

The Moral Cost of the Coase Theorem

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In “The Problem of Social Cost” Ronald Coase argues that if property rights are well-defined, and if the transaction costs associated with trading property rights are negligible, rights over resources will be traded until each resource ends up in the hands of whoever values it most.¹ In consequence, each resource will be put to its most economically productive use. This insight is commonly referred to as the Coase Theorem. The upshot of the Coase Theorem is that private contracts between owners can sometimes maximize economic efficiency even in the presence of externalities and in the absence of government intervention.

As a descriptive claim, the Coase Theorem is an interesting curiosity of microeconomic analysis. As a guiding principle for public policy, however, the Coase Theorem is seriously inadequate. This essay argues that Ronald Coase’s innovative approach to the problem of externalities subverts the moral basis of personal and property rights by undermining our core concept of responsibility. It further attempts to show that the Coase Theorem relies on its own concealed (and controversial) normative assumptions about the function of laws that regulate economic transactions. These assumptions, it is argued, are deeply incompatible with a liberal or libertarian conception of property rights.²

¹ The transaction costs Coase considers include the time and money it takes to negotiate contracts, and the costs normally associated with moving your residence or business.

² Throughout I use the terms “liberal” and “libertarian” synonymously to designate a standard Lockean theory of rights.

Externalities

Externalities occur whenever one person's action affects the utility of another person.³ Although these effects can be positive, I follow Coase in focusing mainly on the negative variety. Negative externalities are *economically* significant to the extent that manufacturers fail to factor them into the cost of producing a good. If it costs nothing for a coal factory to expel mercury into the atmosphere, the cost of producing and consuming coal will be less than it would be were it to include the negative health effects it has on those who live near the factory.

From the standpoint of consumers, when negative externalities are not factored into the cost of producing a good, they fail to be reflected in the price of goods. Hence, those who choose to purchase such goods do so at the expense of those who don't. For example, a driver's decision to buy (and burn) oil results in air pollution that affects the utility of a biker; but if the cost of oil fails to include the negative effects on the biker's lungs, the driver's economic decision has, in effect, been subsidized by the biker.

Externalities are also *morally* significant, since they involve one person's action (inadvertently) benefiting or harming other people. Although all negative externalities *harm* others, they are not always morally significant. This is true for two reasons: first, the harms produced by choosing X rather than Y are not always foreseeable; second, not all harms (including foreseeable harms) violate the rights of others. Consequently, we should not expect all negative externalities to require remediation. For example, your invention of a superior influenza vaccine does not violate the rights of other drug manufacturers, even if they lose market share as a consequence of your innovation. Nevertheless, many

³ See, for instance, Tyler Cowen, *The Theory of Market Failure*, p. 2.

negative externalities do involve significant harm to others and would therefore seem to fall into the domain of moral philosophy as well as economics. If Coase is right, however, this line of reasoning is mistaken.

The Pigovian Approach to Externalities

According to the influential welfare economist Arthur Pigou, externalities occur when “one person A, in the course of rendering some service, for which payment is made, to a second person B, incidentally also renders services or disservices to other persons...of such a sort that payments cannot be extracted from the benefited parties or compensation enforced on behalf of the injured parties.”⁴ If the problem of externalities consists in uncompensated services or disservices rendered to third parties, Pigou’s solution consists in placing taxes and “bounties” (or subsidies) on goods whose manufacture or consumption produces externalities. Examples Pigou gives include the taxes placed on British petrol to offset the social costs of road deterioration (a negative externality of driving), and the subsidies given to German farmers in order to maintain a hardy class of men fit for war (a positive externality of hard labor).

“The Problem of Social Cost” was conceived by Coase primarily as a response to Pigou’s treatment of externalities. Although Coase agreed with the way Pigou framed the issue, he argued that Pigou was too optimistic about the efficacy of state solutions to the efficiency problems posed by externalities. Pigou recognized that in many situations in which each acts in his own interest, a collective side effect can be a diminished social product.⁵ For example, in the absence of incentives to join the military, even the most patriotic person has no

⁴ Ibid, p. 183.

