Failures of Cosean Irrelevance

Nicholas L Georgakopoulos
Nicholas L. Georgakopoulos*

Failures of Coasean Irrelevance

Abstract: An exploration of the Coase theorem reveals more sources of failures than transaction costs, and that transaction costs are misunderstood. After a discussion of Coasean irrelevance, this essay examines a sequence of failures of irrelevance. (a) The shifting nature of transaction costs suggests that they may hide innovation incentives. (b) Negotiation holdouts may prevent agreements. (c) Systematic errors may bias incentives. (d) Risk-aversion may distort action but also enable innovation. (e) Distributional effects may argue for unstable allocations.

I. INTRODUCTION .......................................................... 2

II. COASE AND LAW’S IRRELEVANCE ................................. 3
   A. Coasean Irrelevance .................................................... 3
   B. Irrelevance Failures ....................................................... 5
      1. REVEALING IMPERFECTIONS................................... 5
      2. AN EXAMPLE OF DEPLOYING COASEAN IRRELEVANCE ...... 6
   C. Transaction Costs: The Usual Suspect...................................... 7
      1. VANTAGE POINT MAKES TRANSACTION COSTS ............. 11
      2. INNOVATIONS TRANSFORM TRANSACTION COSTS ........... 12
      3. LITIGATION COSTS: TRANSACTION COST OR NOT? .......... 12
      4. INCREASING SOCIAL GAIN FROM PRIVATE LITIGATION .... 13
      5. NORMATIVE IMPLICATIONS FOR LITIGATION OF THE
         ANALYSIS OF TRANSACTION COSTS ...................... 15

III. MORE FAILURES OF COASEAN IRRELEVANCE .................... 16
   A. Negotiation Holdouts .................................................. 17
   B. Systematic errors ....................................................... 20
   C. Risk-Aversion ............................................................ 20
      1. IMPOSING A TRANSACTION COST ............................... 23
      2. SUBSTANTIVE SOLUTIONS OF RISK AVERSION ............ 23
   D. Distribution ............................................................ 25

IV. CONCLUSION .................................................................. 26

* Harold R. Woodard Professor of Law, Indiana University School of Law - Indianapolis.
I wish to thank … I urge you to send your comments to me at ngeorgak@iupui.edu.
Professor Ronald Coase stated a counterfactual hypothesis that led to a revolution in legal thinking. This hypothesis, despite being against fact, produces an extraordinary hurdle for legal analysis but it is also an equally powerful tool. The counterfactual hypothesis is that in an ideal world, all activity would be the optimal one. Changing the law would lead only to the adjustments that would return all activity to the optimal. Therefore, in such an ideal world, legal change and, by extension, law would be irrelevant. After explaining this counterfactual construct of Coasean irrelevance, this Article shows how jurists in law & economics can use it to show that legal change is desirable. If a jurist can show that a new rule would lead to activity nearer the optimal than the current rule, then that constitutes proof that at least this legal change must occur.

The facts of Meinhard v. Salmon help illustrate the importance of the potential irrelevance of law. Salmon received a lucrative offer from Gerry, a business acquaintance. The offer could have expanded Salmon's business. Unbeknownst to Gerry, Salmon's business that was the reason for their acquaintance, had a secret partner, Meinhard. If Gerry knew that Salmon operated in two capacities, as an individual and as a member of a partnership, then Gerry may have specified which of the two he selected as the recipient of his offer. Meinhard, the invisible partner, claimed the offer should be treated as made to the partnership. The litigation that Meinhard started eventually reached the highest court of the jurisdiction and the seminal American judge, Benjamin Cardozo, and his colleague Andrews, who is almost equally seminal for his vocal dissenting opinions. Previously established law did not answer the question directly. Cardozo and his court would or should have been aware that future partnerships like that of Salmon with Meinhard would adjust their terms in reaction to the law that the court would set. If the reaction would cancel the effect of the opinion, then the change of the law would be pointless. If, however, Cardozo and his court could predict that future activity of partners would improve (approach the optimal) even after adjusting to the change, then the court’s efforts would be truly justified. Then, the

1. 249 N.Y. 458 (1928).
court’s analysis would have overcome Coasean irrelevance and would prove that the new rule would increase welfare.

Part II introduces Coasean irrelevance and explores the principal cause of its failure, transaction costs. Part III studies four other failures of Coasean irrelevance, negotiation holdouts, systematic errors, risk-aversion, and redistributive concerns. Part IV concludes.

II. COASE AND LAW’S IRRELEVANCE

Coase realized that, as individuals attempt to circumvent rules, they press toward economic optimality. While this realization may seem to resist regulatory impulses, it also justifies rules that remove obstacles that prevent individuals from reaching optimal arrangements.

Ronald Coase’s Nobel Prize rewarded more than his pointing out that individuals counteract changes of the rules. Coase identified the direction and the destination of individuals’ efforts, finding that in an ideal world individuals’ bargaining would restore the optimal allocation or setting. Coase probably embarked on this inquiry as an extension of exploring firm size, the optimal location of the boundaries separating firms from markets. He changed that question into the “make or buy” decision. If a firm decides to make an item, then the firm will have a larger size than if it decides to buy the item from the market. Transforming the question of firm size into “make or buy” is ingenious and reveals that Coase recognizes enormous flexibility in people’s affairs and organizations. When firms realize that the cost of buying an item is less than the cost of making it, they cease its production. The firm’s productive activity changes depending on relative costs. The sensitivity that Coase saw in firms’ activities seems related to the sensitivity that he saw in individuals’ activities.

A. Coasean Irrelevance

Economic theory posits that activity is arranged to minimize costs and maximize benefits. Coase recognized that when the law moves an entitlement away from its optimal holders, they would be in the best position to re-acquire it. Since the new holders are not the optimal ones, they do not derive as much benefit from it and
prefer to sell it back to its optimal holder. This bargain restores the optimal allocation. This phenomenon is also called the invariance principle. The allocation that the law imposes is irrelevant if this bargaining can occur unimpeded, and, vice versa, if bargaining is obstructed then a legal measure may be necessary to reach the optimal allocation.

