

# COASE ON LAW AND ECONOMICS<sup>1</sup>

by Alan Cameron

## Introduction

Stephen Medema's intellectual biography, *Ronald H Coase*, reveals the renowned economist's criticisms of economic orthodoxy and its methodology (1994, ch. 6). The implications of these views for the law and economics movement are made explicit in Coase's essay on the relationship of economics to other disciplines.<sup>2</sup> Subsequent exchanges between Richard Posner and Coase in the *Journal of Institutional and Theoretical Economics*<sup>3</sup> and an article by Posner devoted to an assessment of Coase's views on economic methodology (1993) expose sharp differences between two of the leading figures in law and economics.

Posner's attack is not confined to Coase himself. He criticises the school of "new institutional economics" based on Coase's economic methodology and transaction costs theory under the leadership of Oliver Williamson. Though not as dismissive of the latter as he is of Coase, Posner's criticisms were no more appreciated by Williamson (1994) than they were by Coase.<sup>4</sup>

In this clash between Posner and Coase, Coase's views appear to place a large question mark over the law and economics movement. It raises the question as to how one of the leading figures in contemporary law and economics, Richard Posner, could accuse an acknowledged founder of the Chicago-based movement,

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<sup>1</sup> Thanks is owing to Jeremy Traylen of the Economics Department at Victoria University of Wellington for prompting the paper on which this article is based. Thanks also goes to Peter Gorringer from Treasury who provided very helpful background on Coase's views and his differences with Posner.

<sup>2</sup> "Economics and Contiguous Disciplines", originally published in Perlman (ed.) (1977).

<sup>3</sup> The entire debate involving Posner, Coase and Williamson is to be found at pp. 79-87 (Posner, 1993a), 96-98 (Coase 1993), 99-118 (Williamson, 1993) and 119-121 (Posner, 1993b).

<sup>4</sup> Coase, especially, appears to be deeply hurt by Posner's assessment of his methodological position, reflected in Coase (1993). The depth of feeling can be gauged by the following:

"My first reaction on reading Posner's paper was one of amusement. It recalled to mind Miss Elliott's description of Alfred Marshall's lectures on Henry George. She said that Marshall reminded her of a boa-constrictor that slobbered over its victim before swallowing it ... In saying this, I had no intention of equating Posner with Marshall, still less with any kind of snake, although I must confess that the wicked thought did flicker through my mind as I studied his paper with more care and ceased to be amused" (p.96).

Ronald Coase, of misunderstanding the significance of his own insights for law and other disciplines. Or viewed from the other side, and even more mystifyingly, how is it that Coase, for many years editor of the Chicago-based *Journal of Law and Economics*, could disapprove of the application of economic analysis in non-economic disciplines, for example, in Posner's *Economic Analysis of Law*, notwithstanding the central importance accorded "the Coase theorem" in that text?

The answer to these questions, lies in an explanation of the fundamental disagreement over the nature of economics and its methodology between Coase and theorists who have drawn upon his own contributions to economics. This article gives a brief account of Coase's criticisms of economic theory and its uses and discuss some implications of these criticisms for the law and economics movement. First, Posner's assessment of Coase will be briefly summarised. This assessment is then evaluated based on my reading of Coase's view of his own work and his criticisms of economic theory. Finally, I express some views on the significance of Coase's views on economics and his own contributions to economic theory with respect to the relationship between law and economics.

### **Posner on Coase**

At the beginning of Posner's article (1993) marking Coase's award of the Alfred Nobel Prize for Economics, Posner observes that the latter's contribution to economics was more than just two now famous articles, "The Nature of the Firm" (Coase, 1937)<sup>5</sup> and "The Problem of Social Cost" (Coase, 1960). He states that, not only did the Swedish Academy which awarded the Nobel Prize to Coase appear to base its decision on those two articles alone, but Coase himself fosters this impression of the limited extent of his contributions to economics.<sup>6</sup> According to Posner, this is a mistaken assessment, which, in the case of Coase's own interpretation, is owing to "a methodological preoccupation ignored in the conventional appraisals of his contributions" (1993, p. 198). It is on Coase's writings relating to the methodology of economics that Posner's article focuses.

