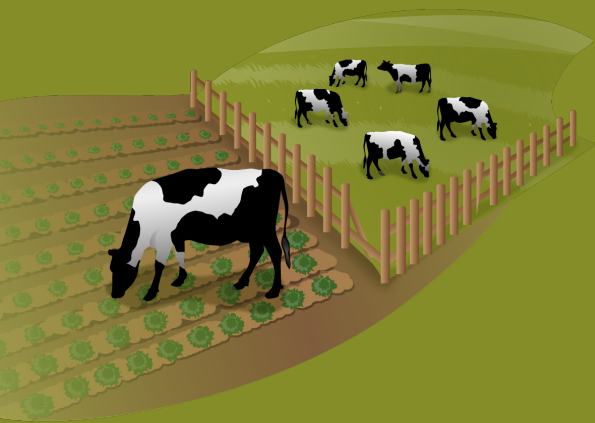




The Problem of Social Cost

Study Guide by Course Hero



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👁 Book Basics

AUTHOR

R.H. Coase

YEARS PUBLISHED

1960

GENRE

Economics

AT A GLANCE

"The Problem of Social Cost" is the second of Coase's two highly influential essays about economic theories. It directly challenges the economic theory of British economist Arthur Pigou who proposed that governmental regulation and taxation are the most effective means of resolving legal disputes that arise from harm caused by businesses. "The Problem of Social Cost" proposes that such disputes can be resolved more economically and expediently through private business

arrangements. Pigou's theories had prevailed throughout business, government, and law until Coase published his essay. The essay has ultimately spurred the growth of capitalist interests around the world.

PERSPECTIVE AND NARRATOR

R.H. Coase's "The Problem of Social Cost" is an analytical essay written for an academic journal. The narrator is the author himself. He writes primarily in the first person and presents the material as a lecture.

ABOUT THE TITLE

Coase sets out to address the problems a business may face when it causes harm through the normal course of producing, manufacturing, supplying, or distributing its goods or services. He calls this harm "social cost."

📌 Main Ideas

The Coase Theorem Is an Improvement

The first part of this essay establishes what has become known as "The Coase Theorem." R.H. Coase uses three examples to illustrate his argument. He first considers the case of a factory that produces toxic smoke which in turn harms the neighboring residents. Coase argues that until the publication of his article, most economists assessed legal liability first by making a distinction between the value of the social product produced by the factory and the private interests of the residents. Next, liability was usually assigned to the factory because the factory caused the damage. The solution to the problem was to compel the factory owner to pay a fine for the damages or for the government to impose a tax on the factory equal to the cost of the damage. Either way the goal in such

cases was to cause the factory to suffer financial harm as an incentive to force it to stop producing the harmful effect, which in this case was toxic smoke. Coase argues that the determination of liability in this example is inappropriate and does not necessarily lead to a desirable outcome

Using the example of the factory, Coase argues that the traditional method of determining liability is faulty. Though it seems obvious that the factory should be liable since it has caused the harm, the traditional remedies demonstrate a misunderstanding of the problem. Specifically, the problem is usually thought of as one in which "A [the factory] inflicts harm on B [the residents] and what has to be decided is: how should we restrain A?" Coase argues that this interpretation is one-sided, when in fact the problem is reciprocal. Avoiding harm to A via taxation or fines would cause harm to B, and imposing fines or taxation on A would relieve the harm to B. A fair resolution can only be achieved by deciding whether A should be allowed to harm B, or whether B should be allowed to harm A. The best solution is one that produces the least amount of harm.

In the case of the factory, there may be many solutions. The residents could move to a different area for a lower cost than fines or taxation on the factory. This solution would cause less harm to the factory, but it would impose an unfair burden on the residents. However, if the costs of moving are lower than the costs of fines and taxation, then the cost of fines and taxation represents an unfair burden on the factory. The ideal solution would be for the factory owner and the residents to work out a bargain in which the factory pays the residents directly to compensate for damage, but at a rate of less than a fine or tax imposed by the government.

