

# **Why Externalities Are Not a Case of Market Failure** \*

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## **INTRODUCTION**

There are many reasons why it is alleged that markets fail. One reason is due to the existence of "externalities." Because of the existence of "externalities," it is claimed that 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 to remedy the situation. In this paper I will show economically, politically, and epistemologically why the externalities criticism of the market is invalid. In fact, I will show why the market actually succeeds with respect to "externalities." Many will be familiar with the economic and political arguments in defense of the market; however, I provide a more powerful defense against the externalities criticism by showing the logical implications of externality theory in politics and economics. Further, I go well beyond the political and economic defense of the market by providing a fundamental epistemological defense. This latter argument provides a more complete defense of the market, without which the economic and political defense cannot succeed.

## **WHAT ARE EXTERNALITIES?**

Economists are familiar with the concept "externality;" however, it is important to give a brief, but precise, description of the term here so that the reader will better understand my criticism of this argument against the market. 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 or *external* to the transaction to buy and sell the good or service.

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 that 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. 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 buy nor sell steel may experience the harmful effects of the pollution (such as sooty curtains and dirty air to breath) but are not compensated for the negative effects they experience.

### **WHY MARKETS ALLEGEDLY FAIL DUE TO EXTERNALITIES**

Although economists understand what the externality argument against the market is, again, it is important to briefly discuss it here because my defense of the market will be clearer in light of it. 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 buy nor sell 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 breath 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.<sup>1</sup> 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.

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<sup>1</sup> This, of course, is known as "internalizing" the externality.

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 both the case of the positive and negative externality, the market is said to fail to capture all the effects involved in some transactions, and thus market prices of goods allegedly fail to reflect all the costs and benefits associated with the goods. The "solution," in both cases, is government intervention into the market. In the case of negative externalities, it is claimed the government must take some action to restrict the 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 the costs they impose on others. With the case of goods that create positive externalities, it is claimed 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 the benefits they bestow on others.<sup>2</sup>

## **THE POLITICS AND ECONOMICS OF EXTERNALITIES**

Many writers, including some Austrian economists, have provided economic and political criticisms of the externality argument against the market. Some of these writers include Ludwig von Mises, Murray Rothbard, Ronald Coase, Harold Demsetz, and Richard Posner.<sup>3</sup> In these criticisms 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 criticisms are deficient. Most fundamentally, the criticisms provided by these writers do not address the epistemological errors with respect to externalities. Further, some of the authors commit errors in the criticisms they put forward against the externality argument. For instance, some of the criticisms are based on an invalid collectivist premise, in that it is believed that society "owns" property and that individual owners are merely given the privilege of managing "society's" property.<sup>4</sup> Another error is the idea that property rights should be granted simply to increase economic efficiency and output for society.<sup>5</sup> In addition, one of the writers

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<sup>2</sup> Of course, 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., 1960), pp. 192-195.

<sup>3</sup> See, for example, Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd Revised ed. (Chicago: Contemporary Books, Inc., 1966), pp. 654-662; Murray N. Rothbard, *Man, Economy, and State: A Treatise on Economic Principles*, (Los Angeles: Nash Publishing, 1970), volume 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): 347-359; Richard A. Posner, *Economic Analysis of Law* (Boston, MA: Little, Brown, and Co., 1972), pp. 10-39.

<sup>4</sup> On rights as privileges granted by society, see Demsetz, 347, 350, & 355.

<sup>5</sup> On using rights simply to maximize "society's" output, see Coase, pp. 2, 34, & 44. On rights as a mechanism that society can use to increase efficiency, see Posner, pp. 10, 13, & 14.

defines far too broad of a sphere of responsibility for the individual.<sup>6</sup>

The criticisms of externality theory provided in this paper have one thing in common with the above arguments: they recognize the corrective effects of a full and consistent protection of property rights. However, the criticisms in this paper avoid the errors committed by the above writers and go deeper than just the mere political and economic criticisms of externality theory. To begin to see as clearly as possible why the externality argument does not provide a valid critique of the market, one must first look at the economic implications of this argument. This is something the writers mentioned above do not do.

### **The Economic Implications of Externalities**

If all 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 outright economic regression!<sup>7</sup> 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 gave out frequent-flyer miles, the first store owner who came up with the idea to allow customers to buy merchandise on layaway, and the first cook to create a great recipe. 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.<sup>8</sup> 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.

Further, based on negative externality theory, inventors and innovators that drive other producers out of business (or cause other businesses to incur losses), due to their innovations, would have to compensate those they

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<sup>6</sup> See von Mises, p. 655.

