

## The Effects of Coase's Thought on the Development of the New Institutional Economics<sup>1</sup>

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### Yeni Kurumsal İktisadın Gelişiminde Coasean Düşüncenin Etkileri<sup>2</sup>

#### Abstract

Among the current trends of economics, the new institutional economics is gaining more and more importance. The characteristic of the new institutional economics is that it has integrated institutions into the research field of economics. With the new institutional economics, the research field of neoclassical economics has widened, and different disciplines such as law, sociology, organizational theory and political science have started to be analyzed from an economic perspective. Although the new institutional economics started to develop in the 1970s, its origins can be traced back to Coase's paper on "The Nature of the Firm". As stated by Williamson, one of the leading theorists of the new institutional economics, it continues to develop in two aspects. First, it focuses on governance structure and contributes to the development of transaction cost economics. Second, it deals with institutional environment and provides a basis for the economics of property rights. This study will discuss the ideas of Coase, known as the founder of the new institutional economics, and also the contributions of his studies to the development of the new institutional economics.

**Keywords** : Ronald H. Coase, New Institutional Economics, Transaction Cost Economics, Property Rights, Comparative Institutional Analysis.

**JEL Classification Codes** : B25, D23, K11.

#### Öz

Günümüzdeki iktisadi eğilimler içerisinde Yeni Kurumsal İktisat yaklaşımı giderek daha fazla önem kazanmaktadır. Yeni Kurumsal İktisadın belirleyici niteliği kurumları iktisadın inceleme alanına sokmuş olmasıdır. Yeni Kurumsal İktisat ile birlikte neo-klasik iktisadın inceleme alanı genişlemiş; hukuk, sosyoloji, örgüt teorisi ve siyaset bilimi gibi farklı bilim dalları iktisadi perspektiften incelenmeye başlanmıştır. Yeni Kurumsal İktisadın gelişimi 1970'li yıllarda başlamış olmakla birlikte; kökenleri Coase'un "The Nature of the Firm" isimli çalışmasına kadar götürülebilir.

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Yeni Kurumsal İktisat'ın öncü isimlerinden Williamson tarafından da belirtildiği üzere Yeni Kurumsal İktisat iki koldan açılımını sürdürmektedir. İlki yönetim yapıları üzerine odaklanmakta ve işlem maliyetleri İktisadının gelişmesine katkı sağlamaktadır. İkinci kol ise kurumsal çevreyle ilgilenmekte ve mülkiyet hakları İktisadına temel oluşturmaktadır. Bu çalışmada Yeni Kurumsal İktisat'ın kurucusu olarak da bilinen Coase'un düşünceleri ve çalışmalarının Yeni Kurumsal İktisadın gelişmesinde yol açtığı katkılar tartışılacaktır.

**Anahtar Sözcükler** : Ronald H. Coase, Yeni Kurumsal İktisat, İşlem Maliyetleri İktisadı, Mülkiyet Hakları, Karşılaştırmalı Kurumlar Analizi.

## 1. Introduction

The effects of Coase's studies can be obviously observed on the origins of the new institutional economics that gathered momentum in the economic literature in the 1970s. Two papers of Coase, in particular, played an important role in shaping of the new institutional economics. With his first paper "The Nature of the Firm (1937)", the concept of transaction costs which was ignored in the neo-classical economics up to that time was included into the analysis. This paper analyzed the theory of the firm that turns inputs into outputs and emphasized that the firm was not a black box as it was previously accepted in the neoclassical economics and that the firm and the market were alternative to each other to decrease the transaction costs. Although Coase carried out this analysis in 1937, this issue was neglected by the economists for a long period of time. In the 1970s, though, the studies of Williamson (1975) showed the importance of the analysis of Coase and contributed to the development of the transaction cost economics as a branch of the new institutional economics.

