Social costs, social rights and the limits of free market capitalism: a re-reading of Kapp

Maurizio Franzini*

Introduction

One of the most impressive and well-known results in economic theory is that perfectly competitive markets, unaided by other institutions, lead to a Pareto efficient situation, a condition that no society can disregard light-heartedly[1].

On the other hand, for many decades now, mainstream economists have been well aware that the ability of a free competitive market system to ensure Pareto-efficiency may be undermined by externalities, i.e. uncompensated damages suffered as a result of somebody else's action not consented to[2].

Externalities, therefore, may strike a hard blow to traditional economics by seriously weakening its appalling thesis on the efficiency of free markets. One important effect of this thesis has been to induce most economists to believe that a decent society requires little more than competitive markets and effective protection of property rights.

Externalities, however, have been metabolized by mainstream economics and there have been no significant changes either in the body of that theory or in the recommendations flowing from it. Basically, externalities are like exceptions which prove the rule.

Outside mainstream economics, several scholars with more radical inclinations based their harsh criticism of free markets in a capitalist society precisely on uncompensated damages. In their opinion, such damages – which they preferably call "social costs" – make it necessary to revise the conventional wisdom about the virtues of free markets. This is what economists like William Kapp and Federico Caffè, among others, strongly believed.

---

* University of Rome "La Sapienza"

[1] As it is well known, Pareto efficiency is fulfilled when there is no alternative to the established situation such that somebody is better off and nobody is worse off.

[2] Talking of damages I consider negative externalities only. Of course it is also possible to have unpaid benefits, in which case we face a positive externality.

A direct comparison between these two competing views took place at the beginning of 1970's when William Kapp and a distinguished orthodox economist, Wilfred Beckerman, quarrelled specifically over the impact of social costs and externalities on conventional economic theory. In the article that started the debate, Kapp stated that "the conventional framework and tools of economic theory are ill-adapted and in fact irrelevant for the analysis of the phenomena under discussion" (Kapp 1970, p. 839). To this Beckerman replied: "I cannot accept without protest the general theme of Professor Kapp's paper" (Beckerman 1972, p.103) and "Perhaps Professor Kapp has missed something through dismissing contemporary economics too contemptuously?" (Beckerman 1972, p. 106). In his rebuttal, Kapp patiently spelled out some of his arguments, which were undoubtedly interesting, but surely did not change Beckerman's mind.

The problem is extremely complex. However, it can be approached in many different ways. In this paper I offer my reading of the debate and my opinion on what lies at the root of this controversy. I will not try in any sense to construct a different type of economic theory compatible with the social costs phenomena, as Beckerman repeatedly and polemically asked Kapp to do in the mentioned paper. It is not a matter of building a radically new economic theory but of drawing the right implications from economic theory and from real world phenomena that can hardly be considered minor exceptions. The dispute revolves mainly around the soundness of economic arguments in support of free markets in a capitalistic system.

As I understand it, Kapp and Caffè, on the one side, Beckerman and lots of orthodox economists, on the other side, are talking about completely different problems, even though the wording might appear similar. Beckerman looks at uncompensated damages from the point of view of economic theory and as a challenge to the Pareto-efficiency of free markets. Kapp and Caffè, on the other hand, were concerned not with the efficiency properties of the market but with the violations of social rights, which are basically what social costs are about. Their primary intent, I believe, was how to make social rights compatible with free market capitalism. And they found that this was not an easy task at all. The implications of these opposite ways of looking at uncompensated damages are far reaching not so much for the foundations of economic theory as for the recommendations economists can make on how to build a decent society and the role that free markets should have in it.

This paper is organized as follows. In the first section I present the dominant interpretation of externalities and its almost exclusive concern with Pareto- efficiency. Then I show how different Kapp's social costs are - being the other side of social rights, which are non-existent in traditional economics. In the next two sections I briefly explain why social rights protection may conflict with both capitalistic property rights and free markets, showing the inadequacy of the institutional recipe (free markets plus capitalistic property rights) recommended by traditional economics. Finally I go into the very difficult and unsolved question of how to protect social rights in a non-paternalistic society - a crucial problem to which, I believe, Kapp so timely drew our attention.

Externalities and efficiency

It is widely believed that the notion of externality made its first appearance in Alfred Marshall's *Principles of Economics in* 1890. Since then a huge amount of economic studies has been devoted to externalities but, unsurprisingly, no shared consensus on the exact meaning of the term has emerged.

Several economists, all of them adopting the mainstream approach, have proposed their interpretations, which differ from one another in several important respects. After the founding fathers Marshall, Sidgwick and Pigou we can recall, among many others, Knight (1924), Meade (1952) Scitovsky (1954), Bator (1958), Coase (1960), Buchanan and Stubblebine (1962), Demsetz (1967) , Arrow (1971)[3].

