Abstract

This paper uses the farmer-rancher example of nuisance law from Ronald Coase’s seminal paper, “The Problem of Social Costs,” to illustrate how mechanism design provides a very general approach to deriving legal rules and institutions that implement social objectives as equilibrium outcomes of legal interactions among strategic individuals with private information. Mechanism design provides a new paradigm for Law and Economics that encompasses the Pigouvian-social-planner and Coasean-transaction-cost paradigms as special cases, while providing a rigorous framework for introducing modern theoretical techniques and results. The framework accommodates different social objectives, alternative equilibrium concepts, heterogeneous agents with private information, endogenous “transaction” costs, incentive compatibility and voluntary participation. It derives legal rules and institutions as endogenous solutions to mechanism design problems. These features address many of the shortcomings identified with previous paradigms. The new paradigm tests the robustness of previous results to more sophisticated economic environments. While it is unlikely that everyone will embrace the mechanism design paradigm, it is desirable to have a branch of Law and Economics with an exacting theoretical foundation.