In Coase's analysis, the concept of the firm is seen as a phenomenon that mainly resulted from production costs and is associated with the rational choice of entrepreneurs against the burdens of bearing especially contract costs. Chiefly based on a wide acceptance of the propositions of the neoclassical economics, this approach moved away from the claims of the trends later described as "Old Institutional Economics"<sup>3</sup> to use historical-social methods. This approach contributed to the analysis of such subjects as organizational analysis, executive behaviours, and the qualities of contracts, and capital ownership that were neglected by micro-economics, a branch of the neoclassical

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<sup>3</sup> Şenalp (2007) claims that this approach that clearly separated itself from the "methodological limitations" of the orthodoxies in economics should be defined as the "Old Institutional Economics", and Veblen, Commons and Galbraith are among the commentators of this approach. This historical differentiation should not mean that the effect of the origin out of the "new institutional economics" is seen as a separate school of thought since the beginning. The reason why the differentiation of the new and the old is reproduced within the trends out of the mainstream economics is a consequence of the acceptance of the differentiations of firstly Williamson (1975) and then of Hodgson (1989: 2000).

economics, with the methods of the mainstream economics<sup>4</sup>. In this regard, Coase's thought refers to a trend enriching the uniformitarianism of the economic analysis in especially the production relations, and Coase was awarded the Nobel Prize in Economics with his explanatory analysis on the concept of transaction costs (Posner, 1993).

"The Problem of Social Cost" (1960) is Coase's second well-known paper that contributed to the development of the new institutional economics and showed that transaction costs had an important economic impact. With this paper, the role of the law in the economic analysis started to be analyzed. When transactions are carried out without any cost as claimed by the neoclassical economics, it does not matter whom the property determined by the laws and traditions will be allocated to. In the real world where carrying out transactions has a cost, though, laws have a decisive role in determining property.

The most significant contribution of the new institutional economics is that it integrated the institutions neglected in the neoclassical economics into the economic analysis. With these two well-known papers "The Nature of the Firm" and "The Problem of Social Cost", Coase included the institutions, transaction costs, and law into the economic analysis, which made him one leading theorists of the "New Institutional Economics". This study will discuss the contributions of Coase's especially the most prominent two papers to the new institutional economics. It will first focus on the development of the new institutional economics in the 1970s, followed by the discussion on the nature of the firms and transaction cost economics. Finally, it will analyze the problem of social cost and property.

## **2. The Development of the New Institutional Economics in the 1970s**

The new institutional economics<sup>5</sup> started to gain importance in the mainstream economics in the 1970s. According to Klein (1998: 1), the new institutional economics is an interdisciplinary field assembly several disciplines such as economics, law, sociology and political science in order to analyze social, political and commercial institutions. The aim of the new institutional economics is to clarify what institutions that were not attached importance in the neoclassical economics are, how they emerged, which objective they tend and how they evolved. In this regard, institutions are the "actors" of the economics as much as the rational individuals and have an important role in shaping the economic relations. Moreover, institutions, as actors stating their choices, influence how the decisions and choices of rational individuals are shaped. Thus, the impacts and the features of institutions are so important and decisive that they can not be neglected.

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<sup>4</sup> Coase's ideas that affected and enriched the economics of the firm can be found in Medema's compilation (1995).

<sup>5</sup> The concept of "new institutional economics" was first used by Williamson (1975).

Although the new institutional economics accepts some specific assumptions of the neoclassical economics like scarcity and competition, it differs in some aspects (Çetin, 2012: 49). In neoclassical economics, markets are perfectly competitive. As a natural consequence of this, market entrance and exits are easy; products are homogenous; and there is perfect information among actors. Also, there is unbounded rationality (Parisi, 1999: 9). The new institutional economics, however, points out that there occurs different degrees among actors and draws the attention to the concept of "bounded rationality" in making choices that results from the information resources. One of the most important foundations of the new institutional economics is that there may be some differences in the qualities of economic actors in terms of accessing information and using this information rationally. The differences in degrees naturally lead to a distant approach to other assumptions of the neoclassical economics. The second important difference of the new institutional economics is that the implementation phase of the contracts that shape economic relations is problematized. Since economic actors usually have asymmetric information while implementing contracts, the potential of opportunist behavior to emerge should not be ignored. Thirdly, asset specificity should be added to the model. Actors are considered anonymous in economic transactions by the neoclassical economics while the new institutional economics claims that the identity of actors is quite decisive in transactions where specific assets are significant. In transactions where some specific assets are important, the problem is generally resolved with hierarchical relations among firms since rent or cheat cannot be prevented. In such a case, an approach considering the power relations among firms becomes critical in understanding how the market functions (Williamson, 2000: 605-606; Yılmaz, 2002: 74-75). Taking these three factors into consideration, it requires governance solution. In this regard, the new institutional economics tries to explain how institutions as governance structure can be used as transaction cost decreasing tools in a world characterized with "ex-post opportunism" and "ex-ante cognitive imperfections" (Parisi, 1999: 9).

