PIGOU'S FABIAN SOCIALIST ATTACK ON ECONOMICS

- Pigou was a eugenicist, rejected Bentham's egalitarianism, followed Nietzsche elitism and supported the gradual (Fabian) transition from capitalism to a USSR-style economy.
- His **concocted** attack on Adam Smith's system of natural liberty was **purely** ideological, intended to support Big Government.
- The idea of **externalities** as an inefficiency is **completely false.**
- **External effects** of human action (such as pollution) are real but do not represent an inefficiency. **Public goods** with strategic behaviour **are** inefficient but represent an entirely different thing.
- Pigou's alleged **gap** between marginal social and private products is **fictitious**. Coase's transaction cost-based attempt to give legs to the idea of inefficient externalities is incorrect.

SANJEEV SABHLOK

Occasional Paper. Draft.

INDIA POLICY INSTITUTE
http://indiapolicy.org

Preliminary sketch 0.007

25 March 2024

Comments or suggestions invited at sabhlok@gmail.com

http://indiapolicy.org/Documents/PigousFabianSocialistAttack-draft.pdf

Frontispiece

"I was a Socialist before I knew anything of economics ... I have ... been steadily growing a more convinced Socialist. ... Socialism is ... a movement for taking the responsibility for a man's life and work ... off his shoulders and putting it on to the State.... It is probable that a future Social Order may greatly surpass the present in … the subordination of material possessions to human well-being"

– *Alfred Marshall,* Pigou's guru

"[I] would accept, for the time being, the general structure of capitalism; but … would modify it gradually.... [I] would take a leaf from the book of Soviet Russia ...If all went well, further steps towards nationalisation of important industries would be taken by degrees."

– *A.C. Pigou, 1948*

"The literature of externality problems, from Pigou to Coase, makes it seem as if they are associated with inefficiencies, **but they are not**."

– *Harold Demsetz, 2011*

"The concept of 'externality' has come to play a central role in welfare economics, with **results which have been wholly unfortunate**."

– *Ronald Coase, 1988*

"by making externality arguments in an institutional vacuum, economists unwittingly developed a **weapon of mass destruction** that, in the hands of journalists and popular policy analysts corroded almost to the point of uselessness the beneficial theory of markets and competition"

- A.H. Barnett and Bruce Yandale, 2009

"This is not science; it is **metaphysics**: value judgments and political goals will enter into the determination of whether externalities occur in our world."

– *Carl J. Dahlman, 1979*

"the **free rider did not ask for his ride**"

– *Murray Rothbard, 1962*

"Society might be **far better off if the 'problem' of social cost had never been discovered**"

– *Prof. Charles Rowley, 1978*

Contents

ABSTRACT 8

1. INTRODUCTION 9

1.1 PRIMARY PURPOSE OF THIS PAPER 9
1.2 SECONDARY PURPOSE OF THIS PAPER 10
1.3 EXTERNAL EFFECTS ARE REAL, INEFFICIENT EXTERNALITIES ARE NOT 11
1.4 WHY AM I EXAMINING THE EXTERNALITY ISSUE? 11
1.5 WHO INVENTED THE TERM 'EXTERNALITY'? 12
1.6 PIGOU ADMITTED (IN FINE PRINT, BEING FABIAN) THAT HIS OWN THESIS WAS COMPLETELY WRONG 14
1.6.1 *Not possible to identify the externality* *14*
1.6.2 *He refuted the theoretical logic of his recommended taxes and subsidies* *15*
1.6.3 *He refuted practical implementation: his taxes & subsidies can't be implemented* *16*
1.6.4 *Baumol also admitted to the impossibility of implementation of Pigovian remedies* *18*
1.7 IDEOLOGICAL STANCE OF PIGOU 19
1.7.1 *Pigou's precursors* *19*
1.7.2 *Why do I care for ideology?* *20*
1.7.3 *Pigou's attack on the system of natural liberty* *20*
1.7.4 *Pigou's belief in a socialist price system and advocacy of socialism* *21*
1.7.5 *Pigou's stance well exceeded Marshall's own errors* *21*
1.7.6 *Both Coase and Demsetz recognised Pigou's ideological underpinning* *21*
1.7.7 *Others have also recognised Pigou's ideological bias towards Fabian socialism* *22*
1.7.8 *Some tend to downplay Pigou's ideology* *23*
1.8 MAKING A HERO OUT OF PIGOU 24
1.8.1 *Claims that he was wise and understood institutions* *24*
1.8.2 *The ideological Pigou Club* *25*
1.9 EXTERNALITIES: FALSE LOGIC AND IMPOSSIBLE IMPLEMENTATION 25
1.10 DEMSETZ'S LAST NAIL IN THE COFFIN OF 'EXTERNALITIES' 26
1.11 DEMSETZ'S THREE MAJOR INSIGHTS 26
1.11.1 *Insight 1: Property rights are exogenous to the economic system* *26*
1.11.2 *Insight 2: Positive transaction costs are just any other cost* *27*
1.11.3 *Insight 3: When there is strategic behaviour, an allocation might not be efficient* *30*
1.12 DEMSETZ'S ACKNOWLEDGEMENT THAT COASE WAS NOT ENTIRELY WRONG 31
1.13 COASE KNEW THAT SOMETHING WAS FISHY, AND OPPOSED THE TERM 'EXTERNALITY' 32
1.14 SAMUELSON BUILT A BRIDGE BETWEEN EXTERNALITIES AND PUBLIC GOODS, WHICH DEMSETZ BROKE 32
1.15 TIME TO PURGE PIGOU AND EXTERNALITIES FROM ECONOMICS TEXTBOOKS 33
1.15.1 *Externality as weapon of mass destruction* *34*
1.15.2 *Great harm to the poor* *34*
1.15.3 *Coercion and the end of Western civilisation* *35*
1.16 DOES THIS MEAN THAT EXTERNAL EFFECTS AND REAL PROBLEMS DON'T EXIST? 36
1.17 TWO STEPS TO MAXIMISE ECONOMIC WELFARE 36
1.18 MARKET FAILURE AS A MEANINGLESS, CATCH-ALL TERM 37
1.18.1 *Market failure is mainly government failure* *37*
1.18.2 *Siglitzians and other pseudo-economists* *38*
1.19 STRUCTURE AND METHODOLOGY OF THIS PAPER 38

IDEOLOGICAL UNDERPINNINGS OF THE EXTERNALITY ARGUMENT 39

2. THE ROOT CAUSE: A FAITH IN THE GOVERNMENT AND THE ELITES 40

2.1 BACKGROUND: THE INFLUENCE OF SIDNEY WEBB AND G.B. SHAW 41
2.2 WAS PIGOU A SOVIET SPY? NO! 43
2.3 IT BEGAN WITH J.S. MILL'S FASCINATION WITH ELITES 44
2.3.1 *J.S. Mill explained why socialism won't work* *45*
2.4 MARSHALL, THE SELF-DECLARED SOCIALIST WITH STRONG SYMPATHIES FOR THE FABIANS 45
2.4.1 *Awareness and sympathy with the Fabians, working with Sidney Webb* *46*

2.4.2 *Was close to a key Fabian (Keynes's father) and knew the Webbs* 46
2.4.3 *Marshall's self-declarations about his socialist ideology* 47
2.4.4 *Marshall's fishing expedition for examples of market failure* 48
2.4.5 *Marshall thought that competition is a "monster"* 48
2.4.6 *Marshall favoured workers' cooperatives instead of private firms* 48
2.4.7 *Schumpeter confirmed Marshall's sympathies with the Fabians* 49
2.4.8 *Marshall motivated an Economic Club which became the Royal Economic Society* 49
2.4.9 *Marshall invented the word "economics" which makes it all sound very scientific* 49
2.5 Pigou's fascination with Neitzsche and support for elitism and eugenics 49
2.6 Pigou the Fabian socialist/communist 51
2.6.1 *Close contacts with the Webbs* 51
2.6.2 *1910s: Lectures questioning capitalism and promoting intervention* 53
2.6.3 *A clear bias by 1912 towards socialism* 53
2.6.4 *Pigou's fawning praise of Webbs's book on communism* 53
2.6.5 *Claim that inequality of income causes "social loss"* 56
2.6.6 *Recommendation for ultra-progressive income taxation* 56
2.6.7 *Pigou's 1937 Fabian socialist manifesto* 56
2.6.8 *Pigou's communist "price system"* 59
2.6.9 *More radical than Sidgwick or Marshall* 60
2.7 Summary of thinkers who have destroyed the world 60
2.8 But Pigou's economics stands or falls without reference to ideology 61

REFUTATION OF THE GAP BETWEEN SOCIAL AND PRIVATE COSTS/ BENEFITS 62

3. #1: REFUTING THE BIGGEST ALLEGED NEGATIVE EXTERNALITY: POPULATION 63

3.1 William Godwin's 1820 refutation of population externalities 64
3.1.1 *Godwin saw man as the ultimate resource, well before Julian Simon* 64
3.1.2 *Godwin believed that we need to love our fellow humans* 64
3.1.3 *Malthusian ethics is harmful and dangerous* 65
3.1.4 *Both of Malthus's assumptions are false* 65
3.1.5 *The false assumption of food scarcity* 65
3.1.6 *The false assumption of unrestrained reproduction* 67
3.2 Bastiat's 1850 refutation of population externalities 67
3.2.1 *Malthus's ignored human capacity for progress* 67
3.2.2 *Human means of existence are constantly expanding* 68
3.2.3 *Poverty is receding, plenty is increasing* 68
3.2.4 *Man is in control of his own reproduction* 69
3.3 Julian Simon's refutation 70
3.4 Others who refuted Malthus's panic regarding increasing population 71
3.5 Unfortunately, James and J.S. Mill got influenced by Malthus 73
3.6 The world's biggest morons: the modern Malthusians 76

4. #2: EXTERNALITIES CANNOT BE DEFINED OR MEASURED 77

4.1 The literature is replete with references to the vagueness of the concept 77
4.2 The problem: everything has external effects (Walter Block) 78
4.3 Externalities are subjective: in the eyes of the beholder 79
4.4 Classifying different types "externalities" is like creating new empty boxes 80
4.5 Someone imposing an inefficient 'externality' is meaningless – all transactions are two-sided 81
4.6 No objectively measurable externalities 81
4.6.1 *Economists pick and choose 'externalities' based on personal political bias* 82
4.6.2 *Impossible to compare utilities across an entire public* 82
4.7 Dalhman showed that externalities are a metaphysical concept 83
4.8 Some bad definitions 84
4.8.1 *Bad definition by James M. Buchanan and Wm. Craig Stubblebine, 1962* 84
4.8.2 *Bad definition by van den Doel and van Velthoven* 85
4.8.3 *Bad definition by Bryan Caplan* 86
4.8.4 *Bad definition by Richard Antonio Tejidor* 86

5. #3: NO GAP BETWEEN SOCIAL AND PRIVATE PRODUCT 87

5.1 The alleged gap between private and social products 87
5.2 Coases's confusion: Positive transaction costs don't create any Pigovian gap (Demsetz) 87

5.2.1 *The example of smoke/ soot* ... *87*
5.2.2 *Coase's bad economics* ... *88*
5.2.3 *Barry Brownstein's explanation* ... *89*
5.3 MARKET ALREADY INTERNALISE EXTERNAL EFFECTS IN A VARIETY OF WAYS ... 89

6. #4: PIGOU CONFUSED A 'TAX' WITH THE MARKET'S NORMAL ACTION (IF ALLOWED TO DO SO) ... 91

6.1 EXAMPLE 1: PIGOU'S CONGESTION (TWO ROADS) EXAMPLE ... 91
6.1.1 *Frank Knight threw out Pigou's two roads case* ... *91*
6.1.2 *An argument that Knight over-did his claim* ... *96*
6.2 EXAMPLE 2: PROPERTY RIGHTS AND THE 'WASTE' PROBLEM ... 97
6.3 EXAMPLE 3: MEADE'S BEES AND THE ORCHARD FARMERS ... 99
6.4 THAT DIFFERENT PROPERTY RIGHTS LEAD TO DIFFERENT OPTIMA DOESN'T CREATE A GAP (DEMSETZ) ... 100

7. #5: A GOVERNMENT CAN'T EVEN SET THE CORRECT CONGESTION LEVY ... 102

7.1 INDIVIDUAL UTILITIES AND COSTS AND BENEFITS ... 102
7.2 COASE'S REFUTATION OF THE IDEA THAT GOVERNMENTS CAN DO BETTER THAN MARKETS ... 102
7.3 DEMSETZ REJECTED PIGOU'S IDEA OF THE NIRVANA STATE ... 103
7.4 THE GOVERNMENT DOESN'T HAVE SKIN IN THE GAME OR THE RIGHT KNOWLEDGE ... 103
7.5 CALCULATING PIGOVIAN TAXES AND SUBSIDIES IS SIMILAR TO SOCIALIST CALCULATION ... 104
7.6 WHAT IS THE GOVERNMENT TO DO WITH THE "PIGOVIAN TAXES" IT COLLECTS? ... 105
7.6.1 *Creating a separate bureaucracy for each "Pigovian tax"* ... *105*
7.7 NO POSSIBILITY THAT A PIGOVIAN TAX OR SUBSIDY WON'T DIMINISH THE TOTAL PRODUCT ... 105
7.7.1 *Example: Pigovian tax on guns* ... *105*
7.7.2 *Example: Victoria's landfill levy* ... *106*

8. #6: PARETO OPTIMALITY DOESN'T PERMIT COERCION OF THE KIND PIGOU WANTED 107

8.1 DEFINITION OF PARETO OPTIMALITY ... 107
8.2 PIGOU'S IMPOSSIBLE CONDITION: A GOVERNMENT MUST NOT HARM ANYONE IN THE PROCESS ... 107
8.2.1 *Vaccine subsidisation and coercion* ... *107*
8.2.2 *Taxation to deal with road congestion* ... *107*
8.2.3 *Subsidies do not come for free* ... *108*
8.3 A POLITICAL 'REMEDY' TO SOCIAL PROBLEMS IS NOT ABOUT PARETO OPTIMALITY ... 109
8.3.1 *Vaccine subsidy as part of political action* ... *109*
8.3.2 *Cap and trade scheme to reduce pollution* ... *109*
8.3.3 *Auction of development rights in town planning* ... *110*
8.4 STEVE KATES'S EXPLANATION OF THE POLITICAL RESPONSE TO SOCIETAL PROBLEMS ... 110
8.5 BARRY BROWNSTEIN'S DEMONSTRATION THAT PIGOU'S TAXES AND SUBSIDIES ARE NOT PARETO OPTIMAL ... 110

9. #7:POSITIVE 'EXTERNALITIES' ARE A BOON, NOT AN ENTITLEMENT TO COERCE .. 113

9.1 WHAT ARE POSITIVE EXTERNALITIES? ... 113
9.1.1 *Doing something can provide an external benefit* ... *113*
9.1.2 *Doing nothing can also provide an external benefit* ... *113*
9.2 ON WHAT BASIS ARE POSITIVE BENEFITS CLAIMED TO BE A PROBLEM? ... 113
9.2.1 *Walter Block's claim that those who don't provide a positive externality must be executed* .. *114*
9.3 THERE IS NO INEFFICIENCY ... 114
9.4 ENJOYING A FREE BENEFIT IS NOT THE SAME AS FREE RIDING! ... 115
9.5 THOUGHTS OF ECONOMISTS ON POSITIVE BENEFITS ... 116
9.5.1 *Ludwig von Mises* ... *116*
9.5.2 *Murray Rothbard* ... *119*
9.5.3 *Simon Cowan* ... *122*
9.6 MARKETS PROVIDE A HUGE POSITIVE BOON TO SOCIETY ... 123
9.7 THE FOLLY OF CLAIMS THAT EDUCATION REQUIRES SUBSIDY DUE TO POSITIVE EXTERNALITIES ... 123
9.7.1 *Summary of perspectives on school education* ... *125*
9.8 FOLLY OF CLAIMS THAT VACCINES PROVIDE A POSITIVE EXTERNALITY SO MUST BE SUBSIDISED ... 125
9.9 KNOWLEDGE EXTERNALITIES (R&D ETC.) DO NOT MOTIVATE A GOVERNMENT SUBSIDY ... 125

10. #8: INCORRECT ATTEMPTS TO RETRIEVE THE CONCEPT OF EXTERNALITIES ... 127

10.1 THE 'NET EXTERNALITIES' ARGUMENT IS IRRELEVANT ... 127

10.1.1 *Steve Kates's claim that net externalities matter* *127*
10.1.2 *Steven Cheung's airport example* *127*
10.2 THE ARGUMENT THAT 'ONLY THE ACTUAL EXTERNALITY' SHOULD BE TAXED 128
10.3 EMPTY BOXES: VARIOUS CLASSIFICATIONS OF "EXTERNALITIES" 128
10.3.1 *Buchanan "policy relevant/ irrelevant" argument* *128*
10.3.2 *The "minor/major" externality argument of William Nordhaus* *129*
10.3.3 *'Expected' vs 'unexpected' externalities (D. Boudreaux)* *129*

11. #9: CBA OF REGULATORY SOLUTIONS TO SOCIETAL PROBLEMS 130

11.1 ASSESSING ALL EFFECTS (THE BASTIAT-HAZLITT MANOEUVRE) 130
11.1.1 *Example: Noise effects of a new runway* *130*

PUBLIC GOODS WITH STRATEGIC BEHAVIOUR 132

12. THE PUBLIC GOODS CASE WITH STRATEGIC BEHAVIOUR 133

12.1 DEMSETZ AGREED THAT STRATEGIC BEHAVIOUR CAN PROMPT GOVERNMENT INTERVENTION 133
12.2 MOST 'PUBLIC GOODS' ARE CLUB GOODS 133
12.2.1 *Lighthouses* *133*
12.2.2 *Whether something is a public good is often determined by state of technology* *133*
12.2.3 *Subsidization of public goods not always justifiable* *134*
12.3 PARETO EFFICIENCY REQUIRES CHARGING EACH PARTY THEIR WILLINGNESS TO PAY 134
12.4 GOVERNMENT FAILURE IN PUBLIC GOODS PROVISION 135
12.5 PHILIPP BAGUS – NOT ALL PUBLIC GOODS JUSTIFY INTERVENTION 135

13. TOUCHING UPON OTHER FABIAN SMEARS OF THE MARKET SYSTEM 138

13.1 MONOPOLY 138
13.2 MINIMUM WAGE 138
13.3 MARKET FAILURE 138
13.4 ALMOST COMPLETELY IGNORING GOVERNMENT FAILURE 138

14. CONCLUSION 139

14.1 EXTERNAL EFFECTS ARE NOT INEFFICIENT, BUT A FEATURE OF OUR EXISTENCE 139
14.2 DEMSETZ'S 2011 PAPER MUST RANK FAR HIGHER THAN COASE'S WORK 140
14.3 MY PREVIOUS WORK ON EXTERNALITIES HAS BEEN EXTREMELY FLAWED 140
14.4 EXTERNALITY SOCIALISM MUST GO 140
14.5 THE TAKEOVER OF TEXTBOOKS BY THE FABIANS 141

15. APPENDIX: SOME OF PIGOU'S EXAMPLES 142

15.1 EXAMPLES 142

Abstract

The purpose of this paper is to eliminate the concept of externalities as currently discussed in economics textbooks. It is a compilation of the relevant arguments and proofs, with nothing original on offer.

Acknowledgements

I have written this paper in the public domain, with preliminary thoughts and drafts shared on the internet. In this process, I have sought inputs and suggestions from the public, and would like to thank those who have provided inputs. I also acknowledge the access to the UNSW library that Prof. Gigi Foster has provided me with.

1. Introduction

An idea has been promoted that externalities fall outside the ***efficient*** general equilibrium framework of markets and are thus a 'problem' that only omniscient bureaucrats and politicians can 'solve'. As it currently stands in most textbooks, the discussion of externalities ends up with an unabashed, ideological promotion of Big Government, i.e Fabian socialism. Innumerable leaps of faith and assumptions are made, and inconvenient facts glossed over in the rush to support Big Government. The externalities argument of market inefficiency in textbooks sounds plausible, except for one thing: it breaks down when subject to a stress test.

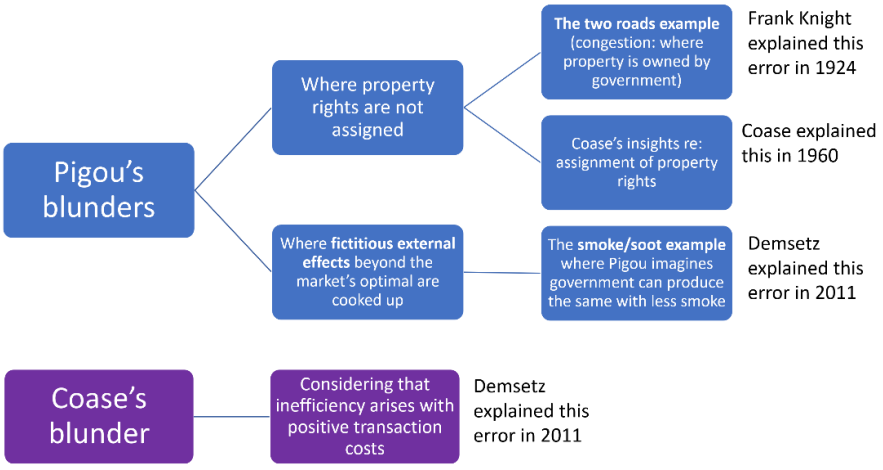
Unfortunately, this argument has been used by many economists to justify a wide range of coercive actions.

1.1 Primary purpose of this paper

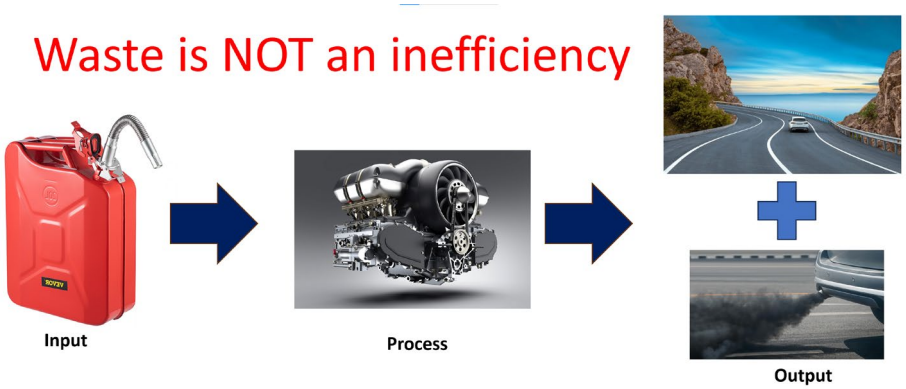
The purpose of this paper is to permanently retire, to put to bed, i.e. to bury, the idea of externalities as an inefficiency.

I show that *all* received wisdom about the *inefficiency* of externalities is wrong. In doing so I am merely bringing together key arguments and proofs. This paper has nothing original to offer.

The following schematic diagram summarises the three major errors in the field of externalities:



An alternative way to look at this, below:



The fact that our body consumes food and produces sweat, urine and faeces is not an inefficiency. That's the best that can be done following the laws of physics and biology (or in the case of an economy), voluntary trade. Thus, the fact that a process (industrial/economic) produces WASTE or other third party effects is NOT an inefficiency.

Whatever bothers us can be managed through incentive based regulation but is NOT cause to impose a Pigovian tax/subsidy. We can have a chapter in economics called "Dealing with things that bother us". It is quite OK to deal with things like human waste (sewage), pollution, but let's not call them "externalities" - a fundamentally wrong idea which then contaminates the whole of economics.

By the end of this paper, "solutions" like Pigovian taxes and subsidies that are recommended in textbooks will be eliminated.

1.2 Secondary purpose of this paper

Pigou's attack on economics was not limited to false arguments re: "externalities". His book is full of other false arguments to motivate a Big Government. As Nahid Aslanbeigui showed in a 1990 paper, the arguments in *The Economics of Welfare* are far broader than externalities. Pigou's view is that:

> Since their inception, Pigou's theories had placed at the heart of the discipline the concept of economic welfare with the intention of showing how the self-adjusting market mechanism failed to maximize it. The premises were set forth in Wealth and Welfare.
>
> > (1) [O]ther things equal, an increase in the size of the national dividend will probably increase economic welfare; (2) other things being equal, an increase in the absolute share of the national dividend accruing to the poor will probably increase economic welfare; and (3) other things being equal, a diminution in the variability of the national dividend, especially of the part accruing to the poor, will probably increase economic welfare.
>
> The first two formed the foundation of Pigou's Economics of Welfare. In a free market economy, private enterprise "often leads to a distribution of resources less favorable to the national dividend". The size of the national dividend and hence economic welfare were not maximized as long as marginal net social product diverged from that of net private product. Such divergences did exist, however, in the presence of externalities, **public goods, and of diminishing and increasing cost industries**. When competition ruled and social and private net products diverged at the margin, it was possible to "put matters right by the imposition of a tax or the grant of a subsidy".
>
> The major criticism of the market mechanism came with the second proposition. In a free market economy, "large masses of productive resources are devoted to satisfying the whims of the rich—providing them with expensive motor cars, fine houses, fashionable dresses and so on —while large numbers of people are inadequately fed, clothed, housed and educated". An **egalitarian distribution** of income "must increase the aggregate sum of satisfactions" because "it enables more intensive wants to be satisfied at the expense of less intensive wants".

Pigou's socialist blunders arose not just from his fictitious "gap" between social and private product, which extended well beyond externalities. He misunderstood the marginal theory of utility to propose redistribution! Pretty bad economics.

Without recognising Pigou's mission (which Demsetz and Coase rightly identified), we will fail to deal with the threat his ideas pose to mankind's welfare. A debate only on externalities would be blinkered by ignoring Pigou's many other blunders. His book seems to be about finding as many possible ways to create a Big Government.

The issue is not whether markets fail to deliver an imaginary "Nirvana" (no Nirvana exists) but whether a costly, ignorant and self-interested, corrupt government can do even slightly better. Inevitably, governments worsen the situation. Only a CBA can check governments, which are fundamentally criminal and would otherwise run amuck, lowering welfare.

To fully address all false and Fabian-motivated arguments of Pigou would take me well beyond the original scope of this work, so I may note them in passing and address them briefly without going into detail. It is the externality argument on which this paper will focus.

1.3 External effects are real, inefficient externalities are not

External effects (both direct and indirect) of human action are real. There is no human action without such external effects. But these are **not an inefficiency** where voluntary action between market participants has led to their existence.

There is a real problem with the definition of this concept. Loose definitions abound, such as those by Samuelson all the way till at least 1968. In his second Canadian edition of *Economics, an Introductory Analysis*, he writes:

> An "external diseconomy" is defined in the same way, except that it refers to **external harm** that is done to others… It is la little easier to find examples of so-called "external diseconomies." Recall that these are defined as **harmful effects** upon other people that result from one man's production.

He then writes in a footnote:

> The late Professor A. C. Pigou, Marshall's prize pupil at Cambridge, was the economist who most emphasized the problem of externalities. There is a clear-cut economic case for a tax (or a subsidy) whenever an external diseconomy (or economy) creates a divergence between private pecuniary Marginal Cost as seen by a firm and true social Marginal Cost. But this truth is quite independent of the supply slope of the industry in question.

Thus Samuelson defined externality merely as an **effect**. But everything has an effect! He did mention Pigou's "gap" in a footnote, a gap which (as Demsetz showed) doesn't exist.

Externalities in the manner described by Pigou, as actions in which the social costs or benefits diverge from private costs or benefits – i.e. as an *inefficiency* of the market system – are unreal, a mere figment of the imagination. Such inefficiencies are mere perceptions of the elites, with no objective way to identify social costs or benefits.

The example which Pigou provided (of two roads, with the problem of congestion being addressed by a tax) summarises the reality of these 'externalities' – basically costs that would be minimised automatically by the private sector, if property rights were assigned. Even with private ownership of roads, however, we never achieve zero congestion. Therefore, a level of pollution or congestion or other 'harm' to third parties is **optimal** from the societal perspective, not something to 'fix' through taxes or subsidies that always end up harming many others.

Based on the two roads example we can also confirm that private costs and social costs, private benefits and social benefits, *always* overlap. **The market *always* leads to a Pareto optimal situation which cannot be improved by any government.** The fact that some 'public bads' might be generated from voluntary market action is for society to address through regulation (such as a cap-and-trade program) that is assessed through a cost-benefit analysis.

1.4 Why am I examining the externality issue?

I studied externalities in 1994 as part of course work for my PhD and then more or less assumed that Pigovian taxes and subsidies are the correct 'remedy' for externalities, as propounded in textbooks. I did not pay attention to the assumptions of the concept and mostly forgot about the idea, anyway.

Somewhere during my broader policy studies focused on India, I came across Milton Friedman's school voucher proposal and thought it was a splendid way to ensure better outcomes for children. The government would provide school vouchers to parents of poor children, to be used in schools of their choice. I then chanced upon

James Tooley's work which made me examine the logic of the claim that education provides positive externalities (social benefit), hence must be subsidised. Tooley's work confirmed to me that **education is a private good,** with most benefits internalised by the family that spends on education. There is a high level of demand for school education even in poorest families, as modern economies create more opportunities for the educated. The school voucher model then became, in my mind, the vehicle to ensure a social minimum and reasonable equality of opportunity, not a justification to subsidise education in any way (let alone government ownership and management of schools).

The second time the externality issue came up was with heritage laws in town planning, as part of my work in the Victorian Treasury. Heritage laws confiscate private property in the name of positive externalities (social benefit).

More recently, I've been looking at this issue in relation to vaccine mandates. One of the arguments used by economists to support vaccine mandates is to claim that (a) vaccines provide positive externalities (social benefits) to the general community which are thus a form of public goods, and (b) those who don't take a vaccine are 'free riding' on those who do. This is then claimed to be sufficient basis for the government to mandate vaccines. Such arguments must be rejected outright.

Undoubtedly, it is extremely hard to get rid of academic brainwashing. That is why I not only accepted the CO2 panic but also Pigou's "wisdom" when I wrote my 2008 book[1] in which I supported carbon tax.

A few years later I had extensive email discussions with Demsetz. But only now have I found time to understand his profound work. His work is truly monumental, as this paper will show.

1.5 Who invented the term 'externality'?

External effects of human action are not a new finding. In the 2023 *Elgar Encylopedia of Ecological Economics*, Clive L. Spash and Amelia Fuselier point out studies that showed many pre-Pigovian analyses of external effects.

