

THE PROBLEM OF SOCIAL COST: WHAT PROBLEM?

A critique of the reasoning of A.C. Pigou and R.H. Coase

by

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Abstract

This essay discusses and refutes allegations by A. C. Pigou and R. H. Coase that a competitive, private-ownership economic system that conforms to the neoclassical model fails to allocate resources efficiently. The essay then suggests a source of inefficiency that differs from and is much more limited in application than are those offered by Pigou and Coase; and the suggested source, moreover, is compatible with the neoclassical model.

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A critical appraisal of A.C. Pigou's and R.H. Coase's Reasoning

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Introduction. The 18th century debate between mercantilists and Scottish philosophers came to an important juncture in 1776 when Adam Smith published his remarkable work *The Wealth of Nations*. Smith's contributions to the emerging new discipline of economics were multifaceted and far reaching, but most relevant to this debate was his claim that a competitive, private ownership economy in which persons acted freely to serve their own interests could, and would, serve the public's interest also. This was a rejoinder to the view held by mercantilists, who saw the well-being of a nation as dependent on its stocks of gold and other precious metals and who called for the State to control trade in ways that enhanced these stocks.

Smith's work set before future economist-philosophers the task of proving or disproving the generality of this claim. Essential to this task was the development of a model of a decentralized, private ownership economic system, one in which individuals freely act on behalf of personal interests, have no control over each other's actions, and inform their decisions by way of market-determined prices. Mainline economists writing during the neoclassical period of economics completed this task (and others) early in the 20th century. The core of their modeling effort became known as the perfect competition model, a label that seems misleading to me. The model really says little about competitive activities except insofar as entry and exit into a market is thought of as a competitive activity; that is, the model says nothing about altering price, improving technology, investing in advertising and so on. Its real contribution is to offer an analytically coherent view of the workings of a highly decentralized, unplanned economic system, and it should have been labeled, and in this essay is labeled, 'perfect decentralization.'

The model sets forth minimal conditions that, if met, were thought by mainstream economists to sustain Smith's belief that pursuit of private interests serves public interests. Most of these conditions are well known. They include extreme decentralization of resource ownership, full information of prices and of one's personal preferences, knowledge of available (but fixed in nature) production technologies, and rational personal behavior in pursuit of self-interest. Not explicitly specified but nonetheless clearly implicit, are presumptions that all scarce resources are privately owned and that private ownership is both understood and respected. The conclusion drawn (rightly or wrongly) from this model was that self-seeking private behavior will result in an efficient allocation of resources. Efficient allocation of resources became the implied marker of public interests. The claim of efficiency presumably was stronger for real economic systems that came closer to meeting the assumptions that defined the model.¹ Serious

¹ These sufficient conditions, however, are not also claimed to be necessary. An economy planned centrally or one whose processes are more dynamic than those embodied in the perfect decentralization model, such as would be an economy dominated by Schumpeterian 'creative destruction,' does not satisfy these conditions but, nonetheless, may allocate resources efficiently.

monopoly problems or serious disrespect of legal ownership, for example, would cast doubt on a claim that an economy allocates resources efficiently. Later work by Schumpeter and others would question the validity of this belief.

By the beginning of the 20th century this model shaped the views of mainline economists. Marx had by this time begun to erode enthusiasm for it (largely by ignoring it) among economists inhabiting the underworld of economics, but it remained popular among mainline economists until 1920, when A. C. Pigou published his important book *The Economics of Welfare*. The book, together with Pigou's papers and lectures, began to win over mainline economists. An important theme of his work was that neoclassical economists had overstated the validity of their claim that efficient resource allocation can be deduced from the perfect decentralization model, and by no later than 1950 his criticism and views became dominant among mainline economists. Then, R. H. Coase, in 1960, published his soon-to-become famous article 'The Problem of Social Cost.' In it he questioned not only Pigou's work but also the modeling work of neoclassical economists. He then offered a novel correction to their work; he claimed that it had seriously overlooked the cost of using the price system. The Coase paper was interpreted by many economists as a refutation of Pigou's claim, but, in fact, it did not refute his claim of inefficiency as much as it did the method he used to support this claim. In fact, Coase set forward a different basis for sustaining Pigou's claim that a perfectly decentralized economy very well might allocate resources inefficiently. I show below (with help from Frank H. Knight) that Pigou and Coase are both wrong.

