CHAPTER 4

SOCIAL COST AND EXTERNALITIES
Introduction:

As conceptual meaning of Social cost in economics may be distinguished from "private cost". Economic theorists model individual decision-making as measurement of cost and benefits. Social cost is also considered to be the private cost plus external benefits. Rational choice theory often assumes that individuals consider only the cost they themselves bear when making decisions, not the cost that may be borne by others.

With pure private cost, the cost carried by the individuals involved are the only economically meaningful cost. The choice to purchase a glass of lemonade at a lemonade stand has little consequence for anyone other than the seller or the buyer. The cost involved in this economic activity are the cost of the lemons and the sugar and the water that are ingredients to the lemonade, the opportunity cost of the labour to combine them into lemonade, as well as any transaction costs, such as walking to the stand. The implications were needed of in social cost, if there is a negative externality, then social cost will be greater than private cost. Environmental pollution is an example of a social cost that is seldom borne completely by the polluter, thereby creating a negative externality. If there is a positive externality, then one will have higher social benefits than private benefits. For example, when a supplier of educational services indirectly benefits society as a whole but only receives payment for the direct benefit received by the recipient of the education: the benefit to society of an educated populace is a positive externality. In either case, economists refer to this as market failure because resources will be allocated inefficiently. In the case of negative externalities, private agents will engage in too much of the activity, in the case of positive externalities, they will engage in too little. (The marginal rate of
transformation in production will not be equal to the marginal rate of substitution in consumption due to the effect of the externality and as a result Pareto optimality will not occur—see welfare economics for an explanation.)

As for as social cost was concerned the theory was most important factor for to know what the social cost is? And how it will be explained. This was discussing in the below diagram.

Theory

The ideas of social cost, externalities, and market failure are often used as an argument for government intervention in the form of regulations. Libertarians who believe in a free market respond that the existence of market failure should not lead to government intervention. They prefer to rely on tradition, community pressure, and dollar voting.

Negative externalities (external cost) lead to an over-production of those goods that have a high social cost. For example, the logging of trees for timber may result in society losing a recreation area, shade, beauty; good quality soil to grow crops on, and air quality but this loss is usually not quantified and included in the price of the timber that is made from the trees. As a result, individual entities in the marketplace have no incentive to factor in these externalities. More of this activity is performed than would be if its cost had a true accounting.
This can be illustrated with a diagram. Profit-maximizing organizations will set output at $Q_p$ where marginal private cost (MPC) is equal to marginal revenue (MR). (This diagram assumes perfect competition, under which price (P) equals MR.) This will yield a profit shown by the triangular area $0, C, F$.

But if externalities are present, the attainment of social optimality requires that the full social cost must be considered. The socially optimum level of output is $Q_s$ where marginal social cost (MSC) or referred to as the Marginal Social Damage (MSD) is equal to marginal revenue (MR). The amount of output, $Q_p$ minus $Q_s$, indicates the excess output due to the externality. Profits will decrease also, from $0, C, F$ to $0, A, F$. It is clearly profitable for the firm to pollute, since "internalizing the externality" hurts profits. The amount of the externality will decrease from $C, D$ to $B, A$.

Because the marginal social cost curve (MSC) is above the marginal private cost curve (MPC), this diagram illustrates the case of a negative externality. If the marginal social cost curve was below the marginal private cost curve, it would be a positive externality and social optimality would require a greater output than $Q_p$ rather than a reduction of output.

Institutional ecological economists in the tradition of Karl William Kapp provide a different definition of social cost, i.e. the share of the total cost of production that is not born by producers but is shifted to third party, future generations or society at large. Kapp, hence, rejected Pigou's confusing terminology of externalities and provides several hundred pages of empirical data to support his argument that social cost are systemic, i.e. rooted in profit maximizing behavior of businesses, and an enormous problem of modern civilization. In the real world, they are usually not or cannot be internalized and must not be considered as accidental minor aberration from the "optimal norm" that can be fixed with adhoc measures.
Externalities, social cost and private cost

1. Externality also one of the substitute word for social cost, as already mentioned above the externality itself social cost. Here is there are two types of externalities, one is negative externality and another one is positive externality. As this was concerned, Air pollution from motor vehicles is an example of a negative externality. The cost of the air pollution for the rest of society is not compensated for by either the producers or users of motorized transport. In economics, an externality, or transaction spillover, is a cost or benefit that is not transmitted through prices. In that it is incurred by a party who was not involved as either a buyer or seller of the goods or services causing the cost or benefit.[1]

2. The cost of an externality is a negative externality, or external cost, while the benefit of an externality is a positive externality, or external benefit.

In the case of both negative and positive externalities, prices in a competitive market do not reflect the full costs or benefits of producing or consuming a product or service. Producers and consumers may neither bear all of the costs nor reap all of the benefits of the economic activity, and too much or too little of the goods will be produced or consumed in terms of overall costs and benefits to society.

For example, manufacturing that cause’s air pollution imposes costs on the whole society, while fire-proofing a home improves the fire safety of neighbors. If external cost exists, such as pollution, the good will be overproduced by a competitive market, as the producer does not take into account the external cost when producing the good. If there are external benefits, such as in areas of education or public safety, too little of the good would be produced by private markets as producers and buyers do not take into account the external benefits to others. Here, overall cost and benefit to society is defined as the sum of the economic benefits and cost for all parties involved.
The term "externalities" is regularly misunderstood by some critics of economics, who allege that it is an attempt to reliable the socially disruptive consequences of corporate activity, and frame them as inevitable and acceptable. However, this does not reflect the actual meaning of the term. In fact, economists often use externalities as a justification for government Intervention in the economy.

**Implications**

External costs and benefits

Standard economic theory states that any voluntary exchange is mutually beneficial to both parties involved in the trade. This is because of buyers or sellers would not trade if either thought it not beneficial to themselves. However, an exchange can cause additional effects on third parties. From the perspective of those affected, these effects may be negative (pollution from a factory), or positive (honey bees kept for honey that also pollinate crops). Welfare economics has shown that the existence of externalities results in outcomes that are not socially optimal. Those who suffer from external costs do so involuntarily, while those who enjoy external benefits do so at no cost.

A voluntary exchange may reduce societal welfare if external costs exist. The person who is affected by the negative externalities in the case of air pollution will see it as lowered utility: either subjective displeasure or potentially explicit cost, such as higher medical expenses. The externality may even be seen as a trespass on their lungs, violating their property rights. Thus, an external cost may pose an ethical or political problem. Alternatively, it might be seen as a case of poorly defined property rights, as with, for example, pollution of bodies of water that may belong to no-one (either
figuratively, in the case of publicly owned, or literally, in some countries and/or legal traditions).

On the other hand, a positive externality would increase the utility of third parties at no cost to them. Since collective societal welfare is improved, but the providers have no way of monetizing the benefit, less of the good will be produced than would be optimal for society as a whole. Goods with positive externalities include education (believed to increase societal productivity and well-being; but controversial, as these benefits are generally internalized, e.g., in the form of higher wages), public health initiatives (which may reduce the health risks and cost for third parties for such things as transmittable diseases) and law enforcement. Positive externalities are often associated with the free rider problem. For example, individuals who are vaccinated reduce the risk of contracting the relevant disease for all others around them, and at high levels of vaccination, society may receive large health and welfare benefits; but any one individual can refuse vaccination, still avoiding the disease by "free riding" on the costs borne by others.

There are a number of potential means of improving overall social utility when externalities are involved. The market-driven approach to correcting externalities is to "internalize" third party costs and benefits, for example, by requiring a polluter to repair any damage caused. But, in many cases internalizing cost or benefits is not feasible, especially if the true monetary values cannot be determined.

Laissez-faire economists such as Friedrich Hayek and Milton Friedman sometimes refer to externalities as "neighborhood effects" or "spillovers", although externalities are not necessarily minor or localized. Similarly, Ludwig Heinrich Edler von Mises argues that externalities arise from lack of "clear personal property definition."[2]

EXTERNALITIES

Private costs are what they say – the costs incurred when producing something. Social costs are greater than private costs. Social costs include
things like pollution and congestion that are suffered by society in general, not by any one producer. These problems are called “externalities” i.e., they are external to the firm producing them. They can be negative externalities (which harm society) or positive externalities (which help).

Social cost = private cost + externality (if any)

Cost-benefit analysis tries to measure all the costs to society of a project

**NEGATIVE EXTERNALITIES:**

The negative externality occurs not only from the producers but also from the consumers too. Here is Common types of negative externalities by producers, like, Air pollution, e.g., smoky factory chimneys, Soil pollution, especially by farm chemicals (closely related to the next type), Water pollution, e.g., rainwater run-off containing farming pesticides and fertilizers, Noise pollution. Do you live near an airport or by a building site?

Some types of negative externalities by consumers. Pollution of air and water, Soil pollution lead pollution in soils from motorcar exhaust emissions, Litter on streets decomposing rubbish in land-fill sites. In the case of Noise pollution, motorcycle noise in urban areas, especially when the baffles have been deliberately removed from the silencer. Vandalism, graffiti on walls. Smoking and alcohol abuse, causing NHS expenditures to rise. We are unsure why the urban sparrow population has plummeted in recent decades but it would seem to be the result of some externality.
The above diagram named as social costs or negative externality. As shown in the above diagram, Equilibrium will be where private costs cut the demand curve at Qa, as firms try to maximise profits and charge price OPa for quantity OQa.

But because of negative externalities (pollution maybe), the socially optimum position should be where social costs cut the demand curve. These would mean producing at Qb, reading from the social costs curve, and selling at the higher price OPb to cover these costs.

**Examples:**

Most of the economists gave a number of examples for negative externality and positive externality. As study was concerned there is a need to know the examples which explains the externalities. As this regards, the negative externality means that, for example, light pollution is an example of an externality because the consumption of street lighting has an effect on bystanders that is not compensated for by the consumers of the lighting. A negative externality (also called “external cost” or “external diseconomy”) is
an action of a product on consumers that imposes a negative side effect on a third party, it is social cost.

Barry Commoner explains very well the costs of externalities on the long run:

Clearly, we have compiled a record of serious failures in recent technological encounters with the environment. In each case, the new technology was brought into use before the ultimate hazards were known. We have been quick to reap the benefits and slow to comprehend the costs.

Many negative externalities are related to the environmental consequences of production and use. As this regards the environmental study was concerned one of the thing is that, the Air pollution from burning fossil fuels causes damages to crops, (historic) buildings and public health. The most extensive and integrated effort to quantify and monetize these impacts was in the European Extern E project series. Anthropogenic climate change is attributed to greenhouse gas emissions from burning oil, gas, and coal. The Stern Review on the Economics of Climate Change says "Climate change presents a unique challenge for economics: it is the greatest example of market failure we have ever seen."

In another example regarding the negative externality is that, as industry was concerned, those which were concentrated on the banks of the river, the water were using by them, and they were release the polluted water. It was cause for the water pollution. And Water pollution by industries that adds poisons to the water, which harm plants, animals, and humans. As noise pollution was concerned most of the developmental activities like nuclear plants, atomic energy industries, and mining, there was chance to originate the negative externality. And this negative externality harm to the human society. Noise pollution is mentally and psychologically disruptive. This type of activities in the form of industrial development, Industrial farm animal production, on the rise in the 20th century, resulted in farms that were easier to run, with fewer and often less-skilled employees, and a greater output of uniform animal products. However, the externalities with these farms
include, contributing to the increase in the pool of antibiotic-resistant bacteria because of the overuse of antibiotics; air quality problems; the contamination of rivers, streams, and coastal waters with concentrated animal waste; animal welfare problems, mainly as a result of the extremely close quarters in which the animals are housed.