> [Marshall] …raised the topic of 'external economies' as the unpaid benefits accruing to firms from investments made by other private firms or the public sector. They might result from generally expanding markets, access to a trained workforce, higher standards of health, education, or culture. …

Further, although Marshall was very much a socialist (as I'll explain later), he did not use this as an excuse for government intervention. Spash and Fuselier distinguish Marshall's observations from Pigou's activist recommendations:

> Marshall's theory concerns the dynamic adjustment of economic structure to increase production/wealth, not the management and regulation of specific welfare-harming activities, which appear in the work of Pigou.

Thus, it is ***purely*** to Arthur Pigou that we must attribute the origin of the **concept** of **externality as a market *inefficiency* that requires the government's magic wand**. According to him there is a "divergence between the private and the social net product" of a transaction[2]. The idea of taxation and subsidies to address to so-called inefficiency of externalities, also arose from Pigou. Pigou's inefficiency model of externalities is now found in all standard economics textbooks, for instance:

[1] https://sanjeev.sabhlokcity.com/book1/BFN-fullbook.pdf

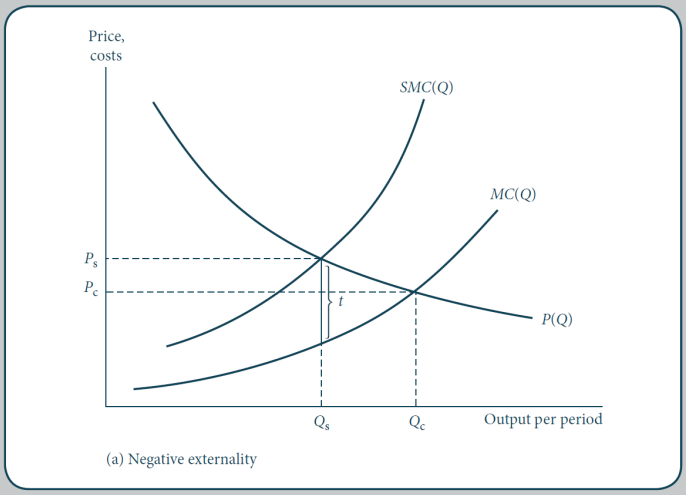
[2] https://www.sciencedirect.com/science/article/abs/pii/S0362331901001586

19.4.1 Pigovian tax

Figure 19.2 shows how Pigou's taxation solution can be used to eliminate the deadweight loss from the negative externality seen in panel (a) of Figure 19.1. As is the case for any tax, imposition of a Pigovian tax here creates a vertical wedge between the demand and supply curves for the good. In the figure, the relevant demand curve is the inverse demand labeled $P(Q)$, and the supply curve is determined by private marginal cost $MC(Q)$. The optimal tax is shown as t. Imposition of this tax serves to reduce output from Q_c to Q_s, the social

FIGURE 19.2
Pigovian Tax

This figure reproduces the panel from the previous figure illustrating a negative externality. A tax of amount t that reflects the social marginal costs above and beyond private marginal costs would achieve the socially efficient production level Q_s.



optimum. The tax is set to reflect the distance between private marginal costs $MC(Q)$ and social marginal costs $SMC(Q)$. Notice that the tax must be set to reflect marginal harm at the optimal quantity Q_s rather than at the original market equilibrium quantity Q_c.

For the rest of this paper wherever I use the term externality without qualification, I mean to use it as an *inefficiency* in the sense of Pigou.

The precise **term**, 'externality' was invented later. Samuelson used the word in 1955, Bator in 1956. Bator defined it thus:

> Externality, therefore, should mean 'any situation where some Paretian costs and benefits remain external to decentralized cost-revenue calculation in terms of prices.'[3]

Both Samuelson and Bator were at MIT at that time, and someone else at MIT could have invented the term. Ronald Coase explained in his 1988 book, *The Firm, the Market and the Law*:

> The earliest uses of the term 'externality' that I have come across are contained in Samuelson's review of de Graaf's Theoretical Welfare Economics in the *Economic Journal* (September 1958): 539-41, and in his article, 'Aspects of Public Expenditure Theories,' *The Review of Economics and Statistics* (November 1958): 332-38. This article was a slight revision of a paper delivered in December, 1955.

Steven Medema provided the following assessment in 2019:

> Bator first used the term in his 1956 MIT Ph.D. thesis, from which his 1957 and 1958 articles were derived (Bator 1956). Whether it was Bator who coined the term is hard to say. Paul Samuelson, Bator's MIT colleague, used it at nearly the same time in an article on the subject of intertemporal price

[3] https://www.jstor.org/stable/1882231

> equilibrium that appeared in Weltwirtschaftliches Archiv (Samuelson 1957). Samuelson noted simply that 'knowledge is a resource loaded with externality' (1957, 210). Bator's article seems to have appeared first and was certainly more widely read, being cited nearly fifty times over the next dozen years as against eighteen cites to Samuelson's piece. (Source: Google Scholar, accessed August 22, 2017). Moreover, none of the citations to Samuelson's article were in the welfare economics/externalities context. There is no input from Samuelson acknowledged in Bator's opening footnote, nor is mention of Bator made in Samuelson's article. The term was picked up relatively quickly though, being used another half-dozen times before 1960. It was also Bator who introduced the term 'market failure' into the literature, this in his 1958 article, 'The Anatomy of Market Failure.'[4]

But the name doesn't matter for the purposes of this paper; only the concept of inefficiency matters.

1.6 Pigou admitted (in fine print, being Fabian) that his own thesis was completely wrong

Over the years, Pigou made many cautionary observations against his own recommendations. While his bold assertions and recommendations for government action occupy 99% of the text in his discussions of the concept, buried dep inside, in less than 1% of the text, are cautionary statements that have been entirely ignored by his cult followers.

1.6.1 *Not possible to identify the externality*

In his 1920 book, Pigou wrote:

> § 5. So much being understood, we have next to **distinguish precisely between the two varieties of marginal net produc**t which I have named respectively social and private. The marginal social net product is the total net product of physical things or objective services due to the marginal increment of resources in any given use or place, no matter to whom any part of this product may accrue. It might happen, for example, as will be explained more fully in a later chapter, that costs are thrown upon people not directly concerned, through, say, uncompensated damage done to surrounding woods by sparks from railway engines. All such effects must be included—some of them will be positive, others negative elements —in reckoning up the social net product of the marginal increment of any volume of resources turned into any use or place. Again an increase in the quantity of resources employed by one firm in an industry may give rise to external economies in the industry as a whole and so lessen the real costs involved in the production by other firms of a given output. Everything of this kind must be counted in.

It was said to be essential to distinguish ***precisely*** between the social and private marginal products, but Pigou provided no empirical method or any objective process to even identify these concepts, let alone measure them. Surprisingly, tens of thousands of economists blindly accepted Pigou's assertions and assumed they could somehow figure out these products. A scientific term must have a precise, unique and measurable meaning. The trouble with Pigou's idea is that: (1) everything has an externality, (2) different people perceive these things differently, and (3) these things cannot be priced (hence can't be measured).

Later, in a 1954 paper, he admitted *in fine print*, that it is impossible to know what action has an externality and to what extent. He deceptively said, 'we seldom know enough' when he meant that we ***never*** know enough. We cannot *ever* know enough, since the concept is purely a figment of our imagination.

> More interesting from the standpoint of the economist is a third consideration. When people decide to spend their money in certain ways it sometimes happens that their spending yields uncovenanted benefits or inflicts uncovenanted damage on other people whose gains or losses do not enter into the calculations of the spenders. There are many examples of this. The social costs involved in the supply of alcoholic

[4] https://ipl.econ.duke.edu/seminars/system/files/seminars/2469.pdf

> drinks includes the provision of police to control the effects of excess, but these costs do not enter into the price that the purchasers of such drinks have to pay for them. Nor does the damage done to people living near smoking factories and the extra washing bills they have to pay enter into the price of the factory's products. If they did, as, with strict social accounting, they ought to do, the price of those products would be higher, less of them would be demanded and less resources devoted to making them. On the other hand, when a good landlord protects the amenities of the neighbourhood man erects a beautiful instead of an ugly house there is a benefit to others for which he gets no payment. These gaps, positive and negative, between private and public costs were not much in people's minds until fairly recently. Now everybody understands about them. **It must be confessed, however, that we seldom know enough to decide in what fields and to what extent the State, on account of them, could usefully interfere with individual freedom of choice.** Moreover, even though economists were able to provide a perfect blueprint for beneficial State action, politicians are not philosopher kings and a blueprint might quickly yield place on their desks to the propaganda of competing pressure groups. 'Fancy' finance, like a fancy franchise, whatever its theoretical attractions, has, at all events in a democracy, dim practical prospects.[5]

Thus, the idea of externalities and their 'remedies' is like a Rorschach test that can mean anything to the beholder. The fact that human population is itself considered a negative externality by many 'economists' is a clear indication of this being an entirely concept (the struggling poor don't think of *themselves* as an externality). The fact that a high-rise building (which will allow the lower economic classes to live closer to their place of work) might have a 'negative externality' is once again a purely elitist concept again. I have never come across a single externality that is objectively verifiable.

1.6.2 *He refuted the theoretical logic of his recommended taxes and subsidies*

In the early paragraphs of his 1924 refutation of Pigou, Frank Knight had stated:

> If economic theory is interpreted as a critique of the competitive system of organization, its first and most general problem is that of determining, whether the fundamental tendencies of **free** contractual relations under competitive control lead to the **maximum production of value** as measured in price terms.[6]

Basically he was highlighting two aspects of the competitive system: (a) it must be free, i.e. voluntary; and (b) it must lead to the maximum production of value (product) as measured in price terms. Pigou was aware that any "solutions" he offered needed to better this condition, else he was basically recommending a lower total product.

And so, in his 1920 book, *Economics of Welfare*, he placed an **impossible condition on his recommendations**, that any tax or subsidy to offset an externality should not reduce net output, which is an impossibility. His argument for a tax or subsidy was a non-starter, at best a sleight of hand that fooled thousands of economists since his time.

> Under conditions of simple competition, if in any industry the value of the marginal social net product of investment is greater than the value of the marginal private net product, this implies that the output obtained is less than the ideal output: if the value of the marginal social net product is less than the value of the marginal private net product, this implies that the output obtained is greater than the ideal output. It follows that, under conditions of simple competition, **for every industry in which the value of the marginal social net product is greater than that of the marginal private net product, there will be certain rates of bounty, the granting of which by the State would modify output in such a way as to make the value of the marginal social net product there more nearly equal to the value of the marginal social net product of resources in general**, thus—**provided that the funds for the bounty can be raised by a mere transfer that does not inflict any indirect injury on production**—increasing the size of the national dividend and the sum of economic welfare; and there

[5] https://journals.sagepub.com/doi/10.1177/039219215400200701

[6] https://www.jstor.org/stable/1884592

> will be one rate of bounty, the granting of which would have the optimum effect in this respect. In like manner, for every industry in which the value of the marginal social net product is less than that of the marginal private net product, there will be certain rates of tax, the imposition of which by the State would increase the size of the national dividend and increase economic welfare and one rate of tax, which would have the optimum effect in this respect. These conclusions, taken in conjunction with what has been said in the preceding paragraphs, create a presumption in favour of State bounties to industries in which conditions of decreasing supply price simpliciter are operating, and of State taxes upon industries in which conditions of increasing supply price from the standpoint of the community are operating.

Basically, he was aware that the logic of his recommendation was fictitious, since there is no way to increase societal output more than what a market achieves thorough voluntary human action. He was aware that there is no way to achieve a higher level of 'social welfare' than the market's without harming someone – typically the poor (as almost always happens with 'town planning' or 'population policy', for instance). This is an iron law which can never be broken. In some ways, the externality fallacy is a replica of the broken window fallacy. The costs of "fixing" the "problem" are ignored and only the benefits of "fixing" are taken into account.

Consider the delusional carbon tax concept.

- No economist (that I'm aware of) has actually assessed the true alleged "marginal social cost" of CO_2. That would require deep knowledge of the science which they simply don't have.

- No economist can possibly work out a tax that both (a) reduces alleged global warming from CO_2 and (b) does not reduce global output.

1.6.3 *He refuted practical implementation: his taxes & subsidies can't be implemented*

In his 1912 book, *Wealth and Welfare*, Pigou explained how a government is corrupt and cannot implement his 'ideal' recommendations.

> It is not sufficient to contrast the imperfect adjustments of unfettered private enterprise with the best adjustments that economists in their studies can imagine. For we cannot expect that any State authority will attain, or even whole-heartedly seek, that ideal. **Such authorities are liable alike to ignorance, to sectional pressure, and to personal corruption** by private interest. A loud-voiced part of their constituents, if organized for votes, may easily outweigh the whole.[7]

In 'State Action and Laissez-Faire' (1935), Pigou elaborated what is today known as a public choice theory argument about government failure:

> In order to decide whether or not State action is practically desirable, it is not enough to know that a form and degree of it can be conceived, which, if carried through effectively, would benefit the community. **We have further to inquire how far, in the particular country in which we are interested and the particular time that concerns us, the government is qualified to select the right form and degree of State action and to carry it through effectively**….
>
> High-sounding generalisations on these matters are irrelevant fireworks. They may have a place in political perorations, but they have none in real life. Accumulation of evidence, the balancing of probabilities, judgment of men, by these alone practical problems in this region can be successfully attacked.

In this manner he showed that his own recommendations cannot be implemented.

Pigovian concepts of inefficient externalities and Pigovian taxes and subsidies are therefore a complete fraud.

---

[7] https://www.aier.org/article/arthur-pigou-warned-of-the-failures-of-government/

There are places in his work which some readers might cite to suggest that he was a genuine economist, not an ideologue. For instance, he is cited thus:

> When defending government intervention in the presence of market imperfections, for instance, Pigou used the following analogy: "A man [i.e., the economy] ordered to walk a tight-rope carrying a bag in one hand [i.e., market imperfections] would be better off if he were allowed to carry a second bag in the other hand [i.e., government intervention], though of course, if he started bagless [i.e., perfect markets] to add a bag would handicap him".[8]

This might sound perfectly fine on the surface, but the innovative ways in which Pigou fished for market imperfections suggests bad faith.

If his ideological stance was not part of the picture, one would simply call him a bad economist and move on. But I will show in this paper that his position is part of the *deliberate* fraud perpetrated by Fabian socialists. **Pigou's ideological goal to eliminate capitalism** and nationalize industry. But elites like 'Nobel' economists Samuelson, Stiglitz – and others like Mankiw never mention any of this – do they! Manikew has even formed a 'Pigou Club'.

This 2021 paper[9] pointed me to a huge section of Pigou's 1948 *Socialism Vs. Capitalism* which further refutes his own 1920 arguments. We know that his basic logic itself is wrong (as Demsetz showed), but Pigou showed that the knowledge to implement his tax/subsidy does not exist. Pigou wrote in 1948:

> Let us consider first failures due to divergencies between what I have called social and private costs. In principle it is plain that these maladjustments are capable, under capitalism, of being set right by an appropriately devised system of bounties and duties—bounties on things whose private cost at the margin exceeds their social cost, duties on things for which at the margin social cost is in excess. But the practical difficulty of determining the right rates of bounty and of duty would be extraordinarily great. **The data necessary for a scientific decision are almost wholly lacking.** How, for example, are we to ascertain to what extent the social cost, as measured in money, of the marginal unit of beer exceeds the private cost by making necessary the provision of extra policemen; **how are we to make the corresponding calculation for a factory industry the smoke of which increases the expenses of the public in washing and cleaning?** How, *per contra*, are we to reckon up the indirect benefits that the planting of a forest may have on climate; or that in some industries an increase in the scale of output may have in enabling their organisation to be improved and their average cost, therefore, reduced? Plainly the difficulties are formidable, so formidable that, so far as I know, no attempt has ever been made in a capitalist regime to use bounties and duties for bringing about adjustments of the kind I have been describing. Up to the present suggestions in this matter have been confined to the writings of economists; and even they have never attempted the quantitative study that would be necessary before their suggestions could be applied to practice. All this is true. Maybe, it demonstrates in this field the bankruptcy of capitalism. But what of socialism? **A central planning authority would find it no more easy than the government of a capitalist State to obtain the data required for these calculations.** Suppose it has successfully fitted supply to demand in some industry under the guidance of consumers' offers and its own private costs. It is then in exactly the same position as a capitalist State confronting an industry similarly, adjusted. It is no worse, but equally it is no better placed to improve on that adjustment. For what is needed, in order to improve on it, is not will, but knowledge. The relevant knowledge is of a sort that we do not at present, possess, and the eventual winning of which is no more likely under the one system than under the other.

While this information about Pigou's refutation of his own thesis is never mentioned in any textbook or the externalities literature, it posed a big problem for Wassily Leontief, the proponent of input-output equations to solve the socialist calculation problem. He expressed his "shock" in a 1938 review:

---

[8] https://www.jstor.org/stable/1059363

[9] https://www.clivespash.org/wp-content/uploads/2021/12/2021-Spash-Externalised_Market_Failure_vs_Cost_Shifting.pdf

> Professor Pigou explains such reluctance to use the theoretical apparatus which he himself was so successful in building up by referring to practical or rather statistical difficulties: "Plainly the difficulties are formidable, so formidable that so far as I know, no attempt has ever been made in a capitalistic regime to use bounties and duties for bringing about adjustments of the kind I have been describing. . . . But what about socialism? A central [socialist] planning authority would find it no more easy than the government of a capitalist State to obtain the data required for these calculations . . .". The author concludes that there is required the relevant "knowledge of a sort we do not at present possess" and he thinks that "the eventual winning of it is no more likely under the one system than under the other."
>
> For the faithful follower of the Cambridge theory of "ideal output" **this admission is bound to be a shock.** Most likely he will wish to know at least the type of data whose lack makes the entire system of welfare economics inapplicable and why it should be so difficult to gather them even in the ideal socialist economy. Professor Pigou's book will not satisfy his curiosity.[10]

In the same year when Coase published his "Problem of Social Cost", Hayek published his *Constitution of Liberty*. In that, he failed to examine Pigou's arguments in the manner that Knight did in 1924 or Demsetz did in 2011, but he noted, then brushed aside the "externalities" issue.

> There is, finally, the theoretically interesting, though in practice not very significant, situation in which, though certain services can be supplied by competitive private effort, either not all the cost involved or not all the benefits rendered would enter the calculations of the market and for this reason it may seem desirable to impose special charges on, or offer special grants to all who engage in those activities. These instances may perhaps be included among the measures by which government may assist the direction of private production, not by specific intervention, but by acting according to general rules.
>
> That these cases are not of great practical significance, not because such situations may not often occur, but because it is rarely possible to ascertain the magnitude of such "divergences between the marginal social net product and the private social net product," is now admitted by the author who has done more than anybody else to draw attention to them: see Arthur Cecil Pigou, "Some Aspects of the Welfare State," Diogenes, 7 (1954): 6: "It must be confessed, however, that we seldom know enough to decide in what fields and to what extent the State, on account of [the gaps between private and public costs] could usefully interfere with individual freedom of choice."

1.6.4 *Baumol also admitted to the impossibility of implementation of Pigovian remedies*

William Baumol must be credited (along with Samuelson) for promoting the concept of externalities, but even he acknowledged that implementation of Pigou's recommendations suffers from "serious difficulties".

> However, as is well known, the Pigouvian proposals suffer from a number of **serious shortcomings** as operational criteria when one seeks to implement them precisely as they emerge from the theory.
>
> *VI. Implementation Problems*
>
> Despite the validity in principle of the tax-subsidy approach of the Pigouvian tradition, in practice it suffers from **serious difficulties**. For we do not know how to estimate the magnitudes of the social costs, the data needed to implement the Pigouvian tax-subsidy proposals. For example, a very substantial portion of the cost of pollution is psychic; and even if we knew how to evaluate the psychic cost to some one individual we seem to have little hope of dealing with effects so widely diffused through the population."[11]

Nevertheless, he insisted on created methods by which to implement Pigou's ideas:

---

[10] https://www.jstor.org/stable/1806802

[11] https://www.jstor.org/stable/1803378

> I therefore discuss a modified approach that recommends itself more for its promise of effectiveness, than its theoretical nicety. It consists of two basic steps: the setting of standards, more or less arbitrarily, of levels of pollution, congestion and the like, that are considered to be tolerable, and the design of taxes and effluent charges whose rates are shown by experience to be sufficient to achieve the selected standards of acceptability. Such a system of charges will, at least in principle, effect any preselected reduction in, say, the pollution content of our rivers, at minimum cost to society. It automatically achieves an efficient allocation of the required reduction in emissions among the offending firms even if they are neither pure competitors nor profit maximizers. Thus, a persuasive case can be made for the use of taxes and subsidies to control externalities, even if they will not produce an optimal allocation of resources in the complex world of reality.[12]

His line of reasoning was entirely futile, as this paper will show.

1.7 Ideological stance of Pigou

Traditional academic economists balk at assessing the ideological stance that underpins Pigou's work, since they pretend that economics is a 'value-free zone', purely scientific. Being a half-economist and half-bureaucrat/ political activist, with no academic tenure to worry about, I have no such compunctions in assessing Pigou's work for what it was: a piece of Fabian socialist propaganda.

Economics is not a value-free zone. It arose from political economy, as a branch of moral philosophy. Everything in economics is linked with one's ideological stance, and one's bias regarding the role of government. The idea of natural liberty that drove Adam Smith's research was a culmination of centuries of incremental evolution to analysis which found that freedom was best for mankind in many ways. Likewise, the pushback against the system of natural liberty which arose in the mid-19th century with Karl Marx, was driven ideologically by a mindset which politically disparaged the greatest producers mankind had ever seen: the new industrialists, and assumed that workers were exploited despite the fact that workers had all *voluntarily* gravitated to industry. And despite the fact that workers progressed enormously both financially and health-wise in the process.

1.7.1 *Pigou's precursors*

Pigou's direct precursors were Sidgwick and Marshall: "Concern about the ills of capitalist development had been given a central place in economics by Sidgwick and Marshall, Pigou's predecessors in the 'Cambridge School' of economic theory". I will briefly touch upon Sidgwick's and in some detail upon Marshall's ideas, but these stem essentially from the same source – a growing sympathy with socialism in the second half of the nineteenth century.

Some of the blame must go to Harriet Taylor and to her daughter Helen Taylor. "Mill's stepdaughter, Helen Taylor, added to his radical reputation by publishing his autobiography and essays on socialism. She also acted as a bridge to the followers of Henry George and the Fabians".[13] As Charles Bradlaugh noted in an 1884 piece, "…Miss Helen Taylor and Mr. J. L. Joynes. They and their co-signatories say: 'Gunpowder helped to sweep away feudalism . . . now far stronger explosives are arranged against capitalism'"[14]. To the extent that J.S. Mill was influenced by Helen Taylor (his wife Harriet Taylor's daughter), Mill is also partly implicated, but as I will show, we can exonerate him.

---

[12] https://www.jstor.org/stable/1803378

[13] https://academic.oup.com/book/6288/chapter-abstract/149967080?redirectedFrom=fulltext

[14] https://www.sabhlokcity.com/2023/07/extract-from-socialism-by-charles-bradlaugh/

1.7.2 *Why do I care for ideology?*

Ideology provides an over-arching worldview, and to that extent frames analysis. I have a visceral problem with socialism. I have seen the *extreme* harm caused by socialism (Fabian socialist, to be precise) to India. Anything which promotes a bigger role for government is deeply suspect in my mind. In my mind, Ivory Tower economists are utterly useless as thinkers since they've not directly experienced the depravity, lies and corruption of all governments. I have. We need government but we must also recognise it as the greatest evil.

Pigou allegedly wanted economics to be a value-free science. His view has been summarised thus: "economists engaged in policy analysis cannot be political partisans—advocates of political doctrines, programs, or ideologies"[15], but no economist can be value-free, since it implies important assumptions about the role and characteristics of the state. In Pigou's mind, the state is not just omniscient but largely honest and diligent (he does allude in a few places to corruption, but overall his tenor is largely supportive.

1.7.3 *Pigou's attack on the system of natural liberty*

Pigou's economics was driven mainly, as I will show in some detail in this paper, by his fervent and dangerous Fabian socialist ideology, underpinned by his strong support for Nietzsche's anti-egalitarianism. **Without recognising Pigou's ideological stance, we will fail to recognise the enormous harm he has caused.** Pigou's sole purpose was to 'prove' that markets 'fail' and that socialist government has a magic pudding to 'fix' this failure.

Arthur Pigou's main message to the economics fraternity was that Adam Smith was wrong. While capitalism delivers prosperity and improved life expectancy for billions of people, it generates vast 'externalities' and inefficiencies which require the government to spend taxpayer money to fix these 'losses' to national output.

He directly attacked Adam Smith's system in his 1920 book:

> There is ground, however, for believing that even **Adam Smith had not realised fully the extent to which the System of Natural Liberty needs to be qualified and guarded by special laws**, before it will promote the most productive employment of a country's resources.
>
> … there are many obstacles that prevent a community's resources from being distributed among different uses or occupations in the most effective way. The study of these constitutes our present problem. That study involves some difficult analysis. But its purpose is essentially practical. It seeks to bring into clearer light some of the ways in which it now is, or eventually **may become, feasible for governments to control the play of economic forces** in such wise as to promote the economic welfare, and, through that, the total welfare, of their citizens as a whole.'

And:

> **No 'invisible hand' can be relied on to produce a good arrangement** of the whole from a combination of separate treatments of the parts. It is therefore necessary that an authority of wider reach should intervene to tackle the collective problems of beauty, of air and light, as those other collective problems of gas and water have been tackled.

He proposed, instead, that taxes and subsidies be applied to produce a "good arrangement":

> It is, however, possible for the State, if it so chooses, to remove the divergence in any field by "extraordinary **encouragements**" or "extraordinary **restraints**" upon investments in that field. The most obvious forms which these encouragements and restraints may assume are, of course, those of **bounties** and **taxes**.

[15] https://journals.openedition.org/oeconomia/1373

The four economists who have caused the greatest harm to mankind include (in descending order of harm caused): Marx, Keynes, Malthus and Pigou. The fact that Alfred Marshall was the tutor of Keynes and Pigou makes him one of the worst, but he doesn't qualify to the top four.

I will therefore begin this paper with a deep dive into Pigou's *ideology* and its precursors in Alfred Marshall. That will set the context for the self-evident bias in all his thinking, which led to his grievously harmful claims about market failure.

As this paper will show, there is no market failure re: 'externalities'. Instead, production may lead to external effects and real problems which *can* be reduced via regulation, cap and trade, etc. Like all socialists, Pigou was plain wrong in his economics, so that will remain the focus of this paper. My main arguments to refute Pigou will remain technical and scientific.

Adam Smith was a scientist and despite a few errors, greatly advanced humanity. But like Marx before him and Keynes after him, Pigou was an ideologue and took humanity backwards. To be a scientist, an economist needs to understand and explain all detail, not wave his arms about. None of Pigou's "findings" or "recommendations" are workable, merely figments of the imagination. Just like Keynes imagined a government "stimulus" to "fix" recessions, Pigou imagined magic money to "fix" externalities.

1.7.4 *Pigou's belief in a socialist price system and advocacy of socialism*

In a separate section I will show in some detail how in 1937 Pigou summarised his views on socialism and capitalism, in favour of socialism. In particular, he believed that socialism would reduce inequality, eliminate unemployment and that the price system can be substituted by a system of fictitious accounting prices and interest rates. But because of difficulties involved, he suggested a gradual move towards socialisation of the society. That gradualism is the hallmark of Fabian socialism.

1.7.5 *Pigou's stance well exceeded Marshall's own errors*

It appears that Pigou had misunderstood some tentative comments of Marshall while proposing his ultra-socialist scheme of taxes/subsidies. In 1972, Krishna Bharadwaj pointed out that Marshall himself had significant concerns about things like "bounties".

> Although Pigou continued to speak in terms of taxation, he had cast the net of tax policy very widely indeed, with a tax on every industry under decreasing returns and a bounty to every industry under increasing returns. **Such complicated and comprehensive taxation would have brought the state into the economy on a grand scale.** The boldness of this policy was in sharp contrast with Marshall's own position. Apart from the fact that his suggestions were limited in scope, he had further tempered them by the recognition of considerations "other than economic". He warned against the "administrative side of state interference" (pp. 712-13) and against evils such as the opportunities for the corruption of public officials opened up by a scheme of bounties; and he feared that bounties could "sap the springs of free initiative and strength of character" (p. 714).[16]

1.7.6 *Both Coase and Demsetz recognised Pigou's ideological underpinning*

In his 1988 book, *The Firm the Market and the Law*, Coase wrote:

> In "The Problem of Social Cost," I said that Pigou's **basic position** was that, when defects were found in the working of the economic system, the way to put things right was through some form of governmental action. This view is expressed with numerous qualifications, but it represents the **central tendency** in his thought. Some have suggested that I was too harsh in my criticism of Pigou, but I believe what I said was essentially correct.

[16] https://www.jstor.org/stable/2552054

In his 1994 book, *Essays on Economics and Economists*, Coase continued his criticism of Pigou's ideological stance which misled economists, causing great harm.

> Some fifteen or twenty years ago, economists, under the influence of Pigou and others, thought of the **government as waiting beneficently to put things right** whenever the invisible hand pointed in the wrong direction. The conclusions they drew for policy involved extensive government regulation. Studies made in the intervening years have shown that such regulation often has no effect or has effects opposite to those expected and was commonly introduced to serve the interests of politically influential groups.

Apart from attacking Pigou's ideology, Coase was clear that Pigou's influence on economics has been bad. He wrote:

> It seems clear to me that Pigou did not fulfil the high hopes which Marshall had of him. In many respects **his influence on the development of economics has been bad**. He seems to have lacked any feeling for the working of economic institutions.

In a 1996 paper[17], Demsetz displayed at least some knowledge of the ideological underpinnings of Pigou's claims. He wrote: "the justification for a larger role of the state must be based on grounds that logically could co-exist with competition. The search for such grounds seems to have been an **important mission of Pigou**".

Further, "[t]he desire to reject the conclusions usually drawn from competition no doubt motivated many of Pigou's followers also, and to Pigou and followers alike the externality issue must have seemed the ideal conceptual vehicle for accomplishing this **mission**." He also wrote about Pigou's followers' "desire to preserve a role for the State".

As Demsetz showed later, even Coase erred badly. As a result, most economists *still* accept fruitless government intervention. The purpose of this paper is to try to stop this ideological belief in the government's capabilities.

1.7.7 *Others have also recognised Pigou's ideological bias towards Fabian socialism*

I'm clearly not the first to identify Keynes and Pigou as Fabian socialists and Alfred Marshall as a Fabian sympathiser/supporter. This 1954 dissertation by Sister M. Margaret Patricia McCarren did so, as well.

