



## Some Coasian Problems with Posnerian Law & Economics

Bruce E. Kaufman

Department of Economics and User Research Workplace Group

Andrew Young School of Policy Studies, Georgia State University

Atlanta, GA 30303

[bkaufman@gsu.edu](mailto:bkaufman@gsu.edu)

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Abstract. The methodological approaches of Ronald Coase and Richard Posner are compared and contrasted with regard to microeconomic theory and its application to law and economics. The central divide is whether positive transaction cost requires a major reworking of the core of neoclassical price theory (Coase: yes; Posner: no). To provide evidence on this matter, the paper examines Posner's well-known treatise *Economic Analysis of Law* and, in particular, his use of two basic price theory tools (downward sloping demand curve; competitive model of demand/supply) for positive and normative analysis of labor markets and labor law. Neither construct is found robust with respect to variation in transaction cost. An alternative positive transaction cost representation of labor demand and wage determination models also reveals that Posner's conclusions on the efficiency effects of various laws and regulations are not well-grounded. The conclusion, as Coase put forward in his Nobel address, is that core tools of microeconomics are contingent on transaction cost and the institutional structure of production.

Modern law and economics (L&E) is widely acknowledged as originating at the University of Chicago. Although a number of people connected with Chicago are recognized for their important contributions, undoubtedly two names stand-out as the seminal figures. They are Ronald Coase and Richard Posner.

The literature tends to homogenize Coase and Posner as fellow contributors to a common intellectual project, frequently portrayed as application of microeconomic principles to the subject of law (e.g., Harrison and Theeuwes 2008: 5-6). Deidre McCloskey (1997) argues, however, that a closer reading of Coase and Posner reveals that they promote two very distinct and even antithetical approaches to L&E. She says on this matter (p. 239):

“law and economics as it has developed in, say Richard Posner's work and as it has been absorbed into the mainstream of economics is not the same things as what might be called a ‘Coasean’ approach. Coase and Posner, though often treated as identical, represent different views on how to conduct economics.”

The dividing line that separates Coase and Posner, claims McCloskey, turns on their different methodological approaches to economics. She begins by describing the Coasian

approach as “commonsense empiricism” and the Posnerian approach as “rationalism.” The latter is also characterized (following Coase) as “blackboard economics” and the former as “anti-blackboard economics” (p. 239). On the next page, however, McCloskey moves to a different and fundamentally more strategic methodological divide centered on the role of transaction cost in economic theory.

According to McCloskey, on one side of this debate is Coase and a relatively small group of Austrians, institutionalists (new and old), and other non-conventional economic thinkers (including McCloskey). Their methodological position is that transaction cost (TC) is ubiquitous, often substantial-sized, and significantly affects economic behavior; hence, economic theory needs to incorporate positive TC as a foundational construct – that is, “from the ground up” (also see Williamson 1993). Coase (1992) claims in his Nobel address that doing so will “bring about a complete change... in what is called price theory or microeconomics” (p. 713). McCloskey expresses this idea as: “transaction costs push our world unpredictably far from the blackboard optimum” (p. 241) – so far, in fact, that Coase (1988) concludes economists and practitioners of L&E must “discard the approach at present used” (p. 16).

On the other side of this methodological fault-line, says McCloskey, are Posner, most conventional economic theorists, and the main body of modern L&E scholars. Their position is that the theorems and models of standard microeconomics are fruitful abstractions even though they rest on an implicit assumption of zero TC. From this perspective, positive TC does not invalidate or require major reworking of the core of microeconomic theory; rather, TC is useful as a way to extend and generalize this core for a set of issues (e.g., market failure; non-market institutions) where imperfect information, cognitive constraints, and incomplete contracts are important considerations. In this spirit, Posner (1993) allows that Coase and colleagues “correct

neoclassical theory, for example by adding transaction costs to the analytic framework” (p. 78) but at the same time asserts, “I reject any suggestion that new institutional economics [positive TC economics] ought somehow to displace the rest of microeconomics” (p. 76). Echoing Friedman (1953), Posner defends neoclassical price with the observation it can be “a useful tool of discovery even if it is unrealistic” and “even though its basic premise [e.g., zero TC] was false” (p. 77).

McCloskey’s portrait of the issues and positions of Coase and Posner may be iconoclastically framed in places but the divergence between the two men is most certainly real, indicated by the quotations featured above and also a deeper perusal of their respective writings on the subject (e.g., Posner 1993; Coase 1993). Further, this debate is not just between two individual Chicago L&E scholars but is representative of a much larger and more general divide spanning more than a century’s time over the proper weight given in economic theory to the *deductive a priori* method and *inductive empiricist* method.

Economists are well-known for having small appetite for methodological disputes, in part because they tend to generate more heat than light. The dispute over method between Coase and Posner is fundamental, however, to the direction of modern law and economics and bears examination as long as the light-to-heat ratio remains well-above unity. This I endeavor to do, in part by using concrete examples drawn from economic theory to distinguish Coase vs. Posner. Although the position of both authors has pros and cons, the thesis staked-out here is that at the end of the day Coase wins the argument. I illustrate this with what may be considered a case study of sorts; that is, examination of Chapters 1 and 11 of Posner’s well-known treatise *Economic Analysis of Law* (1<sup>st</sup> ed. 1973; 7<sup>th</sup> ed. 2007). Chapter 1 lays-out in general terms the

economic tools Posner uses throughout the book; Chapter 11 applies these tools to the topic of employment regulation.