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

<sup>8</sup> 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

drive out of business. For example, the original Henry Ford would have had to compensate horse breeders, buggy makers, and blacksmiths that he drove out of business. This is so because, 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.<sup>9</sup> 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.<sup>10</sup> This result could hardly be deemed "a success."

### **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.<sup>11</sup> In order to do this, one must have well defined and protected property rights. This is the point made by the writers referred to at the beginning of this section.

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. Further, the violation can be traced back to a single individual.

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paid by his competitors who copy it, nor is he paid by their customers who benefit from it. Therefore, those people receive a benefit for which they do not pay, i.e., a positive externality.

<sup>9</sup> Some argue that this is not actually a type of externality because there is no "net social cost" in this situation, since the business that the horse breeders, buggy makers, and blacksmiths lose is directly offset by the gain in business by Ford. However, based on the definition of the concept "externality," the cost that Ford imposes on the other producers is a negative externality because it is a cost imposed on the other producers for which they are not compensated. So-called net social costs are irrelevant to whether the actions of one person have effects on another person and thus are irrelevant to whether an "externality" exists.

<sup>10</sup> By far the two dominant lines of work in an economy that attempted to consistently act on externality theory would be the accountants who kept track of who owed what to whom and the lawyers that exacted payment for their clients.

<sup>11</sup> On this, see Reisman, *Capitalism*, p. 96 and hear his audiotape, "The Toxicity of Environmentalism" (Laguna Niguel, CA: The Jefferson School of Philosophy, Economics, and Psychology, 1991), especially the question and answer period.

As has been recognized by Austrian writers, the above example is not a case of market failure.<sup>12</sup> It is a situation where the government must step in to preserve the existence of a free market. A free market can only exist when individual rights are protected, including private property rights. This is so because a free market is based on *voluntary* trade. The "free" in free market refers to the absence of the initiation of physical force, in any of its variations, including physical alteration to one's property against one's will. Further, 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.<sup>13</sup> Hence, the failure in this case is the failure on the part of the farmer to act within the principles on which the free market is based. Thus, it is proper for the government to step in and protect the property rights of the downstream landowner to preserve the free market. However, when the government does this, *it is correcting the farmer's failure, not the failure of the free market*. This is true for all so-called negative externality cases 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.<sup>14</sup> Each 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. Further, 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.

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

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<sup>12</sup> See Mises, pp. 657-658 and Rothbard, volume 1, p. 156.

<sup>13</sup> 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. 108-124; *Atlas Shrugged*, 35th anniversary ed. (New York: Signet, 1957), pp. 976-978; and *Capitalism: The Unknown Ideal* (New York: Signet, 1967), p. 17. Also see Harry Binswanger, *The Ayn Rand Lexicon: Objectivism From A to Z* (New York: Meridian, 1986), pp. 212-217 for a compilation of excerpts on the concept of rights by Ayn

one has some basis to show that individuals have made a concerted effort to act collectively, i.e., 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* 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*.

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). This latter is harmful because it is a violation of individual rights, since it requires the initiation of physical force against the individual, 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 rational judgment, and take the necessary actions to further their lives, well-being, and happiness. One cannot use his mind-his tool of survival-to further his life if he is constantly being forced to act against his better 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.<sup>15</sup> Because of the production of steel, many people probably had to breath 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. Further, 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

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Rand.

<sup>14</sup> On this, hear Reisman's "The Toxicity of Environmentalism," especially the question and answer period.

<sup>15</sup> 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.

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 breath 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.<sup>16</sup> 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.

### **The Solution to Positive Externalities**

With respect to positive externalities, individuals should pay others only for benefits they *voluntarily* contract to receive from others.<sup>17</sup> Government force needed to increase the supply of goods that create positive externalities violates individual rights. 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 capitalist society. A good example is charity. Charitable donations are a 100% positive externality. This is so because the recipient does not pay for the charity he receives, and the donor receives no compensation in return for his charitable contribution.<sup>18</sup> Therefore, according to externality theory, too few charitable activities allegedly exist in a capitalist society and the government should either subsidize these activities, or completely take them over to increase the supply so it reflects all the benefits bestowed upon the recipients. This, of course, would violate individual rights and be economically harmful.<sup>19</sup> Nonetheless, a large amount of charitable giving takes place in a free society. Each year, Americans give hundreds of billions of dollars to charities, and they would be able to give much more if their incomes were not eroded through massive amounts of confiscatory taxation and the inflation of the money supply, both of which result

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<sup>16</sup> 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-a-week performing back-breaking labor all for a standard of living probably not too far above the level of a modern-day Ethiopian.

