly, Coase envisages governmental solutions, such as zoning or regulation on the technology employed, as being promulgated by statute law or 'more likely' by governmental agencies (regulatory law) (Coase, 1960: 17). However, although direct regulation may appear useful when transaction costs are high, this solution encounters problems:

the governmental administrative machine is not itself costless. It can, in fact, on occasion be extremely costly. Furthermore, there is no reason to suppose that the restrictive and zoning regulations, made by a fallible administration subject to political pressures and operating without any competitive check, will necessarily always be those which increase the efficiency with which the economic system operates. Furthermore, such general regulations which must apply to a wide variety of cases will be enforced in some cases in which they are clearly inappropriate. (*ibid.*: 18)

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<sup>9</sup> For example, he wrote in 1996: 'As legal scholars, such as Judge Posner and others writing on the economic analysis of law, have adopted a similar view [that judges take economic consequences into account], this suggests that my interpretation of Prosser and the judges, ill-informed though it may have been, may well have been correct' (Coase, 1996: 105–106).

<sup>10</sup> This section partly draws on previous work on Coase's view of the role and efficiency of government: Medema (1994: ch 5), Medema and Samuels (1998), Pratten (2001), Campbell and Klaes (2005) and Bertrand (2010).

These are the problems that pertain to any public regulation in Coase's mind: (1) it is by definition too general to be appropriate in all circumstances; (2) regulators operate without competitive check; (3) they lack information and (4) are fallible; (5) they pursue their own interest and are therefore subject to political pressures and industry capture. Apart from the first one, these problems derive, I shall argue, from Coase's specific view of the nature of public intervention, and his view of the regulator as an individual driven by personal interest.

### *Coase's view of the nature of public intervention*

In Coase's analysis, governmental intervention appears as an alternative to the price system (for resources allocation), as does the firm. Like the firm, it directs transactions (Coase, 1960: 17). Hence it faces the same administrative or organisational costs (Coase, 1946: 172), particularly the decreasing returns to management mentioned in 'The Nature of the Firm' (Coase, 1937: 394–395). In contrast to the firm, the government 'is able, if it wishes, to avoid the market altogether' (Coase, 1960: 17).<sup>11</sup> This difference adds two specific costs: the absence of competitive check and the lack of information. These two consequences can be found in Coase's criticism of the allocation of radio frequencies by the Federal Communications Commission (FCC):

Quite apart from the malallocations which are the result of political pressures, an administrative agency which attempts to perform the function normally carried out by the pricing mechanism operates under two handicaps. First of all, it lacks the precise monetary measure of benefit and cost provided by the market. Second, it cannot, by the nature of things, be in possession of all the relevant information possessed by the managers of every business which uses or might use radio frequencies, to say nothing of the preferences of consumers for the various goods and services in the production of which radio frequencies could be used. (Coase, 1959: 18)

The *absence of competitive check* here refers to the absence of monetary evaluation regarding the governmental agency's costs and benefits. It also means that the agency, unlike the firm, does not have to maximise profit. It does not have the same incentive to use resources efficiently (nor the possibility, in the absence of market prices), an example being the waste brought about by the administrative allocation of radio frequencies by the Interdepartment Radio Advisory Committee (IRAC) and the FCC (Coase, 1962; Coase and Johnson, 1979).

Moreover, in the absence of prices, regulators *lack information* on preferences and costs. In his article on the marginal-cost pricing of natural monopoly, Coase began by reminding the reader that, as a mode of resources allocation, the pricing system has the advantage over the

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<sup>11</sup> And it possesses the monopoly on legitimate violence (Coase, 1960: 17).

government of conveying information on preferences that a central planner cannot afford and, more often than not, at a lower cost: ‘No Government could distinguish in any detail between the varying tastes of individual consumers [...]; without a pricing system, a most useful guide to what consumers’ preferences really are would be lacking’ (1946: 172). In his article on social cost, lack of information and problems of calculation are also some of the difficulties faced by a taxation solution to externalities.

Coase’s view of the judge as able to and as actually applying a cost-benefit analysis is therefore at odds with his criticisms of regulators as lacking competitive check and information. And in a similar manner, his view of the judge is very different from his view of human nature in general, on which his criticisms are also based.