Consistent with the position taken by Coase, I demonstrate that: (1) core concepts of standard microeconomics are not robust with respect to variation in transaction cost; (2) Posner's approach to theorizing L&E therefore lacks a solid micro-foundation (certainly for labor markets); and (3) for this reason many of Posner's policy conclusions on labor and employment are poorly grounded in theory. As indicated, these propositions are developed for one sector of the economy – labor markets – and for one area of L&E – labor and employment law, although certain parts (but not all) generalize to other areas of economic analysis.

Posner, Price Theory, and L&E

Posner's colleague at Chicago, Gary Becker, identifies an "economic approach" to studying human behavior based on the three pillars of maximizing behavior, stable preferences and market equilibrium (Becker 1976). The first two components yield the economist's model of the rational actor. Becker generalizes the concept of "market" to all mechanisms that sort, allocate and coordinate scarce resources (e.g., a marriage market) and argues that rational behavior guided by money and shadow prices and operating within the constraints posed by given institutional structures and resource limitations (e.g., imperfect information) yields efficient equilibrium outcomes (also see Lazear 2000). In the spirit of economic imperialism, Becker concludes, "I have come to the conclusion that the economic approach is a comprehensive one that is applicable to all human behavior" (p. 8).

Posner takes Becker's economic approach and applies it to the legal field, as indicated in the citation to Becker in the first footnote of Chapter 1 of *Economic Analysis of Law* (2007: 3). His valuable and insightful contribution is to treat laws and regulations as additional sources of

optimization constraint and relative price variation (often in the form of opportunity cost differentials) and to work out the consequences for human behavior and economic efficiency.

Posner tells readers in the *Preface* that “The explication of economics in this book stresses the unity, simplicity and power, but also the subtlety of economic principles” (p. xxi). These economic principles are then outlined in Chapter 1 in the first section titled “Fundamental Concepts” (p. 3). Included are the core elements of conventional microeconomic theory, such as rational utility maximizing behavior, opportunity cost, the law of demand, demand and supply analysis, competitive equilibrium, and efficiency. The Coase Theorem is also introduced but in the context of its implications when transaction cost is zero (p. 7).

The grounding of Posnerian-style L&E in standard microeconomic price theory is indicated by the first two diagrams featured in the book. They are reproduced here as Figure 1 panels (a) and (b), respectively.

[Insert Figure 1 about here]

The first diagram depicts a downward sloping demand curve. It is featured by Posner as the first diagram because the curve illustrates the most fundamental behavioral relation driving modern L&E. This relation is the law of demand and associated principle of substitution; that is, price and quantity demanded are *ceteris paribus* inversely related. In introducing the demand curve, Posner tells readers, “The concept of man as a rational utility maximize implies that people respond to incentives” (p. 4) and then demonstrates in the next paragraph with the demand curve diagram how they respond in a *predictable way* to incentives. That is, if the price (money or shadow) of some scarce good goes up people on average consume less of it and substitute toward some now-cheaper alternative. The example Posner uses to illustrate the application of the Law of Demand to legal analysis is the quantity of criminal behavior in

society. If the price of committing criminal acts is increased by stiffer jail sentences, L&E predicts that fewer people will commit crimes (*ceteris paribus*).

The second diagram in the book is the demand/supply (DS) curve model, shown in panel (b). It is featured second because the point of competitive equilibrium establishes the benchmark level of prices for the demand curve diagram in panel (a) and the benchmark level of efficiency (maximum) for welfare comparisons among alternative policies and legal regimes. The mechanics of price determination are only lightly touched on by Posner. Instead, the diagram is used to emphasize that competition via DS leads to an equilibrium where prices are equal to opportunity costs (on the margin); through the exchange process resources tend to gravitate toward their most valuable use; profit (and incentives more generally) are a magnet drawing resources into an activity; and at a competitive equilibrium efficiency is maximized since all gains from trade have been exploited. Posner in his discussion of how competition guides resources to their most valuable brings in the Coase theorem; McCloskey claims, however, that in this zero TC rendition the proposition “is actually Adam Smith’s theorem” (p. 240).

#### Theory Applied: Regulation of the Employment Relationship

Posner takes these theoretical tools of standard microeconomics and applies them to analysis of more than two dozen separate topic areas in law. The area I focus on is the labor market and L&E analysis of employment regulation (Chapter 11). Posner defines the domain of employment regulation broadly to include both individual and collective dimensions, such as regulation of individual termination and company-union collective bargaining. These two areas are sometimes separately distinguished as, respectively, employment law and labor law.

I have gone through Chapter 11 and culled-out eight representative propositions and conclusions. In each case I give partial or full quotation in order to ensure that this list closely reflects what Posner has written. The purpose of this list is to make or reinforce certain points about L&E that become the object of Coasean critique in the next section.

