# Section 3: The Externality from the Perspective of Contract

From the perspective of contract, the essence of externality will be clearer. Externality implies that one’s behavior affects the others, but there is no contract to restrain (the bad effects) or buy (the good effects). The causes of externality can be classified into three categories: (1) there is no delineation of property rights, so there is no contract for market transactions; (2) there is a contract, but the use clauses are incomplete; (3) there are complete contract clauses, but MR and MC are not equal for some uses.

As mentioned in Lecture 14, there is not only price clause (income clause) but also use clause in a complicated contract, which means the contract is structural. And as mentioned in Lecture 20, the properties of direct measurement are priced by the price clause in a contract, while those without direct measurement are supervised by the use clause. Lease contracts (including the employment contracts for labor, because in a society where slavery is not allowed, labor can only be rented but not purchased) are all structural. By contrast, in buy-out contracts there is usually only price clause, so they are not structural and much simpler.

As mentioned in Lecture 23, there are three rights in PPRs. Lease contracts only deal with part of the rights of assets (usually use right and right to income for a period of time). The lessee’s use often affects the value of the leaser’s asset, which leads to divergence between private and social costs. For example, careless use will shorten the life of an asset, but as long as the life does not become even shorter than the lease period, it will not affect the lessee but will affect the leaser. Thus, lease contracts need to restrict the behavior of the lessee from careless use with the use clause to prevent divergence between private and social costs as much as possible.

Case (1) is a kind of government failure. Even if there are contracts of market transactions it is still possible for divergence between private and social costs such as Case (2) and (3). For Case (2), there is no contract in the world that can cover all the possibilities about the use of assets in detail, because the transaction cost is too high. On the other hand, besides the clauses written explicitly in a contract, there are laws, default conventions, customs, morals, etc that are not necessary to be repeated in the contract can restrict the lessee. For Case (3), under the constraint of transaction cost, the increase in asset value brought about by equalizing MR and MC is too negligible to outweigh the transaction cost.

In a word, there are following mistakes in the analysis on externality in MSE. (1) There is no market transaction, probably because there is no divergence between private and social costs at all and no need for market transaction. That there is no market does not mean externality. (2) There is no market because there is no delineation of property rights. According to the first version of Coase Theorem, without the prelude of delineation of rights, there cannot be market transactions. (3) There is lineation of property rights, and there are also market transactions, but because the transaction cost of direct transactions is too high, indirect transactions take the place. Sometimes, because there have been implicit contract clauses such as laws and customs, the relevant restrictions are not repeated in the explicit contract clauses. (4) There is delineation of property rights, but the transaction cost of using market (transaction cost in a narrow sense) is too high, so the non-price criteria (non-market institutions) such as judges’ arbitrary decisions (the court) are used to deal with the problem of externality.