⁵ Externalities occur in public goods cases because such goods are *nonexcludable*, thus allowing non-contributors to benefit from them.

instrumental reason to enlist, since he alone is unlikely to make any difference in whether his country is adequately defended. Since others also understand the negligible effect of their individual enlistment, an adequate military will not be provided without further inducements. While many have taken such cases to suggest the need for central governments to provide public goods (such as police and military forces) and to prevent public bads (such as mercury contamination in drinking water), Pigou seems to advocate much more extensive state interference in response to externalities. According to Pigou:

It is as idle to expect a well-planned town to result from the independent activities of isolated speculators as it would be to expect a satisfactory picture to result if each separate square of inch were painted by an independent artist. No “invisible hand” can be relied on to produce a good arrangement of the whole from a combination of separate treatments of the parts. It is, therefore, necessary that an authority of wider reach should intervene and should tackle the collective problems of beauty, of air and of light, as those other collective problems of gas and water have been tackled.

Such remarks have suggested to some that Pigou advocated extensive state intervention to “internalize” externality problems through taxes and subsidies. Whatever the merits of this interpretation, it is important to emphasize that while Pigou tends to focus on externalities associated with the provision of public goods (such as parks and lighthouses) and the avoidance of public bads (such as automobile pollution and road congestion), in “The Problem of Social Cost” Coase focuses on hypothetical negative externalities in which the victims are few and easy to identify, the value of damage is clear, and negotiations are costless.⁶

⁶ For a more detailed study of the differences between Coase and Pigou, see H. Demsetz, “The Core Disagreement between Pigou, the Profession, and Coase in the analysis of the externality question.” *European Journal of Political Economy*, vol. 12 (1996).

The Coasean Approach to Externalities

Coase follows the Pigovian tradition of framing the problem of externalities in terms of a divergence between the *private* costs of production and its (often unintended) *social* costs.⁷ On this view, the problem of *negative* externalities in particular is not that they sometimes lead to individual rights violations by imposing uncompensated harms on third parties, but rather that they decrease social welfare. In fact, Coase explicitly endorses Pigou's assumption that "the aim of economic policy is to ensure that people, when deciding which course of action to take, choose that which brings about the best outcome for the system as a whole...I have assumed that this is equivalent to maximizing the value of total production (and in this I am Pigovian)."⁸

Although Pigou sought to maximize what he called the "national dividend" rather than the "social product" or "value of total production," these are different expressions for the same concept: *economic efficiency*. Economic efficiency in this technical sense is maximized when the resources of a group or country are put to their most "valued" or economically productive use (the *value* of a resource is determined by how much the highest bidder is willing to pay for that resource on a free market). Since both Pigou and Coase take economic efficiency as an index of social welfare, and since both presume that the aim of

⁷ According to Richard Posner, "a social cost diminishes the wealth of society; a private cost rearranges that wealth." *Economic Analysis of Law* 6th ed. (New York: Aspen Publishers, 2003), p. 6.

⁸ *The Firm, the Market, and the Law*, p. 27. It should be obvious that this criterion for policymaking is roughly equivalent to (and faces similar objections as) what Sidgwick calls 'government house' utilitarianism.

economic policy is ultimately to advance social welfare, the problem posed by externalities is their tendency to bring about a suboptimal level of social welfare.⁹

How, exactly, do externalities decrease economic efficiency? *Negative* externalities can decrease efficiency by creating a disparity between the price someone actually *does* pay for a resource, and what she *would* pay in the absence of costs imposed by the externality. For example, if I pay \$300K for a home near an un-owned fresh water source that I expect to use for recreational fishing, and my neighbor decides the following year to add mercury or arsenic to the water in order to study how quickly he can induce genetic mutations in the local fish population, I have paid “too much” for the house. This is because, legal issues aside, my willingness to pay \$300K for the house partly depended on the fresh water and healthy fish stock it afforded me.