### ***Coase’s view of the regulator as a human being***

Coase sees regulators as fallible and as following their personal interest, and thus vulnerable to political pressures and industry capture: they are, after all, merely human beings. While this view may appear rather close to public-choice theory, it is not based on the same assumptions. Coase’s criticisms of the view of man as a rational maximiser are well-known (e.g., Medema, 1995). He wrote, for example: ‘There is no reason to suppose that most human beings are engaged in maximizing anything unless it be unhappiness, and even this with incomplete success’ (1988a: 4). Utility is even described as ‘a nonexistent entity which plays a part similar, [he] suspect[s], to that of ether in the old physics’ (*ibid.*: 2).<sup>12</sup>

Coase’s own view of human beings is closer to that he attributes to Smith, whom he quotes with approval. In his article ‘Adam Smith’s View of Man’ (Coase, 1976), Coase takes the opportunity to buttress his criticism of rational utility maximisation: ‘Adam Smith would not have thought it sensible to treat man as a rational utility-maximiser. He thinks of man as he actually is – dominated, it is true, by self-love but not without some concern for others, able to reason but not necessarily in such a way as to reach the right conclusion, seeing the outcomes of his actions but through a veil of self-delusion’ (*ibid.*: 545–546). Two ideas that emerge from this article are relevant here. First, a person can be mistaken, she is *fallible*, and may even be ‘stupid.’ This is a feature on which Coase increasingly insisted during his later years, for example in a recent interview: ‘it’s not possible to study how things are dealt with without realizing the importance of the stupidity of human behavior’ (2012: 20’). Second, a person is

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<sup>12</sup> On the nature of Coase’s realism, see Bertrand 2014a and the references therein.

*guided by self-love*, which does not exclude ‘concern for others’ or benevolence (Coase, 1976: 533).<sup>13</sup>

These features apply to governmental agents. They are fallible. And benevolence for relatives results in favouritism: ‘A politician, when motivated by benevolence, will tend to favour his family, his friends, members of his party, inhabitants of his region or country (and this whether or not he is democratically elected). Such benevolence will not necessarily redound to the general good’ (*ibid.*: 544). Regulators’ following their self-interest (in its larger Smithian meaning) explains their subjection to political pressures, including by interest groups<sup>14</sup> and, then, industry capture. Industry capture is also explained by a kind of empathy on the part of the regulators of that industry:

However fluid an organization may be in its beginning, it must inevitably adopt certain policies and organizational forms which condition its thinking and limit the range of its policies. Within limits, the regulatory commission may search for what is in the public interest, but it is not likely to find acceptable any solutions which imply fundamental changes in its settled policies. The observation that a regulatory commission tends to be captured by the industry it regulates is I think a reflection of this, rather than, in general, the result of sinister influences. *It is difficult to operate closely with an industry without coming to look at its problems in industry terms.* (Coase, 1966: 442, my italics)<sup>15</sup>

Industry capture, and the role of interest groups more generally, is again something that Coase recognises in Smith’s analysis, which ‘explains that government regulations will normally be much influenced by those who stand to benefit from them, with the result that they are not necessarily advantageous to society’ (Coase, 1977b: 319).<sup>16</sup>

To sum up, regulators are human beings. They are fallible and they do not follow the general interest,<sup>17</sup> but rather their own interest, which is plural (influenced by love of their relatives, political interest, etc.): ‘regulators commonly wish to do a good job, and though often incompetent and subject to the influence of special interests, they act like this because, like all of us, they are human beings whose strongest motives are not the highest’ (Coase, 1974b: 389). Since ‘government regulators may have in mind ends other than raising the value of production’ (Coase, 1974a: 61), since the government is ‘ignorant, subject to pressure, and corrupt’ (Coase,

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<sup>13</sup> Coase does not seem to really distinguish sympathy from benevolence (on this distinction, see, e.g., Dellemotte 2011).

<sup>14</sup> See, e.g., Coase and Johnson 1979.

<sup>15</sup> See also Coase 1965: 166: ‘It is often said that regulatory commissions are, in the end, captured by the industries which they regulate. There is much truth in this observation and the FCC is well on the way providing us with another example.’

<sup>16</sup> In Smith, legislators’ partiality to merchants, for example, may be removed by good constitutional rules (the System of Natural Liberty); see Diatkine 2014.

<sup>17</sup> In Coase’s view, even more radically, general interest above the satisfaction of individual preferences does not exist (Pratten, 2001: 623–624).