The new institutional economics actually became known in the 1970s with the studies referring to the importance of the analysis of Coase on transaction costs. Coase's paper "The Nature of the Firm" did not arouse enough curiosity up to that time (Medema, 1994: 27). According to Coase (1988a: 35), the paper "The Problem of Social Cost" published in the *Journal of Law and Economics* in 1960 and the studies of Williamson contributed greatly to his paper's becoming known.

Coase's papers "The Nature of the Firm" and "The Problem of Social Cost" influenced the theoretical trends in the new institutional economics, helping the new institutional economics develop in two main aspects. First, it deals with the governance structure founded on Coase's paper "The Nature of the Firm". Governance structure, or organizations as called by North (1992: 4), are players that come together to realize the same goal. Political parties, firms, and trade associations can be given as examples to governance structure. Second, the new institutional economics related institutional environment, and its origins trace to Coase's paper "The Problem of Social Cost" (Williamson, 1998a: 24; Şenalp, 2007: 72). Dealing with the rules of the game,

institutional environment shapes individual behaviours in a sense. Institutions are made up of both formal and informal rules. Law, property rights are the examples of formal rules while social traditions and norms are examples of the informal ones (Klein, 1998: 3; North, 1992: 4). In both papers, the meaning of the concept of "transaction costs" should be carefully considered (Medema, 1994: 28). In Coase's paper "The Nature of The Firm", when transaction costs are not included into the analysis, the reasons for the firm's existence disappear. In his other paper "The Problem of Social Cost", it can be concluded that the law does not have a function of solving various problems if the analysis does not start with transaction costs. Although the structure of the discussion is the same in both of his studies, the methods used to solve the factors causing the problem of transaction costs are different. In the first paper, transaction costs are used to explain the reason for the firm's existence while the second one uses the concept of the transaction costs to show how the legal system affects the functioning of economic system (Coase, 1988a: 34). This study has carried out an analysis by taking both of these classifications into consideration.

### **3. The Nature of the Firm and Transaction Cost Economics**

The firm regarded in the neoclassical economics as only a black box turning inputs into outputs was included into the economic analysis with Coase's paper "The Nature of the Firm". This paper tried to answer the following questions within the market functioning, which were difficult for the neoclassical economics to answer: "*Why does the firm exist?*", "*Why is a production activity not organized by a big firm?*", "*What are the factors setting the limits of the firm?*" (Williamson, 1998b: 123). Within this scope, we should firstly focus on the first question "*Why does the firm exist?*".

While the concept of the "firm" is analyzed in the new institutional economics, Coase's approach in his paper "The Nature of the Firm" is attached great importance. According to Coase (1937), using the price mechanism is not costless, which explains the reason for the firm's existence. This explanation rejects the assumption that prices are known by everybody, which was a dominant assumption until then (Medema, 1994: 17). Coase tries to explain the fact that the limits of the organization do not only depend on the given technology but also on transaction costs. According to Coase's approach, deciding where to carry out transactions, in the firm or in the market, depends on internal and external exchange costs. The market mechanism includes some costs like setting, negotiating, and applying prices. However, the organizations within the firm have some specific costs although the entrepreneur can decrease transaction costs by coordinating the activities himself. They are made up of problems mainly related to production such as the problem of information flow, monitoring and auditing problems. From this perspective, a comparison of the costs gives the answer to the question why firms should be regarded as market institutions. With the paper "The Nature of the Firm", Coase emphasized that the market and the firm are institutions alternative to each other and that it is necessary to compare the costs of organizing transactions within the scope of alternative institutional arrangements (Klein, 1998: 11).

In the mainstream theory of economics, the economic system is coordinated by the price mechanism. However, according to Coase (1937: 387), when an employee wants to change his department from Y to X, this does not result from the changes of relative price; the employee may have to change his department because the management wants this change. As obviously seen in this example, the price mechanism is not the only tool coordinating the economic system. Resources are allocated via the price mechanism in the market while this allocation is determined by various rules defined as "hierarchy" in the firm (Coase, 1937: 390). According to Coase, the market and the firm are alternative to each other.