- Labor markets are broadly competitive in nature since “labor monopsony.... is not a serious problem in this country” (p. 342) and “monopolies and cartels carry within them the seeds of their own destruction” (p. 343). Even where competition is not fully effective due to imperfect information or other frictions, one can nonetheless presume that labor outcomes are (mostly) efficient because otherwise unexploited gains from trade “would be negotiated voluntarily” (p. 349). The base-line for analysis, therefore, is “an efficient common law of labor relations” (p. 341).
- Unions act as a labor cartel and win higher wages for their members but at the cost of economic inefficiency and “reduction in the demand for labor caused by union wage scales” (p. 343). The National Labor Relations Act “is a kind of reverse Sherman Act, designed to encourage cartelization of labor markets” (p. 344).
- Workers were not victimized by early 20<sup>th</sup> century “yellow-dog contracts” (a provision that says a worker agrees as a condition of employment to refrain from joining a labor union) because in a competitive labor market “the worker presumably would demand compensation for giving up his right to join a union” (p. 341).
- “Further evidence that job security is inefficient is that ....employment-at-will is the normal form of work contract in the United States. The worker can quit when he wants... An employer who gets a reputation for arbitrarily discharging employees will have to pay new employees a premium...” (p. 348).

- A legal minimum wage “reinforces the effect of unionization on wage rates” (p. 352) and thus represents another form of monopoly influence in labor markets; it also is ineffective in poverty reduction and most harms the job prospects of the workers who are most disadvantaged (e.g., black teenagers).
- “The Occupational Safety and Health Act .... is arguably superfluous. The employer has a selfish interest in providing the optimal.... level of worker health and safety” (p. 354).
- Women’s lower wages relative to men are mostly due to their different human capital and occupational choice decisions, made in light of different family roles and preferences. These differences “would have narrowed even without government intervention” and “not all employment discrimination on grounds of sex is inefficient.” (p. 357).
- Pension protection may well not be necessary because (in part) “[t]he employer’s incentive to abuse the power that incomplete vesting conferred on him by renegeing on his unwritten contract to deal fairly with his employees would be held in check by his concern for preserving a reputation for fair dealing” (p. 363-64).

This list is useful because it illustrates three noteworthy features of Posner’s style of economic reasoning applied to law that are distinctly non-Coasean.

The first is the universality premise of L&E and its underlying paradigm of economic imperialism. That is, the methodological presumption is that the standard tools of microeconomics and, in particular, the two diagrams featured in Figure 1 (the downward sloping labor demand curve; competitive price determination by demand and supply) are in principle

applicable to all areas of human behavior, including labor markets and employment relationships. This premise differentiates modern (Posnerian) L&E not only from Coase but from traditional labor and employment law and the institutional type of economics it is based on. That is, modern L&E treats labor markets as akin to other markets except for second-order “details,” per Posner’s use of the DS diagram to analyze a minimum wage (p. 352). Traditional labor/employment law, on the other hand, maintains labor markets are first-order unique and non-competitive institutions because of the human nature of labor and long-term nature of the employment relationship; not surprisingly, therefore, they typically do not use a DS diagram in discussions of the minimum wage.

The second feature of this list is it reveals Posner’s consistent application of the price theory principles developed in Chapter 1 to analysis of labor and employment law. The law of demand and downward sloping labor demand curve in Figure 1 are explicit or implicit in Posner’s analysis of each item listed above. That is, every employment regulation or workers’ organization with “bite” raises the effective price of labor (either directly through a higher labor compensation or indirectly through lower productivity) and therefore leads (*ceteris paribus*) to a contraction of employment opportunities. Thus, unions, minimum wages, employment security provisions, and equal opportunity legislation have a backfire effect (e.g., pp. 353, 357) since they hurt some of the target group they are meant to help (e.g., black teenagers or working mothers priced out of jobs). With regard to the Americans with Disabilities Act (ADA), for example, Posner asserts, “The goal is to increase employment opportunities for disabled persons; yet the actual effect has been to reduce the number of disabled persons who are employed” (p. 361).

One reads the list of items above and also sees the competitive model of labor markets and DS theory of wage determination in Figure 1 heavily represented. For example, the

competitive-based theory of compensating wage differentials (from Adam Smith) figures prominently in many of Posner's evaluations of labor law. According to Posner, banning yellow-dog contracts or mandating maternity benefits neglects the fact that in competitive markets workers get the cash-value of these rights in the form of higher wages; likewise, employers are refrained from unfairly firing workers since they will develop a reputation as a bad employer and have to pay a higher wage to attract workers. More explicitly, Posner uses the competitive model of demand/supply to analyze and evaluate a minimum wage law.

Equally important, the model of competitive labor markets – augmented where necessary by appeal to the Coase theorem (for competitive-like solutions to bilateral monopoly, externalities and other market imperfections) and the wealth maximizing tendency of the common law – provides the foundation for Posner's argument that observed employment outcomes are on *prima facie* grounds (typically) a first approximation to an efficient outcome. The reasoning is that if outcomes are not efficient then there is, in effect, "money left on the table" and where competition is present these rents will be whittled down until all gains from trade are exhausted (p. 10).