Positive externalities can also decrease economic efficiency when the unintended beneficiaries of goods and services do not pay as much for them as they would if the producer could identify and charge those whom he benefits. For example, American taxpayers fund medical research that benefits the entire world, but American taxpayers often go uncompensated for the fruit of such research by residents of other countries (or by Americans who do not pay taxes but are legally entitled to health benefits). Yet these beneficiaries would sometimes opt to buy the benefits if they faced a choice of either buying them at some price (however minimal) or forgoing them altogether. When this is the case, positive externalities decrease economic efficiency.

The Coase approach to negative externalities is to ask whether the external costs to those affected might be internalized through a voluntary exchange of

⁹ Pigou is slightly more skeptical than Coase of using economic efficiency (as measured by the “national dividend”) as a strict index of social welfare. See his discussion in chapter one of *The Economics of Welfare*, 4th ed.

resources, or rights over resources, rather than through subsidies and taxes imposed by the state. Coase's great insight is that when transactions are costless and when people are legally entitled to exchange rights over resources, the resources will eventually end up in the hands of those willing to pay the most for them, regardless of the initial assignment of property rights.

The most notorious example with which Coase illustrates his insight involves two neighbors, a cattle rancher and a farmer who raises crops. As a normal part of their grazing, the rancher's cattle stray into the farmer's territory and destroy his crops. This is presumably conceived by Coase as a negative externality rather than outright aggression against the farmer's crops because it is unintended by the rancher. According to Coase, there is no need for public intervention to solve the problem, so long as property rights are well-defined. If the farmer owns the right to untrammelled land, then he will either be able to induce the rancher to fence his cattle in to prevent them from roaming, or he will negotiate a settlement whereby the cattle are allowed to trample his crops, so long as the cattle-raiser pays him a sum greater than or equal to that which he expects to gain by growing crops on that patch of land.

Alternatively, if the rancher has the legal right to let his cows roam freely, including outside the boundaries of his ranch, the farmer will negotiate with the rancher and will presumably either pay him to erect a fence, or will simply abandon cultivating the plot of his farm on which the cattle routinely stray. Whatever the initial assignment of rights, the outcome (in terms of how the land is used) is identical, since it is determined by what each of the two neighbors is willing to pay for its use (given what they expect to gain from using it). In such cases, the externality is internalized by the parties involved without the need for state intervention. Thus, in the absence of transaction costs, and where the victims of externalities are easily identifiable, the Coase Theorem implies that the

parties will reach a mutually beneficial agreement regardless of the initial specification of property rights.¹⁰

The Coase Theorem can be interpreted in three distinct ways: (1) as a descriptive theorem of microeconomics; (2) as an empirical generalization about the criterion many judges have used to decide common law cases involving externalities and property rights; (3) as a norm meant to guide public policy and judicial decision making. Coase himself clearly applies his eponymous theorem in all three ways in his essay.¹¹ But it is only in its third (normative) sense that it is philosophically problematic.

Harm and Responsibility

In “The Problem of Social Cost” Coase renounces the language of responsibility for causing harm in favor of a metaphysically and morally neutral vocabulary:

The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is, How should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would be to inflict harm on A. The real question that has to be decided is, Should A be allowed to harm B or should B be allowed to harm A?¹²

In this oft-quoted passage, Coase seems to either reject the idea of responsibility at the core of Pigou’s analysis, or to dismiss the relevance of the fundamentally *evaluative* concept of responsibility to what he considers a purely *empirical*

¹⁰ Although mutually beneficial agreements are always Pareto efficient, this example shows why using Pareto efficiency as a basis for public policy can mask serious moral rights violations. This is the case whenever the allocation of resources (or rights over resources) from which Pareto improvements take place is itself unjust.

