The Problem of Internalization of Social Costs. 
the Ideas of Ronald Coase and the Discovery of 
Another Very important intuition of the English 
Author

enrico baffi
The Problem of Internalization of Social Costs and the Ideas of Ronald Coase

Enrico Baffi
Università Guglielmo Marconi

Abstract
This work examines the influence of Coasian thought on the analysis of the concept of externalities as used by economists and legal economists. Ronald Coase, a Chicago scholar, advanced a series of critiques of the Pigovian tax system; although the theorem that bears his name is the best known. In his 1960 work, he sought to demonstrate that the internationalization of social costs was not always socially useful. In addition, he identified other institutional solutions to which systems can – and often do – resort. One of these solutions is to simply authorize the harmful activity without introducing mechanisms to internalize social costs. Beyond the abstraction of his ideas, Coase’s method of analysis has not greatly influenced economists’ thinking. His theorem, as it is commonly known, looks more like an elegant, abstract reflection than a tool for identifying institutional solutions to concrete societal problems.
Among legal economists, however, Coase’s teachings have had greater influence. Unfortunately, even within this group of scholars, the idea that external costs should, optimally, be internalized often emerges almost unconsciously in their literature.
The risk inherent in this attitude lies in the possibility of finding systems for internalizing social costs in legal institutions that do not appear to have such an underlying logic, as for example some kinds of tort liability.
Ronald Coase’s 1960 article, *The Problem of Social Cost*, begins as a critique of the thinking of Pigou, the father of Welfare Economics, as well as the Pigovian tradition. According to Pigou when faced with a harmful action, lawmakers should develop a mechanism to internalize the external costs. This forces the actor to consider in his cost-benefit analyses all the social costs associated with his activity, including those that fall on others. Pigou believed that this internalization could be best effectuated by imposing a tax equal to the external cost upon the actor. Since the actor would only have an incentive to conduct his activities up to the point at which his net benefit are the same as the external cost, society would reach a Pareto-efficient situation.

Coase also recalls the *oral* Pigovian tradition according to which the internalization of social costs associated with the actor’s activity should have been possible to implement through the institution of civil liability. Theoretically, this regime would force the actor to consider, in his own selfish calculations, external costs as well. These costs would be internalized to the extent that the compensation that the actor must pay equals the externality caused by him or her.

The logic of internalization of Pigou’s followers therefore always led them to hold that for every harmful action it was necessary to come up with a mechanism suitable for ensuring that the actor would consider any external cost as his own. Accordingly, it was necessary to force the actor to internalize the externality.

In his 1960 work, Coase makes a series of observations following this line of reasoning, and proposes others in his 1988 article. He wanted to demonstrate that the world in which every harmful activity has a tax or some other mechanism for internalizing the external costs associated with it is

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2 Ronald H. Coase, Notes on the Problem of Social Cost, in The Firm, the Market and the Law, supra note 1 at 157-195
was unrealistic. He proposed that this abstract world could only exist in the minds of scholars; as a "blackboard economy," he said in 1988. In *The Problem of Social Cost*, Ronald Coase highlights the fact that legal rules govern harmful activities in a way that does not correspond to an internalization of social costs mechanism. Legal rules, in fact, normally authorize or prohibit certain activities. They do not allow the actor to carry out certain actions as long as he is willing to bear the consequences; such consequences may consist of paying a tax or compensating the harm.

It may be said that law, even in promoting economic efficiency, performs an assessment of the social desirability or undesirability of a certain activity, which implies the actor's direct measurement of the private benefit and of the external costs deriving from that behavior. The internalization mechanism has the great advantage of ensuring that the actor utilizes his own information to assess whether it is better to give up an activity, carry out that activity while taking precautions, or to carry out the activity without taking precautions. Thus, the private benefit, in the event that the external costs are perfectly internalizable through the tax or compensation for the harm, coincides with the social benefit.

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4 Legal rules that seem to incorporate the Pigovian logic of internalization of external costs are called, in the wake of the seminal work by Calabresi e Melamed, “liability rules” (Guido Calabresi and Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. R. 1089 (1972)).
5 Sometimes the expression “internalization of external costs” is used purely to indicate the fact that, through various mechanisms, the regulation ensures that human actions are carried out only up to the point where the social benefits equal the social costs. Hence this does not refer exclusively to the mechanism outlined earlier by virtue of which the actor’s information is used to arrive at an optimum activity level. So if the regulation considers that the efficient level of a certain conduct is 3 (e.g., the owner of a dog may choose to go to the park three times a day), then it may impose a very high sanction not commensurate with the possible external harm against the subject who carries out that activity a fourth time. But in such a system we do not find those characteristics of the mechanisms of internalization which Pigou seemed to be thinking of: that is, attribution to the actor of the choice whether to bear the external costs or take precautions, or, finally, give up the activity. To me, it seems more appropriate to use the expression “internalization of social costs” to refer only to those mechanisms which utilize the private information of the subjects, compelling them to compare external costs, internalized through the negative consequences contemplated by the regulation, with the private benefits of the action. This conception of the mechanism of internalization of social costs seems to conform better to the idea Pigou expresses in his works.
Ronald Coase criticizes this mechanism that is championed by Pigou and his followers. The idea called the “Coase Theorem” is merely one of the observations that Coase makes about Pigou’s reasoning. The observation is in fact valid to the extent that the transaction costs are negligible. However, if we put transaction costs back into the analysis, Pigou’s reasoning appears to have some validity. If we hold that transaction costs cannot be left out, then Coase’s other criticisms of the Pigovian tradition need to be considered. Coase’s intention was to show that there are institutional solutions other than the Pigovian tax system for promoting economic efficiency. Legal rules can, for instance, facilitate negotiations among the parties.

