An Economic, Political, and Philosophical Analysis of Externalities

Brian P. Simpson
National University

1. Introduction

Externality theory is used to claim that markets fail. It is claimed that because of the existence of externalities, the market will provide too much or too little of a particular good, and that the government must step in and use taxes, subsidies, restrictions on the provision of the good, or take over the production of the good in order to remedy the situation. However, these conclusions do not hold if one performs a comprehensive analysis of externality theory. In this essay, I show economically, politically, and epistemologically why externality theory does not provide a valid critique of the market.[1] In fact, I show why the market actually succeeds with respect to externalities. Many will be familiar with the economic and political arguments I present; however, by revealing the logical implications of externality theory, I provide powerful criticisms of this theory with which few are familiar. Furthermore, I go well beyond politics and economics by providing a fundamental epistemological analysis of externality theory. This latter helps to provide the reader with a complete understanding of the nature of externality theory.

2. What Are Externalities?

Economists are familiar with the concept "externality"; however, others might not be. Therefore, it is important to give a brief, but precise, description of the term here so that one will better understand my analysis of this theory. An externality is a cost or benefit imposed on people other than those who purchase or sell a good or service. The recipient of the externality is neither compensated for the cost imposed on him, nor does he pay for the benefit bestowed upon him. These costs and benefits are labeled "externalities" because the people who experience them are outside of or *external* to the transaction to buy and sell the good or service.

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[1] My analysis in this essay follows that in Brian P. Simpson, *Markets Don't Fail!* (Lanham, MD: Lexington Books, 2005), pp. 85-100.

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There are two types of externalities. When a person not involved in the production or consumption of a good receives a benefit for which he does not pay, he is said to be the recipient of a "positive externality." An example of this is immunization. Individuals not involved in the sale or purchase of immunization shots benefit from such shots without paying for them. They benefit because the more people who become immunized, the less likely it is that the individuals not involved with the purchase or sale of the immunizations will be exposed to the dreaded disease, since fewer people will contract the disease. A beautiful home with a well-manicured lawn and garden is another example. In this case, passersby who have not paid for the privilege of viewing the beautiful home and grounds still gain from the pleasure of being able to enjoy the view. They, too, receive a benefit without paying for it. A lighthouse provides another example. Ship owners who have not helped to pay for the construction of a lighthouse still benefit from it when they pass by at night.

The second type of externality is a "negative externality." This exists when a person who has nothing to do with the sale or purchase of a good has a cost imposed on him for which he is not compensated. A leading example of a negative externality is pollution being emitted from, say, a steel mill. In this case, people who neither purchase nor produce steel may experience the harmful effects of the pollution (such as sooty curtains and dirty air to breathe) but are not compensated for the negative effects they experience.

3. Externalities and Market Failure

While economists are familiar with the claims concerning market failure made based on externality theory, again, it is important to discuss briefly these claims here for those readers who may not be familiar with them. The alleged failure of the market occurs because, it is claimed, the market provides too many goods that produce negative externalities and too few goods that create positive externalities. Too many goods that create negative external effects are allegedly produced because the costs imposed on those who experience the negative externalities are not taken into account in the production of the goods creating the negative side-effects. Remember, these cost are imposed on people who neither purchase nor produce the goods. If these costs were accounted for in the production of such goods, the cost of producing them would be higher and thus fewer of them would be produced and purchased.

For example, in the case of a good such as steel, if steel manufacturers were required to compensate individuals whose curtains became dirty or who had to breathe in the dirty air, the cost of these negative externalities would be included in the production of steel and would raise the cost of producing it (i.e., the costs would be internalized). This, in turn, would cause the profitability of producing steel to decrease, decrease the supply of steel, and decrease the quantity of steel demanded as the price rose to cover the additional costs. This would decrease the total production and purchases of steel to a level that allegedly takes into account the effects of the pollution.

With respect to goods that create positive externalities, too few are allegedly produced because the recipients of the externalities do not pay for the benefits bestowed upon them. Hence, these benefits provide no extra inducement for the suppliers of such goods to produce more of them. If the recipients had to pay for the benefits, this would provide a greater incentive to produce such goods and increase the quantity supplied.

An example of this is as follows: When passing by a beautiful home and garden, if every person who gained some pleasure from what he saw was required to pay the owner a small fee, the profitability of creating beautiful homes and gardens would increase and cause more to be produced. Hence, the supply of these goods would reflect all the benefits people received from the goods.