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<sup>5</sup> Reprinted in Medema (1995, I, pp. 5-24).

<sup>6</sup> Not that Coase under-estimated the importance of his account of the role of transaction costs in the two articles. "[H]e believes that the ideas in these articles, once they are absorbed into mainstream economic analysis, will 'bring about a complete change in the structure of economic, theory, at least in what is called price theory or microeconomics' " (Posner 1993, p. 196 13quoting Coase from his Nobel Prize address).

Posner sets out to explain Coase's "overall economic position" and its "limitations" expressed in Coase's criticisms of modern economics (198). Posner provides quotations from the Coase corpus which powerfully and wittily express the latter's belief that "the dominant tendencies in modern economics are unsound" (p.196). Coase's dissatisfaction " 'is not with the basic economic theory itself but how it is used. The objection essentially is that the theory floats in the air. It is as if one studied the circulation of the blood without having a body' " (p. 196). Whilst modern economics may be more sophisticated in the last 200 years Coase is convinced that it displays " 'no greater insight into the working of the economic system and, in some ways, our approach is inferior to that of Adam Smith' " (p. 196).

He has an antipathy towards "high theory" which is expressed in his aversion to the use of mathematics in economics and his suspicion of econometrics. On the former Posner quotes him as saying, "In my youth it was said that what was too silly to be said may be sung. In modern economics it may be put into mathematics' " (p. 198, fn 5). And regarding the latter, " 'If you torture the data enough, nature will always confess' " (p. 199, fn 10). His explanation of the existence of the firm in "The Nature of the Firm" as owing to the role of transaction costs is an example of Coase providing an alternative explanation to the monopolistic accounts with which "high" microeconomic theory was preoccupied. However, Posner thinks that Coase carries too far his antipathy towards theory based on "the standard economic assumption of man as a rational maximizer." Coase is sceptical of this assumption in regard to political behaviour or even in respect of "explicit" market transactions (p.199- 200).

The major criticism which Posner levels at Coase is "the *narrowness* of his conception of the domain and methodology" of economics which he considers to be the most "unusual" feature of his writings (p.203). Part of the explanation for this alleged narrowness is attributed to Coase's admiration for Adam Smith and the conviction that "the two centuries since the publication of the *Wealth of Nations* have been largely wasted in economics ..." (203).

Part of this narrowness criticism is relevant to legal theory. Posner remarks on the "insouciance with which Coase appears to regard one of his most signal achievements", the law and economics movement of the last quarter century. According to Posner, this has been "probably the most influential movement in American legal scholarship during this period..." and one which has been

"immensely influenced by 'The Problem of Social Cost' " and its treatment of the problem of transactions costs (p. 203). For Posner, Coase's "characteristic attitude" to this movement is reflected in his Nobel Prize lecture (Coase, 1992) where he quite explicitly declines to say much about the influence of the article on the movement but rather its relative lack of influence in economics (pp. 203-204). He inquires as to why Coase lacks interest in the movement that he had done so much to nurture (p. 204).

He attributes this attitude largely to what he describes as Coase's methodological "Englishness".<sup>7</sup> Posner describes this tradition as "common sense, empiricist, and anti-theoretical (p.205). He sees Coase's theory of transaction costs as part of this "simple theory" tradition typified by the "invisible hand" of Adam Smith. In this approach, according to Posner, there is little room for formal economic theory and its concepts of maximisation and equilibrium. Coase prefers to rely on "basic" economic theory by which he means Smithian insights into the competitive nature of the economic system (p. 205).

Preferring "simple" theory, Coase distrusts abstraction and for this reason finds himself and his "small though rather gallant band of new institutional economists of which he is the guru" "locked in a struggle with economic formalism." Hence, for Coase, "[p]eople are not in fact rational maximizers and prices do not in fact equal marginal cost," nor are markets ever in equilibrium (p. 206).

