

Microeconomics, Module 17, “Externalities – Coase Theorem”

Micro module 17: Readings for eighth edition

(The attached PDF file has better formatting.)

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{The Landsburg textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Focus on one illustration in this chapter: the doctor and the confectioner. Pigou’s analysis was not complete, as Coase showed; we focus on the Coase theorem, not on Pigou taxes.

Read section 13.1 from page 417 through 420, stopping at the section titled “Pigou Tax.” Pigou taxes are rare in practice, and economists no longer advocate them.

Resume with section 13.2, “The Coase Theorem,” on pages 424-435. Know the difference between the strong and weak Coase Theorems on page 433. The section on the reserve clause in baseball (pages 434-435) makes the theory clear.

The final exam may give a scenario like the doctor and the confectioner (or a chemical factory and a flower shop), a court decision about who is liable for damages, and asks for the Coase solution (who pays whom to do what).

The Coase theorem has many applications to insurance, such as

- Who should pay defense counsel costs, the primary insurer or the reinsurer?
- Who should pay adjustment expenses, the insurer or the retrospectively rated insured?

The homework assignment for this module shows an insurance application of the Coase theorem.

Review problem 2 on page 451 and problem 10 on page 452; the final exam problems are similar.