

## RESOURCE MISALLOCATION, EXTERNALITIES AND ENVIRONMENTALISM: A U.S.-CANADIAN ANALYSIS

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It is a truism among economists that only if the full costs and benefits of economic activity are taken into account by the entrepreneur, will resources be allocated in a Pareto Optimal manner. Under present economic conditions, however, some manufacturers are able to impose costs, particularly pollution or disposal costs, onto third parties. As a result, the actual social costs of such activities are greater than the recorded private costs. At present, the benefits of these goods need be equal to or greater than only the lower private costs, not the higher social costs, if the enterprise is to be able to at least break even and thus continue in operation. This being the case, it follows that the value of at least some of these presently produced goods and services will fall below the total or social costs, and should not be produced at all, if wealth is to be maximized.

So far, this argument is straightforward, and unobjectionable. Indeed, it constitutes no more than the logical implications of the basic axioms of microeconomic price theory, as applied to environmental issues. This, unfortunately, does not apply to the next step typically made in this line of reasoning, which consists of the claim that our economy, at present, is organized along free enterprise lines, and that these negative externality -- induced misallocations stem from that system.

The point of departure taken in this paper, in contrast, is the hypothesis that this "economic failure" is indeed a concomitant of our present system, but that it is due to government failure, not market failure<sup>1</sup>. On this thesis, a clear definition of property rights, and the defense thereof, is a necessary underpinning of the market system.

We shall attempt to show that while the government has claimed a monopoly right to engage in just such activities, it has fallen short of this goal. Further, each of these cases of failure, it will be claimed, is the cause of a resource misallocating externality; if the externality is to be internalized, it will not be accomplished by yet further incursions of government into economic planning, but rather by confining government to its traditional roles of defining and defending private property rights.

This analysis also has profound implications for the environment. It is because of government failure to protect private property owners against the depredations of trespassers that our air, water, forest and wild animal resources are presently endangered. If the ecological system is to be better protected, the market will have to be called upon to play a more significant role. But it can only do so if market prices reflect the true costs of producing goods; that is, if the market can generate prices which take into account all costs, specifically including disposal or pollution costs. Only in that way will social costs tend to equal private costs.

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<sup>1</sup>It has been correctly argued that there is both market and government failure, and that therefore the existence of the former does not justify state ameliorative action. In this paper we adopt a stronger thesis, namely, that no market failure has been shown to exist in the environmental field, and that all alleged cases are really instances of the governmental failure to clearly define, or aggressively protect, private property rights. This is not to say that free enterprise is "perfect." Nothing composed of fallible human beings can attain that honorific, at least on this side of the Garden of Eden. It is, however, to deny that any systematic, pervasive or serious "flaw" in this system has so far been uncovered.

Let us consider several cases in order to illustrate our thesis. We shall conclude with a discussion of the U.S.-Canadian cross border implications of the analysis.

### POLLUTION

Suppose I were to take my garbage bag (filled with egg shells, orange peels, banana skins, baby diapers, cereal boxes and all the other by-products of modern day living) and dump it on your front lawn. We all know what would happen to me. You would summon the local police, and they would fine me for violating the local trespassing statutes. If I persisted in this behaviour, I would be incarcerated, and that would be the end of the episode. This is why there is, at present, no widespread "externalities" problem involving people dumping their refuse onto other people's property. Indeed, the very idea is ludicrous.

But suppose I take the precaution of first incinerating my household wastes, and then wafting them over in the direction of your front lawn (and lungs, and laundry washing hanging out to dry) in the form of soot, ash and smoke particles. In this case, things are by no means as simple as before. As a matter of fact, ever since the 1840s, it has been very difficult to establish the property rights of the victim of this sort of pollution<sup>2</sup>.

This radical alteration in jurisprudence took place for three main reasons. First, the courts began to interpret activities which were given government approval and licence as being in the public interest, even if they had third party negative effects, or external diseconomies. For example, if official permission was given for a railroad locomotive to operate, this was seen as carte blanche ratification of all of its effects. Second, the courts would no longer enforce property rights when one trespasser (i.e., the polluter) invaded the property of not one but many victims. This was not anymore seen as an instance of private harms, for which the court could, at least theoretically, provide injunctive relief, but rather as a case of public action, for which the only remedy was legislative action. The courts thus tossed this political hot potato back to the legislatures, which failed to act.

Third and most important, a new philosophical principle began to pervade the halls of justice. Instead of the old fashioned doctrine of protecting private property rights, the new vision was to promote the public interest. And of what did the public interest consist, in this new dispensation? Of economic growth. And how was economic growth best to be attained? By promoting manufacturing. And how could manufacturing be most readily and efficaciously promoted? By considering the plaintiffs in what we would now see as those early environmental cases (they were then called nuisance suits) as unworthy pests. The more modern courts in the 1850s and thereafter ran roughshod over the private property rights of a horde of victim-complainants, and in effect handed over to the polluters the right to use the atmosphere (and thus the front yards and lungs of their neighbors) as sink holes.