However, the main idea in Coase’s work is that some harmful activities can be assessed by the legal system as purely lawful; without the provision of a mechanism for internalizing the external costs. Coase makes four criticisms of the Pigovian tradition, and these can be described as: “the reciprocal nature of the problem;” “Coase Theorem;” “joint causation of harm;” and “the costs of assessing and verifying external costs.” The paper discusses the four criticisms below.

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6 In his works, Ronald Coase was often critical of the rule “price = marginal cost” championed by economists. Cf. Ronald H. Coase, *The Firm the Market and the Law*, supra note 1 at 16 ff. We seem to find the same criticism of the idea that any harmful conduct should be carried out to the point where the social benefits equal the social costs.

7 In discussing a world without transaction costs, he states that “in reality, it does not seem worthwhile to waste time analyzing (its) properties.” Ronald H. Coase, *The Firm the Market and the Law*, supra note 1 at 15.
1. THE RECIPROCAL NATURE OF EXTERNALITY

The first criticism is, as summarized by the Chicago economist, “the reciprocal nature of the problem.”

Coase writes:

“The traditional approach has tended to obscure the nature of the choice that has to be made. 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 inflict harm on A. The real question that has to be decided is: should A be allowed to harm B or should B allowed to harm A? The problem is to avoid the most serious harm.”

Coase thus shows that externalities are the result of subjective rights.

Giving a right to a person allows him to cause harm to third parties. In his article, Coase uses his classic example to adumbrate this concept:

“I instanced in my previous article the case of a confectioner the noise and vibrations from whose machinery disturb a doctor in his work. To avoid harming the doctor would inflict harm on the confectioner. Another example is afforded by the problem of straying cattle which destroys crops on neighbour land. If it is inevitable that some cattle will stray, an increase in the supply of meat can only be obtained at the expense of a decrease in the supply of crops.”

Giving the confectioner the right to make noise allows him to inflict an externality upon the doctor. Recognizing the doctor’s right to prevent the confectioner’s noise allows the doctor to inflict an externality on the confectioner. Likewise, authorizing the cattle-raiser to invade the farmer’s cropland allows him to inflict harm upon the farmer. Recognizing the farmer’s right to keep animals from wandering onto his land allows him to harm the cattle-raiser. The difference lies only in the fact that, in the first case, the externality derives from an action that the subject takes, whereas in the second case the externality derives from the impediment created by the right. Hence, Coase’s reflections highlight some gaps in the way economists’ reason.

Indeed, normally we think of an externality when we assume that a certain subject does not have the right to carry out a certain activity. This means that we mainly imagine the existence of an externality only when a certain action may cause harm to others, not when a subject's action may prevent others from carrying out a productive activity beneficial to others. For example, typically in analyzing problems associated with the use of property (in particular real estate), we think about the externality that arises when a subject invades the physical space of other people’s property. However, we do not think of the external diseconomy that results when a subject prevents others from invading the physical space of his own property.

In addition, it is possible to develop Coase’s thinking by considering some other examples: the production of emissions or the right not to have people passing through or parking on one’s land both include the possibility of inflicting harm on others. In the first case, the externality derives from the subject’s action, an action whose effects have repercussions in the spatial sphere of others’ property. In the second case, the externality derives from the prohibition established by the law and the action does not impact the spatial sphere of others’ rights. In both these hypotheses, however, any protection of a claim by a subject involves a cost to others for which no recompense is paid, i.e., an externality.

Moreover, the right to fly over someone else’s land is the source of an external cost; a sacrifice must be borne by the owner of the land. Notably, however, the right to prevent planes from passing over one’s land also causes an externality; those interested in flying over the land experience a loss of utility. Economists and jurists – and this is one of Coase’s lessons – should not remain tied to a predetermined concept of causality. Thus, a legally protected claim cannot simply be denied to the subject who “causes” the harm. The law must choose the

\[11\] The example of the right to prevent others from parking on one’s land is proffered by Coase himself. See Ronald H. Coase, The Problem of Social Cost, supra note 44.
solution that ensures the greatest net social benefit even if this means that an action may impose a cost on others.\footnote{12}

In fact, property, or the very right to exclusive use of a thing, involves an externality; a sacrifice borne by the subjects who might have otherwise utilized the item.\footnote{13} At this point, it is important to examine the verity of Coase’s first criticism of the Pigovian tradition.\footnote{14} Pigou and his followers believed that the introduction of a tax, or the provision of compensation for harm, was the solution to the problem of external costs. The solution of an \textit{absolute prohibition of the activity in question}\footnote{15} is never addressed (at least explicitly) in Pigou’s work.\footnote{16}

\footnote{12} This is the direction Italian law takes when, for example, art. 840 of the Civil Code stipulates that: “the owner of the land may not oppose the activities of third parties conducted at such a depth in the subsoil or at such a height in the overlying air that he has no interest in excluding them.”