It is possible to answer the question "*Why is a production activity not organized by a big firm?*", referring to Coase's paper (1937: 394-95) as follows: Firstly, the managerial costs increase as the the firm grows. Secondly, the entrepreneur cannot use production factors efficiently as the transaction costs increase. Finally, small-scaled firms can decrease the supply prices of production factors by benefiting from the inverse advantages in contrast to the ones of their scale. What creates these advantages is mainly shaped by the assumptions that small-scaled firms may have higher managerial rationality. The factors mentioned above indicate that entrepreneurs will try to decrease costs via firms, but avoiding costs via firms has some problems.

The answer to this question "*What are the factors setting the limits of the firm?*" lies on whether the cost of carrying out an additional transaction in the firm, will exceed the cost when it is carried out by the market or a different firm. As long as this transaction is carried out by the firm at a lower cost than in the market, the firm will keep growing (Coase, 1988b: 19).

It should not be thought that the firm has an exact impact on reducing costs. In some cases, the price movements out of the firm lead the production in the market via exchange costs. The entrepreneur has limited initiative for bearing the costs emerging at this point. The transactions within the firm, however, can be organized by the entrepreneur. By this way, two different cost systems developing as alternative to each other ensure effectiveness. In other words, the firm and the market should be regarded as alternative institutions to coordinate production (Coase, 1937: 388). The firm, regarded as the production function in the neoclassical economics, went beyond this standard scope with Coase's analysis. Although the analysis of Coase did not arouse much interest until the 1970s, it made a great contribution to the development of transaction cost economics together with the studies of Williamson. Within the scope of the transaction cost economics, the firm is regarded as the organizational structure and compares the institutional structures within the alternative governance structures (Williamson, 1998b: 123).

Williamson (1975: 3-4) argues that the framework drawn by Coase may be logical in evaluating firms according to the advantages that result from steering transaction costs. According to this, the real strategy of firms depends on the choice between the

internalization of the contract type and the internalization of the relevant transaction within the firm (Yılmaz, 2002: 72). From this perspective, Williamson who developed the analysis of Coase and other new institutional economists see the firm not only as a production function but also as a complex type of contracts and a governing structure alternative to the market (Parisi, 1999: 8). The approach of transaction costs that analyzes institutional arrangements puts emphasis on governance costs. According to this approach, a specific mechanism is required for protecting the parties carrying out a transaction from several threats even for simple transactions. Williamson defines this as "governance structure". The suitable governance structure adherence the structure of the transaction. This shows that transaction cost approach applies to comparative contractual analysis. Because of this, transaction cost approach is from time to time seen as the governance branch of the new institutional economics (Klein, 1998: 13). What has shown the importance of transaction cost economics for the new institutional economics is that production costs indicate technical choices while transaction costs have clarified which stages of production process are to be institutionalized by the price system and which ones by the firm. By this way, transaction costs form a framework of the new institutional economics for the functioning of organizations. This, however, does not mean that costs can be analyzed at the same level. These two different costs are analyzed in a complementary way despite their being different from each other (Langlois, 1998: 4).

#### **4. The Problem of Social Cost and Property**

"The Problem of Social Cost" is Coase's another paper that played an important role in the development of the new institutional economics. With this paper, the function of the law to regulate the economic structure, which was neglected in the modern economic analysis, was put under analysis. According to Coase, law plays an important role in regulating and expanding the market, and what is traded in the market is the "bundles of rights" rather than the physical goods. Trade and how trade is carried out can be analyzed within the scope of the rights and the duties of individuals and institutions. The allocation of rights is determined by the legal system. Based on this, Coase claims that the legal system has a deep impact on the functioning of the economic system (Zerbe & Medema, 1998: 218-219).

The issue of property is a part of the economic system on which legal liabilities are the most decisive. Property mainly refers to the "bundle of rights". These rights determine how individuals will use the resources they own. These rights can adopt to the conditions of the time and change from one generation to the other instead of remaining unchanged (Cooter & Ulen, 2004: 77). "A Property right means that people have the right to use the resources belonging to another person but with the permission of the owner" (Alchian, 1965: 195)." In other words, property rights are the rights of individuals to use resources. These rights are designed not only by laws but traditions also play a role (Alessi & Staaf, 1989: 179). The effect of social traditions and rules of good manners on the design of property rights is as important as the effect of the legal system (Alchian, 1965: 194).