Posner considers that Coase's difficulty with formal models of economics is that they only hold as approximations and he is only interested in observable reality. In this respect Coase's position is distinguishable from the so-called "Chicago School" economists, such as Friedman, Becker, and Stigler. They think that formal theory is valuable for investigation of the visible world and in many ways can enhance the "simple" empirical theory of the invisible hand by revealing the complexity of economic reality (p. 206).

Posner connects Coase's hostility to formal theory by examining his view of "what economics *is*" *and* what its relationship is and ought to be with other disciplines (p.207). For Coase, says Posner, economics is merely a "common subject matter", the economic system. By the latter he means the " 'working of the social institutions which bind together the economic system, firms, markets

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<sup>7</sup> Although he admits a more accurate description would be "Britishness", because the tradition he is referring to includes Scots, David Hume and Adam Smith (p. 204 and fn 20).

for goods and services, labour markets, capital markets, the banking system, international trade and so on' "<sup>8</sup> (p. 207). The proper sphere of economic theory for Coase is confined to "explicit" markets including labour markets, capital markets, the economics of regulation "and the economics of information when applied to market phenomena, such as the dispersion of prices for the same good, rather than to (say) "marital search", a subject that for Coase is outside economics" (p. 209).

It is an hostility to theory, expressed in his understanding of what economics is, that explains Coase's scepticism about the application of the economic model to the political process and "his lack of interest in the lawyers' appropriation of the Coase Theorem" (p. 207). Thus it is not because economics and its formal tools have solved the problems of the economic system that it seeks to invade other disciplines. It is because economists are " 'looking for fields in which they can have some success' "<sup>9</sup> (p. 207). "In Coase's view the expansion of economics into other fields signifies the abandonment of economics. Theory, by its very power, formality and resulting generality which tempts economists to seek easy victories over weak disciplines, threatens to ruin economics" (p. 208). The reason must have something to do with Coase's belief that "the binding force of a field of social investigation is the subject matter rather than the theory." So that, whilst the generality of economics facilitates its application to other fields, "the practitioners of those other fields will learn the bits of economic theory from the economists, and thus equipped, will enjoy a decisive advantage over them: knowledge of the particular subject matter of the field in question." (p. 207) Hence Coase's belief that the expansion of economics into other fields means the abandonment of economics, that is, the abandonment of its subject matter (p. 208). Hardly surprisingly, for Posner, a leading populariser of Coasean economics within the discipline of law, there "must be something wrong with this view." After all theorists who are *not* economists study the *economic* system (p. 208).

Posner concludes his assessment of Coases's methodological stance on the discipline of economics by proffering the suggestion that the eccentricity<sup>10</sup> of

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<sup>8</sup> Quoting from Coase (1994, p. 41).

<sup>9</sup> Quoting from Coase (1994, p. 37).

<sup>10</sup> Posner levels the same accusation of eccentricity in his discussion of the new institutional economics where he compares Coase and Williamson: "In his good-nature eclecticism Williamson provides a moderate alternative to Coase's stark, and many would say eccentric, rejection of the theories and the empirical methods of modern economics" (1993a, p. 80). It is hardly any wonder that Coase reacted so vehemently in his brief reply (1993).

Coase's stance is accounted for by his Smithian intellectual independence, a condition of "protracted and brooding intellectual isolation." (p. 209) Posner cannot escape the fact however, that whilst he may disagree with Coase's "methodological prescription" it has served him, economics and allied disciplines, very well in producing work as important as "The Problem of Social Cost" (pp. 209-10).

Is this "eccentric" characterisation of Coase a fair and accurate one? And is there more to be said for Coase's view regarding the nature of economics and its role in other disciplines?