> The policy and principles set forth in Section V of the Tutorial Class syllabus on "National Finance" were consonant with the liberal economics of the day and might have been found in the Economic Journal, the organ of the Royal Society of Economists, where **Webb and Keynes, Pigou and W. A. Robson (Fabians)** were associated; where the names of Haldane, Balfour and Alfred Marshall mingled with Bastable, Beveridge and Tawney (Fabians).[18]

These people were (like Marx) on a fishing expedition to find faults with the market system. They had a "hunch" that markets don't work and governments are benevolent and caring, so they needed to justify their biases with cooked up "market failures".

In a 1971 book on economic thought, *The Growth of Economic Thought*, Henry W. Spiegel wrote:

> Pigou's welfare economics was designed to reveal instances in which the pursuit of private gain did not redound to the welfare of society, and it included a larger number of cases than are recounted here. It offered, in fact, a systematic treatment of such instances, many of which, albeit in isolation, had been the subject of treatment by earlier writers, who had pointed out specific exceptions from the laissez faire doctrine of harmonious interests. Pigou's work transformed what had hitherto been isolated exceptions

---

[17] https://www.sabhlokcity.com/2023/12/the-core-disagreement-between-pigou-the-profession-and-coase-in-the-analyses-of-the-externality-question-demsetz/

[18] https://cdn.mises.org/Fabianism%20in%20the%20Political%20Life%20of%20Britain%20-%201919-1931_3.pdf

> into a full-fledged system and thus represented a far sharper break with the harmony doctrine. It opened up a wide range of opportunities for public policy and constituted an early attempt at developing a principled theory of such a policy. Pigou's welfare economics, with its support of a wider diffusion of income, had its counterpart in the welfare state, which provided for social security and made opportunities for consumption along such lines as education, housing, and health care more nearly equal. In Pigou's native England, the institutions of the welfare state came to be paired with socialist measures resulting in the nationalization of substantial sectors of industry. These measures were not rejected by Pigou, as they would have been by Marshall, who favored some aims of the Socialists but was opposed to public enterprise. **In his *Socialism versus Capitalism*, published in 1937, Pigou in fact took a position close to the Fabian Socialists.** He suggested that with the changing circumstances and with the rise of the public corporation Marshall might have changed his mind.

In this book he specifically confirms that Pigou "took a position close to the Fabian Socialists".

The author J. E. King wrote in 2007 that Pigou was "driven towards socialism".

> Since everyone accepted the law of diminishing marginal utility, 'maximising utility' for society as a whole appeared to require the complete elimination of inequality in income and wealth, subject only to qualifications about the need to avoid seriously damaging the incentives to work, save and take risks.21 Since an extra dollar is worth so much more to a poor person than to a rich one, the case for taking from the latter and giving to the former was hard to deny (`Do you really need 50 cents more than he does?', as the twenty-first century charity advertisements would ask, under photographs of young African famine victims). Even an old-fashioned liberal like **A. C. Pigou was driven a long way towards socialism** by the force of this argument (Pigou 1937, chapter 2).[19]

Spash and Fuselier went much further. They note in the 2023 *Elgar Encyclopedia of Ecological Economics* that "In his later work he **promoted socialist policies and public ownership**". I differ from this interpretation, in that Pigou's entire career was based on the promotion of Big Government – he kept fishing all his life for opportunities for the government to "improve" welfare.

1.7.8 *Some tend to downplay Pigou's ideology*

Typical treatments of Pigou's ideology tend to acknowledge a socialist sympathy but brush off his interventionist attempts. This extract from a 2019 paper by David Campbell is typical:

> Pigou was **sympathetic to socialism** but, whilst he seems to have acknowledged the possibility of an ultimately completely planned economy, his views in this respect were so gradualist as to have no real definition, and he was, for all practical purposes, committed to a mixed economy. Maintaining that 'the working of self-interest is generally beneficent', he conceived of intervention as an exceptional policy. He regarded the first task of regulation as the creation of a framework which channels self-interest, which can, of course, be exercised in destructive ways, into the beneficent form of market exchange, and Coase, who we have seen insisted on the necessity of regulation, was, of course, in complete agreement with this. Though Pigou thought intervention necessary only when the operation of self-interest did not work acceptably, he was of the opinion that, even within the regulative framework, there were occasions when it did not do so. The Economics of Welfare is a compendious attempt to identify those circumstances in which intervention would improve welfare.[20]

These accounts are inconsistent with my analysis of Pigou's ideology in a later section of this paper. I believe he firmly believed in socialism of the Fabian kind and fished actively for opportunities and justifications for state intervention.

---

[19] https://www.tandfonline.com/doi/abs/10.1080/18386318.2007.11682109

[20] https://www6.austlii.edu.au/cgi-bin/viewdoc/au/journals/UQLJ/2016/8.html

In a previous paper (2018), even David Campbell agrees that the piecemeal intervention by Pigou has become "extensive":

> Pigou's **political views were sympathetic to socialism** but, while he seems to have acknowledged the possibility of an ultimately completely socialist economy, his overall views were so gradualist that he was for all intents and purposes committed to a mixed economy. His views were not intended to be a precursor to central planning and in this way he is the source of the economic case for 'piecemeal' intervention. But though Pigou certainly theoretically conceived of intervention as a set of exceptional measures taken in a general market economy, piecemeal intervention has now become extremely extensive indeed.[21]

1.8 Making a hero out of Pigou

1.8.1 *Claims that he was wise and understood institutions*

There are analysts who make use of a bits and pieces of Pigou's writings to claim that he was very aware of government failure and the need for appropriate institutional arrangements, and that he also advocated voluntary bargains where possible. Therefore, apparently he is a hero, not an enemy of economics. For Klink writes in a 1994 paper:

> One has, therefore, to acknowledge an important institutionalist component in Pigou. As he himself correctly states,
>
> > . . . economic motives, in short, operate not in the air, but on rails carefully laid down for them by law . . . Adam Smith's invisible hand is not an external fate taking precedence over political institutions, but does its job, well or ill, only because these institutions have been framed, maybe in the interests of a ruling class or clique, maybe for the general good, to control and direct its movements. (Pigou)
>
> **Contrary to the simplistic and biased interpretation which has been promoted, Pigou does not see state intervention as being synonymous with imposing taxes**, but feels rather that it exists from the moment when laws are promulgated or when the institutional framework is created to encompass economic—and therefore human—activity. As we shall see, Coase agrees with Pigou on this point.

Klink suggests, by italicising the words "The most obvious" in Pigou's text suggests that Pigou's taxes/ bounties are merely one of his many alternative recommended ways for the state to intervene, hence the focus on taxes/bounties is misplaced. This is Pigou's text, with Klink's italics:

> It is, however, possible for the State, if it so chooses, to remove the divergence in any field by 'extraordinary encouragements' or 'extraordinary restraints' upon investments in that field. *The most obvious* forms which these encouragements and restraints may assume are, of course, those of bounties and taxes. (Pigou) *[italics added]*

My point: We need to remain focused on the Big Picture. Pigou **did** recommend taxes and bounties based on entirely spurious logic (that Demsetz has entirely demolished). He was desperately fishing from the first day of his career for as many ways as possible to interevene in markets to justify his *prior bias* towards Fabian socialism. He had a tendency to promote intervention despite some doubts or even concerns that he expressed sporadically. As a Fabian sympathiser, his goal in life was to promote socialism even as he quietly mentioned its impossibility in passing.

---

[21] https://journals.sagepub.com/doi/10.1177/0964663917730122

To credit Pigou with genuine economic wisdom regarding institutions is to misunderstand Pigou's ideological focus. I do not find any authenticity in Pigou's economics; it is purely ideological.

1.8.2 *The ideological Pigou Club*

But some big names in the world of economics today seem to find him to be a hero.

Even as Pigou led economics down a garden path, promising Nirvana (socialism), the control of the discipline by his disciplines – and advocacy for his prescriptions – has reached a peak. Pigou is actually worshipped by some 'economists'. Mankiw wrote a piece on his Pigou Club[22] in 2009:

> For **believers** in Pigovian taxation such as myself, the primary task ahead is one of education. To many economists, the basic argument for increased use of Pigovian taxes is so straightforward as to be obvious. But as George Orwell once put it, 'We have now sunk to a depth where the restatement of the obvious is the first duty of intelligent men.'[23]

His fans push the state intervention wagon at every step. A.H. Barnett and Bruce Yandle have identified the ideological underpinnings of the widespread application of Pigovian concepts:

> Judging from the frequency and breadth of instances in which social scientists use externality as a tool for rationalizing government intervention in markets, it appears that these **protagonists have recognized this potential and leaped at the opportunity it provides.** Indeed, from the perspective of some social scientists the concept is so powerful and so pervasive as to relegate neo-classical welfare analysis to the academic dust ben. Kapp (1969) appears to make this point is his article "On the Nature and Significance of Social Costs."
>
> Needless to say, modern social scientists have continued in that vein. Political scientists, sociologists, environmental scientists, and public policy analysts, as well as some economists, have adopted with a vengeance the externalities concept with its embodied interventionist rationale.[24]

My experience of 38 years within the governments of India and Australia has been valuable in showing me that governments are fundamentally corrupt and incompetence. The government is the most harmful thing in the world. How to minimise its harm must be our main project.

1.9 Externalities: False logic and impossible implementation

There are two ways to refute an argument: by pointing out inconsistencies or impossibilities in its internal logic, and by pointing out the impossibility of its implementation. There is neither any logic to externalities, nor any ability to implement the so-called 'solutions'.

Inner logic of externalities

The inner logic of Pigou's (and Coase's) argument was shown by Harold Demsetz (2011) to be not sustainable. Many others had come to similar conclusions before him, such as Frank Knight in 1924, but Demsetz's 2011 paper is the last nail in the coffin of the theory of externalities.

Implementation of taxes and subsidies

Buchanan had demolished the implementation logic of externalities by showing that a government has no capacity to implement Pigou's 'solutions'.

---

[22] https://en.wikipedia.org/wiki/Pigou_Club

[23] Gregory Mankiw, Smart Taxes: An Open Invitation to Join the Pigou Club, 35 E. ECON. J. 14, 15 (2009):

[24] https://www.cambridge.org/core/journals/social-philosophy-and-policy/article/abs/end-of-the-externality-revolution/19C1E8E4D5AC217B84F55ECB3AB90AB3

Thus, externalities only exist in textbooks, as a ghost that haunts mankind. Most economists, however, are not yet aware of this, since modern textbooks pontificate prolifically about these non-existent inefficiencies.

1.10 Demsetz's last nail in the coffin of 'externalities'

In 2011 Demsetz published a paper with the byline 'A Critique of the Reasoning of A.C. Pigou and R.H. Coase' and a summary which stated that his paper 'refutes allegations by A.C. Pigou and R.H. Coase that a competitive, private-ownership economic system that conforms to the neoclassical model fails to allocate resources efficiently'. In other words, there could not have been a more direct attack on the argument of externalities.

In his paper Demsetz showed[25] that there is no 'problem' of social cost or benefit. There is no externality 'problem' (positive or negative). There is only the problem of strategic behaviour with a non-excludable indivisible good. That's not an externality. He upturned Pigou and Coase. **He showed that markets are efficient regardless of transaction costs and property rights.** After his masterpiece, externalities had no place to exist anymore, no place to hide.

In an email to me on 10 March 2011, Demsetz wrote: '**I expect the paper to cause a stir; all to the good**'. I don't know whether his paper caused a stir, but the concept of externalities as an inefficiency still exists, so hopefully this paper will help to close this topic.

1.11 Demsetz's three major insights

I outline his three main insights below.

1.11.1 *Insight 1: Property rights are exogenous to the economic system.*

Demsetz had pointed out an insight which must be credited to Frank Knight in 1924 while refuting Pigou's formulation. This is what Knight wrote:

> Professor Pigou's logic in regard to the roads is, as logic, quite unexceptionable. Its weakness is one frequently met with in economic theorizing, namely that the assumptions diverge in essential respects from the facts of real economic situations. **The most essential feature of competitive conditions is reversed, the feature namely, of the private ownership of the factors practically significant for production.** If the roads are assumed to be subject to private appropriation and exploitation, precisely the ideal situation which would be established by the imaginary tax will be brought about through the operation of ordinary economic motives.

As I'll show later, Knight applied this example to the case of road congestion that Pigou had argued causes an (inefficient) externality. But as Knight showed, you can't have government ownership of roads and criticise the market!

Coase did well to emphasise the missing property rights element of Pigou's formulation. He brought in the court instead of a government to "fix" the problem. But Coase blundered in considering this to be a market inefficiency. Once again, it was a case in which the "the most essential feature of competitive conditions is reversed, the feature namely, of the private ownership of the factors practically significant for production". It doesn't matter whether property rights are assigned by custom, by a government or by a court: the end result is still an efficient trade.

[25] https://www.sfu.ca/~allen/DemsetzSocialCost.pdf

Demsetz's first insight was therefore a refutation of Coase's attempt to introduce property rights allocation as a way to somehow justify market inefficiency. Demsetz showed that property rights are exogenous, have nothing to do with markets, and that markets are efficient, ***given*** an assignment of property rights:

> As courts are presently constituted, the economic system simply takes court decisions (which, in a small way, affect the distribution of wealth) as exogenously imposed constraints on what can and cannot be done, just as the economic system accepts decisions by the State to use taxes and subsidies to redistribute wealth. **An efficient economic system is one that makes the most of scarce resources within whatever constraints are handed down to it by courts and legislatures.** This means that efficiency is served if the market blocks post-court negotiations between the two claimants discussed, simply because the cost of negotiations between them is expected to exceed the increase in the value derived from realigning ownership of the contested resource. (*ibid*)

The market does its best *given* property rights. Property rights (whether by custom, law or the courts) are an exogenously imposed constraint on the economic system. The economic system will maximise efficiency *given* property rights. The 'Coasean' solution is not special. It is nothing normal bargaining (tatonnement) within any property rights system.

> Coase has treated the legal system and its courts as if they are parts of the economic system, when they are not. … The implication Coase draws from this case is that the economic system, functioning in the presence of positive transaction cost, can inefficiently allocate resources, but this cannot be deduced from the case he has imagined. The court may have made its choice of owner for reasons different from maximization of market value, since it serves broad social principles, or it simply may have made a mistake because it is not guided in its decisions by a market-based calculus. The proper role of courts in a society is a complex issue, one I do not propose to discuss here. Suffice to note that courts as presently constituted do not function as part of the economic system and do not (explicitly) behave as if they were owners of the resource whose control is being resolved. They are therefore irrelevant to an evaluation of the efficiency of the market-based economic system. **The proper domicile of the efficiency calculus**, as this was discussed by Pigou and the economics profession (before recent innovations in political economics), **is wholly within the economic system.** Although there may be very good reasons for not creating a market-like legal system, we may note that if we suppose that courts are remade into market institutions whose survival depends on revenues secured from petitioners who purchase their services and decisions, ownership of a disputed resource would never go to the petitioner who is less capable of maximizing value from its use. Coase's imagined court decision would never have been made. As courts are presently constituted, the economic system simply takes court decisions (which, in a small way, affect the distribution of wealth) as **exogenously imposed constraints** on what can and cannot be done, just as the economic system accepts decisions by the State to use taxes and subsidies to redistribute wealth. **An efficient economic system is one that makes the most of scarce resources within whatever constraints are handed down to it by courts and legislatures.** This means that efficiency is served if the market blocks post-court negotiations between the two claimants discussed, simply because the cost of negotiations between them is expected to exceed the increase in the value derived from realigning ownership of the contested resource.[26]

There is no implication that property rights are necessary to achieve "efficiency". As Demsetz shows, if property rights are expensive, they are still just any other cost in the calculation, and therefore it will be efficient in such cases not to allocate property rights. The existence of pollution is not an inefficiency. No matter which way one looks at them, externalities are not a meaningful concept.

1.11.2 *Insight 2: Positive transaction costs are just any other cost*

The second insight of Demsetz was that the market is efficient *regardless* of positive transaction costs. He rejected Coase's idea that positive transaction costs somehow create a wedge between so-called private and social costs, which the government can somehow improve.

---

[26] https://www.sabhlokcity.com/2023/10/the-problem-of-social-cost-what-problem-my-annotated-study-of-demsetzs-2011-piece/

In his Nobel lecture, Coase argued that a government, through regulation, taxation or subsidies, could potentially improve the efficiency of the market when positive transaction costs are involved, thus supporting Pigou's thesis:

> Pigou's conclusion and that of most economists using standard economic theory was, and perhaps still is, that some kind of government action (usually the imposition of taxes) was required to restrain those whose actions had harmful effects on others, often termed negative externalities. What I showed in that article, as I thought, was that in a regime of zero transaction costs, an assumption of standard economic theory, negotiations between the parties would lead to those arrangements being made which would maximise wealth and this irrespective of the initial assignment of rights. This is the infamous Coase Theorem, named and formulated by Stigler, although it is based on work of mine. Stigler argues that the Coase Theorem follows from the standard assumptions of economic theory. Its logic cannot be questioned, only its domain. I do not disagree with Stigler. However, I tend to regard the Coase Theorem as a stepping stone on the way to an analysis of an economy with positive transaction costs. The significance to me of the Coase Theorem is that it undermines the Pigovian system. Since standard economic theory assumes transaction costs to be zero, the Coase Theorem demonstrates that the Pigovian solutions are unnecessary in these circumstances. Of course, **it does not imply, when transaction costs are positive, that government actions (such as government operation, regulation or taxation, including subsidies) could not produce a better result than relying on negotiations between individuals in the market.** Whether this would be so could be discovered not by studying imaginary governments but what real governments actually do. My conclusion; let us study the world of positive transaction costs.[27]

Of course, the term "better result" might not mean greater Pareto efficiency. By being vague on this matter, Coase has allowed the confusion started by Pigou to continue. There is no doubt that some regulatory solutions can reduce harmful external effects such as pollution. But these will inevitably reduce total output and won't be Pareto efficient. A CBA, however, can support such regulation.

Demsetz rejected this idea. He wrote:

> if transaction cost is assumed to be zero, the perfect decentralization model yields an efficient allocation of resources, **but the model embraces positive costs of producing all other types of goods and services**. If these costs do not block the deduction of efficiency, why should the deduction be blocked by including one more type of service – the provision of a price system? Imagine a railroad capable of shipping goods between two firms. The railroad incurs cost if it does this, and the cost may be so high that the shipment does not occur (and, instead, as Coase wrote in 'The Nature of the Firm' (1937), the would-be receiving firm chooses to rely on in-house production of the good that would have been shipped were there no transport cost). No inefficiency has been created if the shipment does not take place under these circumstances, for the implied gain from making the shipment is less than the cost of doing so. But, pray tell, we reach the same conclusion if we change 'shipment cost' to transaction cost. [28]

He elaborated:

> When turning to the more realistic world in which transaction costs are positive, Coase deceives himself into arguing that the decentralized economic system, after all, may not equate private and social cost. ... [I]f transaction cost is assumed to be zero, the perfect decentralization model yields an efficient allocation of resources, but **the model embraces positive costs of producing all other types of goods and services.** If these costs do not block the deduction of efficiency, why should the deduction be blocked by including one more type of service – the provision of a price system? Imagine a railroad capable of shipping goods between two firms. The railroad incurs cost if it does this, and the cost may be so high that the shipment does not occur (and, instead, as Coase wrote in 'The Nature of the Firm' (1937), the would-be receiving firm chooses to rely on in-house production of the good that would have

[27] https://www.nobelprize.org/prizes/economic-sciences/1991/coase/lecture/

[28] https://www.sfu.ca/~allen/DemsetzSocialCost.pdf

> been shipped were there no transport cost). No inefficiency has been created if the shipment does not take place under these circumstances, for the implied gain from making the shipment is less than the cost of doing so. But, pray tell, we reach the same conclusion if we change 'shipment cost' to transaction cost. [29]

The objection Demsetz has to Coase's interpretation is that it opens the way for a political agenda.

> Demsetz … criticizes the opening to a political agenda that, he says, Coase has provided. … [S]ome interventionists have seized on Coase as a reason for interference with markets.[30]

Thus, I have shown in a paper on the analysis of vaccine mandates how even otherwise sensible public health thinkers like Jay Bhattacharya have ended up supporting vaccine mandates by faultily citing the "Coase theorem". Coase's loose interpretations have re-enforced the concept of inefficient externalities, in the minds of many economists.

Demsetz had expressed his concerns regarding Coase's mistaken attempt to rehabilitate the concept of inefficient externality many years earlier. Fred S. McChesney wrote in his 2004 paper:

> Coasean analysis of externalities has been the subject of much confusion, even disagreeement. Demsetz in particular has recently pointed to aspects of the Coase approach that, as a matter of both economics and of government policy, he finds problematic. As a matter of economics, Demsetz says, Coase's focus on transactions costs is not helpful in resolving questions concerning externalities. **Even in a hypothetical world of zero transaction costs, externalities would still exist**. **[Sanjeev: by which he meant non-inefficient external effects; every human action has external effects, but these are *not inefficient*]** Moreover, Demsetz fears, focus on transaction costs as the reason for the persistence of externalities furnishes spurious reasons for undesirable government intervention in markets.

Coase's focus on transaction costs was misguided, a wild goose chase, almost as bad as Pigou's ill-considered concept of externalities.

In this process, Demsetz refuted Coase and largely dumped his work, but Pigou's idea of externality was made into pure mincemeat. The original idea of Pigou (or later, *partially* of Coase) that governments can mysteriously see through the 'inefficiency' of markets and magically (given omniscient powers) equalize ***mythical*** social costs and benefits through taxes or subsidies, was shown to be a pure hallucination.

We might even call this the Demsetz theorem, that social product = private product in all cases, thus "externalities" do not create any inefficiency or market failure. Markets are always efficient **given** an allocation of property rights and costs (including transaction costs).

Demsetz proved that given an assignment of property rights and ALL relevant costs (transaction costs are just one of them, but there are also costs of ensuring property rights), any "externalities" are socially optimal. There is no inefficiency of the market. Zero externalities are not only not optimal, no government can achieve such a thing. Nirvana does not exist.

Pigou's sleight of hand was to show us a zero externality scenario which a government could magically achieve (Nirvana). The only reason he did it is because he was a die-hard Fabian socialist who wanted to destroy capitalism and nationalise all production.

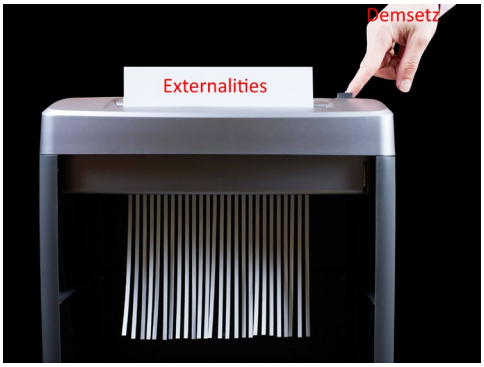
ALMOST SINGLE-HANDEDLY, DEMSETZ TURNED BACK THE CLOCK ON MARKET FAILURE.

How has Demsetz's essay not forced a rewrite of economics textbooks? Is Pigou Teflon-coated?

---

[29] https://www.sabhlokcity.com/2023/10/the-problem-of-social-cost-what-problem-my-annotated-study-of-demsetzs-2011-piece/

[30] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=491182



1.11.3 *Insight 3: When there is strategic behaviour, an allocation might not be efficient*

Under this insight he considers two kinds of cases:

Case 1: Indivisible goods

There is a real (i.e. not fictitious) issue, but entirely independent of the externalities claim, of indivisible goods with strategic behaviour. In such cases (*some* public goods), a government could (not will always!) deliver a Pareto improvement.

Demsetz notes that where possible we can solve this problem by converting a public good into a club good.

> Supply and demand in the neoclassical model express true intensity of desire for goods. The neoclassical model, by way of its assumptions, faces buyers and sellers with given non-negotiable equilibrium market prices, prices that cannot be influenced by individual bargaining. It is not designed for and does not treat strategic action. The possibility of misrepresenting one's position does not depend for its existence on positive cost of transacting; it requires only a prospective favorable distribution of gains from cooperative action.
>
> The production of divisible goods, it may be assumed, is less costly if done by competing private parties than by central planners, but this assumption seems less plausible for the production of indivisible goods. The State offers legitimate power to coerce people into what it perceives to be a (tax paid) solution to the collective good problem. This power is not found in the decentralized economic system; that it is not is what makes markets so attractive to lovers of freedom. Yet, coercion can be especially useful in cases in which strategic behavior has impaired agreement on production. Just as we find the State's ability to coerce legitimately helpful in the maintenance of law and order, so we may find it useful in helping to finance production of goods and services that are important to society but are subject to serious strategic bargaining problems. It is possible in some instances to remedy the problem through a proper set of private rights – that is, to substitute a tollway for a freeway in order to reduce the collective 'bad' we call congestion. In other instances this sort of solution is too costly. Resort to State coercion appears more appealing when this is the case.

Case 2: Divisible goods

In this case an off-price system external effect is infinitely divisible (e.g. pollution) but its control suffers from the same problem, of strategic behaviour. Demsetz recognised that there could be a **free riding issue** with clean air. In that case some form of government intervention could improve the situation (at an *additional cost* to society).

In an interview with Mark Grady, he said[31]:

[31] https://www.sabhlokcity.com/2023/12/transcription-of-externality-related-content-from-a-demsetz-interview/

> If the market can't easily handle a problem like air pollution. Why can't it easily handle the problem?
>
> Well, it's difficult to have somebody own the quality of the air. There's a big **free-rider problem**. If I drive a car and I say I'm going to put a small controlling device (for pollution) on my car at my cost and everybody benefits freely from that because they get to breathe the cleaner air. Well, hardly anybody's going to want to put a device on their car. They want to wait for other people to do it. So it's a difficult problem for the market to wrestle to the ground.
>
> But you can have the authorities, presumably with high quality research behind them – which is not necessarily true – say what the total amount of air pollutants are we want to allow into the air, and then you could specify the number of tonnes of air pollutants. And you could issue coupons or certificates that give permission to put a ton of pollutant in the air. And you could distribute these to the industry with the total number of coupons equaling and sum the total amount of pollution you want to put into the air. And then you let these guys buy and sell these coupons back and forth.
>
> The nice thing about that is that a firm that finds it very costly to get rid of pollution – and that means costly for customers of its product also – would buy the coupons from a firm that finds it very easy to get rid of pollution. And you'd get the total desired amount the pollution obtained at the lowest possible cost, whereas if you go around with detailed regulation of "you could put this out, you could put that out" you get a mess.
>
> So that's a good was a good idea and it shows what private property rights can do. The coupons are a form of property rights.
>
> **Interviewer:** It's a successful idea, they use that idea. The EPA uses that idea. That would be an example of how your ideas on property rights have led to a major policy change. The environmentalists support it. Before you wrote this piece I don't think people understood clearly how property rights solve social problems, and what that article led to was really a more aggressive use of property rights in order to solve some very thorny problems that couldn't be solved [otherwise]

This is effectively a political solution to the problem of a real external effect. The remedy will impose additional costs, so the goal is to minimise these. A cost-benefit analysis (CBA) of options can guide us to a least-expensive remedy.

1.12 Demsetz's acknowledgement that Coase was not entirely wrong

Demsetz agreed in 1996 that Coase was at least partly right in his reluctance to accept Pigou's formulation. In particular, Coase was wary of an idealised state. Coase distrusted the State. Only private remedies were acceptable. Although Coase partly fell into the trap himself when he considered positive transaction costs, he was against ivory-tower imaginations by "economists". He called these imaginations, "blackboard economics".

> 1. Pigou was not neglectful of transaction cost although he definitely failed to perceive its general analytical significance.
>
> 2. It was not Coase's observations on the importance of transaction cost but his 'privatization' of the externality problem that constitutes the main methodological advance in his work.
>
> 3. Coase was guided toward **privatization of the interaction between parties** by his refusal to accept Pigou's and the profession's **idealized State** as a solver of the externality question.[32]

This extract reconfirms that Coase's analysis cannot be used to argue the coercive "assignment" of the right to vaccinate to government (like the health economics textbook of Jay Bhattacharya et al. has done while taking Coase's name). Nationalisation of the citizen's **body** breaches the foundations of economics. Health and other economists have been guilty of this type of "economics" re: vaccine mandates.

- imagining the free rider

[32] https://sciencedirect.com/science/article/abs/pii/S0176268096000250

- imagining things that Coase never said
- ignoring the impossibility of determining social costs and benefits
- imagining that government is omniscient and can set taxes/subsidies
- losing sight of the basic fact that in economics we never do coercion.

1.13 Coase knew that something was fishy, and opposed the term 'externality'

Coase was typically very clear-headed about the way he looked at the world but even he didn't quite understand the points which Demsetz understood and has elaborated at some length in 2011, that it is theoretically impossible to achieve a Pareto improvement from the market solution. Pigovian taxes are an impossibility (but fixing harmful side-effects from markets is not – that's a separate issue). Coase knew, however, that the concept of externalities as commonly bandied about was wrong.

> In his papers, Coase did not use the terms externality or external costs, although many economists directly associate the Coase Theorem with those concepts. His non-use of the term externality was intentional. He explained:
>
> > But, as employed today, the term carries with it the connotation that when 'externalities' are found, steps should be taken by the government to eliminate them. As already indicated, the only reason individuals and private organizations do not eliminate them is that the gain from doing so would be offset by what would be lost (including the costs of making the arrangements necessary to bring about this result). If with government intervention the losses also exceed the gains from eliminating the 'externality,' it is obviously desirable that it should remain. **To prevent being thought that I shared the common view, I never used the word 'externality' in 'The Problem of Social Cost'** but spoke of 'harmful effects' without specifying whether decision-makers took them into account or not.[33]

In his 1988 book, The Firm, The Market, and the Law, Coase was even more explicit in his opposition to the use of the term 'externalities' in the sense commonly adopted in economics after Pigou:

> The concept of 'externality' has come to play a central role in welfare economics, with **results which have been wholly unfortunate**.

1.14 Samuelson built a bridge between externalities and public goods, which Demsetz broke

Papandreou's 1998 book is a good review of the concept of externalities. He shows how Samuelson built a bridge between externalities and public goods:

> If external economies have egos. they were greatly boosted by Samuelson. For the purposes of our historical account let us recount the new clothing in which external economies were dressed. 'External effects' or 'externalities' are now associated with the nature, or definition, of goods. External effects impart 'publicness' to goods. The pure public good is a polar case of external effects. The 'ideal' decentralized function of the competitive market is seriously impaired by public goods. 'Externality' is intrinsic to government activity.