The breakthrough for legal reasoning lies in the opposite of this statement. If bargaining is obstructed and the existing allocation is suboptimal, then a legal intervention is necessary to approach the optimal allocation. This is a corollary that makes law necessary. It overcomes the inadequacy of normative reasoning and offers a truth-valued normative conclusion. After Coase, some laws are truly necessary. Before focusing on the reverse statement, it is important to understand Coasean irrelevance and how the costs of transacting impede the parties’ bargain. An example illustrates.

The classic example involves ranchers and farmers bargaining about fences in the shadow of laws about fencing. Fences protect farmers’ crops from trampling but they impede ranching. Before starting the explanation of irrelevance, it is important to see that fencing depends on costs and benefits. If a single person engaged in both farming and ranching, they would decide to fence their farms only if this increased the total production. Coasean irrelevance means that in an ideal world, despite different owners of the farm and the ranch, the outcome (fences or not) depends on total costs and benefits rather than law. Fencing depends on total costs and benefits because each side can pay the other to waive its legal rights. The two sides can agree only if their arrangement brings them closer to the optimal.

Suppose, first, that farmers gain from fences more than the presence of fences harms ranchers. Fencing harms ranchers by 50 and helps farmers by 100. Coasean irrelevance means that fencing occurs regardless of the law. If the law allows fences, clearly farmers erect fences. Coasean irrelevance becomes salient if the law gives ranchers a right to “open range.” Despite the open range law, fencing occurs by agreement. The law entitles ranchers to the absence of fences, but the two sides can reach a deal to restore fences. Farmers are willing to pay up to 100 to have fences. Ranchers are fully compensated against their harm from fencing if they receive 50. This leaves ample room for an agreement. In exchange for a payment between 50 and 100, ranchers allow
fencing. Thus, if fencing is superior, it occurs in theory regardless of the law’s allocation of the choice between ranchers and farmers.

Coasean irrelevance also holds in the opposite situation where not fencing is superior. Suppose that the absence of fences helps ranchers more than it hurts farmers. Removing fencing costs farmers 50 but benefits ranchers by 100. Coasean irrelevance becomes salient if the law gives farmers the right to have fences. Despite the law, an agreement prevents fences. Ranchers are willing to pay up to 100 for the fences’ removal. Farmers are fully compensated if they receive 50 or more, leaving ample room for an agreement. In exchange for a payment between 50 and 100, farmers will waive their right to fences. Thus, if the absence of fences is superior, it occurs in theory regardless of the law’s allocation of the choice between ranchers and farmers.

B. Irrelevance Failures

Coasean irrelevance has the beauty of elementary simplicity but it is also disturbing. It goes against the intuition that law is relevant. Rather than being frustrated by this contradiction, jurists in law & economics use Coasean irrelevance as a tool. Coasean irrelevance reveals how the actual interactions of individuals differ from those that would take place in an ideal world. This difference may justify rules to overcome it.

1. Revealing Imperfections

The conventional application of Coasean irrelevance employs it to reveal the ways in which reality differs from the ideal world where law is irrelevant. The process starts with the identification of the ideal outcome, i.e., the set of conducts or interactions that are desirable. Since they are desirable, in the ideal world of Coasean irrelevance they would occur without regulation. The question becomes what are the impediments that prevent the desired reactions, i.e., the hurdles that prevent Coasean irrelevance from materializing. This process identifies why private initiative fails and justifies a normative response. The Law & Economics jurist who has identified the impediment to ideal conducts has also identified a need for a legal response. The jurist can proceed to recommend how to overcome the impediment.
This use of Coasean irrelevance can also reveal gaps or imperfections in the edifice of economics as a theory that explains human behaviour. After an example of the use of Coasean irrelevance to identify targets for regulation, we will discuss the typical causes of failures. This part discusses the usual cause, transaction costs that prevent bargains. Other causes that prevent Coasean irrelevance are discussed in the next part.

2. AN EXAMPLE OF DEPLOYING COASEAN IRRELEVANCE

For our example, consider farmers opposite polluting manufacturers and consider environmental rules. Coasean irrelevance indicates that in a perfect world environmental regulation would be irrelevant because polluters and individuals would reach the optimal agreement for reducing pollution. Nevertheless, pollution regulation seems eminently justified. Jurisdictions without pollution regulation have experienced unacceptable pollution as the examples of the liberalized eastern European states reveals. Why do manufacturers and farmers fail to reach the optimal bargain?

Numerous reasons impede the bargain with polluters. Millions of individuals in a region would have to expend a lot of effort and money to communicate their concerns, to reach a coherent, single negotiating stance, to engage all polluters and persuade them to accept the individuals’ suggestion. The monetary and non-monetary costs involved with reaching a decision such as to install filters in smokestacks, persuading manufacturers, and implementing the installation are massive. Regulation of pollution is justified because the Coasean bargain is so costly that it will not be reached.

The above example illustrates the main reason for the failure of Coasean irrelevance, transaction costs. Coasean irrelevance fails—and regulation is justified—for other reasons. Agreements may not be reached because of negotiating tactics (holdouts), errors, or asymmetric risk-preferences. Finally, Coasean irrelevance does not apply to effects on wealth and its distribution. Accordingly, distributional consequences may also justify rules. However, redistribution rarely does motivate substantive rules, because taxes

---

usually redistribute better. The following paragraphs discuss transaction costs. The other failures are the subject of the next part.

C. Transaction Costs: The Usual Suspect

Transaction costs are seen as the main reason for failures of Coasean irrelevance. Transaction costs are the costs of reaching an agreement as opposed to the costs of fulfilling it. Irrelevance does not arise because the cost of reaching the bargain outweighs its benefits.

Some confusion surrounds the precise definition of transaction costs and their distinction from the costs that parties incur after the contract. Whereas transaction costs are borne in the process of reaching an agreement, fulfilment costs are borne after the agreement in the course of its performance and fulfilment. Fulfilment costs may include costs of performance, monitoring or enforcement. The cost of performance is the principal obligation of the party. Monitoring and enforcement ensure obtaining the benefits from the other side’s performance.

