This is the second of a series examining the moral dimensions of economic "externalities", the spillover or incidental side effects in market activity.

The series is available in expanded form, with an introductory chapter and updated essays, as an e-book to facilitate reading and annotating: https://nmichaelbrennen.com/shop/.

In a 1960 paper entitled *The Problem of Social Cost*, the Nobel laureate (1991) economist Ronald Coase turned upside down prevailing economic thought on externalities. As Coase described the response of most economists since Pigou, three options were available in response to a factory producing smoke harmful to a neighborhood: 1) make the factory owner liable for damages, 2) tax the factory owner at the approximate assessment of damage, or 3) ban the factory from the neighborhood. Such a view entails that a perpetrator harms a victim. In Coase's view, these actions would produce results that "are not necessarily, or even usually, desirable" (2.)

One of Coase's original contributions to economic thought in this paper was that such problems are reciprocal in nature. That is, to compensate the neighborhood property owners is to harm the factory owner. In Coase's view, "The problem is to avoid the more serious harm. … What answer should be given is … not clear unless we know the value of what is obtained as well as the value of what is sacrificed to obtain it" (2.) He continued that the problem must be considered in total and at the margin; one must account for both total effects and incremental local changes.. For Coase, fixing liability completely in one or the other party is undesirable from an economic point of view (38.) A complete description of Coase's analyses of the various aspects of the problem is beyond the scope of this post, but I will briefly consider his example of an actual case of a doctor and a candy maker with adjoining properties, *Sturges v. Bridgman*.

A candy maker had had the same property for over 60 years when a doctor moved next door. After eight years passed without incident between them, the the doctor built a consulting room right against the confectioner's kitchen. The doctor then found that the noise from the confectioner's equipment interfered with the doctor's ability to work, and in particular to hear with a stethoscope. The doctor filed suit to force the confectioner to stop using his equipment. The court recognized that the confectioner might suffer some hardship – thus admitting to the reciprocal nature of harm that Coase would later recognize – but it argued that to avoid even greater (unspecified) individual hardship and inhibiting land development for residential use, the confectioner must stop (9.)

Coase proposed considering how the parties might settle the dispute in a market transaction once the court made its findings; for space reasons I will present a simplified version of Coase's argument. Though the doctor had won, in a market settlement he would be willing to allow the machinery to continue to operate were the confectioner to pay the doctor a sum that was greater than the doctor's loss of income from having to either move or install sound abatement material. Conversely, had the confectioner won, in a market settlement he would have been willing to accept payment from the doctor to stop using the noisy machinery if the amount were greater than the confectioner's costs to move the equipment or install sound abatement material.

In difference with Pigou, for Coase the general principle in cases of damage is that each case should be considered for its particular circumstances: "When an economist is comparing

alternative social arrangements, the proper procedure is to compare the total social product yielded by these different arrangements" (34.)

Another of Coase's original insights into this arrangement is that, were the transaction costs between the parties zero – negotiations, communications, contractual arrangements, etc. – "the decision of the courts concerning liability for damage would be without effect on the allocation of resources" (10.) That is, regardless how the court decided to allocate liability, were the parties able to negotiate without cost, they would reach an optimal allocation of resources between themselves without the need for an external authority to intervene. The "Coase Theorem" evolved from this work; expressed in various forms, Carl Dahlman summarized it thusly: "it is neither possible to identify the real source of an externality nor to establish uniquely the fact that there even is an externality, if the possibility of bargaining and side payments is taken into account" (Dahlman, 143.)

Coase of course understood that transaction costs are not zero. An interesting discussion in this regard developed in an Econtalk podcast with Robert Frank. Frank's view was that Coase' point was that legislative or judicial settlements should try to understand and move toward the sorts of arrangements to which the parties might settle in a market solution. Coase's statement on this point is that it would "seem desirable that the courts should understand the economic consequences of their actions and should … take these consequences into account when making their decisions" (19.)

Coase's argument is based entirely on the notion of rights as grounded in common law or legislative law. It is implicit in his argument that all rights are definable in and reducible to monetary values and exchangeable in market transactions. In this regard, Coase is a legal positivist and a consequentialist; I acknowledge the discussion in the Econtalk podcast for so clearly pointing out the latter aspect.

Coase's consequentialism is economic, not ethical, which is clear from the opening statement of his essay that "This paper is concerned with those actions of business firms which have harmful effects on others" (1.) He understood that an initial legal finding of liability was a necessary starting point for a market transaction to settle the matter, and "the initial delimitation of legal rights does have an effect on *the efficiency with which the economic system operates*" (16, emphasis mine.) Even at that, "the ultimate result (*which maximizes the value of production*) is independent of the legal position if the pricing system is assumed to work without cost" (8, emphasis mine.)

Neither Pigou nor Coase considered deontological or natural rights, or those rights that a person may have that should never be violated; for example, neither considered an inherent right to clean air or water, nor to health. All harms are reducible to monetary value, and either by State intervention or by inter-party transactions a suitable economic settlement may be found. This then is the economic view of externalities; as we will see, in recent years it has been challenged.

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