Because Posnerian L&E assumes as a base-line proposition that resources are (more or less) efficiently ordered, it follows as a matter of logic that a labor law or employment regulation enters the scene as "guilty until proven innocent." That is, if the analysis starts out with "assume a competitive labor market" and "assume an efficient regime of common law," it is an easy and non-controversial step to draw a DS diagram of labor markets (e.g., Posner's Figure 11. 2), locate the status quo as the competitive equilibrium, and demonstrate that every labor law and employment regulation listed above is destructive of social wealth. The guilty verdict may be swung to innocent but the onus is on proponents of regulation to make this case; in particular,

they must demonstrate compelling evidence of significant and persistent market failure *and* inability of private bargaining (the Coase theorem) to solve the (alleged) problem.

Posner's default "guilty until proven innocent" position on employment regulation is illustrated in his analysis of employment at will. Two options are considered: first, employment at will (no restriction on hire and fire) and, second, a just-cause termination mandate (fire only for demonstrated good cause). The thrust of his argument is in favor of the "no regulation" option; he observes, for example, that hire and fire promotes labor market flexibility while workers' interests are adequately protected by competitive market forces and employers' self-interest in keeping a productive workforce. Thus, he concludes, "it is difficult to see how workers in general can benefit from such a requirement (p. 349) – a logical deduction if competition has already led employers and workers to the contract curve (or close thereto).

The third noteworthy feature of this list of labor law conclusions is that while Posner's evaluation is in each case negative (i.e., "free market") he nonetheless asserts that they are the joint product of value-neutral (aka, scientific) tools of microeconomic theory and a widely accepted welfare criterion. On one hand, L&E is avowedly normative because practitioners such as Posner purposefully use economic analysis to evaluate the welfare effects of law and regulation and derive policy conclusions and recommendations therefrom. Yet, on the other hand, Posner rebuts critics who assert L&E has (in his words) a "conservative bias" (p. 26). He asserts that the microeconomic tools used in L&E are "ideologically neutral or balanced" (p. 27) and the L&E welfare criterion of wealth maximization asserts no more than "in a world of scarce resources waste should be regarded as immoral" (p. 27).

Interestingly, Coase does not object to many/most of the normative free market implications Posner derives with the help of modern microeconomics because he, like Posner, is

a proponent of economic liberalism. But at the level of theory, McCloskey is correct to argue that Posner's approach to L&E has much greater affinity with Adam Smith and the Invisible Hand theorem of Arrow and Debreu than Coase's positive TC institutional approach to law and economics. The ramifications of this divide for economic analysis of law are next highlighted.

#### The Consequences of Positive Transaction Cost: Theory and Policy

Coase and Posner broadly agree on several points. One is the definition of transaction cost (see Benham and Benham 2010 for a general review). Coase (1937) started out defining TC (he did not, however, use this exact term) as "costs of using the price mechanism" and later expressed this idea as "costs of contracting" (1991: 73). Posner (2007) defines TC in a similar way; that is, "costs of effecting a transfer of rights" (p. 34).

The two men also agree that transaction cost are always positive and sometimes high. Coase (1992) says in his Nobel lecture transaction costs "are pervasive in the economy" while Posner (2007) states, "transaction costs are never zero; in fact they may be quite high" (p. 51).

Where they fundamentally disagree is on the consequences of positive transaction cost for theory and legal analysis. Based on the foregoing review, I assert that the main methodological issues separating Coase and Posner may be framed as these two complementary hypotheses (with Posner's position taken as the null and Coase's as the rejection of the null).

- H1: incorporation of positive TC does not affect in a substantively significant way either the theoretical structure or predictive content of standard microeconomic theory, say as represented by the two panels of Figure 1.
- H2: incorporation of positive TC does not affect in a substantively significant way the positive predictions and normative welfare conclusions of modern L&E regarding

alternative laws and policy regimes, say as represented by the labor and employment law propositions listed above.

Each hypothesis is separately examined, starting with H1.

**Theory.** Hypothesis H1 asserts that variation in TC from zero to positive does not compromise the logical integrity and predictive content of basic microeconomic tools, such as the downward sloping demand curve and competitive DS diagram. Coasean logic indicates this hypothesis is false, and substantively so, for the case of labor markets. The reason is also Coasean – variation in TC from zero to positive fundamentally changes the institutional structure of production and, therefore, the nature of labor demand and the market for labor services.

The neoclassical labor demand curve and competitive labor market diagram are derived with the taken-for-granted assumption that the economy has a factor market for labor services and capitalist employment relationship. In Chapter 11, for example, Posner draws a DS diagram with the wage rate (W) on the vertical axis and quantity of labor (L), measured as either hours or people, on the horizontal axis. The demand curve shows (*ceteris paribus*) how many hours/people firms want to hire from the labor market at various market wage rates; the DS diagram shows how competitive bidding in the labor market between labor demanders (employers) and labor suppliers (would-be employees) determines an equilibrium price and quantity of labor services. This equilibrium is an efficient outcome, as earlier described.