Transaction costs can be difficult to discern because they are extraordinarily common; they truly exist at every interaction. We are so used to incurring these costs that they become virtually unnoticeable. What, for example, are the transaction costs of going to the theatre? Consider first the effort spent learning the available shows and selecting one. Other costs are queuing for tickets, the travel to the theatre, and perhaps parking.\(^3\) These are transaction costs because they are part of reaching the deal, rather than enjoying and fulfilling it. The main transaction involves an exchange of money (the price of the ticket) for admittance to a performance. Two theatre patrons who expect to enjoy a play equally may reach different conclusions because they live at different distances from the theatre. Suppose that the first lives in an apartment within a short walk, while the second must drive a long distance to reach the theatre. Their two exchanges are identical because they obtain the same enjoyment from the play and pay the same ticket price. Whereas that exchange is appealing to the neighbor, the hassle of

\(^3\) Some might object that some of these items are not costs because they do not involve monetary expenditures. Decisions are influenced by non-monetary concerns. Therefore, non-monetary burdens must be included in the calculus of decision-making. Because economic analysis studies decisions on the basis of comparisons of costs and benefits, all items that sway decisions by functioning as costs or benefits must be included, including non-monetary ones.
driving and parking may dissuade the distant patron from a transaction the substance of which is appealing. That hassle prevents an otherwise desirable exchange.

Reaching a binding, long-term contract involves much more significant costs. The mere negotiation of a complex contract is a major effort that likely requires legal expertise and perhaps other specialized skills and knowledge, such as of valuation and deal structure. The monetary nature of legal and brokerage fees makes clear that they are transaction costs. Even without any monetary transaction costs, the parties likely expend significant non-monetary costs in reaching an agreement.

When trying to define transaction costs, their juxtaposition with fulfillment costs is particularly revealing. Again, the setting is confusing because no consensus exists for the term for non-transaction costs. The term “fulfilment” costs corresponds to the substance of incurring costs in the course of, and with the purpose of, fulfilling the contract. Transaction costs, by contrast, are incurred in the course of, and with the purpose of, entering into the contract. It is important to know that both transaction costs and performance costs can be monetary or non-monetary and both include opportunity costs as well as actual expenditures.

Some examples help sort these various types of costs. Pink tomatoes are a hypothetical product that is extremely perishable: they spoil if they are not constantly refrigerated. Suppose that John enjoys eating fresh pink tomatoes and one of the few places where he can obtain them is his local farmers’ market, where area farmers sell their produce every Monday evening from 4pm to 6pm.

1. John usually buys enough pink tomatoes for the entire week. Yesterday, his refrigerator broke. A local restaurant would let John store the tomatoes in the restaurant’s refrigerator for 20 coins per week. The cost of refrigeration is not a transaction cost. Despite the increased cost of refrigeration, the going to the market and entering into the transaction of buying the tomatoes has not become less appealing. The tomatoes themselves are less appealing. If John decides not to rent refrigerator space from the restaurant, he will not buy tomatoes. The cost of enjoying them is too high. He would not buy tomatoes even if the seller delivered them. Refrigeration is a monetary cost that is not a transaction cost.

2. John’s refrigerator is repaired but the bus drivers go on strike. To get to the farmers market, John must hire a taxi at an
expense of 20 more coins than the bus. The taxi fare is a transaction cost for tomato purchasing. If the seller appeared with the tomatoes at John’s door, John would buy them. The cost of getting to the transaction prevents the consummation of it. It is a monetary transaction cost.

3. As 4pm approaches on a Monday with no bus strikes or refrigerator failures, John finds out that his favorite band will hold their only show for the year at 4pm. John chooses whether to buy the tomatoes or attend the show. Going to the farmers’ market precludes attending the show. Going to the show is the opportunity cost of going to the market. If the opportunity cost is too high, John will attend the show. John’s enjoyment of the show creates a time conflict that seems to be a transaction cost that takes the form of a non-monetary opportunity cost. The tomatoes are still appealing to John but he is forced to give them up to obtain the greater gain of attending the show. If the seller were available at a different time, then John would also buy the tomatoes.

4. John receives an invitation to visit for a week a dear friend who lives in a different city, where pink tomatoes are not sold. John cannot transport his tomatoes with him. John chooses whether to buy the tomatoes or visit his friend. Visiting his friend precludes enjoying the tomatoes but the cost of going to the market is unchanged. Visiting his friend is an opportunity cost of having the tomatoes. If the opportunity cost is too high, John will not buy the tomatoes. Visiting his friend is the opportunity cost of enjoying the tomatoes. If the cost were too great, John would not buy the tomatoes even if the seller appeared at his door. The visit is an opportunity cost but it is not a transaction cost.

No easy test exists that would identify transaction costs without ambiguity. One test examines the consequences of enlarging the cost. Enlarging transaction costs does not influence the desirability of the agreement, but frustrates it by making the agreement not worth entering. By contrast, enlarging costs of performance makes the contract undesirable by eliminating the gains from trade. Moreover, costs of performance can be surprises that render the contract unattractive after the agreement. By contrast, transaction costs tend not to cause losses because they tend to stand in the way of reaching the agreement. If transaction costs turn out to be surprisingly high, the usual consequence is that the agreement is not reached, rather than one side regretting its decision.
to agree. In other words, transaction costs should have the effect of impeding the parties from capturing gains, rather than the effect of reducing those gains. Let us try this imprecise tool for distinguishing transaction from performance costs on a few examples.

Return to the example of ranchers and farmers. Consider the following variations.

Ranching used to be more productive but now farming is. The old agreement of ranchers and farmers was to grant to ranchers an easement to graze. Suppose that for the elimination of an easement, some specific clauses must be included in a document (a deed or a contract), and that it must be notarized and recorded. Consider the various costs involved in this contract: costs of grazing, fencing, trampling, and drafting the document, notarizing, and recording it. Which are transaction costs? Grazing, fencing, and trampling are the substantive reasons that motivate the contract. As costs, they are substantive and they cannot be considered transaction costs. The costs of drafting and recordation fall at the opposite extreme. Neither party sees drafting or recordation as part of its principal contractual duties or benefits. A twist that shows their nature as transaction costs is to suppose that the gains from trade are very small so that the contract is barely desirable. In other words, alter the setting so that the contract is at the limit of not being worthwhile. Any increase, from that setting, of the drafting or recordation costs would preclude the agreement despite that its substance remains desirable. Any increase of the cost of the performance of a substantive part makes the agreement itself undesirable.