In the cases of both positive and negative externality, the market is said to fail to capture all of the effects involved in some transactions, and thus market prices of goods allegedly fail to reflect all of the costs and benefits associated with the goods. The "solution," in both cases, is government intervention in the market. In the case of negative externalities, it is claimed that the government must take some action to restrict production of these goods by, perhaps, imposing a tax on the producers of such goods so that these producers will experience the effects of all of the costs they impose on others. With the case of goods that create positive externalities, it is claimed that the government should take some action to stimulate the production of these goods by, perhaps, providing a subsidy to producers of such goods to compensate them for all of the benefits they bestow on others.[2]

4. The Politics and Economics of Externalities

Many writers have provided an economic and political analysis of externality theory. Some of these writers include Ludwig von Mises, Murray Rothbard, Ronald Coase, Harold Demsetz, and Richard Posner.[3] In these

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[2] The call for taxes and subsidies (and government controls in general) to remedy externalities goes back to A. C. Pigou, *The Economics of Welfare*, 4th ed. (London: MacMillan & Co., 1932 [1960 reprint]), pp. 192-95.

[3] See, for example, Ludwig von Mises, *Human Action: A Treatise on Economics*, 3d rev. ed. (Chicago: Contemporary Books, Inc., 1966), pp. 654-62; Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles* (Los Angeles: Nash Publishing, 1970), vol. 1, p. 156; R. H. Coase, "The Problem of Social Cost,' *Journal of Law and Economics* 3 (October 1960): 1-44; Harold Demsetz, "Toward a Theory of Property Rights," *The American Economic Review* (May 1967): 347-59; Richard A. Posner, *Economic Analysis of Law* (Boston, MA: Little, Brown, and Co., 1972), pp. 10-39.

analyses the authors make some legitimate points. For instance, they show that externalities can be remedied by consistently recognizing and protecting property rights. However, ultimately, these analyses are deficient. Most fundamentally, the analyses provided by these writers do not address the epistemological errors of externality theory. Furthermore, some of the authors make significant errors in their analyses. For instance, some of the authors base their analysis on an invalid premise, in that it is believed that society "owns" property and that individual owners are merely given the privilege of managing "society's" property.[4] Another error is the idea that property rights should be granted simply to increase economic efficiency and output for society.[5] In addition, one of the writers defines far too broad of a sphere of responsibility for individuals.[6] I will address all of these errors below.

My analysis of externality theory has one thing in common with the above analyses: I recognize the corrective effects of a full and consistent protection of property rights. However, the analysis in this essay avoids the errors committed by the above writers and goes deeper than a merely political and economic analysis of externality theory. To begin to see as clearly as possible the nature of externality theory, one must first look at the economic implications of the theory.

a. The economic implications of externalities

If all of those who created a negative externality were required to pay for the cost they imposed on others and those who created a positive externality were paid for the benefits they bestowed upon others, it would lead to economic stagnation and even regression.[7] This can be seen in the case of positive externalities if one considers the large number of payments that would have to be made to those responsible for innovations that are easy to copy but that are not eligible for patent or copyright protection. This alone would probably lead to economic stagnation.

For instance, people would have to compensate the owners of the first fast-food restaurant that used a drive-through window, the first airline that

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[4] On rights as privileges granted by society, see Demsetz, "Toward a Theory of Property Rights," pp. 347, 350, and 355.

[5] On using rights simply to maximize "society's" output, see Coase, "The Problem of Social Cost," pp. 2, 34, and 44. On rights as a mechanism that society can use to increase efficiency, see Posner, *Economic Analysis of Law*, pp. 10, 13, and 14.

[6] See Mises, *Human Action*, p. 655.

[7] My discussion on this topic is based on George Reisman, *Capitalism: A Treatise on Economics* (Ottawa, IL: Jameson Books, 1996), pp. 96-97.

gave out frequent-flyer miles, and the first store owner who came up with the idea to allow customers to buy merchandise on layaway. While such fresh thinking is rewarded by those who purchase the products or services offered by the innovators, these original thinkers are not paid by those who copy them. Therefore, this is a benefit bestowed upon the imitators (and their customers) for which they do not pay.[8] They are provided with an innovative idea free of charge. The number of payments that would be required, if one implemented laws consistent with externality theory, could be multiplied as many times over as there are innovations that are easy to copy but that are not eligible for protection. This would lead to an enormous number of payments.

Furthermore, based on negative externality theory, inventors and innovators who drive other producers out of business (or cause other businesses to incur losses), due to their innovations, would have to compensate those whom they drive out of business. For example, the original Henry Ford would have had to compensate horse breeders, buggy makers, and blacksmiths whom he drove out of business. According to externality theory, in driving them out of business by producing an affordable, high quality means of transportation, Ford imposed a cost on them for which they were not compensated. To remedy the situation, Ford should have compensated them. One can easily imagine the large number of payments that would have to be made by those who created this type of negative externality. If payments were actually required to be made for positive and negative externalities, the result would be an endless series of payments, very little production, and a much lower standard of living. This result could hardly be deemed "a success."

