



MARKETS, FIRMS AND PROPERTY RIGHTS

A Celebration of the Research of Ronald Coase

December 4-5, 2009 - The University of Chicago Law School

Ronald H. Coase turns 100 this month. December also marks the 50th Anniversary of his paper “The Problem of Social Cost.” His thinking led directly to the auctioning of broadcast spectrum rights by the FCC and the expansion of the cell phone industry world-wide. One such auction produced \$7.7 billion. Professor Coase received the Nobel Prize in Economics in 1991. Other Nobel Prize laureates attending the Conference included Gary Becker and Douglass North. Presenters included Robert Cooter, Harold Demsetz, Richard Epstein, Michael Levine, Gary Libecap, Thomas Merrill and Richard Posner and Geoffrey Stone.

My notes of all 20 presentations will also be provided separately. This document summarizes the points I found most interesting. Errors in interpretation are mine. Certainly not all the assertions made by presenters were accepted by the audience.

Coase’s Observations – Markets do not exist by themselves. They have to be created. A market consists of a group of standardized, mutual obligations attractive to enough participants that they adopt its conventions. A market can be viewed on a continuum including the firm (an internalized group of mutual obligations), the family (similar to a firm, but organized differently), long-term contracts and short term of spot markets. [This observation was echoed throughout the Conference.]

Good economic work and insights cannot be implemented unless the affected parties see implementation to be in their own interests. The members of a community may not want to be aware of their shortcomings or to make the needed individual sacrifices for the common good. If we take those shortcomings out of the results, the results are (by definition) overly positive.

When Coase first presented his proposals for an auction of broadcast spectrum rights to the members of the US Federal Communications Commission, the first question from an FCC commissioner was, “Is this a joke?” 35 years later Coase’s “joke” resulted in an auction producing \$7.7 billion. President Clinton stood with an oversized check for the proceeds under a banner reading “Government with Common Sense.” So the joke had been transformed into “common sense” government policy. But politicians much prefer dolling out these kinds of rights themselves instead of permitting the market to determine the value of the rights and their recipient. Senator Schumer (Dem-NY) recently blocked using auctions to regulate landing rights at over-crowded NY airports.

The class system in the UK was so rigid that, although Ronald Coase and John Maynard Keynes worked on the same projects, Keynes spoke to Coase only once. In his project for Keynes, Coase realized that

long term contracts simply did not spell out the true terms of the relationship between the contracting parties. Many of the most important obligations were implicit. This observation led Coase to much of his work.

Firms - Firms are organizations, just as families are, but organized on different principles. A firm functions better than a family in some respects because a firm attracts specialties which complement each other. It also shares risks in accordance with the participants' changing appetites for risk and reward. When firms function properly, they manage certain issues internally, so two firms can interact without concern for these issues. However, internally a firm *does* have to deal with these issues. The obligation to deal with partners in good faith is the glue which holds firms together and permits them to operate. The possibility of a fixed return is given up in exchange for a longer term relationship. The demands and needs of people within a firm change and a smoothly-operating firm accommodates those changes. To the extent the government regulates the inner workings of firms, it (may) reduce their efficiency.

Cap-and-Trade vs. Carbon Tax - Air pollution and air wave spectrum rights can both be seen as property rights historically free or "owned" by the state, like common grazing land. Coase's methods of permitting parties and the market to allocate these increasingly scarce assets can apply to both. The commonly discussed alternatives to a Cap-and-Trade system of pollution control include a system of carbon tax and credit and government regulations. Court imposed liability also regulates the use of these assets. To permit the market to find the value and best use of these rights, the transaction costs of trading them have to be low. A smoothly-functioning market requires high amounts of information readily available to all participants. The more uniform the rights being traded, the less information required.

With Cap-and-Trade, the government makes an initial allocation of the rights. This allocation may be based on historic use of the rights. So a potential recipient may increase this use prior to the allocation – increasing pollution - in the hope of gaining a greater portion of the rights.