Hypothesizing some values makes the example more concrete. Farming produces gains of 80 without trampling but 60 with trampling. Ranching produces gains of 110 if the cattle can cross (and trample) the farm but 91 if not. Since trampling costs 20 to farmers and 19 to ranchers, they should agree to do away with it. If drafting and recordation cost 0.40, they leave 0.60 of gains for the parties from a deal. One possible agreement is that the farmer pays 19.30 to the rancher and incurs the drafting and recordation expense of 0.40. The rancher receives an amount that justifies foregoing trampling. The farmer spends less than the gains from no trampling. If the cost of drafting and recordation were 1.01, then they would leave no room for an agreement. Despite that a ban on trampling is
advantageous in substance, the agreement is unappealing. A reduction of the costs of drafting and recordation would restore its appeal.

1. Vantage Point Makes Transaction Costs

The conclusion of the example that drafting and recordation are transaction costs must not be generalized to be an inviolable principle. A twist of the example illustrates, that drafting costs can also function as fulfillment costs.

As ranchers and farmers negotiate and draft their agreement, they consider the ease of its amendment. With some additional drafting expense, the parties can make the contract easier to adapt to new circumstances, more flexible. Is the additional expense on flexibility a transaction cost?

Despite that usually, drafting costs are transaction costs, this setting allows one to argue that this particular incremental cost of drafting is not a transaction cost. The decision to pursue flexibility comes from the parties. In exchange for the costlier drafting, the parties obtain an increment of flexibility, such as an option to terminate unilaterally their contract. Rather than block the gains, this increment of drafting cost seems to create substantive gains arguing against categorizing it as a transaction cost and for treating it akin to consideration, i.e., the premium paid for an option. Thus, the example shows that a single type of costs may have components that take the opposite character from usual.

Granted, some enforcement costs, including some legal fees, are transaction costs. The preceding analysis does not also argue that all enforcement costs (and legal fees) are transaction costs. The possibility for innovations in the design of enforcement indicates that at least part of enforcement costs is not a transaction cost because it is discretionary. One must also realize that the vantage point influences the characterization of a cost as a transaction cost. Enforcement costs that seem as a transaction costs from the parties’ perspective are not such from society’s perspective. The legal fees that parties seek to avoid are instrumental for the improvement of the legal system (and the reduction of legal fees on future parties).
2. **Innovations Transform Transaction Costs**

Any change in the law that imposes a cost as a condition for enforcement, limits the benefits parties obtain from contracts. A comparison of contracts to informal understandings suggests that enforceability is a distinguishing feature of contracts. The parties, however, can influence the cost of enforcement. They can include in the contract clauses or rights that make enforcement less costly. The influence of contract design on the cost of enforcement brings enforcement closer to fulfilment costs. The inadequacy of the contract induces innovation. A better contract clause that produces less costly enforcement, would allow a greater number of mutually advantageous contracts. Parties who knew the pointlessness of contracts without the new clause, refrained from using contracts in some settings. In the same settings after the new clause appears, parties can use contract and capture gains.

If a contract with a less costly enforcement scheme was truly impossible, then those costs of enforcement would seem closer to transaction costs. They could be analogized to artificial barriers that preclude the contract (and that prevent the gains it would bring) rather than attributes of the setting that reduce the gains that a contract can produce.

3. **Litigation Costs: Transaction Cost or Not?**

A problem with assuming enforcement costs are transaction costs is that context matters. Despite that the cost of litigation may prevent some parties from collecting, litigation provides a service to society by advancing legal interpretation, by filling the gaps in the law. Despite that it is a transaction cost for the parties, litigation produces a benefit for society. Society would incur a cost to obtain the refinement of interpretation, the coverage of gaps, the resolution of contradictions between rules and their adaptation to the evolving socioeconomic circumstances. Therefore, litigation can be interpreted as producing a service that society obtains. In exchange for it, society spends resources on the legal system. The litigants also expend resources which, from their perspective, likely are transaction costs.

Two interesting implications arise from the above analysis. First, jurisdictions may differ in extracting services from litigation. Second, the design of the legal system may be able to prevent
litigation costs from being experienced as transaction costs by the parties. International comparisons inform both.

4. **INCREASING SOCIAL GAIN FROM PRIVATE LITIGATION**

Litigation is a zero-sum game from the parties’ perspective. Its by-products, however, have value for society. The clarification of ambiguous laws, the interpretive coverage of omissions, and the resolution of contradictions between laws are undeniably desirable. Jurisdictions have differences in how they extract these benefits from litigation.

Since every law leaves openings for interpretation, one of the services that litigation provides is interpretation. Laws can be interpreted consistently so that similar disputes obtain the same outcome. Else, laws can be interpreted arbitrarily and similar disputes lead to dissimilar outcomes. Naturally, consistency is preferable but for consistency to exist, the legal system must provide some means for interpretations not to change, i.e., for interpretations to solidify.

Several details of the legal system facilitate the solidification of interpretation. A leading one is the use of written opinions. Without written opinions, consistency of interpretation may be impossible. Consistency also requires repetition of prior interpretations. Of further assistance is a habit, norm, or preference for adhering to prior interpretations. A system of appeals to a higher court that monitors interpretations would similarly enhance consistency. These seem to be universal features of legal systems. All liberal democracies use written court opinions, have norms for consistent interpretation, and employ review by appellate courts. Thinking back a few centuries or about systems outside liberal democracies should remind us that these features are neither necessary nor obvious. They are legal technology that is enormously important.