This is not to deny that a necessary condition for a negative externality is an uncompensated damage inflicted to a non-consenting party. Everybody agrees on that. Still there are many unsettled questions.

Nevertheless, a slow process of convergence seems to have unfolded over time and a dominant approach has taken shape. The first distinguishing feature of such approach is the lack of concern for the context within which the uncompensated damage originates. It makes no significant difference whether the damage arises in the production or distribution of goods or else in the consumption sphere. Nor does it matter whether the damage is caused by a monopolistic firm or an unaware charity.

All that matters – and this is the second distinguishing feature – is that there is a loss of welfare suffered by a non-consenting and non-compensated party. No other dimension of the damage is given. A good example is natural environment: its degradation, however serious it may be, is not an externality insofar as nobody believes her welfare is impaired. This is a logical consequence of the welfaristic hallmark of modern economic theory.

---

[3] Papandreou (1994) carefully reconstructs the most important aspects of this debate.

The third and, in my opinion, most important feature of the dominant approach is that it focuses only on uncompensated damages that do infringe Pareto efficiency. Buchanan and Stubblebine (1962) make this point very clear when they define Pareto relevant externalities i.e. externalities the elimination of which may benefit all the parties. In their own words:

"…externalities, external effects, may remain even in full Pareto-equilibrium. That is to say, a position may be classified as Pareto-optimal or efficient despite the fact that, at the margin, the activity of one individual externally affects the utility of another individual……This point has significant policy implications for it suggests that the observation of external effects, taken alone, cannot provide a basis for judgement concerning the desirability of some modification in an existing state of affairs. There is not a *prima facie* case for intervention in all cases where an externality is observed to exist. The internal benefits from carrying out the externality, net of costs, may be greater than the external damage that is imposed on other parties "(Buchanan-Stubblebine 1962 (1972) , pp. 208-9).

Therefore when economists talk of (negative) externalities they refer only to those actions that cause losses to somebody greater than the advantages they bring to somebody else. Actions whereby losses are less than benefits are disregarded, regardless of any other consideration, because they are consistent with Pareto efficiency – i.e. it is not possible to make both parties better off. From the standpoint of Pareto efficiency, a rich acting in such a way as to increase her welfare more than the welfare of a non-consenting poor decreases would not inflict significant damage, even though such little loss may drive the poor to starvation.

In a free market only those transactions that have a net positive value will be carried out: nobody would spontaneously accept to sell something that costs more than the price the buyer is willing to pay. This helps to clarify the close connection between Pareto-relevant externalities on the one hand, and efficient markets, on the other.

Externalities that are not Pareto-relevant are outside the reach of free markets, therefore their persistence cannot be blamed on the bad working of the market. Strictly speaking, the market fails only insofar as Pareto-relevant externalities persist. Therefore the agenda of the orthodox approach is set: focus on that type of externality only and endeavour to demonstrate that its origin lies not in badly working markets but in the lack of some market, in the failure to satisfy all the pre-conditions for markets to develop. It is a well-known fact that this is what the Coasian "revolution" has brought about, at least in the dominant interpretation.

This concern for the efficiency property of the markets explains why the dominant approach picks up externalities that are "anonymous", uncompensated damages, defined as a loss of perceived welfare, the magnitude of which is greater than the benefit accruing to the advantaged party.

It is my contention that to fully understand what marks the difference between orthodox and more radical approaches to externalities one has to bear these features in mind. Otherwise, authors like Kapp or Caffè,[4] who fully belong to the more radical camp, would be incomprehensible. I believe that their first concern was not the efficiency property of the market, even though this is a very important issue.

To them, and to other unorthodox scholars, externalities and social costs were the sign that market capitalism was plagued by a very serious problem: the lack of institutional protection for some basic social rights. Therefore to talk about externalities and social costs is not, primarily, to talk about the Pareto-efficiency of the market but how to reconcile free markets with social rights, and how difficult it is to bridle the capitalistic market so as to eliminate the most unacceptable of those uncompensated damages determined by the violation of social rights. This approach implies that the type of uncompensated damage to look at is quite different from the one which takes centre stage in the more traditional analysis.

Losing sight of these differences makes it impossible to appreciate fully Kapp's ideas and to understand the deepest reasons for his distance from the more traditional approach. The importance of these reasons should not be discounted, as borne out by the rather clumsy debate with Beckerman, a stern defender of orthodoxy, which took place at the beginning of the 1970's[5].

In the next sections I will try to make these points as clear as possible, starting from a brief reconstruction of Kapp's conception of social costs.

Social costs and social rights

"In short, the term *social costs* refers to all those harmful consequences and damages which other persons or the community sustain as a result of productive processes and for which private entrepreneurs are not held accountable." (Kapp, 1963 p. 13)

This concise and clear definition of social costs highlights some important aspects of Kapp's vision.