¹¹ Some of Coase’s followers seem to suggest that the truth of the Coase Theorem in the first two senses defined above *justifies* its use as a normative principle. See Harold Demsetz, “Ethics and Efficiency in Property Rights” in *Time, Uncertainty, and Disequilibrium*, p. 110.

¹² Ibid, p. 96. By “harm” Coase means either lost income or the lost opportunity to gain income.

problem—viz. how to allocate resources between A and B in a way that maximizes economic efficiency.¹³

Coase boasts near the end of his article that he has avoided discussing evaluative concepts because they ultimately derive from metaphysical flights of fancy into an “ideal world” in which the questions “are shrouded in mystery and every man is free to draw whatever conclusion he likes.” Such speculation about “aesthetics and morals” leads to a “looseness of thought” unbecoming of an economist. “A better approach,” Coase tells us, “would seem to be to start our analysis with a situation approximating that which actually exists, to examine the effects of a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one.”¹⁴ This is one of many places in which Coase curiously follows up a dismissal of normative economics with what appears to be an equally normative alternative (calling his a “*better* approach” to the subject of how we ought to craft economic policy).

Harm as a Joint Product

In replacing the morally significant concept of *responsibility* with considerations of economic efficiency, the Coase Theorem flies in the face of how non-economists evaluate situations in which harms occur. Before criticizing Coase’s claim that “to avoid harm to B would be to inflict harm on A,” let us illustrate it with one of Coase’s own examples.

¹³ One reason Coase may be tempted to eschew responsibility is that from an economic perspective a harm done is a sunk cost. And since economic agents (or judges considering the case from an economic standpoint) are forward-looking, the question about who is to blame is naturally substituted with the question of who it would be most efficient to blame. This forward-looking, consequentialist conception of blame, however, does not merely *change* our concept of responsibility. It *destroys* it by reducing questions about liability to economic considerations.

¹⁴ Ibid, 154.

Coase considers a legal case, *Cooke v. Forbes*, in which a fabric manufacturer uses a certain bleaching agent to dye fabric, which he then hangs out to dry in the open air. Nearby, a chemical factory releases fumes into the air which interact with the bleaching agent to alter the color of the fabric after it is hung out to dry. According to Coase, it would be arbitrary to say that one of the parties caused (or was blameworthy for producing) the damage, since both the bleaching agent and the fumes had to be present in order for the fabric to be damaged.¹⁵ In other words, the harm was a joint product of the activities of each manufacturer.

In explaining Coase's reasoning with a similar case, David Friedman urges that "the first step is to realize that an external cost is not simply a cost produced by the polluter and born by the victim. In almost all cases, the cost is a result of decisions by both parties. I would not be coughing if your steel mill were not pouring out Sulfur Dioxide. But your steel mill would do no damage if I (and other people) did not happen to live down wind from it. It is the joint decision—yours to pollute and mine to live where you are polluting—that produces the cost."¹⁶

The fallacy of such reasoning is obvious to anyone outside of the Chicago School of economics: from the fact that I must exist at a particular time and place for harm to be done to me, it does not follow that I am therefore just as *responsible* for the harm as the person who inflicted it on me. All that follows is that it is a

¹⁵ Ibid, 108.

¹⁶ "The Swedes Get it Right," p. 3. As Peter Lewin puts it, "from the perspective of the Coase Theorem,...the question of responsibility for the pollution is blurred. ... The question of 'who causes the pollution?' becomes irrelevant if not meaningless, and an appropriate common law response to questions of this nature then becomes: Award the right to whichever party would have been prepared to buy it in the absence of transaction costs." "Pollution Externalities: Social Costs and Strict Liability" *Cato Journal*, vol. 2, no. 1 (Spring 1982), p. 212.

necessary condition for the occurrence of harm is that there exists both a victim and a culprit, and that the choices of each enabled harm to occur.