In regard to what I write in the next part of this essay, it is important to note the following: (1) Pigou and Coase do not base their critiques on claims of technical or business ineptness, on mistakes by private owners of resources, or on the existence of monopoly; and they do not claim any generalized productive superiority of centralized planning of an economy over a private, decentralized economic system.² What they do claim is that some prices used by or deduced from the model are incorrect. In Pigou's case, these might be the prices of any type of resource which, at the same time, is both scarce and free to all who would use it; in Coase's case, the wrongly priced resource is the price system itself, which requires real resources to sustain but is treated as free by the model. Essentially, then, these critics have aimed their arguments at the model's presumption that prices are *known* and *correct*. (2) The first draft of this essay included references to the externality problem and to the erroneous reasoning that has been used to support the importance and prevalence of this problem. The present essay also implies this, but I have avoided the reference because several readers of the first draft had mistaken notions about the externality problem.. They seemed to mistake the existence of a costly interaction between two parties as an externality problem, forgetting that an efficient allocation of resources often will require an (optimal) level of costly interaction even if the cost of the interaction goes uncompensated. A proper Pigouvian tax on an activity that imposes costs on others will not generally eliminate this activity completely. It reduces it to an optimal level. The externality *problem* is reflected in non-optimal levels of an activity that imposes costs on others. One cannot observe smoke and sparks from the stack of a locomotive, some descending on farm crops, and simply infer from this that he or she is witnessing an externality problem, one in which social and private costs are not equal. With this in mind, the reader can translate statements I make about efficiency and inefficiency as meaning, respectively (if the context is correct) the absence of and the presence of an externality problem. In the proper context 'there is no inefficiency' also means 'there is no externality problem.'

Rejections of efficient resource allocation.

Coase is critical of Pigou's method of arguing, so let us turn to this issue first. Pigou offers constructed examples in which private costs (or benefits) are not equal to social costs (or benefits). His

² However, these critics and defenders of the neoclassical model implicitly presume that the State has advantages when it comes to enforcing private rights and defending against foreign enemies.

examples differ circumstantially but in their essences are very similar: all suppose behavior that is not rational maximizing. A favorite example involves the allocation of traffic between two roads, both of which connect the same terminal points. One road is subject to considerable congestion because it is narrow; the other road is wide and escapes much of this congestion but, lacking the directness of the narrow road, it imposes a longer time to travel between the terminal points. Pigou claims that traffic will be inefficiently distributed to these two roads because drivers who choose the quicker road will have done so without regard to the cost their action will put on other users of this road by way of increasing the degree of congestion they face. Hence, the narrow road is over-used and the broad road is under-used. The claimed difference between private cost (which does not include the added congestion cost borne by others) and social cost (which does include the added congestion cost) is a marker for inefficient resource allocation.

So far, so good. But Pigou fails to show that his example is properly placed in the context of a decentralized, private economy. Can a situation that fits this example also fit the conditions that define perfect decentralization? Pigou's failing in this respect was noted long ago by Frank H. Knight (1924) in a brilliant article on social cost. He notes that Pigou's discussion of the two roads treats these roads as if entry is free to all. Presumably, then, they are publicly provided and managed open access roads. As such, the example cannot illustrate inefficiency of an economic system that rests exclusively on private resource allocation. Knight argues that the use of these roads, had they been privately owned (in a competitive setting), would have been priced by their owners so as to achieve an efficient allocation of traffic; the price to use the narrow road would have been raised to levels higher than the price asked to use the broad road. Pigou's example properly interpreted reveals the opposite of what he intended. It shows inefficiency arising from a flaw in *public* or *collective* management of scarce resources. Public administrators failed to make the use of these roads efficient, either by under-pricing their use or by failing to privatize their ownership. I remind the reader that congestion itself is not evidence of inefficiency. Knight's private roads and Pigou's recommended tax-subsidy remedies both should result in an optimal amount of congestion and not necessarily its complete absence. .