---

[4] In what follows I refer repeatedly to Kapp's writings. On Caffè's approach to externalities see, among others, Caffè (1990) and Ciccarone's remarks(1995)

[5] The debate was originated by an article by Kapp (1970). Beckerman wrote a harsh reply (Beckerman 1972) to which Kapp reacted firmly but politely (Kapp 1972).

First, it is irrelevant whether the action under consideration brings about damages that exceed the gains it yields to the acting party. Secondly, and more important, Kapp explicitly and exclusively mentions damages resulting from production carried out by private businesses.[6] He does not care about uncompensated damages of different origin. The anonymous agent of the orthodox approach now takes on a clear identity.

To shed more light on Kapp's vision, let us consider another quotation where he intends to assert that social costs are not the result of environmental disruption alone :

"by stressing the ecological aspect may divert our attention from those social costs which find their expression in such phenomena as work injuries and accidents, rhythms of work inimical to human health, crowded and inadequate housing conditions, damaging levels of noise, enforced and uncompensated adaptations to structural changes, workman compensation systems rendered inadequate by inflation and, last but not least, monopolistic determination of real estate values and rents in congested urban areas, all of which can and do arise in contemporary industrial societies" (Kapp 1970, p. 838)

This is a long and apparently messy list. Kapp himself admits that social costs so defined cover a great variety of social losses and therefore lack definiteness and precision. But:

"Our concept identifies these characteristics in terms of the empirical consequences of production activities which the entrepreneur does not bear but is able to shift to other persons or to the community at large. In this sense our concept is both concrete and operational" (Kapp 1963, p. 20).

It is definitely clear that Kapp believes that the distinctive character of social costs is that they should be borne by entrepreneurs, but are not. It is as if they were dodging their responsibility. If entrepreneurs have a duty to bear these costs then the "community at large" has the right not to be burdened by them. In other words, entrepreneurs are also violating someone else's rights. In a nutshell, social costs are the monetary side of unprotected social rights. To look at social costs as violated social rights has, in my opinion, far reaching consequences and puts on a firmer ground the difference between orthodox externalities and more radical social costs.

Indeed, all the listed items in the preceding quotation relate to some type of social rights. Also because of this it is foolish to assume that Kapp would consider these violations less relevant and would not care about

[6] One has only to remember the title of his best- known book (*The Social Costs of Business Enterprise)* to understand the importance Kapp attached to this aspect. To be sure, he explicitly stated that this is one distinguishing feature of social costs, the other being their avoidability (Kapp 1963, pp.13-14)

them, were the value of damages in terms of perceived welfare loss smaller than the advantage enjoyed by business firms violating those rights.

I am sure he was not interested at all in Pareto inefficient situations where some rich people suffer a significant loss as a consequence of an action yielding only a small advantage to a poor. This may be Pareto relevant but hardly fits into the conception of social costs as infringements of social rights. Social costs might very well arise in a context that is not relevant to Pareto-efficiency, even though this is not a necessary condition. Kapp's perspective is by no means Pareto-efficiency.[7]

He wants to draw our attention to the many types of damage that businesses impose upon non-consenting people in the real world. He looks at the whole set of uncompensated damages caused by private capitalism in its real working. It is not a coincidence that the examples he provides are so different from the neutral and anonymous cases typically considered by the more traditional literature on externalities (the rancher and the cattler, not to mention the bees and the flowers).

Kapp's crucial problem - and also Caffè's – is not, therefore, how uncompensated damages undermine the market ability to ensure Pareto efficiency. His problem is whether market capitalism can be reconciled with some basic social rights. As I say below, he is very sceptical about this possibility, to put it mildly.

Here lies, in my opinion, the crucial difference between Kapp and the more orthodox approach. He is at pains to make this difference clear in his writings arguing that social costs are different from externalities, making several points to this end.

Kapp argued that social costs are more serious, pervasive and widespread than externalities are believed to be. Therefore they are not a minor disturbance that can be omitted from a more general analysis and mended by the market itself (Kapp 1963, p. 271). He tried to show that externality is too vague a concept, an empty box, a cover-all concept devoid of practical relevance. He also criticized the static nature of externalities but, to be honest, did not develop his analysis of social costs in a full-fledged dynamic setting. He pointed his forefinger at the closed model used to study externality that underestimates interdependencies and cumulative development.[8] From all this he drew the conclusion that "the conventional framework and tools of economic theory are ill-adapted

---

[7] Indeed Kapp criticizes this criterion by subscribing to Reder's remarks (Kapp 1963, p. 41).\

[8] Kapp asserts that the true problem are those macroeconomic extra-market and extra-industry cause and effect relations which are cumulative in character and that neoclassical economics has neglected, in contrast to the classics, Marx and Veblen (Kapp 1970, p. 842)

and in fact irrelevant for the analysis of the phenomenon under discussion" (Kapp 1970, p. 839).
All these points are important. However none of them goes right to the root of the problem, as I see it, which is the nature of the uncompensated damages under consideration. Social costs are infringements of social rights perpetrated by market capitalism, be this in contrast with Pareto efficiency or not. From this perspective, they can support a very radical critique of real markets. To reconcile those rights with market capitalism is not an easy task at all, because most social costs grow out of the lawful exercise of basic capitalistic property rights. Actually, Kapp's problem can be framed as a clash between social rights and capitalistic property rights.

