

THE CHICAGO SCHOOL'S CONCEPT OF PROPERTY RIGHTS: COASE THEOREM AND ANTITRUST REVISIONISM

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ABSTRACT:

In his seminal paper "Problem of Social Cost" Ronald Coase provided a new explanation of externality economics, asserting that under the certain circumstances, voluntary negotiation between the parties involved would efficiently remove external effects. If disputes do occur, the courts, according Coase, should curtail traditional strict liability criterion, making decisions so as to maximize overall social welfare.

Economic efficiency criterion was taken over from the Coase's supporters among the Chicago School antitrust scholars, who applied it in antitrust area. According to them, it was not sufficient to rely upon some objective criteria (e.g. market share) to decide whether some particular action of the firm was monopolizing, but additionally, it was necessary to estimate economic efficiency of that action.

Common basic fallacy of Coase theorem and antitrust revisionism of Chicago School is rooted in their common considering of costs and benefits of the market operations as an objectively given data, able to be measured ex ante by judges and regulators. But, opportunity costs are subjective and, therefore, not known to any "objective" outside observer, except the decision-maker himself.

Introduction:

The theory of the Chicago School of economics is supposed to be a major contribution to revival of free-market approach in the previous decades. Among the majority of economics and social science scholars, Chicago theorists are often considered as radical proponents of economic liberty and their theories sometimes are accordingly labelled as some kind of free market zealotry.

Although this reputation of Chicago School is largely exaggerated, there is a grain of truth in considering Chicago theory as some kind of departure from the mainstream welfare economics of the 20th Century. Among other things, perhaps the greatest and sharpest clash between traditional welfare economics and Chicago School was rooted in Ronald Coase's early attack on standard Pigovian view on the well-known problem of externality. In the circles of many free market economists Coase's "Problem of Social Costs" is accepted as ultimate liberal response to market failure theories of first generation. The so-called "Coase theorem" allegedly provided a simple and persuasive explanation of external economy of the free market and showed how, if the transaction costs were absent, voluntary negotiation and agreement between the parties involved would resolve the problem of the social cost "efficiently," without resorting to any state and judicial authorities. In cases where dispute about property rights does occur, judges should relax the strict liability criterion, and decide so as to maximize overall social utility, regardless how that will affect individual property rights of the parts involved. In this paper I shall criticize this widespread view about subject, disputing the possibility of using Coase theorem to overcome the externality problem, and trying to explain its impact on prevailing "reformist" approach to antitrust, provided by other members of Chicago School, such as Robert Bork, Richard Posner or George Stigler. As well as the Coase theorem, the reformist views on antitrust, supposed by many theorists to be an improvement compared with the old, statist approach to the issue, are products of the same basic fallacy contained in Coase theorem: opting for collectivist idea of maximizing "social welfare" based upon cardinal utility theory, regardless of the violation of property rights that might be committed in such a "maximization". Common feature of Coase theorem and its application in the field of antitrust is therefore their common biased notion of property rights.

Coase's theorem and some of its consequences

In his seminal paper "Problem of Social Cost" Ronald Coase shifted the attention of economic science toward legal treatment of economic efficiency, suggesting a new definition of the place and meaning of legal rules and judicial system in economic

activity. Moreover, he developed some kind of new theory of property rights that severely contradicted the old-fashioned liberal concept of strict liability. This feature of his theory attracted many “modern” economists. As mentioned above, the main Coase's theoretical innovation appeared to be in treatment of the standard problem of externality economics, problem resolved by old Pigovian welfare economics in a statist and interventionist manner, by taxation and subsidizing. Although Coase rejected the basic Pigovian standpoint concerning the internalization of external effects by additional taxation imposed on those market agents who produce them, Coase by and large, based his theory upon the Pigovian collectivist and anti-market criterion of wealth-maximization as the main task of economic theory and policy, based on cardinal utility assumption. Despite the fact that the place of interference with free market and private property rights had changed - substituting judicial arbitrage for government taxation - the underlying welfare economics' disdain for property rights and rule of law remained untouched. In this regard, Coase even outdid the old welfare economics. The best proof for this can be found right in the "Problem of Social Cost“.