Cap-and-Trade is counter-cyclical: the price of the rights declines during slow economic periods. A carbon tax, however, applies during both high and low activity period. Cap-and-Trade is attractive to environmentalists because they feel they get a fixed, lower amount of pollution. Also, they can buy rights to pollute in the market and not use them, much like setting aside raw land. A tax may discourage pollution but provides no cap. Small government advocates like Cap-and-Trade because the government does not get a long-term stream of income. Local inputs (such as labor) do not like Cap-and-Trade because an industry can sell its pollution allocation and move production to Mexico. Under a carbon tax, a polluter might want a tax holiday or credit. Under Cap-and-Trade, it wants a greater allocation. Under a license regime, it wants a special permit. Finding the right level of tax to reduce pollution without destroying industry is very difficult. But some economists think the two systems (Cap-and-Trade and carbon tax) can be made to operate the same way. The public seems to prefer Cap-and-Trade in part because it is not called a tax. Ironically, it creates jobs in the private sector, for bankers and traders.

Land Demarcation Systems as an Aid to Commerce - There are two systems of measuring land: (a) the metes and bounds system, which requires on the ground measurements and reference to landmarks (trees, piles of stones, etc.); and (b) the grid or rectangular survey system, which is a combination of straight lines and right angles and does not require familiarity with landmarks or land contours. The rectangular system developed as populations grew and colonies were populated all at once. Mechanized food production also favored straight boundaries. The rectangular system provides the owner more information about his or her land at lower cost. It reduces boundary disputes. Developing roads along the borders of these parcels is easier and these roads encourage commerce. Trading and assembling land into larger plots is also easier. Empirical evidence shows that areas with the rectangular system far outstripped areas with metes and bounds.

Land Title - Land ownership is a major source of wealth, especially in 3rd world countries. Having clear ownership (“title”) to real estate permits faster economic growth. It is related to reduced household size, higher education and delayed childbearing. It reduces time and effort expended in guarding the property, which is then available for investment. Granting title to land creates winners and losers. Some part of the added value may come from privatization of what really was public land, not just from certainty and more efficient trade.

Auction of the Broadcast Spectrum – The FCC and politicians in general tend to oppose auctions of rights previously held by the government. The process reduces their influence and ability to favor their friends. New Zealand adopted Coase’s proposals for its auction of broadcast rights in only 2 years, from the initial study to implementation. In the US, it took 35 years. American Telephone and Telegraph (ATT) initially opposed auctions. Now it supports them. The nature of the auction itself is very important and there are several types of auctions, with variations. A prime danger of auctions is that a company already in the market puts a premium on keeping a new entrant out. (The monopoly effect.). But the public may have an interest in that new entrant being successful and producing greater competition. Auction techniques include caps on the size of assets purchased, set asides, credits, auction design generally and antitrust regulation. Under a Vickery auction, for example, the bids are secret and submitted only once. The high bid wins, but pays only the amount of the 2nd highest bidder. Alternatively, parties already in the market can be forced to bid first, giving outsiders the right to top them. If lobbyists are successful, they shape the various offered rights so that each bidder is interested in only one set of rights, thereby defeating the purpose of the auction.

Innovation, Silicon Valley and the Spice Trade – The 17th century Spice Trade has parallels to technological developments and entrepreneurship in Silicon Valley. In both cases information (whether trade routes or software) requires capital to generate a high reward in risky circumstances. To function, there must be a solution to the “double trust” problem: the innovator is afraid the investor will steal the innovator’s idea or information and the investor is afraid the innovator will steal the investor’s money. Each has to convince the other that it will achieve a better result by staying in the relationship. The parties require a contract, but no contract can regulate such a dynamic, unpredictable situation. The 17th century solution was the joint stock company. Such firms ameliorate the shortcomings of contracts. An investor cannot demand a fixed return high enough to reward the risks of such a venture. So he must

accept a share of the profits not yet earned. Furthermore, the parties want to be able to exit the venture and secure their gains.

Firms develop through three phases: 1) the initial investor stage, when people invest based on trust, with very little information and few enforcement mechanisms; 2) the venture capital stage, when a contract and court system may more precisely regulate risks and rights; and 3) the IPO stage, when an even more sophisticated and efficient mechanism, the market, takes over the roles of personal trust and the courts and contracts. Without the controls of the market, insiders take the value created.