Social costs and property rights

There cannot be free market transactions without well-defined property rights. Should there be no agreement on the person who owns specific resources, and therefore is to be paid for the right to use such resources to be transferred, no exchange could take place in the market. Starting from this uncontroversial but widely overlooked observation, Coase (1960) came to the conclusion that the lack of well-defined property rights is the ultimate cause of externalities.
Indeed, when transaction costs – broadly conceived - are nil, well-defined property rights are a necessary and sufficient condition for all the reciprocally advantageous transactions to take place between rational and free agents. In other words all the opportunities for Pareto improvements will be exploited and, therefore, no Pareto relevant externalities will persist. Clearly, Coase too looked at externalities as a worrying phenomenon only because they endangered the efficiency properties of the market.
His contribution has been interpreted as an attempt to demonstrate that far from being a proof that markets fail, externalities are the consequence of a missing precondition for their working. Given the emphasis, too often ignored, Coase placed on transactions costs as obstacles to the efficient working of the market, this interpretation may be a bit unfair to him. On the other hand, I believe that it was no little merit to remind that markets too need preconditions, i.e. they are not natural, self-sufficient systems. In particular, from Coase on it is quite clear that the market can, at least in principle, support well diversified systems of property rights and it is a mistake to confuse the market (a system for making decisions, in the end) with capitalism (a system of property rights that has highly significant power and distributive implications). Our concern is not the

debate on Coase. However, his approach is useful in several respects. First, it helps to go into the problem of the relation between social rights and property rights – an apparently awkward matching. Secondly, it allows us to identify and keep separate the criticisms that, starting from social costs, can be levelled against capitalistic property rights, on the one hand, and against market transactions, on the other. I believe that in Kapp's writings both capitalism and the market are under the fire of his critical remarks, but for different reasons.

According to Coase, if Pareto efficiency is the goal, all that is required is a clear allocation of property rights, whatever it may be. If transaction costs are not significant, that sole condition will allow markets to work efficiently. Assume now that your goal is the same as Kapp's, i.e. to protect some social rights, the violation of which gives rise to social costs. Can Coase's proposition be reformulated so that free market will not interfere with the protection of social rights? In principle it can. Social rights could be interpreted as property rights on some specific actions or resources.

Let us consider an example taken from Kapp's list of social costs: technological change. Kapp states that the loss of income and welfare on the part of the workers displaced by innovations introduced by business firms is to be reckoned as a social cost. More to it, he believes that this driving force of capitalism dynamics is one of the most serious and systematic sources of social costs (Kapp 1963. ch.10). It is not my purpose to go into this thorny problem. To highlight the relation between social and property rights, let us assume that workers have property rights on a technology so that entrepreneurs cannot change it without getting their permission , which implies buying the technology from them.

If all the agents are rational only those changes in technology that make the workers better off will take place.[9] Their social right is, therefore, protected by a combination of property rights and free exchange. Moreover, social costs will disappear, because there are no longer benefits accruing to those who, one way or another, are not entitled to them. This is further proof that Kapp's problem can be formulated in terms of property rights.

It seems we have found the solution to make free markets compatible with social rights. But the question is: would that be compatible with capitalism as a system of property rights? The answer is no, at least for a wide range of social rights.

[9] I come back to this assumption in the next section where I take up Kapp's criticism to individual rationality and the reliability of *willingness to pay* as a measure of welfare gains and losses.

The fact is that the assignment of property rights that would eliminate social costs is hardly acceptable in a capitalistic system. Can we imagine firms paying their workers to introduce technological innovation and still talking of capitalistic system? Or can we think of firms paying their employees when they want to introduce systems which worsen the quality of work?
To make free markets fully compatible with social rights, anti-capitalistic property rights may be needed. Looking at them from this angle, social rights clash not so much with free markets but with the system of property rights which distinguishes capitalism. This is not yet the whole picture, still it is an important part of it.
Our reasoning demonstrates that Coase's efficiency proposition can be turned upside down: since markets work in a context of predefined property rights, the market may still work in presence of anti-capitalistic property rights. Of course transaction costs and other obstacles to the working of the market, usually referred to as critical arguments against the Coasian solution, call for much greater caution in making such statement.[10] But the point is that whether social rights conflict with capitalistic property rights and whether they are in contrast with free markets are two separate issues.
Approaching the social costs problem from the side of social rights we reached the conclusion that capitalistic property rights are very often hostile to social rights. I believe that it is not fanciful to assume that an idea like this captures a large part of what lies at the bottom of Kapp's vision.