In Part 6 Coase addresses the missing element in this theory. The previous examples assumed that there was no cost for market transactions, such as the costs of negotiation, bargaining, inspections, and the writing and signing of contracts. When these complications are added to the theory, market solutions may still often provide a more economical method of resolving disputes concerning commercial or industrial liability. However, in some cases these transaction costs would mean that market solutions would no longer be cost effective. Coase suggests that when market solutions are too expensive, companies can form firms that allow them to conduct internal administrative adjustments without assuming the costs of market transactions. Alternatively, some cases may benefit from government intervention, when the

government can act as a "super-firm" and enforce market arrangements without assuming costs. A final option in such cases is to do nothing when assuming the costs of operating in a problematic environment are lower than resolving questions of liability.

Pigou Is Correct to a Point

Arthur Pigou proposed an economic theory that was not entirely incompatible with the Coase Theorem. Pigou argues in *The Economics of Welfare* that an economic arrangement of resources in which the government does not interfere at all with the economic system and allows markets and resource allocation to develop naturally is optimal for production. This arrangement should allow self-interest to determine the implementation of the general economic welfare of the state and its citizens.

However, Pigou also states that in those cases where self-interest does not "promote economic welfare," the reason is that institutions and rules have been formulated to artificially divert or redirect resources. In these cases Pigou argues that government intervention is the best means to restore the natural distribution of resources and the optimum capacity of total production. An economic system will run most efficiently if it is allowed to develop according to its natural tendencies. When this is not the case, the government should intervene to restore the natural balance. Coase responds that he views Pigou's theory as "essentially correct" up to this point.

The Best of Four Solutions

The most important effect of the Coase Theorem is that it considerably weakens the argument in support of the governmental regulation of business. Coase identifies four possible methods of resolving economic disputes resulting from harm caused by business. The first solution is the market, through which parties to the dispute can make their own economic arrangements. The second solution is to establish a business firm or corporation that would allow businesses and other interested parties to make economic arrangements to resolve disputes when market solutions are too expensive. The third solution is for the government to regulate industries in cases where the first two solutions are either impracticable or too expensive. The fourth solution is to do nothing.

Each of these solutions requires the parties to the dispute to consider questions of legal liability and questions of legal rights. Legal realists argue that in some cases, individuals and organizations have fundamental, absolute rights. In such cases the government should enact laws to protect those rights. Such laws often take the form of bans on certain types of activities so that the rights of others are not violated or infringed. Legal cynics argue that absolute, fundamental rights do not exist and that the only rights anyone claims are those they can exercise or enforce either through legislation or economic power. Legal realists acknowledge the truth of both views but tend to interpret laws according to the cynical view since these are the types of actions that generally lead to legal disputes.

Coase's theory considers how the economic considerations of the four possible solutions to liability disputes should affect the many possible legal interpretations of liability. A decision about liability may be made on the basis of an idealist interpretation of law, without regard for economic consequences. Alternatively, some judges may allow the economic force of a given individual or organization to overrule the fundamental rights of an opposing party. Coase advocates for a position in which the law must consider the economic impacts of its decisions not as the sole determining factor of legal decisions, but as one of many. Resolving disputes about the liability of individuals, business, and courts requires that all parties consider the many ways in which their rights may be rearranged through the market, corporate organization, or governmental regulation.

In Context

Coase's Economic and Political Philosophy

[R.H. Coase](#) was a socialist when he was an undergraduate in Britain. Socialism is an economic and political theory that states that the means of production and distribution of goods should be owned and administered collectively or governmentally rather than through private ownership. He became known in the United States when he visited just prior to the publication of his first major article "The Nature of the Firm" in 1937. During this visit he met with a Socialist Party

presidential candidate and management of the Ford and General Motors manufacturing plants. He wrote his article in response to the question of why economists disagree with the views of Russian Communist Party founder Vladimir Lenin (1870–1924). Lenin regarded the entire Russian economy as one big factory. [Coase](#) wondered why American economists disagreed with Lenin, considering that major American firms like Ford and General Motors were run so efficiently. His first major publication answered this question by proposing the idea that firms allowed capitalists the means to make management decisions internally without assuming the expenses of dealing directly with the market. His views were well received and subsequently became accepted as the founding principles of private firms.