1988a: 26), their activities usually produce more harm than good.<sup>18</sup> Coase's opinion that, in general, public regulation would do more harm than good, is in his eyes also an empirical claim, in the sense that it is derived from empirical studies, his and others' (Coase 1974a, 1988b, 1996).

Although the 1960 text does not compare regulation (when property rights are already allocated) with common-law allocation of property rights, but rather compares actual regulation with the ideal, we note that the judge as envisioned by Coase seems to be exempted from his wider treatment of human beings and their motives as applied to regulators. He recognises that judges may be mistaken in their applying cost-benefit analysis (Coase, 1960: 38), but he believes that they pursue, at least among other aims, economic efficiency, and not personal interest, and that they are immune to corruption, political pressures and industry capture.

This difference of treatment between the judge and other governmental agents is most visible when Coase directly compares the efficiency of the allocation of nuisance liability by common law with the inefficiency of that allocation by statute law.

### ***The inefficiency of statutory attribution of rights***

Coase not only criticises regulation solutions (be they promulgated by a regulator or a legislator), as we have just seen, but also the solution through allocation of property rights by a legislator.

In section VII of 'The Problem of Social Cost,' which examines '[t]he part played by economic considerations in the process of delimiting legal rights' (Coase, 1960: 16), Coase asserts, as already said, that common-law judges often take into account the economic consequences of their decisions and compare the costs and benefits of alternative allocations of rights. However, noting that '[t]he discussion in this section has, up to this point, been concerned with court decisions arising out of the common law relating to nuisance,' he goes on to another means of allocating property rights (or liabilities) for nuisance, namely statute law: 'Delimitation of rights in this area also comes about because of statutory enactments' (*ibid.*: 23). And he claims that, in general, this mode of allocation by the legislator is inefficient, because it protects harm producers – gives them the right to pollute – beyond what would be economically desirable. This is another empirical claim, to be opposed to that of the relative efficiency of the judge. Coase asserts that '[t]he effect of much of the legislation in this area is

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<sup>18</sup> Again, he attributes the same belief to Smith, whose 'opposition to more extensive government action did not arise simply because he thought it was unnecessary, but because government action would usually make matters worse. Governments lacked both the knowledge and the motivation to do a satisfactory job in regulating an economic system' (Coase, 1977b: 319).

to protect businesses from the claims of those they have harmed by their actions. There is a long list of legalized nuisances' (*ibid.*: 24) both in England and in the United States.<sup>19</sup>

This finding is in the first place a criticism of the Pigovian-tradition economists who would be keen for public authorities to extend liability to all harm producers and who, more generally, turn to the government as soon as they observe a divergence between private cost and social cost, although such divergences, in Coase's view, are actually due to the government. 'The kind of situation which economists are prone to consider as requiring corrective Government action is, in fact, often the result of Government action' (*ibid.*: 28).<sup>20</sup>

Coase's observation thus suggests that statute law protects harm producers much more than what would be efficient, and is therefore inefficient. And he explains this partly by the government's desire to protect its own activities:

Of course, it is likely that an extension of Government economic activity will often lead to this protection against action for nuisance being pushed further than is desirable. For one thing, the Government is likely to look with a benevolent eye on enterprises which it is itself promoting. For another, it is possible to describe the committing of a nuisance by public enterprise in a much more pleasant way than when the same thing is done by private enterprise. (*ibid.*: 26–27)

This means that statute law may counteract the common law's tendency towards efficiency: 'While statutory enactments add to the list of nuisances, action is also taken to legalize what would otherwise be nuisances under the common law. [...] Such action is not necessarily unwise. But there is a real danger that extensive Government intervention in the economic system may lead to the protection of those responsible for harmful effects being carried too far' (*ibid.*: 28).

In comparing the optimal solutions imagined by traditional economists with actual governmental interventions, Coase stresses that actual regulators and legislators, when distributing property rights as well as when regulating, do not tend toward increasing the value of production, and are thus far from ideal. But he is more optimistic as regards the allocation of rights by a common-law judge. Why does Coase assign different attributes to the figures of judges, legislators and regulators?

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<sup>19</sup> He relies on the third edition of *Halsbury's Laws of England* and, for the United States, on cases regarding the operation of some airports which referred to legislation authorizing nuisances (for example, *Delta Air Corporation v. Kersey*, *Kersey v. City of Atlanta*, 1942; *Smith v. New England Aircraft Co.*, 1930).