Social rights and free markets

Free markets and appropriate property rights may not suffice to guarantee social rights protection. The problem can be approached by quoting at length from a recent writing by Kaushik Basu:

"we do not have an equivalent moral code against one person becoming richer than another by *outwitting* the latter….one reason we have so few safeguards against people cutting irrational deals is that economists' assumption that all human beings are rational has seeped out into our everyday thinking. If no one is irrational there can be no need to protect the irrational. Deals that look lopsided must merely reflect differences in preferences...but some people are impoverished because they cut poor

[10] I said before that Coase was well aware of the practical relevance of those costs; thus he cannot be charged with neglecting them.

deals over and over again, just as some village lenders are rich because they systematically cut "good" deals….Outwitting an intellectually weaker person of her wealth ..has far reaching consequences, especially in global contexts... Hence, the lack of legal or norms-based protection against such possibilities leads to under-contracting and consequent inefficiencies "(Basu, 2003 p.896).[11]

One rarely reads sentences like these from an economist. Few are ready to admit that outwitting is a problem because this would seriously undermine the high moral standing of the market as an epitome of freedom.

The problem Basu draws our attention to is very general, even if specific markets present a different exposure to the risk of unfair free exchanges. The problem may be extremely serious when social rights are exchanged, and this is why the issue is so important to us. The market solution to the social rights problem, regardless of the anti-capitalistic bias of the necessary property rights, must be gauged also from this point of view. Due to lack of knowledge and information, liquidity problems or many other reasons, individuals may be too weak to resist the pressure to undersell their social rights. Thus, the goal of protecting social rights through the formula "anti-capitalistic" property rights plus free market may be missed. The conclusion is that to cope with the social rights problem a more comprehensive institutional framework is needed. To this I shall return in the next section.

In his writings Kapp made several remarks on the working of the market – specifically interpreted as a system of individually conducted exchanges – that fit very well with the problem raised by Basu.

In his reply to Beckerman, Kapp argued that individual Willingness To Pay (WTP) as expressed in the market is not a reliable basis for evaluating things. In particular he was sceptical of the use, suggested by Beckerman and all orthodox economists, of WTP to assign a value to improvements in the natural environment.[12] He believed WTP played down the phenomenon of unpaid social costs "by making them appear more harmless than they actually are "(Kapp 1963, p.317).

Kapp lists three reasons for his scepticism. The most important for our purpose is the second, which is about the "individual's inability to ascertain the full range of short and long run benefits of environmental

[11] On this problem and many related issues, see also Basu (2000)

[12] Kapp writes: " The major emphasis of my reply will be on what I consider to be the central issue raised: namely the question of the adequacy of evaluating environmental goals and values in terms of the individual's willingness to pay or accept compensation" (Kapp 1963, p. 306). This statement can be generalized beyond environmental disruption, as he himself hints at. (Kapp 1972, p. 90)

improvements or, for that matter, of the full impact of environmental disruption upon his health and his well-being" (Kapp 1963, p. 314).[13]
Indeed there is a problem of information and knowledge, because some losses remain hidden for a long time so that the injured persons are not immediately aware of them (Kapp 1963, p.13). But there is more to it, a sort of inherent irrationality in the allocation process which must concern us (Kapp 1970, p. 843). This is why Kapp believes "monetary criteria are not cognitively responsible".
These critical remarks lead to the conclusion that a richer and more comprehensive institutional framework is necessary, in addition to a clearer departure from free markets. Moreover one can argue that traditional economics cannot be of much help in such endeavour. This is what Kapp strongly believes. And this is what Beckerman firmly denies: "I cannot accept without protest the general theme of Professor Kapp's paper in which he argues that "the phenomena of environmental disruption and social cost demonstrate once again that the scope of economic analysis is seriously challenged" (Beckerman 1972, 103).
In light of the preceding considerations it is all but surprising that Beckerman and Kapp take different sides on these crucial issues. The former is a stern defender of the orthodox approach. His exclusive concern is Pareto efficiency.[14] Moreover, he sees no particular reasons to be suspicious about the reliability of individual assessments as a basis for setting the value of things. Due to the first reason, he cannot even make the first step in the direction of understanding why the problem may arise about making social rights and capitalistic property rights reciprocally compatible. Due to the second reason, he is not able to appreciate why a departure from the individualistic solution of free markets may be necessary in order to avoid outwitting and to protect social rights.
Had Beckerman acknowledged both these problems – inadequacy of both capitalistic property rights and free markets – he would have refrained from arguing that no major departure from traditional economics was

[13] The first reason relates to the role that income distribution plays in distorting the outcome in favor of what rich people prefer; while the third is about the possibility that other solutions (in particular support to research) are crowded out by the monetization of environmental disruption. Both are relevant and still debated today. However, for a possible solution to the bias due to unequal income distribution see, among others, Pearce-Barbier (2000)

[14] A recent and clear confirmation comes from his latest book. Beckerman criticizes some distinguishing aspects of sustainable development because they may run against Pareto-efficiency, which is considered a sort of sacred and inviolable principle (Beckerman 2002).

necessary. In a nutshell this is what the debate between Kapp and Beckerman was about. We have now all the essential elements to judge who was closer to being right.

