Block's Erroneous Interpretations

Harold Demsetz

Walter Block has absorbed 64 pages of *The Review of Austrian Economics*[1] to attack a 19-page paper I wrote.[2] This is his second outburst. The first, to which my 1979 paper was partly a response, appeared in *The Journal of Libertarian Studies*.[3] Block should have put this matter behind him rather than stewing over it for the 16 years between his current reply and my 1979 paper. I learn nothing from reading his part of this debate, and apparently he learns nothing from reading my part, so I write this reluctantly and refuse to join in any future similar exercise in futility.

In my response to his first paper, I wrote both about the error in his economics and the naiveté in the moral positions he took. I invite the reader to consult the above-referenced papers if he or she desires to know more about the moral issue. My intent here is to write briefly and to confine my comments to the central economic arguments

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[1]Walter Block, "Ethics, Efficiency, Coasian Property Rights, and Psychic Income: A Reply to Demsetz," *Review of Austrian Economics* 8, no. 2 (1995): 61–125.

[2]Harold Demsetz, "Ethics and Efficiency in Property Rights Systems," in *Time, Uncertainty and Disequilibrium: Explorations of Austrian Themes*, Mario Rizzo, ed. (Lexington, Mass.: D. C. Heath, 1979), pp. 97–116.

[3]Walter Block, "Coase and Demsetz on Private Property Rights," *Journal of Libertarian Studies* 1, no. 2 (Spring 1977): 111–15.

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made by Block in his latest critique. Block's rumination on morals merits no response from me.

The economic argument concerns Coase's[4] analysis of the resource-allocation consequences of alternative assignments of ownership rights. His well-known analysis presented a view of the externality problem different from that held by Pigou (and, at the time Coase wrote, from that held by the economics profession). In the introduction to my 1967 paper "Toward A Theory of Property Rights,"[5] I referred to Coase's analysis to show its applicability beyond Pigouvian-type externality situations, briefly noting military recruitment as an example:

> The taxpayer benefits [from a military draft] by not paying the full cost of staffing the armed services. The costs that he escapes are the additional sums that would be needed to acquire men voluntarily for the services or those sums that would be offered as payment by draftees to taxpayers in order to be exempted. With either voluntary recruitment, the "buy-him-in" system, or a "let-him-buy-his-way-out" system, the full cost of recruitment would be brought to bear on taxpayers. . . .
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> A law that establishes the right of a person to his freedom would necessitate a payment on the part of . . . the taxpayer sufficient to cover the cost of using that person's labor if his services are to be obtained. The costs of labor thus become internalized in the . . . taxpayer's decisions. Alternatively, a law that gives the . . . taxpayer clear title to slave labor would necessitate that the slave owners take into account the sums that slaves are willing to pay for their freedom. These costs thus become internalized in decisions although wealth is distributed differently in the two cases. All that is needed for internalization in either case is ownership which includes the right of sale . . .

[4]Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (1960): 1–44.

[5]Harold Demsetz, "Toward a Theory of Property Rights," *American Economic Review* 57 (1967): 347–59.

> There are two striking implications of this process that are true in a world of zero transaction costs. The output mix that results when the exchange of property rights is allowed is efficient and the mix is independent of who is assigned ownership (except that different wealth distributions may result in different demands).[6]

This example, for reasons known better to Block than to me, led him to make the following outrageous charge: "I shall then consider what can only be considered immoral implications Demsetz draws from Coase's view of property."[7] On this score, I note only that my conclusions were an exercise in positive economics, but if one truly desired to detect my preferences, as between the alternatives considered, all he would need to observe is where I placed the words "freedom" and "slave" in the above quotation. The positive economic conclusions I drew from this example contained nothing really new. They are simple extensions of, and in accord with, conclusions drawn by Coase in his analysis of Pigouvian externalities. What is novel is the non-Pigouvian context.

Block's strategy in his newest critique is two-fold. First, he seeks to separate Coase and Demsetz, claiming that his original critique of positive economics properly applies only to Coase's conclusions, not to mine. He makes this distinction simply because Coase was not as explicit as I was in the parenthetic reference to income effects in the above quotation. I note that he did not separate Coase and Demsetz in his original critique. Having defended his earlier attack on Coase, the second step in his present critique is to extend the coverage of his complaint to even my conclusions. I consider these steps in turn.