Some economists would argue that the above example with Ford is not a "real" externality because its effect is felt through the price of the products sold by the horse breeders, buggy makers, and blacksmiths; that is, Ford's actions decreased the price at which their products could be sold. This is known as a "pecuniary externality" and it is believed by some economists that these can generally be ignored.[9] This is the case because it is claimed that

[8] I will grant that an innovator gains a competitive edge over his rivals and may enjoy a temporary increase in business and/or profits due to his innovation, which are rewards of being an original thinker and a form of compensation for his originality. However, since it is not possible to patent or copyright his innovation, he is not paid by his competitors who copy it, nor is he paid by their customers who benefit from it. Therefore, these people receive a benefit for which they do not pay, i.e., a positive externality.

[9] For examples of this treatment of "pecuniary externalities," see Stan J. Liebowitz and Stephen E. Margolis, *Winners, Losers, & Microsoft: Competition and Antitrust in High Technology* (Oakland, CA: The Independent Institute, 1999), pp. 71-72, and Jack

these types of externalities have no "net external effect." This allegedly occurs because while the lower price is a negative externality for the horse breeders, buggy makers, and blacksmiths, it creates a positive externality for their customers (because the customers can now purchase horses and buggies at a lower price). Because there is no net external effect, the claim is made that no adjustment to the production of the good that is creating the externalities is necessary.

The first thing to note concerning this issue is that the actions of Ford are still considered by economists to create externalities. Some economists simply believe that no action on the part of the government is required in connection with this type of externality. Nonetheless, because this example is still considered to be an externality, my analysis of externality theory applies to it.

The second thing to note is that Ford's actions do not necessarily create a positive externality for the customers of the horse breeders, buggy makers, and blacksmiths. In fact, his actions may create a negative externality for these people or they might create no externality at all. A negative externality might occur if it becomes more difficult or impossible for those who want to continue to purchase horses and buggies to find producers of these products because Ford has driven so many of them out of business. For the buyers to experience a net negative externality in this case, the additional cost of finding the remaining sellers of the horses and buggies would have to be greater than the savings from the lower price at which these goods can be purchased. No externality would be created at all if the horse breeders, buggy makers, and blacksmiths did not lower the prices of their products, but chose to sell a smaller number at the same price[10] (perhaps in an attempt to cover their costs on the horses and buggies they did sell), or if all of the former horse and buggy buyers simply chose to buy cars. If any of these occurred, there would be a net negative externality and, according to externality theory, Ford should compensate those who experience the negative externalities.

Furthermore, even if Ford did create offsetting externalities, externality theory could still be used to attempt to justify payments from Ford to those experiencing the negative externality (because they have been harmed), and to Ford from those experiencing the positive externality (because they have benefited). In essence, redistribution would take place from those who received the positive externality to those who experienced the negative

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Hirshleifer and David Hirshleifer, *Price Theory and Applications*, 6th ed. (Upper Saddle River, NJ: Prentice Hall, 1998), pp. 484-85.

[10] Here I assume that it is no harder for horse and buggy buyers to find sellers of these goods. If it is harder, buyers of these goods would experience a negative externality in this example.

externality.[11] No matter what types of externalities are created, payments of some sort can be justified based on externality theory.

The solution to the problems created by externality theory is not to distinguish between situations that have a net external effect and ones that do not. This is ultimately a superficial attempt to get around the problems created by the theory. As I will show below, the problems with externality theory are too deep (from a philosophical standpoint) for a distinction like this to improve matters.

b. The solution to negative externalities

If it would lead to stagnation to require everyone to pay for negative externalities they create and be paid for positive externalities they create, how does one answer the question concerning who should pay and be paid? With regard to negative externalities, the only ones for which people should be compensated are those that cause demonstrable physical harm to a person or his property and can be traced back to the actions of an individual or a group of individuals working in concert.[12] In order to do this, one must have well-defined and -protected property rights. This is a point made by the writers referred to above.

For example, a negative externality is said to exist in the case of a downstream landowner's land being contaminated by, say, fertilizer used by a farmer whose land is upstream. This is said to be the case because the cost imposed on the downstream landowner is not accounted for in the costs that the farmer incurs to grow his crops. However, if property rights are well-defined and -protected, the downstream landowner could sue in a court of law to be compensated for the farmer's actions and get a court injunction imposed on the farmer requiring him to cease the relevant activities. This is a legitimate case for government action against the farmer because he is violating the property rights of the downstream landowner. The farmer is altering the downstream landowner's land against his will. Furthermore, the violation can be traced back to a single individual.[13]

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[11] See Hirshleifer and Hirshleifer, *Price Theory and Applications*, p. 485, for an example of economists who, despite believing in making the distinction between pecuniary and non-pecuniary externalities, also believe that pecuniary externalities can be used to justify income redistribution.