The problem for Posner and neoclassical economics is that both diagrams have no logical existence with *either* zero or positive TC (i.e., they are not robust to TC period). If TC is zero, Coase demonstrates that the institutional structure of production disaggregates (disagglomerates) to its lowest level of decentralization. The reason is that coordination of the division of labor (e.g., the separate tasks required to produce Adam Smith's pins) can be

performed by two modes – price and competition in markets and command and administration in organizations (e.g., firms) – and if  $TC = 0$  then market coordination is everywhere favored.

Demsetz (1991) calls this institutional structure of production “perfect decentralization” and says in this economy “each individual acts as a firm, selling the output of his effort to other individuals acting in a similar fashion” (p. 162).

The implication of perfect decentralization is that all firms are single-person proprietorships (independent contractors, etc.) and buy/sell the intermediate goods needed at the various positions in the division of labor through product market transactions. The firms may be large agglomerations of capital and workers but the workers provide their services, not as employees of (say) Ford Motor, but as John Jones Windshield Installation, Inc. and Nancy Smith Rent-a-Marketing Executive, Corp.

The logical implications for both parts of Figure 1 are dire. Specifically, with zero TC the institutional structure of production is such that: (1) firms do not have employees (as that term is understood in the law); (2) accordingly, firms have no demand curve for labor (in the factor market sense) and panel (a) is thus an empty space; and (3) the DS diagram in panel (b) also disappears since firms do not compensate labor with a rental rate per time period (a “wage”), they have no demand curve for employees so one of the Marshallian blades is missing, and there is no factor market so the supply curve of labor transposes to a product market DS diagram.

Neoclassical economics is built on a zero TC foundation and what the above demonstrates is that in this situation an economy has no labor market, employment relationship, labor demand curve, or demand/supply model of wage determination. The tools in Figure 1 are still applicable to product markets and the associated legal topics in Posner’s book but they are

not scientifically grounded logical abstractions for labor and, therefore, for the evaluation of labor and employment law in Chapter 11.

Posner may retort that this demonstration is perhaps interesting but also a straw man since it rests on a pure Walrasian  $TC = 0$  model when (per a previous quotation) he adopts a more elastic version of neoclassical theory in *Economic Analysis of Law* that makes room for  $TC > 0$  (e.g., limited information, bounded rationality). That is, one could surely argue that the labor demand curve and DS model of labor markets remain viable and useful abstractions even if (say) employers do not have perfect information and workers cannot compute all alternative outcomes; to maintain otherwise is to (purportedly) make the dissenter's mistake of discarding microeconomic theory because it fails the test of realism.

The counter-response is that the critical flaw is not lack of realism but lack of good logic. This is a more serious charge against any theory given that the essence of a theory is a logical chain of cause-effect reasoning. To appreciate this, consider the alternative case of a  $TC > 0$  economy. It turns out that both diagrams in Figure 1 again disappear.

By wide agreement, imperfect information and limited human cognitive ability are central to generating positive transaction cost. Positive transaction cost, in turn, means buying/selling in markets consumes scarce resources and creates incomplete contracts. A consequence of  $TC > 0$  is that it becomes economical to shift some of the coordination of the division of labor inside firms (i.e., "make" replaces "buy") and have the visible hand of management replace the invisible hand of the market. Management coordination, however, requires that one or more people in the organization have power and authority to direct/control the performance of others. Under a common law legal code, managers do not have this authority with contractors; they do have it, however, with employees. When  $TC = 0$  controls

rights have zero economic value since the environment is fully known and buyers/sellers can write complete contracts; as TC grows, however, future events become more uncertain, contract incompleteness expands, and gaining control rights to direct labor by converting contractors to employees takes on greater value. The upshot is that with  $TC > 0$  the institutional structure of production starts to agglomerate, multi-person firms appear, these firms obtain labor services by hiring employees, the economy forms a specialized factor market for labor where buyers and sellers interact, and out of this interaction is established a rate of pay (wage) and level of employment.

On a surface level a positive TC economy appears consistent with the microeconomic models in Figure 1 and the Posnerian position; that is, firms have a demand for labor and the economy has a labor market with many buyers and sellers. Figure 1 gives abstract representations of both realities. The problem, however, is with the *nature* of these representations. In particular, with positive transaction cost neither labor demand nor wage determination take the form represented in Figure 1.

The key consideration is the incomplete nature of labor contracts. Because of bounded rationality and costly information, labor contracts cannot specify every task and performance standard and, hence, have large gaps that are filled-in as the production process unfolds. Further, positive TC creates frictions and interdependencies (e.g., types of asset specificity emphasized by Williamson (1985)) that create an incentive for firms and workers to replace spot contracting with longer-term relational contracting. Entrepreneurs, therefore, find it is more economical (*ceteris paribus*) to re-hire incumbent employees (insiders) rather than replace them with new hires from the external labor market (outsiders). Also, since labor is embodied in people, work effort is volitional and entrepreneurs find they can get more of it by investing (up to some point)

in job security, promotion systems, dispute resolution programs, and other accoutrements of internal employment systems.