To separate Coase and me, Block serves up his interpretation of Coase's writings. His claim is that Coase's conclusions are invalid because Coase makes no statement equivalent to mine in its explicitness in regard to income effects. Coase, of course, is quite capable

[6]Ibid.: 349. The parenthetic phrase is contained in the original.
[7]Block, "Coase and Demsetz on Private Property Rights": 111.

of speaking for himself, but I find Block's interpretation of Coase quite unreasonable and quite lacking in any real attempt at understanding. Coase's statement about the consequences (in a zero-transaction cost case) of a court's decision regarding the right to control an externality-relevant resource is that the decision "would not affect the allocation of resources but would merely alter the distribution of income" as between the two parties, plaintiff and defendant.[8]

Persons trained in economics, which is the audience Coase was addressing, would know that an alteration in income distribution generally implies a change in resource allocation, simply because the two parties before the court spend their incomes differently. Coase should have no need to make this point explicit. Block takes the opportunity afforded him by the incompleteness of Coase's exposition to interpret Coase as claiming that different incomes result from the court's decision, but that these differences in income generate no derivative effects on resource allocation.

Block is entitled to his interpretation, but it is unreasonable. A reader seeking to understand Coase could easily understand why he does not waste words on the obvious. He is dealing with Pigouvian *efficiency* conclusions in regard to externalities. One could simply modify the quotation from Coase by rewriting the first phrase to read "Would not affect the *efficiency* of the allocation of resources." This would be entirely within the spirit of Coase's article, and is an accurate reflection of Coase's disagreement with Pigou. The modified statement completely undermines Block's criticism of Coase. Incomes might be altered by the court's decisions, and these altered incomes would affect resource allocation, but they would not affect the efficiency of resource allocation. After all, it is the efficiency of allocation, not the specific allocation of resources, that is Pigou's issue.

[8]Coase, "The Problem of Social Cost": 5, cited in Block, "Ethics, Efficiency, Coasian Property Rights, and Psychic Income": 64.

Perhaps more important, the misallocation in resources that Pigou (and the profession) saw as a consequence of externalities *has nothing to do with changed consumption expenditures resulting from altered incomes*. For Pigou, a laundry cleans too few clothes and a neighboring factory produces too much output because the factory owner fails to take account of the costs that soot from his factory imposes on the laundry owner's operations. The inefficiency does not come from the reduced consumption that might follow from the greater poverty in which the laundry owner finds himself as a result of soot from the factory. In demonstrating the error in Pigou's logic, it is only necessary for Coase to show that all costs of the interaction between the parties are taken into account. A laundry owner made wealthier by a court's decision in his favor spends more on a variety of goods, and a factory owner made poorer by the same decision spends less on a different variety of goods, but what has this to do with the logic that connected externalities to inefficiency? Absolutely nothing. It would have been a waste of time for both Coase and his readers to use several paragraphs to discuss the changed pattern of expenditures that can result from a change in the distribution of income, only then to deny its relevance to the externality question. Hence, he simply writes that the court's decisions can alter the wealth between the two parties. Block, in his most recent critique, uses Coase's brevity to support a claim that Coase, although he noted the change in income distribution that would result from the court's decision, erred by not concluding that, as a result, resource allocation would be affected. But it is Block who is wrong, for he confuses the changed consumption patterns that accompany a redistribution of wealth with the Pigouvian logic that derives an inefficient alteration in resource allocation from the failure of one party to take into account the effect his activity is having on the production cost of a second party.

The second statement referred to by Block is one used by me in commenting on his first criticism of the logic used by Coase and me:

> The substantive issue has to do with whether or not the assignment of right ownership will alter the mix of output when "bargaining transactions . . . are costless [and] changes in the distribution of wealth . . . can be ignored." Coase and I [with a proviso about "free riders"] say no; Block says yes.[9]

I clearly state that an unaltered mix of output requires both that transaction cost should be zero, and the income effects should be absent, so Block cannot level at me the same trivial debating point he levels at Coase. He is required, if I am to be found in error, to show that a change in resource allocation follows from a change in ownership identity, and that this does not result from positive transaction cost or an income effect. To do this, he again trivializes the issue, this time by renaming income effects as psychic effects.

The case in point is an interaction between a factory and a neighboring homeowner. Soot descends on the neighbor's soil, making it unfit to grow a garden. The neighbor, if he owns the right to control the soot content of air, refuses to allow the next door factory to put soot into the air, and he does so even if the factory offers him a sum equal to the cost to it of installing a smoke stack soot cleaner. This clearly reveals that in this state of affairs, the gardener puts a higher value on his garden than the sum he foregoes. Suppose, however, that the factory has the right to control the soot content of the air. To preserve his garden now, the gardener must pay the factory to have it remove soot from the air. However, his wealth position is such that he cannot afford to pay for the installation of the soot cleaner even if he were to devote his entire wealth to the task. Hence, if he owns the right to control the soot content, there is a garden and no soot. If the factory owns the right, there is soot and no garden. Resource allocation is altered, yet we are assuming no cost of negotiating between the two parties. Has an income effect produced the reallocation? I say yes. Block says no. He writes:

[9] Demsetz, "Ethics and Efficiency in Property Rights Systems": 98.