\footnote{13} It could be said that the very idea of a legally protected claim arose because the exercise of a right normally involves a sacrifice for the other subjects (also including the \textit{lost utility} of those who wanted to utilize the resource). It is however possible to imagine that an activity that does not cause any harm to third parties ought also to be subject to a legally protected claim. Think of a person who uses his own PlayStation at a time when no one wishes to use that PlayStation at the same time. Assume that the place occupied by that person does not interfere with anyone. In this case it can be stated that the individual’s activity does not cause harm to third parties. However, it may be desirable to attribute a right to that subject, i.e., a legally protected claim, to avoid rent seeking activity: someone in fact might try to block the subject’s activity for the sole purpose of taking over part of his wealth. Hence the need to prevent the carrying out of costly activities directed solely at redistributing wealth among associates may lead to attributing rights to activities that cause no harm to anyone.

\footnote{14} Coase’s analysis was followed up by a clarification in 1962 by Buchanan and Stubblebine, who distinguish between “\textit{Pareto relevant externalities}” and “\textit{Pareto irrelevant externalities}”. According to these two economists, a \textit{Paretoian relevant externality} is when the cost inflicted on third parties is greater than the net benefit obtained by the actor, and for which a mutually advantageous agreement would be possible. Thus when an actor obtains from an action a benefit of 5 while causing a damage of 10, we are dealing with a Paretoian relevant externality. If the benefit is 10 and the harm is 5, then the externality is Pareto irrelevant. Only in the former case is there an inefficiency. Hence we must imagine that when economists speak of externalities, they mean to refer only to \textit{Pareto relevant externalities}, it being socially not desirable to eliminate the others (James M. Buchanan and William C. Stubblebine, \textit{Externality}, 29 Economica 371 (1962)).

\footnote{15} A price could be paid for all externalities that are produced only in the event that the State, by means of Walrasian auctioneers, put up for auction all legally protected rights. In a system of laws in which some rights are attributed directly to individuals, without their having to pay a price, there will be cases when a human behavior that involves costs for third parties may be engaged in without there being negative consequences of any type for the injurer.
Thus, at first glance it might seem that Coase’s first observation on Pigou’s thinking is off the mark. However, at closer reading, the Chicago economist’s analysis sheds light on a situation that is normally neglected by the Pigovian approach. Where the law gives a subject the right to prohibit a certain activity the problem of externalities arises as it would in any other case, and it is possible that the private cost which the holder of the veto power manages to avoid by exercising his power is in fact lower than the lost utility for the subject who sought to carry out a certain action. Pigou seems to be referring in fact only to *activities* that cause harm to third parties.

How can we explain the fact that economists have not noted the possibility of inefficient results in this case, i.e., in the event that a subject has *the power to prevent a harmful activity*?

The answer can be found in the second criticism that Ronald Coase advances against the Pigovian tradition, a criticism represented by his well-known theorem.

### 2. EFFICIENCY IS EVER ASSURED: COASE THEOREM

Once we have revealed the reciprocal nature of externalities, it would seem that the solution to the problem of correcting external effects becomes more complicated. The solution *cannot* in fact lie in the *prohibition* of harmful activities, since such a prohibition would involve a social cost represented by the loss of benefits that such activities may yield. The solution lies in prohibiting certain harmful activities and authorizing others, or in reducing those harmful activities to an optimum level.

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It is then possible that private cost and social cost diverge (if the conditions required by Coase theorem are not met).

However, this problem disappears in the presence of a particular condition identified by Ronald Coase, a condition consisting of the “absence of transaction costs.”

Thus, we come to the second idea presented by the Chicago economist in his 1960 article, consisting of the theorem that bears his name. Coase did not formulate the theorem, however. In addition, it has multiple definitions.

One formulation, however, found in Coase’s article can be presented as follows: in the absence of transaction costs, the harm caused to others by a subject’s activity also constitutes a cost for the actor — more precisely, an opportunity cost — represented by the missed gain obtainable through an agreement with the victim.

Private cost and social cost are thus equal, in the absence of transaction costs, since the cost incurred by another is a benefit lost for the actor. The externality is therefore always internalized in the form of a lost gain — id est in a contract between parties.

In order to keep the activity from being carried out, the victim would be willing to pay a sum equal at most to the harm that he would otherwise suffer if the harmful activity were carried out. Thus, in assessing whether it is worthwhile to carry out a certain harmful activity, the actor should consider the benefit he will lose if he decides to carry out the activity rather than come to an agreement with the victim to avoid the activity.

Coase’s theorem can also be described by saying that “in the absence of transaction costs, the right always ends up in the hands of the one who values it more.” Imagine the case where Tom, owner of a piece of land, has the right to prevent Dick from letting his herd of cattle graze on the land. Suppose also that Tom values that right more than Dick is willing to pay. We have here an externality: Tom suffers an inefficient loss because it is bigger than the benefit for Dick.

Here, the right being considered is not simply the right to let one’s herd graze; it is a two-sided right: the right to have one’s herd graze and the right not to have the herd graze on one’s own land.
The proposition that “the right always ends up in the hands of the one who values it more” indicates that since Tom holds the right not to have the neighbor’s herd grazing on his land, he will not grant it (since Dick will not be willing to pay the minimum amount that Tom requires to grant it). However, if Tom did not hold the right to prevent the herd from grazing on his land, he would acquire it from Dick (since Dick is willing to grant it for a sum lower than the maximum amount that Tom is willing to pay; Tom “values the right more.”) Regardless of the initial attribution of rights, at the conclusion of any negotiations Tom will hold the right not to have the neighbor’s herd grazing on his land. The inefficient externality has been eliminated.