*"The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is, how we should restrain A? But, this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would be to inflict the 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."*¹

Put differently, the basic economic philosophy Coase here proclaims is based on so called cost-benefit analysis concerning harm to someone's property done by someone else. By his opinion, there are no sacrosanct property rights, the breaking of which must be punished and the property holder rectified for it. There is only the task of maximization of overall "social welfare," regardless whether the procedure of its maximization would harm someone's legitimate individual property or not. If I kill you, the real problem, according to Coase, is not my aggression on your right to live ("this is wrong"), but the harm I did to social welfare, by eliminating a productive citizen able to produce and

¹ Ronald Coase (1960), p.2.

enhance the prosperity of the society. If I find the way to convince the judge that you were actually an unproductive member of society, whose life brings to taxpayers more harm than benefit, he should praise the assassination I committed, because I maximized the overall social welfare that way. My failing or hesitating to kill you is harm inflicted to me by you, as well as my killing you is the harm you inflicted on me. The question, according to Coase, is not whether I have the right to kill you, but rather what the probable consequences of killing you would be on social welfare, that is, whether the "social cost" of killing you would exceed cost of not killing you.

Or consider a similar, but a bit less radical example: *“suppose I were to steal your wallet. The old-fashioned (pre-Coase) judge would inquire into the past history of this item. If there were, for instance, your credit cards and pictures of your family in it, and if this wallet had a bill of sale with your name on it that would pretty much be the end of the matter. I would be the thief, and you the rightful owner. But, for the judge under the influence of Coase, the past would be irrelevant. On the contrary, the judicial inquiry should be directed toward the future. If I could prove that I would make better use of the wallet and its contents than you, than I would become a legitimate owner, that is, until someone else who could use it even more efficiently than I came and relieved me of it.”*²

Whether such a situation occurred, it is up to the judges and regulators to decide. Simply, for Coase there are no unalienable rights; there is only “optimal solution” brought about by cost-benefit analysis of **future** "social welfare." That way, it becomes clear that Coase endorses one of the basic fallacies of standard neoclassical perfect-competitive equilibrium analysis - availability of necessary knowledge for entrepreneurial decision ex ante, that is, the “perfect information”. Needless to say - if information is perfect in the given sense, then competition itself becomes inefficient and wasteful mean to use the entrepreneurial knowledge.

One can consider the way I characterize Coase's views about property rights somehow exaggerated. But there is nothing principally different in previously considered examples of killing, or wallet stealing, compared with the famous Coase's example of railroad spark

² Walter Block, OJ's Defence; A Reductio ad Absurdum of The Economics of Ronald Coase and Richard Posner.

and crop grower. Railroad, in this example, sets crops on the fire, harming crops that way, and the crop grower can sue the Railroad Company for damaging his property. What should the court decide, according Coase (and his disciples), is not who violated whose property, but how to resolve the whole problem so as the overall harm would be effectively minimized, whatever that means concerning the railroad's and grower's legitimate property rights, as commonly understood. If the cost of installing a spark-preventing device is higher than cost of burning crops, the court should deny the grower's claim, and force him to bear the cost, despite he probably first established his property. Otherwise, if the cost of burning is higher than the cost of spark preventing, the court should hold the Railroad Company liable, and force it to compensate damages to the grower. So, here we can easily discern the same logic employed in our previous examples of killing and stealing; the problem of expediency is substituted for the problem of justice and unalienable rights. Nobody has a right on anything, but the "Society" as a whole has a "right" on everything, e.g. on maximized welfare through arbitrary reassignment of property rights undertaken by the courts, and depending upon ex ante "estimated" costs and benefits of alternative arrangements of those rights.