> All that is necessary is that there be an otherwise penniless farmer who derives more value from his flower bed than the cost of installing a smoke prevention device, and cannot bribe the factory to install it, even though he inhabits a zero transaction costs world. He cannot do so . . . because even though his psychic income [from a garden] is $100,000, and the smoke prevention device costs a mere $75,000, this psychic income is specific to him and him alone. It does not translate into a value recognized by anyone else, particularly including the factory owner. He cannot sell this flower bed to a third party, and use the proceeds to bribe the factory owner. This is because the flower bed, his only possession, is not valued by anyone else besides himself. . . . It is impossible for him to "give up $75,000 of the other goods" (as claimed by Demsetz in his indifference curve analysis) because he simply does not have such funds available to him.[10]

The last phrase "because he simply does not have such funds available to him" sounds like an income effect to me. If the gardener possessed much wealth, he would buy the clean air his garden needs, but if he is poverty-stricken he will not. That he will not because he "cannot" does not make this any less an income effect. From the perspective of the economic analysis of income effects, there is no difference between a person not purchasing good X because he desires to spend his wealth on other goods and a person not purchasing good X because he hasn't the wealth to make the purchase. In both cases, more of good X will be purchased if more wealth is provided to this person.

Consider the last sentence in the quote from Block more fully, because it misrepresents my indifference-curve analysis. The figure from my paper referred to by Block conveyed the following message. It says that if the gardener owns the right to control the soot content of the air, he can have his garden and still continue to consume as much of

[10]Block, "Ethics, Efficiency, Coasian Property Rights, and Psychic Income: A Reply to Demsetz": 71.

other goods as has been his habit. Alternatively, he can give the garden up by selling permission to the factory owner to put soot in the air, in which case, because of the payment he receives, he can buy $75,000 of other goods. This is $75,000 more of other goods than he could have bought by doing without his garden if he did *not* have the right to control the soot content of the air (but the factory owner did). This clearly establishes that the gardener's budget constraint is different under the two possible court decisions, and that is what I portray in the indifference curve figure to which Block refers. It should be obvious to everyone (other than Block) that the right to control soot content is valuable. Hence, the court's decision does alter the wealth of the parties. That the gardener is too poor to buy clean air when he does not possess this right cannot constitute a denial of this wealth effect. That he does buy clean air when he possesses this right is clear from the fact that he forsakes the $75,000 he could have received were he willing to tolerate soot (and the loss of his garden).

Why is he willing to buy the garden by foregoing $75,000 if he owns the right but not if the factory owns the right? Since we are assuming that his preference map has remained unchanged across the court-determined alternatives, the explanation for his changed behavior can only reside in the altered position of his budget constraint. His refusal to accept the receipt of $75,000 to give up his garden (if he possesses the right) is an implicit cost to him of retaining the garden. In effect, contrary to Block's assertion about the gardener's inability to sell the garden to anyone, the garden can be sold to the factory for $75,000. If the gardener does not possess the right to control the soot content of the air, this implicit $75,000 is converted to an explicit cost of retaining the garden, for now the gardener must pay $75,000 to the factory owner to secure the needed reduction in soot. Hence, the price to retain the garden is the same in both cases, $75,000, but in one case this price is measured by income foregone and in the other case by income spent. This conversion from implicit to explicit cost *is* a reflection of the altered distribution of wealth wrought by the court. With the gardener's utility map unchanged and the price for retaining the garden unaffected by the court's decision (i.e., implicit and explicit cost are simply two different ways in which this $75,000 price enters the utility maximization equation), the gardener's changed behavior can only result from the wealth effect that accompanies the switch from an implicit to an explicit cost.

Block cannot deny the altered behavior, because this is necessary for him to claim that resource allocation has been changed as a result of the court's decision, but he cannot attribute the change either to transaction cost or to income effect if he is to sustain his refutation of my conclusion. Wealth clearly has been changed by the court's decision, the gardener's utility function has not been changed, and the price of the garden, $75,000, has not been changed. Well, there seems nothing left for Block to do than to admit that resource allocation has changed because of an income effect.

How does Block maintain his critique? Why, by changing the name of the income effect to that of psychic effect. Block's discussion of psychic value versus market value is the way he slips this change into the discussion. But, why is psychic value exercised one way if the gardener owns the right to control soot content and exercised the other way if the gardener does not? Is his case any different from someone who thinks a building is underpriced by the market but refuses to buy it because he is too poor, and then, after inheriting some wealth, makes the purchase? Does it matter to the definition of income effects in economics whether the reason he believes the building is undervalued is (a) because he thinks he can generate higher money income (than "the market" thinks) from renting the space out or (b) because (although the market estimate of income is correct) he derives additional "non-marketable" personal utility from his being identified as the owner of this particular building? There is no analytical difference between these cases, and they are both properly classified as income effects when associated with the change in this person's behavior that results from his inheritance.