[12] On this, see Reisman, *Capitalism*, p. 96, and hear his audiotape, "The Toxicity of Environmentalism" (Laguna Hills, CA: The Jefferson School of Philosophy, Economics, and Psychology, 1991), especially the question and answer period. See also Murray Rothbard, *The Logic of Action Two* (Cheltenham, UK: Edward Elgar Publishing, 1997), p. 164.

[13] To avoid any possible confusion in this case, one can assume that the downstream landowner settled on his land before the farmer polluted the land.

As has been recognized by some writers, the above example is not a case of market failure.[14] It is a situation where the government must step in to preserve the existence of a market. A market can only exist when rights are protected, including private property rights. This is so because interactions in a pure market economy are based on *voluntary* trade. Such trade depends on freedom (i.e., the absence of the initiation of physical force, in any of its variations, including physical alteration to one's property against one's will).

Rights are moral principles defining and sanctioning a man's freedom of action in a social context. Therefore, when one's rights are protected, one's freedom is protected, and thus one is protected from the initiation of physical force.[15] Hence, the failure in this case is the failure on the part of the farmer to act within the principles on which voluntary trade is based. Thus, it is proper for the government to step in and protect the property rights of the downstream landowner to preserve the existence of the market. However, when the government does this, *it is correcting the farmer's failure, not the failure of the market.* This is true for all so-called negative externalities where it is legitimate for the government to take action. It is always the case that the government is correcting the failure of some individual(s) to interact with others in a voluntary manner.

People who have so-called negative externalities imposed on them that cannot be traced back to an individual or group of individuals working in concert should not be compensated. Examples of this kind of externality include smog in a city created by millions of people independently operating motor vehicles, or flooding downstream on a river from development and flood control devices used by millions of people living upstream on the river. These cases are natural byproducts of economic activity and must be considered the same as other natural phenomena that produce harmful effects (such as bad weather). One cannot yoke the individual to the collective and treat people who acted independently as if they acted collectively.[16] Each

[14] See Mises, *Human Action*, pp. 657-58, and Rothbard, *Man, Economy, and State*, vol. 1, p. 156.

[15] For the source of this definition of rights and more on the nature of rights, see Ayn Rand, *The Virtue of Selfishness* (New York: Signet, 1964), pp. 108-24; Ayn Rand, *Atlas Shrugged*, 35th anniversary ed. (New York: Signet, 1957 [1992 reprint]), pp. 976-78; and Ayn Rand, *Capitalism: The Unknown Ideal* (New York: Signet, 1967), p. 17. Also see Harry Binswanger, ed., *The Ayn Rand Lexicon: Objectivism From A to Z* (New York: Meridian, 1986), pp. 212-17, for a compilation of excerpts on the concept of rights by Ayn Rand.

[16] On this, hear Reisman's "The Toxicity of Environmentalism," especially the question and answer period.

individual acting independently causes a negligible amount of pollution or flooding (or whatever else it might be) which *does not cause any physical harm*. Therefore, no individual should be held accountable for harmful results for which he is not responsible. Furthermore, because no physical harm has been done by an individual or group of individuals acting in concert, no one's rights have been violated and so it is not proper for the government to take action in this case.[17]

Human beings are not, fundamentally, a collective. They are individual, independent, autonomous beings and should be treated as such. In order for individuals to act collectively, they must choose to do so. Therefore, unless one has some basis to show that individuals have made a concerted effort to act collectively, that is, to act as a single entity, one has no basis to treat a group of individuals as if they have acted in a collective manner. To do so is to ignore the fact that individuals are acting independently of each other, and thus no *one* individual is responsible for the cumulative effect of the actions of *all* of the individuals. Nor is he responsible for only a small portion of the *demonstrable* harmful effects. Each individual, acting alone, is responsible only for what he has contributed, which by the nature of the case is negligible and *does not cause any harm*.[18]

By ignoring the fact that the individuals are acting independently, one makes erroneous conclusions and engages in or advocates harmful actions. That is, one treats people as if they have done something that they have not done (i.e., acted in a collective manner), and one holds them responsible, and would presumably want them punished, for results that they did not, as independently acting individuals, bring about (i.e., one holds them responsible for demonstrable amounts of pollution, flooding, or whatever it might be). Punishing those who are allegedly responsible for the demonstrable amount of pollution or flooding is harmful because it is a violation of rights, since it requires the initiation of physical force (given that the alleged culprits have not actually harmed anyone), and thus stands in opposition to the requirements of human life. Such action stands in opposition to human life because a fundamental requirement of human life is freedom from the initiation of physical force. Humans require this in order to be able to use their minds to think, act on their own judgment, and take the necessary actions to further their lives, well-being, and happiness. A person cannot use his

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[17] However, in the case of pollution, a private road owner might properly be held liable for pollution generated by users of his roads if the pollution is great enough to cause demonstrable physical damage.