### **Coase on Economics and the Law**

Posner refers to Coase's dislike of formal economic theory. But it is not the theory itself which Coase dislikes so much as the fact that it "floats in the air" detached from the economic phenomena to which it is supposed to relate<sup>11</sup> (Posner, 1993, p. 196). The perfection of formal techniques of analysis will not produce valuable economic knowledge if it is not employed to elaborate insights gained from investigation into the actual economic system and its economic entities (Coase, 1988, p. 3).

By the "economic *system*" Coase means the processes through which choices are made by people in the presence of scarcity *within their institutional settings*. It is by pursuing a conception of economics which focuses on the "approach" or techniques of economics that economic theory is led into barren territory. So that, whilst its techniques may allow for a degree of "success" in colonising other disciplines, its consequences for economics itself are detrimental (Coase, 1988, p.3; 1994, 38). Why? Because its focus has been on formal methods rather than on the economic system, the subject matter of the discipline. It is the common subject matter that in the long-run gives it coherence and enduring existence as a profession<sup>12</sup> ( Coase, 1994, p.39). Coase has no objection to the formalising of

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<sup>11</sup> At times Posner acknowledges that it is not "economic theory *tout court*" that Coase opposes but the dominant formalistic paradigm. "Some of [the new institutional economists] like Coase, want to go back to the earlier, simpler, looser, non mathematical theory of Adam Smith" (Posner 1993a, p. 75). Nevertheless, because Coase eschews the *use* to which modern formal economic theory is put, Posner characterises Coase's position as anti-theoretical, as though it were formal theory itself which he dislikes. It is this picture of himself that so riles Coase.

<sup>12</sup> "To the extent that this movement [into other disciplines] is based on technique or approach, we can expect a gradual displacement of economists from their newly won ground. To the extent that it is necessitated by their subject matter, we may expect the range of studies undertaken by economists to be permanently broadened" (1994, p. 39).

basic economic insights, such as his own transaction cost theorem. But in many ways this kind of formalisation misses the point by directing its gaze away from economic phenomena and its institutional setting, the subject matter of economics (Coase 1994, pp. 39, 44).

For Posner to accuse Coase of narrowness in his conception of economics fails to take on board Coase's point. Coase's own complaint against modern economics is that it is both too narrow and too broad (Coase 1994, p.38 ff). It is too narrow, in its preoccupation with formal theory at the expense of a broader inquiry into the institutional setting of economic processes, and too broad, through its attempt to invade other disciplines based on the apparent applicability of its methods to these other disciplines. Economics needs to broaden the scope of inquiry within its own subject matter instead of expanding into other disciplines where the practitioners in those fields have better knowledge of their subject matter than the economist (pp. 38-39). Coase admits that economics appears to be more advanced than any other science. This is owing to the precision it can bring to its analysis through having available "the measuring rod of money"<sup>13</sup>. But this advantage is left behind when economists move into other non-economic disciplines because the same techniques which are appropriate for economics will not be suitable for analysis in other disciplines at least not without "major modifications" (pp. 44).

Rather than seeking to colonise other disciplines using the economists formal techniques, economists would do better to study other social systems, such as the legal and political ones, "not with the aim of contributing to law or political science, but because it is necessary if they are to understand the working of the economic system itself" (p. 45). Economists have come to realise in recent times, "parts of these other social systems are so intermeshed with the economic system as to be as much a part of that system as they of a sociological, political or legal system" (pp. 45-6). Hence the functioning of a market cannot be understood without considering the nature of the legal regime of property rights. The functioning of the labour market, and patterns of consumption and production are affected by the family or household and the educational system, so those systems should be studied. Firms and individuals functioning in the economic sphere are set in a framework of regulatory agencies and therefore they also need to be studied by economists for their effects on the *economic* system. (p. 46)

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<sup>13</sup> For a searing critique of the conception of money as the objectively precise and non-normative criterion of human preferences within the Posnerian version of law and economics see Leff.