Armen Alchian's study "Some Economics of Property Rights" and Harold Demsetz's study "Towards a Theory of Property Rights", in particular, affected the development of the property rights economics. According to the common view of the property rights approach, "property rights are developed in order to internalize the externalities when the benefits from the internalization of externalities is higher than the cost of internalization". Similar opinions were developed by Coase in his paper "Federal Communications Commission". According to Coase, the definition of property rights is required for transactions to be carried out in the market. One goal of the legal system is to definitely determine how rights are to be traded and reallocated in the market. (Williamson, 1995: 252-253). Actually, Coase analyzed the views he stated in the paper "Federal Communications Commission" more systematically in his paper "The Problem of Social Cost" (Parisi, 1999: 11). It should be noted that Coase's papers inspired other studies which were important to the development of property rights.

The idea that externalities can be solved via the market was not analyzed in the neoclassical economics prior to Coase's paper "Social Cost Problem" because of the traditional externalities approach (Parisi, 1999: 12-13). According to the analysis of Pigou that was quite influential on the traditional approach, that one party gives harm to the other forms the basis of the problem while the concept of externalities is analyzed. For the party that causes harm, there is a difference between marginal private product and marginal social product. According to Pigou, this difference can be resolved either by the compensation of the damage from the party causing harm, by the taxes paid or by the regulations of the government. The analysis of Pigou does not consider the choice of the victims' intervention even if they can compensate the damage at a lower cost (Medema, 1994: 79; Demir, 1996: 231-232). According to *Coase*, though, externalities occur not because one party inflicts harm on the other but because the behaviours of the parties conflict. In other words, within the scope of the analysis of Coase on the problem of negative externalities, it is better to think that the problem results from ill-defined rights than to see parties as an injurer and a victim (Butler & Garnett, 2003: 133-134). The "reciprocal nature" of the problem becomes more of an issue in this case.

*"From the traditional perspective, the problem is that A inflicts harm on B and the decision to be taken should be how to restrict A. However, what is missed here is that the disagreement has a reciprocal nature. Avoiding the harm to B may inflict harm on A. The main problem that has to be decided is: Should A or B be allowed to give harm to the other one? What is actually important is to avoid causing more harm."* (Coase, 1960: 2)

Coase refers to two important points that should be thought separately. The first one is the "dual nature of rights" while the second one is the "allocation of rights in a way to minimize the harm" (Medema, 1994: 68). These two points emphasize the possibility of achieving an effective result via the choice of mutual agreement. However, reaching a solution via mutual agreements is left out by the neoclassical theory.

Coase (1960: 6) starts the analysis by dealing with the reciprocal nature of the problem. Then he states that if the pricing system works well or without cost in the absence of transaction costs, the resource allocation will be the same whether the party causing the harm is held liable for the harm or not. The well-known example of Coase given to explain this case, also known as Coase Theorem, is on the relation of externalities between a cattle raiser and a farmer residing on a neighborhood property. We can take the following case as an example. The cattle raiser and the farmer have adjacent properties, and there is not a fence between their properties. When the profit the cattle raiser will make from having one more cattle is 50\$ and the loss of the farmer because of this extra cattle is 60\$, the farmer will offer to pay the cattle raiser the loss of 60\$ if the cattle raiser is not liable for the loss. The cattle raiser will accept this offer as long as the farmer's offer is more than 50\$ since he will get also make profit. The same result is expected even if the cattle raiser is liable for the loss. The cattle raiser will make a profit of 50\$ by increasing the number of his cattles but have to pay the farmer 60\$ as he is liable for the loss. In this case, it is more rational for the cattle raiser not to increase the number of his cattles (Demsetz, 1972: 14-15). The price of the payment, in this case, depends on the abilities of the parties to negotiate. Such an agreement does not affect the resource allocation but change the income and wealth allocation between the cattle raiser and the farmer (Coase, 1960: 5). When the transaction costs are low, it is not important which party is held liable. What is highly important is to determine whom the property belongs to since everyone is allowed to use the property as they want if the property rights of the land are not clearly determined, and this leads to a confusion. The solution to this problem lies on the property rights determined by the legal system. Thanks to the legally-assigned property rights, an individual who wants to use the resource pays the owner to get this resource, which ends the confusion (Coase, 1959: 14).