<sup>17</sup> On this, see Reisman, *Capitalism*, p. 96.

<sup>18</sup> 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.

<sup>19</sup> "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.

from government intervention into the economy (i.e., the government's use of the initiation of physical force).<sup>20</sup>

Free and rational individuals are capable of finding ways to provide goods that create positive externalities. 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 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 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.<sup>21</sup>

This argument also assumes ship owners (and businessmen in general) are irrational and short-sighted and want to get something for nothing. Such an argument is based, not on a view of man as the rational animal—the being who possesses reason—but on a view that man is by his nature irrational. This is a false view of man's nature and is not an appropriate foundation on which to base one's economic analysis. If such a view was valid, man never would have made all of the advances he has so far.

If necessary, rational ship owners will gladly pay a portion of the cost to build a lighthouse because they know it is in their rational self-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 to the self-interest of the large shippers to build the lighthouses even though some of their smaller competitors may benefit from the lighthouses. This is so 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% or 75% of other shippers in the region sign the contract. The cost of building the

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<sup>20</sup> 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. 508-510, 511-517, & 920-927.

<sup>21</sup> In fact, as Coase shows, some of the lighthouse owners made a fortune in the business. See his article "The Lighthouse in Economics," *The Journal of Law and*

lighthouse may be divided up based on the amount of shipping each company does in the region in a typical year.<sup>22</sup> 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 is to the self-interest of those involved to provide such goods. Small obstacles like those associated with the lighthouse are not hard for free and rational individuals to overcome.

Finally, if individuals 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 under provided). 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.<sup>23</sup> How could this be considered "a success"?

More fundamentally, forcing individuals to pay for such things violates individual rights (usually the rights of taxpayers). Notice here the link between individual rights and economics. Violating individual rights harms the economy, in this case by decreasing the level of satisfaction and well-being achieved by individuals in the economy. Likewise, when the government protects individual rights, by allowing individual taxpayers to be free to spend their money on what they see as best for them, this benefits the economy by increasing the level of satisfaction and well-being that each individual is able to attain. This link between protecting individual rights and benefiting the economy, and violating individual rights and harming the economy, as a general principle, always exists. This is so because, as stated previously, rights protect people from the initiation of physical force; they protect people's freedom. Therefore, when people's rights are protected it leaves them free to act in their own rational self-interest and therefore set prices, respond to the profit motive, and spend the money they earn in a manner that benefits them the most. All this helps to maximize the production of wealth and allows individuals to improve their lives and well-being to the greatest extent possible.

Further, as stated previously, the protection of individual rights requires that people interact with others in a voluntary manner. This is beneficial because all parties to a voluntary trade gain from the trade. This is the basis for why trade occurs in the first place. For instance, when I trade money with the grocer to buy food, I give up the money to get the food because I consider the food more valuable than the money. Likewise, the grocer gives up the

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*Economics* 17 (October 1974): 357-376, especially pp. 360-368, for a detailed investigation of the lighthouse in Great Britain.

<sup>22</sup> For more on this, see Reisman, *Capitalism*, pp. 97-98.

<sup>23</sup> 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

food to get the money because he considers the money more valuable than the food. We both gain. Therefore, whenever voluntary trade is prevented from taking place through a violation of individual rights by the government, the would-be traders are prevented from gaining (i.e., they are worse off than they would be had the trade taken place). This, in brief economic essentials, is why protecting individual rights always benefits the economy and violating individual rights always harms the economy.<sup>24</sup>

### **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 individual rights. When individual rights are protected consistently, it fully protects the existence of the free market and leads to the highest productive capability, standard of living, and level of individual satisfaction that are possible.

### **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. Further, I show that if individual 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, is an invalid concept. To understand what a concept is, what it means for a concept to be valid or invalid, and why the concept "externality" is invalid, I must elaborate on the nature of concepts.<sup>25</sup>

### **The Nature of Concepts and the Invalidity of the Concept "Externality"**

Concepts are mental tools used to classify and categorize concretes of a certain kind. For instance, the concept

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spend it on. When the government expropriates, say, 20% 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.

