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The Coase Mechanism and the Iteration Argument*

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Abstract

The “iteration argument” presented in SCHLICHT (1996) shows that the allocation of property rights may generate inefficiencies, contrary to what the “Coase Theorem,” as commonly understood, asserts. The argument may be summarized by saying that markets (and bargaining) cease to function properly if several people are entitled and prepared to engage in the same externality-ridden activity and each of them has to be bribed individually from being the first offender. Given that the harm from pollution does not rise linearly with the amount of pollution, the sum-total of the damages produced when all of the potential offenders engage in the harmful activity may be smaller than the sum-total of the bribes which must be offered to prevent each potential offender from starting the offensive activity, even if the ensuing social damages exceed the associated private returns and an inefficient outcome is obtained. If pollution without permission by the community is not permitted, a different – and in this case efficient – outcome results.

*This is an excerpt of SCHLICHT (1997) which was originally written as a comment on BÜTTER and SCHÄFER (1997). As this is taken out of context, some clarifying additions are added *in teal*.

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An understanding of market processes requires an understanding of the advantages of market organization *as well as an appreciation of the limits of markets*. Economists may be quick in pointing out the advantages obtainable from introducing markets in realms of life which, up to now, have been coordinated by other mechanisms, but they may respond with less confidence when asked under what conditions markets perform poorly. When arguing for markets, they may present a coherent deductive argument, while resorting to sundry ad-hoc reasoning when induced to argue in the other direction.¹ It will be easy for any economist, for example, to write a well-argued essay about the advantages of making voting rights salable, introducing markets for newborn babies, or monetising Christmas gifts. To explain and defend the systematic absence of such markets is much more difficult.²

We do not understand markets if we do not understand their limits. The conundrum about the limits of markets has, up to now, received two main systematic answers, related to informational asymmetry and asset specificity, respectively. The issue of informational asymmetry has been elaborated in several contributions (FARRELL 1987, ILLING 1992, SCHWEIZER 1988). The specificity argument, popularized by WILLIAMSON (1985) in the transactions cost framework, has not remained undisputed, however. COASE (1993, 69-72) has argued for example that specificity problems can be solved, and are often solved, by market contracting.

The “iteration argument” presented in SCHLICHT (1996) offers a further argument about the limit of markets which is quite remote from what is commonly understood as transaction costs. It may be summarized by saying that markets (and bargaining) cease to function properly if several people are prepared to engage in the same externality-ridden activity and each of them has to be bribed individually **by the affected individuals of the community** from being the first offender. The sum-total of the damages **to the community** produced when all of the potential offenders engage in the harmful activity may be smaller than the sum-total of the bribes which must be offered **by the community** to prevent each potential offender from starting the offensive activity, even if the ensuing social damages exceed the associated private returns.

The following example illustrates the core issue. Assume that there are three potential offenders. Each of them has the right to start the externality-ridden activity. If

¹ Some of these reasons may even be inadmissible within the economic argument. This applies in particular to ethical reasons against the market, because preferences, properly defined, will comprise ethical preferences. There is no systematic reason to suppose that the market cares for “normal” but never for “ethical” preferences.

² See, however, TITMUSS (1970) and FREY (1997).

they enter in sequence, their private profits are (10, 5, 2) while the externalities they create are (15, 6, 1). In order to bribe each of them from being the first offender, a bribe exceeding 10 must be offered to each of them. The accruing costs exceed 30, while the externalities amount to 22. It is, thus, not worthwhile to offer side-payments to the first offender, although the sum-total of profits (17) is smaller than the sum-total of the damages (22). It is, further, not worthwhile to bribe the last entrant from not entering because this would be inefficient (his profit of 2 exceeds the damages of 1 he creates). There is no way to solve the problem in an incremental fashion. A grand coalition would be required to solve the issue, but this entails other difficulties.

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