For these and other reasons, insiders and outsiders in firms are not perfect substitutes. Given this, then both the labor demand curve and DS curves in Figure 1 change shape. If workers are not homogeneous, the labor supply curve to the firm becomes upward sloping as at any given wage some workers are preferred over others. Also, firms acquire some degree of independent wage-setting ability when labor has some element of immobility. The labor market, therefore, transitions from competitive to imperfectly competitive with some non-zero element of monopsony. Just as the marginal cost curve no longer yields a well-defined product supply curve for a firm in an imperfectly competitive output market (e.g., a monopolist), by similar reasoning the marginal revenue product curve no longer yields a well-defined labor demand curve for a firm (e.g., a monopsonist) in an imperfectly competitive labor market (Fleisher and Kniesner 1980: 198). Hence, with  $TC > 0$  the conclusion is that the neoclassical labor demand curve in panel (a) does not have logical existence and, as it disappears, so does one blade of the DS model in panel (b). Without a well-defined labor demand curve in panel (b), the wage determination process has to be closed with some other device, such as management “take it or leave it” wage offers in labor markets having more job seekers than job vacancies.

To summarize, Coase’s claim (earlier quoted) is that inclusion of transaction cost “will bring about a complete change .... in what is called price theory or microeconomics.” The notion of what comprises “complete change” surely varies among economists but, arguably, the above may qualify as an example. That is, when transaction cost is brought into the standard price theory model of labor markets its two most fundamental tools – the downwards sloping labor demand curve and the competitive model DS wage determination – do not survive as well-

defined logical constructs. Equally significant, by transaction cost reasoning the entire concept of a *competitive* labor market turns out to be a logical *non sequitur* and, accordingly, one concludes *labor markets are always and everywhere imperfectly competitive*.

If logical congruence was the sole test of a theory, at least for Chapter 11 Posner would have to replace the two diagrams in Figure 1 with alternative constructions. One candidate for panel (b) is a monopsony labor market diagram, perhaps broadly interpreted as representing monopsonistic competition or some variant. Thus, in this new set-up there are still buyers and sellers of labor who interact in markets; what changes is the institutional structure of the market, the nature and balance of the competitive process, the predicted level of wages and other terms and conditions of employment, and their welfare properties. Likewise, we know from previous research by Becker (1962) that due to the elemental existence of scarcity and budget constraints there must exist at some broad level an inverse relation between price and quantity demanded. Instead of a well-defined monotonic relationship, however, Coasean reasoning suggests labor demand curves have some indeterminacy and perhaps an upward sloping segment (because for any given wage  $W$  and employment level  $L$  there are a range of possible marginal products due to volitional effort and incomplete contracts). One way to represent this is to replace the pencil-thin demand curve in panel (a) with a broad shaded band.

For a person committed to an instrumentalist methodology, as Posner so indicates, these arguments based on logic are not determinative; rather, the ultimate test of the utility of a theory is its predictive ability. Although I cannot here go into a detailed analysis of empirical research on labor markets, let me suggest that here too the evidence is likely to support Coase more than Posner. Two examples are illustrative.

Regarding the competitive model of labor markets in panel (b), Ashenfelter, Farber and Ransom (2010) summarize a symposium of empirical papers on labor markets and wage determination published in the *Journal of Labor Economics*. They conclude (p. 208-09),

“The remarkable common feature of all the studies reported here is the high ‘monopsony power’ implied by the firm-level estimates of labor supply.... In general, if exploited by employers, such high rates of monopsony power imply large welfare losses to society through the misallocation of labor and considerable redistribution of income away from workers and to residual claimants.... The articles in this issue provide remarkable evidence that labor markets are far from competitive.”

Regarding the neoclassical labor demand curve in panel (a), Doucouliagos and Stanley (2009) do a meta-analysis of 1,474 estimated wage elasticities reported in minimum wage studies. They conclude, first, the employment effect is effectively zero – consistent with an institutional labor demand “band” but not a negatively-sloped neoclassical labor demand line and, second, minimum wage research is skewed by publication bias toward results that favor minimum wage critics (i.e., the research has a “conservative bias”). They conclude (p. 422-23):

“We still find strong evidence of publication selection for significantly negative employment elasticities, but no evidence of a meaningful adverse employment effect when selection effects are filtered from the research record....If this interpretation were true, it implies that the conventional neoclassical labor model is an inadequate characterization of the US labor markets (especially the market for teenagers). It also implies that other labor market theories, such as those involving oligopolistic or monopsonistic competition, or efficiency wages or heterodox models, are more appropriate.”

**Policy.** Hypothesis H2 can be disposed of in shorter fashion. Because of their disparate methodological positions, Posner and Coase counsel and practice quite different approaches to policy evaluation.

Posner takes the standard theoretical tools of neoclassical economics, adopts the Friedmanite proposition that labor markets can be treated “as if” they are (mostly) competitive, and then compares efficiency outcomes before and after adoption of various proposed labor laws

and employment regulations. As demonstrated above, the verdict he reaches is “guilty-leaning” for each law and regulation put under the microscope. Coase, on the other hand, works from a positive TC framework and, hence, all human-constructed institutions – including markets – are imperfect. His dictum, therefore, is that the economist cannot decide a policy issue on *a priori* reasoning from an abstract model of a perfect (or quasi-perfect) world but, instead, has to decide the matter based on an empirical weighing of benefits and costs. Coase therefore follows Demsetz (1969) in claiming that the Posnerian approach commits the “Nirvana fallacy” -- that is, it evaluates law and regulation with a model that presupposes resources are already optimally allocated. The high probability of a negative verdict is built into the process.