In 2011 Demsetz broke that imaginary bridge which has caused so much grief (insight 3 above). We must separate the two concepts completely.

[33] https://www.jstor.org/stable/26617802

1.15 Time to purge Pigou and externalities from economics textbooks

Just like there's no mention of Karl Marx in any economics textbook because his was junk economics, the name of Pigou needs to be purged from modern economics. Despite his late-life sympathies for socialism, J.S. Mill had still not gone headlong into advocating a role for government for everything under the sun. It was, instead, the two students of Alfred Marshall: Keynes and Pigou, all three of them under the strong influence of Fabian socialist Sidney Webb, who turned economics into the branch of Fabian socialism that it is today.

It is high time to give Pigou's ghost a final burial, and to subsume Coase's work on transaction costs and bargaining into the standard assumptions of the general equilibrium model, even as he definitely remains a great economist in many ways. We need to get rid of the meaningless term, 'externalities'. Instead, let's use precise words that define real problems, such as pollution, congestion, strategic behaviour.

Steven Cheung notes how Pigou's work underpins the modern rush in economics for 'solutions' to non-existent problems, or ones that are poorly understood.

> In two successive classic works on welfare, Pigou analysed various inefficient situations in terms of what has become known as divergence between private and social costs. Like the Pareto condition, the 'divergence' applies only to society as a whole, but it provides a frame of reasoning within which an economist may stretch his imagination far and wide in evaluating the state of the economy. Above all, it yields apparently easy prescriptions for corrective government actions. **After one lesson on Pigou, a newcomer may feel he knows how to improve the world**.[34]

I was myself one of these newcomers. We don't need to mass-produce foolish 'economists'. Just like public health textbooks need a comprehensive clean-up, economics textbooks need a spring clean.

Even a cursory scan of this paper will show the reader the many types of questions that surround the concept of externalities. However:

> **today's textbooks give students the impression that Pigou's polemic is fundamentally sound**, leaving them inadequately equipped to critically assess policies proposed as "solutions" to alleged market failures arising from externalities.[35]

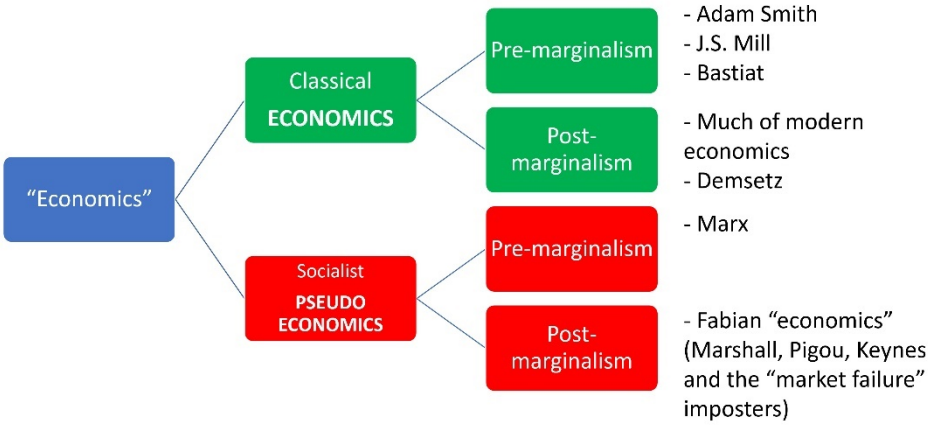
The concept of externalities has allowed the loose and harmful thinking in policy circles, with things getting worse with concepts such as carbon tax. We need to focus on real problems, with real solutions. The 'toolkit' of Pigovian taxes and subsidies is not just meaningless but positively dangerous. Today, when someone reads an economics textbook, he is effectively being indoctrinated into (soft) socialism.

Now that it is clear that Marshallian "economics" is a branch of Fabian socialism, the broad umbrella of "neo-classical" economics must be rejected. We need to separate out the Fabians as pseudo-economists along with Marx. These people have badly polluted public policy analysis. I must add that Keynes did not even make the pretence of using marginal analysis. He made all kinds of wild assertions to "prove" his claims (although neo-Keynesians have tried to retro-fit his claims into the marginal school).

---

[34] https://maisliberdade.pt/site/assets/files/1371/the_myth_of_social_cost.pdf

[35] https://www.jstor.org/stable/26725777



Economics textbooks need to be re-written to recognize these basic facts, if it has to continue to have any claim of being a scientific discipline.

1.15.1 *Externality as weapon of mass destruction*

In everything for which a good economist would balk at recommending government intervention, 'modern' economists, fully indoctrinated into bogus 'models' and 'free rider' hypotheses, confounding also the huge mistakes of Coase, never hesitate to recommend full-blown communism. A.H. Barnett and Bruce Yandale lamented in 2009 the use of the concept of externality as a 'weapon of mass destruction' in public policy:

> Despite the large volume of literature dealing with externalities, or perhaps because of it, we believe the understanding of the concept of external effects held by informed policy makers, and perhaps some members of the academy, and the political economy for dealing with them at times remain fractured and confusing. This confusion has been partly responsible for the use of externalities as rationale for government intervention into a very wide array of markets. Indeed, it seems that **by making externality arguments in an institutional vacuum, economists unwittingly developed a weapon of mass destruction** that, in the hands of journalists and popular policy analysts corroded almost to the point of uselessness the beneficial theory of markets and competition.[36]

Further:

> **the concept of externality has been to microeconomics what Keynesian economics was to macroeconomics. Specifically, it provides a rationale for virtually unlimited government intervention into private transactions.** When viewed through this lens, unintended (uncontracted) effects are pervasive. We find them in virtually every sphere of human activity. Each can be characterized as an externality, with a corresponding appeal for government action. (ibid)

1.15.2 *Great harm to the poor*

Although many externality economists might not think they are harming the poor, the policies that emerge from their analysis inevitably do so. Since externalities are nothing but the inconveniences of the rich, it is but to be expected that they will exercise the maximum political pressure to ease their own 'problems' such as congestion. To the extent there is any overlap with the welfare of the poor (such as with sanitation), one can support these

[36] https://www.cambridge.org/core/journals/social-philosophy-and-policy/article/abs/end-of-the-externality-revolution/19C1E8E4D5AC217B84F55ECB3AB90AB3

policies but by and large, these policy prescriptions end up harming the poor the most. That is particularly true of town planning policies.

As a general rule, the concept of negative externalities is used purely for political purposes by the rich/elites. The worst of these effects is happening today via 'carbon' taxes and subsidies. Invariably, the rich are being subsidised and the poor punished, since subsidies come from the pockets of the poor. Only the poor cause these externalities, the rich are able to subsidise themselves with EV and battery subsidies and get hundreds of times richer (Al Gore is a classic, but also Elon Musk). EVs are subsidised up to $7,500 in the USA but the poor drive around with cars worth $1,000. They can't dream of buying an EV, even as the subsidies for the rich come out of essential funding/infrastructure; and worse, converts into inflation for the poor since the money for subsidy is borrowed from future generations. Socialism was always a plan for the people at the top to grow ultra-rich at the expense of the poor. Now **'externality' socialism has become the way for the ultra-rich and corrupt to grow even richer at people's expense.** The government now borrows without limit to fund the rich.

1.15.3 *Coercion and the end of Western civilisation*

In everything for which a good economist would balk at recommending government intervention, "modern" economists, indoctrinated into market failure "models" based on Pigou's work, confounding also the huge mistakes of Coase, never hesitate to recommend full-blown intervention, bordering on communism (such as vaccine mandates). But as I will show in this paper, coercive intrusions are not part of the economics discipline.

The weak case made by

A case to amend economics textbooks was made in 2016 by James McClure and Tyler Watts.

> In 1920, Pigou professed that the unreliability of the invisible hand in conjunction with pervasive externalities (particularly negative ones) necessitated broad-based market intervention by government. Today, the typical chapter on externalities one finds in an undergraduate microeconomics principles or intermediate-level text **reflects too little of the significant body of scholarly pushback to Pigou's (1920) anti-market polemic**; specifically, the typical textbook externality chapter (a) makes no distinction between pecuniary and technological externalities, (b) pays no attention to the invisible hand's unintended and emergent consequences as, in the aggregate, a positive externality of enormous magnitude (c) overemphasizes negative over positive externalities, (d) ignores Coase's critique of Pigouvian policy "solutions," and (e) ignores the potential relevance of inframarginal external benefits in discussions of policy "solutions" to negative externalities.
>
> Taken together, these textbook omissions **diminish student assessments of benefits that market processes confer on economies that embrace them**. Lacking a complete understanding of these benefits, student perceptions of the efficacy of governmental interventions to address negative externalities are bound to be overly optimistic. The greatest harm to imparting economics students with an anti-market, pro-interventionist bias may well manifest itself in those who move into majors such as political science or degrees that lead them into jobs as policy makers (where their bias can metastasize into interventions that are wealth-reducing).
>
> To the extent that undergraduate textbooks are simply **reflections of the general mind-set of the profession**, this article's criticism of textbook authors may be too narrowly focused. After all, as an anonymous referee pointed out, textbooks "cannot deviate from it [the general mind-set of the profession] and expect to be used." To the extent this is so, **our criticisms of the overly Pigouvian approaches to externalities found in textbooks also apply to the profession writ large**. We hope this article will stir up a demand among economics professors for textbooks that carefully address the deficiencies in the anti-market, interventionist polemic that Pigou proffered nearly a century ago.[37]

[37] https://www.jstor.org/stable/26725777

As this paper will show, most of the points raised in this critique by McClure and Watts are weak. For instance, there is no basis to distinguish between pecuniary and technological externalities (no classification of any kind is called for: the concept is completely dead as a dodo), no case to reject the textbooks on the ground that they overemphasize negative over positive externalities (

1.16 Does this mean that external effects and real problems don't exist?

Bad external effects of market operations, like pollution exist, but the issue is not that these are an inefficiency. These are the outcome of the best that can be delivered by voluntary action in markets, thus delivering the *highest possible* welfare for society. The market generates an optimal level of pollution.

That pollution, however, might still be too high from some other societal perspective. In that case we need action to reduce it directly. But in doing so we must necessarily harm someone and reduce GDP, something which Pigou's magic pudding doesn't allow for. Jobs will need to go (typically of the poorest). The best we can do is to reduce the problem at the lowest possible cost to society. A cap-and-trade policy can achieve such an outcome in the case of pollution, but it is delusional to think that we can achieve such an outcome through a Pigovian tax.

Further, as Demsetz pointed out, there is a real problem of public goods in which strategic behaviour is implicated. In such cases, the best outcome is achieved by re-assigning property rights to convert a public good into a club good. A second-best solution can be achieved by the government regulating or otherwise directly supplying the 'good'.

Thus, there are real problems with real economic solutions, customized to each problem. What we need to do, however, is to stop using the meaningless and misleading word 'externality' to justify taxes and subsidies. By merely using the term 'market failure', Fabian economists today (which is the vast majority of them) justify coercive government actions (such as vaccine mandates). This must stop.

1.17 Two steps to maximise economic welfare

The fact that the free market (to the extent it is free – never perfectly) generates both some poverty and some filth/pollution is not a criticism of the market. It is the best anyone can achieve. But from the wealth so generated, a government can address both poverty and pollution.

There is no market failure. The failure is, instead, of our understanding of markets. Markets are for maximising innovation, employment and national wealth. Other things like poverty, cleaning up the environment, etc are not its business. The fact that the market doesn't consider these issues is not a sign of failure but of its success. If a market were to get involved with social/environmental objectives instead of profit maximization, society would lose the wealth which is essentially needed, first and foremost.

From an analysis of the literature, it appears to me that there is a two-step process to maximise human welfare.

<u>Step 1</u>: Let the market freely produce the maximum possible goods at lowest possible cost.

This will generate the following.

- Maximum possible wealth
- And a bit of a 'mess' (waste, spillovers)
- And some people can't compete and fall below a minimum

This step includes assigning clear property rights to the private sector, so it has the incentive to maximise wealth.

<u>Step 2</u>: The society can use the wealth so created to:

- mitigate any 'mess' (subject to CBA)
- directly fund those who fall below a social minimum.

Do not: The main finding of this paper is that one should not use 'Pigovian' taxes or subsidies which are always harmful to society.

1.18 Market failure as a meaningless, catch-all term

Externalities are the most prominent of the so-called 'market failures' or inefficiencies, identifying which is a huge cottage industry in economics. The term 'market failure' was introduced in the economics literature in 1958 by Bator. But it is a very loose term, often reflecting government and institutional failure, not market failure.

1.18.1 *Market failure is mainly government failure*

Even to function minimally, a market needs a supporting institutional framework with at least three main functions. If these are not provided adequately, then a market will allegedly 'fail'.

1) Authentication of property rights: No market can exist if property rights are not firmly embedded in the society's institutions. Typically, this is a function of the government but courts can get involved. Failure to assign property rights is not a market failure.

2) Security and justice: The market was never expected to provide community services such as defence, police, justice and even infrastructure. That is why we have a government. The market needs many of these functions, such as contract enforcement and punishment for any fraud, in order to exist. These are lumpy public goods with *strategic behaviour*. For a government to provide such services is not a 'market failure'.

Supportive functions for markets are typically limited in scope. When a government bites off more than it can chew, it can 'fail' the market. Instead of focusing on contract enforcement and fraud protection, modern governments waste a lot of effort on things that markets can do better, possibly with some regulation, such as money supply and the supply of schools and the health system. An over-reach by government is not market failure but government failure. Many early economists were incorrect in suggesting a role for government in many such things. Adam Smith supported a role for government in infrastructure and Thomas Jefferson and Lord Macaulay's supported a role of government in the supply of education. This was an over-reach, and under certain circumstances, the private sector can deliver these functions better than any government could.

3) Regulation of 'public bads': Economic growth and prosperity through markets is not angelic, i.e. without 'unwanted' side effects such as waste.

Actions of free markets *can* harm (or benefit) third parties since all human action has unintended consequences. Even governments are not angelic and have unintended effects. Such external markets effects are not a 'failure'. A factory might pollute but it also produces goods and creates jobs and populates towns which attract doctors and teachers, which then benefit those who might experience the adverse consequences of pollution. Factories are *always* associated with human flourishing, despite a few harms they might cause. Humanity has benefited enormously (through increased longevity and prosperity) from the action of markets. One can't reduce pollution through a 'Pigovian' tax without also damaging output and jobs. As suggested earlier, once markets have achieved the optimal level of output and waste (e.g. pollution), it is up to society to further improve human welfare through political action and regulation.

The 'public bads' which accompany market action requires treatment that is largely an extension of J.S.Mill's harm principle. A government can set limits on pollution and establish pollution permits that can be traded so the lowest cost option for reducing pollution can be determined. But the term 'market failure' cannot be used to refer to pollution since the market did not fail: it produced the greatest possible output under the institutional arrangements in place. The inevitable side-effects of market action such as waste/pollution/environmental harm, require a *separate* remedy.

Societies have long recognised the existence of public bads and imposed regulations on a range of market outputs for thousands of years. In the *Arthashastra*, there were regulations for alcohol (there are many ways to do so, with prohibition generally being the worst option). The Pigovian model of taxes and subsidies will always harm society without delivering any improvement. Instead, regulatory approaches that directly deal with the consequences of human action, might well be justified.

1.18.2 *Siglitzians and other pseudo-economists*

As Adam Smith showed, the free market works wonderfully to produce wealth – and being based on voluntary action, eliminates inefficiencies such as alleged "externalities". But since the 20th century, "economists" have spent most of their time in fiddling with markets to worsen everything. Each such fiddle gets a Nobel prize.

Based on these largely fictitious models and claims, "economists" sit in their ivory tower making false assumptions to justify government intervention, e.g.

- that the poor won't educate their own children
- that people who don't take vaccines are "free riding" on those who do
- that government can magically improve "externalities".

There is a derogatory term 'Stiglitizian' to refer to such pseudo-economists who wave their arm about to justify coercive government interventions on the grounds of 'market failure':

> When Stiglitzians are confronted by an Observer with allegations of some market failure they are generally sympathetic. Stiglitzians have no great confidence in the ability of private parties to correctly assess the state of the market or to competently act in pursuit of profit to improve resource allocation. They have confidence in the ability of government officials, especially economists, to assess the state of the market and to competently design and carry out effective interventions that generate improved resource allocation. Stiglitzians' policy conclusions are very different from that of Stiglerians and Hayekians.[38]

1.19 Structure and methodology of this paper

This paper goes into detail regarding the issues outlined in this introduction. This paper is in the public domain, and I expect to continue to work on it and update it with new information, as time permits. This paper is not limited by any space constraints, therefore I quote liberally, reducing the need for the reader to leave this paper to hunt for these sources. I've done the leg work for you.

[38] https://jstor.org/stable/26617802

IDEOLOGICAL UNDERPINNINGS OF THE EXTERNALITY ARGUMENT

2. The root cause: a faith in the government and the elites

There is a natural bias that underpins everyone's views regarding the role of government in society. It is not my intention to refute Pigou's economics by refuting his ideology. However, it is important to keep in mind that Pigou was operating from a Fabian socialist mindset, whose goal was to eliminate capitalism and property rights.

How did I think of Pigou's socialist tendencies? Till a few weeks ago, Pigou was just a name to me. I knew nothing about him as a person. But when I read his 1920 book, my intuition told me something was fishy. Within days I came to know that Pigou was indeed a socialist ideologue, apart from being a bad economist.

* * *

Somewhere around the early 19th century, a 'feeling' emerged among some thinkers that markets require superintendence from a benevolent government. Even excluding the direct streams of socialism, including Marx, it infiltrated 'traditional' political economy in the line of thought emerging from Adam Smith. This feeling started forming in the mind of J.S. Mill but fully crystallised with Alfred Marshall, Pigou's teacher.

While Pigou must bear the blame for the wild goose chase of externalities and other market failures that he set the economics profession on, he did not arrive at his views in a vacuum. He merely reflected the dominant thinking of his times.

I begin by citing this passage from Pigou's essay, 'State action and laissez-faire', in his 1935 book, *Economics in Practice: Six Lectures on Current Issues*, which holds the key to the shift of economics from a discipline that sought a limited role for government to a discipline that actively sought for and canvassed a much greater role.

In this passage, Pigou, following on from Marshall, sang high praise for UK civil servants and claimed that politicians are not personally corrupt. He did want some caution, noting that politicians are subject to pressures from log rolling, but the overall worldview, or ideology was clearly supportive of a big role for Big Government.

> Adam Smith's belief in laisser-faire—so far as he was a believer in it—rested much less upon a theoretical view that, if you leave things alone, they are almost bound to work out right, than upon practical experience that, if you interfere in the sort of way in which governing authorities, as he knew them in his day, did interfere, they are almost bound to work out wrong. But this class of consideration is evidently not one that will have the same application at different times and places. Let us, therefore, look for a moment at the status of our own governing authorities now.
>
> One thing at least is immediately clear. **These governing authorities are enormously better equipped for successful action than they were in the days of Adam Smith or in the later days of Bentham.** As Marshall has well said, during the last century in England 'there has been a vast increase in the probity, the strength, the unselfishness and the resources of Government . . . and the people are now able to rule their rulers and to check class abuse of power and privilege, in a way which was impossible before the days of general education and a great surplus of energy over that required for earning a living'. The British Civil Service is an institution of high capacity and unquestioned public spirit; and the politicians who constitute the Government for which this service works—whatever else we may think about them—are never in this country personally corrupt. But these politicians are subject to great pressure from persons who can control votes. Log-rolling and lobbying are powerful forces in any democratic country, and, when government policy touches private business, they are certain to be called in play. As a result, State action, which, it may be, is really needed in the interest of the weak, is most likely to be invoked successfully by the strong.
>
> This, and not any abstract plea for laisser-faire in matters of trade, is the principal argument against attempting to divert the national energy by State action along lines other than those which it tends of itself to follow. Whatever kind of action we are contemplating, considerations of this class are relevant.

> For different kinds of action their importance is different: sometimes it is trifling, sometimes dominant. The invention of Public Service Boards and Commissions, not directly subject to political control, of which I spoke earlier, has greatly widened the range of what is practicable.

Socialism begins with great faith in the trustworthiness of government. The Fabians expressed this faith very strongly:

> The Fabians were highly confident of the fairness and effectiveness of action by the state—the nineteenth century democratic state of Western Europe and America. This state is "the representative and trustee of the people," "their guardian, their man of business, their manager, their secretary, even their stockholder." The existing state can, in these capacities, be made, without radical transformation, "if not absolutely perfect, at least trustworthy." 38 Changes are needed in the way of broadening the suffrage, securing a better trained civil service, and equalizing educational opportunities. Beyond such improvements, no fundamental innovations in political machinery are necessary. If the citizens of a democracy will simply make adequate use of powers they now possess, they can, through their national, provincial, and municipal governments, bring about gradually the appropriation by the community of all forms of economic rent from both land and industrial capital.[39]

All economics textbooks today are built on this faith. There's no countervailing discussion of its ignorance, corruption and criminality. The results are everywhere: Massive increase in government powers. There is a missing chapter in all economics textbooks, on the intrinsic problems with government.

2.1 Background: the influence of Sidney Webb and G.B. Shaw

A 1916 *History of the Fabian Society* notes that if Bentham and Mill were key representatives of individualism, Sidney Webb and George Bernard Shaw were their collectivist counterparts.

> [Re: a] book by Mr. Ernest Barker of New College, Oxford, entitled "Political Thought in England from Herbert Spencer to the Present Day."
>
> Then Mr. Barker goes on: "Fabianism began after 1884 to supply a new philosophy in place of Benthamite Individualism. Of the new gospel of collectivism a German writer has said **Webb was the Bentham and Shaw the Mill**. Without assigning roles we may fairly say there is some resemblance between the influence of Benthamism on legislation after 1830 and the influence of Fabianism on legislation since, at any rate, 1906.

I do find it inappropriate for Mill to be combined with Bentham in the above paragraph, since Bentham absolutely abjured socialism and would only countenance government intervention where the benefits were conclusively greater than costs. Nevertheless, this does show the enormous significance of Sidney Webb and G.B. Shaw to the Fabian movement. In fact, Sidney Webb together with his wife, Beatrice, were two of the most significant proponents of Fabian socialism. They were prolific writers, possibly writing thousands of pages over their lifetime. Their work set the scene for the steady shift in British policy towards socialism in the 20th century.

In a chapter entitled, "Historic" in the 1989 book, *Fabian Essays in Socialism* edited by George Bernard Shaw, Sidney Webb wrote:

> Since then the tide has turned. The publication of John Stuart Mill's "Political Economy" in 1848 marks conveniently the boundary of the old individualist Economics. **Every edition of Mill's book became more and more Socialistic.** After his death the world learnt the personal history, penned by his own hand, of his development from a mere political democrat to a convinced Socialist.
>
> The change in tone since then has been such that one competent economist, professedly anti-Socialist,' publishes regretfully to the world that all the younger men are now Socialists, as well as many of the older Professors.

---

[39] From *Recent Political Thought* by Coker (1934). https://archive.org/details/recentpoliticalt0000coke/page/120/mode/2up?view=theater

… The political economist now knows that with free competition and private property in land and capital, no individual can possibly obtain the full result of his own labor.

… Thirty years age Herbert Spencer demonstrated the incompatibility of full private property in land with the modern democratic State; and almost every economist now preaches the same doctrine. The Radical is rapidly arriving, from practical experience, at similar conclusions; and the steady increase of the government regulation of private enterprise, the growth of municipal administration, and the rapid shifting of the burden of taxation directly to rent and interest, mark in treble lines the statesman's unconscious abandonment of the old Individualism, and **our irresistible glide into collectivist Socialism**.

In 1895, George Bernard Shaw laid out the mission and policy goals of the Fabian Society[40]:

REPORT ON FABIAN POLICY.

The Mission of the Fabians.

THE object of the Fabian Society is to persuade the English people to make their political constitution thoroughly democratic and so to socialize their industries as to make the livelihood of the people entirely independent of private Capitalism.

The Fabian Society endeavors to pursue its Socialist and Democratic objects with complete singleness of aim. For example:—

Fabian Socialism.

Socialism, as understood by the Fabian Society, means the organization and conduct of the necessary industries of the country, and the appropriation of all forms of economic rent of land and capital by the nation as a whole, through the most suitable public authorities, parochial, municipal, provincial, or central.

Fabian Natural Philosophy.

The Fabian Society endeavors to rouse social compunction by making the public conscious of the evil condition of society under the present system.

Finally.

The Fabian Society does not put Socialism forward as a panacea for the ills of human society, but only for those produced by defective organization of industry and by a radically bad distribution of wealth.

Nationalization and Municipalization of Industry.

In view of the importance of losing no opportunity of transferring industrial capital from private to public control, and securing to as many wage-workers as possible the comparative independence and permanence of employment enjoyed by public servants, especially in the more democratic countries, this Congress recommends all workers to agitate and vote in favor of:

1. The immediate nationalization of all mines, railways, canals, telegraphs, telephones, and other national monopolies

2. The immediate municipalization of the supply of water, gas, electric light; of docks, markets, tramways, omnibus services, and pawnbroking; lake and river steamboat services; and of all other local monopolies;

3. The immediate undertaking by public authorities of: (a) the manufacture and retailing of tobacco and bread; of the supply of coal, milk, and other universal necessaries; and of the building of dwellings for the workers; (b) the manufacture and retailing of alcoholic drinks.

[40] https://archives.brandonu.ca/media/Text_Records/OCR_PDFs/howland_255.pdf

We find an extremely strong resonance (even overlap) between this manifesto and the works of Marshall, but more particularly the works of Pigou. I would estimate an overlap of around 70 per cent between Pigou and the Fabians' goals.

I do not intend to enter into the detailed history of Fabian socialism, but suffice it to say that Fabian socialism has been the single most important socialist movement in the world. By the early 1920s, the UK Labor Party was almost 100% Fabian, and remains so till today. Virtually everything it wanted in its many manifestos has been achieved, taking the Western world far from its roots in liberalism. For instance, the UK has become an almost entirely Fabian socialist nation. Atlee was an active proponent of Fabianism and when he became PM, the idea of liberalism came to an end in the UK.

> Twelve years after his *Labour in Perspective* appeared, Clement Attlee was to re-state: "Socialism is not just **State Capitalism**. The **taking over of an industry** is not an end in itself—it is a means of attaining freedom." "Freedom" meant the breakup into Councils, and other subsidiary groups. His book expounding the Socialism of a Fabian is a complete restatement again in 1949, as twelve years before, of the points Webb exposed in the tutorial syllabus of 1920. It preaches **total nationalization of land, industry and labor**, and of course the abolition of Capitalism. Attlee believes Capitalism might be abolished without State ownership of all industry. He suggests worker ownership and worker control—under the Party.[41]

Clement Attlee had joined the Fabian Society in 1907 and wrote about it in a book in 1937:

> The Fabian Society, essentially a middle-class body, was the antithesis of the S.D.F. **Rejecting the frontal attack, it worked by permeation**. Sidney Webb and his colleagues worked in the field of ideas. They inserted into the amorphous mass of Left opinion a Socialist leaven which worked with ever increasing results.[42]

He confirmed that the Fabians took a radically different approach to the Marxists, to achieve the same goals: via permeation, infiltration. Theirs has been the most successful social engineering project - completely undoing the foundations of Western civilisation.

A few additional points about the Fabians' enormous influence are worth noting: First, the *Economic Journal* was started by the Fabian society in 1891 and was the preferred place for publication by Pigou. Second, the London School of Economics was started in 1895 by the Fabians[43]. Third, the Fabians established the Royal Economic Society. It is important to note that although the Fabians were instrumental in the establishment of these institutions, they did allow non-Fabian ideas to also be published/considered.[44]

2.2 Was Pigou a Soviet spy? No!

Despite his very strong support for policies adopted by the USSR, I want to refute at the outset the idea that arose in the 1970s and has not yet died down, that Pigou was a Soviet spy. He was not!

For instance, in his 2009 book, Mark Skousen continued to promote the idea that Pigou was perhaps a Soviet spy. I agree with Nahid Aslanbeigui and Guy Oakes's 2015 book on Pigou (*Arthur Cecil Pigou (Great Thinkers in Economics)*) which summarises and dismisses the claim.

> *Cambridge professor of political economy Soviet spy?*
>
> On 29 May 1979, The Guardian published excerpts from a forthcoming book by Richard Deacon, a pen name used by Donald McCormick. His most sensational revelation was the accusation that Arthur

[41] https://cdn.mises.org/Fabianism%20in%20the%20Political%20Life%20of%20Britain%20-%201919-1931_3.pdf

[42] https://archive.org/details/labourpartyinper0000attl/page/n9/mode/2up?view=theater&q=fabian

[43] https://www.lse.ac.uk/about-lse/our-history

[44] https://journals.sagepub.com/doi/abs/10.1177/095269519200500403

> Cecil Pigou (18 November 1877-7 March 1959), Alfred Marshall's successor in the Chair of Political Economy at Cambridge University, was the mysterious 'Fourth Man' in the Cambridge spy ring operated by the KGB. The first three were Guy Burgess, Donald Maclean, and Kim Philby, all of whom had studied at Cambridge in the early 1930s. Working as agents at the same time that they held important posts in the Foreign Office or the intelligence services — for a time, Philby was a leading candidate for chief of MI6 — they passed secret British and American intelligence to the Soviets in the early years of the Cold War.
>
> Presumably, McCormick did not know that MI5 had already identified the Cambridge Fourth Man: Anthony Blunt, former director of the Courtauld Institute of Art in London and Surveyor of the Queen's Pictures. His accusations had a short life. A few months after they were published, Prime Minister Margaret Thatcher revealed the identity of the Fourth Man, ending speculations about Pigou's clandestine political life.

If Pigou had anything to do with spying for the USSR, we would have had plenty of documentary proofs of it by now. Anyone who claims that Pigou was a Soviet spy is converting wishful thinking into reality.

While he was not a Soviet spy, he was a passionate supporter of many aspects of Soviet economics, albeit a 'refined' branch that is called Fabian socialism.

2.3 It began with J.S. Mill's fascination with elites

The great professor of political economy, John Elliott, explained to his students that included me at the University of Southern California how Mill slipped into socialism towards the end of his life. While this was not a complete slippage, his tendency to separate mankind into two categories: the clerisy (elites) and the ordinary citizen, had started in the 1820s itself, and crystallised in the 1830s. It appears that it was after a trip to France in 1820 at the young age of 14, when influences that were outside the framework of his father's, started influencing him. One of these was his increasing love of an 'elite', a concept advocated by Carlyle.