How to protect social rights?

It is all too obvious that to raise a problem is not to find a solution, especially when the problem is as serious as how to protect social rights without interfering too much with other basic principles of western democracies. In the preceding sections I have argued that social rights may conflict with two pillars of western civilization: capitalistic property rights and free markets. But the problem is, to some extent, more general because several solutions we can think of contrast with other defensible principles. To give an example: some solutions may be highly paternalistic and this, at least in some cases, may be at odds with the foundations of democracy. Moreover, there are social rights that conflict with one another, posing highly challenging moral problems.

The problem raised by Kapp, as I understand it, has not yet been solved, after all these years. Actually, no easy and perfect solution is within our reach.

To protect individuals and their social rights there are, in theory, several possible remedies which could also be combined with one another. Some of these remedies are preventive, others compensatory; some are paternalistic, others based on more democratic procedures; some work through the markets, others do not. But all face complex difficulties and none of them is free from imperfections and defects.

A first type of solution is a collectively decided compensation, typically of a monetary nature. Several provisions of the Welfare State, as we know it, fit into this scheme and have been justified exactly on these grounds (Titmuss 1987). It is all too clear that with respect to some rights an ex-post compensation is not a good solution. More generally, it can be quantitatively inadequate and, above all, subject to the vagaries of political and economic tradeoffs. One has only to recall that the "big" Welfare State that many western countries built up in the Seventies and Eighties today is considered no longer affordable by a large majority; as a consequence – inefficiencies and waste aside - some social costs will not be compensated and the range of protected social rights will shrink.

Also because of this, one might wonder whether the inclusion of social rights in constitutional law would help to solve the problem. As it is well known, this is one of the most debated issues in the process of writing a European "Constitution". Another recent experience is that of South

Africa, where the new Constitution acknowledges some of those rights (Sunstein 2001). The crucial problem here is whether socio-economic rights are within judicial capabilities. As Sunstein puts it:

"How can courts possibly oversee budget-setting priorities? If a state provides too little help to those who seek housing, maybe it is because the state is concentrating on the provision of employment, or on public health programs, or on educating children. Is a court supposed to oversee the full range of government programs, to ensure that the state is placing emphasis on the right areas? How can a court possibly acquire the knowledge, or make the value judgments, that would enable it to do that?" (2001, p. 3)

This is a serious problem, which can be given only imperfect and quite complex responses.

To protect social rights, public expenditure is not the only solution, nor the most effective. An alternative is to keep in check business behaviour by means of monetary incentives or through the introduction of standards. All this is well known to those who are familiar with the debate on environmental policy, where a distinction between price and quantity instruments is drawn (Weitzman 1974).

Kapp did not like monetary incentives, like taxes. He was much more in favour of standards that could be used not only to prevent environmental disruption but also to protect other social rights. He argued that environment disruption cannot be defeated "with customary ways of thinking and established methods of conducting business, modified only by a few and *ad hoc* controls".(Kapp 1970, p. 836)

There are disadvantages with standards. In particular they may not be very cost-effective, as shown by a large number of studies on the comparison between economic instruments and "command and control" policies.

But Kapp's primary concern in this matter was a different one, not surprisingly related to distributive issues. He feared that ex post remedies, like incentives and disincentives via subsidies and taxes, might turn out to be ineffective (Kapp 1970, p. 836). A crucial question to him was: who is the ultimate bearer of the taxes levied on the firm? Will the market power firms enjoy allow them to pass on to consumers environmental taxes without any visible change in their attitude towards the environment? [15] These are difficult questions. Perhaps Kapp is much

[15] Kapp is afraid that these policies will achieve "not much more than the passing on to consumers or to society as a whole the costs of 'cleanliness' without really coming to terms with the serious problems raised by the current disruption of our environment".

too suspicious about economic instruments and his conclusions are a bit hurried.[16]

But there is a more general and more fundamental question. How do we decide which social rights need protection and how wide this protection should be?

Do we need deliberative democracy?

Deciding which social rights are to be protected and the amount of resources that can be used to protect them is all but an easy problem. In a society institutionally characterized by capitalistic property rights and free markets – and nothing else - social rights would not be a problem because they are not even recognized. This is exactly what happens in the abstract world of more traditional economics – which is not, however, a good picture of reality.

Once we care about social rights we have several problems: defining them, protecting them and – most of all – avoiding that some social rights are protected at the expenses of others without being aware of that.