As consumption pattern in economics, In the case of luxury good car, when car owners use roads, they impose congestion costs and higher accident risks on all other users. And this is also negative externality. Consumption by one consumer causes prices to rise and therefore makes other consumers worse off, perhaps by reducing their consumption. These effects are sometimes called "pecuniary externalities" and are distinguished from "real externalities" or "technological externalities". Pecuniary externalities appear to be externalities, but occur within the market mechanism and are not a source of market failure or inefficiency.

Negative externality totally neglects the social welfare concept. As this regards Shared costs of declining health and vitality caused by smoking and/or alcohol abuse. Here, the "cost" is that of providing minimum social welfare. Economists more frequently attribute this problem to the category of moral hazards, the prospect that a party insulated from risk may behave differently from the way they would if they were fully exposed to the risk. For example, an individual with insurance against automobile theft may be less vigilant about locking his car, because the negative consequences of automobile theft are (partially) borne by the insurance company.

Some of the human activities may cause for the negative externality. The cost of storing nuclear waste from nuclear plants for more than 1,000 years (over 100,000 for some types of nuclear waste) is included in the cost of the electricity the plant produces, in the form of a fee paid to the government and held in the Nuclear Waste Fund. Conversely, the cost of managing the long term risks of disposal of chemicals, which may remain permanently hazardous, is not commonly internalized in prices. The USEPA regulates chemicals for periods ranging from 100 years to a maximum of 10,000 years,
without respect to potential long-term hazard. And also in the case of Antibiotic use contributes to antibiotic resistance, reducing the future effectiveness of antibiotics. Individuals do not consider this efficacy cost when making usage decisions, leading to socially sub-optimal antibiotic consumption. Government policies proposed to preserve future antibiotic effectiveness include educational campaigns, regulation, Pigouvian taxes, and patents.

In the case of liquor stores those which are part of the societal environment, There is evidence that crime in a neighborhood increases after the opening of a liquor store. Liquor stores may draw an undesirable class of citizens into the neighborhood to shop and hang out. They may also cause more people in the area to drink; such people may then proceed to commit acts in the neighborhood that they would not normally do, or else these drunken people may become easy targets for the crimes of others. Even if the crimes start out small, they may eventually become much worse if not effectively addressed (broken windows theory). Liquor stores are more likely to be open late into the night than other stores, and may result in increased noise levels which harm property values in the community.

**POSITIVE EXTERNALITIES:**

When these exist, society would gain more than the producer – who therefore is producing less than the optimal social amount. Examples include, Labour training in firms; one firm may do little, as it knows that when a trained worker leaves, someone else benefits - but the first firm paid for all the training. Education generally. Health generally, especially in poor Third World countries. The provision of playing fields at or near schools so that the health and sporting skills of the children improves. Free museums and art galleries that can encourage the poor and uneducated to widen their horizons, educate themselves, and generally improve.

As shown in the below diagram the positive externality was explained, it’s just reverse the labelling of the curves of social cost and private costs
above. This is done in the diagram below where you can see that we produce too little for society if firms profit maximize for themselves (as they do). They choose to produce at OQa and sell for a price of OPa, but for the greatest good of society they should be at OQb and selling at the lower price of OPb.

Examples of positive externalities (beneficial externality, external benefit, external economy, or Merit goods) include:

Here is the human activities those which are done by an individual may helpful for the whole society. In the case of educational facilities, increased education of individuals can lead to broader society benefits in the form of greater economic productivity, lower unemployment rate, greater household mobility and higher rates of political participation. And one more example is that, an individual planting an attractive garden in front of his or her house may provide benefits to others living in the area, and even financial benefits in the form of increased property values for all property owners. Like this most of the individual person activities were helpful for the societal well-being those are called as positive externalities. Those are as follows.
A beekeeper keeps the bees for their honey. A side effect or externality associated with her activity is the pollination of surrounding crops by the bees. The value generated by the pollination may be more important than the value of the harvested honey.

A public organization that coordinates the control of an infectious disease preventing others in society from getting sick.

An individual buying a product that is interconnected in a network (e.g., a video cellphone) will increase the usefulness of such phones to other people who have a video cellphone. When each new user of a product increases the value of the same product owned by others, the phenomenon is called a network externality or a network effect. Network externalities often have "tipping points" where, suddenly, the product reaches general acceptance and near-universal usage.

Knowledge spillover of inventions and information - once an invention (or most other forms of practical information) is discovered or made more easily accessible, others benefit by exploiting the invention or information. Patent law is a mechanism to allow the inventor or creator to benefit from a temporary, state-protected monopoly in return for "sharing" the information through publication or other means.

Sometimes the better part of a benefit from a good comes from having the option to buy something rather than actually having to buy it. A private fire department that charged only those people whose house fire they responded to, would arguably provide a positive externality to the entire community at the expense of an unlucky few who actually had to pay. Some form of insurance could be a solution in such cases, as long as people can accurately evaluate the benefit they have from the option.

The major downside to such a system is that the service provider has no obligation to provide the service. In 2010 in Tennessee, a home caught fire and the fire department refused to put the fire out because the household had failed to pay their fire fee of $75.00. In this instance, House A (Did not pay their fee) and the fire department refused to respond to quell the fire. After
the fire spread to the neighbor’s home, the fire department responded and put House B’s (Paid the fee) fire out. House A eventually burned to the ground and House B incurred some fire damage but was generally still stable structurally etc. If the fee is not purchased, you will not receive the fire service. The optimal solution to this externality would be to instead charge a mandatory tax rather than an optional fee.

The sprinkler systems could eliminate the need for a fire department if it effectively eliminates the fire. “California and Pennsylvania, starting Jan. 1, 2011, will be the first two states in the country to require sprinklers in every new home based on the International Code Council (ICC) mandating the installation of residential fire sprinklers in all new one- and two-family residences, including townhouses in the 2009 International Residential Code (IRC). Other states, however, plan to adopt the residential fire sprinkler mandate but delay its implementation, while other states still oppose it.” (www.contractormag.com) this would have the potential to reduce the need of a large fire department in the long run. The argument could be made that the installation of a sprinkler system could pay for itself quickly, instead of having to pay a fire fee each year. Similarly, an “opt-in” policy of this nature would enable residents to pay the fire protection fee if they desired fire service; otherwise, they would not need to worry about being victimized by a neighbor’s “production” of fire damage (cost) to their home.

Some studies find that home ownership creates a positive externality in that homeowners are more likely than renters to become actively involved in the local community. A controlled study on the topic, however, disputes that this effect is causal. Still this is often a justification given for why, in the US, interest paid on a home mortgage is an available deduction from the income tax.

As noted, externalities (or proposed solutions to externalities) may also imply political conflicts, rancorous lawsuits, and the like. This may make the problem of externalities too complex for the concept of Pareto optimality to handle. Similarly, if too many positive externalities fall outside the
participants in a transaction, there will be too little incentive on parties to participate in activities that lead to the positive externalities.

A common solution to providing positive externalities is taxation. A tax requires everyone to pay for a beneficial service, such as police and fire protection, which eliminates the free rider problem. A second way is an Individual mandate, a legal requirement that people purchase a beneficial product, such as insurance. In the United States, the 2010 Patient Protection and Affordable Care Act included a requirement that all citizens purchase health insurance so as to lower the cost of insurance for unhealthy people.

As for as social cost was concerned there is a need to government intervention may be necessary to correct or offset market failure caused by negative externalities – usually the government chooses to tax those producing too much, or they may use the law to prosecute for water pollution or whatever externality the government is tackling.

There are probably fewer cases of external benefits, but if we find any (such as private firms training labour well) we can encourage this by tax breaks or subsidies. Here is government must action with external diseconomies and Government might try by imposing many policies like,
1. Taxation.
2. Regulation.
3. Perhaps extending property rights.
Let us think about polluters – what can the government do using the three points above?

**Taxing polluters:**

The need is to try to stop the problem being “external” and try to “internalise” it. To make the polluter pay for it via a tax. As economists, what we are really doing is trying to get the firm to stop looking only at the private costs and benefits. In the diagram below, we do this by putting a tax on, which shifts the supply curve up from “S Private costs” to “Private costs + tax”. If we get it right, this moves the equilibrium quantity produced from Qa to the smaller output Qb.
For example, in the UK, we now have a Landfill Tax (since October 1996) to encourage recycling. Landfill operators have to pay a tax to the government. It was introduced at the rate for inactive waste, which is easy to deal with, of £2 a ton and other waste at £10 per ton. These amounts might increase shortly.

**Trading permits to pollute:**

Many believe that it is so difficult and expensive to stop companies polluting (identifying who did it can be impossible e.g., with one stream and dozens of factories discharging into it) that instead we should auction off the right to pollute. Only those firms that pay a high price for the limited number of licenses would be allowed to pollute. The government could then use the large sum of money raised to tackle the pollution itself. The end result could be much better than we currently have. If we allow a firm to sell its right to pollute (it may have used only 80 per cent of what it is permitted, for example) then those with the greatest demand for their product, and hence the most profitable, can buy the remaining 20 per cent. It means the things we most desire still get produced but the government has the resources to tackle the resulting pollution. Yet many think it is morally wrong to allow permits to pollute at all! Singapore uses such permits for ozone-depleting substances. The Kyoto Summit on Climate Change (Dec. 1997) saw a move towards such
permits as being an improvement at least! But the United States and Russia refuse to ratify this. In September 2004, President Putin of Russia agreed to it, but it still has to go before the Russian Parliament.

**Positional externalities:**

In case of Positional externalities refer to a special type of externality that depends on the relative rankings of actors in a situation. Because every actor is attempting to ‘one up’ other actors, the consequences are unintended and economically inefficient. One example is the phenomenon of "over-education" (referring to post-secondary education) in the North American labour market. In the 1960s, many young middle-class North Americans prepared for their careers by completing a bachelor's degree. However, by the 1990s, many people from the same social milieu were completing master's degrees, hoping to "one up" the other competitors in the job market by signaling their higher quality as potential employees. By the 2000s, some jobs which had previously only demanded bachelor's degrees, such as policy analysis posts, were requiring master's degrees. Some economists argue that this increase in educational requirements was above that which was efficient, and that it was a misuse of the societal and personal resources that go into the completion of these master's degrees.

Another example is the buying of jewelry as a gift for another person, e.g. a spouse. For Husband A to show that he values Wife A more than Husband B values Wife B, Husband A must buy more expensive jewelry than Husband B. As in the first example, the cycle continues to get worse, because every actor positions him or herself in relation to the other actors. This is sometimes called keeping up with the Joneses. One solution to such externalities is regulations imposed by an outside authority. For the first example, the government might pass a law against firms requiring master's degrees unless the job actually required these advanced skills.
Inframarginal externality:

Inframarginal externality also one type of the externality as externality was concerned. Inframarginal externalities are externalities in which there is no benefit or loss to the marginal consumer. In other words, people neither gain nor lose anything at the margin, but benefits and costs do exist for those consumers within the given inframarginal range.

Technological externalities also one type of externalities and these directly affect a firm's production and therefore, indirectly influence an individual's consumption.