The consequence of Coase theorem is at least two-fold. There is, on the one hand, a moral and legal problem following from that theorem, and also, on the other hand, an economic one.

Concerning the former, an obvious feature of Coase's redefining of problem of rectification for invading someone's property is as that there are no stable property titles, that is, the titles depend upon regulatory decision. Depending upon what the result of court's cost-benefit analysis will be, everyone's property rights over the some object or capital good could be challenged. This provision contradicts not only the standard liberal conception that nobody should endanger anybody else's individual liberty, but also the ancient tradition of justice, which was developed even in the Roman Common Law, against invasion of private property. The whole tradition of rule of law must be completely abolished, if one seriously seeks to apply the idea of reassignment of property titles depending on the "rule of reason" of bureaucrats and judges according their estimations of "social cost" of using this property. Costs of this "redefining" of property

rights will be immense: *"The major problem that is never confronted by Coase and his many defenders, namely that his theorem imputes zero economic value - and therefore zero relevance - to the owner's sense of the moral and legal right associated with willful violation of his property. It also ignores the economic relevance of third parties' sense of moral outrage and helplessness when there is no predictable enforcement, by the civil government, of owners' legal immunities from invasion, even if done in the name of a "more efficient" social good or social goal."*³

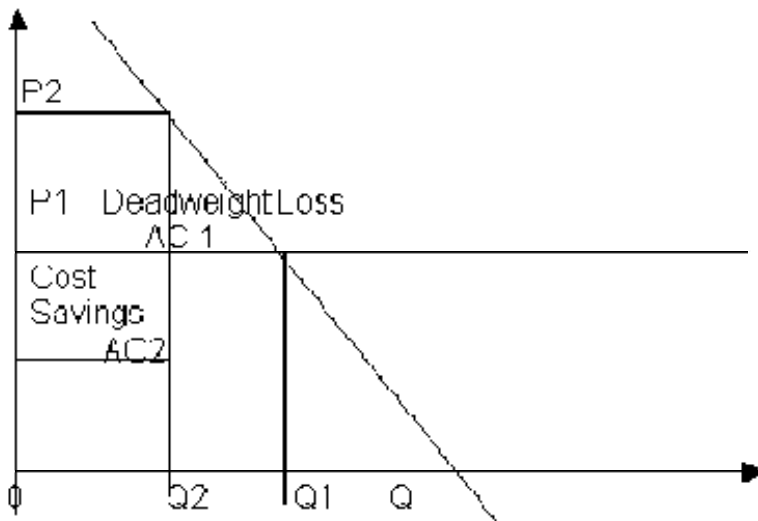
So it is obvious that the Coase theorem does not eliminate externalities, but rather that it imposes the biggest possible transaction cost - undermining the very idea of private property, and that way destroying any possibility of rational economic behavior. If the main idea of his theorem is to be taken seriously, that is, if private property entitlements of the people should depend upon the ex ante cost-benefit estimation of judges or bureaucrats regarding market transactions, then nobody would employ his property and money in any market operation, because every market outcome could be arbitrarily changed by political redistribution of property rights according to the "most efficient use" of resources. Essence and content of the notion of private property has disappeared.

Antitrust Revisionism and Coase Theorem

It is well known that Ronald Coase heavily impacted many economic and legal theorists of the Chicago School. Among the most famous Coaseians are Richard Posner and Robert Bork, economics and legal scholars, which had mostly met with approval for their endeavors in the field of antitrust policy analysis. It is not an exaggeration to notice that Posner and Bork apply the chief conclusion of Coase theorem to the antitrust. Seeking to replace the old fashioned approach to combating "monopolies," relying on objective criteria for prohibiting, e.g. market share of the firm or "intent" to monopolize, those scholars introduced Pigovian-Coase idea of wealth-maximization as the alleged shibboleth for assessing various allegedly "monopolistic" behaviors and practices. For

³ Gary North, (2002).