[18] I am not the only one to use this method of dealing with the effects of the actions of independently acting individuals. For an example of another writer who uses this method, see Rothbard, *The Logic of Action Two,* p. 165.

mind—his basic tool of survival—to further his life if he is constantly being forced to go against his rational judgment.

A final issue with regard to negative externalities is that one must also consider the cost of getting rid of them. A good example to illustrate why one must consider this cost is the creation of pollution in Pittsburgh from the production of steel during the height of that industry.[19] Because of the production of steel, many people probably had to breathe polluted air and deal with soot on their curtains. However, in such a situation, one still has to show that the pollution has caused physical harm to oneself or one's property for one to have a legitimate case against the steel manufacturers. Furthermore, if one is able to show this, and which particular steel mill or steel mills working together created the pollution that is causing the harm, one must also consider the costs of getting rid of such pollution. Steel mills should not be required to implement pollution control devices that are so costly they are forced to shut down. In general, if rights are violated, one must weigh the magnitude of the harm done against the cost of getting rid of the harmful action, or the compensation to be provided to those harmed. The costs imposed on the guilty party should not be large compared to the harm done.

Here, one must also consider the advantages of an industrialized society versus a non-industrialized society. Having to deal with sooty curtains or breathe air with trace amounts of pollutants is a small price to pay to get the enormous benefits of an industrialized society. The standard of living and the average lifespan have risen dramatically thanks to industrialization. Consider that the average lifespan in Great Britain prior to the Industrial Revolution (i.e., prior to the mid-eighteenth century) was about thirty years. Any reader over the age of thirty (or who plans to live to be older than thirty) probably owes (or will owe) his life to industrialization. Consider also the standard of living prior to the Industrial Revolution. People worked eighty hours per week performing back-breaking labor for a standard of living probably not too far above the level of a modern-day Ethiopian. In the case of the steel mills in Pittsburgh, the great majority of people who lived there owed their incomes—and thus their lives—to the existence of the steel mills. Destroying the steel industry would have made the people of Pittsburgh worse off, not better off.

c. The solution to positive externalities

With respect to positive externalities, individuals should pay others only for benefits they *voluntarily* contract to receive from others.[20] Government force needed to increase the supply of goods that create positive externalities

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[19] I am indebted to Ayn Rand for this example. She used it in her audio taped lecture titled "The Intellectual Bankruptcy of Our Age" (Gaylordsville, CT: Second Renaissance Inc., 1961). Hear especially the question and answer period.

[20] On this, see Reisman, *Capitalism*, p. 96.

violates the rights of individuals. This is no solution because it leads to the sacrifice of some individuals (such as taxpayers) to others (such as those who benefit from the goods whose production is subsidized by taxpayers). Typically, activities or goods that create external benefits are not lacking in a market economy. A good example is charity. Charitable donations are, in essence, a 100 percent positive externality. This is the case because the recipient does not pay for the charity he receives, and the donor receives no compensation in return for his charitable contribution.[21] Therefore, according to externality theory, too few charitable activities allegedly exist in a market economy and the government should either subsidize these activities, or completely take them over to increase the supply so that it reflects all of the benefits bestowed upon the recipients. This would violate the rights of individuals and be economically destructive.[22] Nonetheless, a large amount of charitable giving takes place in a market economy. Each year, Americans give hundreds of billions of dollars to charities, and they would give more if their incomes were not eroded through massive amounts of confiscatory taxation and the inflation of the money supply, both of which result from government intervention into the economy (i.e., the government's use of the initiation of physical force).[23]

People are capable of finding ways to provide goods that create positive externalities, as long as they have the freedom to do so. For instance, with the case of a lighthouse it is claimed that no one will want to pay to help build it because once it is built, a ship owner can "free ride" off of those who have paid to help build it. Here, the ship owner gets the benefit of the lighthouse even though he does not pay to help build it. Since everyone has the incentive

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[21] Some might think a tax deduction is compensation to the donor. However, this is not compensation, but a reduction in the effective cost of the charitable contribution. Furthermore, charity is not exactly the same as a positive externality since no "third party" is involved. However, the basic effect is the same as a positive externality: someone receives a benefit for which he does not pay. Therefore, my analysis still applies to charity.

[22] "Charitable" activities (viz., welfare) provided by the government are destructive because they lower the productive capability and thus the standard of living of the average person in the economy. They do this by providing people an incentive not to work and by taking money away from the more productive people in an economy and giving it to the less productive, or unproductive, people in an economy.