Supply and demand diagram as concerned to externality:

Here is externalities can show by the supply and demand diagrams. The usual economic analysis of externalities can be illustrated using a standard supply and demand diagram if the externality can be valued in terms of money. An extra supply or demand curve is added, as in the diagrams below. One of the curves is the private cost that consumers pay as individuals for additional quantities of the good, which in competitive markets, is the marginal private cost. The other curve is the true cost that society as a whole pays for production and consumption of increased production the good, or the marginal social cost.

Similarly there might be two curves for the demand or benefit of the good. The social demand curve would reflect the benefit to society as a whole, while the normal demand curve reflects the benefit to consumers as individuals and is reflected as effective demand in the market.

External costs:

The graph below shows the effects of a negative externality. For example, the steel industry is assumed to be selling in a competitive market, before pollution, control laws were imposed and enforced (e.g. under laissez-faire). The marginal private cost is less than the marginal social or public cost by the amount of the external cost, i.e., the cost of air pollution and water pollution. This is represented by the vertical distance between the two supply
curves. It is assumed that there are no external benefits, so that social benefit equals individual benefit.

Demand curve with external cost, if social cost are not accounted for price is too low to cover all cost and hence quantity produced is unnecessarily high (because the producers of the good and their customers are essentially underpaying the total, real factors of production.)

If the consumers only take into account their own private cost, they will end up at price $P_p$ and quantity $Q_p$, instead of the more efficient price $P_s$ and quantity $Q_s$. These latter reflect the idea that the marginal social benefit should equal the marginal social cost, that is that production should be increased only as long as the marginal social benefit exceeds the marginal social cost. The result is that a free market is inefficient since at the quantity $Q_p$, the social benefit is less than the social cost, so society as a whole would be better off if the goods between $Q_p$ and $Q_s$ had not been produced. The problem is that people are buying and consuming too much steel.
This discussion implies that negative externalities (such as pollution) are more than merely an ethical problem. The problem is one of the disjuncture between marginal private and social costs that is not solved by the free market. It is a problem of societal communication and coordination to balance cost and benefits. This also implies that pollution is not something solved by competitive markets. Some collective solution is needed, such as a court system to allow parties affected by the pollution to be compensated, government intervention banning or discouraging pollution, or economic incentives such as green taxes.

**External benefits:**

The externality not only gives the external cost but also it gives external benefits. The diagram below shows the effects of a positive or beneficial externality. For example, the industry supplying smallpox vaccinations is assumed to be selling in a competitive market. The marginal private benefit of getting the vaccination is less than the marginal social or public benefit by the amount of the external benefit (for example, society as a whole is increasingly protected from smallpox by each vaccination, including those who refuse to participate). This marginal external benefit of getting a smallpox shot is represented by the vertical distance between the two demand curves. Assume there is no external cost, so that social cost equals individual cost.
Supply curve with external benefits, when the market does not account for additional social benefits of a good both the price for the good and the quantity produced are lower than the market could bear.

If consumers only take into account their own private benefits from getting vaccinations, the market will end up at price $P_p$ and quantity $Q_p$ as before, instead of the more efficient price $P_s$ and quantity $Q_s$. These latter again reflect the idea that the marginal social benefit should equal the marginal social cost, i.e., that production should be increased as long as the marginal social benefit exceeds the marginal social cost. The result in an unfettered market is inefficient since at the quantity $Q_p$, the social benefit is greater than the societal cost, so society as a whole would be better off if more goods had been produced. The problem is that people are buying too few vaccinations.

The issue of external benefits is related to that of public goods, which are goods where it is difficult if not impossible to exclude people from benefits. The production of a public good has beneficial externalities for all, or almost all, of the public. As with external cost, there is a problem here of societal communication and coordination to balance benefits and cost. This also implies that vaccination is not something solved by competitive markets. The government may have to step in with a collective solution, such as subsidizing or legally requiring vaccine use. If the government does this, the good is called a merit good.

**Possible solutions:**

There are at least four general types of solutions to the problem of externalities:

1. Criminalization: As with prostitution in some countries, drugs, commercial fraud, and many types of environmental and public health laws.

2. Civil Tort law: For example, class action by smokers, various product liability suits.

4. Pigovian taxes or subsidies intended to redress economic injustices or imbalances.

One of the solution for control the externality with pigovian tax. A Pigovian tax is a tax imposed that is equal in value to the negative externality. The result is that the market outcome would be reduced to the efficient amount. A side effect is that revenue is raised for the government, reducing the amount of distortionary taxes that the government must impose elsewhere. Economists prefer Pigovian taxes and subsidies as being the least intrusive and most efficient method to resolve externalities. Governments justify the use of Pigouvian Taxes saying that these taxes help the market reach an efficient outcome because this tax bridges the gap between marginal social costs and marginal private costs.

Another solution is that, some counter arguments against Pigouvian Taxes say that the tax does not account for all the transfers and regulations involved with an externality. In other words, the tax only considers the amount of externality produced. Another argument against the tax is, it does not take private property into consideration. Under the Pigouvian system, one firm for example, can be taxed more than another firm, when in reality; the latter firm is producing greater amounts of the negative externality.

However, the most common type of solution is tacit agreement through the political process. Governments are elected to represent citizens and to strike political compromises between various interests. Normally governments pass laws and regulations to address pollution and other types of environmental harm. These laws and regulations can take the form of "command and control" regulation (such as setting standards, targets, or process requirements), or environmental pricing reform (such as Eco taxes or other pigovian taxes, tradable pollution permits or the creation of markets for ecological services). The second type of resolution is a purely private agreement between the parties involved.
One more solution is that, Government intervention may not always be needed. Traditional ways of life may have evolved as ways to deal with external costs and benefits. Alternatively, democratically run communities can agree to deal with these costs and benefits in an amicable way. Externalities can sometimes be resolved by agreement between the parties involved. This resolution may even come about because of the threat of government action.

As for as this solution for externality was concerned, Ronald Coase argued that if all parties involved can easily organize payments so as to pay each other for their actions, then an efficient outcome can be reached without government intervention. Some take this argument further, and make the political claim that government should restrict its role to facilitating bargaining among the affected groups or individuals and to enforcing any contracts that result. This result, often known as the Coase Theorem. This theorem requires that, Property rights be well defined, People act rationally, and Transaction be minimal. If all of these conditions apply, the private parties can bargain to solve the problem of externalities.

**Growth of the social cost and externality theories:**

There were several economists have said about the social cost concept in many decades and they said that in generally the term externality and social cost were same in the sense of welfare concept. And the term also shows the results equally that is “because of the any action from the private people that may results to burden to the third party as negatively.” This is clears that any developmental activities may harm to the society and from this particular action people may suffers a lot. There were many theories are grown up by the many economists about this social cost was concerned. This social cost was earlier it is called as externality when the Karl willium kapp was given first theory on the social cost; the term externality was called as social cost. As given below theories shows that growth of the social costs externality concepts.
1) Karl willium kapp.
2) A.C. Pegoe
3) Ronald Coase.
4) Joseph Stiglitz and Krugman

1) Social cost theory by Karl willium kapp and Karl Polanyi:

The social cost concept was originated by the Karl willium kapp, he only used the term social cost at the first time. Both Karl Polanyi and K. William Kapp were concerned with social costs. Although Polanyi did not use the term extensively, but Polanyi use the term commodity fiction on behalf of the word “social cost”. His concept “commodity fiction” communicates many of Kapp’s concerns. This theory explores the kapp social cost concept with three objectives 1) To draw attention to Kapp’s institutionalism, particularly his “cost-shifting” concept. 2) To promote Polanyi’s fundamental contribution to the analysis of social costs. 3) To recast the social cost concept itself in the context of the pervasive consequences of economic activities on individuals, socio systems, and ecosystems.

The first section examines Kapp’s definition of social cost and his related concept of cost-shifting. The second section explores Kapp’s evolution into institutionalism from the 1940s to his last works in the mid-1970s. The third section reviews the concepts of Karl Polanyi as they relate to social cost, focusing on the commodity fictions, the disembedded economy, the double movement, the obsolete market mentality, and the economistic prejudice. As shown here, Polanyi’s The Great Transformation provides a broad and quite general methodological framework for the study of social costs. Finally, the fourth section compares the social cost concepts of Kapp and Polanyi, intending both to demonstrate their reciprocality and to offer suggestions for pursuing ecological economics.
Social Cost and Cost-Shifting

In the 1950 the Karl willum kapp gave a definition to the social cost. The term social costs refers to all those harmful consequences and damages which third persons or the community sustain as a result of the productive process, and for which private entrepreneurs are not easily held accountable.

He used social cost term on behalf of externality. Although this definition is apparently synonymous with the traditional definition of externality, Kapp preferred "social cost." He was aware of the externality concept and its roots in the work of Alfred Marshall, but considered the term inappropriate and misleading. He chose instead "social cost," because "externality" implies that uncompensated side effects are exceptional rather than pervasive, incidental rather than systemic.

According to Kapp, "Economic theory continued to treat allocation, production, exchange and distribution as if they occurred in an essentially closed and autonomous 'economic' sphere with only minor effects on man's natural and social environment"[3].

But the so-called autonomous sphere is a fiction, and the effects on the environment and society are anything but negligible. So “externality” is inappropriate for historical as well as etymological reasons.

Furthermore, as a concept within neoclassical theory, externality assumes an exogenous institutional structure. "The theory of social costs has always regarded this positivistic acceptance of institutions as a severe self-imposed limitation on neoclassical analysis." But changes in institutional structure are particularly significant for analysis of social costs because there is a built-in tendency for the market system to create new institutions (and new techniques) that actually generate externalities. This fundamental propensity of a competitive system to shift costs is addressed momentarily.

Kapp also objected to the use of "social cost" to describe total social opportunity costs of production and distribution activities because it
robs the term of its content. If some authors appropriate the term social costs in order to refer to the total or actual cost of production in the sense of costs to society, they give it an apparently more harmless meaning than those who prefer to use the term with reference to costs not reflected in conventional cost accounts.

Here is the kapp said that the social cost effect to the third party because of the individual action. And "social cost" refer to much more than third-party spillover effects in an institution static, partial equilibrium setting. Social cost result directly and systematically from the market system, and also the kapp argues that because of the individual action the environment will be harmed, and also these harmful impacts on workers and other people in addition to the environment: "When we speak of environmental disruption we mean in effect the disruption of man's natural and social environment".

The kapp gave a more attention on the health hazards due to individual action as concerned to social cost. The social cost concept applies to chronic health effects suffered by workers because of long-term exposure to hazardous chemicals, overly monotonous or routinized tasks, excessive pressure, or other ‘second-party’ effects. Likewise, second party effects occur when consumers unwittingly purchase unsafe or contaminated products. ‘First-party’ effects include work related illnesses of the self-employed, and of corporate, union, and government bosses. "Social cost" refers also to "n-party" effects, where multiple, often distant individuals or groups or societies or human-supporting ecological systems are injured. Kapp's social cost concept provides a substantial methodological umbrella, under which the widest range of unaccounted for costs can be explored. The Social Costs of Private Enterprise examined the harmful consequences of child labor and the work environment, concluding that "the present system of social and labor legislation represents, at best, only a first step toward the elimination of the phenomenon of social costs". the kapp discussed the book ‘Elsewhere’ in this classic book Kapp
addressed air and water pollution, animal and energy resources, soil erosion, deforestation, unemployment, transportation, technological change, monopoly, and distribution. Notwithstanding his broad perspective and thorough examination of a variety of social costs, Kapp has not been cited by later, less inclusive environmental economics authors. As Alan Coddington pointed out, even unorthodox treatments of environmental problems by Ezra Mishan and John Kenneth Galbraith fail to mention Kapp, although The Social Costs of Private Enterprise is "the only book known to me which could be regarded as a sustained attempt to comprehend environmental problems within the framework of economic theory." Closely related to "social cost" is the concept "cost-shifting," introduced in the preface to The Social Costs of Private Enterprise [4].