Indeed these were the type of studies which Coase saw published under his editorship of the *Journal of Law and Economics*. "Such work, because of its focus on the economic system, is likely, in general, to be best done by economists", though in collaboration with other social scientists (pp. 45-46). And it is Coase's belief that "the study by economists of the effects of the other social systems on the economic system will ... become a permanent part of the work of economists", "[u]nlike the movement by economists, which has as its aim the improvement of these other social sciences ..." The latter's effect is only likely to be temporary in Coase's view (p. 46).

The theory of the person "as a rational utility-maximizer" is what, according to Becker and Posner, is supposed to give an economist her "decisive advantage" in handling social problems within other disciplines (p. 42). Coase seems to suggest here that the theory of the person on which this conception of economics is based bears little relation to empirical reality. That people within the economic system tend to pursue their economic self-interest is far from saying that people are rational utility maximisers in the sense required by formal economic theory. Hence, he is sceptical regarding the value of utility theory in economic analysis<sup>14</sup> and this scepticism is the reason for doubting Becker's claims to have uncovered important "commodities"<sup>15</sup> in other disciplines within an economic approach (pp. 42-44).

Coase's views on economics and its relation to other disciplines are strongly informed by his own experiences as a economist, by what he perceives to be the true value of his own contributions to economic theory and, importantly, by the manner in which they have been received into economics and other disciplines.<sup>16</sup> It may be helpful, therefore, to briefly consider Coase's methodological views in the context of Coase's own contributions to economics.

Coase is renowned in both economics and law for his insights concerning the economic phenomenon of transaction costs and for the famous article with which this concept is most closely associated, "The Problem of Social Cost" (1960). Coase has pointed out, however, that the central point of that article was also the main point of his next most noted piece of writing, "The Nature of the Firm"

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<sup>14</sup> "Up to the present it has been largely sterile. Utility theory seems more likely to handicap than to aid economists in their work in contiguous disciplines" (Coase, 1994a, p. 43). See Posner's criticism of Coase for describing the rational utility maximisation concept as "meaningless" (1993b, p.119).

<sup>15</sup> For a detailed discussion of "commodification" and its criticisms see Trebilcock, (Ch 2, pp. 23ff).

<sup>16</sup> The following section draws mainly on Coase (1988, pp. 1-31).



(1937), although it was not until the popularity of the former article that the latter became well known (Williamson & Winter, 1991, p.62). Even after both articles have become well known Coase complains that they are still not appreciated by economists for their true point. The point of both articles was to reveal the importance of "positive" transaction costs for the functioning of the economic system. The earlier article provided an explanation of why firms exist; in the later, he was trying to show "that if transaction costs were not introduced into the analysis, for the range of problems considered, the law had no purpose" or, put another way, the concept of transaction costs was used "to demonstrate the way in which the legal system could affect the working of the economic system" and nothing more (Williamson & Winter, 1991, p. 62). Though it was not his intention from the outset, Coase came to the view that incorporation of the concept into economic analysis "would transform the whole of economic theory" (p. 62).

To Coase's profound disappointment, he observes that, *within the economic profession*, whilst the 1960 article is extensively cited and discussed, it is rarely applied for its main point. Instead there has been a preoccupation with the Coase "theorem", the hypothesis concerning market transactions where transactions costs are absent in a given state of legal liability and rights affecting the transacting parties. But the point of the theorem, says Coase, was to set the background for the economic significance of transaction costs in the real world where they are not zero, that is to say, where they actually exist. After all, what is the point of investigating the properties of a world that does not actually exist? But this is what most economists are intent on doing in concentrating on the "Coase Theorem"<sup>17</sup> (Coase,1988, pp.13-16).

Though disappointed with this response by economists, Coase finds it understandable. "The world of zero transaction costs, to which the Coase Theorem applies, is the world of modern economic analysis, and economists therefore feel quite comfortable handling the intellectual problems it poses, remote from the real world though they may be" (1988, p. 15). This misapplication of his transaction costs analysis renders much criticism of the theorem, "invalid, unimportant, or irrelevant." And the criticism too is quite understandable because "current economic analysis is incapable of handling many of the problems to which it purports to give answers." (p. 15)

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<sup>17</sup> Most, but not all. Williamson and "the new institutionalists" are concerned with the study of the economic implications of transactions costs for institutions and their organisation.