[23] It is easy to understand how the government initiates force when it confiscates money from people in the form of taxes; however, it is more difficult to understand how government intervention is responsible for inflation. I am not going to explain here how it is responsible, but for a thorough explanation, see Reisman, *Capitalism*, pp. 508-10, 511-17, and 920-27.

to free ride, it is claimed that few people will want to pay for the construction of lighthouses, and thus an inadequate number of them will be built because the funds will not be forthcoming from those who could benefit from the lighthouses. Hence, it is claimed that the government must tax everyone and build the lighthouses itself.

This argument ignores the fact that the majority of lighthouses built in Great Britain, starting in the early-seventeenth century, were built by private individuals. Here, lighthouse fees were collected at ports located near the lighthouses. Lighthouses continued to be owned and operated by private individuals in Britain up through the 1830s, when the British government bought the last remaining privately owned lighthouse. It is hard to believe that private individuals could operate lighthouses for 200 years if it was not a profitable activity.[24]

This argument also assumes that ship owners (and business owners in general) are irrational and short-sighted and want to get something for nothing. Such an argument is based not on a view of human beings as rational animals—beings who possess reason—but on a view that human beings, by their nature, are irrational. This is a false view of human nature and is not an appropriate foundation on which to base one's economic analysis. If such a view were valid, human beings never would have made it out of the cave.

If necessary, rational ship owners will gladly pay a portion of the cost to build a lighthouse because they know it is in their interest to do so. They know that lighthouses are necessary so that ships do not run aground and thus so they can run successful shipping businesses. It could be that large shippers in a region get together to pay for the lighthouses in their region. Here it would be in the interest of the large shippers to build the lighthouses even though some of their smaller competitors may benefit from the lighthouses. This is true because to the extent that shippers are large, they have much more to lose if their ships run aground. It could be that shippers in a region engage in a contingent contract, which stipulates that they will pay for a stated portion of the construction of a lighthouse if, perhaps, 50 percent or 75 percent of other shippers in the region sign the contract. The cost of building the lighthouse may be divided up based on the amount of shipping each company does in the region in a typical year.[25] Whichever way it is done, such goods could and would be provided in sufficient quantities (and have been provided in the past, as the history of the lighthouse in Great Britain attests) because it

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[24] In fact, as Ronald Coase states, some of the lighthouse owners made a fortune in the business. See his "The Lighthouse in Economics," *The Journal of Law and Economics* 17 (October 1974), pp. 357-76, esp. pp. 360-68, for a detailed investigation of the lighthouse in Great Britain.

[25] For more on this, see Reisman, *Capitalism*, pp. 97-98.

is in the interest of those involved to provide such goods. Small obstacles like those associated with the lighthouse are not hard for individuals to overcome, as long as they have the freedom to do so.

Finally, if people are not willing to pay for more of something voluntarily, then it should not be provided in greater amounts (in other words, the good or service is not underprovided). Forcing individuals to pay for goods and services they do not want is economically harmful because it decreases satisfaction and well-being in the economy. It forces people to spend more money on things that bring them less satisfaction, and less money on things that would bring them greater satisfaction.[26] How could this be considered "a success"?

d. Conclusion to the politics and economics of externalities

As one can see, from a political and economic standpoint, if one acted on externality theory in a consistent manner and implemented policies based on it, it would lead to economic stagnation, a much lower standard of living, and thus a much lower level of individual satisfaction in the economy. It certainly would not be a success to eliminate all externalities. It is beneficial to eliminate only those externalities that violate the rights of individuals. When rights are protected consistently, this activity fully protects the existence of a market economy and leads to the highest productive capability, standard of living, and level of individual satisfaction that are possible.

5. A Deeper Analysis of the Concept "Externality"

In the above I focus on the political and economic aspects of externalities and show why it would not be beneficial for the government to implement policies based on the externalities doctrine. Furthermore, I show that if rights are protected, the problem associated with externalities disappears. However, there is a more fundamental, philosophical argument that can be made against externality theory. That is, the concept "externality," including its positive and negative variations, leads to serious contradictions. This is so because the concept classifies fundamentally different things together, as if they were the same. Because of this, use of the concept leads to confusion and false conclusions.

[26] One does not need to commit the error of making interpersonal utility comparisons to make this statement. One just has to understand that, given the income individual taxpayers earn, they achieve a higher level of satisfaction and well-being when they are allowed to spend their income on things they voluntarily choose to spend it on. When the government expropriates, say, 20 percent of each person's income in taxes and spends it on something that each person has shown through his own voluntary action that he would *prefer not* to spend it on, the level of satisfaction in the economy decreases.

