The Costs of Coase

Daniel Rothschild, *San Jose State University*
“Coase, get your cattle off my land.” –Walter Block

Kip Viscusi, et al, mention the Coasian theorem as a supposedly market approach to deal with externalities. The Coasian theorem looks at wealth maximization in determining reciprocity. According to Coase, the assignment of property rights is irrelevant since however property rights are assigned, the property will go the party who values the property the most (measured in willingness to pay). According to Coase, the problem is not one of externalities but transaction costs. If the transaction costs are low then both parties will bargain to an efficient outcome regardless of the initial allocation of property.

The example Viscusi use of Coasian bargaining is when a farmer’s cattle (Farmer A) strays onto another farmer’s field (Farmer B) damaging his crops. According to Coase, it is irrelevant who has the property right. If farmer A has the right to let his cattle stray onto someone else’s property or farmer B has the right to not have his crops damaged by another doesn’t matter since if transaction costs are low, it is in the interest of both parties to bargain and the person who is willing to pay the most have the right. If farmer A has the right to let cattle stray on farm B, then farm B will pay farmer A to build a fence if the damage of farm B’s crop exceeds the cost of building a fence. If farm B has the right to not have cattle stray on his property then farmer A will pay to build the fence if the cost of building the fence is cheaper than the damage done to the crop. It doesn’t matter who has the property right since either way the fence will be built; it’s just a question of who pays to build it. Or in the words of Ronald Coase, “such an agreement would not affect
the allocation of resources but would merely alter the distribution of income and wealth as between the cattle-raiser and the farmer.” (Coase 1960, 5).

Coase acknowledged that bargaining isn’t always possible since not all cases of externalities have low transaction costs (in the case of bilateral monopolies and free-riders who create a holdout problem making bargaining difficult). When transaction costs are high and bargaining isn’t possible, the court should rule in favor of the party who is more economically efficient (i.e., increases social utility).

What is important about Coasian bargaining is to make sure that the person who pays compensation isn’t the person who necessarily damages the property but the person who can pay at the least cost. The example Coase gives is of a train that throws spark that damages the property of farms. The question Coase asks is if the railroad should be liable for damages. For instance, in Case 1: The farmer has the property right to not be damaged by sparks. Damage by fires amount to $200. A spark arrester costs $100. And the worth of goods that the railroad transports is $150. According to Coase, since the damage is greater for the farmer, the farmer has the property right and the efficient outcome is to have the railroad pay for a spark arrester or not to throw sparks. In Case 2: This time the value of the goods on the railroad is $400. The railroad has the right to throw sparks and the farmer has to either pay the railroad up to $200 to get him to stop throwing sparks or pay for a smoke prevention device. In both cases it is the railroad causing the damage to the farmer, yet in one case the railroad is liable for the destruction he causes and in the other one he is not. According to Coase, “With these figures it is clear that it is
better…the railway should not be liable for the damage it cause, thus enabling it to operate profitably…By altering the figures, it could be shown that there are other cases in which it would be desirable that the railway should be liable for the damage it causes. It is enough for my purpose to show that, from an economic point of view, a situation in which there is ‘uncompensated damage done to surrounding woods by sparks from railway engine’ is not necessarily undesirable.” (Coase 1960, 34).

Gary North points out that according to Coase,“a civil court has the obligation to allocate damages between the farmer and the railroad in its quest to maximize the public’s social value. Each party damages the other, and the courts must allocate this damage. In Coase’s legal world, the farmer’s refusal to allow the railroad company to set fire to his crops is seen as imposing economic damage on the railroad company—damage which may be greater, in terms of reduced social utility, than the damage imposed on the farmer by the engine that spews out sparks.” (North 2002, 79). Such a view justifies violating property rights under the vague excuse of “minimizing social costs.”

For Coase, the justification for a particular set of rights is that they maximize wealth, which is why Coase criticizes Pigou by looking at property damage being determined by whoever caused the damage. For Coase, there is no one person who caused the damage. All actions involve harming one person at the expense of another. As Coase points out, “We are dealing with the problem of a reciprocal nature. To avoid the harm to B we 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?...In the case of the cattle and the crops, it is
true that there would be no crop damage without the cattle. It is equally true that there
would be no crop damage without the crops.” (Coase 1960, 2 and 15).

What Coase is saying is that there is no such thing as one person damaging another
person’s property but rather in all externalities it is the fault of both parties. It may be true
that the farmer’s cattle destroyed the crops, but if there were no crops to destroy then the
cattle wouldn’t damage them, therefore both parties are to blame. Economist Walter
Block offered a perfect response to such nonsense: “If I punch Coase in the nose, without
provocation or mitigating circumstances under the old ‘unsophisticated’ legal
dispensation, I could go to jail for assault and battery since I aggressed against him…it
would be an open and shut case. Now consider what would occur under the Chicago
school’s legal dispensation. Here,…it is no longer clear that I aggressed against him. It is
equally possible that he aggressed me by sticking his nose out at my onrushing fist.”
(Block 2001, 4).

Another problem of Coase is that you can’t add people’s utilities together. All costs
(including transaction costs) are determined by the subjective values of each individual.
Since each person’s utility differs from everyone else, costs can’t be added together.
There is no way of knowing that the gain of the railroad is greater than the loss of the
farmer’s crops. People’s value their property beyond just monetary costs, but include
psychic utilities as well. Since you can’t add people’s costs together, the idea of social
costs is meaningless.
Coasian bargaining is viewed as a way to try to deal with externalities. Viscusi mentions that while the result will be the same irrespective of how property rights are assigned, he mentions that this might not be equitable. While the result in terms of who pays for the fence might be the same whether the crop owner or the cattle owner pays, it makes a great deal of importance to them who pays.

According to natural law, a person is responsible for the damage they cause to another, while in the Coasian world it may sometimes be the responsibility of the victim to pay the aggressor in order to cease and desist or to pay for resources to compensate the aggressor for any destruction of property he caused. Coasian bargaining is inefficient and inequitable since it gives free reign for firms to damage the property of others if the firm is able to convince the courts that he did so in order to maximize social utility, since the gains from destroying property is worth more than the loss of property he destroyed.

Without a principle of property rights, no ones property is safe. Instead of trying to defend the victim, Coase obscures who owns what. If it doesn’t matter how property rights are determined then why does it matter if they are violated? Without understanding that a person owns himself and what he produces then why is pollution something that should be regulated? The problem with negative externalities is that they harm another person or their property. The reason that pollution is bad is because it violates a person’s property. Without this understanding, any talk of efficiency is vague and incoherent.
The Problem With The Coase Theorem
By: Daniel Rothschild

Dr. Colleen Haight
Econ 205B
References