Pigou's other examples are of the same sort. A private person (or the Dept. of Recreation) constructs a park on owned property but does not control its use by others; the park is over-crowded as a result. But it must be that the owner of the property takes pleasure from the overcrowding or neglects his own interest. In the first case there is no inefficiency, since his or her self-interest is served; in the second case, this person cannot be a resident of the neoclassical decentralization model, for he or she has failed to rationally maximize self-interest. A third type of example involves what we now call an agency problem. An owner of land rents the land to an occupant. Pigou asserts that the occupant will not take proper care of the land because he cannot be monitored closely by the owner of the land. Hence, Pigou calls for legislation to reduce the severity of misuse of property. But there is no reason to suppose the State can monitor the renter more effectively than the land's owner. It must be then, if the owner is rational, that the cost of monitoring exceeds the tenant's behavior exceeds the added value that it brings to the owner's property. Hence, there is no inefficiency. All of Pigou's examples that I have examined suffer from this failure: they assume faulty behavior or an organizational arrangement (State ownership or the complete absence of ownership) that is precluded by the neoclassical model.

In response to the mis-allocation of resources that he sees, Pigou turns to the State to levy taxes or confer subsidies that result in equality between private and social cost. His manner of doing this idealizes the State, which somehow knows the facts and is able to employ them at less cost than could private parties. He writes of idealized State-directed solutions to the problems that, as illustrated above, are likely to have been caused by the State itself. A 'handy' State is a dangerous tool, for it diverts attention from the real underlying problem, the source of, and reason for, the situation in which ownership is lacking or in which owners are behaving against their own interests. In *The Economics of Welfare* or in the doctrine that it has spawned, the State is but a magic wand that Pigou waves with no effort to make private and

social cost equal -- the same State that has, through its mismanagement, caused many of the inequalities between private and social cost that Pigou discusses. Notwithstanding the weaknesses in Pigou's demonstration, his view commanded attention from economists and succeeded in replacing or becoming an appendage to the neoclassical model. Then, in 1960, R. H. Coase's 'The Problem of Social Cost' appeared. .

Coase noted, as had Knight, that Pigou's examples were offered without rationalizing their emergence from or within a private ownership, decentralized, competitive economy. Coase then goes on to modify the conditions that defined perfect decentralization, the effect of such modification being to put a source of 'imperfection' into the perfect decentralization model. Since perfect decentralization assumes that all persons know all prices that are relevant to their decisions, the model implicitly assumes that the cost of acquiring knowledge about various opportunities for employing resources is zero. Coase identifies this implicit assumption as a presumption that the price system is free to all to use, and he argues effectively for rejecting this assumption. For Coase, and in reality, the price system is not free; treating it as free creates possibilities that cannot in fact be realized. Following contemporary discussion, I henceforth denote the cost of creating and maintaining the price system as the cost of transacting. And I concur with Coase in his claim that the perfect decentralization model treats the price system as if it were free. Where Pigou simply conjures unowned resources and failures of contracts, Coase essentially proposes a modified model of a private ownership, decentralized economic system in which positive transaction cost is embedded; this seems more acceptable than assuming that scarce goods are treated as free goods without inquiring why this might be so. However, had Coase remembered Knight's work, which, surprisingly, is not cited in 'The Problem of Social Cost,' he might have found an equally good, or in my judgment, a better way to enrich the neoclassical model. The model assumes that private ownership attaches to all resources and that rights of ownership are fully respected. In effect, it assumes that ownership is free, when, on consideration, we know this is not the case. Rather than rely on positive transaction cost, Coase could have insisted on positive cost of ownership, or both. He (and, more obviously, Pigou) could have argued that positive levels of this cost create the possibility of a separation between private and social cost. Instead, Coase relies exclusively on positive transaction cost. No doubt, Coase's thinking was guided by the success he experienced with his 1937 article 'The Nature of the Firm,' which explained the dependency of a firm's vertical structure on positive costs of transacting. No matter, I will argue below that transaction and ownership costs both fail to defeat neoclassical theory's efficiency conclusion.