With regard to the right to conduct harmful activities, the assertion that, in the absence of transaction costs, the right will end up in the hands of the one who values it more means that these activities will be carried out if the actors value the right to perform them more than the victims value the right to prevent them, regardless of the right’s initial configuration. Hence the right is double-sided. One may have the right to perform a certain activity, or the right to keep that activity from being performed. Coase’s theorem states that, in the absence of transaction costs and regardless of the initial attribution of claims, the right will always appear in the form that has the greater value. Now we must determine whether Coase’s second criticism of Pigou’s thinking is on target. It should be noted that the Chicago economist himself considered the world without transaction costs to be quite far removed from his own idea of the real world. So it can be said that, since transaction costs do in fact exist, and thus we cannot rely on private accords to correct externalities up to the efficient level, Pigou’s argument remains valid. In other words, since the prescriptions of Coase Theorem are not applicable to a world with positive transaction costs, externalities must be corrected through other mechanisms and cannot rely on negotiation between individuals.

Coase formulates a third criticism of Pigou. Immediately after advancing the idea that became associated with his name, in fact, he formulated his third criticism of Pigou’s reasoning, represented by the problem of the “joint causation of harm.”
3. NOTHING WORKS: JOINT CAUSATION OF HARM
AND THE PARADOX OF PERFECT COMPENSATION

Having shown the reciprocal nature of externalities and the non-existence of
the problem when transaction costs are absent, Coase describes the
problem represented by the joint causation of harm, which leads to what
Robert Cooter would call the “paradox of compensation.”¹⁷
Coase asserts:

“Assume that a factory which emits smoke is set up in a district previously
free from smoke pollution, causing damage valued $100 per annum. Assume
that the taxation solution is adopted and that the factory owner is taxed $100
per annum as long as the factory emits smoke. Assume further that a smoke-
preventing device costing $90 per annum to run is available. In these
circumstances, the smoke-preventing device would be installed. Damage of
$100 would have been avoided at a an expenditure of $90 and the factory-
owner would be better off by $10 per annum. Yet the position achieved may
not be optimal. Suppose that those who suffer the damage could avoid it by
moving to other locations or by taking various precautions which would cost
them, or be equivalent to a loss in income of, $40 per annum. Then there would
be a gain in the value of production of $50 if the factory continued to emit its
smoke and those now in the district moved elsewhere or made other
adjustments to avoid the damage.”¹⁸
Coase thus highlights the problem by which the amount of harm deriving from
a certain activity may depend also on the activity carried out by the victim,
for which reason it seems that the optimal social solution would be to apply
certain precautionary charges to the victim, or restrict his activity. This idea
will not be developed until years later when it is considered the best discipline for
tort liability.

¹⁷ Robert Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Cal. L. R. 1
(1985), p. 3.
Those cases in which the promotion of efficiency requires that the victim take some measures to mitigate the harm are usually termed: “cases of bilateral precaution” or “cases of joint causation of harm.”

As Cooter notes:

“When each individual bears the full benefits and costs of his precaution, economists say value is internalized. When an individual bears part of the benefits or part of the costs of his precaution, economists say that some social value is externalized. The advantage of internalization is that the individual sweeps all of the values affected by his actions into his calculus of self-interest, so that self-interest compels him to balance all the costs and benefits of his actions. According to the marginal principle, social efficiency is achieved by balancing all costs and benefits. Thus, the incentives of private individuals are socially efficient when costs and benefits are fully internalized, whereas incentives are inefficient when some costs and benefits are externalized. In situations when both the injurer and the victim can take precaution against the harm, the internalization of costs require both parties to bear the full cost of the harm. To illustrate, suppose that smoke from a factory soils the wash at a commercial laundry, and the parties fail to solve the problem by private negotiation. One solution is to impose a pollution tax equal the harm caused by the smoke. The factory will bear the tax and the laundry will bear the smoke, so pollution costs will be internalized by both of them, as required by social efficiency. In general, when precaution is bilateral, the marginal principle requires both parties to be fully responsible for the harm. The efficacy condition is called double responsibility at the margin.”

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19 Although the expression “cases of bilateral precaution” would seem to refer solely to those cases in whose presence it is desirable for there to be precautionary duties for the victim, the expression can however also be used in those cases in which it is socially useful to control the victim’s own level of activity.

Internalization through the mechanism of strict liability, a mechanism that some economists seem to point to as the solution to the problem of external costs,\textsuperscript{21} seems in many cases then to be inefficient. In fact, it is not capable of producing the optimal incentives for the victim.

As Cooter states:

“One problem with the combination of justice and efficiency, however, is that compensation in its simplest form is inconsistent with double responsibility at the margin. In the preceding example, justice may require the factory not only to pay for harm caused by the smoke, but also to compensate the laundry for the harm. Compensation, however, permits the laundry to externalize costs, thereby compromising efficiency. Thus a paradox results: If the factory can pollute with impunity, harm is externalized by the factory; if the factory must pay full compensation, harm is externalized from the laundry; if compensation is partial, harm is partly externalized by the factory and partly externalized by the laundry.”\textsuperscript{22}

The “paradox of perfect compensation” is explained as follows in a well-known textbook of economic analysis of law:

“Consider this paradox: (1) In order for the injurer to internalize costs, he or she must pay full compensation to the victim. (2) In order for the victim to internalize costs, he or she must receive no compensation for injurer. (3) In private law, compensation paid by the injurer equals compensation received by the victim. Therefore, private law cannot internalize costs for the injurer and the victim as required for efficiency.

The paradox has a solution. In fact, efficient incentives do not require internalization of total costs. Instead, efficient incentives require the internalization of marginal cost.”