So the transactions costs debate is but a specific instance of the general point about the failure of economics to locate its subject matter and study it. Coase's explanation of the function of transaction costs in explaining the existence of firms and the effect of the legal system on the economic system is a positive example of the empirical methodology which he recommends for economics.<sup>18</sup>

But if it is true that economists within their own discipline, owing to their "narrow" conception of economics, have misapplied his own insights can the same be said of those who seek to apply them within other disciplines and especially within the discipline of law? Surely he should appreciate Posner's economic analysis of law (Posner 1992) in which his own transactions costs concept occupies a central role?<sup>19</sup> Whereas for Coase it is a case of what the study of the law can do for understanding economic systems, for Posner it is a matter of what economic analysis can do for the discipline of law. By economic analysis Posner means the application of the formal techniques and assumptions of current economic practice which Coase so abhors when detached from empirical study of the "economic system". This abhorrence is encapsulated in his dislike of Posner's view of economics as a science of rational utility-maximising choosers.

What we have in this debate between Posner and Coase are opposing accounts of the role of theory, not a debate between an anti-theory position (Coase) and a pro-theory stance (Posner, Becker et al). Whilst Posner may label Coase's position as naive Smithian empiricism the formalism which Posner defends bears the influence of a modern form empiricism, logical positivism. But the strength of Coase's case lies in the example he is able to provide from his own empirical studies and contributions made thereby to economics and the law and economics movement.

### **The Value of Coase for Law and Economics**

Having defended Coase against a mischaracterisation of his view of economics and its methodology, I move on to consider some of the positive implications of

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<sup>18</sup> His work on marginal pricing theory and his contribution of the concept of multi-part pricing is another less famous illustration. For Coase's own view of this contribution see Coase, (1988, pp. 16-20).

<sup>19</sup> For a critique of Coase and Posner's application of Coase see Barbara White.

Coase's approach with respect to law and economics using the "The Problem of Social Cost" (1960) as an illustration.

As Coase himself points out, the "The Problem of Social Cost" and its insights resulted from a subject matter-based approach which sought to enhance understanding of economic phenomena by exploring the role of non-economic systems in the economic system (1988, pp. 10 ff). That article revealed the role of the legal system with respect to economic transactions - "explicit" market transactions – through the concept of transactions costs. Whilst economists had previously noted the social costs (externalities)<sup>20</sup> of market transactions, Coase was also able to reveal the reciprocal nature of costs by examining the legal context in which market transactions occur. Thus, not only residents in the vicinity of a polluting factory suffer harm, but also the factory owner if it is required to "internalise" the cost of pollution (1960, pp.1-2, 41-42).

Had Coase not conducted his examination of the role of law he would not have been able to explain the role of transactions costs in market transactions. Conversely the law, that is to say, the common law,<sup>21</sup> the legal regime most attuned to the functioning of markets, is not explicable without the economic concept of transaction costs.

In the end, I am not convinced of the soundness of the Coase theorem, or his account of the relationship between "positive" transaction costs and the function of private and public law.<sup>22</sup> In his polluter example he makes what I consider to be a fundamental error in equating economic costs with "justitial" costs.<sup>23</sup> From the standpoint of state law, whether public or private, the issue does not concern who bears the greater *economic* cost, but who has suffered an injustice which the law should redress. Therefore the *prime* aim of neither the Courts, nor the legislature, is to maximise the total social product *in an economic sense* when they adjudicate a private dispute or (in the public interest) regulate the activity. It is a fundamental error to describe the main function of the Courts as being in the

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<sup>20</sup> Coase does not like the term, because it conceals a pre-disposition towards government intervention, preferring the concept of "harmful effects." (Coase, 1988, pp. 26-27).