In passing, I pause to defend the way neoclassical economists modeled the economic system. They sought to deduce the consequences of *price-informed private* decisions. This goal cannot be reached if transaction or ownership costs are positive. Take the extreme case of infinitely high levels of these costs. Infinitely high transaction cost blocks exposure to price-guidance; infinitely high privatization cost completely blocks privatization. These costs, then, defeat accomplishment of the desired task -- discovering the consequences of price-guided privately made decisions. Positive, but less than infinite, transaction and ownership costs allow for some price and private ownership, but this only reduces the degree of inadequacy of attempts to fulfill this task. Treating these costs as positive is more realistic but does not make for greater ease of understanding the roles played by prices and ownership in a highly decentralized economic system.

Interestingly enough, Coase's emphasis on transaction cost in his social cost article marks a change from the position he took a year earlier in his 1959 article on 'The Federal Communication Commission.' Most economists and legal scholars see Coase's FCC article as the point of departure for his 1960 social cost paper, but in at least one important respect the two papers stand in contrast. The FCC paper is much more in the spirit of Knight's 1924 article than in that of Coase's 1960 social cost paper. It was written for a conference whose task was to examine and evaluate the Federal Communication Commission. The dominant rationale used then to justify the existence of the FCC was that the

Commission was needed to prevent users of the frequency spectrum from interfering with each other's broadcast signals. The FCC's task, and its accomplishment, was to eliminate or reduce the severity of this interference. The Commission achieved this through limits it imposed on the power of broadcast signals, on the closeness in spectrum space of assigned broadcast frequencies, and on the closeness in geographic space of broadcast stations. Coase's major contribution to the conference undermined this rationale. He argued convincingly that private ownership of the right to broadcast on a specifically defined frequency would suffice to eliminate interference problems or to reduce their severity significantly, doing so by way of legal methods like those used by landowners to prevent trespassing. Coase's understanding - that private ownership resolves conflicts in the use of a scarce resource - seems to have come as a surprise to many economists but it was much like Knight's understanding.

However, in discussing the role of ownership, Coase mentions an exception. The resolution of such conflicts through negotiations between private parties might, on occasion, become so complex that something like the FCC might usefully be of help. This exception appears in the FCC paper as just that, an exception. The generally applicable proposition in the article is that market negotiations between broadcasters who are private owners of broadcast rights will effectively resolve interference problems. In Coase's social cost article, published a year later, this exception becomes the dominating consideration in his criticisms of Pigou and neoclassical economics; 'complexity' of negotiations (in the FCC paper) easily becomes 'cost of using the price system' (in the social cost paper).

If we are to understand Coase's argument in his social cost article it is useful first to understand what he means by the cost of using the price system. He describes what he intends as follows:

In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal with and to what terms, to conduct negotiations leading up to a bargain, to draw up the contract and undertake the inspection needed to make sure that the terms of the contract being observed, and so on. (Coase 1960 at p. 15)³

Coase, using this notion of transaction cost, then demonstrates brilliantly that externality-type inefficiencies cannot exist in a world such as is assumed in the perfect decentralization model, one in which markets and price information are freely accessed and used. This demonstration undermines Pigou's arguments, since Pigou does not stress or even openly mention transaction cost when attempting to establish error in the neoclassical deduction of efficiency. Following this demonstration, Coase then goes on to declare that a world without transaction cost is irrelevant. When turning to the more 'realistic' world in which transaction costs are positive, Coase deceives himself into arguing that the decentralized economic system, after all, may not equate private and social cost. After having pointed to Pigou's failure to provide a link between an inequality between these costs and the perfect decentralization model, Coase provides a link (or so he thought) in the form of an amendment to the model - simply add transaction cost to the neoclassical model.