The kapp said that, Cost-shifting occurs when entrepreneurial outlays (or the accounting costs of any enterprise, public or private) are reduced, not by employing production methods that are superior from an overall social perspective, but rather by avoiding outlays at the expense of workers, the environment, or the community at large. The accounting entity that accomplishes such a shift will benefit, but society as a whole will be damaged, particularly if this shift occurs in a competitive environment where other enterprises are free to either follow or exit. Cost-shifting is not a core concept, however, in The Social Costs of Private Enterprise. It is mentioned occasionally, and emphasized in the concluding chapter, but the concept remains "underdeveloped." Since costs are not paid by the producing unit, they are by definition borne by others, which means they have been shifted from where they belong. In this sense, cost-shifting is nearly synonymous with social costs: those who created the harmful consequences are not held responsible. Since they do not pay, someone else does. But cost-shifting implies much more than this. It implies that accounting entities have an incentive to shift costs onto others, and, if unconstrained, will do so if it appears to be
profitable. This far richer and more radical "developed" cost-shifting concept appears in Kapp’s articles published in 1969 and 1970 in the journal Kyklos [5], and is emphasized by Kapp in his new introduction for the reissue of The Social Costs of Private Enterprise in 1971.

The Evolution of Kapp’s thought

This section traces Kapp's gradual but continuous evolution into institutionalism from the critical, but somewhat neoclassical, economist of early essays and The Social Costs of Private Enterprise, to the Kapp of the early 1960s, who wrote a critical methodology and substantially revised his 1950 classic, to the Kapp of the late 1960s and 1970s, who pursued a thoroughly institutionalist research agenda. Although Kapp maintained continuity of theme and concept, having never abandoned his underlying concerns, the mature Kapp is certainly much different in methodology, value theory, and research agenda than the early Kapp. At no point was there anything approaching a revolution in Kapp’s thinking, but the cumulative effect of evolving ideas over more than a quarter century amounted to a conversion.

The second part of the kapps social cost concept focus on the evolution of the social cost and cost-shifting concepts from the publication of The Social Costs of Private Enterprise in 1950. It is in this context, and for expository purposes, that we identify ‘three Kapp’s’ the critical but somewhat mainstream economist (early), the emerging unorthodox social scientist (middle), and the mature institutionalist (late). To know these concepts there is a need to study briefly examine two of Kapp's early (1940s) essays to identify some of the early Kapp's basic positions. Then we use The Social Costs of Private Enterprise as the starting point to explore Kapp's evolution in three key areas, efficiency, social accounting, and the definition of economics.

Kapp began his career as a more or less conventional economist with an empirical bent, a critical mind, a broad historical social science perspective, and a desire to contribute to constructive economic policy.
This “early Kapp” is seen clearly in two essays published in 1943 [6] and 1946 [7]. The former essay questions the accuracy and effects of the "rational economic man" assumption of neoclassical theory, points out that psychology is used increasingly to develop and alter wants, bemoans the "serious degeneration of tastes", and suggests a policy of consumer education and counter persuasion by disinterested parties. The latter essay argues that the first course in economics should be an interdisciplinary historical approach to "contemporary civilization," with economic history and history of economic thought in the second course. This essay also demonstrates Kapp’s early interest in national income and social accounting. Kapp argued that these introductory courses should analyze the performance and overall efficiency of the economy in terms of national income and he discussed "social accounting," attributing the term to J. R. Hicks. With an empirical grounding in national income accounting and a perspective on modern society, students would then be ready for "principles" and abstract theories.

In both of these early essays Kapp demonstrated an affinity for institutionalism with his critiques of neoclassical economics, charging that it ignored empirical reality, real world problems, and developments in other social sciences. While the early Kapp was critical of mainstream economics, The Social Costs of Private Enterprise demonstrates his considerable common ground with neoclassical economists. He appealed to the efficiency criterion as the value principle; he apparently believed comprehensive social accounting could be accomplished by reforming traditional double-entry accounting practices, and he accepted Lionel Robbins's formal (wants-scarcity dilemma) definition of economics. Yet Kapp's basic methodology was always historical and empirical, if not always holistic, and he maintained continuity of theme in his work on social costs. This theme is stated clearly in kapp’s 1971 article "Introduction" to The Social Costs of Private Enterprise Maximization of net income by micro-economic units is likely to reduce the net income of
other economic units, and conventional measurements of the performance and "growth" of the economy in terms of national income indicators are inadequate and hence misleading [8].

The early Kapp questioned accounting procedures, but did not attack that fundamental value criterion of neoclassical economics, efficiency. Indeed, he embraced efficiency! The goal of improved efficiency under laid Kapp's appeal to traditional economists to develop social accounting procedures to measure the uncounted social costs imposed on the social and natural environment by production and distribution activities. As Michael Barratt Brown wrote in the "Editor's Preface" to the 1978 edition of The Social Costs of Business Enterprise, Kapp "engages the neo-classical economists in particular in their own language and on their own terms". In both The Social Costs of Private Enterprise and The Social Costs of Business Enterprise, Kapp's analysis is largely "within the framework of economic theory," to repeat Coddington's phrase. Furthermore, in The Social Costs of Private Enterprise, Kapp repeatedly appealed to the efficiency criteria.

In discussing the social costs of technological progress and unemployment in general terms, he commented that these costs are reflected in reduced efficiency of the operation of the economic system as a whole. And in his summary chapter, Kapp argued that, because of social costs, "competitive equilibrium implies necessarily an arbitrary and highly wasteful utilization of resources". Kapp continued to appeal to the efficiency norm of neoclassical economists in later works, though the context was typically suggestive of a broader meaning. For example, "Environmental disruption and social costs put in question not only the scope of economic analysis but above all the efficiency of the market as a mechanism of steering and coordinating the decisions of the various microeconomic units or subsystems in the light of the indicators or signals provided by the price system". and, "Normative economics will have a role to play in the search for and the determination of those
policies and instruments of control that are called for and which achieve the relatively highest efficiency in order to make production and consumption compatible with the environmental norms and goals. We do not imply that efficiency arguments have no place.

As Harry M. Trebing recently pointed out, "It is important to note that government intervention is justified on the basis of improving overall efficiency, and not primarily on the grounds of income redistribution, equity, or fairness". This efficiency focus is important for regulation, because one can then make the case for regulation within the value-domain of the dominant paradigm, which means neoclassical economists and "market-oriented" politicians can be convinced of the need for regulation. Yet Kapp bent over backwards to couch his argument in efficiency terms and to employ the language of microeconomics.

In both The Social Costs of Private Enterprise and The Social Costs of Business Enterprise, Kapp was clearly trying to communicate with neoclassical orthodoxy, and he continued in this vein in later work, even though his efforts were never very successful. In an essay that appeared posthumously in the Journal of Economic Issues, Kapp wrote: "I still hope that [neoclassical] economics can go beyond its traditional boundaries and make a significant contribution to the exploration of environmental problems and policies". In short, Kapp knew the language of neoclassical theory, he tried to communicate with orthodoxy, and, in his two Social Costs books, he leaned heavily on efficiency arguments. Although Kapp's two-part central theme (that the invisible hand generates environmental disruption and that the national accounting system needs reform) did not change, his definition of terms within that theme evolved significantly. The resulting change in emphasis can be seen through an examination of the evolution of his views on social accounting. In The Social Costs of Private Enterprise, Kapp gave no indication that he recognized the major methodological, empirical, or institutional impediments to social accounting. Here Kapp has not even
hinted at methodological problems, empirical problems, or cost-shifters' institutional resistance to social accounting. But, in later works, Kapp cautioned that proper social accounting is neither easy nor precise. Although far more cautious than in earlier works, Kapp still seemed to hold out the possibility that "monetary terms" could be applied in most cases. But in one of his last works, he cautioned that "proposals of 'deducting' social costs from gross or net national product measurements will not get us very far" And finally, in his essay, Kapp wrote: "I am denying that monetary values constitute appropriate and responsible criteria for the evaluation of the damages caused by environmental disruption" [9]. Other convincing evidence of Kapp's evolution toward institutionalism is seen in his different treatments of the definition of economics in the two Social Costs books. In The Social Costs of Private Enterprise (1950), he wrote that he had no "quarrel with Robbins's definition of economics as 'the science which studies human behavior as a relationship between ends and scarce means which have alternative uses'"

Kapp expressed doubt that Robbins would be willing to include social as well as individual means and ends, but, since the definition is not restrictive in this regard, Kapp had no objections to it.

But the Kapp finessed around Robbins' definition, suggesting it addresses. Apparently Kapp's evolution into institutionalism was something of a drift [11]. Kapp, while discussing the relationship between culture and feelings of anxiety and helplessness, cited Polanyi's concept of the embedded economy and quoted from The Great Transformation. Kapp's footnote shows an awareness of, and sympathy for, Polanyi's view, but Kapp remained tentative: "Polanyi seems to go even further in his thesis that economic interests are rarely paramount and that man's economy tends to be completely submerged in his social relationships". Elsewhere in this article, Kapp used John Dewey and J.M. Clark, and developed the theme that the assumption of autonomous individuals must be replaced by
contemporary theories from psychology if economics wants to begin to actually learn about human behavior [12]. So, while Kapp was trying to communicate with traditional economists in the Social Cost of Private Enterprise, he was simultaneously criticizing neoclassical methodology, exploring interdisciplinary topics, and drawing on the work of institutionalists. The kapp says that Other implications may not be "mainstream institutionalist," but follow from his inquiry. Kapp asserted that, "Above all, we must abandon the fatalistic belief in the autonomy of technological change," implying that technology assessment techniques are crucial; and, "In my estimation the environmental crisis may force us to reverse or even replace the utilitarian moral principle of maximizing pleasure by the social and moral imperative of minimizing human suffering."

"In "The Nature and Significance of Institutional Economics," Kapp articulates a two-part institutional value principle: "Possible and desirable Futures need to be defined in terms of essential or basic human and collective needs and the minimization of human suffering". This value premise, although decidedly pessimistic, is not unlike Marc Tool's "continuity of human life and no invidious recreation of community through the instrumental use of knowledge". Both of Kapp's criteria appear to be subsumed under Tool's "continuity of human life," yet both the "basic needs" and "minimum suffering" components also imply equal rights and entitlements analogous to Tool's principle. More important than the similarity of specific value principles is their common approach to social value. Marc Tool could easily be mistaken as the author of Kapp's statement. "Institutional economics aims at a normative system of knowledge which calls for explicit value premises of a preliminary and hypothetical nature".