<sup>21</sup> In an era of the merging of equitable and common law principles, "private state law" might be a better description.

<sup>22</sup> Barbara White's critique of Coase's "policy recommendation" in the 1960 article supports these doubts, at least, with regard to the second point regarding the relationship between law and transaction costs.

<sup>23</sup> I prefer this term to "legal" to indicate a basis of claim in justice which may or may not be embodied in law. For an account of the justitial aspect as the "qualifying" normative dimension of law see my essay in Boston and Cameron, pp. 37-68, esp. pp. 47-48, 59-62.

business of allocating rights to maximise the total social product understood in terms of economic efficiency or to propose maximising the total social product as a normative prescription (White). It not wrong, descriptively or normatively, however, to argue that there is a important economic aspect involved in the courts carrying out their "justitial" function. Economic costs and consequences ought to be taken into account, indeed are taken into account, in the adjudicative function. The issue, then is, whether they are taken into account with the degree of competence and insight required. In this regard law and economics has something to offer.

Notwithstanding the above criticism of Coase's seminal article, there is real merit in the approach, which *from within the discipline of economics*, seeks to focus on the economic subject matter and those non-economic phenomena which affect the economic systems. As Coase, indicates, it may be a matter of "common sense", to observe that there is a law of supply and demand at work. (1988, 4) That is to say, people learn this economic truth through their everyday experiences. The challenge for economic theorists is to elaborate the significance of this in their theory. Similarly, within the discipline of law, it is well understood that market transactions involve contracts which entail the exchange of rights as well as mere physical objects. Coase would readily agree that *within the discipline of law* it is common knowledge that the functioning of economic systems such as markets depends upon the specification of property rights. These are truisms for lawyers. But economists, who do not take them on board in their theorising, lose touch with economic reality. One does not have to agree with Coase's view that factors of production comprise rights (rather being mere objects of rights) (Coase 1960, p. 44) to take on board his point about the importance of legal rights for economic activity.

Thus for Coase, the economist, it is a case of what the study of law can do for economics rather than the reverse. But if, as I have suggested, the basic methodological point is sound, then, for practitioners of the legal discipline, the reverse ought also to be true. An agreement entered into by business people intended to have economic consequences for both parties<sup>24</sup> is an economic transaction. Too obvious too mention, you say? Perhaps, but the fact is fundamental for a proper insight into the nature and function of contract law. There is an important distinction to be made between the *contract* as a juridical

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<sup>24</sup> I do not say, "intended to be legally binding", because there is a distinction between a contract and the legal recognition of the existence of a contract for the purposes of private state law.

device serving a primarily *economic* function within the economic system and the *law* of contract sourced in the courts and legislature.

By the law of contract is usually meant the rules and principles of private law developed by the Courts, modified and extended by Parliament. Only by attending to the economic function of contracts as *economic* devices can lawyers and judges acquire a sound basis for developing and applying legal principles which serve the adjudicative function of administering justice in commercial contexts. It is important to observe, however, that for the transacting parties the contract, independently of state law, serves a justitial function, but one that is subservient to its economic end. Business people have long recognised the economic value in giving their economic transactions a juridical form. It is a norm of *economic* justice that parties to contracts ought to abide by their agreements and, it is highly desirable from an economic standpoint to have rules which provide remedies in the event of breach and regulate the rights and liabilities of the parties. Coase fully appreciates the significance of this point.<sup>25</sup>

However, Coase is mistaken in thinking that the state legal institutions which replaced mercantile institutions serve exactly the same function. Insofar as the common law courts uphold the principles of sanctity and freedom of contract they, as the merchants' own adjudicative institutions, respect the internal law-making competence of the parties in their commercial agreements. But, unlike the legal institutions of business people, the Courts have an additional public legal responsibility. They are required to ensure that the internal law-making power of commercial people and the legal norms which result from the exercise of that power conform to *public* principles of legal justice – equity, good faith, etc. For example, only state legal institutions can declare a contract void for being contrary to *public* morals. As courts of justice, it is the public "justitial" function which qualifies the courts legal role. And the norms which the Courts require commercial people to observe are legal norms of justice.