Coase demonstrates the importance of transaction cost by contrasting two cases. The first involves zero transaction cost and, when worked through, shows no possibility of a difference between private and social cost; all who would bear costs from someone else's action can bring these costs into this person's calculations by offering payment to him or her to desist from or to modify the extent of the intended action. Nothing is left unaccounted for if legal rights of ownership are in place so that these payments can be made and reliably responded to. His presentation of the second case, involving positive transaction cost, claims that an inefficiency may arise because some of the negotiations that would be required to account for all

³ My intent here is, and I suppose Coase's intent was, to avoid a tautological notion of transaction cost, one that would define any source of separation between private and social cost a transaction cost. Coase clearly relied on a market-oriented view of this cost, intending to distinguish transactions across markets from negotiations within a firm.

costs and benefits will not yield sufficient incremental value to surmount the barrier put in place by positive costs of negotiating. And, here, Coase makes an error that still goes unrecognized by economists.

He begins this demonstration with an element of ambiguity about ownership. This ambiguity is not only inconsistent with the perfect decentralization model, which assumes that all scarce resources are owned unambiguously, but it also has little to do with the externality problem.⁴ Two parties contend for control of a resource that, apparently, is not yet owned. They take their dispute to a common-law court. The court identifies one claimant as the legal owner, but it does not prescribe the use to which the chosen person may put the resource; this person might, if he or she chooses, sell control of the resource to someone else. It might well be that there are differences between the two contenders in their capabilities for using the contested resource productively. Assume the court awards the right of ownership to the party whose capability to generate wealth from the use of the resource is the more limited. Realization of the higher value use would nonetheless obtain if the two parties can negotiate after the court has made its decision, since the losing party, by assumption of superior capability, can and will pay more to purchase the resource from the selected party than this party can obtain by directly employing the resource. No inefficiency here. However, the cost of transacting might be so high as to block such negotiations; in this case it appears, as it did to Coase, that the economic system has failed to put the resource to its best possible use. Should this situation be realized, Coase claims that the economic system fails to allocate resources efficiently. However, the appearance of inefficiency is but an illusion.

Coase has treated the legal system and its courts as if they are parts of the economic system modeled by neoclassical economists, but, as noted, their model assumes that all resources are privately owned and that ownership is fully respected; there is no place in its deductions for the courtroom drama imagined by Coase. Moreover, should the reader favor realism, please note that real social systems in fact design their courts so as to insulate them the influence of the marketplace. Offers and acceptances of payments to the court for desired decisions are illegal, and court survival is not made to depend on profit earned from decisions it renders. The neoclassical model of an economy and the conclusions drawn from it are confined to economic institutions, to firms, buyers, sellers, markets and so on. The model draws no conclusions about resource allocation that results from actions taken by non-market institutions such as courts and legislatures.

The implication Coase draws from this case is that the economic system, functioning in the presence of positive transaction cost, can misplace resources, but this cannot be deduced from the case he has imagined. The court may have made its choice of owner for reasons different from maximization of market value or it simply may have made a mistake because it is not guided in its decisions by a market-based calculus. The proper role of courts in a society is a complex issue, one I do not propose to debate here. Suffice to note that as presently constituted they do not function as part of the economic system. They are therefore irrelevant to the efficiency of the market-based economic system. The proper domicile of the efficiency calculus, as this was discussed by Pigou and the economics profession before recent innovations in the political economics, is wholly within the economic system. Although there may be very good reasons for not creating a market-like legal system, we may note that if we suppose that courts are remade into market institutions whose survival depends on revenues secured from petitioners buying their services and decisions, ownership of a disputed resource would never go to the petitioner who is less capable of maximizing value from its use. Coase's imagined court decision would never have been made. As courts are presently constituted, the economic system simply takes court decisions as exogenously imposed constraints on what can and cannot be done, just as it accepts decisions by the State to use taxes and subsidies to redistribute wealth. An efficient economic system is one that makes the most of scarce

⁴ Ironically, Coase's demonstration has circled round and come back to the source of Pigou's difficulty – the presumption of the existence of a yet unowned resource.

resources within the constraints handed down to it by courts and legislatures. This means that efficiency is served by a market that blocks post-court-decision negotiations between the two claimants discussed above if the cost of their transacting is expected to exceed the increase in the value derived from the resource as result of a change in its ownership.