Polanyi on Social Cost

Polanyi also said about the social cost concept. Polanyi's studies also said, moral umbrage at the ravages of capitalism led Polanyi to conclude that the events culminating in World War II stemmed in large
measure from the enthronement of the ‘self-regulating market’ and its mentality at the expense of society. Polanyi’s approach in The Great Transformation is holistic and ecological, providing a broad framework for the identification, classification, and understanding of social costs. Polanyi’s anthropological approach to economics, on a methodological scale of radicalness, is arguably equal to or even more radical than the historical materialism of Marx. Polanyi contended that the Marxist argument (that is, social relations are determined by economic forces) was correct, but only in a market system. That is, once severed from social control by subjecting land, labor, and capital to self-regulating markets, the economy became "determinative of the life of the body social". Polanyi argued that this was a thoroughly ‘unnatural’ state of affairs, in that history showed no previous instance of such radical separation of the means of ‘getting a living’ from other social relations. The provision of the goods and services necessary for physical survival had never before been left to a mechanism that operated on its own, entirely divorced from the rest of society. In short, Polanyi argued that the economy had never before been disembedded. The crucial element in this disembedding of the economy was the development of self-regulating markets for land and labour, wherein both were treated as mere commodities. Commodities are items produced for sale, and because neither labor nor land can be so described with any accuracy, their commoditization in a market society is ‘entirely fictitious’.

As already known that the Polanyi use the term commodity fiction instead of social cost. Hence, Polanyi coined the term “commodity fiction." This fabrication is nonetheless essential in that the market system, designed to be "self-regulating," could offer no guidance toward the socially constructive utilization of labor and land resources. "The commodity fiction," stated Polanyi, "handed over the fate of man and nature to the play of an automaton running in its own grooves and governed by its own laws".
Polanyi believed this “commodity fiction" to be unsustainable. Production organized under the dictates of an artificial construct "disregarded the fact that leaving the fate of soil and people to the market would be tantamount to annihilating them". As an ethos, as an organizing principle, "commodity fiction" therefore was fundamentally flawed, and was described accordingly by Polanyi as "a postulate that cannot be upheld". Such protection did occur. As the market economy spread, leaving chaos in its wake, society reacted with "protective countermoves" to mitigate the damage. This spontaneous social protective reaction “against the perils inherent in a self-regulating market system was the one comprehensive feature in the history of the age”. The historical occurrence of this spontaneous reaction against the ravages of the free market, even as free market advocates continued to push the market into new areas, Polanyi dubbed the "double movement." Society's protective countermovement was fundamentally subversive of the free market system in that it eroded the self-regulating basis of the market [13].

As a result of this intervention on behalf of land and labour, the autonomous, disembedded economic system of the juggernaut market was partially imbedded within the society. Thus, the market system was, in the purest sense, a uniquely nineteenth century phenomena, one that has all but disappeared [14].

Yet the principles that sustained the system continue to distort our view of man and society even to this day. This distorted view, the "obsolete market mentality," is apparent in the continued uncritical acceptance of the status quo of economic and political power, and in the widespread faith in the invisible hand of free markets as a universally beneficent force. The resiliency of this destructive mentality limits the further "reabsorption of the economic system in society," and frustrates "the vital task of restoring the fullness of life to the person" quoted in Ron article [15].
The market mentality also permits widespread use and acceptance of the "economistic prejudice," which was Polanyi's term for any analysis that judges the merits of a situation with mere market valuations or other narrow material yardsticks. Social costs, those harmful consequences of economic activity that are imposed on persons or the community, are largely ignored or tolerated as a result of the obsolete market mentality, and, particularly, the economistic prejudice. These attitudes suggest that social costs are the inevitable byproducts of progress, and that what really matters is higher "real income." In historical perspective, the implementation of free, self-regulating markets for land and labor was the wellspring of social costs. The disembedded economy, while it lasted, exacted a huge toll on man and nature through the vehicle of social costs, as evidenced by the spontaneous social protective reactions. While restrictions on the free markets for land and labor were implemented long ago, the double movement continues as free market advocates push into new areas, social costs arise, and society reacts for protection. Environmental problems, the most critical of contemporary social costs, reflect this continued play of the double movement. Environmental reality requires that we escape the obsolete market mentality, because to survive, we must learn to plan ahead and to coordinate our intervention rather than to simply react after social costs become apparent.

The Social Cost Concepts of Kapp and Polanyi: A Comparison

There is a close relation between the kapp and Polanyi concepts as related to the social cost. The kapp use the term social cost, but the Polanyi use the term commodity fiction instead of social cost. As this was concerned, few economists have made the connection between Kapp and Polanyi. Richard Norgaard cites Polanyi's The Great Transformation as an example of the "institutional critique of the atomistic-mechanistic characterization of social systems" [16]. Norgaard argues this critique is "an analog of the present critique of the atomistic mechanistic characterization of ecological systems," for which he refers to Kapp
among others. William Ophuls cites Polanyi as an excellent starting point for combining ecology and economics, and then cites Kapp as beginning the "contemporary critique of the market economy as a generator of social costs" [17]. Finally, as we saw earlier, Kapp credits Polanyi with rewriting history from a social cost perspective. Like social costs, cost-shifting is related to the commodity fictions, the disembedded economy, the double movement, and the market mentality. The belief that everything should be treated like a commodity provides the institutional setting within which social costs and cost shifting are tolerated.

The establishment of the self-regulating market system, with its treatment of land and labour as commodities, created the market mentality, but the reactive social protection that followed failed to destroy it. In short, the market mentality continues to dominate our thought patterns long after society eliminated the free markets for land and labor with a barrage of unplanned restrictions. It is this market mentality that provides the climate for wholesale cost-shifting, because the outcome of micro-unit maximizing is believed to be socially beneficial.

In other words, the market mentality, as an established part of the dominant myth system, perpetuates cost-shifting by allowing it to masquerade as technological advance or another form of legitimate cost-reducing activity. Without the market mentality and the accompanying economistic prejudice, cost-shifting would be recognized as such, and would be sanctioned or fined accordingly.

Here the Kapp was economist-turned ecologist, and Polanyi was economist turned historian and anthropologist. Like Marx, Polanyi emphasized the deplorable conditions endured by workers and their children in nineteenth-century England. Thirteen Polanyi's anthropological focus reveals his preoccupation with people, the focus being on the social rather than the natural environment. As Walter C. Neale points out, "Polanyi concentrates upon the creation of a labor market, the market for land having already been largely created by the enclosures of the 1790s"
[18], for Just as it would be a mistake to suggest that Kapp ignored or was unconcerned with labor, likewise it would be incorrect to imply that Polanyi considered environmental disruption a trivial matter. Although Polanyi's relatively light treatment of environmental concerns seems to suggest they are tangential to his theme, the holistic nature of Polanyi's thinking demonstrates a strong ecological bias. People and nature are linked; man and his environment are structurally unified. Consider the following excerpt from a chapter in The Great Transformation, entitled "Man and Nature"[19].

2. Social Cost theory by A.C. pegoe:

A.C. Peguo was the one of the economist as concerned to social cost, and he gave a theory about the social cost in his own view. According to his view social cost considered as “externality”. He has a concept of externality, and Externality exists whenever the exchange between two parties causes benefits or costs to the third or more parties without any equivalent or corresponding gain or compensation. It is the result of the existence of a difference in cost or benefit between the private exchanging parties and the society as a whole. Whenever externality exists, it implies a situation of “getting something for nothing”.

As for as this concept the pigoe gave a three classic examples for understanding the theory. The first example is that, suppose there are two roads, named as Road ABD and Road ACD both leading from A to D. Road ACD is the longer, wider and more winding road. Road ABD is the shorter, narrower but straight road. At the beginning, users will go to the "faster" (i.e. a shorter travelling time) road ABD. Congestion on road ABD will increase the time of an extra user as well as on all other users because traffic is slow down as a result.

Here is anyone user will impose time cost (as well as petroleum expense etc.) on himself as well as on other users on the road - a social cost.
A possible example is the route from Central to Aberdeen by either Pokfulam Road (like Road ACD) or the Aberdeen Tunnel (Road ABD).

In the second example pigoe use a two variables, cattle raiser and Farmer. Here he explains as, there are two pieces of land lying side by side, one for wheat growing and the other for cattle raising. The raiser’s cattle eat or damage the farmer’s crops as they stray when there is no fence surrounding the wheat land. The cattle gains in weight and the raiser gains the value of meat obtained as a result.

Based on Pigou’s analysis, if the raiser is not liable for the damage on crops, he will simply ignore the crop loss and run too many cattle. Conversely, the farmer raises too few crops and external cost is created by the raiser’s cattle.

In the third example pigeo use another two variables orchard and bees. In this example he said, an apple grower provides apple trees for the bees to make nectar. If there is a bee-keeper nearby the apple grower, the bee-keeper benefits from the trees grown by the apple grower, since the benefit may not be realized by the apple grower, planting will be too little. Conversely, the bee-keeper provides a pollination service to the apple grower. Since the service is not paid by anyone, he doesn’t take into account of this external benefit and too few hives will be established.

Here is the two interested parties are not guided by Adam Smith’s invisible hand to the optimal amount of apples and honey production. As come across this in traditional economic theory, such cases are examples of external (to the exchanging parties) costs or benefits leading to a question on the efficiency and power of a free market. Some suggested that it was an indication of “market failure”.

The piguo also said in his theorem the externality itself have a social cost and social benefit. The existence of externality would imply that the private costs or benefits of the exchanging parties are not the same as the costs or benefits imposed on the society as a whole. The difference is called the external cost or benefit.
Here is the theorem also express the private cost and social cost concepts. Private cost refers to the highest-valued option forgone of a resource available to a producer or a person who makes the decision. Social cost measures the highest-valued option forgone of a resource available to the society. External cost is the cost inflicted to a third or more parties without compensation. It exists when an act of a person imposes cost on others, and the person does not need to bear the cost for some reasons. The private cost and social cost had a divergence.

The below equation shows the social cost.
Social Cost = Private (Internal) Cost + External Cost

The External benefit is a spillover to a third party without payment. Means that,
Social Benefit = Private (Internal) Benefit + External Benefit

The piguo in his theorem said about divergence between private cost (benefit) and social cost (benefit) as this was concerned he use a below diagram for show this divergence.

**Divergence between Private Cost (Benefit) & Social Cost (Benefit)**
Pigou also gave a solution to externality as part of his theorem. He said that the market mechanism reacts to the private or internal costs or benefits with the forces of demand and supply. It is criticized that the market fails to take into account of the external costs or benefits so that efficiency (i.e. MUV = MSC = MPC) cannot be achieved.

In the case of piguos two roads example Piguo argued that if both roads are left free to use by drivers, there will be too many cars on Road ABD (i.e. congestion) and too few cars on Road ACD. Road ABD is said to be over-utilized and Road ACD is under-utilized. It leads to an inefficient allocation of resources (roads). There is a (dead-weight) loss in social welfare.

Pigou suggested that a government intervention by levying a tax (toll) on Road ABD users to discourage the potential users. Traffic congestion could be avoided with some users drive on Road ACD. As a result, the external costs are “internalized “by the taxation because users of Road ABD have to bear the full cost, i.e. social cost = original private cost + tax (toll charge).

In the case of the cattle raiser and farmer example, he suggested that, the traditional approach is to minimize the damage or cost rather than to maximize the total gain. In Pigou’s opinion, the government should intervene by introducing a tax on the cattle raiser and gives a subsidy to the farmer; or a legal prohibition on the cattle raiser on his cattle to eat the crops.
In the case of orchard and the bees’ example, the traditional approach would agree to give subsidies to the bee-keeper and the apple-grower because they provide mutual benefits. The problem lies on the difficulties in pricing and measurement of nectar, the value of services provided by the bees [20].

