Episode 1,125: Are Economists Obsessed With "Efficiency"?

Guest: Bob Murphy

WOODS: In particular we're focusing on topics that happen to be covered in your History of Economic Thought courses over that LibertyClassroom.com, so these are topics people ought to know about because they're very important. The Coase Theorem, I don't know how many times the "Problem of Social Cost" article has been cited, but apparently it's — it's certainly more than any of my articles have been cited. Let's just say that. Probably you and me put together, Bob. I would even venture to say that.

MURPHY: Yeah, I think so, yeah.

WOODS: Anyway, Ronald Coase —

MURPHY: We'd have to use scientific notation at that point to keep track of it, but still.

WOODS: [laughing] That's right, that's right.

MURPHY: Two gigantic numbers.

WOODS: So Ronald Coase, I think he actually didn't die all that long ago. He lived to a ripe old age. I can't remember exactly what it was, but my goodness, a lot of these economists lived very long lives. He wrote this very, very influential article, and it has provoked some controversy, and certainly among Austrians there's been some controversy. So we're going to start with that, and then we'll say a little something about so-called public choice, which is something else you should be familiar with if you're interested market economics and/or libertarianism.

So tell me about the Coase article and what problem was he purporting to solve in that article?

MURPHY: Sure. So some of the backdrop here that we need to know is the way economists traditionally dealt with and still to this day deal with what are called externalities. So in particular, we'll just talk about negative externalities. So the idea here is, most economists, if things are voluntary and what you're exchanging doesn't really have a big impact on other parties besides the two in the exchange, most economists would agree, yeah, as a default, that's probably okay to let them go ahead and do that. Even there, if it talks about inequality and so on — but most people are okay with that. So the way that economists would justify government intervention and to say that actually the market outcome is suboptimal is if there are what's called externalities, in particular negative externalities.

So a classic example: something like the factory's making television sets, but in so doing, it's pumping pollution into the air. And so the price of the TV is not fully reflecting the full what's called social costs of TV production. It's not fully accounting for the fact that workers have got to put in labor hours at the factory, you've got to use the various inputs to build the thing, but the fact that people around the world are not being subjected to more air pollution, that's not being reflected in the market price, and so there's too many TVs being produced.

So the standard way economists would deal with that is they say: okay, well, in principle if the government levied the correctly sized tax on TV production, then that would what's called internalize the externalities. So the idea is it's not — they're economists. They're not just saying, *Oh my God, pollution's bad. The optimal on pollution is zero; therefore, ban TV production*. They don't say that. They just say no, it's just too many TVs are being produced if the owner of the factory's not taking fully into account the pollution that it's causing, so if the government levies, whatever, a dollar per television tax, then the factory owner will cut back a little bit, prices of TVs will be higher, so consumers will realize exactly what pain it's imposing on the rest of humanity if they buy one more television set. And so that's supposed to lead back towards the optimal outcome.

So that was the baseline. That was the way economists thought about it. And then Ronald Coase comes along. His article was published in 1960 called "The Problem of Social Cost." And what he was trying to say is it's wrong to look at it as there's one party that's the aggressor, let's say, and then there's the other side that's the victim. He was saying no, it's just a matter of — what he says is there's the reciprocal nature of the problem, and our example, that it's not so much that there's a factory putting pollutant in the air and that's going to hurt everybody else; it's more just that, hey, there's competing uses for the air, and if there were no one living near the factory and we're just talking about local air pollution, then there wouldn't be an issue. So from the factory owner's point of view, the fact that there are so many people living right around him, that impedes his ability to make TVs. And so Coase is just saying there was an issue there of competing uses for this scarce resource, and that's the way he tried to reframe it.

WOODS: So what kind of a result do we get from Coase that would be different from what we would have gotten before?

MURPHY: Okay —

WOODS: Like let's take a typical case of it's the old train emitting the sparks in the old-timey trains.

MURPHY: Yeah, and that's probably good switching to that example, because the TV factory making pollution is harder to think about conceptually. So yeah, good example or good strategy, Tom. Coase's actual paper deals with that. So he's imagining a train going by some farmland, and the train kicks off sparks, and the idea is if the farmers plant too near the tracks, then some of the crop's going to get burned. And so again, under the standard framework, it would have said, *Oh, gee, this train's causing a negative externality on the crop production, and so we've got to levy a tax on people shipping stuff through with trains or something like that*. So what Coase said is that no, that's not necessarily the right thing to do.

