

# Coase Theorem

**Avinash S. Ganu**

Advocate

B.Sc. LL.M. (Pune), LL.M. In International Economic Law (Warwick, U.K. )

**Sayali Ganu-Dabake**

Advocate

LL.M. (Business Laws), M.B.L., PGDIPRL, LL.M. (Health & Media Laws)

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# Coase Theorem

## Articles by Ronald Coase

- The Federal Communications Commission (1959)
- The Problem of Social Cost (1960)

Externality problem

- Actions of business firms with harmful effects on others

# Pigouvian Approach

- Traditional Approach – treatment by Pigou (The Economics of Welfare, 1932)
- Pigouvian approach
  - Taxes (Environmental taxes = pollution damages)
  - Damages (to Victim)
  - Subsidies
  - Regulation (to shift Injurer to other zone)

# Coase Response to Pigouvian Approach

- Approach inappropriate, with undesirable results
- Reciprocal nature of the Problem
- To avoid harm on B, is to inflict harm on A
- Problem is to avoid more serious harm

# Coase Theorem

- Named so by George Stigler (1966)
- Coase did not state it in the form of theorem

## Various versions

- Stigler

under perfect competition, private and social costs will be equal

- Calabresi (1968)

if one assumes rationality, no transaction costs & legal impediment to bargaining, all misallocations of resources would be fully cured in the market by bargaining

# Coase Theorem

## ➔ Polinsky (1974)

If transaction costs are zero, the structure of law does not matter because efficiency will result in any case

## ➔ Cooter & Ulen (1988)

When parties can bargain together and settle their disagreements by co-operation, their behaviour will be efficient, regardless of underlying rule of law

# Coase Theorem

## ► Efficiency Hypothesis

Regardless of how rights are initially assigned, the resulting allocation of resources will be efficient.

## ► Invariance Hypothesis

The final allocation of resources will be invariant under alternative assignments of rights

# Coase Theorem

## ➤ Strong version

encompasses both the efficiency and invariance hypothesis

## ➤ Weak version

encompasses only efficiency hypothesis



# Coase Theorem

- Various cases considered by Coase
  - i) Confectioner & Doctor (Sturges v/s Bridgmen, 1879)
  - ii) Rancher and Farmer – straying cattle
  - iii) Contamination of stream killing fish in the pond
  - iv) Smoke pollution
  - v) Railway engine sparks and neighbouring farmers
  - vi) Shadow on swimming pool (Florida, 1959)

# Coase Theorem

- Assumptions Raised
  - Zero transaction costs
  - Initial allocation and rights specified
  - Free market and bargain

# Coase Lesson

- ▶ Law and legal rights certain
- ▶ Institutions of Property rights and Contracts
- ▶ Initial allocation efficient
- ▶ Bargain impediments to be reduced
- ▶ Law to reduce transaction costs
- ▶ Law should be efficient
- ▶ Court approach to promote efficiency