Despite the above basic similarities, the legal systems of liberal democracies do have great differences. A particularly profound one may be the division in “common law” and “civil law” systems. Many think that the primary difference between the two jurisdictions is whether court opinions are “primary” sources of law, i.e., have a binding effect on subsequent decisions. The strong discussion about the propriety of judicial activism suggests that judges do deviate from narrow adherence to precedent. No similar
debate seems to arise in civil law jurisdictions. Rather, those jurisdictions seem to have mechanisms that prevent judicial activism, perhaps unwittingly. Common law presents the opposite setting, producing an environment that induces activism, again likely unwittingly. These arguments suggest that common law jurisdictions that elevate judicial decisions to primary sources of law actually place part of the responsibility of legal evolution on courts. The law-making function of the courts is not limited to establishing rules; it also reflects the updating of rules by courts. The endpoint of this argument is that common law systems place part of the burden of updating the law on courts rather than the alternative source of legal rules, legislatures.

The above statements are limited. Courts in civil law jurisdictions may also occasionally update rules. Moreover, jurisdictions within each group do differ. The above sequence of hypotheses does not argue that every common law jurisdiction assigns the entire task of updating rules exclusively to courts and that all civil law jurisdictions preclude their courts from ever performing any updating. A nuanced view is certainly more accurate. Common law jurisdictions tend to have courts perform more of the task of updating than civil ones. This analysis also has limited breadth. Judicial activism may have other consequences in addition to updating rules, perhaps negative ones. While the limited breadth of the analysis precludes a conclusion about the desirability of judicial activism, the conclusion that common law courts do more updating is secure.

The inquiry into updating started as an inquiry into jurisdictions’ gains from courts. Since updating the law is a desirable service, the conclusion that common law courts update more than civil means that common law jurisdictions tend to obtain that service from their courts more than do civil law jurisdictions.

As one more caveat, this difference will influence other functions of the legal system. For example, as common law jurisdictions assign more of the updating task to courts, they reduce the corresponding demand on legislatures. This indicates one may find repercussions for legislatures.

The exploration of the services that legal systems obtain from litigation was undertaken for the purpose of recognizing the

---

changing nature of transaction costs. The litigation expense that is a
transaction cost for the parties provides desirable services to society.
This is an important observation. The economist dislikes transaction
costs but the above observation precludes economists from jumping
to the normative conclusion “first, kill all litigation.” This
contradiction can be the basis for normative analysis.

5. **Normative Implications for Litigation of the Analysis of
Transaction Costs**

Since Coasean irrelevance is a normative tool, the study of it
and of transaction costs should include a normative extension.
Moreover, the above analysis contains a major tension that requires
resolution. The tension is that litigation has value for society while
being a transaction cost for the parties. Yet, society defines the rules
and institutions of litigation. If litigation were solely a transaction
cost, society’s legal system should eliminate it. Its value for society
indicates some amount of litigation is desirable. When a
contradiction contains choices of the legal system, improvement
must be possible. This must be fertile ground for normative
analysis.

Facile proposals are easy. They would involve reducing the
cost of litigation while compromising the benefits society receives
from litigation. Consider, for example, a proposal to replace courts
with summary tribunals that do not publish their opinions. This type
of dispute resolution might reduce the cost of litigation to the
parties. Because opinions would not be published, this scheme
would eliminate the gains to society from consistency of
interpretation. The tribunals would resolve disputes but other
tribunals would not know their interpretations.

The challenge is to design a litigation system that reduces
parties’ litigation expenses and, ideally, eliminates them, while
maintaining or increasing the benefits that society obtains from
litigation. Since the current state of research cannot specify
accurately the benefits of litigation for society, it is unlikely that a
proposal can be identified as optimal. Nevertheless, some proposals
would be recognized as improvements compared to the status quo.

A British experiment with criminal defence funding offers a
framework for thinking about alternative regimes. Likely concern
that the expenditure of criminal defence was beyond individuals’
budgets, the British government established a fund for criminal
defence. Unlike nationalized medicine, this is not nationalized criminal defence (after all, since criminal defence is litigation against the government, nationalized criminal defence would nearly be an oxymoron). Rather, the British system supervises the reimbursement of law firms, which receive normal fees and the selection of which is made by the client and defendant. A defining feature of this system is that the defendant retains the powers of the client, despite the government funding. Thus, this system can be called government-funded litigant-directed.

The experience with the British system is still brief and conclusions are necessarily tentative. Nevertheless, it may be an extraordinary solution to a major problem. Litigation becomes costless for the client. By comparison, a system that lets defendants pay for their criminal defence causes wealth to influence the quality of defence. In the United States, the legal system tries to avoid injustice by funding the defence of the indigent. The result is underfunded representation that becomes inadequate representation and leads to biased justice.

Part of the appeal of the government-funded-litigant-directed scheme is that litigation only appears to be costless. The appearance is due to the absence of any cost for the client. Compared to a system where some litigation does not occur or occurs under inadequate conditions, its cost is likely increased. The focus should be on quality. The additional litigation of the British criminal system is not its central feature. Defendants receive better representation than they could afford. Courts obtain the benefit of better advocacy. The judicial system approaches the ideal of treating all defendants equally with respect to wealth.

The result seems ideal: no cost and improved quality. The next part explores other failures of Coasean irrelevance.

III. MORE FAILURES OF COASEAN IRRELEVANCE

The previous part introduced the normative use of Coasean irrelevance and the main obstacle to irrelevance, transaction costs. This part continues by exploring the less conventional reasons that prevent irrelevance.

---

A. Negotiation Holdouts

The standard analysis of Coasean irrelevance presumes that the parties reach an agreement in every instance where it is advantageous for them, i.e., whenever the total gains exceed the total costs including transaction costs. In an ideal world of perfect and symmetric information, each side knows the other side’s valuation and, when room for it exists, an agreement seems inescapable. In a world of imperfect information, however, occasional bluffs and ruses are plausible negotiating tactics. The side that seeks the advantage by the “hold-out” negotiating tactic does risk losing the agreement. This means that Coasean irrelevance may occasionally fail despite that an attractive bargain is available. The bargain is not reached due to bargaining tactics that prevent it.