This did promote economic growth, at least insofar as it does not take into account harm to third parties. For, armed with victories in these lawsuits, manufacturers no longer had economic incentives to engage in smoke pollution abatement. They need not install smoke prevention devices, nor attempt to substitute cleaner burning high grade anthracite coal for the high sulfur content alternative. There was little reason to engage in research and development into techniques which economized on pollution intensive methods of production. Was this done in any one case, perhaps out of sympathy for ecological concerns, or out of a desire not to destroy the property rights of others, bankruptcy would have been the inevitable result. Such a firm would have taken on additional costs, which did not apply to its competitors.

As a result of these judicial decisions, the entire economic structure was thus "led by an invisible hand" to engage in pollution intensive techniques. Consumers had little or no incentive to avoid the goods and services produced under these conditions, as their true social costs were not reflected in the prices they faced. But it is by now crystal clear that the reason for this resource allocation was completely unrelated to any breakdown in the market. It was due to governmental failure to provide the regime of property rights without which no marketplace system can function.

<sup>2</sup>The historical treatment of pollution cases in the next few paragraphs relies heavily on Morton J. Horwitz, *The Transformation of American Law: 1780-1860*, Cambridge, Harvard University Press, 1977, pp. 74-78; Ronald Coase, "The Problem of Social Cost," *The Journal of Law and Economics*, October 1960, Vol. III, pp. 1-44. See also Murray N. Rothbard, "Law, Property Rights, and Air Pollution," and Walter Block, "Environmental Problems, Private Property Rights Solutions," in *Economics and the Environment: A Reconciliation*, ed. Walter Block, Vancouver: The Fraser Institute, 1990; Peter H. Aranson, "Pollution Control: The Case for Competition," *Instead of Regulation: Alternatives to Federal Regulatory Agencies*, Robert Poole, ed., Lexington, MA: D.C. Heath and Co., 1982.

No one would claim that the market failed if government allowed people to dump raw garbage on each other's front lawns. The identical analysis applies when the courts determine that it is not illegal to deploy incinerated garbage in such a fashion<sup>3</sup>.

### PLASTICS

Recently, a Macdonalds restaurant was allowed to be opened in Moscow. This, of course, is an occasion for great rejoicing. It signals that the Soviet Union is entering the path toward economic freedom, and this cannot help but better the lot of the average denizen of that country.

Paradoxically, at the same time that Ronald Macdonald was appearing in the U.S.S.R. for the first time, his attempt to start up more outlets in the U.S.A. -- "land of the free" -- ran into great difficulties. Several American communities have refused business licenses to this firm, largely on the ground that a welter of plastic cups, plates, knives forks and spoons follows in its wake, and that these objects are environmentally unfriendly, in that they do not easily biodegrade.

This is another instance where market failure is commonly charged. The manufacturers of plastic implements are forced to take most costs into account: the salaries of their employees, rent for the real estate they occupy, payments for raw materials used in the production process, interest on loans, etc. But there is one cost from which they escape completely; it spills over onto third parties, or onto society as a whole. And that is the cost of disposing of the chemically inert plastic after the consumer is finished with it. This is a negative external diseconomy.

But as in the above analysis, further reflection paints a very different picture. This emerges when we ask Why is it that the manufacturer is able to impose these costs onto others? Why is it that the market is unable to lead to prices which reflect the full costs of the item. The answer, as before, is because of other government interferences with the market place; again, it is not due to any intrinsic flaw in this system.

Let us reflect upon the experience of the shopper who has just had her groceries rung up at the supermarket check out counter, and is asked whether she wishes them placed in paper or plastic bags. Right now, the only incentive she has to demand the paper<sup>4</sup> bag is philosophical: both cost the roughly the same amount of money, and the only reason she might choose the paper is out of environmental convictions, or the desire to be a good citizen. There is nothing wrong with benevolence. Indeed, an entire sector of our economy (charitable contributions) is based upon it. However, as Adam Smith pointed out, benevolence is a relatively weak foundation for human action. ("It is not from benevolence that the butcher, the baker, the candlestick maker provide us with their products...."). If we are to competently address this problem as a society, then it is important that self interest be added to benevolence as a motivation for eschewing the more environmentally harmful plastic products.

In a well functioning market, the additional disposal costs of plastic would be taken into account by the shopper. The reason that this result does not obtain at present is because government has nationalized a related industry, namely that of solid waste management, and garbage carting.