Thus, (DN: try to locate the source for the following text)

> he sympathized in principle with Comte's idea for a picked body of persons charged with the keeping and renovation of knowledge. To Mill, the possibility of such an artificial class of authorized guardians was always attractive; he would be equally drawn to it, under a more theological description, in Coleridge's account of a 'clerisy.' In later writings he mocked the compulsive detail with which Comte elaborated the offices, the dignities and rituals, the mandatory worship by a grateful society of the secular sages of progress: an excess of speculative self-absorption of a sort that Mill could only regard with distaste. Yet the acknowledgment of an outstanding class appeared to him necessary in order to civilize democracy.

This concept of clerisy (an intellectual elite) is described in in a 2009 paper by Lynn Zastoupil:

> Coleridge's book, *On the Constitution of the Church and State*, had a deep impact on Mill. Published in 1830 as a defence of the established church in the wake of Catholic Emancipation, Coleridge's work raised several important issues for Mill. … Coleridge helped convince Mill that society requires an intellectual elite as security against the debilitating effects of a commercial culture.
>
> …Mill's defence of traditional learning hinged upon the issue of endowments. Here the debt to Coleridge is clear and precise. In 1833 Mill had written an article in which he defended endowments against the utilitarians and other reformers who wished to see them abolished. Endowments were indeed open to abuse, as their critics cried, but they also held great potential for promoting education and, more generally, the intellectual improvement of society. Pointing to Coleridge's idea of a clerisy,

> Mill argued that endowments could be used to sustain such a class whose primary responsibility would be the cultivation of learning?)[45]

2.3.1 *J.S. Mill explained why socialism won't work*

Some people claim that J.S. Mill started leaning towards socialism towards the end of his life, but I've skimmed through his chapters (published posthumously by his step-daughter) and while he thinks the goals of socialists might be commendable, he shows that they are not achievable.

> The preceding considerations appear to show that an entire renovation of the social fabric, such as is contemplated by Socialism, establishing the economic constitution of society upon an entirely new basis, other than that of private property and competition, however valuable as an ideal, and even as a prophecy of ultimate possibilities, is not available as a present resource, since it **requires** from those who are to carry on the new order of things **qualities both moral and intellectual**, which require to be tested in all, and to be created in most; and this cannot be done by an Act of Parliament, but must be, on the most favourable supposition, a work of considerable time. **For a long period to come the principle of individual property, will be in possession of the field**; and even if in any country a popular movement were to place Socialists at the head of a revolutionary government, in however many ways they might violate private property, **the institution itself would survive, and would either be accepted by them or brought back by their expulsion**, for the plain reason that people will not lose their hold of what is at present their sole reliance for subsistence and security until a substitute for it has been got into working order. Even those, if any, who had shared among themselves what was the property of others would desire to keep what they had acquired, and to give back to property in the new hands the sacredness which they had not recognised in the old.[46]

What he described above in 1880 (posthumously) applies very clearly to what has happened both in the USSR and Mao's China. The concept of private property clearly outlasted all their attempts. If only Lenin and Mao had read Mill.

2.4 Marshall, the self-declared socialist with strong sympathies for the Fabians

Marshall had strong socialist sympathies, as shown by Prof. John Elliott[47] (who was on my PhD committee), one of the most knowledgeable political historians in the world.

Elliott's book, *Comparative Economic Systems*, makes clear that Marshall and Pigou inspired socialist economists like Oscar Lange. Marshall and Pigou both wanted redistribution. They misused marginalism to "prove" socialism.

> EQUITY AND EQUALITY
>
> Of these other goals, Lange, like most Western socialists, emphasized equity and equality in the distribution of income, but on bases drawn as much, if not more, from the welfare economics of English neo-classical economists Alfred Marshall and Arthur C. Pigou than from the literature of socialism. **"Only a socialist economy," he argued, "can distribute incomes so as to maximize social welfare."** [39: 99] Under capitalism, inequality in the distribution of ownership of land and capital helps to create inequality in the distribution of income. Assuming comparability and equality in the marginal utility of income for all consumers, demand prices under capitalism do not "reflect the relative urgency of the needs of different persons...." Thus, even at its best, a capitalist allocation of resources, determined

---

[45] https://www.cambridge.org/core/journals/utilitas/article/abs/j-s-mill-and-indian-education/F4C64246BC82E2FA9117E5DAD02538A3

[46] https://archive.org/details/chaptersonsocial00mill/page/396/mode/2up?ref=ol&view=theater&q=equal

[47] https://jstor.org/stable/29769527

by consumers' demand prices, "is far from attaining the maximum of social welfare. While some are starving, others are allowed to indulge in luxury."

2.4.1 *Awareness and sympathy with the Fabians, working with Sidney Webb*

Marshall was aware of the Fabians and knew Sidney Webb at least from the early 1890s when he served on the Royal Commission on Labour.

> Marshall had served on the Royal Commission on Labour from 1891 to 1894, where he had opportunities for discussion with experts on labor issues such as Ben Tillett (1860-1943) and **Sidney Webb** (1859-1947). He returned with a strong impression of the interest and importance of labor issues and encouraged his other students as well as Pigou to study such issues.[48]

In a letter of 1901, he admitted in writing his strong sympathy with the Fabians but wanted to not have that known publicly. He wrote:

> 19.2.1901
>
> My dear Hewins,
>
> I did not answer your letter, because I thought I might meet you at the Political Economy Club, to which, by rare exception I went last Friday week. Failing that, I again delayed till I should have seen Acworth. He came here yesterday, delighted the young men's Club beyond measure by his talk about railways, and has just left. I had heard rumours that led me to think there was some danger that the economic department of the London University might be "captured" by people acting more or less in alliance with the Fabians. **I am more in accord with some Fabian opinions and aims than are many academic economists**: but I could not contemplate such a danger without grave anxiety. I have spoken without reserve on this subject to Miss Brooke and to Bowley: and I think you may have heard something of my views on it. So I write at once to say that Acworth has convinced me that my fears were based on a misapprehension.

2.4.2 *Was close to a key Fabian (Keynes's father) and knew the Webbs*

John Maynard Keynes had a preferred place in the life of Alfred Marshall since he had been close to John Neville Keynes (who has also been Marshall's student). "At the end of 1884, Alfred Marshall, then at Oxford teaching economics to Indian civil service students, was appointed as professor of Political Economy at Cambridge and persuaded Neville Keynes to fill in for his teaching duties at Oxford."[49]

Neville wrote a book in 1890 sharply criticising the competitive system.

> His [Maynard Keynes's] father, John Neville Keynes, was a professor at Cambridge [**Sanjeev: precisely, he was not a professor but Cambridge University Lecturer in Moral Sciences**], who published a book in 1890 entitled *The Scope and Method of Political Economy*. For its strictures against the free enterprise system, therein called laissez faire, the book was approved by early leaders of the London Fabian Society. It was also included on reading lists of Socialist-slanted works recommended by The American Fabian magazine to its public.
>
> Later the joint patronage of Marshall, Pigou and **Sidney Webb** (himself escaped from bondage in the Colonial Office, to become the high priest of Fabian Socialism) was responsible for making [Maynard] Keynes editor of the *Economic Journal* in 1911, and secretary of the Royal Economic Society in 1913.[50]

---

[48] https://read.dukeupress.edu/hope/article-abstract/46/3/357/12589/The-Sanguine-Science-The-Historical-Contexts-of-A?redirectedFrom=fulltext

[49] https://www.hetwebsite.net/het/profiles/nevillekeynes.htm

[50] From the 1966 book by Rose Martin, "Fabian Freeway". It appears

This para suggests that Marshall knew Sidney Webb.

I wish to note that the fact that Neville Keynes's book was recommended reading by the Fabians doesn't mean that he himself was a Fabian. We have documentary evidence of his comment on the 1889 Fabian Essays in Socialism (edited by G.B.Shaw), in which he states:

> Ther is a **good deal** in this essay ["The Basis of Socialism" – chapter entitled "Moral" by Sydney Olivier] **that I sympathise with** – but it is thoroughly one-sided. I should say the writer is an honest enthusiast, but unreasonable and conceited in his abuse of those who are not like unto himself.[51]

This short extract, however, doesn't tell us about Nevill's overall position regarding the Fabian socialism.

2.4.3 *Marshall's self-declarations about his socialist ideology*

All key elements of Fabian socialism are found in Marshall and since at least 1885 he described himself as socialist. Pigou was only taking forward the ideas of his master.

> Thus, in his famous discussion of "economic chivalry," in 1907, he writes that "much" of the work of social amelioration
>
> > can be better performed by the State than by individual effort . . . In this sense **I was a Socialist before I knew anything of economics**; and, indeed, it was my desire to know what was practicable in social reform by State and other agencies which led me to read Adam Smith and Mill, Marx and Lassalle, forty years ago. **I have since then been steadily growing a more convinced Socialist in this sense of the word**" (1956, p. 334).
>
> In a letter, in 1909, in which he considers the "Residuum" (Marshall's adopted term for those who are genuinely unemployable), he similarly writes:
>
> > My own notion of **Socialism is that it is a movement for taking the responsibility for a man's life and work, as far as possible, off his shoulders and putting it on to the State**. In my opinion, Germany is beneficially `socialistic' in its regimentation of those who are incapable of caring for themselves; and we ought to copy Germany's methods in regard to our Residuum (1956, p. 462).
>
> As long as the socialist movement proceeds gradually, and avoids rapid and thereby disruptive change, it may well serve as the banner for successful, widespread social transformation. Thus, as early as 1885, Marshall declares that in "one sense indeed **I am a socialist** for I believe that almost every existing institution must be changed" (1968, p.173). And, from the perspective of old age, he reflects:
>
> > It is probable that a future Social Order may greatly surpass the present in justice and generosity; in the **subordination of material possessions to human well-being**; and even in the promptness of its adjustments to changing technical and social conditions (1956, p. 367).[52]

In 1925, after Marshall's death, Pigou compiled many of Marshall's writings and letters. In that compilation we note that in 1907, Marshall had greatly praised the ability of government to intervene for common well-being. Marshall was socialist sympathiser and of trade unions. (This extract strongly influenced Pigou, since he cites some of it in his essay, 'State action and laissez-faire', in his 1935 book, 'Economics in Practice: Six Lectures on Current Issues'.)

> Mill had seen a **vast increase in the probity**, the strength, the unselfishness, and the resources of Government during his life; and it seems that each succeeding decade had **enlarged the scope of those interventions of Government for the promotion of general well-being** which he thought likely to work well. One of the chief causes of this improvement was a change of sentiment which had, perhaps, its chief origin in the Wesleyan Revival,

[51] https://www.christies.com/en/lot/lot-2033978

[52] https://jstor.org/stable/29769527

> as Lecky has well shown. The movement was promoted by Parliamentary reform; by the spread of education, and by increasing zeal in the Established and Nonconforming Churches; by the cheapening and improvement of literature; by the rise of co-operation, itself largely due to Owen, that **noble** if weird **prophet of socialism**; by the writings of Scott and Dickens, of Wordsworth and Tennyson, of Carlyle and Ruskin, of Newman and Maurice; and by the personal influence of Queen Victoria and of Gladstone, and other public men. [**Sanjeev: it is clear that Marshall held a favourable view of elitist writers like Carlyle and Ruskin, a sentiment which obviously flowed into Pigou's veins**]
>
> These and similar influences have co-operated with technical progress to enlarge the scope for the **beneficial intervention of Government since Mill's death** even more than during his long life. Government has now many new large and subtle resources for finding out where it can do more harm than good. Partly through the co-ordination and mutual aid of the forces of central and of local authorities, it has a much increased power of putting into effective operation any decision at which it has arrived.[53]

2.4.4 *Marshall's fishing expedition for examples of market failure*

Keynes's wrote a 1919 book entitled, *The End of Laissez-Faire*, an explicit title. In the book he explained that laissez faire was dead since market outcomes were not harmonious with alleged "social interests". Marshall was one of the earliest to work out ways to find "market failures" and other faults.

> Cairnes, in the Introductory Lecture on "Political Economy and Laissez-Faire," which he delivered at University College, London, in 1870, was perhaps the first orthodox economist to deliver a frontal attack upon laissez-faire in general. **"The maxim of laissez-faire," he declared, "has no scientific basis whatever**, but is at best a mere handy rule of practice."' This, for fifty years past, has been the view of all leading economists. **Some of the most important work of Alfred Marshall—to take one instance—was directed to the elucidation of the leading cases in which private interest and social interest are not harmonious.** Nevertheless the guarded and undogmatic attitude of the best economists has not prevailed against the general opinion that an individualistic laissez-faire is both what they ought to teach and what in fact they do teach.[54]

2.4.5 *Marshall thought that competition is a "monster"*

Capitalism is characterised by competition, from which emerges innovation, productivity, massive improvement in the welfare of society. But Alfred Marshall detested competition, called it a monster.

> Competition is a monster now grown of overwhelming strength. If we were perfectly virtuous, he would now feel himself out of place and slink away. As it is, if we resist him by violence, his convulsions will reduce society to anarchy. But, if he can be guided so as to work on our side, then even the removal of poverty will not be too great a task.[55]

There was not much difference between the sentiments of Marshall and Marx.

2.4.6 *Marshall favoured workers' cooperatives instead of private firms*

Even as Marshall demonised normal competition was demonised ("monster"), John Elliott explained that Alfred Marshall supported workers' cooperatives. Effectively, Marshall thought highly of almost everything that's part of standard communism.

> Marshall lauds cooperation for its contributions to social well-being which go well beyond industrial efficiency and business success. "The days of romantic chivalry," he laments, "are past. [B]ut there is as

---

[53] https://archive.org/details/memorialsofalfre0000mars/page/322/mode/2up?view=theater&q=socialism

[54] https://archive.org/details/endoflaissezfair0000keyn/page/4/mode/2up?view=theater

[55] https://archive.org/details/memorialsofalfre0000mars/page/322/mode/2up?view=theater&q=socialism

> loud a call as ever for courage and chivalric self-sacrifice for great and worthy ends." Cooperation, he declares, is "the great order of modern chivalry." Thus, in addition to the fact that cooperative enterprises avoid the major "evils" of both governmental and private corporative businesses, the cooperative movement deftly mediates between the "broad and strong business basis" of capitalism and the "high social aim[s]" of socialism by ("alone") combining both qualities (1956, pp. 240, 251).
>
> Marshall identifies several contributions of **workers' cooperatives** to "high social aims."[56]

2.4.7 *Schumpeter confirmed Marshall's sympathies with the Fabians*

Schumpeter has stated Marshall's Fabian sympathies, although he differed in their economics.

> In 1906 or 1907 Sidney Webb gave a course of lectures on method at the London School [of Economics], one of which I attended. If it be safe to generalize from this lecture and its tone, he must have presented in that course just about what a German *Katheder-sozialist* would have done. The lecturer said nothing about Marshall and his teaching. The implications were, however, strongly anti-Marshallian. The difference was not primarily political: **Marshall was largely in sympathy with the aims of the Fabians (as they were at that time)**; the difference was primarily one of scientific method.

2.4.8 *Marshall motivated an Economic Club which became the Royal Economic Society*

This is important information, showing that Marshall was close to the Fabians:

> The so-called "Economic Circle," which met at the house of the stockbroker Henry Raime Beeton, who was a close personal friend of such economists as Phillip Wicksteed and Foxwell, played an important part in the formation of Fabian economic ideas; and at its meetings, Shaw recalls "the conditions were practically university conditions," and Jevons' theory of utility was one of the principal topics of debate. Its members included Wicksteed, Foxwell, Edgeworth, G. Armitage Smith and, less frequently, **Marshall** and William Cunningham, in addition to the Fabians Shaw, Sidney Webb and Graham Wallas; and we are told that its meetings **led to the formation of the Economic Club in 1889, which was "organized mainly at the instance of Alfred Marshall."** [57]

Marhsall motivated the Economic Club at which all key Fabians attended. The Fabians clearly took ideas from this Economic Club, which was later converted into the Royal Economic Society. Marshall thus clearly knew, and supported the Fabian leaders. Neville Keynes – who opposed the competitive system – was chosen by Marshall as editor [DN: provide the relevant proof]

Undoubtedly, it was through Marshall that Pigou and (Maynard) Keynes became so close to the Fabians.

2.4.9 *Marshall invented the word "economics" which makes it all sound very scientific*

In 1890, Alfred Marshall created the word, "economics". Previously the link of this discipline with politics was always clear (Political Economy). I propose this was part of his strategy to institutionalize socialism. Economics seems "scientific" to us, disconnected from ideology. This is Fabian trickery at its best, since Marshall's ideology now percolates all standard courses in economics. A superb way to proselytise new students.

2.5 Pigou's fascination with Neitzsche and support for elitism and eugenics

In 1908, Pigou published a paper, "The Ethics of Nietzsche", in which he seems to have been persuaded by Nietzsche's anti-egalitarianism. The paper does not suggest that Pigou in any way opposed Nietzche's dastardly sentiments.

> He is **prepared to sacrifice one man for the good of other men** in just the same way as he is prepared to sacrifice one aspect of a man for the good of his other aspects. Hence his thesis that there

[56] https://jstor.org/stable/29769527

[57] https://jstor.org/stable/2229470

> are **gradations of rank among persons**, that "moral systems must be compelled first of all to bow before gradations of rank," and that "it is immoral to say that what is right for one is proper for another." The point is that some persons, being incapable of realizing any large good in themselves, contribute best to the goodness of the whole by remaining bad in themselves, and in their badness serving merely as means. In this category apparently Nietzsche places all the women in the world. No higher education of woman for him. "Her first and last function is that of bearing robust children." She must not in any way be "cultivated," lest her fitness for that office be impaired. And the same is true of all common people.[58]

Such sentiments underpin Pigou's support for eugenics and hierarchy of experts/central planning. Daniela Donnini Macció agreed in 2019 that Pigou was "inspired" by Nietzsche:

> Arguably **inspired** by Nietzsche's condemnation of democracy and egalitarianism, some of Pigou's writings endorsed eugenic principles and revealed an ambivalent attitude toward political and economic inequality.[59]

This elitism was also part of Alfred Marshall's worldview, in which he considered the government had the capacity to make wise decisions – a trend that started with J.S. Mill, unfortunately.

His elitism came through strongly in his works. His 2017 biography discusses it:

> Kumekawa explains that 'though Pigou set out to help the poor, he did not respect them,' and he 'saw broad segments of the population as totally unfit to make even minor decisions.'[60]

It was not too far a stretch from Neitzsche to Galton (both strands of thought which came to fruition later in Adolf Hiter). Pigou was a lifelong eugenicist, albeit who wanted some checks and balances on his remedies, definitely nowhere in the league of Hitler.

In an *explicitly* eugenicist paper entitled "Social Improvement in the Light of Modern Biology", Pigou wrote in 1907 in the *Economic Journal* (established by the Fabian society):

> This does not mean, however, that no use at all should be made of the knowledge that we already possess. There are extreme cases. Not a few medical men are urging that propagation among the obviously unfit, those afflicted with definite hereditary taints, the imbeciles, the idiotic, the sufferers from syphilis and tuberculosis, should be authoritatively restrained. No doubt our procedure in the matter should be rigorously guarded. But **occasions frequently arise when such tainted persons**, whether on account of crime or of dementia, are compulsorily passed into governmental institutions. It appears that **sterilisation** can be affected in either sex by a simple operation that carries few incidental ill-effects. Has not the time come when, with due safeguards and under proper restrictions, this method of social improvement could be recognised and employed?[61]

In his 1912 book, Wealth and Welfare (a precursor to *The Economics of Welfare*, which is largely an expanded version of the 1912 book), he had a chapter on eugenics (Chapter IV: The National Dividend and the Quality of the People). Later, in his 1920 book, *Economics of Welfare*, he had a similar chapter (Chapter X: The National Dividend and the Quality of the People) in which he discussed Galton and various theories of the types of "stocks" of people, superior and inferior. In both the 1912 and 1920 books he advocated sterilization of tainted persons:

> In sum, as the last-quoted writer states, there is little doubt that "some serious physical and mental defects, almost certainly also some morbid diatheses, and some of the forms of vice and criminality

---

[58] https://www.proquest.com/docview/2383405104?pq-origsite=gscholar&fromopenview=true&sourcetype=Scholarly%20Journals

[59] https://www.proquest.com/docview/2383405104?sourcetype=Scholarly%20Journals

[60] https://www.imf.org/external/pubs/ft/fandd/2017/06/book2.htm

[61] https://www.jstor.org/stable/2220474

> could be eradicated if society so determined." This is a conclusion of extreme importance. It is one, too, that seems prima facie susceptible, without great difficulty, of some measure of practical application. Occasions frequently arise when **tainted persons**, whether on account of crime or of dementia, are compulsorily passed into governmental institutions. When this happens, propagation might be prevented, after careful inquiry had been made, either by permanent segregation, or possibly, as is authorised by law in certain American States, **by surgical means**.'

In his 1923 Galton lecture (named after the main founder of eugenicism) he said much the same thing that he had written in 1907. In that lecture he also stated:

> Certain notable sorts of physical and mental defect found in potential parents can be recognised with reasonable certainty as congenital, and it is known that congenital or inborn defects in parents are frequently passed on to their children, or reappear in some or all of their children's children. Our omnipotent Eugenist, therefore, may with some confidence pick out a number of obviously degenerate individuals and **decree that they shall remain childless**.

An attempt has been made to suggest that Pigou was not such a bad eugenicist. Thus, Satoshi Yamazaki suggests in a 2014 paper, "An Aspect of Welfare Economics in the Formative Age: Pigou and Eugenics", that:

> The reason why he approves of segregation and serialization of those with serious and evident congenital diseases, by which he could be considered to be affiliated with negative eugenics, is not to prevent the corruption of hereditary quality and the average quality of the nation, but to eradicate people's unhappiness and wretchedness.[62]

I suggest that it is a slippery slope to justify Pigou's eugenicist proclivities. Once we admit that it is ethical to forcibly sterlise some people, there is little to stop the natural progression of logic towards others forms of totalitarianism.

2.6 Pigou the Fabian socialist/communist

I smelled a lot of (albeit rather refined) socialist thinking in Pigou's *Economics of Welfare*, and suspected he might be linked with the Fabians. While Keynes was definitely a socialist, Pigou is sometimes classified as 'progressive'[63] but in my view he was a pure Fabian Socialist. He pushed for far greater government intervention than had been ever been acceptable in standard economists before his time (excluding Marx).

I believe there is sufficient evidence to link Pigou with the Fabians. A Fabian's ideology is to avoid showing his or her true colours and to infiltrate the system. Pigou never joined the Fabian Society but knew everything about the Webbs, praised to the sky their advocacy for the USSR, and wrote a detailed document which is equivalent to a Fabian Socialist Manifesto, like Marx's Communist Manifesto.

2.6.1 *Close contacts with the Webbs*

In a paper of 2014, Norikazu Takami seems to think that Pigou was not as directly associated with the Fabians as Keynes was:

> **J.M. Keynes, who left the India Office and returned to Cambridge in 1908, had close relationship with the Fabian Society members** at King's College such as Brooke, Dalton, and Shove. Biographers of Keynes agreed that Keynes harbored sympathy to socialism in this period. In the Union debate in February 1911, he spoke in support of a motion '[t]hat the progressive reorganisation of Society along the lines of Collectivist Socialism is both inevitable and desirable' (Skidelsky 1983, 241); and when he had lunch with Beatrice Webb in 1913, Keynes described it as 'deep spiritual experience.'

[62] In the *Economic Review*, 2014, https://ideas.repec.org/a/hit/ecorev/v65y2014i2p126-139.html

[63] https://hope.econ.duke.edu/sites/hope.econ.duke.edu/files/takami-pigou-welfare-new.pdf

> Later in the essays 'Short views on Russia' and 'Liberalism and Labour' written after the First World War, he left favorable comments on socialism.
>
> Unlike many of his colleagues I have so far discussed, **there is no record that Pigou took part in the activities of the Fabian Society**; he thus seems to have distanced himself from the organization. This is in sharp contrast with his active involvement in the political campaign for free trade. Even so, it is not true that Pigou did not respond to this intramural political movement at all. For, Pigou opened lecture courses in the Economics Tripos that would have attracted students with progressive political views. Pigou gave a course on 'wages and conditions of employment' in the years 1908-09 and 1909-10; and gave a course on 'economic principles in relation to some practical problems' in the years from 1911-12 through 1914-15. *The Cambridge Review* reported on the latter course in 1912-13. Following the first introductory lecture, the course consisted of six lectures, each dealing with a separate topic. The topics were 'employers and economic chivalry,' 'the principle of the minimum wage,' 'the principle of laissez-faire in practice,' 'the housing problem,' 'advantages and disadvantages of international trade,' and 'the uses and abuses of statistical reasoning.' It was pronounced that these lectures did not require prior knowledge of economics; therefore, students who attended the meetings of the Fabian Society and other political organizations could have attended and brought some knowledge back from them.[64]

The fact that Pigou did not join the Fabian society doesn't mean much, given the objectives of the Fabian society, built on deception and subterfuge. Alfred Marshall, his teacher, was very close to the Fabians, but he himself displayed extensive knowledge of their works.

Pigou's 1905 book *Principles and Methods of Industrial Peace*, is full of references to Webb's many books on trade unionism. In 1907, the Royal Commission on Poor Laws (of which Beatrice Webb was a member) consulted him and he agreed with the minority (dissenting) position of Beatrice Webb.

> In 1907, Pigou was consulted as an academic expert by the Royal Commission on the Poor Laws, for which he composed a technical memorandum on the measurable economic costs associated with relief programs, both in terms of the size and distribution of national wealth. Pigou argued that in the first instance, the poor laws "react upon the value of people as ethical personalities," and he expressed concern about relief curtailing industrious "economic virtues." Though his memorandum, which he wrote in 1907 while traveling with Corrie, was less overt in its normative commitments than was his 1901 chapter on private charity on which it was based, his Liberal values were clearly on display. These values were **in step with those of the Commission's subsequent Minority Report, compiled largely by the Fabian socialist Beatrice Webb and researched partly by a young William Beveridge**, a rising Liberal reformer and future architect of Britain's National Health Service. Like Webb and Beveridge, Pigou endorsed both a system of aid to the poor that was differentiated according to the recipient's opportunity to be employed and a national compulsory insurance scheme.[65]

In 2012, Michael Holroyd noted in The Guardian: "In 1909 Beatrice Webb was to publish her minority report to the Royal Commission on the Poor Law, which contained a collectivist scheme that amounted to a **blueprint for the welfare state**"[66]. The fact that Pigou worked closely with one of the founders of Fabian socialism probably says it all. It may be noted that William Beveridge claimed to be liberal but was a comprehensive supporter of Fabian socialism, as his post-World War II work confirms.

---

[64] https://read.dukeupress.edu/hope/article-abstract/46/3/357/12589/The-Sanguine-Science-The-Historical-Contexts-of-A?redirectedFrom=fulltext

[65] *The First Serious Optimist, 2017.*

[66] https://www.theguardian.com/stage/2012/jul/13/george-bernard-shaw-doctors-dilemma

2.6.2 *1910s: Lectures questioning capitalism and promoting intervention*

During the period when the socialist movement was on the ascendant in Cambridge, Pigou gave lectures that questioned the free market and promoted government intervention e.g. a minimum wage.

His main writing during that period was his 1912 book, *Wealth and Welfare*.

> Unlike many of his colleagues whom I have discussed above, there is no record that Pigou took part in the activities of the Cambridge University Fabian Society; he thus seems to have distanced himself from the organization. This is in sharp contrast with his active involvement in the political campaign for free trade. Even so, it is very unlikely that Pigou remain undisturbed by such an active movement occurring in such proximity, and there is at least indirect evidence to show that he was trying to respond to this intramural political group. In these years he initiated various lecture courses in the economics tripos that appeared perfectly suited to the general atmosphere at Cambridge that has been described in this section. For example, Pigou offered a course on "wages and conditions of employment" in 1908-9 and 1909-10; and another on "economic principles in relation to some practical problems" in the years from 1911-12 through 1914-15. The Cambridge Review reported on the latter course in 1912-13: following an introductory lecture, the course consisted of six lectures, each dealing with a separate topic: "employers and economic chivalry," "the principle of the **minimum wage**," "**the principle of laissez-faire in practice**," "the housing problem," "advantages and disadvantages of international trade," and "the uses and abuses of statistical reasoning." It was announced that these lectures did not require prior knowledge from economics and were thus intended to attract a wide audience.[67]

2.6.3 *A clear bias by 1912 towards socialism*

It is important to note that this tendency of Pigou to distort the capitalist system did not arise towards the end of his life, but was evident at the beginning of his career. In his 1912 book, *Wealth and Welfare*, chapter descriptions include the following:

> CHAPTER XV
>
> STATE INTERVENTION
>
> § 4. Certain modern developments have, however, rendered governmental agencies better fitted for intervention than they were in former times
>
> CHAPTER VIII
>
> DIRECT TRANSFERENCES OF RESOURCES FROM THE RELATIVELY RICH TO THE RELATIVELY POOR
>
> § 4. Transference of this kind being thus obviously possible, inquiry must be made into the effect on the magnitude of the national dividend of (1) the fact of it, (2) the expectation of the fact of it.

2.6.4 *Pigou's fawning praise of Webbs's book on communism*

In 1936, Pigou fawningly reviewed (in the *Economic Journal*, the review was entitled, "The Webbs on Soviet Communism"[68]) a book, *Soviet Communism: a New Civilisation?*

He praised the book to the sky, and the "splendid service to social science" of the Webbs, but does find – to his credit – the over-simplification of economic analysis somewhat problematic, although some of it could be because Marshall and his own work were not cited in the book.

Extracts:

---

[67] https://read.dukeupress.edu/hope/article-abstract/46/3/357/12589/The-Sanguine-Science-The-Historical-Contexts-of-A?redirectedFrom=fulltext

[68] https://www.jstor.org/stable/2225134

Students of **economics and social institutions have for very many years been under a heavy debt to Sidney and Beatrice Web**; these for us will be their names, whatever King or Council may decree I In this, their latest work, a monument of industry, written with extraordinary clarity and vivid with the ardour of perennial youth, they win once again our enthusiastic gratitude.

The book is admirably constructed. The first volume describes machinery and organisation, the environment of man as citizen, as consumer, as producer, in respect of the vocation of leadership; the second, which is headed "Social Trends in Soviet Communism," is an account of the way in which the machine works and of its significance for life and welfare. The arrangement is excellent, and the authors command over the art of presentation supreme.