<sup>24</sup> It is not the point of this paper to show in detail the link between individual rights and economics. For now, the reader will have to be satisfied with the brief explanation and one example I have given. Those who want a deeper explanation and more examples of this link will have to wait for the publication of my forthcoming book titled *Markets Don't Fail!*

<sup>25</sup> I will by no means provide an exhaustive discussion on the nature of concepts. That is a task that falls under the field of epistemology and is one that a philosopher must undertake. I owe my understanding of the nature of concepts to Ayn Rand. For a detailed discussion on this topic, see her, *Introduction to Objectivist*

"man" is used to identify and classify beings of a certain kind: beings whose most fundamental characteristic is the possession of reason (or the ability to think at the conceptual level). In general, concepts are used to classify and categorize entities, actions, relationships, etc.-any aspect of reality. We perform such classifications and categorizations for a specific purpose: to be able to apply the knowledge we gain about *some* concretes in a category to *every* concrete in the category. For instance, we use the knowledge gained and subsumed under the concept "man," such as that he has ten fingers, ten toes, walks upright, has a pair of lungs, a heart, a conceptual faculty, etc. and apply this to all men. This allows us to, among other things, retain an enormous amount of data concerning a large number of concretes and thus allows us to economize on the use of our mental capacity. We do not have to treat every concrete that we come upon as a completely new phenomenon. Once a specific concrete has been conceptualized, we can apply the knowledge gained about that concrete in general to specific instances of it.

A simple example of how concepts enable us to economize on our mental space is the act of counting. Without numerical concepts, one would have to hold in his mind at one time a number of specific entities corresponding to the number he was trying to retain in his mind. For instance, the number sixteen, instead of one concept, would be ///////////////. It is impossible to retain this in one's mind at one time, let alone distinguish it from ///////////////, or retain sixteen million entities in one's mind. Without counting, man would be limited to retaining, perhaps, five or six objects at best. Without mathematical concepts, a growing number of entities quickly blurs into an unretainable sum.<sup>26</sup>

In order to achieve the crucially important cognitive purpose above, a concept should group existents based on their fundamental similarities and differences. Those existents that are fundamentally similar should be grouped together, while those that are fundamentally different should be grouped separately. A fundamental characteristic of a concrete is one that explains all the other characteristics, or the largest number of other characteristics, of that concrete. For example, the possession of reason is the fundamental or distinguishing characteristic of man because it is the one characteristic that explains virtually all the things that man is capable of, but of which other living beings are incapable. For instance, the possession of reason explains why man can count, follow a recipe, play a board game, read a book, read engineering drawings, learn calculus, invent the computer, write a symphony, etc.<sup>27</sup> By classifying concretes based on their fundamental similarities and differences, concepts enable man to obtain a

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*Epistemology*, 2nd ed. (New York: Meridian, 1990), pp. 10-18, 49, & 62-74 and *Atlas Shrugged*, p. 934, and Leonard Peikoff, *Objectivism: The Philosophy of Ayn Rand* (New York: Meridian, 1991), pp. 73-91, 105-109, & 113-116.

<sup>26</sup> I owe this example to Leonard Peikoff, *Objectivism: The Philosophy of Ayn Rand*, p. 107.

<sup>27</sup> I owe this example to Ayn Rand. See her *Introduction to Objectivist Epistemology*, p. 45.

deeper and clearer understanding of reality. They enable him to, among other things, understand the causal relationships between the concretes he observes.

The above does not apply to the concept "externality." This concept classifies fundamentally different things together, as if they were the same. This is why the concept is invalid. Further, this is why the concept leads to confusion. As an example of this confusion, 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 individual rights (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 individual rights. Ford was able to get people to voluntarily 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 individual 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 individual rights and actions that respect individual 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 non-essential 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 to consistently apply this concept, one will believe the government should use force in each case to prevent the individuals from creating these negative externalities.

However, the effect of the government 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* individual rights. In the case of the farmer, the government would be using force in a *retaliatory* manner and thus *protecting* individual 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 individual rights cannot be stressed too strongly. This is so because one type of action is pro-human life and the other is anti-life. When the government protects individual rights it is acting in a manner consistent with the requirements of human life, and thus is acting to preserve human life. When it violates individual rights it is acting in opposition to the requirements of human life, and thus is acting to harm life. Protecting individual rights *is* a requirement of human life because, as stated previously, 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 well being. A man cannot further his life and well being if someone forces him to go against his 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, 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 twice. First it would sanction the violation of the property owner's rights by the landscaper; then 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 violates individual rights to expropriate money and subsidize, or completely take over the production of, the activity creating 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, individual 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.

Grouping fundamentally different things together based on non-essential characteristics is harmful when forming concepts precisely because it leads to greater confusion, not a clearer understanding of reality. This is so in the case of the concept "externality," where it leads to confusion over when it is proper for the government to use force, and it is true in the case of any other concept as well. As an example, think of the confusion that would arise if a horse and a dog were grouped together under the same concept based on some non-essential characteristic, such as that they both have tails. This new "concept" could be called a "dorse."