Coase immigrated to the U.S. in the early 1950s with a reputation as an insightful and revolutionary economist who had already influenced the structure of the American market. His most influential article is "The Problem of Social Cost," which was published in 1960. Prior to this article, economists everywhere adhered to the teachings of Arthur Pigou. Pigovian (also spelled Pigouvian) economics are based on a theory derived from an analogy about a neighboring farm and cattle ranch. According to Pigou if any of the cattle rancher's steer trespasses onto their neighbor's farm and destroys the farmer's crops, the dispute should be resolved through government intervention. Specifically, the rancher should be prohibited from letting any of their cattle trespass onto the farm. In the event that they are unable to prevent them from trespassing, they should be required to pay a tax to compensate the farmer for their loss. Without government intervention the rancher would have no incentive to stop their cattle from roaming, and the farmer would continue to suffer losses. This analogy is used to support the argument in favor of governmental regulation of industry.

Coase's article challenges this view by arguing that Pigou's theory is too one-sided. Coase believes that by eliminating the rancher's legal liability for crop damage, the farmer and the rancher would be forced to make some type of financial arrangement to manage the potential losses resulting from the rancher's cattle trespassing on the farmer's crops. Thus, Coase argues that industry would be better regulated through market solutions than government intervention.

Critical Analysis of Pigou's Economic Theory

The basis of the Coase Theorem, that disputes are better settled directly than by government intervention, comes from Coase's criticism of Arthur Pigou's conclusions. According to Pigou many people acknowledge that the economy can perform at its optimum level only if there is no action by the government. However, maximum efficiency of the economy has resulted only because of governmental intervention. The economic system is also still flawed. Therefore, government action is necessary to attain maximum economic performance.

Coase argues that Pigou's final conclusion is logically flawed. According to Coase the "proper procedure" for "comparing alternative social arrangements" is to compare the "total social product yielded by these different arrangements." Pigou uses the example of a real case in which the railways in Britain were not required to "compensate those who [suffered] damage from the fires" caused by sparks from an engine. Pigou argues that the loss in crop value from such fires is a natural occurrence that lessens the overall value of production. This "natural tendency" should be corrected by government intervention, in this case by imposing liability on the railway and requiring it to compensate those whose land or crops were destroyed by railway fires.

Coase applies his theorem to this situation to show that it mirrors those of a factory and the neighboring residents or the cattle rancher and the farmer that he uses at the beginning of the essay. In many cases not imposing liability on the railway may actually result in a more economically productive whole. If the railway were not liable, farmers would not be likely to plant near the railroad. This would decrease the cost of any potential damage. The loss in crop value would be offset by the railway running more trains and increasing the value of transportation. The profit from operating trains may be significantly lowered with no offsetting benefit if the railway were required to pay the costs of liability regardless of whether any fires resulted from railway sparks.

Coase agrees with the fundamental concepts of Pigovian economics but argues that Pigou fails to follow the proper procedure of economic analysis before reaching his final conclusion. Therefore, in some cases governmental regulation may provide necessary intervention to ensure maximum

economic productivity, but there are many cases in which alternative forms of intervention or no intervention at all would be better at achieving this goal. In other cases government intervention would result in lowered economic productivity.

The Article's Critical Reception

After Coase published his article, the prominent American economist George Stigler of the University of Chicago invited Coase to Chicago, Illinois, to discuss the potential impact of his theory with American economist Milton Friedman (1912–2006) and about 20 other prominent free-market economists. Coase successfully convinced the group of the soundness of his theory and of its applicability not only across all areas of economics but also to interpretations of legal disputes. His views were regarded as particularly important because they provided both economists and legal scholars with a new perspective on disputes involving social status and property rights. The publication of "The Problem of Social Cost" also resulted in Coase leaving the University of Virginia, where he had been previously employed, and joining the staff at the University of Chicago. He remained there until he retired.