So first of all, he walks through this analysis that says: if we neglect transaction costs, then notice the efficient outcome is going to happen whether the person running the train has the legal right to emit sparks and it's the responsibility of the farmers to then just take that as a given and plant accordingly, or whether the legal liability's the other way around and it's the farmers have the right to be free from sparks falling under their crops and therefore the train owner needs to take that into account.

Because either way — Coase comes up with some hypothetical numbers just to make the point, but the insight is to say if it really does maximize total production value for the train to keep going and emitting sparks — like in other words, if it would be more expensive for the train to install equipment to catch the sparks or to just stop running altogether rather than just not plant within 100 yards of the train, then the train owner, if it's his legal responsibility to stop it, he would just make a side payment to the farmers and say, *Look, I know legally you have the right to get an injunction and stop me, but here, let me just pay you on the side and let me keep shooting sparks off and then you just don't plant within 100 yards of the train*, or whatever the number is.

And so if that's the right thing to do, if that maximizes profits, that's what will happen, that the train will keep running and the farmers just won't plant near it. Or vice versa, if the train has the right of course to emit sparks, then the farmers aren't going to make a side payment to pay the train to stop doing it, because it wouldn't be worth it. It would be cheaper for the farmers just to not plant near the tracks. So Coase's point is that if the train owner could make side deals with all the farmers that are located along these tracks across the whole length, then it it's the right thing to do, if it's the most profitable thing to do for the train to keep running, that's what's going to happen regardless of which party has the legal right.

And so Coase's point was economists have traditionally thought perhaps that the property rights were going to be assigned in a certain way and then the government had to come in and try to maybe augment that to make it complete with a tax. And he was saying no, actually, in a baseline case where parties can freely negotiate, all that's going to happen is one party might be richer or poorer based on the side payment, but we don't need to worry about efficiency in a macro sense, that the right, profitable thing to do is going to happen in that baseline case. And so that's the bulk of his analysis, and that's what most people think of as what Coase's contribution was. Can we get into, Tom, the issue of what the misunderstanding is?

WOODS: Yeah, please, because — is there any misunderstanding even on our side of things when looking at what Coase is saying?

MURPHY: Yes, there is, so both friends and foes I think get this wrong, and Coase himself complained about this years after publishing this famous paper, that he was saying a lot of people misunderstand what he was trying to say there. So a lot of people think that what Coase's point was was to say we don't need all this regulation, we don't need to tax polluters, we don't need to tax people who are causing negative externalities, because don't worry, transaction costs are pretty low in the real world, and so people would just make side payments and take care of it. And that's not what Coase was saying. So again, his critics would accuse him of saying that and say that's stupid, but a lot of times his friends also think that, oh, that's what Coase was getting at and they might try to say, *Ah, as Coase showed, we don't need to worry about these problems*.

So that wasn't what he was doing. His point was to just first set up this baseline case in showing if there were sufficiently low transaction costs, notice it wouldn't matter how we assign property rights so long as they were delineated and there was a strict rule that everybody understood. So the government in his view needed to define property rights, but it really didn't matter so much as to which party got what particular right.

WOODS: Right. So in other words, whether or not it's the case that we assign the right — we say that it's the train that has the right to emit the sparks or it's the farmer who has the right to be free from the sparks, his point is you can choose one of those, but the actual outcome that's going to occur interestingly enough will be the same in both cases.

Now, back up just a minute. I don't want to assume people know what transactions costs are. This is one of these terms you economists throw around like normal people use this term every day. We actually don't, so when you say, "Assuming that there are low transactions costs," what in heaven's name are you talking about? Explain yourself.

MURPHY: Well, in our defense, mostly we're just friends with each other, so we have no idea that regular —

WOODS: Yeah, that's a little bit of the problem.

MURPHY: Yeah. So a transaction cost, what it means is it's not like you're going and buying labor but you're buying steel or something to put into the thing you're making. A transaction cost is more like the costs of you negotiating contracts with people. So if it's an example of — another one is like if there's a rock band that's practicing in a studio and then right next door there's an ear doctor who's giving hearing tests to people, there's going to be some conflict there, and so that might be an application of the Coase Theorem. And you'd say yeah, it's not that hard for one party to say to the other, "Hey, let me buy you out. I really can't have you practicing your rock music next door when I'm trying to give ear tests over here, and so let me just make a side payment to you to get you to walk away and we'll get somebody else to come in here." Or vice versa, if the rock band pays the ear doctor off and says, "Look, can't you just go somewhere else because we need to practice?"