\textsuperscript{21} In his 1960 article, Ronald Coase makes his criticisms mainly against that system of internalization of social costs represented by the institution of tort liability. See Ronald H. Coase, \textit{The Problem of Social Cost}, supra note 1.

\textsuperscript{22} Robert Cooter, \textit{Unity in Tort, Contact, and Property: The Model of Precaution}, supra note 18 at 4.
This paradox points out a problem that afflicts all areas of the law." 23 To examine this problem in greater depth, consider the following example: Dick takes his child to the park, and Tom takes his dog. If the dog bites the child, it can be said that Tom’s action has harmed Dick. Compensation, however, means that one’s own harm is turned into an externality, that is, into an external harm. If a system of strict liability exists, as in the example at hand, Dick’s decision to take his child to the park harms Tom and he does not consider how many times to go to the park, id est the level of activity. Even if Tom must take precautions, he will go too many times to the park because he does not consider the expected damage that Dick suffers and his costs of precautions.

Coase’s third criticism of the Pigovian tradition seems to address this issue in part: internalization through the mechanism of strict liability can in fact lead to inefficient outcomes. But the double liability at the margin that Cooter speaks of can be achieved through various mechanisms. This result is ensured by the system of strict liability with a defense, which may consist of the contributory negligence defense, or the comparative negligence defense.

In this regard, however, two observations can be made:

- First, these systems do not achieve complete internalization of social costs. In the system of liability for negligence, the injurer does not internalize the external costs of his conduct represented by the expected damages and precaution costs of the injured; in the system of strict liability accompanied by a defense, the injured does not internalize the expected damages precaution costs.

Consequently, in the presence of a system of liability for negligence, the harmful activity can be carried out up to an inefficient level; the actor will not compare his benefits with the external harm caused by his activity and she will choose an excessive level of activity. In a system of strict liability accompanied by a defense the victim’s activity will be carried to inefficient levels; the victim will not compare his benefits with the harm that the injurer must bear by virtue of the benefits transfer carried out by the law.

Finally, it is important to note that in these systems the traditional mechanism of internalization of external costs is absent. Indeed, the law directly assesses the level of precaution adopted by the subject (injurer and injured) and expresses a judgment that either penalizes or approves the behavior.

In the case of liability for negligence, the injurer’s diligent behavior is purely lawful. The same must be said for the injured person’s behavior in the case of strict liability. There is not any system of internalization on external costs. For this reason it is not possible to leave the parties to choose the societal best level of precautions and activity level.

However, the observations offered up to this point are valid only with regard to a certain system of internalization of social costs: the system that hinges on the tort liability of the actor.

Is this criticism also valid with regard to Pigovian taxes?

Such taxes create a system of *decoupled liability*: both subjects, injurer and injured, bear the costs deriving from the harmful activity, as required by efficiency. The injurer bears the tax, whilst the injured bears the harm. It would seem then that Coase’s third observation does not compromise the validity of Pigou’s system. William Baumol came to this conclusion in 1972.

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24 A system of *decoupled liability* is a system in which the payment that must be made by the author of the harmful conduct differs from the payment received by the victim. In a Pigovian tax system, the amount received by the victim is zero. There are other cases in which *decoupling* occurs. For example, many American states provide that, when punitive damages are granted, only 67% of the amount paid by the defendant goes to the actor, while the remainder is assigned to the state. The concept of *decoupled liability* was introduced in 1980 by Warren Schwartz. See Warren Schwartz, *An Overview of the Economics of Antrust Enforcement*, 68 Geo. L. J. 1075 (1980).

4. THE COSTS OF ASSESSING AND PAYING DAMAGES AND PIGOVIAN TAXES

Baumol’s reasoning led to the widely held belief that the Pigovian tax mechanism was a usable instrument to pursue economic efficiency. The three criticisms examined up to this point were not able to significantly weaken the validity of the Pigovian tax system: such taxes, in fact, do not involve absolute prohibition of certain activities, do not require that transaction costs be zero, and achieve decoupling.

Conscious of this, Coase responded to Baumol in 1988, developing new arguments. His attention focused on the difficulty of assessing the social damages caused by a harmful activity.

Baumol’s analysis had shown that the amount of the Pigovian tax had to be calculated by taking into account not only the actual harm but also the “reduction in the production value,” making the regulator’s work more complex. Coase underscored the informational problems a regulatory authority would encounter in setting a system of Pigovian taxes. It would be an impossible task.

5. OUTGROWTHS OF COASE’S IDEAS

In the years following publication of *The Problem of Social Cost*, certain themes involving the problem of internalization of social costs were dealt with by some of the most eminent American legal economists. This debate is still under way; its concepts are still being explored and new theories developed.

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26 That is, the tax must be calculated taking into account the possibility that the victim may take efficient precautions or may reduce the harm by limiting or stopping his own activity.

27 Cf. Steven Shavell, *Liability for Harm versus Regulation of Safety*, 13 J. Legal Stud. 357 (1984) and
5.1 The contrast between regulation and civil liability in the work of Steven Shavell.

In the early 1980's, Steven Shavell analyzed the problem of whether mechanisms for internalizing social costs were efficient. He pondered the relative advantages of civil liability versus direct regulation, and identified some general principles to guide the selection of a system.

According to Shavell, it is important to first assess the parties’ awareness of the activity’s degree of riskiness. If private parties have a higher degree of awareness than the regulator regarding the riskiness of a certain activity, then a mechanism for internalizing social costs seems preferable to direct regulation. This solution seems sensible in the event that the internalization mechanism consists of strict liability. However, it has the disadvantage of always requiring payment for damages, with the attendant administrative costs.