For instance, take the case discussed above of the person who owns property downstream and has his land contaminated by a farmer using fertilizer upstream. This is an example of a so-called negative externality and represents a violation of someone's rights (namely, the property rights of the downstream landowner). In this case, it is proper for the government to take action to protect the property rights of the downstream landowner by requiring the farmer to compensate the landowner, or pay for the cleanup of the chemicals, and ensure that it does not happen again.

In contrast to the above example is the case of Henry Ford driving the horse breeders, buggy makers, and blacksmiths out of business. This is also an example of a negative externality. However, this occurred in the context of voluntary trade and the protection of rights. Ford was able to get people voluntarily to switch to his product. If the government acted in this case and forced Ford to compensate these producers, kept him out of business, or prevented people from buying his product, this would have been a violation of rights. Here, it would have been improper for the government to act to correct the negative externality.

A concept should not obliterate, ignore, or even push into the background fundamental distinctions between concretes. In this case, it should not obliterate the distinction between actions that violate the rights of individuals and actions that respect rights. But this is what is done when both the actions of Ford and the farmer are said to create negative externalities. By subsuming these actions under the same concept, based on the characteristic of having some negative effect on others, both actions are evaluated as being fundamentally the same when, in fact, they are not. If one attempts consistently to apply this concept, one will believe that the government should use force in each case to prevent the individuals from creating these negative externalities.

However, the effect of the government's taking action in both cases would be radically different. In the case of Ford, the government would be using the *initiation* of force and thus *violating* someone's rights. In the case of the farmer, the government would be using force in a *retaliatory* manner and thus *protecting* rights. This is a fundamental political distinction that cannot be forgotten when determining whether the government should act or not. It is a distinction that the concept "externality" leads people to ignore.

The fundamental distinction between protecting and violating rights cannot be stressed too strongly. This is true because one type of action is pro-human life and the other is anti-life. When the government protects rights it is acting in a manner consistent with the requirements of human life, and is thus acting to preserve human life. When it violates rights it is acting in opposition to the requirements of human life, and is thus acting to destroy life. Protecting the rights of individuals *is* a requirement of human life because, as stated above, freedom from the initiation of physical force is a fundamental requirement of human life. Humans need this in order to do the necessary thinking and acting to further their lives and happiness. People cannot further their lives and happiness if someone forces them to go against their rational judgment.

Similar problems arise based on the positive variation of the concept "externality." For instance, if someone landscapes a property owner's lawn and plants a beautiful garden on his property without his permission, and if this has any benefit to the property owner at all, according to the externality doctrine, the government should act to force the property owner to pay for the work. Here, the government would act inappropriately in two ways. First, it would sanction the violation of the property owner's rights by the landscaper, and second, it would violate the rights of the property owner again by forcing him to pay for the landscaping. Likewise, if a passerby enjoys the view of a beautiful home, according to the externality doctrine, the government should force the passerby to pay for the privilege of viewing the home. Here, the government would violate the rights of the passerby. In general, when the government acts to eliminate positive external effects, it is violating someone's rights by expropriating money and subsidizing, or completely taking over the production of, the activity that creates the effect.

The two situations above are grouped together because a positive externality exists in each of them. However, in the case with the landscaper, someone's rights are violated, while in the case with the passerby, no one's rights are violated. Again, such fundamentally different situations should not be grouped together and evaluated as being the same when, in fact, they are not.

There are other problems with the concept "externality." The term is supposed to identify and help one understand some significant phenomenon, as any term that is important to an academic field should. However, upon closer inspection, it turns out the term identifies a phenomenon that is so widely prevalent that it is meaningless and implies many absurdities. For example, when an individual buys a unit of any good (such as a loaf of bread), this has a negative external effect because now this unit of the good is no longer available for others to purchase and this makes it harder for others to obtain the good. In other words, whenever *any* unit of a good is purchased, a cost is imposed on those who consume the good, or who might have consumed the good, because less of it is available for them to purchase and they are not compensated for that cost. If individuals refrained from purchasing goods, more units would be available for others and therefore it would be easier for others to obtain the good. The implication is that people who purchase a good should be forced to pay all other individuals who consume, or might consume, the good in order to compensate those individuals for making the good harder to obtain. Clearly, this is absurd.

Based on the logic of externality theory, compensation should be paid to anyone who consumes, or might consume, virtually any good, even goods radically different from the good in question. This is true because the purchase and consumption of any good consumes resources that could have been used to produce virtually any other good. Therefore, it can be argued based on externality theory that the supply of virtually any good has been decreased, and thus has been made harder to obtain, due to a person's consumption of any other good.