So there there's just one negotiation that needs to happen, whereas if it's the train owner who has to negotiate with 100 different farmers, let's say, who own the plots of land, that gets more problematic. Or if it's my original example of the factory spitting pollution into the air and technically would have to cut deals with every homeowner within 100 miles, that gets unwieldy. So yeah, the principle's there, but in practice, the cost of going through all those negotiations could be prohibitive. So that's what we mean by transaction costs.

Okay, so just to circle back, though, Tom, the misunderstanding of Coase, once we clarify what he was saying in terms of here's the baseline with the low transaction cost; it's just a matter of defining the rights — he wasn't then saying anything goes. His then follow-up point — and it's understandable, because his article was long and it's dense reading, so I could see how people would miss it. But his point was then to say: so really, what judges or legislatures should do when they're defining these property rights is try to imagine what would be the outcome if transaction costs were zero or really low, and then in the real world when transaction costs might be high, assign the property rights such that that's the outcome that happens.

So like with the train thing, if we think that yeah, if the owner were allowed to negotiate with all the farmers, surely he would be paying them or they would refrain from paying him and the sparks would occur and they just wouldn't plant near the tracks, then in the real world because it's going to be prohibitive and the train owner really can't negotiate with 100 different farmers, let's just assign the legal rule of saying yes, the train has the right to incidentally shoot sparks off. That's part of what you own if you buy the land to lay down the track. You own the right to be able to shoot some sparks off. And so that's where he's coming from.

So he's not saying, in the real world, transaction costs we can always assume are sufficiently low. He's saying: use that hypothetical scenario to try to guess and say what would be the actual use of resources in that world with the side payments possibly happening, and then let's assign property rights in the real world thinking that that will be the outcome.

WOODS: Bob, is it safe to say that this article is really foundational in the subfield of law and economics?

MURPHY: Oh, yeah, totally.

WOODS: Okay, so I do want to, before we critique it or anything, I do want to get into the real-world application. Like are there judges who make reference to the Coase Theorem, or are there legislators who have used the Coase Theorem, or is this entirely abstract? So let's talk about that right after we thank our sponsor.

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All right, let's get into the real-world application before we critique this thing, because I want people to understand why this matters. First of all, it is as we said a very, very widely cited paper in which Coase outlines this theorem. But is it actually ever used? Did the thinking that's reflected in the Coase Theorem actually have an influence on the way property rights are — I hate to use the word "assigned" because it sounds so arbitrary — but, yeah, assigned? Did it actually have any real-world consequences?

MURPHY: I think — well, certainly the field of law and economics I think has influenced the way certain — if you don't like that term, do you like the term "policymakers," Tom? There's a real nice bland term for you that I'm sure makes your skin crawl.

WOODS: [laughing] Yeah, yeah, yeah.

MURPHY: It probably makes them — it at least changes the language, or when they're trying to justify what they're doing, then certainly this framework that Coase helped inspire I think permeates it. So I think it would be saying too much to say the very idea of a cost-benefit analysis comes from this paper. That's not true. That's overstating. People would have been doing that earlier. But certainly the way people think about it. And I think for sure many judges were influenced by this type of analysis, and so again, I can't say whether like on a particular specific decision the majority opinion said, "Ah, because of Coase's paper, we're ruling such and such." But I think for sure when they want to invoke economic considerations as part of the rationale for why they're ruling the way they're ruling, that yes, this type of literature comes into play. So I don't know if that's answering your question.

The other thing too is it shows — what he did show in the paper, even after the part that I just said, he then goes to show why if you were relying on the traditional what's called Pigouvian analysis after A.C. Pigou, this idea of, oh, just tax the negative externalities, that that could lead you to an inefficient outcome. So just to give a quick example, suppose it really is supposed to be the case that the railroad, like you would maximize total output, if you want to think of it that way, if the railroad just was allowed to continue running and shoot sparks off and that the farmers just didn't plant right next to it and that was the way they minimized the damages and so on. If that is the efficient outcome in the sense of maximizing the value of total output, then if instead if the legislature just assumes that, oh no, that's a negative externality, we're going to levy a big tax on emitting sparks, then the farmers would have no incentive to not plant right next to the railroad. They would keep planting the normal way, and then the railroad would cut back on the routes it would run and there'd be fewer sparks. And so the point is that might be the wrong thing to do. That might be the wrong outcome.