This failure seems highly artificial without an example that shows the potential appeal of “hold out” tactics. Suppose that the gain from each agreement between a rancher and a farmer about fencing is 20 and they would normally split it equally. Ranchers know, however, that 20% of the farmers succumb to hard negotiating tactics and accept 3 leaving 17 for the rancher. A 5% fraction of farmers dislikes hard negotiation and refuses to deal after experiencing it. If a rancher expects 100 negotiations with farmers, cooperative negotiation produces 10 for the rancher in all 100 instances. Hard negotiation results in a loss of 5 agreements and extra gains in 10 (the rest remain unchanged). The five lost agreements cost 50 (5 times the gain that would have been obtained by avoiding the hold out, which is 10) but that cost is less than the gains. The rancher receives 17 instead of 10 in ten agreements, for a gain of 70. After accounting for the lost deals, the hard negotiating tactics produce a net gain of 20 and appear to be an appealing strategy for the rancher. Society’s assessment differs. The hold out strategy did not increase the gains. Each agreement still produces gains of 20 for both sides. The hard negotiation does no more than change their division, sending more toward the rancher. From society’s perspective, the only consequence of hard negotiation is the loss of five bargains that would each create a 20 gain. That loss comes with no mitigating features.

When hard negotiating tactics are appealing to the participants, some bargains may fail to occur. Since Coasean irrelevance depends on bargains materializing, it does not occur in such settings.
The potential for holdouts qualifies Coasean irrelevance. An unqualified Coasean irrelevance obtains only if all advantageous bargains occur, whereas holdouts indicate that some bargains might not be reached. The qualifications that holdouts impose on Coasean irrelevance depend on the frequency and nature of the holdouts, i.e., on their quantitative and qualitative implications. Of further interest is the question of symmetry. In some settings, holdout tactics may operate with equal force against buyers and sellers. The implications for Coasean irrelevance of this setting would be quite different from one where one side endures the most of holdout tactics.

Holdouts have only quantitative consequences if they only distort price or the number of bargains. The example had some farmers capitulate to holdouts. Their bargains were more advantageous for ranchers than the baseline of equal division. Compare the alternative that all bargains occur and the division of the gain is even, which leads to Coasean irrelevance. The other terms of the agreement are the same in holdouts and not. The effect of holdouts is limited to price and the non-occurrence of some bargains. Because holdouts in that setting only influence the price and number of bargains, their effect can be considered only quantitative.

Holdouts could also influence the bargains’ terms, their nature, the conduct of parties, or the background in ways that are unrelated to price. Those changes might not influence the number of bargains. Nevertheless, holdouts with qualitative effects likely produce outcomes that differ from Coasean irrelevance. That difference likely has a qualitative component, next to the quantitative nature of the number of lost bargains.

The example also displayed a lack of symmetry because only ranchers employed holdout tactics and only farmers succumbed to them. In a symmetrical setting, the effect would be the same on both sides.

Be they symmetrical or not, quantitative or qualitative, holdouts may cause a deviation from Coasean irrelevance. Without holdouts, in an otherwise ideal environment where individuals are trusting and divide gains evenly, individuals’ bargains and conduct would produce Coasean irrelevance. Since the threat of holdouts changes bargains and conduct, it can prevent Coasean irrelevance. Therefore, a law that reduces this cost of holdouts and lets conducts approach the optimal would be preferable.
Interestingly, this conclusion does not imply assigning a right to the group that would most often buy the right. It may be more important to avoid holdouts than to reduce the number of bargains. One group may use holdout tactics when buying rights but not when selling them. Then, assigning the right to that group would avoid holdouts and could be preferable to assigning the right to the group that is more likely to place the highest value on the right. Assigning the right to the latter group would reduce the number of bargains (and transaction costs) but would also produce a social loss due to bargains sacrificed to holdouts.

Thus, the appropriate legal response to holdouts may be the opposite of the appropriate response to transaction costs. Because transaction costs are considered the primary cause for failures of the Coase theorem, this difference could have practical importance. When Coasean irrelevance fails due to transaction costs, the desirable response of the legal system is to reduce transactions or their costs. This, for example, guides the default terms of contract law, or the allocation of property rights.

An example underscores this difference, that while transaction costs argue for reducing transactions, holdouts may argue for increasing them. Returning to the farmer-rancher example, assume that if an agreement is desired, each would enter it with a specific member of the other group. The number of such pairings is 100. Suppose that if the law entitled ranchers to no fences, in 70 of the rancher-farmer pairings, the farmer would acquire the right to fences. If transaction costs prevent 10% of the agreements from materializing, they indicate that farmers should have the right to fences. This allocation leads to 30 of the rancher-farmer pairings needing an agreement rather than 70. The loss of 10% due to transaction costs means that of all the pairings, only three (rather than seven) fail to reach the optimal outcome. If instead the problem is holdouts and only ranchers employ tactics that prevent 10% of agreements only when they buy rights, then assigning the right to ranchers is preferable. Because farmers do not employ holdouts, despite that agreements occur in 70 of the pairings, all 100 pairings do reach the optimal.

Despite that holdouts appear to have significant policy implications, they have drawn little attention. The problem of holdouts fails to produce generalizable conclusions, echoing a
drawback that appears in a lesser degree in the problem of systematic errors.

B. Systematic errors

Psychological inroads into economic analysis have revealed weaknesses in the assumption of rationality. Evidence indicates individuals make systematic errors. The relevant implication for Coasean irrelevance is that some advantageous bargains may appear undesirable due to errors and, therefore, may not materialize. Errors are an objection, not only to Coasean irrelevance but also to economic analysis generally. They are discussed under the heading “bounded rationality” in a very extensive body of literature.6

C. Risk-Aversion

Individuals are averse to risk. The intensity of risk aversion varies by individual and by setting. Uncertain gains are discounted and each side may discount the other’s offer by different amounts. Appealing Coasean bargains may appear unappealing after the sides adjust for risk.

Society may also be averse to some risks that influence all of society, such as depressions or wars. Those sources of risk tend to be rare. A more usual setting involves uncertainties that do not involve global harm. Uncertainty that involves local or specialized harm joins a multitude of other such uncertainties when it is considered at a social level.