<sup>20</sup> And Coase's irony towards Pigovian-type economists is worth quoting: 'When they are prevented from sleeping at night by the roar of jet planes overhead (publicly authorized and perhaps publicly operated), are unable to think (or rest) in the day because of the noise and vibration from passing trains (publicly authorized and perhaps publicly operated), find it difficult to breathe because of the odour from a local sewage farm (publicly authorized and perhaps publicly operated) and are unable to escape because their driveways are blocked by a road obstruction (without any doubt, publicly devised), their nerves frayed and mental balance disturbed, they proceed to declaim about the disadvantages of private enterprise and the need for Government regulation' (Coase, 1960: 26).

#### 4. Removing (or not) Coase's inconsistency

##### *The inconsistency thesis*

Coase started by asserting that a clear definition and allocation of property rights (including rights to harm others) is necessary for the price system to operate. When the definition or allocation are not clear enough, the situation is brought before courts, and the judge, says Coase, should take into account the economic consequences of his decisions and consider allocating the right to the person who values it the most. This normative rule is substantiated by the following argument: if the right is not distributed in the hands of the person who values it the most, then either some resources will be lost in exchanging this right, or some regulations (by regulators and legislators) would have to be set up, which would be even more costly. In addition, Coase's giving this role to common law rather than to statute law may be explained by his empirical claim that legislators have a tendency to legalise nuisances beyond what would be economically desirable. The normative role given to the judge is therefore tightly linked to the inefficiency of regulatory and statutory law. In other words, the figure of the judge is necessary in Coase's economics because of his view on the inefficiency of public intervention and the account of human nature on which this view is partly based. However, the judge precisely escapes these views on public intervention and human nature, the very views that made the judge's role necessary in the first place. This does not mean that Coase is arguing that judges will *always* choose the economically efficient solution: for they may be mistaken, they do not pursue economic efficiency alone, and some do not take economic considerations into account at all.<sup>21</sup> However, 'The Problem of Social Cost' reveals great confidence in judges, or at least a confidence that runs deeper than for regulators and legislators. In a sense, the common-law judge is closer to the price system (and its result) than would be regulators and legislators.

Is it possible to explain why the judge, in Coase's system, can avoid the pitfalls that surround regulators and legislators?

##### *The implicit advantages of common law in Coase's thought*

The main object of 'The Problem of Social Cost' was to undermine Pigou's analysis (see, e.g., Bertrand 2010); hence Coase's insistence on criticism of governmental solutions on one

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<sup>21</sup> Coase himself gives one example of judges not taking into account economic considerations. In *Bass v. Gregory* (1890), a pub that brewed beer in a cellar was confirmed in its right to let the air circulate from a hole in a well situated in a neighbour's yard, by the 'doctrine of lost grant' (Coase, 1960: 14). Coase insists on the irrelevance of such an argument from an economic point of view: "the 'doctrine of lost grant' is about as relevant as the colour of the judge's eyes" (*ibid.*: 15).

side and his praise of common-law judges, who understand the economic problem better than economists do, on the other. But this is not the only element that accounts for this difference of treatment. Coase insists on several relative advantages of common law (including mentioning the relative drawbacks of regulation and statutory attribution of rights), in terms of adaptation, information, or understanding of reciprocity. These advantages relate to some features of common law that he implicitly brings to the fore.

First, Coase's analysis suggests that the judge's fallibility has far less dramatic consequences than that of regulators and legislators: courts' decisions can be appealed and are open to other judges' interpretations in similar cases. The decision on which Coase relies to assert that judges understand the reciprocity of the problem, for example, is an appeal decision (*Bryant v. Lefever*, concerning the smoking chimney, see Coase, 1960: 11–12).<sup>22</sup> And we must not forget Coase's argument that exchanges of rights attributed by a common-law judge can take place to modify this initial allocation.