Or to give an even more exaggerated example, suppose it made sense for a certain place to have a nuclear power plant, but then you really wouldn't want to have people — you wouldn't have a daycare center one block away or something just because of the risk, and then it might just make sense, no, it's not hard to move the daycare center further away to minimize the risk of something happening to the kids, and then you get to have the cheap nuclear power. Whereas if you instead just assumed, no, you levied this enormous tax on the nuclear plant to account for the fact that there's a daycare center right there, then they might just not build the plant in the first place. So there's thing like that where you can come up with sort of exaggerated examples showing that this Pigouvian framework could lead to a suboptimal outcome, whereas maybe the right thing to do is just to sort of change the game, if you will, and have one party kind of just change what they're doing so that this conflict doesn't exist.

WOODS: Let's talk now about critiques of the Coase Theorem, and I'd be curious to know what you think any problems with it might be. I'm familiar with some Austrian criticisms of it, but I'm not familiar with the Murphy view of it.

MURPHY: [laughing] Okay, well, I mean, I guess part of the problem is just the fact that it takes everyone so long to see what he was saying, I think that indicates that perhaps he could have been clearer in his original paper. Because again, you can sit there and try to read the thing, and it's not obvious what he was trying to say. And so just in terms of the exposition, I think there's that element. In fairness, he was trying to overturn this real conventional way of thinking, and so that might have been part of the problem.

I agree with guys like Walter Block that there's — it's not so much that I have a problem with anything Coase says in his paper, but the broader law and economics tradition that came out of that, it is kind of creepy. And I think it almost is circular in a sense. And so I'm going to be a little bit unfair here and exaggerate, but I just want to make sure your listeners get the idea. Strictly speaking, if what we're going to say is, *Oh, we should assign property rights based on what maximizes wealth* — and that is a fair statement, a crude way of putting it — strictly speaking then, like if some mugger takes a lady's purse and she wants to sue the mugger and it goes before the judge, he would have to weigh and say, *Well, does the mugger value the contents of that purse more than the lady does?* Now, you might come up with the "right answer" by saying no, she has a sentimental value, and if there's a $100 bill in there, they both value the $100 bill at $100, and so plus her sentimental value, she values the purse more than the mugger does and so she should get the property right.

But isn't that kind of a weird thing that we have to run through that exercise as opposed to just saying no, people own stuff and we have some theory by which we delineate property rights? And yeah, if it comes to something new like radio spectrum or something, maybe we've got to come up with some way of — but clearly to say I own this house, does it make sense to say that that ownership should flow from considerations of maximizing the value of output, or is it more like, no, you own it for some other reasons about the nature of property rights? So I think that there's that element, and if for no other reason, it sort of blows itself up that if you thought your property rights were always going to be subject to a review to make sure it's maximizing production value, then you wouldn't be secure in your property rights.

And so I think there's that sort of an element there, just sort of like my problem with crude utilitarianism, that if everyone were really just doing that and you thought your neighbor was refraining from murdering you in your sleep just because he was running arithmetic problems at night, and saying, *No, no, actually I think it's going to maximize his social welfare or social utility if I don't kill him tonight*, that would not be a very good outcome.

WOODS: So is it a case of they're smuggling in an ethical assumption, or is it more a matter of if/then: if you want to maximize utility, then you should follow the following thing? But since we all know everybody wants to maximize utility, then unless you're completely crazy, we should follow this rule.

MURPHY: [long pause] That's a good question [laughing].

WOODS: I was going to say: either that was the dumbest question in the world, or I've done the impossible here.

MURPHY: Yeah, I'm trying to be polite and let you down easy [laughing].

WOODS: [laughing] *Yeah, actually, that was a really tricky question for me to answer, Tom.*

MURPHY: I'm just trying to remember the actual language that Coase used in his paper, so let me say this for sure —

WOODS: All right, so that is kind of a subtle — but that is kind of a subtle question. I guess our point of view, if I'm speaking for Austrians, our point of view really would be: we make more or less if/then statements. We don't say the Austrian — people say: what's the Austrian position on the minimum wage? Well, there is no — well, first of all, I'm not even sure there is an Austrian position on wages, necessarily, but anyway, there's no Austrian view because that's a policy question. What we can tell you is: if you do X, then Y is going to occur, or you're going to get more Y than you would have if you hadn't implemented X. And that's as far as we go. Whereas sometimes with the Chicago people, you get the feeling that, although probably they would protest that they're being value-free, when push comes to shove, it sure sounds like they're imposing a utilitarian worldview on the discipline.