Author Biography

Early Life and Education

R.H. Coase was born Ronald Harry Coase on December 29, 1910, in Willesden, Middlesex, England. In 1932 he earned a bachelor of commerce degree from the London School of Economics. In 1951 he earned a doctor of science (ScD) in economics from the University of London. After his graduation he was employed as an economist at many universities in both the United Kingdom and the United States.

Professional Career

As an economist Coase gained recognition for challenging many of the established norms and assumptions of the economics profession. He visited the United States and the factories of Ford and General Motors while he was an undergraduate student. Coase was originally a socialist, and he

eventually used what he learned during his trip to write and publish his first article "The Nature of the Firm" (1937). This article outlines Coase's theory that private firms exist because they allow business owners to manage transactions without the expense of using the markets. His views were considered groundbreaking at the time and have become the accepted view of the reason for the formation of private firms.

Coase worked at the London School of Economics from 1935 to 1951. Subsequently, he immigrated to the United States and was employed at the University of Buffalo from 1951 to 1958. From 1958 to 1964, he worked at the University of Virginia.

In 1960 Coase published his second highly influential article "The Problem of Social Cost." This paper challenged the fundamental theory of the British economist Arthur Pigou. Pigou's theory focused on the position that market disputes are best handled by government intervention and taxation. Coase's article successfully challenged the economic basis of this theory and caught the attention of economists at the University of Chicago. Coase was invited to the University of Chicago where he successfully defended his theory. He taught economics at the University of Chicago Law School from 1964 through 1981. He continued to serve as professor emeritus and senior fellow in law and economics after he retired in 1982. He was also the editor of the *Journal of Law and Economics* from 1964 to 1982.

In 1996 Coase founded the International Society for New Institutional Economics and served as its president through 1997. In 2000 he founded the Ronald Coase Institute, where he served as a research adviser and promoted the study of new institutional economics.

Legacy and Death

Throughout his career Coase challenged many of the most fundamental assumptions and norms of the economics profession. He wrote only about 12 articles throughout his career. The two most important and most influential of these articles, "The Nature of the Firm" and "The Problem of Social Cost," were published 23 years apart. Coase used very little mathematics in his economic theories. Instead, he used economic principles and theories to explain the actions of political, legal, and social institutions. His goal was to try to gain an understanding of how these institutions either encourage or impede economic growth. In 1991 Coase received the Nobel

Prize in Economics "for his discovery and clarification of the significance of transaction costs and property rights for the institutional structure and functioning of the economy."

Coase's later works include *The Firm, the Market, and the Law* (1988) and *How China Became Capitalist* (2012). Coase died on September 2, 2013, in Chicago at age 102. He is best remembered as the founder of new institutional economics.

Key Figures

R.H. Coase

R.H. Coase was a British-born American economist who became known for successfully challenging some of the fundamental economic assumptions of his time. His two most influential publications were "The Nature of the Firm" (1937) and "The Problem of Social Cost" (1960). These two publications changed the way economists viewed the purpose of corporations and the role of government regulation in industry. His efforts in economics led to the establishment of the school of thought known as "new institutional economics." In 1991 Coase received the Nobel Prize in Economics. He founded the International Society for New Institutional Economics in 1996. In 2000 he founded the Ronald Coase Institute where he served as a research adviser promoting the study of new institutional economics.

Full Key Figure List

Key Figure	Description
R.H. Coase	Ronald Harry Coase (1910–2013) was a Nobel prize-winning American economist. Coase was the founder of new institutional economics and became known for challenging many of the fundamental assumptions of economics and encouraging the interpretation of law according to economic principles.
Sir Alfred Denning	Lord Alfred Thompson Denning (1899–1999) was a British judge known for advocating the rights of people over big business.
Arthur Pigou	Arthur Pigou (1877–1959) was a British economist known for his research in welfare economics. Until the publication of Coase's essay, Pigou's theory was predominant throughout most of economics.
George J. Stigler	George J. Stigler (1911–91) was an American economist and free-market capitalist known for his research into the behavior of the marketplace and the effects of government regulation. Stigler won the Nobel Prize for Economics in 1982.

