Torts Handout

THE "COASE THEOREM"

Ronald Coase (1910-2013) was a British economist who taught for many years at the University of Chicago School of Law. He was awarded a Nobel Memorial Prize in Economic Sciences in 1991.

Coase was interested in the "efficiency" of tort rules, i.e., in the rules' tendency to bring about an *efficient* outcome, defined as one in which the net sum of social wealth (a proxy for social happiness, but more easily measured) is maximized.

Recognizing that safety has costs, Coase and his followers think of an efficient rule as one that minimizes the sum of accident costs and prevention costs, because such a rule will, given other assumptions, subtract the least from social wealth. Note that *efficiency* in this sense (called "Kaldor-Hicks" efficiency) does not require that costs be allocated justly between people. Justice, from the economists' perspective, is a separate ideal. Some economists (not all) have argued that justice is a confused, contestable idea, and that society would be better off if tort rules were fashioned solely to advance efficiency.

To illustrate Coase's idea, consider the facts in the *LeRoy Fibre* case. Make the following additional assumptions about the investments the parties would have to have made to avoid the loss suffered there, using the *Hand* formula notation:

Smokescreen (B_Δ) $150

Swath (B_π) $50
PL $75

The cheapest, and therefore the "efficient" solution would be a swath. If LeRoy Fibre's contributory negligence is not an issue, and LeRoy thus has a right to recover damages, will an inefficient result occur, on the present assumptions? Not, according to Coase, if LeRoy Fibre and the RR can bargain *costlessly*. Rather than pay for the fire losses, a rational RR will offer to cut a swath for LeRoy or pay LeRoy to do so itself. The swath will get cut and the expensive smokescreen will not be built. But this is exactly what we would expect to happen if the *LeRoy Fibre* case had come out the other way. If LeRoy's failure to cut the swath would bar it from recovery against the RR, we would expect LeRoy to build the swath itself. Assuming that the two parties can deal with each other costlessly, the efficient result is reached no matter which legal rule is adopted. Hence,

> COASE THEOREM: If there are zero transaction costs, the efficient outcome will occur regardless of legal entitlement. If the property owners and the RR can deal costlessly, it does not matter *from an efficiency standpoint* who has the legal "right."

If we believe that the administrative costs of allowing LeRoy to sue are a net loss to society, shouldn't we bar LeRoy's suit, and let the losses lie where they fall, confident that the efficient result will be reached anyway? Before drawing a firm conclusion, we should ask, have all the possible effects been included in our *Hand* calculation? What if there were 5 property owners, including LeRoy? In that case,

Smokescreen $150

Swath (×5) $250
PL (×5) $375

Now it appears that the efficient solution is smokescreen. If the property owners and the RR can deal costlessly, does it matter *from an efficiency standpoint* who has the "right"?

Answer: Again, No, by the Coase Theorem. If there are zero transaction costs, the efficient outcome will occur regardless of legal entitlement. If the RR has the relevant legal "right," LeRoy Fibre and the other property owners will get together and build a smokescreen for the RR rather than suffer damages or cut swaths. If, on the other hand, LeRoy Fibre and the other property owners have a right to recover in tort, the RR will build a smokescreen rather than pay damages or for swaths. Either way, the smokescreen gets built, and that's the efficient outcome.

What are transaction costs? From LeRoy Fibre's viewpoint, these would include the time and trouble of finding out who their neighbors are, getting together with them to discuss the spark problem, agreeing on a negotiation strategy and getting together with the RR to strike a bargain. In the real world, transaction costs are never zero, and are frequently too great to allow a cooperative solution. To illustrate: Assume LeRoy Fibre and the other property owners incur transaction costs of $25/each (time lost, transportation, etc). Now each property owner faces:

Smokescreen $55 (150/5 + 25)
PL $75
Swath $50

Result: Inefficient over-investment in swath-cutting, unless the RR can be held liable for losses caused by sparks.

Where does this leave us? With a…

REVISED COASE THEOREM:
If there are positive transaction costs, the efficient outcome *might not* be reachable under every choice of legal entitlement. Where this is so, the preferred legal rule is the one that *minimizes the effects of transaction costs*, including both the costs themselves and their effects i.e. inefficient choices.

In our present example, the Revised Coase Theorem would argue for a rule allowing LeRoy Fibre a right to recover, because that minimizes the effect of transaction costs. The smokescreen is the efficient answer to the problem, but transaction costs make it impractical for the property owners to organize this solution.

What is the significance of the revised Coase Theorem? For our purposes, it is very limited. Rarely will a court have the data it needs to determine what an "optimal" or "efficient" level of safety is, and rarely will it know what the transaction costs are and how they have impeded an efficient result in the marketplace. Nonetheless, we will notice a number of judicial opinions in which the language of "cheaper" or

"better cost avoider" is used. This language usually reflects an effort to make use of Coase's insights.