The devil is in the details. It is one thing if I trespass on your property, wrap my mouth around your car's tailpipe, and subsequently die of carbon monoxide poisoning. This would be a poor decision for which I am responsible. It is quite another if you erect a smokestack in my neighborhood which spews noxious gasses into the air and thereby ruin my health or damage my property. To ignore the asymmetry in such cases by arguing that protecting my lungs causes harm to the factory, is to ignore my right to breathe freely or manufacture fabric on my property without interference.¹⁷

In order to focus on the issues of responsibility and harm, and to avoid substantive disputes about the moral foundations of property rights, let us consider two stark examples.¹⁸ Although these cases are not purely monetary, they are structurally similar to the kinds of cases Coase discusses insofar as they involve uncompensated harms, and highlight the centrality of the concept of responsibility to our moral beliefs about the goal of economic and non-economic policy.

Consider first the case of a married man who sleeps with a prostitute, unwittingly contracts a venereal infection, and then transmits the infection to his wife. The infection is a negative externality of his indiscretions. It is also true that unless his wife had chosen to sleep with him, she would not have been infected. But does it follow from this, as Coase would have it, that the harm to

¹⁷ Several critics have pointed out just how deeply the Coase Theorem conflicts with a liberal conception of property rights. See especially Murray Rothbard, "Law, Property Rights, and Pollution"; Peter Lewin, *op cit*; Walter Block, "Coase and Demsetz on Private Property Rights"; Gary North, "Undermining Property Rights: Coase and Becker."

¹⁸ Coase has a tendency to use examples in which it is not immediately obvious who is the victim and who is the creator of an externality. Although there are genuinely indeterminate cases, Coase is ultimately committed to a view in which even in the clearest of cases, harm is a joint product of both the victim and perpetrator.

his wife is a joint product of her trust and his indiscretions? Or is he instead responsible for both his infidelity and his choice not to inform his wife of his infidelity? And if a friend in whom he had confided his indiscretions chose to disclose the lurid details to his wife before she contracted the infection, would we say that his friend “harmed” him by telling the truth to his wife?

We would not. For unlike Coase, we do not think that preventing harm to his wife entails inflicting harm on her husband. The reason we think this is that we hold this man responsible for both the contraction and transmission of the infection, whether or not he knew he had it. We consider him culpable – i.e. responsible – for putting himself (and his wife) at risk of contracting an infection.

Consider a second example in which responsibility makes a crucial difference in the attribution of harm. Prior to 1948, Jews in Palestine were forced to pay taxes to Muslim overseers in order to exercise their right to practice Judaism. This was done, one might say, in order to offset the “costs” to Muslims of allowing infidels to tread on hallowed ground. These *dimmi* taxes were justified not because Jews had injured Muslims by violating their personal or property rights, but rather because Jews were thought to be so depraved that their mere existence as infidels on land conquered by Muslims constituted harm to the Muslim population. The mere act of openly professing heretical beliefs generated a negative externality for devout Muslims.

Most of us find such intolerance deplorable, and consider the taxation of thoughts or beliefs a kind of extortion that violates the rights of free individuals. The party that is taxed is clearly harmed, and the party coercively collecting such taxes is responsible for this harm. Yet according to the Coase Theorem, there is no fundamental difference between assigning Muslims the right to tax Jews for their beliefs, on the one hand, and permitting Jews to either leave their ancestral homeland or to accede to the tax, on the other. The only reason for a Coasean

policy-maker to assign A the right to tax B's beliefs or B the right to freely hold his beliefs is if that assignment of rights is more economically efficient.

Although such examples show just how worthless the goal of maximizing a social product is to a persecuted minority, the main point is that without the idea of responsibility, Coase has no way of deciding such cases except to ask which party (or group) is willing to pay more—the person who is willing to pay a fine for the right to hold an unorthodox belief or the person who prefers that nobody holds beliefs he considers abominable.