To see if a Coasean approach yields different conclusions, let’s return to the list of labor laws and regulations listed above that Posner in his Chapter 11 renders a “mostly guilty” verdict. It will be seen that if the neoclassical labor demand line in panel (a) and DS curves in panel (b) are replaced with a labor demand band and a monopsony diagram the conclusions on all the listed labor laws and regulations immediately shift. That is, where once the guilty verdict was more or less foreordained now the verdict is an open question which depends on the strength of empirical evidence pro and con.

For example, consider unions (item #2) and minimum wages (item #5). Posner’s charge is that they reduce employment, raise wages above the competitive level, and create a deadweight efficiency loss. If the labor demand relationship is a band, both institutions may have a zero effect on employment -- particularly for modest-to-moderate wage hikes. In an imperfect world, an exogenous increase in labor costs can be offset or absorbed through alternative buffers and adjustment channels; for example, managers can tighten up on organizational slack and employees can increase work effort. Likewise, if the labor market has a monopsony element then

both unions and minimum wages may not only leave employment unaffected but also improve or at least not harm efficiency. The case for and against these government interventions, therefore, cannot be deduced on *a priori* theoretical grounds because their effect is *a priori* indeterminate. That is, since both unions and minimum wage laws can be either distortion-creating or distortion-reducing, the only neutral way to render a verdict is through a balanced assessment of empirical evidence from case to case, albeit with due attention to generalized findings from past empirical evidence and the implications/predictions of positive TC theory.

Or consider mandates that abridge employment at will (item #4) and regulate workplace safety and health conditions (item #6). For reasons described in the previous paragraph, these regulations may not have the perverse employment backfire effect Posner alleges because firms can absorb and offset the increase in costs through other channels. Also, Posner's main argument for why these mandates are unnecessary is because in a competitive labor market demand/supply create compensating wage differentials that not only pay workers for the additional risk but also motivate employers to provide the efficient level of workplace security and safety. However, in a world of asymmetric and costly information, constraints on labor mobility, incomplete contracts and consequent incentives for opportunism, and (typically) an excess supply of job seekers, compensating wage differentials may be inefficiently low or even non-existent. Accordingly, employers often (not always) have a dominant position in labor markets while the markets themselves yield wages and conditions below the social optimum because of positive TC contracting problems (externalities, public goods, moral hazard, etc.).

Thus, the case for and against employment at will and safety and health regulation, like for unions and minimum wages, cannot be determined on an *a priori* basis since in a human world *all* alternatives are imperfect. The only viable recourse, therefore, is to examine the weight

of empirical evidence. As Coase (1988) states, “Realism of assumptions [ $TC > 0$ ] forces to analyze the world that exists, not some imaginary world that does not” (p. 65).

## Conclusion

Posner criticizes Coase’s position as “disdain for theory” (Posner JEP 205) and “stark rejection of the theories and empirical methods of modern economics” (JTISE p. 80). Coase (1993 reply), on the other hand, claims “I do not dislike abstraction... My aim is to bring into existence and economic theory which is solidly based” (p. 97).

Economists can in good faith come down on either side of this debate – as they have done for more than a century. As I have endeavored to demonstrate, however, Posner’s position on methodology is not well-grounded on several counts. By this rendering, Coase is not “anti-theory” but “anti-zero TC theory” – a distinction McCloskey (1997) emphasizes but which Posner elides. Likewise, Posner’s position is that taking into account positive TC does not endanger the main body of neoclassical theory, including elementary concepts such as demand curves and demand/supply diagrams. At least for labor markets, this paper shows that in fact these constructs are not invariant to TC and, in fact, have no logical existence in either a  $TC = 0$  or  $TC > 0$  economy. This finding supports Coase’s institutional position. Finally, this paper also shows that the Coase vs. Posner approach to theory-building has large ramifications for the field of law and economics and its positive and normative evaluation of law and regulation. The Posnerian approach puts much weight on *a priori* deductive conclusions from neoclassical models and thereby predisposes the verdict toward “guilty until proven innocent;” the Coasian approach, on the other, hand, opts for an institutional-style of theory where markets (and alternatives) are imperfect and the verdict on law and regulation therefore is *a priori*

indeterminate and must be decided on the weight of the evidence pro and con. Such a review is outside the bounds of this paper; two suggestive examples, however, support Coase.

In all such debates, opposing positions typically contain their own insights and truths and this paper in no way denies this due to Posner. The paper does maintain, however, that Posner substantially overstates the merits of his case and the defects of Coase's. But, of course, this is what a good prosecuting attorney does. Further, Posner appears to have moved somewhat in Coase's direction.

In 2010, Posner was awarded the "Ronald H. Coase Medal" by the American Law and Economics Association. In his published address he considers the lessons of the 2007-2020 economic crisis and comes to this Coasean conclusion: "We have discovered that economic theory is more fragile and provides a less secure basis for understanding economic behavior and improving economic policy than we had thought." Ronald Coase would say "Amen."