This example illustrates, more forcefully, how implementing policies based on externality theory would lead to economic stagnation and regression. There would be massive costs imposed on the economic system if individuals who consumed any good had to compensate others who might have purchased that particular good, or most other goods. Imagine the cost of trying to figure out who might have purchased which goods and how much they might have purchased. Imagine the cost of keeping track of who owes money to whom, and the proliferation of pleas by people that they should be compensated because they have been harmed by a particular individual's purchase.

The absurdity does not stop here. In some cases the buyer of a good can also be said to be imposing a positive externality on suppliers of the good. This can be said to be the case because when the buyer purchases the good, this increases the demand for the good and might increase the price for which subsequent units of the good can be sold. Here, one can imagine buyers of the good calling for payment from sellers of subsequent units of the good for the positive externality the buyers have created. At the same time, subsequent buyers of the good will be calling for payment from buyers who purchased previous units. In essence, redistribution from sellers to buyers would take place.

The opposite would occur if individuals refrained from purchasing a good. Here, the individuals who refrained from purchasing the good would call for payments from buyers who had an easier time obtaining the good. Furthermore, sellers would demand payments from the individuals who refrained from making purchases if this led to a lower selling price of the good. In essence, redistribution from buyers to sellers would occur.

The absurdity continues. What about, for example, when a person dresses nicely for a job interview? This has a negative external effect. When a person is well dressed for an interview he makes it harder for other people to get the job. This is a cost imposed on them for which they are not compensated. The same can be said about being intelligent and articulate. Should those who are well dressed, intelligent, and articulate be forced to pay the sloppy, ignorant, and incoherent? Clearly not. But this is the conclusion one would come to if he attempted to consistently apply the concept "externality."

The absurdity can be taken even further. What about the external effects of beautiful and ugly people? Should people be forced to compensate handsome men and beautiful women for the privilege of being able to look at them? Likewise, should ugly people be forced to pay others as compensation for having to look at them?[27] What about the positive external effect of cosmetic surgery or the negative external effect of a person's unpleasant body odor in a crowded elevator? There are many absurd implications one could draw if one took the term "externality" seriously.

Some economists might argue that the examples of the job interview and the buyers who have effects on others are not "real" externalities because their effects are felt through changes in prices and therefore they do not create any net external effect. As with the example of Ford discussed in a previous section, some economists would claim that these "pecuniary externalities" can be ignored. However, even though it is believed that these externalities can be ignored, they are still a type of externality and therefore are still subject to all of the criticisms I have been making regarding externality theory. Furthermore, as I discussed above, these types of externalities could still be used to attempt to justify redistributing income from those who experience the positive externality to those who experience the negative externality. If one believes that externalities should be eliminated, there is no reason why externality theory could not be used to attempt to justify such redistributions. Ultimately, the claim that pecuniary externalities should be ignored is an attempt by those who subscribe to externality theory, and who recognize that externalities exist everywhere, to try to prevent the theory from becoming meaningless and leading to many absurdities. However, the attempt fails.

6. Conclusion

Based on the above analysis, one can conclude that the market neither underprovides nor overprovides goods, as one would believe based on externality theory. Ultimately, the market provides the right amount of goods because it provides them based on people's own voluntary choices. If some good is temporarily under- or overprovided, prices adjust based on supply and demand and people react correspondingly to correct the situation. Goods provided in an economy guided by the externality doctrine would not be provided optimally because the initiation of physical force would have to be used on a massive scale to provide more of some goods and less of others, against the voluntary choices of individuals.

The concept "externality" should be discarded. It should not be used in intellectual discourse or debate. It does not provide a critique of the market because it is a contradictory, cognitively harmful, and invalid concept. Such a

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[27] I owe this example to Reisman, *Capitalism*, p. 96.

concept does not help one gain a better understanding of some aspect of reality; it only leads to greater confusion because of the absurd implications of the concept and because it leads people to ignore (or, at least, not to recognize the importance of) fundamental political distinctions, such as the distinction between the government acting to violate rights and protect rights.

In saying that the term "externality" should be discarded, I am not denying the existence of what the term attempts to categorize. The actions of people can have effects on others. However, what I am saying is that the use of such a term is unnecessary and harmful to one's understanding of the world. It leads to the support of all of the false conclusions and harmful actions I have been discussing. That is why the term must be discarded.

After the term "externality" is discarded, one can still recognize all the effects of people's actions on others; however, one can do so while giving them a proper consideration of the facts involved, particularly the fundamental requirements of human life. The proper consideration with respect to people's actions is not whether they have a positive or negative external effect. The proper consideration is whether a person's actions respect or violate rights. If a person's actions violate someone's rights, it is appropriate for the government to act to protect the individual whose rights have been violated. If no one's rights have been violated, then the government should take no action.[28]

[28] I would like to thank the participants of the Austrian Scholars Conference 9 who gave me helpful comments.