Parts 6–7

Coase's analysis of economic theory in the first part of his essay assumes that businesses operate under perfect conditions in which there are no costs involved in "carrying out market transactions." In Part 6 he acknowledges that such conditions do not exist in the real world, so he adjusts his theory to account for the additional expenses that businesses encounter when conducting market transactions. Such expenses include the costs of negotiation, bargaining, inspections, and the writing and signing of contracts. In Part 7 he proposes that his economic theory of liability should be adopted by the courts so that the determination or "delimitation" of rights takes into account the potential economic consequences of such legal decisions.

Parts 8–10

The final part of Coase's essay discusses the theories in Arthur Pigou's *Economics of Welfare*. Part 8 provides a detailed analysis of the flaws in Pigou's theory. Part 9 discusses the so-called "Pigovian Tradition," which Coase refers to as an oral tradition of economists who continue to adhere to Pigou's theories despite those theories' lack of clarity on certain points. Part 10 proposes "a change of approach" to assessing legal liability for the harm caused by businesses. This new approach should reinterpret legal liability on the basis of economic considerations rather than merely legal considerations.

Plot Summary

Parts 1–5

[R.H. Coase](#) begins his analysis in Part 1 with an illustration of how most people think about liability for harm caused by businesses. If a factory produces smoke that harms neighboring properties, many people conclude that the factory owner should be held legally and economically liable for the resulting damage. This is the basis of Arthur Pigou's economic theory. In Parts 2 through 5, [Coase](#) makes his case that Pigou's economic theory is based on a misunderstanding of how liability should be determined. He identifies flaws in Pigou's reasoning and then provides several examples of how liability should be assessed.

“” Quotes

"This paper is concerned with those actions of business firms which have harmful effects on others."

— R.H. Coase

Coase states the main focus of his essay at the very beginning, providing context for the analysis that follows. The harmful effects he mentions here are the social costs mentioned in the title.

"The suggested courses of action are inappropriate [and] lead to results which are not ... desirable."

— R.H. Coase

Coase expresses opposition to three courses of action intended to restrict the activities of a factory. The three courses are to fine the factory for damages it has caused, to tax the factory, or to force the factory to relocate. Coase introduces the idea that there are more equitable and more economical alternatives to these standard forms of dispute resolution.

"The real question ... is: should A be allowed to harm B or should B be allowed to harm A?"

— R.H. Coase

Coase draws a conclusion from an analysis of the legal reasoning involved in determining whether a factory should be held liable for damages resulting from the harmful effects of its

business. This conclusion represents the basis of the reasoning for the Coase Theorem.

"The ultimate result (which maximizes the value of production) is independent of the legal position."

— R.H. Coase

Coase believes that courts and judges should make a more concerted effort to consider the economic impacts of their legal decisions. In many cases a legal decision violates existing interpretations of the law, but alternative interpretations may be more economically sound.

"The harmful effects of the activities of a business can assume a wide variety of forms."

— R.H. Coase

At the beginning of his essay, Coase uses an example of a factory that produces smoke to illustrate the idea of a nuisance. The smoke harms neighboring residents. However, disputes may arise in a variety of situations in which the legal implications may not be as obvious.

"Only if the value of additional residential facilities obtained was greater than the value [of production] lost."

— R.H. Coase

As an economist Coase generally concerns himself with how to guarantee that legal decisions ensure optimal economic

production. Many people may be motivated to make zoning decisions on the basis of aesthetics, history, or convenience. Coase believes such decisions should consider whether they will result in greater economic productivity.

"The question is not a trivial one since it lies at the heart of the problem under discussion."

— R.H. Coase

Coase considers a case in which a resident's chimney began to smoke after his neighbor erected a wall. The man whose chimney smoked after the wall was built complained that his neighbor should be held liable, but the court disagreed. Coase analyzes this decision and shows why this seemingly insignificant distinction is important.

"Judges have to decide on legal liability but this should not confuse economists about the ... economic problem."

— R.H. Coase

Decisions of the court necessarily prevail when disputes are litigated. However, Coase insists that legal decisions about liability do not always solve the economic problems that caused the dispute.

"The reasoning employed by the courts in determining legal rights will often seem strange to an economist."