instance, according to them, it was not enough to assert that firms A and B, if merged, will possess more than 50% of relevant market, to ban the merger those firms intended to undertake. According to Chicago antitrust revisionists, it was necessary to find out whether the prospective merger would enhance the consumer welfare, or diminish it; that is, whether cost savings deriving from the economy of scale will exceed deadweight loss from harming the optimal market structure. Consider the following figure that summarizes both the neoclassical view on monopoly and the new Chicago approach:



As Bork puts it: *"The diagram assumes that the merger reduces the long-run average costs of the two firms from AC1 to AC2 but that increased market power created by the merger results in a restriction of output so that the rate moves from Q1 to Q2. We then see that consumers have lost output - for which they would have been willing to pay an amount above the cost equal to the area labeled A1 - and have gained in resource savings an amount equal to the area A2. Obviously, if A2, the cost savings, is larger than A1, the deadweight losses, the merger represents a net gain to all consumers. If A1 is larger than A2, a net loss results."*⁴

The only problem we are confronted with here is how could we know all those things Bork supposes we should? For example, how can we estimate the ratio between the

⁴ Bork, (1978), p.

allocative and productive efficiency in the case of merger, to make the right decision whether to approve that merger or not? Based on which criteria and by what analytical devices can some judge meet the task of objective estimation of cost and benefits? By and large, Borkian antitrust judge, just as Coaseian one, must take into account not (only) subsumption of some real event under the legal rule, but, primarily, consider economic "efficiency" of this or that use of property **in advance**. To approve or forbid a merger, the judge must be able to have an ex ante estimation of deadweight loss/cost savings ratio. He must be able, just as Coaseian one, to know which use of resources is efficient, and which is not, independently from their actual market use. What is problem here is: Bork considers so-called Harbergers' triangle (reflecting deadweight losses) to be objectively measurable ex ante. To consider it measurable in the given way, it is necessary to know the position of the demand curve, which is on one side of that triangle. But, we do not know ex ante position of the demand curve. The only thing we do know is one point on it, the PQ. In Bork's neoclassical construal, the demand curve is really an existing entity, waiting "out there" to be measured by theoreticians and regulators. But it is not "out there" and it couldn't be measured in the given way. Demand curve is just a hypothetical alternative, coming into play only by consumer decisions, the state of technology and many other unpredictable things and events, which can shift it in this or that direction quite unpredictably. The precise position of the demand curve can only be reported ex post, not defined in advance. Relying upon an analysis of it is completely useless for the estimation of *future* events on the market, and therefore for ex ante estimation of future costs and benefits of some market operation (e.g. a merger). An entrepreneur could define ex ante only the cost curve of production he currently decides to undertake, and not the cost curve of profitable production, which is to take place. The real cost curve will be defined in consumers' verification through their deciding or not deciding to purchase a good or service offered to them by the entrepreneur. Also, entrepreneurially estimated demand curve is one of the assumptions of estimated cost curve. But none of them, "real" cost curve or the demand curve, cannot be known in advance even to the entrepreneur, nothing to say about government regulator. To grant to regulators, as Bork does it, the ability to correctly estimate cost and benefits of various ways of production in advance, means only to assume away, by definition, any range of uncertainty, transaction costs or

insufficient knowledge from the very model of competition. Objective estimations ex ante, which Bork imagines to be the main task of antitrust policy, are possible only in the state of affairs Rothbard described as Evenly Rotating Economy, a never changing static equilibrium, completely deprived of any entrepreneurship or advance.⁵