…Of course, in all these things what is attempted is often very imperfectly attained. Many of the doctors are insufficiently trained; there are not enough school buildings; not enough teachers; and so on. Moreover, from an educationalist's point of view, the strenuous inculcation into every child, however young, of the dogmatic communist creed is anything but attractive. All this must be granted. But, none the less, to have enshrined in the actual policy of a great country the doctrine that it is life, not machinery, which matters in the end, that the supreme commodity is man himself, and that the approaches to civilisation should be free to all, not a privilege of the few, is to have made a unique contribution to history. Here, if nowhere else the leaders of Russian communism have lit a candle that will not be put out.

The foundation upon which the Bolsheviks' new world is to be built is science. The outstanding fact in the mentality of the Soviet administrators is "implicit and unswerving belief, as the main instrument of achievement, in knowledge itself" (p. 948). There is an immense organisation for scientific research and an immense keenness for the latest and best in every field.

In Chapter VIII[69] eight pages are covered by the headings: "The Abstract Economist's Criticism of a Planned Economy "and "The Communist's Reply to the Economist's Criticism." Here a band of persons, variously described as "the economists of the Western world," "the deductive economists of the Western world" and "the deductive economists," are made to condemn the Soviet system chiefly upon the ground that "the operation of the price mechanism in an absolutely free market necessarily secures the maximum satisfaction then and there possible of the wants and desires of the whole aggregate of consumers" (p. 675). The Communist replies by pointing out that, as between rich people and poor people, equal money demand cannot reasonably be taken to represent equally urgent desires, and that, therefore, equilibrium under free competition does not imply maximum satisfaction. The present writer, who belongs to the Western world, and has, for a number of years, believed himself to be an economist—perhaps even, so far as the distinction has meaning, a deductive economist—confesses to some astonishment at this argumentation. **The Communists' words have so close a resemblance to these of Marshall [Sanjeev: this is a give-away: here, he agrees that Marshall was closer to the communists than Mises and Hakek cited in the Webbs' book]** the words of his colleagues of the Western world so strongly suggest a Mad Hatter's Teaparty! [**Sanjeev: here he is referring to the works of Mises and Hayek**] Indeed, for a moment in these pages Homer has nodded. Apart from the absurdity of endowing "the economists of the Western world," or even "the deductive economists" with a single voice, **to make them reason on these lines is to perpetrate a caricature**. The comparative economic effects in various conditions of systems under which private enterprise, limited and controlled in greater or less degree, is dominant, and systems under which direct State planning fills the centre of the stage, if they are to be studied at all, should be studied seriously. Knowledge is not advanced by setting rip and knocking down ninepins a century old. [**Sanjeev: his objection seems to be that Marshall's work should have been used as a basis for the "deductive economist", or his own work, since economics has moved much forward than the works of**

[69] I have extracted chapter 8 of the Webbs' book for public perusal at https://www.sabhlokcity.com/2023/12/the-webbs-refutation-of-mises-and-hayek-in-their-1935-book-extolling-soviet-communism/ so no one has the slightest confusion about the ideals of Fabian socialism.

> **Mises and Hayek which are a century old**] have But why this pother about eight pages? Homer has nodded for eight minutes only out of 1143. What does that matter in the face of his achievement? Let him nod—with his tongue in his cheek, it may be—and laugh to have shocked our primness!
>
> …**It may well be that their impressions are over-favourable, their hopes unduly sanguine**. They would, indeed, be the last to claim that their picture is final or complete. Reality has many facets. They have presented one. The student of Russian Communism will rightly seek enlightenment also from other writers of different views. But, **though the Webbs' book will not stand in his library alone, it will most assuredly stand there, and that in a place of honour.** Nor, when he looks at it and takes it down, will he be thinking only of the book itself. He will remember also, with heightened gratitude, the long list of its predecessors and the splendid service to social science, that its authors, over so long a span of years, have jointly rendered.

This is Beatrice's 1936 response:

> [? Passfield Corner]
> February 11th 1936
>
> Dear Professor Pigou
>
> We were of course delighted with your review of Soviet Communism — all the more because your very warm and, I am afraid, rather **over-appreciative account**, was accompanied by a delightful sense of humour! It is certainly **one of the most 'selling' reviews we have had** because it gives a description as well as a **criticism of our book**. [**Sanjeev: basically, that Marshall and Pigou were not adequately cited**] We quite agree with your own one or two demurrers. Whether we have over-estimated the success of the U.S.S.R. the event will prove.[70]

His claim that Marshall's deductive economics supported the communists and should have been referred to, instead of the "Mad Hatters" Hayek and Mises, is the strongest evidence of his alignment with Fabian socialism.

Note: The deduction I make that Pigou thought of Hayek and Mises as Mad Hatters is because the Webb book explicitly cites these two authors (among others):

> We may cite, as the most serious of the economic examinations of the Plan …The two volumes edited and contributed to by Professor F. A. Hayek, entitled respectively *Collectivist Economic Planning and Economic Planning in Soviet Russia* (mainly by Boris Brutzkus), 1935, deserve attention as the most competent of the adverse statements. … The communist may safely admit that, *if it must be accepted that personal satisfaction is accurately measured by retail price, the conclusions of Professor Mises and Professor Hayek are correct.* But it is obvious that, in a population having unequal incomes, they are **glaringly at variance with the facts.**

It is worth noting that volume 2 of the Webbs' book starts by citing Karl Marx and Lenin:

> SOCIAL TRENDS IN SOVIET COMMUNISM
>
> "The philosophers have only interpreted the world: our business is to change it." KARL MARX
>
> "In order to manage successfully, in addition to being able to convince, and in addition to being able to conquer in Civil War, it is necessary to be able to organise. This is the most difficult task, because it is a matter of organising in a new way the most profound economic foundations of life of tens and tens of millions of people. And it is the most grateful task, because only after it is fulfilled, in its main and fundamental outlines, will it be possible to say that Russia has become not only a soviet but also a socialist republic." LENIN

[70] https://archive.org/details/lettersofsidneyb0003webb/mode/2up?view=theater&q=pigou

2.6.5 *Claim that inequality of income causes "social loss"*

In his essay, 'State action and laissez-faire', in his 1935 book, 'Economics in Practice: Six Lectures on Current Issues', Pigou's socialist tendencies show up. He makes the claim that inequality of income can cause a social loss. So let's confiscate Taylor Swift's income?! This claim has no basis in economics. It is purely an ideological claim.

> There is also an important disharmony of distribution. Prima facie all large inequalities of income entail **social loss**. for the ninth course of the plutocrat's dinner, despite the indirect benefit that it may confer on his doctor, yields much less satisfaction on the whole than the milk which the cost of it might have secured for a poor man's child. [71]

Bad argument! Economics does not say any of that!

2.6.6 *Recommendation for ultra-progressive income taxation*

Following on from this wild claim that inequality reduces GDP, Pigou advocates extreme taxation of the rich.

> … Here the State planner has the good wishes of all humane men. But, none the less, he must always be on his guard. He must not, in his eagerness to improve the distribution of income, so act as to dry up the sources from which it is produced. This is a very old problem. Economists to-day are, I think, agreed that taxes on the rich for the benefit of the poor can be pushed much further than their predecessors supposed without serious damage to production
>
> Economists to-day are, I think, agreed that taxes on the rich for the benefit of the poor can be pushed much further than their predecessors supposed without serious damage to production.

Like the 97.5% marginal income tax rates seen in India during Indira Gandhi? He's unambiguously a socialist.

2.6.7 *Pigou's 1937 Fabian socialist manifesto*

In his 2017 book, *The First Serious Optimist*, Ian Kumekawa wrote:

> **"Stimulated" by** noted Fabians Beatrice Webb and Sidney Webb's glowing book on Soviet Communism, Pigou wrote (though never delivered) a series of lectures about the economic implications of socialist planning.

This inspiration from the Webbs' book was also noted by Louis Leo Snyder in 1938:

> Under capitalism the incentive of private profit-making is extraordinarily strong, based as it is upon what appears to be a normal desire. In Russia, however, the new regime has aroused a tremendous enthusiasm for work upon the part of manual wage earners by introducing into industry the sport motif, which challenges one factory group to beat the output of another. **Drawing heavily upon the Webbs (*Soviet Communism*)**, Professor Pigou believes that it may be possible to solve the problem of incentive under socialism, although he warns that it would be rash to expect an equal response in Russia after the new order has become established and commonplace.

Pigou corresponded with the Webbs, who greatly praised the Soviet Gosplan and encouraging Pigou to publish his popular lectures on "socialist central planning":

> Passfield Corner
> Liphook
> Hants
> 19th January 1937

[71] https://archive.org/details/economicsinpract0000pigo/page/120/mode/2up?view=theater

Dear Professor Pigou

Very many thanks for your most concise and witty answer to my question.

One reason for my interest in these technical terms used by the opponents of socialist planning is, that we are thinking of a little book entitled *The Unexpected in the Economics of Socialism as Applied in the U.S.S.R.* Certainly to us the use of currency (perhaps you have read my husband's article in the *Political Science Quarterly*?) and its relation to saving and pricing, and the absence of any relation to foreign trade, was quite unexpected; also the success of the self-governing workshop, the collective farm, and the consequent appearance of a free market and free contract always supervised by Gosplan. Moreover, who would have imagined that in the first socialist state you would have had this mass movement in favour of increased productivity by the lowering of labour costs, and the frantic effort to increase mechanisation. Poor Citrine, (the General Secretary of the Trade Union Congress) was terribly distressed to discover that the trade unions who administer the artificial wage fund are insisting on piece work, costing, shock workers' brigades, and every other device which can be invented to increase productivity relatively to the number of persons employed! Also the trade unions encourage production by prisoners and the Red Army — it all adds to the wage fund by diminishing expenses. Such is the effect of the absence of the landlord and the capitalist!

It is this **socialist competition**, accompanied by the obligation to bring all your defeated rivals, whether individuals or factories, up to your own level of productivity, which is now ensuring the **success of Gosplan**. Then again, we socialists have always considered that the nationalisation of the means of production, distribution, and exchange was the main principle of socialism. Now we discover that it is the **exclusion of the profitmaker**, whether employer, trader, or financier, which is the fundamental principle of collectivism. Indeed, so far as one can see, there will be a far larger distribution of the instruments of production among individuals and groups of individuals than in any capitalist country in the world. **All that is needed is the nationalisation of land and the key industries**, whilst **penalising all forms of profit-making** by individuals or groups of individuals, and the requirement from every able bodied man and woman of their contribution towards the national income to be used for national defence, social services. cultural development, scientific research, an artificial wage fund and governmental expenses.

Forgive this lengthy reply. It needs no answer.

We should very much like to see any report of **your popular lectures about Socialist Central Planning**, and I do hope you will print them. I think there would be a large demand for the book.

Always yours

Mrs Sidney Webb[72]

His lectures (never delivered, although these were said to be "popular", so there might be a conflict of facts here between Beatrice Webb and Ian Kumekawa) were published in 1948 as a book, *Socialism vs Capitalism*. In this extract I recognise everything that Fabian socialist Nehru did to destroy India. This extract reads like a Fabian Socialist Manifesto, with high praise for Soviet Russia, and advocacy for nationalisation, albeit gradually.

My annotations and comments in colour, below. This is the single most damning proof of Pigou's ideology.

> If, then, it were in the writer's power to direct his country's destiny, he would accept, for the time being, the general structure of capitalism; but he would modify it **gradually**. [**Sanjeev: this gradualism is Fabian socialism**] He would use the **weapon** of graduated **death duties** and graduated income tax, not merely as instruments of revenue, but with the deliberate purpose of **diminishing the glaring inequalities** of fortune and opportunity which deface our present civilisation. **He would take a leaf from the book of Soviet Russia** and remember that the most important investment of all is investment in the health, intelligence and character of the people. To advocate 'economy' in this field would, under his government, be a criminal offence. All industries affected with a public interest, or

[72] https://archive.org/details/lettersofsidneyb0003webb/page/416/mode/2up?view=theater&q=pigou

> capable of wielding monopoly power, he would subject at least to public supervision and control. Some of them, certainly the manufacture of **armaments**, probably the **coal** industry, possibly the **railways**, he would nationalise, not, of course, on the pattern of the Post Office, but through public boards or commissions. The Bank of England he would make in name—what it is already in effect—a public institution; with instructions to use its power to mitigate, so far as may be, violent fluctuations in industry and employment [**Sanjeev: He believed in Keynesianism**]. If all went well, **further steps towards nationalisation of important industries would be taken by degrees**. In controlling and developing these nationalised industries, the central government would inevitably need to **'plan' an appropriate allocation for a large part of the country's annual investment in new capital**. [**Sanjeev: The Communist 5-year plans, so popular in India**]

In a 1990 paper, Nahid Aslanbeigui summarised Pigou's (and Keynes's) support for soviet socialist policy:

> A simple glance at the Soviet union, for instance, proved to Pigou that government intervention had evoked "tremendous enthusiasm for work on the part of manual wage-earners". To generate such enthusiasm in a market economy, Pigou advocated progressive income and inheritance taxes in addition to government control and/or nationalization of some key industries for which he also prescribed some appropriate form of planned investment. These measures won Keynes's approval.[73]

Reviews of Pigou's 1937 book confirm my reading that this is a socialism-supporting document, overall. For instance, a 1938 review notes:

> On most counts **Professor Pigou finds, on balance, some net advantage of socialism over capitalism**, though in some cases it is slight and tentative. Assuming that the state will take over productive resources not by confiscation but by purchase, he concludes that there need be no fear as to the effect, direct or indirect, of socialism on capital formation, and that "**the case for socialism as a remedy for inequalities of distribution among persons is much stronger** than, at one stage of our discussion, it seemed to be."…
>
> On the other hand, **in the handling of the unemployment problem socialism, with centralized planning, would have definite advantages over capitalism**….
>
> In his final "confession of faith" Professor Pigou says that if he had power to direct his country's destiny he would accept for the time being the general structure of capitalism but **would modify it gradually**. But, "he would add, in large capitals, a final sentence that gradualness implies action, and is not a polite name for standing still."[74]

Another 1938 review notes:

> how can the rival systems solve urgent problems, supposing that Socialism can be as workable as Capitalism? **The balance of this argument is turned in its favour.** Even if capital is expropriated at a fair price, so that there is no immediate effect on distribution of wealth, there will be a new starting point, so that **future inequalities will be restricted**; and this without necessary reactions on savings, because the State will arrange that for itself. These is a slight advantage for Socialism in respect of the allocation of resources, turning on the fact that the control of private monopoly is a social cast, which would be avoided. And also **in respect of unemployment**; because of a better regard to social costs, the better co-ordination of centralised data, the clearer
>
> It is no surprise, therefore, that Professor Pigou ends in a modest programme. He would deliberately use taxation to lessen inequalities; well, that is a fine point between motives and other conditions. Graduated taxation came about because of the fiscal needs of a social programme under Free Trade, but it also veiled the **motive of equalisation**. Then, he wishes to have monopolies controlled; our Common Law, seriously defective in this respect, even if not on the whole favourable to monopoly, is now embarrassed

[73] https://www.jstor.org/stable/1059363

[74] https://www.jstor.org/stable/2278928

> by the fact that the Government has itself set up monopolies, and some kind of special Tribunal has long been urged. It is a bolder suggestion to nationalise the armaments industry, "probably the coal industry, and possibly the railways."[75]

In his 1938 review, Wassily Leontief wrote:

> This book may well be entitled A Modern Economist's Reflections on Socialism.... Professor Pigou discusses in eight well balanced chapters the main practical and theoretical aspects of socialist economics and **arrives at the conclusion in favor of gradual socialization**.[76]

In a note published in The American Political Science Review in 1938, Selig Perlman noted his many justifications for socialism:

> He affirms socialism's superior ability to equalize the distribution of wealth…. A socialistic society is also superior in combating unemployment… it can also remedy more readily the "stickiness" of money wage-rates. Professor Pigou brings out that capitalism's score in respect to an "appropriate" allocation of productive resources (that is, in harmony with its distribution of income) is far from brilliant and that socialism could do at least as well.[77]

2.6.8 *Pigou's communist "price system"*

I wish to single out one particular point made in Pigou's 1937 book. Pigou imagined that a central planner could create a "substitute" for the price system. The ultra-communist Leontief appreciated Pigou's "mock" price system in which the government mimics the price system – despite Leontief clearly displaying awareness of Mises's work.

> With great precision and clarity Professor Pigou describes the structure and operation of the hypothetical price system in a socialist economy. (The theoretical possibility of such a system, Professor Mises' objections notwithstanding, can be considered by now to be definitely established.) Following the path indicated by Dr. Lange and other authors, he visualizes it as a system of fictitious accounting prices and interest rates. Having in mind a strictly equalitarian system of income distribution, Professor Pigou introduces a new concept of "accounting wages" : although the actual renumeration of different types of work in his socialist society will have nothing to do with the specific productivity of corresponding professions, the autonomous socialist business managers will be expected to calculate their cost on the basis of special accounting wage rates adjusted by a central planning board in such a way as to equate the demand for particular types of labor to the available supply. The supply in its turn is to be determined by the planning authority. "When it has decided, for example, that so many doctors are required it chooses the youths to be trained for doctors". Professor Pigou apparently does not put much stock in Marshallian concepts of subjective disutility of labor.[78]

Given this, it would be even fair to think of Pigou as a full-blown communist as far as his understanding of price system is concerned.

---

[75] https://www.jstor.org/stable/2225478

[76] https://www.jstor.org/stable/1806802

[77] https://www.jstor.org/stable/1949155

[78] https://www.jstor.org/stable/1806802

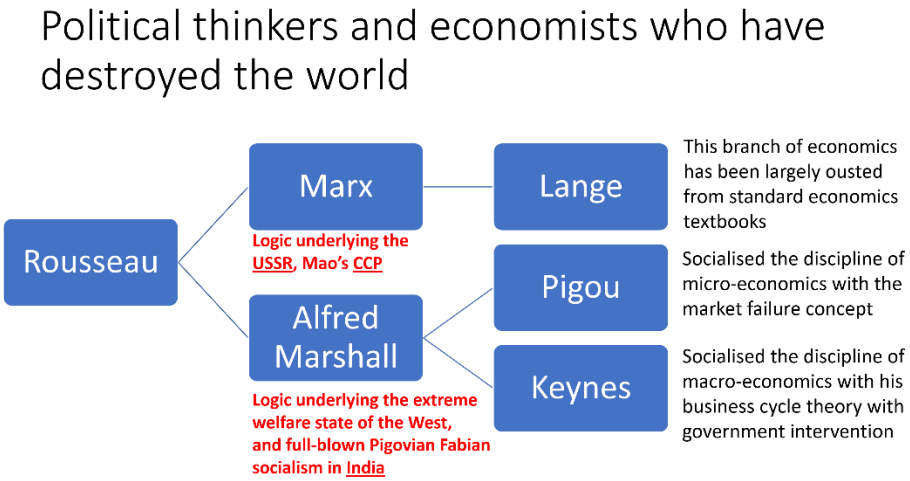
2.6.9 *More radical than Sidgwick or Marshall*

Pigou had precursors in Sidgwick, but Roger E. Backhouse wrote in 2006 that "Pigou was more radical [than Sidgwick]."[79] Further, Norikazu Takami's paper notes that "Pigou did not share Sidgwick's caveat that redistributive measures would involve strong adverse effects on incentives".

And as we have already seen, he was far more radical than Marshall. Norikazu Takami's paper notes that "in his biography of Alfred Marshall, Peter Groenewegen (1995, 598) described Marshall's attitudes on income distribution as the ones that emphasize self-help and mutual voluntary assistance over government action".[80]

2.7 Summary of thinkers who have destroyed the world

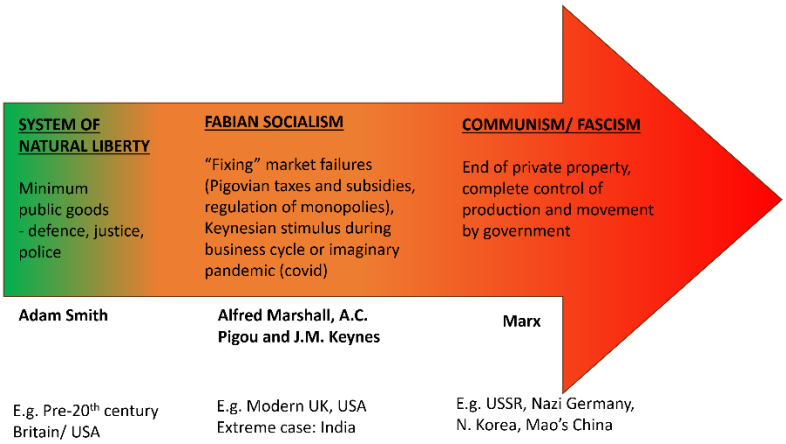
The main bias of the socialists is the belief that governments are miraculously competent and honest. The following high-level summary can guide our understandings. A lot of detail has been simplified in this schematic chart.



Another depiction, below:

[79] https://read.dukeupress.edu/hope/article-abstract/46/3/357/12589/The-Sanguine-Science-The-Historical-Contexts-of-A?redirectedFrom=fulltext

[80] https://read.dukeupress.edu/hope/article-abstract/46/3/357/12589/The-Sanguine-Science-The-Historical-Contexts-of-A?redirectedFrom=fulltext



J.S. Mill started looking inside the dark chamber of socialism. Alfred Marshall opened the door to state intervention by an "efficient" government. Marshall's student Pigou rushed in and justified a strong take-over of the economy by the State. Also, his other student, Keynes.

2.8 But Pigou's economics stands or falls without reference to ideology

Marx wanted the total and immediate overthrow of capitalism. Pigou wanted the total but gradual overthrow of capitalism. Both provided incorrect, if not fraudulent arguments in support of their claims.

Pigou has won because economics has ousted Marx, while not just retaining Pigou but elevating him to a pedestal, as the man who showed how flawed markets are. His work is so deeply embedded in economics today that it is hard to know what classical economics looks like, any more.

Nevertheless, for the rest of this paper, I move on from Pigou's ideology. While Pigou's ideological stance is crucially important to have at the back of the mind, his economics stands or falls based on the merit of his arguments.

The rest of this paper focuses on his economics.

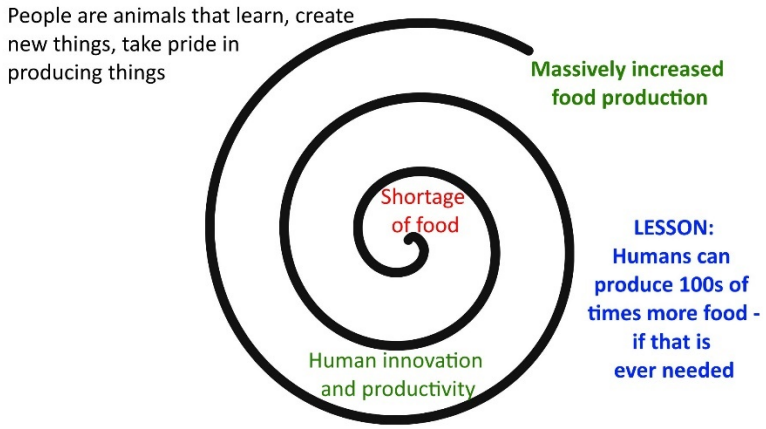
REFUTATION OF THE GAP BETWEEN SOCIAL AND PRIVATE COSTS/ BENEFITS

3. #1: Refuting the biggest alleged negative externality: population

To set the stage for refuting the ridiculous arguments propounded by Fabain economists for government to get involved in 'fixing' so-called negative externalities, it is useful to begin with the biggest such alleged negative externality: population.

Population has been provided in innumerable books and writings as a major example of negative externalities. We are told that food is a constraint (Malthus), but others will tell us that population growth makes people poorer, reduces education levels and health. "Scientists" (who typically have no understanding of economics) claim that the Earth will not be able to sustain many people.[81]

Of course, by now we know that food is not a constraint. The way we look at the world depends on the model inside our head. If we are like Malthus, we think of humans as rabbits that multiply and run out of food. But if we think through carefully (as William Godwin and Bastiat, and later Julian Simon did), we'll see population as the ultimate resource.



Julian Simon said it succinctly in his book, *The Ultimate Resource 2*:

> 1. An additional person **causes not only costs but also benefits** for others in a variety of ways …. The central question may be expressed quantitatively: Which are greater in various years following a child's birth, the costs or the benefits to others? Once we know whether these 'external' effects are positive or negative in any given year, we must next ask: Are the external effects large or small compared with other costs and benefits in the economy?
>
> 2. The burden upon the community of an additional child **depends very greatly upon the nature of the economic-political system**. In Chinese cities, where housing and transportation systems are owned by the government, an additional child imposes a much larger burden upon others than in the United States, where schooling is the only major cost of a child that the parents do not pay from their own pockets. If the parents pay the full costs of a child, their individual childbearing decisions are likely to be optimal for the community at large.

[81] Isaac Asimov put the limit of sustainability at 5 billion people in a 1988 interview: https://www.youtube.com/watch?v=qkaobW8UNXo

3.1 William Godwin's 1820 refutation of population externalities

Although the idea of 'externalities' had not come into place, it was implicit in Malthus's arguments – that food would run out as the number of people increased, causing famine and death.

William Godwin was the first to challenge Malthus. In his book *Of Population* in 1820, Godwin wrote:

> It is not a little extraordinary, that Mr. Malthus's book should now have been twenty years before the public, without any one, so far as I know, having attempted a refutation of his main principle.
>
> I hold Mr. Malthus in all due respect, at the same time that I willingly plead guilty to the charge of regarding his doctrines with inexpressible abhorrence.[82]

3.1.1 *Godwin saw man as the ultimate resource, well before Julian Simon*

He wrote:

> Man is the only animal capable of persevering and premeditated industry, with the fruits of which the land and even the water of our globe are interspersed and adorned. Man is the only creature susceptible of science and invention, and possessing the power of handing down his thoughts in those permanent records, called books. Man has in him the seeds of sentiment and virtue, and the principle of comprehensive affections, patriotism and philanthropy. The human species is capable of improvement from age to age, by means of which capacity we have arrived at those refinements of mechanical production and science, which have been gradually called into existence; while all other animals remain what they were at first, and the young of no species becomes better or more powerful by the experience of those that went before him.
>
> It cannot be but that a being so gloriously endowed should be capable of much enjoyment and happiness. Our tastes and our judgment are fitted to add indefinitely to our pleasures: we admire the works of God and the works of man. Our affections are to us a source of enjoyments, variegated and exquisite. Self-approbation and self-complacency are main pillars of human happiness. The consciousness of freedom and the pride of independence are inexhaustible sources of joy. There is a peculiar and an inexpressible delight which belongs to perseverance and a resolved constancy in the operations of science, in the cultivation of mind, and in a course of virtuous action. We are delighted with these things in solitude and intent application; and society in such pursuits increases our delight.

He was in awe of human ingenuity and intellectual prowess:

> It is one of the most certain features of human progress, the invention of machinery; and there is no reason to suppose that there is **any species of industry, which may not ultimately be abridged** by the application of this faculty.

3.1.2 *Godwin believed that we need to love our fellow humans*

Malthus's main focus in his works was to eliminate any charity towards the poor, who needed to be wiped out from the planet. This hatred for the poor subsequently converted into eugenics and later, the passion for aggressively reducing population by CCP, Indira and Sanjay Gandhi in India, and now Bill Gates.

Instead, he wanted to remind us of the need to respect fellow human beings.

> The lessons of Christianity on this subject are plain and incontrovertible. We are there taught to 'love our neighbours as ourselves,' and to 'do unto others as we would they should do unto us.' When an ingenuous young man came to Jesus Christ, desirous to be instructed in his duties, he was referred to the commandments; and, having answered, 'All these have I kept from my youth up; what lack I yet?'

[82] https://oll-resources.s3.us-east-2.amazonaws.com/oll3/store/titles/1720/0876_Bk.pdf

> Christ bade him, 'Go, sell all that he had, and give to the poor:' upon which 'the young man went away sorrowful; for he had great possessions.'
>
> There is a kind of Oriental boldness in this, at least considered as a general exposition of the moral law: for it would be reasonable to answer, If it is my duty to render the greatest benefit to my fellow-creatures, and if my mind is well prepared to discharge this duty, it will probably be better done, by my devoting my income to this purpose, than by at once divesting myself of the-principal.
>
> But nothing can be more clear than the general tenour of revelation in this question. By it we are instructed that we are stewards, not proprietors, of the good things of this life, we are forbidden to pamper our appetites or our vanity, we are commanded to be fellow-workers with and impartial ministers of the bountiful principle of nature, and we are told that, when we have done all, we have done nothing of which we have any right to boast.

And:

> We return to the morality of our ancestors. We return to the morality of the Christian religion, and of all the religious leaders and legislators from the beginning of the records of mankind. Wherever I meet a man, I meet a brother. I recognise in him the image of the all-perfect. I see a creature, 'fearfully and wonderfully made,' and admire the exquisiteness of the workmanship. I do not think of effacing God's image, or of neglecting and superciliously setting light by that on which he has affixed his seal. I do not seek to suppress the most natural impulses of a human being, and turn the world into a great monastery.

3.1.3 *Malthusian ethics is harmful and dangerous*

He wrote:

> This speculation brings us back to the feelings of unsophisticated humanity, which it is the clear tendency of Mr. Malthus's theory to expel out of the world. He says, No, eve must not increase the happiness of our contemporaries, lest by so doing we should immeasurably increase the candidates for happiness and subsistence. He would sent generation, that he may kill the next.

And:

> …what extravagant and monstrous propositions the human mind is capable to engender, when once men shall be prompted, upon a fable, a gratuitous and wholly unproved assumption, to build a system of legislation, and determine the destiny of all their fellow-creatures.

We are reminded of CCP's one child policy and Sanjay Gandhi's coercive sterlisation of the poor in India.

3.1.4 *Both of Malthus's assumptions are false*

He explained that both assumptions of Malthus were false:

> The fundamental error of Mr. Malthus's system, as far as the constitution and structure of man, independently of the geometrical ratio, is concerned, seems to me to lie in two propositions, which were explicitly stated in the first edition of his book.
>
> …These are, 'First, that food is necessary to the existence of man; and, secondly, that the passion between the sexes is necessary, and will always remain nearly in its present state.'

3.1.5 *The false assumption of food scarcity*

He refuted at great length the idea of any food scarcity. Productivity and innovation would eliminate any such constraint. Nature is abundant, full of resources.