Society is not risk-averse when each source of uncertainty is one of numerous and unrelated sources of risk. In those cases, society is diversified and, therefore, risk-neutral. Society would accept to add one more advantageous wager to the numerous wagers it effectively takes. Society would not discount the gains from each for uncertainty because their aggregation produces a diversified stake. Akin to an investor who is risk-neutral when holding a diversified portfolio, society is risk-neutral about the many independent uncertainties. When society is risk-neutral and expects gain from a bargain but individuals’ risk-aversion makes them not pursue that gain, the result is a failure of Coasean irrelevance. The socially superior arrangement does not occur.

---

6. Pending.
To construct an example that would illustrate the effect of aversion to risk, it is necessary to quantify it. Suppose that farmers who allow the passage of cattle suffer probabilistic harm. Instead of losing a specified amount, they lose one of two amounts depending on the conditions. Suppose that if worms create their tunnels near the surface, the cattle cause greater harm. The farmers’ harm is 55 if the tunnels are high and 25 if not. The tunnels are equally likely to be high or low, suggesting an expected loss of 40. The uncertainty, however, is distasteful to farmers.

For practical purposes, it is important to clarify that the tunnels’ location cannot be determined. Otherwise, the parties could address the uncertainty in their agreement. For example, the agreement could specify that low tunnels are a condition for cattle’s passage or that the farmer’s compensation depends on the tunnels’ location. Private contracting is remarkably resourceful and routinely outwits stylized hypotheticals. Nevertheless, for the purpose of the example, the farmers must be unable to avoid this uncertainty.

Suppose that the farmers’ distaste for the risk is equivalent to a loss of 12. Despite that they, on average, lose 40, they treat that uncertainty as a cost of 52. The farmers are averse to risk and require this additional 12 to become indifferent to bearing it. The farmers would need a comparable inducement to suffer other displeasures of the same size. This compensation is necessary for them to bear the risk, to sit on the proverbial pins and needles.

The farmers’ aversion to risk influences the capacity to reach an agreement with the ranchers. If the ranchers benefit from their cattle crossing the farmers’ land by 50, risk aversion precludes the possibility for an agreement. The farmers do not accept less than 52 and the ranchers do not offer more than 50.

Since risk is distasteful, one might think that avoiding it may be appropriate. The conflict with what is socially ideal becomes clear if we aggregate all farmers. Make all farmers form a single corporation and contribute their land in exchange for shares. All farms are identical and all farmers receive the same number of shares. The corporation only engages in the negotiation with the ranchers and the farms are its only assets. Each farm’s harm is not related to that of other farms. Because the corporation holds many

---

7. A technical note explains the provenance of this figure. This is approximately the discount that farmers with wealth of 30.375 would place on a 50% chance to lose 30 and have 0.375 if they exhibit constant relative risk aversion with a coefficient of 1.
farms, about half will have high tunnels and half low ones. Although half the farms suffer harm of 55 and half 25, the corporation suffers harm of about 40 per farm. As a result, no farmer is exposed to the uncertainty. Each farmer loses 40 due to the passage of cattle. The result is that the farmers would want their corporation to accept any payment over 40 from each rancher. Society’s attitude toward local risks is analogous to the corporation example. Society contains all farmers and loses about 40 per farm.

The uncertainty that individual farmers dislike, does not exist for society. When agreements that would create value from society’s perspective do not occur because of risk aversion, this phenomenon is a failure of private contracting to achieve the socially optimal outcome. A rule that gives ranchers the right to cross farms is preferable in the example. Because the farmers’ risk-aversion has not been cured, however, the impetus still exists for them to reach a bargain with the ranchers against trampling.

Since the cattle induce harm of 52, farmers offer up to that amount for the ranchers to stop crossing, i.e., for the ranchers not to exercise their right. Ranchers accept offers over 50. A deal seems feasible at about 51 where ranchers would promise not to cross farmers’ land. The attempt to avoid the waste of risk-aversion by assigning the right to ranchers appears to fail.

Because of this incentive to reinstate the wasteful arrangement, the new allocation of rights is not stable. For the solution that the legal system imposes to be stable, it must either contain a mechanism that prevents agreements to return to the suboptimal outcome or provide a substantive solution that cancels farmers’ aversion to risk. Naturally, the latter is a vastly superior arrangement. A substantive solution is stable and allows further improvements. It is stable because the farmers will not want to avoid the risk and it is flexible because it can adjust to future changes of the relative values of ranching and farming and allows further improvements of the risk-sharing mechanism. The farmer-rancher example can show this.

Suppose that the law did assign the right to cross through farmers’ land to ranchers. Since farmers suffer a loss that due to their aversion to risk they value at 52, they seek to induce ranchers not to exercise their right. Ranchers, in turn, are ready to accept not to cross the farmers’ land if they receive compensation over 50. Numerous farmer-rancher deals are imminent. Since these would
cancel the attempt to avoid the waste due to risk-aversion, a response seems desirable.

1. **Imposing a Transaction Cost**

   Consider, first, the response of requiring a fee of 20 before enforcing any agreements about crossing land. This would eliminate the impending agreements. Because farmers would need to pay 20 to have an enforceable agreement to avoid harm of 52, they would only offer up to 32. The ranchers would decline that offer because they find appealing only offers that exceed 50. The fee prevents the agreements as any transaction cost would. The parties continue to find the agreement desirable in substance.

   This imposition of a transaction cost seems to achieve the goal of preventing the agreements that would recreate the waste of risk aversion. However, transaction costs have undesirable consequences for the long term. Suppose that farming became more profitable so that avoiding trampling is worth 51 instead of 40. Even if farmers lost their aversion to risk, the fee of 20 would not allow them to reach an agreement with the ranchers that would prevent cattle from crossing into their land. The point, of course, is that this is undesirable. Under the new conditions, society is better off without the cattle crossing the farms. Private contracting would prevent cattle crossings but the fee stands in the way.