The second characteristic of common law that seems essential in Coase's argument is its adversarial nature. One of its advantages is that it poses the problem to the judge almost immediately in economic (and reciprocal) terms, as a problem of comparison between costs and benefits. This point had already appeared in Coase's first comment on the *Sturges v. Bridgeman* case: 'What the courts had, in fact, to decide was whether the doctor had the right to impose additional costs on the confectioner through compelling him to install new machinery, or move to a new location, or whether the confectioner had the right to impose additional costs on the doctor through compelling him to do his consulting somewhere else on his premises or at another location' (1959: 26). This way of posing the problem derives from the adversarial nature of common law, and would impose itself on the judge as at least one way of looking at it – which would explain their better understanding of the economic problem of nuisances. Coase's argument in 'The Problem of Social Cost' is indeed that, contrary to what could be naively expected, economists are stuck with their ethics of responsibility, which prevent them from understanding the reciprocity of the problem, while judges take into account economic considerations to solve a problem that they view as reciprocal.

Third, what Coase seems to retain from common-law judges is that they act *ex post*, considering specific and actual cases, while legislators and regulators decide *ex ante*, on a great

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<sup>22</sup> Another appeal decision is examined in 'The Problem of Social Cost': the reduction of damages paid in *Andreae v. Selfridge and Company Ltd* (Coase, 1960: 22–23).



variety of cases to come.<sup>23</sup> In this perspective, common law would make a resolution of nuisance problems on a case-by-case basis possible, thus retaining all its specificity in each situation. This is no doubt important for Coase, who argues that ‘[t]he result brought about by different legal rules is not intuitively obvious and depends on the facts of each particular case’ (1988a: 178). This, in Coase’s mind, is very different from regulatory and statutory law: not only will decisions not be applied to inappropriate cases, but they will also be easier to make since it may seem simpler to decide *ex post* on one case rather than *ex ante* on numerous (and sometimes hypothetical) cases at the same time. Judges also need less information to decide on one case than regulation does to decide on a multitude of (hypothetical) circumstances.

The proximity of judges to the specificities of each situation would also give them better information than would be possessed by remote agencies. Coase indeed partly explained information problems by the distance from the centre: ‘The remoteness of the centre from the areas affected by the decision may lead to a failure to understand the significance of the issues under consideration’ (1962: 39).

Coase’s attachment to case-by-case solutions can be seen in what he considers evidence that judges take into account economic considerations: this evidence lies mainly in the fact that they do not decide automatically (*ex ante*) what constitutes a nuisance, but think about the particular case and sometimes decide differently on similar cases (on the nuisances caused to windmills for example, see Coase, 1960: 20–21). Their approach is therefore close to the comparative institutional method that he advocates. His preference for standards against rules is most visible in his comparison between a rigid rule of liability for rabbit owners (one example from Pigou 1932) and a standard interpreted by common-law judges:

The objection to the rule in *Boulston’s* case [a 1597 case that established a precedent] is that, under it, the harbourer of rabbits can *never* be liable. It fixes the rule of liability at one pole: and this is as undesirable, from an economic point of view, as fixing the rule at the other pole and making the harbourer of rabbits always liable. But, as we saw in Section VII, the law of nuisance, as it is in fact handled by the courts, is flexible and allows for a comparison of the utility of an act with the harm it produces. [...] To bring the problem of rabbits within the ordinary law of nuisance would not mean *inevitably* making the harbourer of rabbits liable for damage committed by the rabbits. This is not to say that the sole task of the courts in such cases is to make a comparison between the harm and the utility of an act. Nor is it to be expected that the courts will always decide correctly after making such a comparison. But unless the courts act very foolishly, the ordinary law of nuisance would seem likely to give economically more satisfactory results than adopting a rigid rule. (Coase, 1960: 38, his italics)

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<sup>23</sup> On the relative merits of giving content to the law *ex ante* (rules) or *ex post* (standards), see Kaplow (1992)’s seminal contribution.

Coase thus brings to light three characteristics of common law that could explain the relative efficiency of judges: common law is flexible, adversarial, and *ex post*. Do these characteristics apply to common law only? And are they sufficient to make the judge economically efficient?

### ***Restoring the thesis of Coase's inconsistency***

Coase's belief in a fundamental difference between judges on the one hand and legislators and regulators on the other can be called into question; this promises to reaffirm the inconsistency of his differential treatment, and therefore undermine the justification for his confidence in a common-law solution to externalities.