The "common law" of contract serves the function of co-ordinating the private law-making (contracting) of economic subjects by regulating that activity according to norms of (public) justice. Whereas the private law-making of economic subjects is characteristically economic in character, the justice which Courts administer, is of a typically public legal character (Boston & Cameron,

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<sup>25</sup> See his reference to the *legal* institutions developed by merchants to regulate the functioning of *economic* institutions of markets and fairs from medieval times (Coase 1988, p. 8).

pp. 59-61). This public juridical function not only entails providing justice in private disputes by means of contractual tortious, equitable and restitutionary remedies according to norms of equity, fairness, etc. but also providing (public) legal recognition to private legal ordering in different social spheres. The practice of contracting is an institution of private ordering operating within the economic sphere. By giving public legal recognition and sanction to this private institution for example, in the rules for determining the formation of contract, the State through judge-made and statutory rules and principles serves the public interest. It provides a secure (public) legal basis for of the institution thereby enabling the flourishing of economic market processes. The principles of freedom and sanctity of contract embodied in those rules are basic legal norms which promote certainty in business transactions.

It is therefore a fundamental mistake made by those in the law and economics, such as Posner, to explain the legal justice which the Courts administer and the norms which their decisions embody in primarily economic terms (economic efficiency or wealth maximisation). This is a different criticism from Coase's criticism of Posnerian law and economics. Coase criticises Posner and Becker for misunderstanding the nature of *economics* in their attempt to colonise other disciplines. My point is that Posner and Becker have also misinterpreted the nature and function of *law*.<sup>26</sup> It is not surprising, however, that Coase does not make the same criticism because he too fails to give adequate recognition to the public justitial function of state law.<sup>27</sup>

## Conclusion

The value of Coase's 1960 article lies in the attention he drew to the manner in which law serves economic systems through its concepts of property, rights and contract. He was concerned to show the way in which the juridical dimension affects typically economic institutions or "systems". The focus of the law and economics movement, however, is on the functioning of the economic dimension in legal phenomena whether it be in the economic sphere of explicit market transactions, which is Coase's central concern, or in non-economic spheres such as the family (Becker). Valid criticisms of such as Becker and

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<sup>26</sup> For critiques of Posner see for example, Leff, White, and for a critique of Becker, see Estin.

<sup>27</sup> White argues that the application of Coase's efficiency criterion ("total product rule") "does not promote economic efficiency any more than the prevailing judicial policies that incorporate the traditional principles of fairness and equity", in fact it "serves primarily as a mechanism for redistributing wealth." (p.579)

Posner for their intrusion into the non-economic disciplines via economics do not deny the value of considering the role of economic considerations in the determination of legal policy affecting the family or issues of sexual morality.<sup>28</sup> What they deny is the (social scientific) value of attempting to view these policy determinations within solely economic categories and, as Coase would argue, based on an empirically-impooverished conception of economics at that. Law and economics is a diverse movement and it may well be that more modest versions of law and economics will provide more lasting contributions. One such version is contained in the writings of Michael Trebilcock (1993) *The New Zealand-born, Director of the Law and Economics Programme at University of Toronto* who defends the "private ordering paradigm" – the economic institution of contract and its ordering in the law of contract – drawing upon modern neoclassical economic thought and liberal political theory. Although viewing (state) contract law as serving primarily economic purposes – mistakenly according to the position I outlined above – Trebilcock, readily acknowledges the limitations of liberal economic and political theory and displays a refreshing openness to their criticisms from a wide range of perspectives. There seems to be an implicit recognition by him that the demands of justice in society are not fully met by reliance on the private-ordering paradigm dominated by values of (economic) freedom and utility-maximisation.

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<sup>28</sup> For criticism of Posner's *Sex and Reason* (1992) see Sanger, and Hutton.

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