3) Ronald Coase theory on social cost:

Ronald Coase, a Chicago scholar, advanced a series of critiques of the Pigovian tax system. The theorem that bears his name is merely the best known. In his 1960 work, [21] he said about the social cost concept. He gave more importance in his theorem for societal problems. He sought to demonstrate that the internationalization of social costs was not always socially useful. In addition, he identified other institutional solutions to which systems can and often do resort. One of these solutions is to simply authorize the harmful activity without introducing mechanisms to internalize social costs. Beyond the abstraction of his ideas, Coase’s method of analysis has not had a great influence on economists thinking. His theorem, as it is commonly known, looks more like an elegant, abstract reflection then a tool for identifying institutional solutions to concrete societal problems.

Among legal economists, however, Coase’s teachings have had a greater influence. Unfortunately, even within this group of scholars, the conviction that external costs should, optimally, be internalized often emerges almost unconsciously in their literature.

The risk inherent in this attitude lies in the possibility of finding systems for internalizing social costs in legal institutions which do not appear to have such an underlying logic, as for example some kinds of tort liability.

The coase constructing his theorem on the critics of the peguo welfare concepts. The 1960 article by Ronald Coase, The Problem of Social Cost begins as a critique of the thinking of Pigou, the father of Welfare Economics, as well as the Pigovian tradition. According to Pigou when faced with a harmful action, lawmakers should develop a mechanism to internalize the external
costs. This would force the actor to consider in his cost-benefit analyses all the social costs associated with his activity, including those that fall on others. Pigou believed that this internalization could be best effectuated by imposing a tax equal to the external cost upon the actor. Since the actor would only have an incentive to conduct his activities up to the point at which his net benefit equaled the external cost, society would reach a Pareto-efficient situation.

Here is Coase also recalls the oral Pigovian tradition according to which internalization of social costs associated with the actor's activity should have been possible to implement through the institution of civil liability. Theoretically, this regime, would force the actor to consider, in his own selfish calculations, external costs as well. These costs would be internalized to the extent that the compensation that the actor must pay equals the externality caused by him or her. The logic of internalization of Pigou’s followers therefore always led them to hold that for every harmful action it was necessary to come up with a mechanism suitable for ensuring that the actor would consider any external cost as his own. That it was necessary to force the actor to internalize the externality. In his 1960 work, Coase makes a series of observations following this line of reasoning, and proposes others in his 1988 article.

The coase strongly argues that, the government should impose the tax on every harmful activity in the world. He wanted to demonstrate that the world in which every harmful activity has a tax or some other mechanism for internalizing the external costs associated with it was unrealistic. He proposed that this abstract world could only exist in the minds of scholars, as a “blackboard economy,” as he said in 1988 [22]. In The Problem of Social Cost, Ronald Coase highlights the fact that legal rules govern harmful activities in a way that does not correspond to an internalization of social costs mechanism. Legal rules, in fact, normally authorize or prohibit certain activities. They do not allow the actor to carry out certain actions as long as
he is willing to bear the consequences, consequences which may consist of paying a tax or compensating the harm.

It may be said that law, even in promoting economic efficiency, performs an assessment of the social desirability or undesirability of a certain activity, which implies the actor's direct measurement of the private benefit and of the external costs deriving from that behavior.

The internalization mechanism has the great advantage of ensuring that the actor utilizes his own information to assess whether it is better to give up an activity, carry out that activity while taking precautions, or to carry out the activity without taking precautions. Thus, the private benefit, in the event that the external costs are perfectly internalizable through the tax or compensation for the harm, coincides with the social benefit.

Ronald Coase criticizes this mechanism championed by Pigou and his followers. The idea that goes by the name “Coase Theorem” is merely one of the observations that Coase makes about Pigou’s reasoning. The observation is in fact valid to the extent that the transaction costs are negligible. However, if we put transaction costs back into the analysis, Pigou’s reasoning appears to have some validity. If we hold that transaction costs cannot be left out, it is then Coase’s other criticisms of the Pigovian tradition that need to be considered. Coase’s intention was to show that there are institutional solutions other than the Pigovian tax system for promoting economic efficiency.

Legal rules can, for instance, facilitate negotiations among the parties. But the main idea in Coase's work is that some harmful activities can be assessed by the legal system as purely lawful, without the provision of a mechanism for internalizing the external costs.

Coase makes four criticisms of the Pigovian tradition. These can be described as: “the reciprocal nature of the problem;” “Coase Theorem;” “joint causation of harm;” and “the costs of assessing and verifying external costs.”
THE RECIPROCAL NATURE OF EXTERNALITY:

The first criticism is, as summarized by the Chicago economist, “the reciprocal nature of the problem.”

Coase writes:

He says, the traditional approach has tended to obscure the nature of the choice that has to be made. The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is, how should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would inflict harm on A. The real question that has to be decided is, should A be allowed to harm B or should B allowed to harm A? The problem is to avoid the most serious harm. So Coase thus shows that externalities are the result of subjective rights.

Giving a right to a person allows him to cause harm to third party. The Chicago economist uses his classic example to adumbrate this concept: “I instanced in my previous article the case of a confectioner the noise and vibrations from whose machinery disturb a doctor in his work. To avoid harming the doctor would inflict harm on the confectioner. … Another example is afforded by the problem of straying cattle which destroys crops on neighboring land. If it is inevitable that some cattle will stray, an increase in the supply of meat can only be obtained at the expense of a decrease in the supply of crops.”

The coase said about the pigous examples, he opinioned that, giving the confectioner the right to make noise allows him to inflict an externality upon the doctor. Recognizing the doctor’s right to prevent the confectioner’s noise allows the doctor to inflict an externality on the confectioner. Likewise, authorizing the cattle-raiser to invade the farmer’s cropland allows him to inflict harm upon the farmer. Recognizing the farmer’s right to keep animals from wandering onto his land allows him to harm the cattle-raiser. The difference lies only in the fact that, in the first case, the externality derives from an action which the subject takes, whereas in the second case the externality derives from the impediment created by the right.
Hence, Coase’s reflections highlight some gaps in the way economist’s reason. Indeed, normally we think of an externality when we assume that a certain subject does not have the right to carry out a certain activity.

That means that mainly we imagine the existence of an externality only when a certain action may cause harm to others, not when a subject's action may prevent others from carrying out a productive activity beneficial to others. For example, typically in analyzing problems associated with the use of property (in particular real estate), we think about the externality that arises when a subject invades the physical space of other people’s property. However, we do not think of the external diseconomy that results when a subject prevents others from invading the physical space of his own property.

In addition, it is possible to develop Coase’s thinking by considering some other examples, the production of emissions or the right not to have people passing through or parking on one’s land both include the possibility of inflicting harm on others. In the first case, the externality derives from the subject’s action, an action whose effects have repercussions in the spatial sphere of others property. In the second case, the externality derives from the prohibition established by the law and the action does not impact the spatial sphere of others rights. In both these hypotheses, however, any protection of a claim by a subject involves a cost to others for which no recompense is paid, i.e., an externality.

Moreover, the right to fly over someone else’s land is the source of an external cost; a sacrifice must be borne by the owner of the land. Notably, however, the right to prevent planes from passing over one’s land also causes an externality, those interested in flying over the land experience a loss of utility.

Economists and jurists said that, this is one of Coase’s lessons should not remain tied to a predetermined concept of causality. Thus, a legally protected claim cannot simply be denied to the subject who ‘causes’ the harm. The law must choose the solution that ensures the greatest net social benefit even if this means that an action may impose a cost on others. In fact,
property, or the very right to exclusive use of a thing, involves an externality, a sacrifice borne by the subjects who might have otherwise utilized the item.

At this point, it is important to examine the verity of Coase’s first criticism of the Pigovian tradition. Pigou and his followers believed that the introduction of a tax or the provision of compensation for harm was the solution to the problem of external costs. The solution of an absolute prohibition of the activity in question is never addressed (at least explicitly) in Pigou’s work.

Thus, at first glance it might seem that Coase’s first observation on Pigou’s thinking is off the mark. However, at closer reading, the Chicago economist’s analysis sheds light on a situation that is normally neglected by the Pigovian approach. Where the law gives a subject the right to prohibit a certain activity the problem of externalities arises as it would in any other case, and it is possible that the private cost which the holder of the veto power manages to avoid by exercising his power is in fact lower than the lost utility for the subject who sought to carry out a certain action. Pigou seems to be referring in fact only to activities that cause harm to third parties.

How can we explain the fact that economists have not noted the possibility of inefficient results in this case, i.e., in the event that a subject has the power to prevent a harmful activity?

The answer can be found in the second criticism that Ronald Coase advances against the Pigovian tradition, a criticism represented by his well-known theorem.

**EFFICIENCY IS EVER ASSURED: COASE THEOREM:**

The coase said that, once we have revealed the reciprocal nature of externalities, it would seem that the solution to the problem of correcting external effects becomes more complicated. The solution cannot in fact lie in the prohibition of harmful activities, since such a prohibition would involve a social cost represented by the loss of benefits that such activities may yield. The solution lies in prohibiting certain harmful activities and authorising others, or in reducing those harmful activities to an optimum level.
However, this problem disappears in the presence of a particular condition identified by Ronald Coase, a condition consisting of the “absence of transaction costs.”

Thus, we come to the second idea presented by the Chicago economist in his 1960 article, consisting of the theorem that bears his name. Coase did not formulate the theorem, however. In addition, it has multiple definitions [23]. One formulation that is however to be found in the Coase’s article can be presented as follows. In the absence of transaction costs, the harm caused to others by a subject’s activity also constitutes a cost for the actor more precisely, an opportunity cost represented by the missed gain obtainable through an agreement with the victim.

As Ronald coase said about the transaction costs. Here is, Private cost and social cost are thus equal, in the absence of transaction costs, since the cost incurred by another is a benefit lost for the actor. The externality is therefore always internalized in the form of a lost gain idest in a contract between parties.

In order to keep the activity from being carried out, the victim would be willing to pay a sum equal at most to the harm which he would otherwise suffer if the harmful activity were carried out. Thus, in assessing whether it is worthwhile to carry out a certain harmful activity, the actor should consider the benefit he will lose if he decides to carry out the activity rather than come to an agreement with the victim to avoid the activity.

Coase’s theorem can also be described by saying that “In the absence of transaction costs, the right always ends up in the hands of the one who values it more.” Imagine the case where Tom, owner of a piece of land, has the right to prevent Dick from letting his herd of cattle graze on the land. Suppose also that Tom values that right more than Dick is willing to pay.it is an externality, Tom suffers an inefficient loss because it is bigger than the benefit for dick.

The example also explains here, the right being considered is not simply the right to let one’s herd graze. It is a two sided right, the right to have one’s herd graze and the right not to have the herd graze on one’s own
land. The proposition that, the right always ends up in the hands of the one who values it more, it indicates that since Tom holds the right not to have the neighbour’s herd grazing on his land, he will not grant it (since Dick will not be willing to pay the minimum amount that Tom requires to grant it). However, if Tom did not hold the right to prevent the herd from grazing on his land, he would acquire it from Dick (since Dick is willing to grant it for a sum lower than the maximum amount that Tom is willing to pay, Tom ‘values the right more.’) Regardless of the initial attribution of rights, at the conclusion of any negotiations Tom will hold the right not to have the neighbour’s herd grazing on his land. The inefficient externality has been eliminated.

