

Standard Theory of Deterrence

Basic proposition:

Liability should be equal
to the harm caused

*Polinsky & Shavell,
Harvard Law Review,
Trex-280034*

In other words, costs
should be internalized

*Coase,
Journal of Law & Economics,
Trex-280024*

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“If damages equal harm, potential injurers will have the socially correct incentives to engage in risky activities.”

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THE PROBLEM OF SOCIAL COST

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1. THE PROBLEM TO BE EXAMINED¹

This paper is concerned with those actions of business firms which have harmful effects on others. The standard example is that of a factory the smoke from which has harmful effects on those occupying neighbouring properties. The economic analysis of such a situation has usually proceeded in terms of a divergence between the private and social product of the factory, in which economists have largely followed the treatment of Pigou. In *The Economics of Welfare*. The conclusions to which this kind of analysis seems to have led most economists is that it would be desirable to make the owner of the factory liable for the damage caused to those injured by the smoke, or alternatively, to place a tax on the factory owner varying with the amount of smoke produced and equivalent in money terms to the damage it would cause, or finally, to exclude the factory from residential districts (and possibly from other

¹ This article, although concerned with a technical problem of economic analysis, arose out of the study of the Political Economy of Broadcasting which I am now conducting. The argument of the present article was implicit in a previous article dealing with the problem of allocating radio and television frequencies (The Federal Communications Commission, 17 *Law & Econ.* (1976)) but comments which I have received seemed to suggest that it would be desirable to deal with the question in a more explicit way and without reference to the original problem for the solution of which the analysis was developed.

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