Innovation occurs also in 3rd world countries, but usually in the form of markets, not technology. In these countries, without sophisticated markets or well-developed court systems, family and trust have to be the substitute.

Airlines and Regional Carriers - The relationships between major airlines and regional carriers are a complex mixture of distance, carrying capacity, market perceptions, needed coordination, labor unions and controls, both contractual and practical. Failure of a regional feeder airline to meet a major airline's connection schedule can damage the major carrier. But major carriers cannot be too closely related to the smaller carrier without creating labor problems. Furthermore, labor is not interchangeable since pilots qualified on one airline cannot fly for another the same equipment for another airline without substantial training and testing. Furthermore, no airline can survive a lengthy labor shutdown. Within unions, pilots are paid differently depending on the size and speed of the planes they fly. But within their union, voting is equal. Branding (and repainting planes) also makes changing alliances expensive. The hub-and-spoke system works. New market entrants may start with other route models, but move to hub-and-spoke as they expand. Southwest has become a more normal airline.

Behavior of Governments – In China, misalignment of government interest resulted in non-enforcement of government issued cell phone licenses and the collapse of the regulatory system. Laws in China regarding responsibility for badly build apartments (“lemons”) can be structured efficiently or not. Buyers and sellers have different abilities to judge and bear the risk of these lemons and price the apartments differently. This discrepancy creates opportunities to speculators.

Government operates through a mixture of regulations, taxes, property rights and liability. Each branch of government deals with these factors differently, based on its own make up. Regulations require a different understanding of risk than courts and liability rules. Insurance plays a role, here, too. To the extent regulations do not address all risk factors, they encourage that risky behavior. Members of governments want to exercise discretion and power and they thereby distort the functioning of markets and their allocation of limited resources. To the extent the rights included in the concept of “ownership” become too varied, information demands go up and dealing with private property becomes more unwieldy and less efficient. New kinds of ownership raise information barriers. Consumers have to invest time to learn what time-shares and Zip cars are. These concepts are more sophisticated than simple “no trespassing!” Some economists think the variations on ownership arrangements should be restricted.

The public has different views on the different ways the government uses to regulate risk. Despite the public's distaste for traders, apparently a cap-and-trade system (complete with traders and speculators) is favored over politicians and a carbon tax.

Governments try to have the public think of private property rights in less fixed, black and white terms, thereby giving the government a greater chance of adjusting (taking and regulating) those property rights.

The First Amendment and the Marketplace – The 1st Amendment to the Constitution protects free speech. Coase is anti-government regulation and pro-market place, including the market place of commercial ideas, not just political ones. Indeed, the public cares more about flat screen TV's than political speech. But the authors of the Constitution did not feel a need to protect commercial speech. It had not been threatened by government control as political speech had been and was not essential for good government. Over time, US courts have taken a more differentiated view of commercial speech, providing it some protection.

Keynes - The General Theory of Employment, Interest and Money is still relevant and, if read and understood, could have saved us from the most recent crisis. One observation of Keynes relates to savers and the entrepreneurs who put saver's money to work. These are different types of people. One is more willing to take risks. Risks are of two basic types: the knowable risks of a casino and the unknowable risks of, say, divorce for any particular couple just married. How can someone make a cost-benefit analysis with the latter kind of risk? Some individuals by nature are more willing to do so. But this psychological asset is fragile. Too much uncertainty creates depression even for these risk-friendly personalities.

Miscellaneous Comments and Observations

An economist can produce or destroy huge amounts of wealth by providing good or bad advice or speeding up implementation a good policy or slowing down implementation of a bad one. One participant suggested that implementation of Coase policies when he published his paper in 1960 could have created trillions of dollars of assets and prevented creation of industries which now block progress.

Too high cell phone termination charges may cause users to keep multiple phones, wasting resources.

Economists tend to work with static supply and demand curves, but in fact innovation and growth are essential to a healthy economy. Individual products and firms go through cycles and are not static.

Capitalism is made up of many factors, only one of which is the free market. Despite the recent financial crisis, China and Brazil have not abandoned capitalism.

Rudolph (Rob) Houck
RHouck@rhoulaw.com