Up to this point it was assumed implicitly that it is possible to make interpersonal comparisons of utility. But such a methodology could not be justified in the first place. An implicit assumption of cardinal utility comparisons is present when we consider some business arrangement which is not taking place to be incurring losses to consumers on the part of buyers. It is assumed that someone could measure deadweight losses and cost savings, and manage them so as the later would exceed the former. But such an assumption completely confuses the difference between ex ante and ex post efficiency. Sure, every transaction on the free market is ex ante efficient; otherwise the parties involved certainly would not engage in such an activity. But it is a very different thing to assert that a mere failure of some market transaction to take place (Q1, Q2 remains unsold) automatically entails that consumer welfare is harmed that way. That means that the comparison of the seller's and buyer's utility can be made from the viewpoint of an extra market "objective" observer (e.g. Antitrust division of Justice Department and FTC in America, or "Competition Commission" in Europe) instead by consumer verification. But it is contrary to the basic assumption of market economy - the market itself through the price system confers the knowledge necessary for entrepreneurial decisions.

The application of Coaseite criteria of welfare maximization in the field of antitrust was institutionally facilitated during previous decades. At Chicago University, a famous antitrust seminar was organized, where Chicago professors of law and economics (Manne, Bork, Posner, Peltzman, Stigler, etc) had been seeking to educate federal bureaucrats and judges to implement economic efficiency judgments in resolving antitrust cases. The main force in shifting a general trend in enforcement policy towards abandoning of the old objective criteria in assessment of monopolies, and endorsing the "rule of reason," efficiency-based guidelines, was the Chicago antitrust seminar. The

⁵ See, Ludwig von Mises, (2004), pp. 244-250.

change in enforcement policy that occurred in 70-es was rooted in the theories developed by Posner, Bork, Stigler and others in previous decades, actually starting from the Borkian analysis of DWL/CS trade-off we previously demonstrated. That change in enforcement guidelines improved antitrust policy immensely and weakened the pressure on big firms. But, at the same time, this change was both insufficient and ambiguous; the number and extent of antitrust trials and litigation has decreased in 1980-ies, but this change was not due to the full apprehension of economic fallacy of the very concept of competition on which the antitrust was based, but only to empirical evidence of harmful effects of rigid trust-busting employed in previous decades, without reconsidering the fallacious, static concept of market economy that underlined it.

Conclusion:

Ronald Coase heavily influenced the revisionist movement in the field of antitrust. That impact is mainly due to the changing concept of private property rights Coase has established, in an effort to resolve the externality problem without the state intervention. The idea of reciprocity of damage and judicial ex ante estimation of cost and benefits of market operations underlined the eventual antitrust revisionism of Chicago School. Bork, Posner and Stigler shift to courts and regulators to correct the market failure of monopoly, or at least to estimate economic efficiency of some particular market action (merger, tying) in a very similar fashion Coase shifts to courts to correct externalities and to impose punishments for those who use recourses less efficiently. In both cases, the very idea of private property rights disappears because, in the absence of a strict liability criterion, there are no incentives for owners to use their property efficiently, because their bundle of rights over property is significantly narrowed. They could be arbitrarily harmed by court findings and devoid of their legitimately acquired property, by gaining which, they were not breaking anyone else's property rights. The crop grower could be held liable for first establishing his property if the judge found that the cost of installing a spark preventing device is higher than the value of burned crops, as well as the fact that the owners of two firms intending to merge could be punished if the judge "estimated" that deadweight loss of that enterprise would be higher than cost savings. In any case, the

owner and entrepreneur cannot know in advance what is prohibited and what is not, and therefore their behavior becomes risk-averse.

The basic economic fallacy that underlines both Coase's theorem and antitrust revisionism is the neoclassical use of perfect competitive equilibrium as an ideal benchmark against which real competitive world should be tested, as well as the objective theory of costs, by which judges and regulators could define the opportunity cost of the firm operation ex ante, independently from the competitive process and decisions of consumers, and according to that knowledge, to correct market "inefficiency." On the contrary, opportunity costs are purely subjective and not measurable by some external observer, but only available to the decision-maker in the moment of decision. So, "maximization" of social welfare in terms of correcting the "market failure" by extra market regulators, which underlies both Coase's theorem and antitrust revisionism inspired by it, is a completely senseless and useless concept.

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