With regard to the right to conduct harmful activities, the assertion that, in the absence of transaction costs, the right will end up in the hands of the one who values it more means that these activities will be carried out if the actors value the right to perform them more than the victims value the right to prevent them, regardless of the rights initial configuration.

Hence the right is double sided. One may have the right to perform a certain activity, or the right to keep that activity from being performed. Coase’s theorem states that, in the absence of transaction costs and regardless of the initial attribution of claims, the right will always appear in the form that has the greater value.

Now must determine whether Coase’s second criticism of Pigou’s thinking is on target. It should be noted that the Chicago economist himself considered the world without transaction costs to be quite far removed from his own idea of the real world. So it can be said that, since transaction costs do in fact exist, and thus we cannot rely on private accords to correct externalities up to the efficient level, Pigou’s argument remains valid. In other words, since the prescriptions of Coase Theorem are not applicable to a world with positive transaction costs, externalities must be corrected through other mechanisms and cannot rely on negotiation between individuals.
Coase seems cognizant of this. Immediately after advancing the idea that became associated with his name, in fact, he formulates his third criticism of Pigou’s reasoning, represented by the problem of the “joint causation of harm.”

The Ronald coase lastly concludes with Having shown the reciprocal nature of externalities and the non-existence of the problem when transaction costs are absent, Coase describes the problem represented by the joint causation of harm, which leads to what Robert Cooter [24], Would call the “paradox of compensation.” Coase thus highlights the problem by which the amount of harm deriving from a certain activity may depend also on the activity carried out by the victim, for which reason it seems that the optimal social solution would be to apply certain precautionary charges to the victim, or restrict his activity [25].

4) Joseph stiglitge and krugman theory on social cost:

The Paul krugman who was a Nobel laureate in economics 2009, and another economist Joseph stiglitz said an opinion about the external cost. They said that because of the individual activity which harm to the society creates a social cost. As for this was concerned they give an explanation by using a financial crisis or recession. Here they more concentrate on United Nations economy. Five years after the onset of the financial crisis that badly damaged the US economy, the nation remains mired in chronic joblessness. The unemployment rate, stubbornly above 8 percent, actually makes the situation look better than it is. Many millions have given up looking for work and no longer figure in the statistics. Long-term unemployment remains at levels unseen since the Great Depression. Young Americans are entering the worst job market in at least a half-century. For both the long-term unemployed and new job seekers, this sustained absence from the workforce will have permanent effects on both their earnings and their well-being. And not just theirs. We have all lost, and continue to lose, from the prolonged mass idleness of potentially productive workers.
These economists opined that the reason for the social cost occur in the country is that, according to Stiglitz, is that the vaunted American market is broken. And the reason for that, he argues, is that our economy is being overwhelmed by politically engineered market advantages, special deals that Stiglitz labels with a term familiar to economists. “Rent-seeking.” By this, he means economic returns above normal market levels that are derived from favorable political treatment. In the most powerful parts of The Price of Inequality, Stiglitz chronicles the blatant tax and spending giveaways to big agriculture, big energy, and countless other sectors. Yet he also pointedly argues that much of the rent-seeking that plagues our economy takes a more subtle form, also familiar to economists. Negative externalities or costs that economic producers impose on society for which they do not pay.

These economists said that individual action create the external cost in the society. The spectacular profits of the energy industry, for example, rely heavily on the failure of regulation to incorporate fully the social and economic costs associated with environmental degradation, including climate change. Similarly, the increasingly aggressive activities of Wall Street, whether in the marketing of unsound mortgages, the use of excessive leverage, or the irresponsible use of derivatives, create huge risks for the economy as a whole. Yet these risks are largely not taken into account in the prices paid in financial markets. Without effective regulation, the costs are borne by all of us. Most acutely by the struggling millions who have been pushed out of jobs.

America’s long-term debt picture poses serious problems, as both Stiglitz and Krugman recognize, especially in funding health care, for example, but Krugman pointedly reminds us that the economic and social costs of a premature pivot toward deficit reduction are catastrophic. (He quotes Keynes: “The boom, not the slump, is the time for austerity.”) The forces demanding major cuts now, however, are immensely powerful. To take just one example, former commerce secretary Pete Peterson (with a huge personal fortune built on Wall Street) has dedicated roughly half a billion
dollars to the cause of reshaping elite and public discussion of deficits. Peterson and other deficit hawks have funded activities ranging from highly publicized Washington meetings with administration officials and politicians, to advocacy organizations insisting that deficits pose the nation’s greatest crisis, to educational materials for high schools. The latest such effort is a $25 million campaign led by the Peterson-funded Committee for a Responsible Federal Budget that includes one hundred CEOs of Fortune 500 companies. These campaigns are cast as nonpartisan drives for good governance and shared sacrifice. Far too often, however, the push for austerity falls on weak claimants rather than weak claims.

These economists said that, without a clear understanding of the forces reshaping American politics, efforts to reverse these trends are unlikely to triumph. By putting politics center stage, Krugman and Stiglitz greatly advance that cause. Yet neither offers a fully convincing diagnosis, albeit for very different reasons. In Stiglitz’s case, the problem is that his book is too sweeping. In his view, the political system is wholly owned and operated by and for the top 1 percent. This is certainly the direction, in which things have been trending, but it ignores the notable, if limited, successes Democrats achieved both before and after 2008, including the Affordable Care Act, and it does a disservice to the efforts of many political leaders on behalf of middle-class economic interests. For all the pull of money, the differences between the two parties on economic issues are greater than they have been since at least the 1930s. To take only one example, which could be endlessly multiplied, current GOP plans to “repeal and replace” the Affordable Care Act would result in around 50 million more Americans without health insurance.

Weeding out these and other forms of rent-seeking would thus promote both efficiency and equity, and Stiglitz provides a broad list of reform ideas, ranging from strict regulation of financial markets to more effective anti-trust laws. Yet he is most passionate about the need for political reform. Either those at the top will realize that things must change, or, he
suggests, the kinds of popular revolts sweeping Middle Eastern nations will come to the United States. “In important ways,” he writes, our own country has become like one of these disturbed places, serving the interests of a tiny elite. We have a big advantage, we live in a democracy, but it is a democracy that has increasingly not reflected the interests of large fractions of the population.

Indeed, the most striking feature of these two books by Nobel Prize–winning economists is their emphasis on politics. Economists have traditionally insisted on the primacy of economic factors. In studying growing inequality, for instance, they have focused on economic forces like trade and technological change. Only in recent years (in part through the urgings of iconoclasts like Krugman and Stiglitz) has there been a turn to politics to explain America’s distinctive economic challenges. A reorientation that brings economics back toward its original conception as the science of political economy.

No one can doubt that the American political economy has changed dramatically over the last generation. Perhaps most fundamental is a transformation that Stiglitz and Krugman seem to assume and barely mention the huge shift in the relative influence of business and labor. The sharp decline of unions outside the public sector (where they are now deeply embattled) has not only affected the bargaining power and compensation of employees in the workplace. It has also greatly weakened the major organized group most capable of defending less affluent Americans in the political arena.

Yet Washington is stuck in neutral. Worse than neutral, it is in reverse. As the last elements of the 2009 stimulus phase out, the initial flood of federal aid has slowed to a trickle. If no agreement is reached before early next year, the trickle will become a huge backward flow, as President Obama’s payroll tax cut and all the Bush tax cuts expire while automatic spending cuts agreed to in previous legislative sessions kick in. Already, Republican leaders are threatening to replay last year’s standoff over the debt ceiling. Meanwhile,
state and local governments prohibited from running sustained deficits, increasingly dominated by anti-spending forces continue to cut aid to those out of work and slash programs that invest in the nation’s future while laying off teachers and other public workers. Without those layoffs, the current unemployment rate would probably be around 7 percent.

Against this backdrop, no book could be timelier than Paul Krugman’s *End This Depression Now!* Since the crisis began, Krugman has argued with consistency and increasing frustration that the United States has become caught not in a normal recession, but in a “liquidity trap.” Since interest rates are already at rock bottom, normal measures, such as easy credit, will not work, and expanded government expenditures must play a central part in boosting anemic demand. Otherwise, the efforts of private citizens to pay down debts laid bare by the financial crisis will continue to hold the economy back.

To Krugman, this is all the more regrettable because it is almost wholly preventable. We know what to do, he argues, increase public spending and make it clear that monetary expansion will continue until the economy fully recovers. Krugman advocates greater federal aid to state and local governments, as well as an aggressive effort to relieve private mortgage debts. He also argues that the Fed has been too timid in setting higher inflation targets to restore expectations of growth. “Unfortunately,” Krugman writes,

We are not using the knowledge we have, because too many people who matter politicians, public officials, and the broader class of writers and talkers who define the conventional wisdom have, for a variety of reasons, chosen to forget the lessons of history and the conclusions of several generations worth of economic analysis, replacing that hard won knowledge with ideologically and politically convenient prejudices.

Krugman is at once ruthless and humorous in taking on these prejudices. Early in the crisis, he started writing about a “Confidence Fairy” invoked by deficit hawks the notion that credibly tackling the deficit would
lead to increased investor confidence and thereby economic expansion. He was equally dismissive of the notion that “bond vigilantes,” a staple of the Wall Street Journal editorial page, would go after the United States by demanding higher interest rates on loans if the US didn’t immediately slash its deficits. He reserved his greatest scorn, however, for those who predicted that expansionary policies would unleash crippling inflation. This, he insisted, was a “phantom menace.” Weak demand and rock-bottom interest rates have made banks reluctant to lend even with looser money; without such lending and the resulting expansion, Krugman argued, underlying inflation couldn’t and wouldn’t escalate.

A few years later, Krugman has been entirely vindicated in these judgments. Though the US deficit remains large—mainly due to the downturn and policies set in place before it, not the 2009 stimulus—interest rates have not spiked; quite the opposite: they are at record lows. The bond vigilantes and runaway inflation are nowhere to be seen. Economic performance has been unimpressive in the countries that have voluntarily slashed spending, such as the UK and the Baltic states of Estonia and Latvia. As Krugman patiently argues, stalled investment and the pattern of unemployment across different sectors of the economy point again and again to a shortage of demand as the central problem. By contrast, the evidence provides virtually no support for the repeatedly shifting conservative talking points about incipient inflation, business skittishness over regulatory uncertainty, or a sudden collapse in the quality of the American workforce.

Clearly, however, those driving economic policy in Washington do not agree and that is what really frustrates Krugman. He laments what he sees as the growing insulation of America’s economic and political elite from the struggles of ordinary Americans. “For middle-income families, even before the crisis,” he writes, there was only a modest rise in income under deregulation, achieved mainly through longer work hours rather than higher wages.
For a small but influential minority, however, the era of financial deregulation and growing debt was indeed a time of extraordinary income growth. And that, surely, is an important reason so few were willing to listen to warnings about the path the economy was taking.