First, in a Coasean setting, the costs of each system would have to be taken into account, and this would mitigate the strength of some of Coase's arguments. For example, statutes or regulations apply to numerous similar cases, and this economises on the costs of resorting to judges for each case. In other words, Coase sees the costs of rules but not their benefits compared to standards, which Kaplow sums up as follows: 'Rules cost more to promulgate; standards cost more to enforce. With regard to compliance, rules' benefits arise from two sources: Individuals may spend less in learning the content of the law, and individuals may become better informed about rules than standards and thus better conform their behavior to the law' (1992: 577). Regulations have other advantages in terms of information. On the production side, they can rely on expertise, which benefits from scale economies. On the enforcement side, they are easier to find and learn than common-law decisions. Generally speaking, therefore, Coase seems prone to forget the costs of common law, while he never forgets the costs of the market or the costs of other types of public intervention.

In addition, Coase deals differently with judges, legislators and regulators because they pertain to different institutional arrangements. However, he seems to overestimate the specificity of common law compared to regulatory and statutory law. All three of them provide *both* rules *and* dispute resolutions.

On the one hand, regulatory and statutory laws may have some of the advantages of common law mentioned earlier. Regulations also require interpretation by courts and may also be overturned. This means that they leave room for adjudication, interpretation and choice (Michelman, 1980), by courts which may be closer, better informed and more specific. Fallibility is thus not irreversible: not only can regulations be changed when new information

is available, but they also can be interpreted and modified by courts.<sup>24</sup> And the argument concerning the advantage of having an adversarial nature is also valid for regulatory law, via administrative litigation (Wangenheim, 2000).

On the other hand, common law may also have the same disadvantages as statutory and regulatory law. The common-law judge may produce a precedent that will be used to direct the treatment of more-or-less similar cases.<sup>25</sup> The presence of a precedent, while economizing on the costs of decision, diminishes the judge's flexibility (adaptation to specific cases and to changing conditions) and increases the consequences of fallibility. Further, the judge's reasoning anticipates that she is producing a precedent and therefore takes into account future and hypothetical cases. Thus the precedent 'essentially transforms the standard into a rule' (Kaplow, 1992: 577), but delays the benefits of the rule until the precedent is established although entailing the same cost of promulgation (Kaplow, 2000: 511–512). In 'The Problem of Social Cost,' Coase gives the example of a common-law decision constrained by a precedent to declare that a public authorized airport had the right to harm its neighbourhood (*Delta Air Corporation v. Kersey*, *Kersey v. City of Atlanta*, see Coase, 1960: 25).

Common law on the one hand and statutory and regulatory law on the other are less opposed than Coase seems to believe. More fundamentally, these three systems are complementary. Attribution of property rights by statutes may need to be completed by common law. Statutory and regulatory laws choose the level of detail of the regulation (rule or standard) and therefore the importance of the role of the common-law judge. What remains is that Coase seems to prefer standards interpreted by common-law judges who would be efficient. But why would they be?

Here, Coase relies on the judges' motivation. He suggests that the judge, contrary to the legislator, takes into account, at least to a certain extent, the economic criterion.<sup>26</sup> Therefore the difference between judges on the one hand and regulators and legislators on the other would lie not only in the means at their disposal (the common-law system with its better information, adaptation and flexibility) but also, and maybe above all, in the aim they pursue. However, that judges understand reciprocity and seem conscious of costs and benefits could also mean that they *consider* these elements, but not that they decide in accordance with them. Even if Coase's

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<sup>24</sup> Not to mention the fact that 'adaptation to circumstances' is a questionable criterion of efficiency. For example, Epstein argues that 'the importance attributable to changing social conditions as a justification of new legal doctrines is overstated and quite often mischievous' (1980: 253).

<sup>25</sup> On the efficiency of precedents, see Harnay and Marciano 2004 and Marciano and Khalil 2012, but their notions of efficiency are different from Coase's.

<sup>26</sup> Note that the role of the interactions of judges with lawyers and juries is not mentioned by Coase.

argument regarding their taking into account economic consequences was valid, it would not be sufficient to claim that judges are not subjected to political pressures and industry capture, and that they do not need a competitive check to be efficient. Why would the judges' motivation be different from legislators' and regulators'? And even if it were, this would not show that judges pursue economic goals. Why, when motivated by self-love, would they pursue economic efficiency? In fact, this question remains pending. To the best of my knowledge, Coase's texts do not offer any explicit solution.