> Nature has presented to us the earth, the *alma magna parens*, whose bosom, to all but the wild and incongruous ratios of Mr. Malthus, may be said to be inexhaustible. Human science and ingenuity have presented to us the means of turning this resource to the utmost account. 'Rest, rest, perturbed spirits!' **Your anxieties are vain**, and infinitely more senseless than those of the proprietor of a province, who

should fear that, by some unexpected turn of fortune's wheel, he should be compelled to die in a workhouse.

Plenty of land

Mr. Malthus repeatedly calls our attention, and with great propriety, to the period when the whole earth, or any considerable division of it, shall be 'cultivated like a garden.' **Till that shall be the case**, it is perfectly clear that there can be **no permanent deficiency** in the means of subsistence, except what is produced by the restrictions imposed on us by human institutions.

The abundance of the sea

To the speculations already mentioned upon the means of human subsistence, is to be added the sea. The sea occupies two-thirds of the surface of the globe: it is every where full of animal life, and nearly all that life may be rendered subservient to human subsistence. This is a species of crop that we are not called upon to sow; it needs no manure; and the farmer who takes care of it, will seldom have occasion to observe the face of the heavens, and send to the parish-minister to solicit a prayer for fine weather, or a prayer for rain. There is no long watching the progress of growth, but one fine day will be sufficient for him to bring in his stores.

Productivity

OF THE IMPROVEMENTS OF WHICH THE PRODUCTIVENESS OF THE GLOBE FOR THE PURPOSES OF HUMAN SUBSISTENCE IS CAPABLE

To the improvements of man, more particularly in art, and the application of human industry, there is no end. No sooner therefore shall we have got rid of the geometrical ratio, and the still more absurd doctrine (if indeed there be any degrees between these) of 'population necessarily and constantly pressing hard against the limits of subsistence, from the present moment to the time when the whole earth shall be cultivated like a garden,' than our prospects will grow very cheering indeed.

… as far as the laws of nature are concerned, there is no difficulty arising from the increasing numbers of mankind, if there be any increase, till a very remote period. The idea of 'pressing hard against the limits of subsistence,' where the cultivation of the earth is understood, and as long as there shall be any portions of a country cultivable, and not yet cultivated, is, I trust, banished for ever.

In the first place then I would observe, that, after what has been stated, it will hardly be denied, first, that the food produced in England and Wales, if equally distributed, is more than enough for the present number of the inhabitants; or, secondly, that many tracts of land in these 'countries might be rendered more efficient for the subsistence of man, than they actually are.

Further:

Mr. Coke's Norfolk estate, when he came to the succession more than forty years ago, was regarded as some of the worst land in the country. A great part of it was leased out at three shillings an acre. The entire rental amounted to £2200 per annum. By his example and encouragement its produce is now so far raised, that it may serve as a sort of model to the whole island. The rental has increased **ten-fold**: the cultivators are happy: the population is tripled. They have no longer need for a poor-house, which has accordingly been pulled down. The very land, which was lately an object of so much contempt, now produces five or six quarters of wheat, and ten of barley, per acre.

…Thus we see that by a very simple process, the example of which we have under our eye, the produce of our island might be **much more than doubled**.

Creating food out of the elements

All the substances that nature presents, all that proceeds from earth or air, is analysed by us into its original elements. Thus we have discovered, or m ay discover, precisely what it is that nourishes the human body. And it is surely no great stretch of the faculty of anticipation, to say, that whatever man can decompose, man will be able to compound. The food that nourishes us, is composed of certain elements; and wherever these elements can be found, human art will hereafter discover the power of reducing them into a state capable of affording corporeal sustenance. No good reason can be assigned,

> why that which produces animal nourishment, must have previously passed through a process of animal or vegetable life. And, if a certain infusion of attractive exterior qualities is held necessary to allure us to our food, there is no reason to suppose that the most agreeable colours and scents and flavours may not be imparted to it, at a very small expence of vegetable substance.

In this he anticipated the Beyond Burger by 200 years, and it is certain that man will one day be able to extract food from rock, once unlimited fusion energy becomes available.

3.1.6 *The false assumption of unrestrained reproduction*

In his introduction to William Godwin's 1976 edition of Enquiry Concerning Political Justice, Isaac Kramnick wrote

> The only important book produced in these two decades was his study *Of Population* in 1820. In this work he answered Malthus, who in *An Essay on the Principle of Population* had criticized Godwin's utopian vision of men **conquering sickness and even death through reason**. What would such numbers subsist on, asked Malthus? Godwin's *Of Population* suggested that **rational man would sense the folly of unlimited procreation and self-consciously limit population growth in the victory of reason and intellect over passion**.[83]

Although he did not quite understand all the factors that operate, Godwin recognized that human fertility is *controlled*. And the controller is the woman.

> Let us grant then, that the laws of chastity in civilised countries are more rigidly observed by the women than the men: what is the reason of this? Not that they have more energy of understanding, or weaker passions, than ourselves: but simply on this account, because they are more under the influence of 'moral restraint.' In this affair of 'the passion between the sexes,' which Mr, Malthus puts on a level with the appetite of hunger, and seems to suppose that we have as little reason to believe, that any considerable variety can be produced in the
>
> operation of the one as of the other, the women have more cogent reasons of self-interest and self-preservation than we have, to submit to the regulations of a strict morality. Still it is reason, and reason only, that restrains them, that power of which Mr. Malthus speaks with so much contempt, and respecting which he says, that 'the error which pervades Mr. Godwin's whole work,' is the considering man too much in the light of a being purely rational.
>
> Nothing then, I think, can be more clear, than the immense power possessed by this principle of 'moral restraint;' and nothing more irresistible, than the inference that, if as powerful motives to forbearance can be presented to the minds of the male sex as of the female, the operation of those motives will not be less conspicuous and certain.

3.2 Bastiat's 1850 refutation of population externalities

In his 1850, while JS Mill (influenced by Malthus) was spouting anti-population rhetoric, Bastiat wrote in his book, *Economic Harmonies*. Although he does not seem to be aware of William Godwin's works, some of his arguments mimic Godwin's, although Godwin dug deeper into the issue of food production and checks on fertility.

3.2.1 *Malthus's ignored human capacity for progress*

Bastiat writes:

> It may be that I do not entirely share Malthus' opinions. There are two sides to every question, and I feel that Malthus kept his attention fixed too much on the dark side.

---

[83] https://archive.org/details/enquiryconcernin00godw/page/16/mode/2up?view=theater

We have seen that progress consists in making the forces of Nature serve more and more as means for the satisfaction of our wants, so that in each successive age the same amount of utility is obtained at the cost of less effort, leaving at the disposal of society either increased leisure or a greater supply of labor for providing new satisfactions.

…[regarding the] theory of Malthus; but it seems to me that there is **one attribute of man** to which he, like most authors, has not attached the importance it deserves. It plays a very great role in the phenomena of population, it solves a number of the problems that this great question raises, and it renews in the soul of him who loves mankind the assurance and confidence that an incomplete understanding of political economy might have shaken. This attribute, which, moreover, is included in our notions of reason and foresight, is perfectibility. **Man is perfectible**. **He is capable of improvement** or degeneration. If, in a strict sense, he is capable of remaining stationary, he is also capable of moving up or down the endless ladder of civilization. This is true of individuals, of families, of nations, and of races.

Malthus did not fully appreciate this capacity for progress.

3.2.2 *Human means of existence are constantly expanding*

Bastiat writes:

Population, it has been said, tends to keep at the level of the means of subsistence. Let me note that for this term, the means of subsistence, once universally accepted, J. B. Say has substituted another term that is much more accurate: the means of existence. At first glance it would appear that subsistence alone is involved in this question. Such is not the case. Man does not live by bread alone, and a study of the facts shows clearly that population stops increasing or declines when the sum total of all the means of existence, including clothing, housing, and the other things that climate or even habit render necessary, becomes insufficient.

We must say, therefore: Population tends to keep at the level of the means of existence.

But **are these means a fixed, absolute, uniform quantity? Certainly not**. As civilization improves, man's wants become greater, even for his mere subsistence. Considered from the point of view of man as a perfectible being, the means of existence, among which must be included the satisfaction of moral, intellectual, and physical wants, permit of as many varying degrees as there are in civilization itself, that is, an infinite number. Undoubtedly, there is a lower limit: the satisfaction of hunger and a certain amount of protection against cold are basic necessities for the maintenance of life; and we can observe life at this level among the Indians in America and the poverty-stricken in Europe.

... Once natural wants are satisfied, others arise that are artificial at the beginning, if you will, but which in their turn become natural through the force of habit, and, when they are satisfied, others arise, and still others, with no discernible end.

Hence, with every step that man takes along the road of civilization, his wants become more extensive, and his means of existence, which we may call the point at which the great laws of increase and limitation meet, keep pace with his wants. For, although man is capable of degeneration as well as improvement, he naturally turns away from the one and aspires toward the other. **His efforts tend to keep him from falling back from the heights that he has already won and to raise him even higher**; and habit, which has so well been called second nature, acts like a valve in our arteries to block any backward movement.

3.2.3 *Poverty is receding, plenty is increasing*

As a consequence, Bastiat was certain that there would never be a scarcity of food:

If it were true, as Malthus says, that for each increase in the means of existence there is a corresponding and greater increase in population, the poverty of our race would necessarily be constantly on the increase, and civilization would stand at the beginning of time, and barbarism at the end. **Just the opposite takes place.**

As evidence:

…**For a long time now Europe has not experienced a famine**, and the elimination of this scourge has been attributed to a multitude of causes. A number of them do exist, undoubtedly, but the one most generally responsible is that the means of existence have risen, by reason of social progress, far above the means of subsistence. When years of scarcity come, many satisfactions can be sacrificed before any curtailment of food is rendered necessary.

3.2.4 *Man is in control of his own reproduction*

Bastiat dwelled at length on man's ability for preventative checks on fertility, if that becomes necessary:

> It is therefore quite natural that man's habitually progressive tendency should manifest itself also in the **control he exercises over his own multiplicatio**n and impel him to apply to this problem his best moral and intellectual efforts.

Further:

> …**Man is an intelligent being and can make unlimited use of the preventive check**. He is perfectible; he seeks to improve his situation; he finds decadence repugnant. Progress is his normal state; progress implies an increasingly enlightened use of the preventive check; hence, **the means of existence increase more rapidly than population.** This result is not only to be deduced from the theory of perfectibility, but is also confirmed by the facts, since everywhere we find the range of man's satisfactions widening.[84]

His argument in detail:

> This second force I call the *law of limitation*, and it is clear, and that the rise and fall of population, in every country, is the result of the combined action of this law with the other.
>
> But what is this law of limitation? We may say, in a very general way, that the propagation of life is restricted or impeded by the difficulty of sustaining life.
>
> … Organisms endowed with life but not with feeling are strictly passive in this struggle between the two forces. For plant life, it take only one form, that of destruction. But **man is endowed with reason, with foresight**; and this new factor alters the manner in which this force affects him.
>
> But, if he exercises foresight, this second law comes within the orbit of his will. He alters it; he directs it; indeed, it is no longer the same law; it is no longer a blind force, but an intelligent force; no longer merely a natural law, it becomes a social law also. Man is the meeting point where these two principles, mind and matter, merge and become one; he is not entirely under the dominion of either the one or the other. Hence, the law of limitation is evidenced in the human race under two forms and maintains population at a necessary level through the double action of foresight and destruction.
>
> We in France do not fully appreciate how great the domain of foresight is, for Malthus' translator, by retaining the vague and inadequate literal words 'moral restraint,' * has put into general circulation a most imperfect idea of what the concept includes. He further weakens Malthus' meaning by appending this definition: 'Moral restraint is the virtue of not marrying when one does not have the means to support a family, and yet living in chastity.' **The obstacles that society wisely puts in the way of mankind's possible increase in population take many other forms** than that of moral restraint as just defined. For example, why the blessed ignorance of the earliest years, doubtless the only ignorance that it would be criminal to dispel, which is respected by all and guarded by the zealous mother like a treasure? Why is the age of ignorance followed by that seemly and mysterious modesty with which the maiden awes and enchants her lover, lengthening and beautifying the days of innocent courtship? How marvelous, and yet under any other circumstances how absurd, are the veils that are drawn between ignorance and knowledge, and, later, the obstacles that are placed between knowledge and bliss. Why does public opinion, with all its power, impose such strict laws upon the relations between the sexes, brand with shame their least infraction, and pursue relentlessly those who succumb to weakness and their unfortunate offspring, even unto the fourth and fifth generation? And then the punctilious code of honor, the rigid reserve, so universally admired even by those who do not practice it, the standards, the exacting conventions, the precautions of all kinds—what are all these except manifestations of the law of limitation operating on the moral, intelligent, and preventive level, the level, in a word, that is man's and man's alone?
>
> Allow these bars to be let down, allow the human race, in matters that relate to the union of the sexes, to lose its concern for the conventions, for fortune, for the future, for public opinion, for good

[84] https://files.libertyfund.org/files/79/0187_Bk.pdf

conduct, let it descend to the plane of plant or animal life; and can there be any doubt that man's power of reproduction, like that of the plants and animals, will function so overwhelmingly as soon to necessitate the intervention of the law of limitation, operating this time on the physical, brutish, and repressive level, that is, through the instrumentality of poverty, disease, and death?

Can anyone deny that, but for foresight or moral considerations, sexual impulses would be too strong to be resisted, in our species as in all others, from the age of puberty on? If we set this age at sixteen, and if the civil records show that, in a given country, **marriage is not contracted before the age of twenty-four**, this means that the moral and preventive aspects of the law of limitation have subtracted eight years from the period that the law of reproduction would otherwise be in operation; and if to this figure we add those who practice complete celibacy, we shall recognize that the Creator has not dealt with intelligent man as He has with the unreasoning beasts, and that man has it within his power to turn repressive limitation into preventive limitation.

'God,' he would say, 'has not bidden men to be fruitful like the beasts of the field, without measure, without discernment, without heed for the future. He has not endowed his chosen creatures with reason only to forbid them to use it in meeting the most crucial problems of their lives. He has indeed bidden man to be fruitful; but, to be fruitful, man must live, and to live, he must have the means of supporting life; and **in God's commandment that man multiply is implied the commandment that he provide for his young ones the means of existence**. Religion has not classed virginity as a crime. Far from it: religion has made it a virtue, has honored, sanctified, and glorified it. We must not, therefore, feel that we are violating one of God's commandments when we take steps to obey it with prudence, and with a view to the prosperity, the happiness, and the dignity of our families.'

3.3 Julian Simon's refutation

In his book, *The Ultimate Resource 2*, Julian Simon elaborated on the point that Godwin had made (although Simon did not display knowledge of Godwin's logic), that food supply can increase indefinitely, if needed:

> The notion that we are facing a long-run food shortage due to increased population and a Malthusian shortage of land is now scientifically discredited. High-tech methods of producing vastly more food per acre will not be needed for decades or centuries. Only after population multiplies several more times will there be enough incentive to move beyond the present field cropping
>
> systems used in the more advanced countries. But **beyond the shadow of a doubt, the knowledge now exists to support many times the present world's population on less land than is now being farmed**—that is, even without expanding beyond our own planet.
>
> Malthus might be rephrased thusly: Whether or not population grows exponentially, subsistence grows at an even faster exponential rate (largely but not entirely because of population growth). And capacity to improve other aspects of the standard of living, beyond subsistence, grows at a still faster exponential rate, due largely to the growth of knowledge.
>
> **The main reason why more food has not been produced in the past is that there was insufficient demand for more food.** As demand increases, farmers work harder to produce crops and improve the land, and more research is done to increase productivity.

This chart from Julian Simon's book summarises agricultural productivity and human innovation.

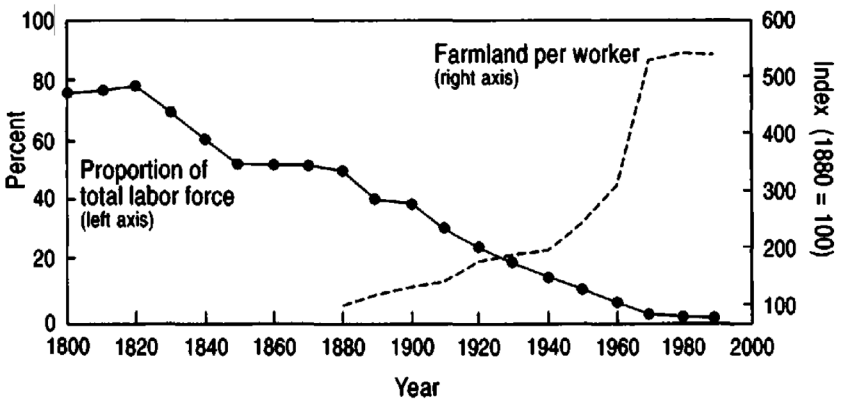


Figure 7-1. Agricultural Labor Force in the United States

It took ~80% of the much smaller population of USA of 1800 to produce food to feed the country. Now only around 2% of a much larger population is needed to feed USA and export a lot!

3.4 Others who refuted Malthus's panic regarding increasing population

Many later economists such as Richard Easterlin and David Friedman have refuted the population externalities arguments.[85] My PhD dissertation is part of this group of economists. I've summarized key arguments in my book, *Breaking Free of Nehru* (Online Notes), that I reproduce below:

> **Fertility is related to the level of freedom**
>
> The subject of human population growth has spawned numerous debates over the past 210 years since Malthus first published *An Essay on the Principle of Population* in 1798. I am summarising below a rigorous and persuasive model that has been found far better at explaining observed changes in human population than Malthus's conjectures. This models explains fertility at the individual level, ie, the number of children a couple choose to have. Being an economic model, it applies well *on average*; not necessarily to specific individuals. If you are interested in a more detailed discussion, you can read my PhD dissertation.[86] Even though no parent *consciously* calculates the things summarised below, this model successfully predicts, on average, the number of children parents actually choose to have. It also applies irrespective of whether parents live in developing or developed societies.
>
> **A model of fertility**
>
> When considering the number of children they want to have, couples ask themselves either explicitly or implicitly the following questions:
>
> *a)* Survival of children: '*How many of our children will survive?*'
>
> Human population hardly increased for tens of thousands of years. Malthus's laws seemed to apply: populations would rise for a while and then be decimated by natural causes, bringing them back to square one each time. **Until modern health came on the scene, it was critical to the survival of the human species for each woman to have about seven children.** That was roughly the 'natural' level of fertility that the human species had evolved to. On average, of these seven children, just over two would survive well into adulthood. However, this need for women to have a*ll* the children they could

[85] His March 2023 lecture available on YouTube at https://www.youtube.com/watch?v=u0X44y_e_QA

[86] A copy of the dissertation is available at:

http://www.sanjeev.sabhlokcity.com/almaak/Dissertation/sabhlok-disstn-1999-web.pdf

possibly have, has changed dramatically after modern health has come to the scene. Malthus's laws no longer seem to apply.

But the high fertility of the past was not an instinctive phenomenon; it was a *rational* response to the high mortality rates that parents observed. Parents estimate the probability of their children not surviving childhood, by looking around them. Infant and maternal mortality rates are generally high in less free countries because these countries are poor and can't afford health care. In societies like Nehruvian India parents may rationally choose to have *all* the children they can possibly have. Nonetheless, even with the extremely poor health care programmes put in place in India, more children and women started surviving than they had in the past. This led to an unanticipated bump in India's population as parents had not anticipated that so many more of their children will survive. Newer parents have quickly re-adjusted their estimates of child survival, and have fewer children than their parents did.

Having access to family planning technology has been important for this choice to be exercised, but not critical. Numerous historical instances of family planning being practiced without modern technology are well known. Even today, one-third of Italian couples (Italy has a particularly low birth rate) use withdrawal as the family planning method since Catholicism doesn't encourage contraception. When parents are determined not to have children, technology becomes a secondary factor.

b) Cost-benefit:

After the survival question has been answered, there is another important question. Parents can choose to have (1) fewer but better-educated children, or (2) a larger number of poorly-educated children. Parents answer this question by maximising their benefits and minimising their costs.

'What will we gain from our children?' Parents everywhere, but particularly in countries such as India which do not have old-age pension or welfare systems, take into account two kinds of financial and non-financial returns from their children: *one*, some form of 'help'—not necessarily financial—when the children are young, and *two*, 'insurance' *if* the parents need to be looked after in old age. This insurance comprises of two components, a financial return if needed, and a non-financial 'care', if needed. This gives us the *total expected benefit* from each child. To estimate this benefit, parents first need to predict their country's future economic prospects. That will tell them what their children *could* earn in the future when they (the parents) are old. Parents generally look at the current economic policies of a country to predict the future. **If capitalist, free market policies are in place in a country, parents expect future growth in incomes for their *educated* children.** On the other hand, if socialist policies are in place, parents can't see much of a future for their children.

'What will the children cost?' Bringing up children and, in particular, educating them, costs time and money, both the real costs of bringing up children and the opportunity costs of the time of parents and the children, assuming that the state provides 'free' education.

Final decision:

- Parents will choose to *educate* their children and hence have fewer children since parents only have limited resources, if they expect their children's future income to become significantly larger than if they were *not educated*. This will happen only if the future economy is likely to generate good jobs for educated people.
- Conversely, they will choose *not to educate* their children and hence have more children if they believe that their children's future income will not be affected by the children's level of education because of the poor future economic environment.

What *rational* parents will choose in socialist India

In India—which was predominantly socialist at least till the late 1980s—the so-called 'education' provided in ramshackle school buildings in villages and slums was not really an education. The future income of such children was only marginally impacted by such 'education'; nepotism and bribery were far more influential in securing jobs. Jobs that required genuine education were very scarce, anyway: many MA degree holders could also not get jobs beyond that of junior office clerks.

Parents in village India could see clearly that there was *no point* in having fewer, more educated children. It was far better for them to have *many* children and use these children as labour when the children were young, save money for their old age, and also hope that at least one or two of these children would take care of them in old age. Child labour was therefore significantly exacerbated by Nehru's socialist policies. The first major change in fertility in India was prompted by declining infant mortality rates. But it was only from late-1980s, with increasing liberalisation, that parents in villages realised that educating their children made economic sense. Today they know that educating their children can make a *huge* difference to their children's future income. Therefore, *private* English medium schools are sprouting even in remote villages wherever the modicum of good governance is being delivered by governments. Parents are sensible enough not to send their children to government schools. I commend millions of Indian villagers for displaying eminent common sense and reacting rationally (and in my mind, beautifully!) to economic incentives, something their urban well-educated counterparts rarely display when talking about our villagers' highly evolved thinking capacities.

Some implications

We therefore learn that **policies of freedom and good governance always reduce the demand for children.** Indeed, policies I advocate in this book will not only stabilise India's population, but will help to significantly shrink it over the next 50 years. The wealthier a society becomes, the lesser parents need to be financially supported by their children in old age. That further reduces the 'demand' for children. They do continue to need non-financial 'care', though, and so this demand never falls to zero. Most people will still have *at least one child.*

What is the 'optimal' level of population for a society? There is no such level. Nevertheless, once a free society arrives at a **sustainable balance with the environment**, then the society can aspire for is average woman choosing to have 2.05 *highly* educated children. That would sustain that level of population potentially for ever. Of course, this is not something for a government to spend its policy resources or taxpayer's money on. An important implication to keep in mind: this model shows that it is not sensible to introduce old age pensions in a society. Where such schemes exist, the demand for children can plummet precipitously, and relations between parents and children can get strained. Let the government not disturb this age-old relationship.

3.5 Unfortunately, James and J.S. Mill got influenced by Malthus

James Mill was influenced by Malthus. He wrote:

> This is the proposition which **Mr Malthus** added to the doctrine of population; and it is undoubtedly a proposition of extensive import, pregnant with consequences of the greatest moment, and materially changing our views of the measures necessary to be pursued for improving the condition of mankind.
>
> It is perfectly evident, that, so long as men are produced in greater numbers than can be fed, there must be excessive misery. What is wanted then is, the means of preventing mankind from increasing fast; from increasing faster than food can be increased to support them. To the discovery of these means, the resources of the human mind should be intensely applied. This is the foundation of all improvement. In the attainment of this important end, it is abundantly plain that there is nothing impracticable. There is nothing which offers any considerable difficulty, except the prejudices of mankind.
>
> Of this doctrine, one of the facts which it is on the present occasion peculiarly necessary to carry in view, is the mode in which the misery in question, the misery arising from the existence of a greater number of human beings than there is food to maintain, diffuses itself.
>
> For a share of the food which is brought into existence, the greater part of mankind have nothing to give but their labour. Of those who are endeavouring to purchase food by their labour, there is not enough for all; some must want. What is the consequence? Those who are in danger of being left out in the distribution, offer more labour' for the same quantity of food; that is to say, they agree to work for leas wages; by this competition, **the wages of labour are reduced, and made so low that they are not sufficient to procure food for the families of all the labourers.** The whole are placed in the lowest and most afflicting of poverty; and of those whose wants are more than usually great, or supply more than usually small, a portion must die, from the want of a sufficiency of the necessaries of life.

> The state of wages is sufficient to afford the means of existence to as many as the food produced can barely preserve alive; the superabundance, who, by their competition, have rendered thus miserable the situation of the rest, must inevitably perish. Whatever the state of production in regard to food, the wages of the labourer are sufficient to enable the labourers, as a body, to raise a number of children sufficient to keep up the population to the level of the food. The labourer who has the number of. children correspondent to that increase, has just enough to keep his family alive, and no more. Those who have a greater than this number, and not a greater than the usual means of pro-. curing food, must partially starve.
>
> This is the natural **unavoidable condition of the greater part of mankind, so long as they continue to produce numbers greater than can be fed**.[87]

In 1826 James Mill wrote a piece against open borders with Ireland. He didn't want the 'plague' of starving Irish to be allowed into England. He wanted to cordon off England against migration from Ireland:

> But here a most serious consideration occurs. An Irish population, wretched and degraded to the last degree, is pouring into this country. Suppose that we should succeed in implanting that high-toned morality in the minds of our people, whence an English labouring man should feel it as a crime, and a turpitude, more to be shunned than death, to be the means of bringing children into life without the means of maintaining them; what would be the consequence? Such conduct, if left to its own natural effects, would speedily raise the condition of the labourer, and place him in those circumstances of physical well-being which are essential to his existing in a state of intellectual and moral well-being. It can have no such effect if a **perpetual influx is permitted of starving Irish.** This may be sufficient, and there is the strongest probability that, unchecked, it will be sufficient, to keep wages down to the starving degree, whatever the prudence and morality of the English population. If so, the continued prudence of the English population would have no other effect than gradually to **diminish their number, and increase that of the Irish, till our own superior population would be wholly rooted out** and supplanted by the Irish, a misfortune with which no other which can be dreaded for this land, is at all to be compared. Here is an evil, against which a wise and beneficent legislature would lose no time in seeking a remedy. If a cordon against the ordinary plague is an expedient measure, **a cordon against the most dreadful plague** that ever infested human nature cannot be regarded as too much.

Two things are worth noting here. First, James Mill supported quarantine for infectious disease like the plague. Second, he considered the Irish worse than the plague.

If Southwood Smith (influenced strongly by Charles Maclean) was close to Bentham (who was still alive) and the Mills lived in the house owned by Bentham, then it is indeed a question mark how James Mill could think in this elitist manner.

By 1848 when he wrote his economics textbook, J.S. Mill reluctantly gave some credit to agricultural productivity for pushing back the famines predicted by Malthus and his father. But he still rejected the idea that productivity would outgrow population. He was completely wrong.

> In all countries which have passed beyond a rather early stage in the progress of agriculture, **every increase in the demand for food, occasioned by increased population, will always, unless there is a simultaneous improvement in production, diminish the share which on a fair division would fall to each individual.** An increased production, in default of unoccupied tracts of fertile land, or of fresh improvements tending to cheapen commodities, can never be obtained but by increasing the labour in more than the same proportion. The population must either work harder, or eat less, or obtain their usual food by sacrificing a part of their other customary comforts. **Whenever this** necessity **is postponed**, notwithstanding an increase of population, it is because the improvements which facilitate production continue progressive; because the contrivances of mankind for making their labour more effective, keep up an equal struggle with nature, and extort fresh resources from her reluctant powers as fast as human necessities occupy and engross the old.

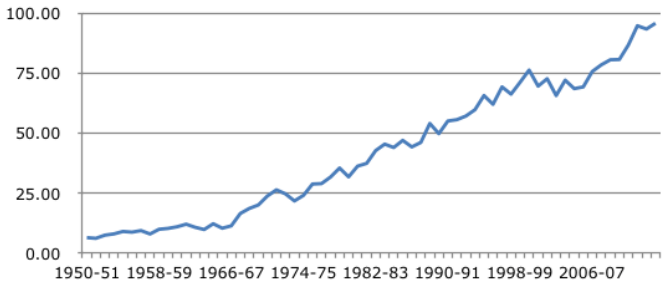
---

[87] https://oll.libertyfund.org/page/the-political-writings-of-james-mill-toc

From this, results the important corollary, that the necessity of restraining population is not, as many persons believe, peculiar to a condition of great inequality of property. **A greater number of people cannot, in any given state of civilization, be collectively so well provided for as a smaller.** The niggardliness of nature, not the injustice of society, is the cause of the penalty attached to over-population. An unjust distribution of wealth does not even aggravate the evil, but, at most, causes it to be somewhat earlier felt. It is in vain to say, that all mouths which the increase of mankind calls into existence, bring /with them' hands. The new mouths require as much food as the old ones, and the hands do not produce as much.

3.6 The world's biggest morons: the modern Malthusians

The world's greatest living moron, Paul Ehrlich, wrote in *The Population Bomb*: 'I have yet to meet anyone familiar with the situation who thinks that India will be self-sufficient in food by 1971, if ever'. Apparently India's production of 1967-68 would be India's greatest, *ever*. Such a pathetic joke. Consider just the wheat production of India. The following chart shows the dramatic increase since 1950:



Source: https://www.projectguru.in/agriculture-sector-india/

India's wheat production over the past five years (around 2020) has been 105 million tonnes.

But despite ***all*** his Malthusian predictions having proved to be wrong, he continues as a 'professor'.

Not just a surplus of food but of wine. A recent news report stated:

> "Our situation reflects the global environment, as world wine production has exceeded consumption every year for at least the past 10 years".[88]

The Club of Rome and its subsidiaries like the WEF continue to ply Malthusian propaganda, with Bill Gates being the biggest advocate of controlling population in developing countries.

Thus, population is not a 'negative externality' but a boon. Each human being comes not just with a mouth but with two hands, as Julian Simon said.

[88] https://www.theaustralian.com.au/business/agribusiness/wine-australia-estimates-wine-glut-of-22-billion-litres-despite-falling-production/news-story/52b8520f7840b35df456b407ac06380d

4. #2: Externalities cannot be defined or measured

External effects (spillovers) are *absolutely* real. They are everywhere. Anyone who understands economics knows about the direct and indirect effects of human action. But claims that externalities are an inefficiency do not have any objective meaning or existence.