MURPHY: Yeah, so for most of Coase's paper, yeah, it's not like — I don't think you could point to anything, and then I would say: oh, yeah, I think that's a demonstrably false statement. So that's certainly true, so in that sense, it's neutral and he's just saying if we assume this, then this would happen. But you're right, when people say: so what is Coase saying? What is the conclusion that pops out of that? And what I said to you earlier I think is defensible and a lot of Coase scholars would agree, is to say, yeah, he was saying, okay, if you want to use this to guide decision-making, then it means the judge should assign the property rights in a case where there's high transaction costs such that he thinks these actual outcome there will mimic the outcome that will happen regardless of the assignment in a low-transaction-cost scenario. So there, that is a normative statement. He's saying this is what the policymakers should do. So yes, I think you're right that they are assuming that the reader agrees why would we eve tolerate an outcome that was inefficient. Why would we want to boost the total value, because even if there are losers, in principle we could compensate them with the gains to the winners.

WOODS: Now, it may sound like a trivial objection, but couldn't you say that you can't really quantify the value that somebody gets from something precisely for one of the reasons you mentioned? How can you quantify sentimental value? That land that the farmer enjoys could be valued by him at an amount that no judge would be willing to sign off on, but so what? It is valued by the farmer at that amount. So it seems arbitrary to say that we could say one party values it more than another. How can you know that? How can you judge the intensity of somebody's valuing of something? Now, it seems like that has to be something he anticipated, so I feel silly even raising it.

MURPHY: Right, in this literature in general there's also the problem of, depending on who gets assigned the property right, that person's wealthier and so they have a higher ability to pay for things, so their willingness to pay for an outcome is augmented if they get assigned the property right in the first place. So with a lot of these things, if we're assuming the assignment of the property right is some trivial little matter that doesn't really greatly affect everybody's wealth, then it seems pretty straightforward, but if you realize — in the extreme case: well, gee, with sufficiently low transaction costs, it doesn't matter whether this group of people owns their bodies or not, because if the right thing to do is for them to be free, they would just make side payments to buy their own freedom. But like that's kind of a big thing [laughing]. That's like some trivial detail.

And so I agree with you, and you're right: this has been well-discussed in the literature. But still, I think the fact that critics have raised it and the Coaseans have responded I don't think means it's a silly objection. So yes, they're well aware of these issues, and again, I think when you're asking me what's my view, I'm glad he wrote the paper and I think it certainly helps to show what the problem is with the conventional: negative externality, *Oh, so therefore let's have the government levy a tax* — I think it helps to show that that logic isn't even right on its own terms, because a lot of times if someone wants to push back against that, they'll just raise questions like: oh, well, maybe the government gets the tax wrong or how can we trust them; they might make the tax too high just to raise revenue and blah, blah, blah. And that's all fine, but I like Coase's perspective, because he's showing even in principle that could be the wrong thing to do on your own terms, because Pigou also was just worried about Pareto efficiency. But you're right that it is kind of creepy and ultimately, just as that, if you think the property rights come from something besides just pure considerations of efficacy, then yeah, that is creepy.

So to answer your question, I think in terms of neutral economic analysis, it's fine insofar as it goes, but yes, if actual real-world judges are using this thing, I think it could have some bad consequences for no other reason than that they could easily say: yeah, the government has the right to take your property to build a highway and we'll compensate you and blah, blah, blah. We're maximizing — you're right: the person doesn't have the right to say, *No, I actually valued my land more than what you just paid me*. Then how are you supposed to prove the person wrong?

WOODS: And I think also, by the way, this whole episode is a useful reminder — I don't mean this podcast episode; I mean this episode in the history of thought is a useful reminder to people who would accuse the Austrians of believe that — and it's by people who don't know anything about the Austrians, but people who accuse the Austrian school or all free-market economists of thinking only in terms of efficiency. Well, then why would we be pushing back against some aspects of the way the Coase Theorem is applied? Why wouldn't we just be blandly cheering it? Because we don't like that way of thinking either.

So anyway, what we'll do is on the show notes page I'll link to the article by Coase. I assume it's got to be — I mean, for heaven's sake, it's got to be available online — "Problem of Social Cost." So we'll link to that, and maybe link to a couple of free-market critiques that are valuable. I can think of a couple off the top of my head. And anything else Bob thinks is useful. Of course you should check Bob out at ConsultingByRPM.com. His blog there is really, really great, so by all means do that. And of course read Bob's books and all that. You can find them at ConsultingByRPM.com.

MURPHY: And plug Liberty Classroom while you're at it.

WOODS: I was just about to [laughing].

MURPHY: Oh, geez. You know what? Who am I — who is it?

WOODS: But the thing is I feel funny wording it this way, but: *more* than going to visit Bob, go check out LibertyClassroom.com where you can learn from Bob and actually ask him questions and get answers from him. How about that? All right, that's it, Bob. Thanks for talking to us.

MURPHY: All right, thanks. Glad to be here.