To take this stand is to go somewhat beyond the social cost problem as presented by Kapp. But his contribution is an essential starting point. In fact, while business firms are very often the primary creators of social costs, the most likely breakers of social rights, they are not alone .

Moreover, the infringement of social rights does not always further business interests. Think of some tragic choice like deciding whether a limited amount of resources is to be allocated to a hospital for organ transplants or to paediatric care. Two basic social rights here are clashing. Think also of the conflict that very frequently arises between the workers of a polluting factory and the inhabitants of the town where the factory is located – sometimes friends and relatives of those workers, if not the workers themselves, who may very well have substantial misgivings about the situation.

My point is that there are many instances in which the conflict is not simply between social rights and private profit – as in Kapp. There are

[16] Unfortunately Kapp does not delve into the problem. He makes a scant reference to a short statement by Schaar-Wolin (1970). More specifically, the two authors wrote: “It was predictable that the first target chosen by the government in its new zeal for nature would be that ancient enemy, Standard Oil, which had polluted the waters of New Orleans. It is also predictable that future policies will not be implemented—any more than the Sherman Act was—to transform the corporate structure. We may expect, instead, ingenious devices for passing on to the consumer the costs of cleanliness”.

several instances in which some social rights interfere with other social rights. If we have a solution for these tragic cases we are in a much better position to solve the social rights-private profit conflict. This is why it may be advisable to go beyond social costs to face up to the moral dilemma implicit in the clash between different social rights.

Unfortunately there is no ready-made solution, but neither are we at the starting point. Paternalism is a possible response. A team of experts or of politicians may be delegated to solve the most difficult problems. There are good reasons for advocating this solution in some cases. However, it would be wrong, in my opinion, to rely on paternalism only. Because even a benevolent paternalist makes mistakes - and more often than not paternalists are not benevolent.

Democracy, of the right type, is a better guarantee. What is needed is that kind of deliberative democracy which has been advocated also in recent years by several scholars (Elster 1998, Guttman-Thompson 1996). Deliberation is free discussion which, as it unfolds, helps people to forge their responsible opinion, makes them ready to take difficult decisions and softens social conflict. There is no guarantee that everybody will share the same view. However, but there are good reasons for believing that reciprocal understanding, and the propensity to cooperative action will be reinforced, with a low risk of free riding. In a deliberative democracy decisions are not simply aggregation of individual preferences, whatever the degree of information and knowledge of the persons involved.[17]

Such procedure is to be preferred to the delegation of decisions to experts. On the contrary, experts should make their knowledge and information accessible to everybody, leaving the decision to a well informed set of interacting individuals. Whatever advantage the expert enjoys in technical knowledge, he has no lead in the choice of how to compare two conflicting social rights.

It is reassuring to learn that Kapp made statements that go in this direction, showing to some extent that he too was going beyond the social costs problem, i.e. the case in which social rights are broken by profit-eager firms only.

The need for a collective decision is clearly stated in this quotation: “the elaboration and acceptance of environmental goals call for a collective or social choice with a direct participation and expression of preferences by

[17] As Guttman and Thompson (1996, p.174) put it: "aggregating what citizens want individually, which is what utilitarian policy analysis does best, does not necessarily produce the same result as asking citizens to consider together what they want collectively"

all members of society, even those outside the market and without reference to effective demand[18]" (Kapp 1963, p. 317)
In the following quotation, Kapp seems to be talking specifically about deliberative democracy: "in order to satisfy these human needs and to arrive at a substantive rationality in the utilization of society's scarce resources, these requirements (environmental requirements) will have been defined as objectively as our present knowledge permits and evaluated by means of a deliberate collective, i.e., political decision in comparison to other public goals to be pursued" (Kapp 1963. p. 317). These are the final sentences of his reply to Beckerman, maybe the last stage in the development of his thought. How far all this is from traditional economics need not be stressed.
A society that gives social rights the importance they deserve should not fail to consider extensive recourse to deliberative democracy as the most important institutional progress it can make. It has been correctly said that deliberative democracy helps to sustain a conception of democracy with a capacity for moral improvement (Guttman-Thompson 1996, p. 9). And there can be no progress in social rights without moral improvement.
We should not forget, however, that deliberative democracy has its problems: it may be costly, it may take a lot of time to produce its decisions, it cannot include all the persons concerned. [19] As I said before there is no simple and effective solution to this problem, so crucial to modern democracies, that Kapp so timely and so passionately pointed to us. A problem which lies outside the realm of traditional economics, making for the limited relevance of this theory to the true progress of our societies.

Concluding remarks

In this paper I have argued that the best way to look at social costs is to consider them as the result of the infringement of social rights of one type or another. Viewed in this perspective, social costs have much less in common than it appears with externalities - as they are dominantly interpreted in the economic literature – and the problem Kapp was struggling with is more aptly reformulated as one of difficult compatibility between the protection of social rights and free market capitalism.