Let us now set aside the court and its operations. These are quite separate from those of the marketplace. There remains a relevant issue regarding transaction cost. Let us adopt two assumptions. As the neoclassical model does, let us assume that all ownership rights are established, unambiguous, and respected. But, as the neoclassical model does not do (explicitly), let us also assume that the cost of transacting is positive. Does the introduction of positive transaction cost lead us to reject the neoclassical conclusion that markets allocate resources efficiently in a competitive, private ownership economy? Transaction cost does prohibit owners of resources from knowing all values that might be realized from various uses of their resources, especially for uses imagined by others. The cost of transacting may prevent some of these opportunities from being brought to a resource owner's attention by way of negotiated offers. However, those values that are not known will be only those for which the cost of acquiring price information is expected to exceed the value of the knowledge that is expected to be obtained from this information. All other prices are known because they are worth knowing. Put differently, there is an efficient amount of ignorance in an economic system if the cost of acquiring information is positive. The amount of ignorance that is efficient increases as does the cost of transacting (viewed as the cost of conveying information). Ignorance not only may be bliss, it may be efficient. One cannot claim that resources are wrongly allocated simply because information is not possessed or negotiation is absent; nor can one claim that resources are misplaced because a specific market does not exist. None of these is free, and the costs of acquiring information and creating and maintaining markets may be so high as to make it efficient to forego some information and some markets. A decision that something is not worth taking into account is not, because of this, a source of inefficiency. That this something is not taken into account is a reckoning if it follows from a thoughtful anticipation that it is not worth taking into account. An explicit accounting for every 'something' would be inefficient indeed in a world in which knowledge is not free. ⁵

There is no difference between transaction cost and other costs in this respect. The amount of soot from the production of steel may remain positive even if its presence results in an increase in the cost of laundering to a nearby laundry owner. If it remains positive because the cost of transacting between laundry and mill owners is too great to make a transaction worth undertaking *or* because the launderer and steel mill owner believe that the cost of substituting hard coal for soft is too great to make a transaction worth undertaking, then this positive amount of soot is efficient. In both cases, more soot descends on the laundry than if the cost of reducing soot were smaller, but if we do not think resources are wrongly allocated in the case in which hard coal is too costly to use why should we think resources are wrongly allocated in the case in which transaction cost is too great to bear? Both situations are compatible with efficient resource allocation, and, after all, it is efficiency that is claimed by the neoclassical model, not the complete absence of interaction costs; neither negotiation nor hard coal is sought in and of itself. Indeed, one can rewrite the neoclassical model with transaction cost embedded in it and still deduce from it an efficient allocation of resources. Transaction cost just shifts supply curves upward (or demand curves downward or some combination of both) as would an increase in any cost, and it carries no special implication of inefficiency at equilibrium values of price and output.

The above discussion also applies to positive costs of ownership. Private ownership cannot be created and maintained without the bearing of costs to do so, even if the neoclassical model simplifies things by presuming that all resources are effectively, privately owned. There exists an efficient degree of

⁵ Early statements of the importance of this principle in regard to transaction costs are found in Demsetz (1963, 1969).

ownership that generally is smaller than '100 per cent' and in many cases larger than 'zero percent.' While the neoclassical model eases the path to efficient resource allocation, it could, with a bit more difficulty, reach the same conclusion with a positive cost of ownership. Ownership, as a result, would be less than perfect, but perfect would be inefficient if the cost of ownership is positive. (However, see the final section of this essay.)

I emphasize that none of what is written above denies the possibility of inefficiency in a competitive, private ownership economy. My message is that this possibility is not a result of positive transaction cost. Our reliance on a transaction cost rationale has caused us to exaggerate the scope of externality problems that might remain. For reasons given next, I am of the opinion that no such problems arise for reasons of transaction cost.