Let us consider, then, the contrary to fact conditional situation where there is a thriving private market for these activities. Given our present assumptions about the relative harm of paper and plastic, the private owner of a dump

<sup>3</sup>From this historical-legal exegesis, no specific public policy immediately follows. One alternative is to attempt to "turn back the clock" to the 1830s, and insist upon a regime of complete private property rights. This might be considered the best policy from a purely economic perspective. But given political realities, many commentators have urged what might be deemed a second best policy of tradeable emission rights which would be sold at auction by government. See for example Douglas A. Smith, "The Economics of Protecting the Ozone Layer," and Edwin G. Dolan, "Controlling Acid Rain," *Economics and the Environment: A Reconciliation*, Walter Block, ed., Vancouver, The Fraser Institute, 1990; Don G. McFetridge, "The Economic Approach to Environmental Issues," *The Environmental Imperative*, G. Bruce Doem, ed., Toronto, C.D. Howe Institute, 1990; Robert W. Hahn and Gordon L. Hester, "Where Did All the Markets Go? An Analysis of EPA's Emissions Trading Program," *Yale Journal of Regulation*, Vol. 6, No. 1, Winter 1989, pp. 109-153; Robert W. Hahn, "Economic Prescriptions for Environmental Problems: How the Patient Followed the Doctor's Orders," *Journal of Economic Perspectives*, Vol. 3, No. 2, Spring 1989, pp. 95-114.

<sup>4</sup>We are now assuming the truth of the claim that paper is much more environmentally friendly than plastic. We will later drop this assumption, and adopt a more realistic one.

site will tend to charge a price that reflects this<sup>5</sup>. If plastic causes five times more damage to his property than paper, the price he charges the carting company will tend to take this into account. The firm which collects ~~garbage~~ from the homeowner at curbside will then translate this price differential to its clients<sup>6</sup>.

Let us now return to our homemaker at the supermarket check out counter. Having been told that she must pay more for the disposal of plastic products, she now has an additional needed incentive to eschew the paper. Given this new mindset, there is little doubt that the "externality" problem will disappear. As long as the government protects property rights by prohibiting border crossings or trespass (e.g., allowing the dumpsite owner to simply burn the plastic, imposing these costs on third parties) there is no reason to believe that the price differential for disposing of these two products will not conform to the real cost differentials.

This does not mean that no one will use plastic. It only implies that this item will not be used unless its added utility, vis a vis paper, is less than fully offset by the additional disposal costs. If the total costs (including costs of disposal as well as everything else) of using plastics are five times greater than paper, it will only be used if its advantages are greater than this differential. And that is the way resources should be allocated, if we are to reach Pareto Optimality.

It is now time to call into question this cost differential. We have been assuming it to be large and positive, mainly because of the hysterical outbursts and protests which have earmarked the environmentalist movement, such as its opposition to the opening of new MacDonalds outlets. But there are scientists who have authoritatively challenged this assumption<sup>7</sup>. Suppose, now, that they are correct. This means either there is no disposal cost differential between the two products, or that it is very small, or that it is the reverse of that which is usually assumed.

Notwithstanding this complication, there is no reason to suppose that a completely privatized solid waste management industry could not accurately incorporate the full costs of consuming both plastic and paper, including the disposal costs. Given this, there is no externalities problem endemic to the market; instead, it arises because a vital sector of the market has been compromised. The charge of external diseconomies is based on a confusion between the breakdown of a market, and the legally enforced absence of a market.

#### U.S.-CANADA IMPLICATIONS

What are the implications of this analysis for U.S. - Canada relations? We have interpreted air borne pollution, when it crosses private property boundaries, as a trespass. It is akin to sending any other object to another person's property against the will of the recipient. Except, perhaps, for the degree of harm imposed, it is equivalent to bombarding someone else with sticks and stones. When the pollution crosses state boundaries, it is morally and legally<sup>8</sup> indistinguishable not only from launching those items, but from hand grenades, bullets and bombs as well.

Of course there is no need for hysterical demands for declarations of war between the two countries. The longest unguarded border in the world does not exist between the U.S. and Canada for no reason. This problem, as well as others which have from time to time plagued the North American neighbors -- fishing, border placements, trade -- can and will be resolved peacefully, through negotiation. But any interaction between the two which takes place under the assumption that air and water pollution, acid rain, harm to fish stocks, etc., is not equivalent to a taking, is doomed to misdirection. What is needed is a treaty, or a series of treaties, outlining how and when the various cross border environmental crossings will be reduced. Fortunately, if each nation addresses its own internal environmental difficulties, the international aspects will be radically reduced.

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<sup>5</sup>We abstract from monitoring and sorting costs. When these are incorporated into the analysis, the price differential between plastic and paper will be reduced accordingly.

<sup>6</sup>Not only will privatization of this industry solve an environmental problem, it will also save the taxpayer-consumer significant amounts of money, due to the greater efficiency of the market compared to socialism. See Robert Poole, *Cutting Back City Hall*, New York: Universe Books, 1980.

<sup>7</sup>See William L. Rathje, "Rubbish!," *Atlantic Monthly*, December 1989, pp. 99-109.

<sup>8</sup>Not, of course, based on how law is currently interpreted, but rather on the basis of how it would be interpreted if it were predicted on the sanctity of property rights.