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The two classic works that have defined the economic analysis of social costs and externalities are A.C. Pigou's The Economics of Welfare (1920) and Ronald Coase's "The Problem of Social Cost" (1960). The traditions based on these works differ sharply, with Pigouvians calling for frequent government action to remedy market failures, while Coasians emphasize the potential benefits of market resolutions to problems of externalities. This paper examines the original writings of Pigou and Coase, finding that the fundamental differences between the two authors are more limited than it might appear from contemporary debates between their partisans.

COASE ON SOCIAL COST

Coase wrote his seminal article in 1960 in reaction to the already established Pigouvian tradition of social cost analysis. This orthodoxy proposed the use of government taxes, subsidies, or regulations in order to force externality-generators to internalize the true social costs of their actions. Coase claimed that such Pigouvian policy recommendations were frequently either infeasible, or so costly that they might not be preferable to the status quo.

Coase argued that externalities are reciprocal -- the polluter's activity harms the victim, while reducing pollution imposes harm (i.e., costs) on the polluter. The real question is, who has the right to harm others, or to be protected from harm? Coase demonstrated that, in the absence of transaction costs, regulation is unnecessary for the attainment of efficiency; any clear initial assignment of rights will allow private negotiations that will reach an efficient allocation of resources, maximizing the value of output without government intervention.

Because of the presence of transaction costs, the bargaining solution to externalities may not be feasible. Coase suggested three possibilities for such situations. First, when one producer's actions affect another, they could be combined into a single firm, internalizing the externality and lowering transaction costs. Second, government regulation, in Coase's opinion, could "on occasion" lead to an improvement in economic efficiency, particularly when large numbers of people are involved and transaction costs are therefore high. Finally, given the problems with all other approaches, the best solution in many cases could be to do nothing at all; the social gains from regulation could be less than the cost imposed by its regulation. Comparative institutional analysis is necessary to determine which option to pursue in any given situation. Coase maintained that the market mechanism is more useful than generally perceived, and that its failures might be less harmful than the failures of government regulation.

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PIGOU ON ECONOMIC WELFARE

Pigou, like his predecessor, Alfred Marshall, saw human welfare as a broad ethical question. Economics addresses a subset of all welfare-related ethical concerns --specifically those that can be compared, directly or indirectly, with the "measuring-rod of money." For the most part, Pigou assumed that what promotes economic welfare also promotes non-economic welfare (however, the occasional divergences are important to consider). He developed the analysis of public goods and externalities, showing how a reallocation of resources would lead to a welfare improvement.

Pigou's approach to social cost is similar to Coase's, except in terminology. When the number of parties involved is small (and hence transaction costs are low), externalities could be internalized through private contracts. In the case of public goods and externalities, where the numbers of people involved (and the transaction costs) are large, there was a prima facie case for government action. Pigou, cautioned however, that government inefficiency, corruption, administrative costs, and distortion of market relations would have to be considered. Even when government action is appropriate, he relied less heavily on taxes than many of his followers. For example, he suggested public subsidies to industries that install pollution control devices.

COMPARING PIGOU AND COASE

Both Pigou and Coase were more pragmatic, and more similar in their views, than is usually recognized, and Pigou's work was more thoughtful and practical than one would gather from Coase's critique. What, then, were the true differences between them?

First, they differed in their view of policy objectives. For Coase, efficiency and maximization of the value of output is the primary concern. Pigou is interested in promoting increases in output, but sees this objective as part of a larger social and moral agenda. He argues that if efficiency is achieved at the expense of lower-income groups, total welfare is likely damaged; that is, his welfare criterion combines efficiency with an ethical preference for protecting the poor. Coase's focus on efficiency alone implicitly assigns equal weights to all individuals and activities, ignoring distributional questions. His focus on disputes between producers makes this perspective a natural one to adopt. Coase offers the familiar argument that economists can only address part of the process of social choice, clarifying the efficiency implications of different proposals; Pigou construes the role of economists in broader ethical terms.

Second, Coase criticizes Pigou for failing to recognize the reciprocal nature of externalities; to protect one party is inevitably to harm the other. Coase is correct in this critique, but remedying this theoretical error would not affect Pigou's approach to policy. Pigou focuses on externalities that affect large numbers of people, such as air pollution, or employment practices that force women to work in factories immediately before and after childbirth. Assigning business the right to pollute, or to dictate unhealthy labor practices, is a clear possibility in Coase's framework, but would seem unethical and anti-social to Pigou.

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Finally, despite many points of commonality on the role of government and its limitations, Pigou and Coase part company on the political implications of their analyses. Both acknowledge that government is fallible, corruptible, costly, hampered by inadequate information, and likely to cause market distortions. Coase goes on to conclude that the potential of the market to solve externality problems, either by creating a market in externality rights, or by simply living with market failure, is often (although not always) superior to government intervention. Pigou, in contrast, believes that government intervention often (although not always) succeeds in improving welfare, and could be designed in ways that would minimize its limitations.

CONCLUSION

Both Coase and Pigou assumed that despite working imperfectly, markets function reasonably well. For Coase, this is part of the conventional view of his philosophy, although his pragmatism is often overlooked. For Pigou, the market-affirming passages in his work may come as more of a surprise. However, he argued that there is no such thing as a market independent of the state; all economic activity occurs within a framework of civil government and contract law. In Britain, he believed, the necessary institutional framework had been created in considerable detail, but there were always failures and imperfections that called for further reform.

The genuine differences between Pigou and Coase stem from two primary sources: the ethical underpinnings of Pigou's analysis, as compared to Coase's almost exclusive focus on efficiency, and their differing judgments of the ability of government to improve on market failures. Politically, Pigou supported an activist program of reform, compared to Coase's laissez-faire conservatism. But Pigou's interventions were designed to improve, not replace, the market mechanism. Both shared the broader goal of making the market work more effectively in response to externalities.

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