

The Encyclopedia of
LIBERTARIANISM

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2455 Teller Road
Thousand Oaks, California 91320
E-mail: order@sagepub.com

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1 Oliver's Yard
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B 1/I 1 Mohan Cooperative Industrial Area
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<i>Cover Designer:</i>	Ravi Balasuriya
<i>Marketing Manager:</i>	Amberlyn Erzinger

Contributors

AC	Andrew Coulson <i>Cato Institute</i>	AV	Alexander Volokh <i>Georgetown University</i>	CB	Clint Bolick <i>Goldwater Institute</i>
AdJ	Anthony de Jasay <i>Author of The State, Against Politics, and Justice and Its Surroundings</i>	BAS	Bradley Smith <i>Capital University Law School</i>	ChB	Charles Baird <i>California State University, East Bay</i>
AeS	Aeon Skoble <i>Bridgewater State College</i>	BBG	Bettina Bien Greaves <i>Foundation for Economic Education</i>	CD	Christie Davies <i>University of Reading</i>
AF	Antony Flew <i>University of Reading</i>	BC	Bryan Caplan <i>George Mason University</i>	CH	Charles Hamilton <i>The Clark Foundation</i>
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AS	Aaron Steelman <i>Federal Reserve Bank of Richmond</i>	BP	Benjamin Powell <i>Suffolk University</i>	DBa	Doug Badow <i>Competitive Enterprise Institute</i>
				DBK	Daniel Klein <i>George Mason University</i>

of self-creation that the state's attempts to shape our wishes and our nature.

GHS

See also Foucault, Michel; Individualism, Political and Ethical; Nietzsche, Friedrich; Rights, Theories of; State

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EXTERNALITIES

There is no universally accepted definition for the term *externality*, but that put forward by Harvey Rosen adequately conveys the principle. He writes that an externality occurs when "the activity of one entity (a person or a firm) directly affects the welfare of another in a way that is outside the market mechanism." Externalities may be negative (as when industrial pollution injures people's health or positive (as when the presence of a security guard whose function is to prevent theft from a store serves to protect you as well). In both cases, someone's welfare must be directly affected incidental to another's activity. Thus, externalities differ from altruism or spite. Additionally, the effect must be "outside the market mechanism," that is, not mediated by prices. The pecuniary externality created when incoming residents drive up housing prices, benefiting local homeowners and hurting tenants, is not a proper externality.

The presence of externalities is often considered a *prima facie* argument for remedial government intervention. In *The Economics of Social Welfare*, A. C. Pigou distinguished between the *private net product* of an activity and the *social net product* (which takes into account all externalities). When private net product exceeds social net product, production is greater than is efficient, and vice versa. Pigou proposed using damage remedies or taxes and subsidies, set at the amount of the external cost or benefit, to bring about efficiency by making market actors internalize the externalities of their behavior.

Ronald Coase questioned Pigou's solution, on the same efficiency grounds, in a path-breaking article, "The Problem of Social Cost." Coase noted that all externalities are reciprocal. Suppose factory production, through its pollution, reduces the quantity of fish, so that any increase in production comes at the expense of fish, and vice versa. Then giving the factory the right to pollute would harm the

fishery, but giving the fishery the right to be free from pollution would harm the factory. Coase further pointed out that if the parties can negotiate, they will, under certain assumptions, come to the efficient arrangement regardless of who holds the rights: Either the factory will compensate the fishery for its reduced catch or the fishery will pay the factory to produce less or to introduce pollution control devices. Even if the parties cannot negotiate because of high transaction costs—so that the initial allocation of rights determines the ultimate outcome—who should pay is not obvious on efficiency grounds alone; the factory should not pay if it is the highest valued use of the resources involved. Thus, even when externalities exist, the Pigovian "polluter pays" solution is not necessarily efficient.

Whether an externality even exists depends on prevailing institutions. For instance, common pastures tend to be overgrazed because each of many users can increase the size of his herd without taking into account the harm (i.e., crowding out) he imposes on the other users—in economics, this is known as "the tragedy of the commons." Private ownership of the pasture, which lets the owner exclude other users, eliminates these externalities. Similarly, the costs of unhealthy behavior are mainly borne by the individual. However, when the government subsidizes medical care, unhealthy behavior generates fiscal externalities, harm to the taxpayer that may be alleviated by regulating health risks or eliminated by removing the subsidy.

Externalities are ubiquitous. Some people's happiness depends on whether they live in a drug-free world, how income is distributed, or whether the Grand Canyon is developed. Given such moral or ideological tastes, any human activity can generate externalities; one may choose to ignore such effects for moral or political reasons, but they are true externalities nonetheless. Moreover, some behavioral economists have recently noted that when individuals are time-inconsistent (e.g., smokers who always want to quit "tomorrow"), their present selves impose costs, which one might call *internalities*, on their future selves. On this view, even if smokers impose no costs on others, taxes on cigarettes or restrictions on their sale may improve the well-being of smokers by their own standards—a form of utilitarian paternalism.

The libertarian concern with preventing harm to others customarily implies that most justifiable interventions by the government in a libertarian society can be characterized as remedies for externalities. But given the pervasiveness of externalities, the breadth of harms they encompass, and their potential implications for sweeping government measures, libertarian theory is loath to consider the presence of negative externalities to be a sufficient condition for even ideal government interventions, much less an intervention in the real world, where it may be inappropriate to assume that government is omniscient, omnipotent, or benevolent. Free expression, for instance, will inevitably offend some, but such offense generally does not justify regulation in the libertarian framework for any of several reasons: because

there exists a natural right of free expression, because offense cannot be accurately measured and is easy to falsify, because private bargaining may be more effective inasmuch as such regulation may make government dangerously powerful, and because such regulation may improperly encourage future feelings of offense among citizens. Among some libertarians, even the possibility of conferring positive externalities is not sufficient for government intervention. Suppose a reduction in the work day would make everyone better off. Such an arrangement is unlikely to arise voluntarily because of the large number of people involved and because it would require policing owing to the high rewards to being the lone holdout. John Stuart Mill, a utilitarian, argued in his book *Principles of Political Economy*, that regulation conferring such positive externalities was acceptable. However, without actual consent by all parties, it is hard to see how such regulation would fit into the framework of libertarian theory.

AV

See also Coase, Ronald H.; Environment; Market Failure; Nonaggression Axiom; Utilitarianism

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