Liability for negligence does not have this disadvantage; under this type of regime, damages are only assessed in the presence of negligence. However, liability for negligence requires that the court establish the efficient level of prevention, thereby forfeiting the indirect use of the information possessed by the actor to determine efficient precautions. However, with regard to direct regulation, this evaluation should occur ex post facto, and the court could be sufficiently prepared to carry out such an analysis. However, it is always a difficult task to understand if a party is at fault.

It bears repeating that the institution of liability for negligence involves certain activities, so long as they are carried out in compliance with the legal standard of diligence, being authorized by law, without any mechanism for internalizing social costs being set up. It is also important to underline that, as various scholars have discovered, a regime of negligence has the consequence of an excessive level of activity on the part of the injurer. This means that the activity level may be carried out up to an inefficient level.

28 Steven Shavell, Liability for Harm versus Regulation of Safety, supra note 28.

29 Steven Shavell, ID at 359.

The liability mechanism, according to Shavell, seems preferable to regulation.
even in the event that the administrative costs that the regulator must bear to ensure compliance with the regulation of diligence are high.\textsuperscript{30} Even in this case, however, only liability for negligence, and not strict liability, can normally present a clear advantage over direct regulation. This is because only liability for negligence involves the finding of damages and the assessment of the optimal level of diligence being made in limited hypotheses (when the actor does not seem to be up to the standard of diligence). Strict liability instead requires the finding and payment of damages whenever the harmful event occurs. Shavell has declared that it is not possible to give a clear answer because the determination of negligence asks for a high level of costs.

The other two factors examined by Shavell are: 1) the possibility that the injurer is unable to pay the damages, and 2) the risk that the injurer manages to avoid being ordered to pay compensation for the damage.\textsuperscript{31}

### 5.2 Prices and sanctions in Robert Cooter’s thinking

That same year, Robert Cooter took up the conceptual difference between \textit{prices} and sanctions.\textsuperscript{32} According to Cooter, the \textit{price} is the amount of money required by law for an allowed activity, while the \textit{sanction} is the negative consequence associated with a prohibited activity.\textsuperscript{33} In Cooter’s analysis, he seeks to determine when a legal system concerned with economic efficiency should resort to \textit{sanctions} rather than to \textit{prices}. In Cooter’s analysis only \textit{prices} reflect the logic of internalization of social costs.

\begin{footnotesize}
\begin{enumerate}
\item Steven Shavell, \textit{Liability for Harm versus Regulation of Safety}, supra note 28 at 363.
\item Steven Shavell, ID at 360 and 363.
\item Robert Cooter, \textit{Prices and Sanctions}, supra note 28 at 1523
\item ID supra note 28 at 1523.
\end{enumerate}
\end{footnotesize}

Initially,\textsuperscript{34} Cooter adopts a paradigm to identify when a negative
consequence
established by a law can be called a sanction and not a price. He determines
that a consequence is a sanction if: 1) a psychological factor of the act is
relevant; and/or 2) a negative consequence is increased in the event that the
harmful consequence is repeated.35
A fundamental difference between prices and sanctions is the elasticity of
the behavior as certain variables change. In the case of sanctions, the
amount of precaution the subject takes is not very flexible in relation to change in
the sanction, thus the behavior is inelastic. This is because a change in
sanction creates a discontinuity in the curve of the actor’s expected costs; a
discontinuity at the level of diligence desired by the system of law. The
actor’s behavior is instead strongly responsive to changes in price, since this
discontinuity is not present on the curve of expected costs.
On the other hand, as the level of precaution required by a law providing for
a sanction changes, the subject’s behavior changes, since the subject is
normally interested in conforming to the prescription. In the case of prices,
however, a similar argument cannot be made, since there is no level of
precaution required by the law.

34 ID supra note 28 at 1537.
35 “The efficient price depends on the level of external harm, not on the actor’s state of mind.” Robert
Cooter, Prices and Sanction, supra note 28 at 1537.
Cooter also identifies a more general rule for identifying sanctions: he states that, if the actor can take
various levels of precaution, we are dealing with a sanction when the law creates a discontinuity, that is, a
jump in the curve of the actor’s expected costs such that, for the latter, if he acts as a rational and self-
interested subject, he will take the desired precautions.
The problem with this definition is that for some behaviors it is not possible to identify a different series
of levels of precaution, as for example parking in a prohibited zone. Cf. Robert Cooter, Prices and
Sanctions, cit., p. 1527.
We may also hold that we are dealing with a sanction in the event that the system of laws attributes to
public officials the ability to prevent a certain act from being carried out. It cannot in fact be asserted that
the law approves a certain behaviour if the subject is willing to bear the consequences, when a prohibitive
power is attributed to certain subjects
This leads to some indications of policy: if the public authorities can determine, relatively precisely, the ideal level of precautions and at the same time make mistakes in measuring the external costs, then the use of sanctions is surely desirable. In the event that the public apparatus is capable of successfully estimating the amount of the external costs and at the same time is unable to determine the optimum level of diligence, the use of a price system is desirable. The “possibility of gathering information” must then guide lawmakers in choosing between prices and sanctions. The overall results arrived at by Cooter can be summarized in the following diagram:

<table>
<thead>
<tr>
<th>Best observer of social costs</th>
<th>Best observers of social benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Officials</td>
<td>Regulations</td>
</tr>
<tr>
<td></td>
<td>Regulation</td>
</tr>
<tr>
<td>Private person</td>
<td>Liability and sanctions</td>
</tr>
<tr>
<td></td>
<td>Subsidies</td>
</tr>
</tbody>
</table>

It is worth noting that, in the context of tort liability systems, Cooter places compensation of damages for negligence among the sanctions, and objective liability among the prices, confirming the impossibility of finding a mechanism in this institution for internalizing social costs. The damage for negligence is considered a sanction because if the potential injurer take a behavior that is diligent he does not pay nothing, but it’s sufficient a small amount of negligence to make a jump in the payment and the injurer is liable for expected damages e his own precautionary costs.