— R.H. Coase

Throughout his essay Coase states that courts make decisions about liability using reasoning that is often completely different from the reasoning of economists. A judge may consider the fundamental rights of citizens not to be harmed, of businesses not to cause harm, or of some unrelated legal precedent. However, an economist will always make decisions based on how to maximize economic production.

"The argument has proceeded ... on the assumption ... that there were no costs involved in carrying out market transactions."

— R.H. Coase

The first part of Coase's essay illustrates the fundamental logic of his argument from an entirely theoretical perspective. Once he has established how to resolve disputes from a purely economic rather than a purely legal perspective, he addresses how that theory can be adapted in practice when it is complicated by the costs of doing business.

"The rearrangement of legal rights through the market ... would lead to an increase in the value of production."

— R.H. Coase

Coase's approach to dispute resolution differs from what many people may expect. When someone brings a case to court in which one party complains that his rights have been violated, many people would expect the guilty party to be held liable and punished. Coase proposes a system in which rights are not absolute but instead can be rearranged to accommodate economic considerations.

"The administrative costs of

organizing a transaction through a firm are [not] inevitably less than the costs of ... market transactions."

— R.H. Coase

Coase supports the resolution of liability disputes by making financial arrangements through the market to compensate for the harmful effects of businesses. Sometimes, the costs of market transactions can be prohibitively expensive. In such cases Coase advocates the forming of business firms that can make the same arrangements at a lower cost than directly through the market. However, there are also cases in which firms do not represent a less expensive alternative to market transactions.

"The firm is not the only possible answer to this problem."

— R.H. Coase

When market transactions are too expensive to make feasible the rearrangement of rights to resolve disputes about liability, Coase advocates the use of private firms to achieve the same purpose. However, in some cases firms are also unable to achieve the goal of dispute resolution. In such cases government regulation can provide the most cost-effective means of resolving concerns about liability.

"The aim of this article is to indicate what the economic approach to the problem should be."

— R.H. Coase

At the beginning of the essay, Coase stated the focus of his

analysis in general terms. After he establishes the main principles and concepts of his argument, he identifies a more specific goal.

"In devising and choosing between social arrangements we should have regard for the total effect."

— R.H. Coase

Throughout his essay Coase challenges many widely held beliefs about economic and legal principles. He suggests that there are more beneficial ways for businesses and private citizens to resolve disputes that arise from liability for the harmful effects of business than simply identifying the responsible party and imposing a penalty. Ultimately, he believes that all parties to such disputes should make an effort to consider the impact of their decisions from a holistic perspective.

Glossary

commons (*n*) a tract of land owned or used jointly by two or more members of a community

confectioner (*n*) a company or person that makes or sells candy

delimitation (*n*) a decision or statement indicating the boundaries or limits of something

exposition (*n*) a written work that is intended to explain a difficult concept

firm (*n*) a legally established company or other commercial organization that allows its members and associates to conduct business transactions

injunction (*n*) a written order by a court that requires someone to do or not do some specific type of activity

laissez-faire (*n*) an economic doctrine that opposes any governmental interference beyond the minimum necessary

liability (*n*) legally determined responsibility for one's actions or the actions of other people

market (*n*) a system, mechanism, or institution that enables producers of goods and services to sell to customers, which helps establish pricing and other concerns related to the costs of business

market transactions (*n*) the costs associated with identifying buyers and/or sellers of goods and services, which may include the costs associated with identifying potential buyers or sellers, negotiation, and writing and signing contracts

nuisance (*n*) the unreasonable use of property by one individual in a way that interferes with another individual's ability to use or enjoy his own property

Pigovian (*adj*) of or relating to the economic theories of Arthur Pigou; also Pigouvian

pricing system (*n*) systematic organization of economic activity through the coordination of the financial decisions of consumers, producers of goods and services, and owners of business capital

production (*n*) the total output of an industry or an economy

public house (*n*) a saloon or bar

social product (*n*) goods or services provided by the state for the benefit of the majority of the public, such as education, healthcare, or housing

statutory (*adj*) of or relating to statutes or laws

supersede (*v*) to replace, displace, or set aside something regarded as inferior with something else