---

[18] It is worth noticing that by referring also to member outside the market, Kapp anticipates the modern notion of "non use value".
[19] In the ongoing debate on deliberative democracy there is no scarcity of perplex or squarely critical views. See Macedo (1999).

I sought to clarify why social rights are a challenge both to capitalistic property rights and to free markets, keeping these two building blocks of the system as separate as it is convenient to do. The result that Kapp reached taking social costs as his starting point – i.e. "the scope of economic analysis is seriously challenged" - stands on firm ground, if regarded from the perspective I have suggested.

Approaching the problem as a Pareto efficiency conundrum, which is what Beckerman and others do, leads to different landing-places and hides the fundamental reasons of the inadequacy of traditional economics and of the economic system it recommends.

The protection of social rights, once we acknowledge they exist, is a compelling reason to take very seriously questions which go to the heart of economics: do capitalistic property rights give the right incentives? Are individuals always able to protect their interests and their rights in a system where exchange is free in any meaningful sense? Are individual market-based solutions always adequate?

All these questions have positive answers in traditional economics. But Kapp knew and we all should know by now that such positive answers are very easy and not apt to allow our complex society to make civil and social progress. We need to take seriously the challenge of social costs and social rights, thinking of them as the starting point for designing richer institutional settings, where decision mechanisms are more collectively oriented than the market and property rights systems are more subservient to the fulfilment of social rights.

References

Arrow, K. J., (1971), "Political and Economic Evaluation of Social Effects and Externalities", in *Frontiers of Quantitative Economics,* edited by M.D. Intriligator, North Holland.

Basu, K, (2000), *Prelude to Political Economy* Oxford: Oxford University Press.

Basu, K., (2003), "Globalization and the Politics of International Finance: The Stiglitz Verdict," *Journal of Economic Literature* XLI: 885-899.

Bator, F. M., "The Anatomy of Market Failure," *Quarterly Journal of Economics* 72: 351-379.

Beckerman, W.,(1972), "Environmental policy and the challenge to economic theory", in *Political economy of the environment. Problems of method* (Papers presented at the symposium held at the maison des sciences de l'homme, Paris), Paris , Ecole pratique des hautes etudes and mouton & co.

Beckerman, W., (2002), *A Poverty of Reason. Sustainable Development and Economic Growth* Oakland, California: The Independent Institute.

Buchanan, J. and W. C. Stubblebine, (1962), "Externality," *Economica* 29: 371-384.

Caffè, F. (1990) *Lezioni di politica economica*, Bollati Boringhieri, Torino

Ciccarone, G. (1995) “La tipologizzazione dei regimi di Wwelfare State e il pensiero di Federico Caffè” in *Federico Caffè. Realtà e critica del capitalismo storico*, Meridiana Libri, Catanzaro

Coase, R. H., (1960), "The problem of social cost," *Journal of Law and Economics* 3 (1-44

Demsetz, H., (1967), "Towards a Theory of Property Rights," American Economic Review 57: 347-59.

Elster, J.,(1998), “Introduction”, in *Deliberative Democracy*, edited by J. Elster, Cambridge, Cambridge University Press .

Gutman, A. and D.Thompson, (1996), *Democracy and disagreement* Cambridge (Mass.): The Belknap Press of Harvard University Press.

Kapp, K. W.,(1972), “Social costs, neo-classical economics, environmental planning”, in *Political economy of the environment. Problems of method* (Papers presented at the symposium held at the maison des sciences de l'homme, Paris), Paris, Ecole pratique des hautes etudes and mouton & co.

Kapp, K. W., (1963), *The Social Costs of Business Enterprise* Notingham: Spokesman.

Kapp, K. W., (1970), "Environmental disruption and social costs: A challenge to economics," *Kyklos* 23: 833-848.

Knight, F. H., (1924), "Some fallacies in the interpretation of social cost," *Quarterly Journal of Economics* 38: 582-606.

Macedo, S. (ed.), (1999), *Deliberative Politics* New York: Oxford University Press.

Meade. J., (1952), "External Economies and Diseconomies in a Competitive Situation," *Economic Journal* 62: 54-67.

Papandreou, A., (1994), *Externality and Institutions* Oxford: Clarendond Press.

Pearce, D. and E. Barbier, (2000), *Blueprint for a Sustainable Economy* London: Earthscan Publications.

Schaar, H. and S.S. Wolin, (1970) “Where we are”, *The New York Review of Books*, May 7, 1970, pp.

Scitovsky, T., (1954), "Two concepts of external economies," *Journal of Political Economy*: 143-151.

Sunstein, C. R., (2001), "Social and Economic Rights? Lessons from South Africa ," *University of Chicago, John M. Olin Law and Economics Working Paper No. 124*

Titmuss, R., (1987), *The Philosophy of Welfare* London: Allen and Unwin.

Weitzman, M., (1974), "Prices vs. Quantities," *Review of Economic Studies* 41: 477-91.