

Microeconomics, Module 17, “Externalities – (Pigou and) Coase”

Required reading:

(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 435 through 437, stopping at the section titled “Pigou Tax.” Pigou taxes are rare in practice, and economists no longer advocate them.

Resume with section 13.2 on pages 440 - 443, stopping at “alternative solutions”; then read from example 1 on page 444 until “The Coase Theorem with Many Firms” on page 446.

Skip pages 446-450, and then read the section “Income Effects and the Coase Theorem” on pages 450-451 and the baseball example on pages 452-453.

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.