By classifying these beings together, one is saying that they are fundamentally the same and thus should be subsumed under the same term. However, there are significant differences between these two animals and to treat them as being the same one would have to ignore those differences. One would have to ignore differences whose recognition would help one gain a better understanding of these animals. Grouping them together would lead to confusion over, for example, how to distinguish them from other creatures that have some of the same characteristics, what they should be fed, and how to care for them in general. This is so because, since each one would be treated as a specific instance of the same type of animal, the same basic principles of care and nutrition would apply to them (just as the same basic principles apply to actual instances of one particular type of animal).

With a "concept" like "dorse," the fundamental differences between the things classified are obvious because many of the differences are directly perceivable. Therefore, it is easy to understand that horses and dogs do not belong under the same concept and, because of the blatantly obvious differences between them, it is hard to even imagine how one could make the mistake of grouping them under the same concept, or how any confusion could arise in the care of the animals. With a "concept" like "externality," the fundamental differences between the things classified are not directly perceivable. This is why it is easier for these differences to be missed or ignored, and why it is easier for these fundamentally different things to be grouped under the same concept. However, it is just as important to distinguish between fundamentally different characteristics when forming concepts to identify the actions that the concept "externality" attempts to classify, as it is when forming concepts to identify horses and dogs. In more general terms, when forming concepts, it is just as important to recognize fundamental differences that are not directly perceivable as it is to recognize fundamental differences that are directly perceivable.

### **The Absurdities of "Externalities"**

There are other problems with the "concept" externality. The term is suppose 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, and so insignificant, 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 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 that consumes, or might consume, virtually any good, even goods radically different from the good in question. This is so 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. There is no doubt that such pleas would lead to greater income redistribution from the rich to the poor since, it would be claimed, the rich consume more goods than the poor and thus allegedly impose more cost on the poor than vice versa.

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 is so 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 and demand for it decreased because of this. Here, the individuals that refrained from purchasing the good would call for payments from buyers that had an easier time obtaining the good. Further, sellers would demand payments from the individuals who refrained from

making purchases if this lead to a lower selling price of the good. In essence, redistribution from buyers to sellers would occur.<sup>28</sup> If the measures necessary to act consistently on the concept "externality" appear ridiculous, they are, and should be taken as a clue to the invalid nature of the concept.

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?<sup>29</sup> What about 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.

### **The Collectivist Nature of "Externality"**

In addition to the above problems, and as is implicit in many of the above examples, the "concept" externality is also a collectivist term put forward by economists and other intellectuals who believe in collectivism. They do it in an attempt to justify forcing individuals to live for some group or collective. Whether it is Ford being forced to support horse breeders, buggy makers, and blacksmiths; taxpayers being forced to pay for the production of goods that create positive externalities; or those who purchase a product being forced to give it up to others, those who criticize the free market using the "concept" externality seek to sacrifice some individuals for the sake of others. However, forcing individuals to live for some collective is harmful toward human life because it violates individual rights. Only by embracing and creating a politico/economic system based on individualism-which says that each man is an independent, sovereign entity that has a right to his own life -will human life be able to flourish. Only then will each individual be able to live his life for his own enjoyment and not be sacrificed to the needs and desires of

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<sup>28</sup> It has been argued that the effect of some buyers' (or potential buyers') actions on sellers and other buyers of a good is not actually an example of an externality because there is no "net social cost," since the negative (positive) effect on other buyers is directly offset by the positive (negative) effect on sellers. However, as stated in the section titled "The Economic Implications of Externalities" in conjunction with the example of Ford driving the horse breeders, buggy makers, and blacksmiths out of business, whether a so-called net social cost exists is irrelevant to whether an "externality" exists.

others.

## CONCLUSION

The market neither under provides nor over provides 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 over-provided, 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 an invalid and thus harmful concept. Such a 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, the collectivist nature of it, and because it leads people to ignore (or, at least, not recognize the importance of) fundamental political distinctions, such as the distinction between the government acting to violate individual rights and protect individual 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 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 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 individual rights. If a person's actions violate individual 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.

The externality argument does not provide any evidence of market failure. The only evidence of failure this argument provides is the failure of contemporary economists and other intellectuals to embrace sound concepts and

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<sup>29</sup> I owe this example to Reisman.

ideas. By rejecting the externality argument and coming to an understanding of the importance of protecting individual rights, economists will take a large step toward establishing the science of economics on a much stronger base.

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