5.3 Property rules, liability rules and subsequent interpretations.

Even before Shavell and Cooter turned their attention to the general problem of internalization of social costs, the acquired wisdom of the reciprocal nature of externalities, together with an awareness of the problem that transaction costs may pose in achieving an efficient solution, led Guido Calabresi and Douglas Melamed\(^{36}\) to identify four rules relating to harmful activities that could be abstractly used to regulate such activities.

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They are as follows:

- **Rule 1**: the subject interested in the harmful activity does not have the right to carry it out and the potential victim has the power to prevent him from doing so.

- **Rule 2**: the subject interested in the harmful activity does not have the right to carry it out; however, the potential victim cannot prevent him from doing so if the interested subject pays the indemnity set by the courts or by law.

- **Rule 3**: the subject interested in the harmful activity has the right to carry it out and the potential victim cannot prevent him from doing so.

- **Rule 4**: the subject interested in the harmful activity has the right to carry it out; however, the potential victim can prevent him from doing so by paying the indemnity set by the courts or by law.

In 1993 some scholar has put in evidence other rules. In fact these rule are options and it’s possible to find other kind of options, as it is happened.

Calabresi and Melamed determined that in order to achieve efficiency, it was necessary to prevent transaction costs from allowing externalities to exist. In the course of their attempt to remove the inefficiencies caused by transaction costs, they discovered possible criteria for choosing between rules 1 and 3 on the one hand, the so-called *property rules*, and rules 2 and 4 on the other, the so-called *liability rules*.

According to Calabresi and Melamed, the liability rules\(^\text{37}\) are preferable when transaction costs are high, since private negotiation is prevented by them, whereas

\(^{37}\) In the debate among legal economists, two different conceptions of liability rules seem to coexist. On the one hand, there is those for whom the liability rules are identified based on the consequences that the law attributes to a harmful behavior: if these consequences specifically provide recovery, we are dealing with a liability rule. This approach runs into problems, however, in those cases in which the law can only provide for equivalent recovery, since compensation in specific form is materially impossible. This occurs, for example, when the effects of a harmful behavior can be eliminated only for the future, not the present. Thus, in the case of an intolerable input, the injunctive remedy may be valid for the future, but for the behavior already carried out the only sanction may be the payment of compensation for the harm. A classic hypothesis in which recovery in specific form is not possible is the death of a person.

On the other hand, there are those for whom identification of the liability rules must occur based on the assessment that the law makes regarding the social desirability or undesirability of the harmful act: thus we are dealing with a liability rule when, for the law, social welfare increases in the event that a subject, aware of the consequences befalling him by virtue of his carrying out some harmful activity, engages in that activity nonetheless, because his benefits are superior then damages for society.
the property rules are preferable when transaction costs are low (and, hence, negotiation is possible).\textsuperscript{38}

The liability rules thus reformulate the logic of internalization of social costs, although only in situations of high transaction costs.

Using the example given above, it is possible to see how the four rules can be applied. Dick accompanies his child to play in the park, while Tom takes his dog. There is a risk of harm caused by the dog possibly biting the child.

- According to the first rule, Tom may not take his dog for a walk in the park, and Dick may obtain injunctive relief. Tom may obtain the right to take his dog only through an agreement with Dick (the property rule).

- According to Rule 2, Tom may take his dog for a walk in the park but has to pay an indemnity to Dick, and the indemnity may or may not correspond to the harm actually suffered by the child. In this way Dick’s right is restricted without any need for his consent (the liability rule).

- According to Rule 3, Tom has the right to take his dog for a walk in the park. Since Dick is the one who must bear the harm that actually occurs, he may take his child to the park but at his own risk. He can acquire the right to have Tom not come to the park only through an agreement with Tom (the property rule).

- According to Rule 4, Dick may prevent Tom from coming with the dog by paying the amount predetermined by law or set by the court. In this way Tom’s right is restricted without any need for his consent.\textsuperscript{39}

The liability rule is therefore characterized by providing a certain \textit{price} for an activity, but even the use of the term \textit{price} may lead to misunderstandings: any cost deriving from a law can be considered the “price” which the subject must pay to carry out the activity covered by the law; however, it would seem more appropriate to use the term “price” when the law positively values the performance of that activity in the event that someone is willing to bear the consequences. This position can be explained with an example: the law may provide for a pecuniary sanction for the subject who travels a certain stretch of road closed to automobiles, or it might set a fare for those who intend to travel that stretch. In the first case, it can be said that social welfare does not increase when a subject engages in the behaviour of travelling the road even though he is aware that he will certainly be penalised; in the second case, it can be asserted that, when the subject decides to pay the fare and travel the road, social welfare undergoes a positive variation.

The writer is unable to provide adequate bibliographic references, since these remarks are more the fruit of conversations held with legal economists than the product of readings.

\textsuperscript{38} No explanation is offered however regarding the cases in which rule 1 is superior to rule 3.

