Coase theorem

Business

Coase Theorem Coase Theorem Coase theorem targets economic efficiency that is attributed to economic allocation and outcome when externalities are present. The theory stipulates that if trade is possible in the presence of an externality when transaction costs are significantly low, the end result will be an efficient outcome when initial allocation of property is not considered. The major obstacles to Coasian bargaining emerge when property rights have been defined poorly (Buchanan, 2005). This paper will discuss Coase theorem as an alternative to government regulation in terms of facilitating for the provision of goods and services.

Ronald Coase stipulated that transaction costs that are found in the real world are not sufficiently low to create room for efficient bargaining, and thus an indication that the theory cannot be applied to reveal economic reality. Nevertheless, Coase theorem is regarded as the basis for economic analysis, especially in the event of government regulation when externalities are present (Walter, 2001).

Based on the essay The Nature of the Firm, Coase offered an explanation as to why an economy comprises of various firms as opposed to a large number of independent and self-employed individuals who undertake contracts with each other. Since it is possible to undertake a transaction without the presence of any organization, Coase was puzzled on the appropriate conditions that should be imposed to facilitate for the emergence of firms (Walter, 2001).

Today, most firms emerge when an entrepreneur begins to employ people. In this perspective, Coase considers the appropriate conditions under which it would be sensible for an entrepreneur to pursue for the help of employees instead of contracting out to facilitate for the completion of a certain task.

While using the market, there are various transaction costs involved because the cost of acquiring a good or service through the market is above the usual price. Other additional costs comprise of those involved while searching for information, bargaining, policing, enforcement, and in keeping secrets of trade (Coase, 1988). All these costs significantly raise the cost of acquiring something from a different party. This reveals that firms emerge in order to internalize the production process to facilitate for the delivery of a product, and hence avoid these costs.

Coase notes that a natural limit prevails that provides a limit as to the extent to which a firm should produce internally (Buchanan, 2005). Also there are times when a manager to an organization may make mistakes with respect to allocation of resources. Additionally, the decreasing function of the entrepreneur raises the overhead costs, which tend to countervail the costs that a firm incurs. In this perspective, the government is needed in order to ensure that firms operate in line with the set regulations so as to make sure that they do not impose unsustainable costs to their customers (Buchanan, 2005).

The “ Problem of Social Cost” allowed Coase to provide an insight on the challenges that are attributed to externalities. In case transaction costs are absent, the assignment of property rights initially does not make a difference regardless of whether an entrepreneur can realize efficient economic outcomes. The allocation of property rights initially determines whether it is efficient for a firm to incur additional costs, especially in the event of damages (Walter, 2001).

The paper has revealed that Coase made a significant contribution with respect to facilitating for efficient economic allocation, and in determining how to handle externalities that prevail. Therefore, based on transaction and social costs, it is possible for the government to intervene on the production process of a firm in order to ensure that it is operating optimally and efficiently.

References

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