A different view. Problems we associate with climate change, air quality, and so on are somewhat different from some of those discussed above, and they are highly suggestive of inefficiencies. These problems, however, have their prime source in the existence of prospects of benefitting from strategic behavior and not from positive transaction cost. The strategic behavior that is involved may, however, reflect positive cost of ownership. It would be costly, bordering on infinitely costly, to create and maintain decentralized ownership of the condition of climate (except within the confines of air-conditioned and heated homes). Inability to establish partitioned ownership rights creates a need for collectively organized solutions. Such solutions would be forthcoming without difficulty if all persons would willingly reveal the true values they attach to changes in climate. The public-good nature of problems like climate change (in combination with an inability to exclude persons who do not pay for a desired change) makes *deceit* an attractive game to play, but this is a result of product characteristics and not of transaction cost. If everyone who would benefit from improved climate could transact freely (that is, could be gathered at no cost, could speak to each other at no cost, could write and enforce contracts at no cost), the problem of deceit or of under-revelation of true demand would still remain. Under-revelation of demand is not, in its essence, a *result* of cost imposed by some on others (like soot on a laundry); it is a result of psychological propensities to enjoy a larger share of whatever rent is created by taking correct collective action. Surely, the strategic game imposes costs of delay and costs of practicing deception, but the game would be played even if these costs were zero, simply because some persons believe they are more skilled at or more enjoying of deceiving others. These costs differ little or not at all from those borne to play the advertising game, a game that is self-selected and practiced and has no non-pecuniary externalities associated with it.

Supply and demand in the neoclassical model express true willingness to cooperate in a world that is highly dependent for its wealth on specialization. The neoclassical model, by way of its assumptions, faces buyers and sellers with given, non-negotiable equilibrium market prices, prices that cannot be influenced by individual bargaining. It is not designed for treating strategic action, action that arises from attempts to get others to settle for a smaller share of the surplus made available through cooperative behavior. The possibility of misrepresenting one's position does not depend for its existence on positive cost of transacting; it requires only a prospective favorable distribution of gains from cooperative action. Close reading of Pigou and Coase does not reveal concerns about strategic misrepresentation. The distribution of traffic between Pigou's two roads is inefficient because no price is charged for using them, not because drivers deceive each other. The failure to realize maximum value from available resources in Coase's court-room drama is a problem of legal error, not one of false testimony.

What advantage in resolving strategic problems is offered by the State? The State offers legitimate power to *coerce* people into what it perceives to be a solution to the collective good problem. This power is not found in the decentralized economic system; that it is not found is what makes markets so attractive to lovers of freedom. Yet, coercion can be especially useful in cases in which private ownership fails or is prohibitively costly. Just as we find the State's ability to coerce legitimately helpful in the maintenance of

law and order, so we may find it useful in helping to finance production of goods and services that are both important to society and are subject to serious strategic bargaining problems. It is possible in some instances to remedy the problem through a proper set of private rights – that is, to substitute a toll way for a free way in order to reduce the collective ‘bad’ we call congestion. In other instances this sort of solution is too costly. Resort to State coercion is more appealing when this is the case. However, ‘appealing’ is relative. People will value this solution differently, depending on the confidence they attach to the coercive performance of the State and the value they attach to the personal freedom that will be lost by way of coercion. There is a rationale for State action, but it exists only because the State can employ levels of coercion that are useful in the resolution of strategic action problems and are not available to parties in a competitive, market based economy. Transactions as voluntary arrangements cannot be performed more cheaply or effectively by the State as compared to the market, so this is not a transaction cost problem. Fences to protect one’s property cannot be constructed more cheaply by the State. However, overcoming strategic behavior in an acceptably legal way may require State action, since the ability to coerce is not notably present in private, competitive dealings. Strategic behavior problems linked to public good acquisition may be the only category of problems calling for State action in the cause of efficient resource allocation. Unfortunately, verification of this efficiency is lacking without market-based processes.

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