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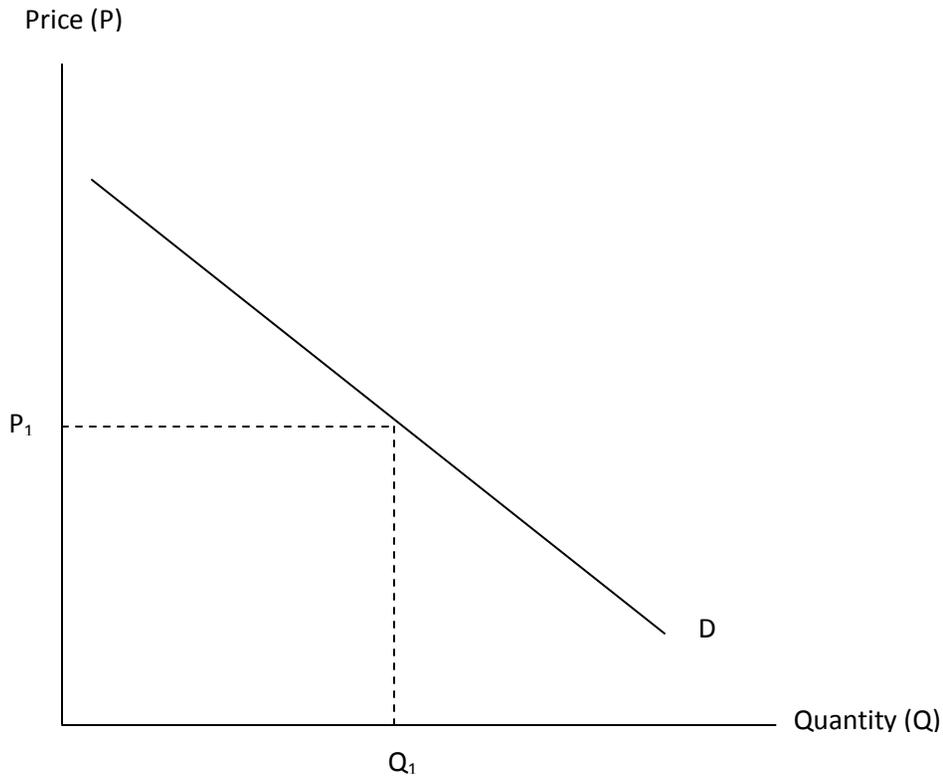
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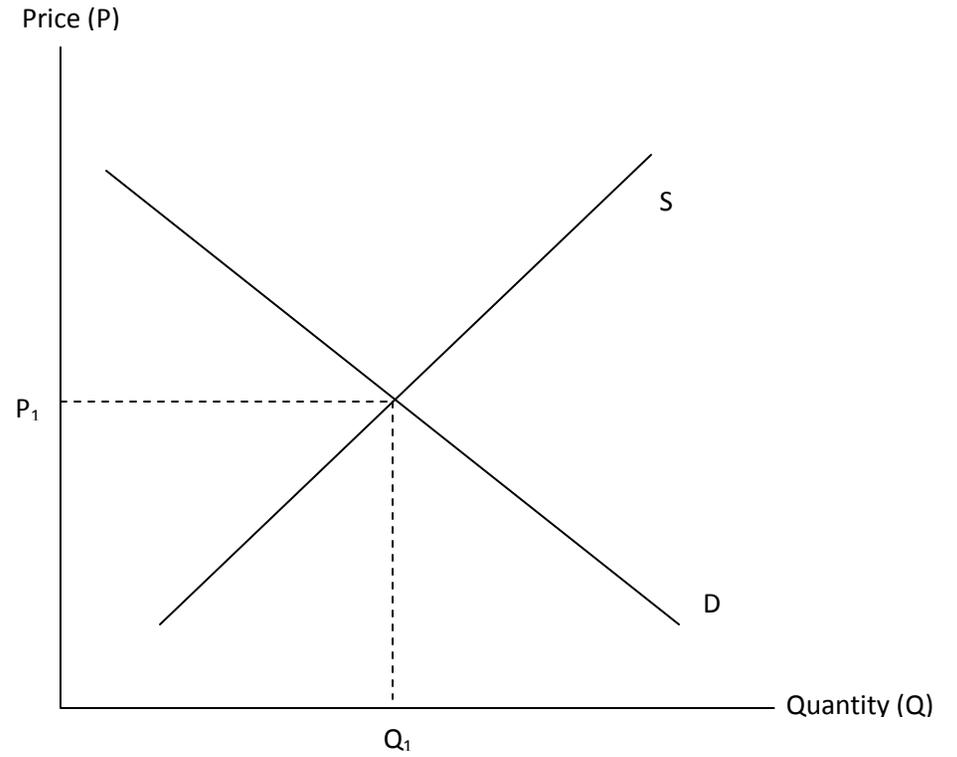
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Figure 1. Posner's Two Fundamental Diagrams



Panel (a): Demand Curve



Panel (b): Price Determination in Competitive Market