In this indictment, Krugman is joined by another Nobel laureate economist, Joseph Stiglitz, whose claims are much more sweeping than his. In an argument that dovetails with those of Occupy Wall Street protesters, Stiglitz insists that the huge and growing divide between the richest 1 percent and “the 99 percent” is not just one concern among many, but the defining characteristic of a thoroughly sick economy. We may be the richest nation in the world, but poverty is higher and social mobility between generations lower than in other rich nations. In other respects, our model is bloated. We release far more carbon dioxide and use far more water on a per capita basis, and we spend far more on health care, while leaving tens of millions uninsured and achieving health outcomes that are mediocre at best.

House and doll, Firebaugh, California, 2009, photograph by Ken Light from Valley of Shadows and Dreams, which pairs his images of the economically hard-hit Central Valley with text by Melanie Light. It includes a foreword by Thomas Steinbeck and has just been published by Heyday.

Krugman’s view is more measured. He believes inequality is a huge problem. But he recognizes that there is considerable uncertainty regarding many matters about which Stiglitz expresses greater confidence. For example, he notes that we still do not know exactly how or by how much rising inequality contributed to the financial crisis. And he is often astute in outlining the formidable barriers to better policymaking in Washington.

Yet Krugman sometimes falls into the opposite trap: he plays down the deep structural barriers that advocates of reform face. Krugman keeps returning to the notion that President Obama did not aim high enough or try hard enough. The economic stimulus was too small; the president too deferential to Wall Street; the White House too slow to recognize the need for additional action and too timid in demanding that action once it did. These
complaints certainly have some basis, but they seriously understate the hurdles the president had to surmount.

Adding to this imbalance is the ever rising flood of money into American politics, vividly on display in this first presidential race to take place after the Citizens United decision. Commentators wonder whether President Obama can hold even in the resulting money contest. But the impact of big donors and highly partisan outside groups is likely to be at least as great, and more lopsidedly Republican, in the battles across the nation for control of Congress and especially of the House. Like the presidential race, the congressional contests are well on their way to record spending levels, particularly for continuing GOP control of the House.

What’s more, campaign contributions are only a small proportion of political spending. The organized energies of corporations and the wealthy influence every aspect of American governance. These efforts range from direct lobbying of political officials, to drives to shape both mass and elite opinion, to the long cultivation by conservative activists of a Supreme Court majority advancing a more pro-business economic agenda, to the carefully planned use of fiscal crises in many states to mount a frontal assault on public sector unions.

For the Republican Party, the effect of the new balance of organized power has been radicalization. Economic interests that support the GOP have ample money to give, and they give it aggressively. Donors have had enormous success in creating organizations to set and enforce a hard-right agenda. Such organizations include Grover Norquist’s Americans for Tax Reform, influential think tanks like the Heritage Foundation, and state-level lobbying organizations like the American Legislative Exchange Council, financed by the conservative multibillionaires Charles and David Koch. This rightward march is long-standing, but it has only been accelerated by the rise of the Tea Party—itself supported in part by some of the same groups.

The story on the other side is very different. While the shifting balance of money and organization has encouraged Republicans to become sharply
more conservative, it has created conflicting incentives for Democrats. Still reliant on their traditional but declining base within organized labor, they have nonetheless sought with increasing success at least until recently to develop pockets of financial support within sympathetic corporate quarters. Now that the financial industry has swung back toward the GOP, it is easy to forget that tapping Wall Street donors allowed Democrats to approach financial parity with Republicans in the 2000s. And unlike the GOP, where moderates have essentially vanished, some important groups of Democratic politicians self-consciously describe themselves as centrists (usually, they are also the ones most actively seeking business support). The result for Democrats has been an awkward dance between tepid populism and compromised centrism that has frequently divided the party and muddled its message.

The disturbing effects of these two growing imbalances between the rich and the rest and between a conflicted Democratic Party and a more united and aggressive GOP are exacerbated by America’s ailing political institutions. Our constitution was designed to simultaneously make compromise necessary, owing to the separation of powers, and also to facilitate compromise by making sure that individual politicians would not coalesce into hardened blocs. In writing Federalist 10, however, James Madison did not anticipate the rise of hyper partisanship and money driven politics or the emergence of the Senate filibuster as a routine method of minority obstruction. The necessity to compromise still applies, but the features intended to facilitate compromise, such as staggered terms of office and the dependence of politicians on highly distinct local constituencies, no longer reliably work. The result is not only gridlock, but (especially on the GOP side) a form of zero-sum conflict in which any action that might be helpful to the other party is by definition an action to be relentlessly opposed.

This immobilization and trench warfare reinforces all the forces pushing toward greater inequality. First, a government that cannot act has no way of responding to disruptive economic change. This is a big part of the
story of recent financial excesses, as powerful interests effectively stalled efforts to adapt financial regulations to rapidly evolving markets. Second, gridlock and incessant bickering disgust and alienate voters, feeding confusion, distrust, and disenchantment. As ordinary voters set their sights lower or disengage, they cede political ground to well-organized activists and economic interests.

Finally, gridlock blurs accountability, making it easier for politicians to depart from voters’ priorities. In parliamentary democracies, voters can relatively easily reward or punish politicians. The party or coalition in power, from the prime minister to the backbenchers, must bear responsibility. In the United States, responsibility is much harder to assign especially now that a party needs at least sixty votes in the Senate to overcome the omnipresent filibuster. GOP leaders know the president and his party are likely to receive most of the blame for poor economic performance, even if the scorched-earth resistance of conservative Republicans is the biggest obstacle to enacting the president’s policies.

They said that, the priorities of the wealthy and powerful show up not only in the premature focus on deficit reduction, but in the way austerity seems likely to be targeted. A genuine effort to combat long-term deficits would address the myriad ways, documented by Stiglitz and many others, in which the federal government subsidizes economic behavior that has real costs for our society—whether by failing to require companies to pay a tax on their carbon emissions or allowing billionaire hedge fund managers to pay taxes at rates far lower than those affecting middle-class families.

Most obviously, since projected long-term deficits are largely driven by rising health costs (which threaten the private sector at least as much as the public), a serious response to long-term deficits would address the factors that make our health care by far the most expensive in the world. We would follow the example of other nations, using the buying power of government to produce real cost containment in the medical industry, rather than following the blueprint outlined in the Ryan Plan, which produces “cost
“savings” by simply gutting the programs that give tens of millions of Americans access to care.

This is the central message of Krugman and Stiglitz: we have a choice. Politics got us into our economic mess, and only a revitalized politics can get us out of it.

From the day he entered office, the president was engaged in fierce organized combat with well-financed defenders of the status quo and a monolithically opposed Republican Party. To get the Affordable Care Act through Congress, President Obama not only had to court recalcitrant Democratic moderates (after it became clear that the few Republican moderates would be of no help). He also had to buy off the major industry interests, whether insurance companies, hospitals, or the pharmaceutical industry, which meant, above all, forgoing more direct and effective measures to control costs.

With regard to the stimulus, Krugman makes a strong case that the president and his economic advisers should have pushed for more. Still, from the outset the main constraints he faced were political. There is little reason to think that a bolder administration could have gotten stimulus expenditures that were close to what was required. (A more self-inflicted wound, which Krugman rightly bemoans, was the weakness of the administration’s efforts to tackle the crippling problems of the housing market—underwater homes, defaults, foreclosures—that continue to drag down demand.) Nor, given the continuing rightward shift of the GOP, is there reason to think that the administration’s lack of leadership represents the big problem today. “All that is blocking recovery is a lack of intellectual clarity and political will,” Krugman concludes. Yet even the most strong-willed president would still confront an army of powerful interests, a radicalized GOP majority in the House, and the filibuster in the Senate, along with a lot of Democrats caught between their traditional constituents and commitments and an increasingly money-driven political world.
Krugman’s equal emphasis on the need for “intellectual clarity” provides the justification for his important book. As he recognizes, the struggle over how to fix the economy is in part a battle of ideas, and the Keynesian prescriptions that Krugman favors (and he marshals impressive evidence in favor of them) are losing that battle. Yet it has to be acknowledged that proponents of these ideas have struggled to win favor with voters as well as elites. The Keynesian insight that, under special conditions, increased government spending can create demand and boost growth is, for many, counterintuitive and complex (even Krugman’s lucid discussions are occasionally hard going), and it runs up against traditional notions of household thrift. Revealingly, even during the heyday of American liberalism, FDR and other leaders rarely argued for spending on Keynesian grounds. They called for concrete programs—from unemployment insurance to progressive taxation—that had the effect of boosting demand when the economy was slack.

Today, the argument for a positive role for government is harder to make than ever, and not just because one party categorically rejects it. Public distrust of government is deep—in large part, ironically, because many citizens feel it is under the thumb of powerful economic interests—and polarization has fueled skepticism that there are any accepted economic prescriptions. Americans say the economy must be fixed, but that doesn’t mean they know how to fix it, much less think Washington can fix it.

Still, voters do have some ideas about what should be done. A majority of Americans have consistently told pollsters that creating jobs is a much higher priority than tackling the deficit. And when asked how deficits might be reduced, the public strongly endorses increasing taxes on the wealthy and cutting defense spending. The problem is not that these ideas couldn’t guide policy. It’s that they have almost no political traction in Washington. The most influential Republican budget plan—the blueprint put forward by Representative Paul Ryan and given even greater prominence by his selection as Mitt Romney’s running mate—would do just the opposite of what most
people say they want. The plan would add to the Bush tax cuts for the wealthy; increase, rather than cut, defense spending; and enact huge cuts in social programs for the poor and middle class, including Medicaid and Medicare. These are changes that polls show Americans (including, at least with respect to Medicare, even Tea Party supporters) strongly oppose.

While the Ryan budget is at odds with the stated priorities of the majority of Americans, one group appears quite supportive of its general thrust—the superrich. Most polls reach few if any extremely wealthy Americans. But thanks to a pilot poll recently commissioned by a team of political scientists, we now know that the very rich are indeed different from the rest of Americans: They place much higher priority on deficit reduction and cutting spending, and much, much lower priority on reducing unemployment.

Certainly one of the most striking features of current debates is the economic hawkishness of the American upper crust. Krugman and Stiglitz are rightfully amazed at how, once the most intense part of the crisis was past, economic elites averted their gaze from the ongoing hardship. That powerful CEOs and financial executives could cause so much damage and yet restore their position (and paychecks) so quickly suggests an extraordinary culture of self-justification and demand for deference. Perhaps most telling is the apparently genuine and widespread fury among financial elites at Obama’s occasional, mild criticisms of their excesses.

Nowhere are the effects of unequal power clearer than in the shifting commitment of elites to limited government and deficit reduction. When many of today’s loudest deficit hawks had the opportunity a decade ago, they repeatedly chose policies that worsened the deficit in order to lavish benefits on the wealthy and powerful business interests. These benefits ranged from two huge tax cut bills to new subsidies for the oil and gas industry to an unfunded Medicare drug benefit full of handouts for the pharmaceutical industry. They were backed by the economic seers of their era, such as former Fed Chair Alan Greenspan, who insisted, astonishingly, that large-scale tax
cuts were justified in 2001 because then-projected surpluses might eventually eliminate the federal debt, forcing the federal government to begin buying up corporate stock. Occasionally the mask slips off entirely. During the last round of intense fighting over the deficit, in the mid-1990s, then House Majority Leader Dick Armey confessed.

Balancing the budget is the attention-getting device that enables me to reduce the size of government. Because the national concern over the deficit is larger than life. So I take what I can get and focus it on the job I want. If you are anxious about the deficit, then let me use your anxiety to cut the size of government [26].
References:


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