The Priority of Rights

In cases of small-scale externalities in which the parties are few, the effects are localized, and transactions are costless, Coase proclaims that it is “obviously desirable” that the externalities be internalized by the parties, rather than through state intervention.¹⁹ The rationale for this is that the function of public policy is to maximize social wealth, or economic efficiency, rather than to punish those who are responsible for harming others. Indeed, Coase makes it clear that “[t]he economic problem in all cases of harmful effects is how to maximize the value of production.”²⁰

Coase takes his understanding of the proper role of government in crafting economic policy as self-evident. But libertarians will beg to differ. For Coase the problem of externalities, and the consequent problem of resolving property rights disputes, is merely one aspect of the problem of inefficiently allocated resources. We should assign rights over resources in whatever way is expected to maximize the value of production. For libertarians the problem of externalities instead concerns how to stop some people from violating the rights

¹⁹ *The Firm, The Market, and the Law*, p. 27

²⁰ *Ibid*, p. 114.

of others. From a standpoint in which property rights are treated as moral claims rather than legal instruments for the maximization of social wealth, externalities are only problematic insofar as they violate the person or property of others. In order to decipher the victim from the violator of rights, however, we need to retrieve the concept of moral responsibility that Coase eschews. We must also make our own normative assumptions explicit.

As Murray Rothbard argues, libertarians hold that “the major function of government—of courts and police—is to stop aggression” against the rights of others.²¹ If your cattle-ranching neighbor runs a more efficient operation than your own farm and consequently diminishes your ability to turn a profit by selling cattle, that is his business. The successful entrepreneur may (in some sense) harm his less successful competitors, but he does not *ipso facto* violate their rights. If instead he achieves success by allowing his cattle to feed from your land, that is your business, even if by permitting his cattle to stray on your land he happens to be increasing the net social product. Rights-violating externalities do not necessitate state intervention: the farmers in this case are free to negotiate solutions to the problem. But libertarians maintain that one should be able to count on the courts to uphold our property rights against our neighbor’s aggression, rather than facing the burden of convincing a judge that your use of your own property is more socially productive than your neighbor’s use of your property.

On the libertarian alternative to Coase, our moral rights to person and property are logically independent of their affect on social wealth.²² This does not always have happy economic consequences. The fundamental commitment

²¹ *For a New Liberty*, p. 271.

²² This commitment can be justified even if we believe it emerged as a consequence of biological or social evolution, which selects for moral principles that tend to increase the wealth of the tribe or society in which we find ourselves. Contra Coase, explanation is not justification.

to individual rights can, in principle, lead to a dramatic reduction in the social product. Although Milton Friedman and other champions of capitalism often assume that enforcing property rights tends to increase social wealth, this is a defeasible empirical claim that flows from an instrumental commitment to property rights as a means to increasing the social product.²³ The libertarian alternative reflects a fundamental commitment to the principle that personal and property rights ought to be upheld even at great cost to the legal system or to the social product.

Conclusion

Some economists treat the Coase Theorem as a purely analytic or explanatory device. Whether it can be used to successfully predict or explain political decision-making is an empirical question. But to the extent that Coase and his followers commend the Theorem as a decision procedure for politicians and judges, it is a legitimate target of moral criticism. In its normative guise, the Coase Theorem treats all harms created by externalities as joint products; in doing so, it reduces the concept of responsibility to the more mathematically tractable notions of transactions costs and economic gains and losses.

To the ordinary observer, however, responsibility is a conceptual category the moral implications of which are logically independent of the concepts of economic efficiency or social welfare. Who is responsible for the creation of a negative externality is one question. Who it would be socially useful to assign legal liability to is another question. It is likely that the answer to both questions is often the same, and when this is true, liberals may well agree with Coase that the two parties will internalize the externality without state intervention. But

²³ See, for example, Friedman's *Capitalism and Freedom*, p. 166.

this should not mask the deep inconsistency between the two approaches to externalities, nor should it blind us to the moral cost of using the Coase Theorem as a normative basis for public policy and judicial decision.

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