   The transaction cost solidifies the allocation of rights to ranchers and prevents innovative contracting. Replacing the fee with a substantive solution of the problem of risk aversion yields a sharply different outcome.

2. **Substantive Solutions of Risk Aversion**

   A solution of the problem of risk aversion is substantive if it aligns preferences with those of society as opposed to preventing an agreement that the sides consider desirable. If either law or contract produces a substantive solution, then the drive toward an undesirable contract (and a sub-optimal allocation of rights) disappears. Moreover, a substantive solution need not impede contracting and, therefore, the incentive for innovations remains. Thus, a substantive solution maintains the optimal setting in the short term and preserves the optimal path in the long term.
Continuing the rancher-farmer example, suppose that an insurance scheme is created to address farmers’ risk. The risk for the farmers is that the crossing cattle may reduce the farm’s product by either 25 or 55, each outcome occurring with 50% probability. The terms of the insurance are that each farmer may purchase a policy for 14 and will receive 26 when this farmer’s property suffers the high damage. Restated using conventional insurance terms, the policy has a premium of 14 and a deductible of 29. In probabilistic terms, farmers who buy a policy reduce their risk. If the good outcome materializes, they suffer damage of 25 and have paid the premium of 14, for a net loss of 39. If the bad outcome materializes, they suffer damage of 55, receive an insurance payment of 26, and have paid the premium of 14, for a net loss of 43. Thus, the uncertainty is between losing 39 and 43. Compared to the risk of either losing 25 or 55, the insurance has vastly reduced the farmers’ risk.

Again, we can assign a value to the burden of bearing this risk. Suppose that farmers consider bearing this risk equivalent to a loss of 1. Their new calculation is that cattle harm them either 39 or 43, on average 41. Adding the suffering from the risk brings the total harm to 42. The ranchers still demand 50 to forego crossings. The high aversion to risk that farmers exhibited (without insurance) produced an inferior arrangement. Even regulation granting ranchers the right to cross farms would be countered by the farmers because they would induce ranchers not to cross their farms. The insurance contract that allows farmers to reduce risk also prevents the suboptimal arrangement. The insurance that reduces farmers’ risk gives stability to the allocation of the right to ranchers. More importantly, the insurance scheme avoids the need for allocating the right to trample to ranchers.

The superiority of substantive solutions is that they preserve the incentives to innovate. That is clear if we consider any improvement of the insurance scheme or if the crossing of farms by cattle becomes inferior. In the former case, the new insurance scheme would attract business. In the latter case, farmers and ranchers can reach a new agreement. The agreement reversing the allocation of the cattle-crossing right to ranchers would be optimal in most cases.
D. Distribution

The strong, routine and unavoidable distributional effects of law lead to one of the main sources of frustration with Coasean irrelevance. Whereas Law & Economics focuses on the allocation that occurs after the parties adjust to the law, lawyers tend to focus on the net consequences for the parties. This difference in focus can be restated as between the economy and its individuals. The economist focuses on the economy and its total product. The lawyer focuses on individuals and their position. Coasean irrelevance only exists from the economist’s viewpoint. Law is relevant for individuals even if it is irrelevant for the economy and its total product. Naturally, if Coasean irrelevance does not materialize, then the rules matter for both total product and individuals. Therefore, the analysis applies only if Coasean irrelevance does materialize. Coasean irrelevance becomes a necessary background assumption.

If the law establishes a suboptimal allocation, the parties’ bargain restores the optimal allocation. That bargain establishes a payment, usually from one party to the other. This payment places the parties in different positions than they would have under the optimal rule. The total product is the same but one party enjoys more of that product. An example illustrates.

Revisiting the farmer-rancher bargain illustrates this concern. Suppose the status quo is a rule that allows the farmers to erect fences against trampling by cattle. Suppose that ranching is more profitable and ranchers do bargain with farmers and pay farmers not to erect fences. The bargain restores the optimal allocation. The farmers enjoy the benefits of the ranchers’ payment. A change of the law that prohibits fences will eliminate this payment. The label “irrelevant” fits the change of the regime only for those who ignore individuals and focus on total product.

The payments violate Coasean irrelevance from individuals’ perspectives and their direction matters for individuals. From a policy perspective, the direction of the payments can have distributional consequences. The direction of the payments may not matter if the payments cancel out or are unrelated to wealth. If the payments tend to occur from the poor to the wealthy, they aggravate concerns about the distribution of wealth. If the payments tend to occur from the wealthy to the poor, they may mitigate distributional concerns. Therefore, distributional policy seems likely to argue in favour of rules that induce a payment from the wealthy to the poor.
Nevertheless, the conventional analysis argues against that position. The standard analysis compares redistributive rules to taxation as redistributive schemes and points out that taxation, particularly if it follows the schedules that bring it close to optimal tax, tends to be preferable according to the double distortion argument. The argument is that any income tax causes a distortion because it reduces individuals’ drive to produce, the chilling effect of the tax. Equal redistribution, through either a tax or a redistributive rule, produces an equal chilling effect. Since the redistributive rule is different from the optimal rule, it produces an additional distortion. Since the rule has two distortions, the tax is preferable.

Revisiting here that argument, the attention is on Coasean irrelevance, not taxes and their chilling effect. If Coasean irrelevance holds, however, then the double distortion argument disappears. Coasean irrelevance means that a bargain restores the optimal, with no loss in productivity. Therefore, if a particular redistributive rule is consistently circumvented by a bargain, it does not produce the second distortion. Naturally, since Coasean irrelevance depends on stringent assumptions, such as lack of transaction costs and complete knowledge, redistributive rules may be circumvented by bargains but never consistently. Double distortion is unavoidable. Nevertheless, the administration of the tax system is costly. In some exceptional instances, redistribution through Coasean bargains could involve a smaller cost.

IV. CONCLUSION

In closing, it is important to realize that the failure of Coasean irrelevance does not have a closed listing of reasons. The failures of irrelevance correspond to imperfections of market interactions, in an economic sense. Research that will reveal new imperfections will also identify new reasons for the failure of Coasean irrelevance and provide new guidance for better regulation.