It is, however, important to emphasize that property rights determine whom the right belongs to at the beginning. If the parties can agree without any cost, there is not a need for the governmental intervention since the allocation of rights does not have an impact on the efficiency when carrying out transactions does not have any cost. One point that Coase emphasizes is the possibility of reaching an effective result without any intervention thanks to the mutual agreement of the parties on the property (Calabresi & Melamed, 1972: 1094-95).

In the real world, however, transactions have a cost, which means the parties cannot achieve efficiency by making an agreement. The costs that will prevent making an agreement may result from research cost, bargaining cost or implementation cost (Oğuz, 2003: 27). When there is one of these costs, shortly called transaction costs, to whom the property right will be allocated by the law is of great importance. In other words, "when transaction costs are zero, the allocation of resources is independent of the legal position while the law plays a key role in deciding how the resources will be used when the transaction costs are positive" (Coase, 1988c: 178). When transactions are carried out without any cost, the result that the neoclassical economics suggests is achieved. Carrying out a transaction in the real world has a cost, though. Because of this, "institutions and

particularly property rights" have an important role in the market efficiency (North, 1992: 4). The analysis of Coase shows that Pigovian solutions are not necessary when the assumptions of the analysis of the neoclassical economics are valid. In the real world, where transactions have costs, it is more possible to achieve a more effective result in solving the problem of externalities with the determination of property rights rather than Pigovian solutions like tax and regulation. In short, Coase, analyzing this issue from a perspective different from that of Pigou, thinks that it is important to choose the most appropriate solution that will help achieve efficiency by making a comparison between various social arrangements. The most important contribution of Coase who used institutions as an important part of the analysis is his introduction of comparative institutional analysis as a solution to the problem of negative externalities (Medema, 1994: 94; Samuels & Medema, 1998: 161-62).

According to Coase, the main issue of economic policy should be to analyze how alternative social institutions work. This will make it possible to compare the total effects of social institutions by evaluating their working performance. It can be argued that the analysis of Coase has four key elements. First, it reveals the reciprocal nature of the problem by pointing out that both parties can lead to harm when there is an externality problem. Because of this, his analysis shows a total approach. Second, he emphasizes a realistic approach. According to Coase, in the analysis of a standard economic policy, ideal cases are analyzed rather than the real world. What is more important to Coase is that economists should leave the "blackboard economics" and explore what happens in the real world. Third, his analysis includes a "comperative institutional analysis". This analysis points out that it is important to consider all the alternatives while solving the problem of externalities. Finally, profit-cost analysis plays an important role. Coase argues that it is important to choose the least-cost solution among all alternatives at this point (Samuelson & Medema, 1998: 163-166).

## 5. Conclusion

It can be argued that Coase is the founder of the new institutional economics that started to gain importance in the 1970s. The new institutional economics is composed of several sub-branches. This study, though, discusses the papers of Coase and the contributions of his studies to the new institutional economics. Coase's paper "The Nature of the Firm" was the inspiration for the transaction cost economics while his paper "The Problem of Social Cost" analyzed the importance of the law for the economic analysis. Thus, led to the development of new fields like the law and economics and economics of property rights. From the perspective of Coase, the concept of property rights forms the basis for the relation between law and economics. The inspiration Coase gave to the new institutional economics becomes more meaningful within this scope.

In his paper "The Nature of the Firm", Coase explained the reason for the firm's existence based on transaction costs. In the neoclassical economics, carrying out transactions does not have any cost. On the contrary, the reason for an organization's

existence like the firm was not explained. From the perspective of Coase, economics gains its real importance when it only deals with the relations in the real world. In this regard, explaining the firm which is a decisive factor in economic relations in daily life becomes vital. From Coase's perspective, the firm has greater potential to offer more effective alternatives to the problem of transaction costs than the market does. This shows that the first step of the entrepreneurs in economic activities is to establish such organizations. It is wrong, however, to think that firms are in a totally privileged position about cost advantages. What "comperative institutional approach" requires is to consider low-cost alternatives. Coase's approach that puts the firm against transaction costs in the market has become one of the main issues of the new institutional economics thanks to the analysis of Williamson. It is essential to emphasize this contribution as it helped lay the theoretical foundation of the transaction cost economics, which is today regarded as a subfield of economics.

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