\textsuperscript{39} Normally, in examples like this, we think it is Tom who causes the harm, because the harm falls on Dick.
The explanation offered by Calabresi and Melamed, as based on transaction costs, appeared misleading to some authors.\textsuperscript{40}

It has in fact been shown that in the presence of low transaction costs the efficient solution can also be achieved by instituting a liability rule. The parties can negotiate by taking into account the rule of law, and thus reach the efficient solution.

In addition, it has been proposed that the discipline of \textit{harmful externalities} be distinguished from that of \textit{possessory interests}.\textsuperscript{41} This distinction has not been definitively formulated and merits further exploration; however, it is one more criticism against the Pigouvian logic of internalization of social costs. Indeed, in the case of \textit{possessory interests}, Kaplow and Shavell’s analysis leads us to prefer property rules to liability rules. This is because the use of liability rules leads to significant undesirable effects when the appropriation of a \textit{possessory interest} is reconnected to an indemnity or compensation that is undervalued.

The problem inherent in possessory interests is the possibility of a \textit{common value component} existing. There is a common value component when a potential taker values an object for the same reasons as the owner. In this case, if the legal system gives an undervalued indemnity to the owner in case of takings, many forced transfers are destined to take place. In this case, the subject wanting to take possession of the property invests resources in a purely redistributive activity; for his part, the subject risking expropriation modifies his choices, orienting himself towards property that can be expropriated only with greater

But if we introduce a compensatory system by virtue of which Dick’s harm is transferred to Tom, then it seems clear that Dick’s actions cause harm to Tom. Therefore, the harm that Tom must bear depends either on Dick’s decision to take his child to the park or on the measures that Dick takes to avoid or reduce the harm. The situation is exactly turned around.


\textsuperscript{41} As explained by Steven Shavell and Louis Kaplow, \textit{Property Rules versus Liability Rules}, supra note 41 at 716, note 2, “by the protection of possessory interests in things, we refer to the prevention of the unwanted transfer of possession of a physical object to a taker. By harmful externalities, we mean adverse outcomes that occur as a byproduct of an injurer’s activity, a familiar instance being pollution caused by a firm’s operations.”
difficulty, and takes precautions aimed at avoiding the expropriation, thus bearing costs not corresponding to social benefits. Therefore, mechanisms for internalizing social costs, like the liability rules, do not seem desirable, even in the presence of high transaction costs.

6. CONCLUSIONS

Ronald Coase’s intention when he wrote his article in 1960 was to subject the Pigovian approach to the problem of externalities to a series of critiques. Economic thinkers have taken from Coase’s work the idea that, in a world without transaction costs, Pigovian taxes and the mechanisms for compensating harm are useless. However, as there are positive transaction costs in the real world, Pigou’s reasoning was considered most valid. Coase’s critique of Pigou’s approach appeared nothing more than a refined theory in the textbooks of welfare economics. Ronald Coase’s thinking is confined to the world of abstract ideas, and the prescription that every harmful action must be associated with a tax or mechanism for compensating the harm – a price, in other words – is still practicable. Regrettably, some of Coase’s other important observations have not managed to influence the thinking of economists.

In the light of the clarifications offered by him and other scholars, some of these concepts can be summarized as follows:

- The internalization of external costs through the mechanism of strict liability carries with it significant administrative costs, since the harm is not left with the subject who suffers it. This transfer requires information about the amount of external damages. This is information that a legal system may not have readily available and thus it may make mistaken assessments of this damage, resulting in inefficiency. Furthermore, the internalization of external costs through the mechanism of strict liability requires that a defense be introduced to encourage the injured to take precautions. This defense requires the legal system to make a
direct assessment of whether or not the optimal level of precaution was adopted by the victim. Finally, it is not suitable for maintaining the victim’s level within the efficient level.

- The internalization of external costs through Pigovian taxes does not present any of the drawbacks of the mechanism of strict liability, since it achieves decoupling, but it does carry with it heavy administrative costs and requires precise measurements of the external costs of harmful activities, which could be very expensive.\(^\text{42}\)

- Human actions that produce benefits for the actor but which also cause external costs are the norm. The idea that every harmful human behavior should be associated with a tax could lead to a need to tax a large number of human actions.

- But a system that authorizes certain activities in compliance with certain protections (by setting a legal standard of diligence), or that allows certain behaviors that do not involve high levels of external harm, is not called upon to implement costly and imperfect mechanisms for measuring harm, or taxes.

In conclusion, it can be stated that Ronald Coase’s analysis sheds important light on the functioning of legal systems: these systems, and those that seem to respond to a logic of economic efficiency, resort to solutions other than the internalization of social costs. For many activities they authorize or prohibit, and they directly perform the assessment that economists would like to leave to the actors. At other times, they directly identify levels of precaution to which subjects must adapt themselves in order to avoid negative consequences.

Legal systems resort more frequently to sanctions than to prices, to use Cooter’s language, and it may be said that the logic of jurists is often preferred to that of economists.

\(^{42}\) Commenting on the thinking of Baumol, who had found Pigou’s approach flawless, Ronald Coase expressed himself as follows:

“It is obvious that what Baumol intended when he said, “taken on their own terrain, the conclusions of the Pigovian tradition are in fact flawless,” was that their logic was flawless, and that, if his tax proposals were carried out, even though that is impossible, the allocation of resources would be optimal. I have never dreamed of denying this. My point was simply that these taxation proposals are made of the stuff of dreams.” (Ronald H. Coase, Notes on the Problems of Social Cost, supra note 1 at 185).