This is not the place to discuss the motivations of judges (see, e.g., Posner 2008), but we may mention just a few elements that could also have a role in their decisions (some of which run contrary to economic efficiency): the influence of organized interest groups, monetary interests (Leff, 1974; Horwitz, 1977), desire for reputation (Miceli and Cosgel, 1994; Harnay and Marciano, 2004) and policy views. But in Coase's works, there is no justification for bringing the judge's self-love closer to the pursuit of economic efficiency.

Finally, even if the motivation of common-law judges was actually different from that of legislators and regulators, why would they have sufficient information to decide according to the efficiency criterion? Why would they obtain the information that is necessary, since, like regulators and legislators, they lack the information transmitted by prices? The problem is all the more crucial when costs and benefits are subjective and therefore neither observable nor measurable.<sup>27</sup> This is a common Austrian criticism, summed up by Pasour: 'The calculation problem lies at the heart of the Coase approach. A court cannot determine whether the railroad or farmer's use of affected land has greater value for at least two reasons. First, market signals in this case are unreliable as a measure of social cost,' for, in the presence of externalities, prices would not reflect opportunity costs, which are not knowable since subjective. Second, Pasour adds, 'the Coasean judge, constrained by the Mises-Hayek knowledge problem, cannot obtain the information necessary to determine the most efficient pattern of resource use. [...] In short, the Mises-Hayek arguments are just as applicable to the Coasean judge as to the Pigouvian tax assessor and the overall central economic planner' (Pasour, 1996: 249–250). Even in Coase's setting, judges' cognitive capacities would have to be as limited as those of regulators and legislators. For example, even *ex post*, judges do not base their decisions on *all* the relevant factors (Kaplow, 1992: 594).

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<sup>27</sup> Contrary to the notion of subjective opportunity cost that Coase (1938) developed in his youth, in his 1960 article, he assumes that the judge takes into account the costs of a decision that he will not bear; these are thus objective costs, and are measurable in practice (see Bertrand 2014b).

To sum up, in Coase's framework, it is possible to consider judges, legislators and regulators as human beings of the same kind, all motivated by self-love, but where that self-love is expressed differently according to the institutional arrangement in which they operate. The common-law features that Coase underlines are, however, neither specific to common law nor sufficient to make judges' motivation coincide with economic efficiency.

## 5. Concluding remarks

'The Problem of Social Cost' tends to assert a normative role for the judge: to allocate the property right to the person who would pay the most for it, thus diminishing the need for exchanging this right and hence the costs associated with such an exchange. It has been shown that Coase's giving this role to the judge comes from a conjunction of empirical theses about: i) the relative inefficiency of both regulation (be it promulgated by regulators or legislators) and allocation of property rights by legislators, and ii) the relative efficiency of such allocations by judges. This has two consequences. First, the judge as envisioned by Coase seems to be exempt from his views on public intervention and his conception of human beings and their motives (inspired by Adam Smith). Second, the figure of the judge escapes the tenets of Coase's theoretical system that made it first necessary. This paper has provided some reasons that could explain, in Coase's view, this difference of treatment between the judge and other figures of public intervention: by nature, common law would be adversarial, *ex post*, and flexible.

Certain elements, however, call into question Coase's belief in the fundamental difference between judges and other public agents, and therefore restore the thesis that his view is inconsistent. The costs of each system are not evaluated or compared. The opposition Coase asserts between common law on the one hand, and statute and regulatory law on the other, must be softened. The features of common law that could help judges take into account economic considerations are not sufficient to assert that they do or that they are motivated by economic efficiency; neither are they sufficient to claim that judges have the necessary information and cognitive abilities. In the end, the specific motivations and abilities of judges remain unexplained.

Coase's confidence in the common-law solution to externalities is therefore more presupposed than argued for. But this does not mean that this solution must be dismissed. Other conceptions of efficiency are more favourable to it. Coase conceives of efficiency as an external standard (Pareto optimality or maximization of the value of production<sup>28</sup>), whereas thinking of

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<sup>28</sup> In Coase's theoretical framework, Pareto-optimal allocations are equivalent to allocations that maximize the net value of the production (Kaldor-Hicks efficiency).

efficiency as an evolutionary process makes it rest upon the litigation system and not on the motivations and capacities of judges (Rubin, 1977; Priest, 1977; Goodman, 1978; Landes and Posner, 1979; Cooter and Kornhauser, 1980). Here again, however, the specificity of common law, i.e. its relative advantage, would have to be argued for (Rubin, 1982).

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