4.1 The literature is replete with references to the vagueness of the concept

The confusion surrounding this concept has not yet been alleviated since the concept of externality as an inefficiency is basically meaningless. In an October 2023 paper, Marek Hudik has tried to retrieve this irretrievable concept from the dustbin of history, but as I will show in this paper, that attempt does not succeed:

> Although externality is one of the basic concepts in economics, its rigorous definition remains **elusive**. ...once we dig deeper into the definition, the externality concept becomes **problematic**. … The mere existence of spillover effects does not in itself imply inefficiency. As mentioned, in the world of scarcity, spillover effects are unavoidable, and no institutional arrangement is able to eliminate them. What matters for the analysis is the comparison of resource allocations under different arrangements.
>
> …Based on the preceding analysis, a case can be made that the externality concept is confusing and should be abandoned (Anderson, 2004; Barnett & Yandle, 2009; Cheung, 1970). However, considering its deep-rooted presence in the lexicon of economics and other disciplines, adopting a sufficiently broad definition of externality, which does not misguide managerial and policy decisions, appears to be a more promising approach.
>
> The definition of the externality that is consistent with this approach and, at the same time, remains as close as possible to the established view is as follows: Externality is present whenever the well-being of a consumer or the production possibilities of a firm are directly or indirectly affected by the actions of another agent in the economy. In comparison to Mas-Colell et al.'s (1995) definition, it includes indirect effects, i.e., effects mediated by prices. Nonetheless, the existence of externalities in itself does not imply inefficiency. As pointed out by Buchanan & Stubblebine (1962), only some externalities are Pareto-relevant in the sense that addressing them would lead to a Pareto-improvement.[89]

I will show in this paper (following Knight and Demsetz) that where property rights are duly assigned to the market (as they should be, else we are dealing with a government failure), there is no inefficiency. Not even the Buchanan-Subblebine "Pareto-relevant" ones.

Being a concept that exists outside of the price system, it is impossible to determine where an inefficiency begins or ends. As a result, the literature is similar to blind men describing an elephant; only, in this case, the elephant does not exist.

In 1954, Scitovsky wrote that 'The concept of external economies is one of t**he most elusive in economic literature**. ... Definitions of external economies are few and unsatisfactory'[90]. He tried to address this elusiveness but did not quite ask the essential questions which Demsetz later asked.

In a paper entitled, 'Learning from the debate on externalities', Maurice Lagueux wrote:

---

[89] https://link.springer.com/article/10.1007/s11127-023-01122-4?

[90] Scitovsky, T. (1954). Two Concepts of External Economies. *Journal of Political Economy*, *62*(2), 143–151. http://www.jstor.org/stable/1825572

> According to the opening sentence of Tibor Scitovsky's 1954 paper, 'the concept of external economies is one of the most elusive in economic literature'. Had Scitovsky written his paper forty years later, I am convinced that his opening sentence could have been left unchanged.[91]

Things had not changed much by 1998. In his book, *Externality and Institutions*, Andreas A. Papandreou wrote:

> Given the importance of externality in economic theory, and the effort put into characterizing externality, **it is surprising how hazy a concept it has remained.** Extending the empty-box metaphor, not only has there not been consensus on what externality should signify, but the box seems to be semi-opaque, preventing a clear understanding of what the different ideas are.
>
> … At least one hundred years have passed since 'external economies' entered into economists' vocabulary.' The concept has been used widely, but **no precise and agreed-upon meaning** of the term seems yet to have emerged. This might not be of much concern if it were just marginal differences of interpretation that were under discussion. But this is not the case, as the differences in meanings attributed to this notion are often fundamental in nature. Despite concerted attempts over the years by very prominent economists to zero in on the basic notion of externality, the claims regarding the true nature of externality have not converged. This is all the more striking given both the wide use of the notion, and the steadily growing volume of work done in the area known broadly as the 'theory of externalities'.

In 2021, Joakim Book noted:

> If everything is an externality, the concept becomes rather meaningless. More importantly, it lets technocrats and governments arbitrarily invoke it when issuing commands they like while refusing to invoke it for their opponents' commands.
>
> If the role of governments is to correct externalities in markets and everything is an externality, there are few hurdles left for governments to dismantle; anything is up for grabs. Everything is political; nothing is above or outside the scope of the all-seeing political master.[92]

4.2 The problem: everything has external effects (Walter Block)

Everything has external effects, as Walter Block explained in 1983.

> There are any number of external economies, neighborhood effects, spill-overs, benefits to third parties, which flow from the purchase and use of supposedly private goods. Take, for example, the paradigm case of a private good, socks. First, there is a health question. People who do not wear socks are liable to colds, sore feet, blisters, and possibly pneumonia. And sickness means lost days of work and lost production; it means possible contagion (as in the diphtheria case); it may result in rising doctor bills and increased health insurance premiums for other policyholders. Increased demand for doctors' time and energy will result in reduced medical attention for others. There is, in addition, an aesthetic problem: many people take umbrage at socklessness. Restaurants often forbid bare feet, presumably in the interests of retaining their more sensitive customers. Not wearing socks is also interpreted by some as a disturbing political statement, like flag or draft-card burning. Many mothers—a third party, if ever there was one—rejoice when their 'hip' sons finally don footwear. That benefits of sock-wearing 'spill over' to these mothers cannot be denied.
>
> The problem is by no means limited to the socks example, for all so-called private goods affect second or third parties in some way. The reader is challenged to think of any item the use and purchase of

[91] https://papyrus.bib.umontreal.ca/xmlui/handle/1866/22111

[92] https://mises.org/wire/why-interventionist-economists-love-talk-about-externalities

> which is not affected with a public interest, i.e., which does not similarly have spill-over effects on other people.[93]

Therefore, Walter Block noted, we have no basis to pick and choose between 'them' (even if they were to exist):

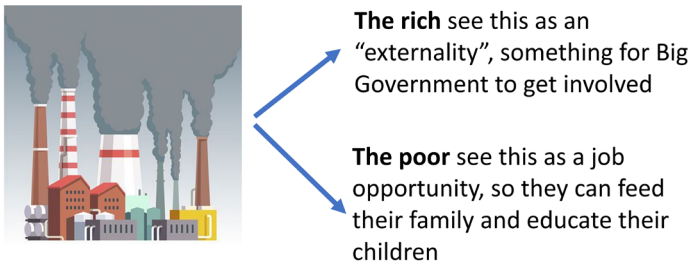
> The major flaw in the externalities argument is, as we have seen, the fact that it is vulnerable to a *reductio ad absurdum*, for indeed there is precious little (if anything) that is not an example of an externality. And unless we are willing to follow the internal logic of the argument and hold that government is justified in taking control of practically every aspect of our economy, we must, perforce, pull back from the conclusions of the argument from neighborhood effects.[94]

Walter Block cited the *reductio ad absurdum* argument:

> *all* so-called private goods affect second or third parties in some way. The reader is challenged to think of any item the use and purchase of which is not affected with a public interest, i.e., which does not similarly have spill-over effects on other people.
>
> …
>
> there is precious little (if anything) that is *not* an example of an externality. And unless we are willing to follow the internal logic of the argument and hold that government is justified in taking control of practically every aspect of our economy, we must, perforce, pull back from the conclusions of the argument from neighborhood effects.[95]

4.3 Externalities are subjective: in the eyes of the beholder

Externality (as an inefficiency) cannot be objectively identified. It exists purely in the eyes of the beholder. Most often 'externalities' are merely a list of inconveniences of the elites.



Llewellyn H. Rockwell, Jr. pointed out in 1991 that externalities are entirely subjective:

> externalities are inherent in every economic transaction because costs and benefits are subjective. I may be delighted to see factories emitting smoke because I love industry. But that does not mean I should be taxed for the privilege of viewing them. Similarly, I may be offended that most men don't have beards, but that doesn't mean that the clean-shaven ought to be taxed to compensate me for my displeasure.[96]

In a Masters thesis of 1994, Richard Antonio Tejidor wrote:

> Planting flowers in one's front yard has externalities. Some may consider them an improvement to the street, others may consider them a detriment. The same with women's makeup, designer clothes and

[93] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

[94] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

[95] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

[96] https://cdn.mises.org/why_ae.pdf

perfume. Externalities exist in the eyes of the beholder. The externality may be positive, negative or not even concern an individual.[97]

As Peter Klein notes in a YouTube lecture, spillovers are ubiquitous. Any attempt to fixate on one at the expense of others is arbitrary and entirely subjective.

> The second problem: positive and negative spillovers, unpriced external benefits and external costs, are ubiquitous. They're everywhere. Not only is there a farmer next to the steel factory who's losing some of his crop yield every year because of the pollution but there's a Greenpeace activist who lives down the street and just hates factories and suffers a pain in his stomach whenever he thinks about the steel industry. That's a negative externality. There's somebody else such as Ayn Rand when she was writing Atlas Shrugged. She got a positive thrill thinking about the steel industry right, so that's a **positive spillover**. Maybe the steel plant is very nice-looking it's a cool modern design. People who like modern architecture get a thrill every time they drive by it. That's a positive externality. It is sort of arbitrary which externalities are considered to be relevant for analysis and which are not.
>
> If we force the steel industry to pay a tax to compensate the farmers that would shift up the supply curve and the equilibrium quantity would fall but if we took into account the Any Rand fans who get great benefits from thinking about steel and steel production? What if the farmers only suffer a tiny bit of damage, then the negative externality is small but the positive externality that Any Rand fans get from thinking about steel is very large. So the true social demand (when we take all the externalities into account) might actually be to the right, rather than to the left. In other words**, simply compensating for one externality while leaving other externalities uncompensated may push the market farther away from the social optimum.** [98]

4.4 Classifying different types "externalities" is like creating new empty boxes

There was one rather amusing writer, Clapham, who published a critique of Pigou's fantasies in 1922, calling them "empty boxes", i.e. "boxes without content", meaningless. He challenged the concept of building castles in the air and imagining they were real just because pretty graphs and equations could be postulated.

> Was it not obvious to you that we did not pretend to have set up measured units of managerial capacity, units of capital, and units of labour, compounded into a joint-unit of resources? Of course there are endless practical difficulties in fixing on standard units of product for particular industries and correlating them with the application of units of resources. Did not the rarity of illustrations in our discussion of "returns" indicate what we were doing? A standard hat is not a mathematical concept. We are generalising the bewildering detail of industry. Do you admit the logic of the conception of the laws of returns? Yes?
>
> Well, we are building a framework into which we hope facts may in time be fitted. If those who know the facts cannot do the fitting, we shall regret it. But our doctrine will retain its logical—and, may we add, its pedagogic—value. And then you know **it goes so prettily into graphs and equations**. Besides, in the history of thought analysis has often outrun verification.[99]

Anyone who has tried to create "categories" of externalities is indulging in an empty boxes charade.

---

[97] Tejidor, Richard Antonio, 'Economists and the state: An Austrian critique of public finance economics' (1994). UNLV Retrospective Theses & Dissertations. 428. https://digitalscholarship.unlv.edu/rtds/428/

[98] https://youtu.be/0ORLOIBPizs?si=xxzm1P0gu011n7-G

[99] https://www.jstor.org/stable/2222943

4.5 Someone imposing an inefficient 'externality' is meaningless – all transactions are two-sided

The fact that a factory causes pollution is does not implicate the factory in causing an inefficiency. After all, it is producing things that consumers want, it is giving jobs, people want to live around it. So the "blame" also goes to people who want to live around it. The idea that the factors "causes" an externality is meaningless; the people living around it are also responsible for experiencing the external effects. All such "transactions" or effects are two-sided.

In a 1998 paper Dierdre McCloskey pointed out one of the main points that Coase was making:

> Another way of putting it, as Coase does, is to point out that 'whoever is generating the externality' is not a meaningful notion. Coase has the famous, and confusing, railway farmers example: who 'causes' the burnt fields of corn, the railway which makes the sparks, or the farmers who plant imprudently close to the line? [The question arises naturally in the common law; on a blackboard by contrast you can't see it: equalize marginal private and social cost, that's all]. A better example is **noise pollution around airports**. We usually think of the airplanes as the cause. But wait. Suppose that there were no ears close to the airport. (Or that the ears were easily protected from the noise.) In that case the noise would be harmless, and it would be silly to curb it. So the presence of ears is just as much a 'cause' as the vibrations in the planes' motors. Where then should the Pigou Samuelson tax be placed?[100]

4.6 No objectively measurable externalities

Mohring highlighted the impossibility of measurement: 'the data required to place dollar values on externalities are **lacking'**[101].

In a 1980 paper, Barry Brownstein explained:

> The whole argument for governmental subsidy payments in the case of external benefits revolves around the idea that these benefits can be **objectively measured by someone not involved in the transaction**. ...costs are by nature subjective and not objectively measurable by an outside observer.
>
> … even individuals with similar knowledge and preferences will not necessarily reach the same choice. The subjective impression of the benefits from an action can and will differ from individual to individual and they cannot in any way even be compared.
>
> ... the subjective nature of costs leads to the inescapable conclusion that **there can never be objectively measurable external benefits.** Costs (or benefits) are subjective and are inseparably tied to the act of choice. That is, an individual not involved in the economic decision or choice can never objectively measure another individual's costs (or benefits). Thus no statement about either the size or the very existence of external benefits can ever be falsified.
>
> Since benefits or costs are tied inexorably to the act of choice, not even a survey of individuals can determine the magnitude of the external benefit. A choice-bound concept of costs implies that only if a person is actually faced with a choice between alternatives can we say that he prefers one to the other.[102]

Peter Klein noted in a YouTube lecture the impossibility of measurement:

> First how do we measure these benefits and costs? How do we know what is the true social cost as opposed to the private cost? Because these spillover costs and benefits are not demonstrated in action. **They are asserted** by the person who is bearing the cost, or in the case of a positive externality right someone says I'm receiving a benefit that I'm not paying for, so somehow we want to force that person to compensate the producer so the producer will produce more. Well, how do we know what is the

---

[100] https://www.jstor.org/stable/40325879

[101] Mohring, cited in Walter Block (1983), https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

[102] https://cdn.mises.org/4_1_6_0.pdf

> actual size of these benefits and costs? How high should the tax be or how high should the subsidy be in the case of a positive externality? [103]

One of the key failures of externalities theory is that social marginal costs/benefits are assessed by a social planner. Unlike typical demand and supply curves which can be (largely) objectively determined, there is no objective method to determine social cost/benefit curves. The typical method of measuring externalities is to ask a few surveyed individuals about their hypothetical dollar values (actual prices don't exist). That method works for a policy CBA which looks at all costs and all benefits but can't be used to derive one-sided social curves. Policy CBAs assume that all people have the same utility function. There are no marginal curves involved, only additive average costs and benefits. But demand and supply curves are marginal and require extremely precise utility measurements (everyone is different).

4.6.1 *Economists pick and choose 'externalities' based on personal political bias*

In 1994, Richard Antonio Tejidor paraphrased Walter Block's arguments: where does one start and where does one stop?

> If externalities call for government intervention, then government intervention must not only stop at police provision, national defense and roads, but must extend to the entire economy as all actions have externalities. To apply the criterion to only a few areas is illogical and defeats the purpose of having any such criterion. [104]

Don Herzog explained in 2000:

> 'I want to argue that **the criteria economists actually use to identify externalities — inside and outside market settings, promiscuously, unhesitatingly come from moral and political theory**, not their own views about utility maximization.'
>
> '...economists are opportunistic about invoking externalities. They do so not whenever we find people with preferences about others' preferences and actions; they actually do so in ways closely tracking the traditional harm principle of liberal theory.'[105]

He noted that "the concept [of externality] is secretly parasitic on the liberal harm principle. But nothing within economic analysis generates or supports such a principle."

4.6.2 *Impossible to compare utilities across an entire public*

Walter Block explained one more reason why economists cannot determine the inefficiency caused by an external effect:

> the assumption of interpersonal utility comparison is not merely implicit in the thinking of mainstream economists. Samuelson, for example, speaks of a 'social welfare function that renders interpersonal judgements,'[40] and then proceeds to draw an indifference curve map encompassing the utilities of two or more different people.[106]

---

[103] https://youtu.be/0ORLOIBPizs?si=xxzm1P0gu011n7-G

[104] Tejidor, Richard Antonio, 'Economists and the state: An Austrian critique of public finance economics' (1994). UNLV Retrospective Theses & Dissertations. 428. https://digitalscholarship.unlv.edu/rtds/428/

[105] https://www.jstor.org/stable/1600344

[106] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

4.7 Dalhman showed that externalities are a metaphysical concept

Carl Dahlman's 1979 critique of Pigou is the most stinging in the literature. In a 1979 paper, 'The Problem of Externality'[107], Dahlman wrote:

> The conclusion is rather startling: transaction costs per se have nothing to do with externalities. What is involved is a value judgment: if you believe that markets internalize everything, you will believe that externalities do not exist; on the other hand, if you believe that markets do not internalize side effects, you will believe in the persistence of externalities as deviations from an attainable optimum. **This is not science; it is metaphysics:** value judgments and political goals will enter into the determination of whether externalities occur in our world. You cannot show analytically that the government, in principle and in all cases, handles externalities better than the market; nor can you prove the opposite: it all depends on what point of reference you choose. And that is not a question of positive economics. By choosing the appropriate point of reference, the 'conclusion' is reached that government intervention (or no government intervention) is optimal.

He was probably the first to identify the argument which Demsetz later highlighted:

> The conclusion, unpalatable to many economists, would seem to be that **if it exists it must be optimal, and if it does not exist it is because it is too costly, so that is optimal too.** If you do not like the smell of the air, seek comfort in the knowledge that it would cost you more than it is worth to you to do away with the stench, for, otherwise, would you not do it? Again, the conclusion is the same whether we talk about large or small number cases—the only difference being that in the former case we introduce an important setup cost of the group of bargainers on one side of the market, or both. Conceptually, the problem is the same: if it is too costly to eliminate, the side effect is optimal. If we include transaction costs in the constraints, this appears to be the unavoidable conundrum we end up in: **externalities are irrelevant**.

After Dahlman, we can precisely define externality – as the **halo** of a market transaction. A halo is speculative, ill-defined, not measurable, and nothing can be done to 'fix' it. That's what externality is.

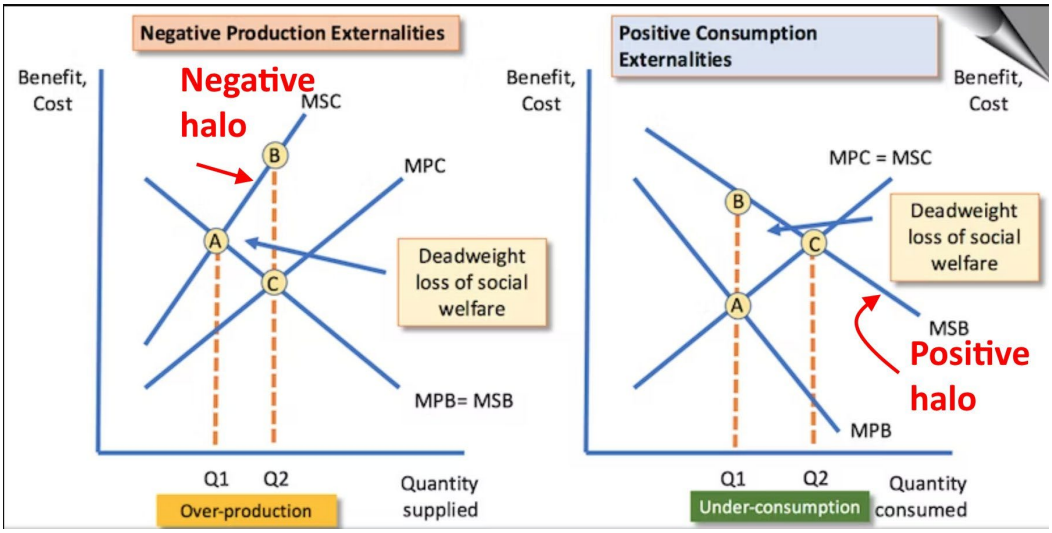
What's about a halo around a god/ satan/ rakshasa?

- some people see it, others don't
- some think it is bright and shiny, others think it is dark
- those who see it describe it but can't measure it.

We can easily replace the word "halo" with externality without loss of meaning. The misleading word "externality" must be binned.

Effectively, the typical externality diagrams in economics textbooks are metaphysical, scriptural, not scientific. That's because marginal "social" costs and "social" benefits are impossible to define, measure, and – more particularly – to "fix".

[107] https://www.jstor.org/stable/725216



In my view, the use of the word "externality" was a socialist masterstroke. It made this fuzzy and ill-defined/impossible to measure concept suddenly sound scientific. But the moment we replace "negative externalities" with "negative halo", any residue of science evaporates.

4.8 Some bad definitions

The literature is strewn with bad definitions of externalities, definitions which have no scientific, realistic meaning. I consider a few below.

4.8.1 *Bad definition by James M. Buchanan and Wm. Craig Stubblebine, 1962*

In their 1962 paper, Buchanan and Stubblebine discuss the definitional issues of externalities:

> Externality has been, and is, central to the neo-classical critique of market organisation. In its various forms—external economies and diseconomies, divergencies between marginal social and marginal private cost or product, spillover and neighbourhood effects, collective or public goods—externality dominates theoretical welfare economics, and, in one sense, the theory of economic policy generally. Despite this importance and emphasis, rigorous definitions of the concept itself are not readily available in the literature. As Scitovosky has noted, 'definitions of external economies are few and unsatisfactory'. The following seems typical:
>
> > External effects exist in consumption whenever the shape or position of a man's indifference curve depends on the consumption of other men.
> >
> > [External effects] are present whenever a firm's production function depends in some way on the amounts of the inputs or outputs of another firm.
>
> It seems clear that operational and usable definitions are required.
>
> In this paper, we propose to clarify the notion of externality by defining it rigorously and precisely. When this is done, several important, and often overlooked, conceptual distinctions follow more or less automatically. Specifically, we shall distinguish marginal and infra-marginal externalities, potentially relevant and irrelevant externalities, and Pareto-relevant and Pareto-irrelevant externalities. These distinctions are formally developed in Section I. As we shall demonstrate, the term, 'externality', as generally used by economists, corresponds only to our definition of Pareto-relevant externality. There follows, in Section II, an illustration of the basic points described in terms of a simple descriptive example. In Section III, some of the implications of our approach are discussed.
>
> It is useful to limit the scope of the analysis at the outset. Much of the discussion in the literature has been concerned with the distinction between technological and pecuniary external effects. We do not

> propose to enter this discussion since it is not relevant for our purposes. We note only that, if desired, the whole analysis can be taken to apply only to technological externalities. Secondly, we shall find no cause for discussing production and consumption externalities separately. Essentially the same analysis applies in either case. In what follows, 'firms' may be substituted for 'individuals' and 'production functions' for 'utility functions' without modifying the central conclusions. For expositional simplicity only, we limit the explicit discussion to consumption externalities.[108]

The reason this is a bad attempt is because it seeks to justify the existence of externalities when we have seen that it is a meaningless concept (without specificity or measurability).

4.8.2 *Bad definition by van den Doel and van Velthoven*

Hans van den Doel and Ben van Velthoven's 1993 book, *Democracy and Welfare Economics* states:

> According to Buchanan and Stubblebine (1962) external effects in consumption are present if, for example:
>
> $U^a = U^a(q1^a, q2^a, \ldots qm^a, qj^b)$.
>
> This means that the utility of an individual a depends not only on his own consumption pattern, but also on the consumption of another individual b. Here it is just one specific good j that is at stake, but there may be more. This cross-dependency operates outside the market and can both be positive and negative by nature. When a's utility is positively affected by b's consumption there is a *positive* external effect (external economy); when a's utility is negatively affected by b's consumption the external effect is called *negative* (external diseconomy).
>
> If individual b, for example, builds a sea-wall for his own use, this will inevitably protect individual a as well. This means that a's utility is then positively influenced by b's consumption. If, on the other hand, b plays his transistor radio too loudly, a will experience negative external effects.
>
> External effects are of great interest for a welfare theoretical analysis, because they can lead to inefficiencies, i.e. to non-Pareto-optimal outcomes. The reason for this is that individual b, when deciding about his consumption of good j, will take due account of his own costs and benefits, but not of the positive and/or negative external effects of his decision for person a (and possibly others) when these effects do not affect him in any — financial or other — way.
>
> In the case of a positive external effect for a, the total social benefits of the consumption of good j by person b are higher than the private benefits b is taking account of. **Person b will therefore be inclined to consume a quantity of the good which is too small from a social welfare point of view.** A Pareto improvement is easily contrived. That is, if individual a would pay a (small) contribution to b to induce him to increase his consumption of good j (a little), both a and b, but in any case one of them, could be better off.
>
> The opposite holds in case of a negative external effect.

Assume I'm b and I have (I consume) a nice flower garden. What this book is saying is that I make (consume) less of a nice garden just because you might enjoy it. That's absurd. I do not make my garden for your pleasure but mine. The situation is already Pareto optimal. All people involved have put in their best foot forward voluntarily and exhausted all potential gains from trade.

Now, someone might want to donate to me to prompt me to plant even more flowers, but all I probably need is a word of praise, instead. On the other hand, I've got other uses of my time and would not change my decision no matter if I'm subsidized or praised. Worse, let's say that I get used to receiving donations for my garden. What happens if, in due course, payments stops? Would I then stop making my pretty garden? (This is exactly the argument why blood donation is voluntary, not paid.)

---

[108] https://www.jstor.org/stable/2551386

The most important point, however, is that there is no inefficiency involved in the starting situation. There is nothing to remedy.

4.8.3 *Bad definition by Bryan Caplan*

Bryan Caplan defines positive externalities as 'benefits that are infeasible to charge to provide'[109].

Once again, this fails the basic test of specificity and measurability. Positive externalities are not intended to be '**provided**', they are incidentally 'provided' – entirely free of cost. Never is any intention to charge part of the human action involved.

A smiling face provides a positive "externality". The person who's smiling has no intention of 'charging' for the smile, and is smiling due to her happy disposition.

Likewise, the person taking a vaccine does so for his own benefit. Any herd immunity effects are incidental.

Further, as we have seen, the existence of these things is entirely subjective and variable. Someone might like my garden, someone else might think of is as a mess. Moreover, it is impossible to objectively determine the magnitude of any benefit provided since there is no market for this 'benefit'.

4.8.4 *Bad definition by Richard Antonio Tejidor*

In a masters thesis, Richard Antonio Tejidor defines a positive externality as 'a benefit that cannot be fully captured by either the producer or owner'.[110]

Once again, this is incorrect. The benefit has definitely been captured by the 'producer'. The gardener has enjoyed his flower garden. He can enjoy it no more! As far as others are concerned, the gardener never had any intention to benefit them, nor to charge them for any such benefit.

[109] https://www.econlib.org/library/Topics/College/marketfailures.html

[110] https://digitalscholarship.unlv.edu/rtds/428/

5. #3: No gap between social and private product

A gap is alleged between social and private product.

5.1 The alleged gap between private and social products

Pigou wrote in his 1920 book:

> [W]e have next to distinguish precisely between the two varieties of marginal net product which I have named respectively *social* and *private*. The marginal social net product is the total net product of physical things or objective services due to the marginal increment of resources in any given use or place, no matter to whom any part of this product may accrue. It might happen, for example, as will be explained more fully in a later chapter, that costs are thrown upon people not directly concerned, through, say, uncompensated damage done to surrounding woods by sparks from railway engines. All such effects must be included – some of them will be positive, others negative elements – in reckoning up the social net product of the marginal increment of any volume of resources turned into any use or place.

But based on Pigou's two roads example we know that private costs and social costs, private benefits and social benefits, *always* overlap. The market *always* leads to a Pareto optimal situation which *cannot* be improved by any government. Any external effects which the society decides to deal with separately are another, political matter.

5.2 Coases's confusion: Positive transaction costs don't create any Pigovian gap (Demsetz)

I have introduced this topic in the Introduction. Here we go into some detail.

5.2.1 *The example of smoke/ soot*

Pigou identified smoke as an inefficiency (externality) in 1920:

> Smoke in large cities imposes a heavy uncharged loss on the community, in injury to buildings, vegetation, expenses for washing clothes and cleaning rooms, expenses for the provision of artificial light, and in many other ways.

In his 1980 piece[111], Barry Brownstein showed how Ronald Coase opened the door for government regulation in a case with high transaction costs.

> Ronald Coase, in his classic article on social costs, discusses the possibility of government intervention **improving efficiency** when transaction costs are large:
>
> > There is no reason why, on occasion, such governmental administrative regulation should not lead to an improvement in economic efficiency. This would seem particularly likely when, as is normally the case with the smoke nuisance, a large number of people are involved and in which therefore the costs of handling the problem through the market or firm may be high.

Both these are severely mistaken views, as Demsetz has shown. These views of inefficiency assume that there is some way to maximise production while achieving zero smoke, and that government can magically deliver such an outcome at zero cost to society. That is an impossibility. The market has achieved the optimal level of smoke,

---

[111] Brownstein, Barry P. (1980). "Pareto Optimality, External Benefits and Public Goods: A Subjectivist Approach" in *The Journal of Libertarian Studies*. Vol. IV. No. I (Winter). https://cdn.mises.org/4_1_6_0.pdf.

given all kinds of costs that it faces, while maximising production and human welfare. A government cannot do better at lower cost. If it then decides to reduce soot, it will impose a new, **additional cost** on society.

Demsetz dispelled Coase's delusion that transaction costs in dealing with 'soot' create an inefficiency, i.e. an "externality": the very term Coase disliked. Demsetz also rejected the mental gymnastics of the sort undertaken by Donald Boudreaux 2019 (expectations, sequencing, etc.); instead, went straight for the jugular. He wrote:

> There is no difference between transaction cost and other costs in this respect. **The amount of soot from the production of steel may remain positive even if its presence results in an increase in the cost of laundering to a nearby laundry owner.** If it remains positive because the cost of transacting between laundry and mill owners is too great to make a transaction worth undertaking or because the launderer and steel mill owner believe that the cost of substituting hard coal for soft is too great to make a transaction worth undertaking, then this positive amount of soot is efficient. In both cases, more soot descends on the laundry than if the cost of reducing soot were smaller, but if we do not think resources are wrongly allocated in the case in which hard coal is too costly to use, why should we think resources are wrongly allocated in the case in which transaction cost is too great to bear? Both situations are compatible with efficient resource allocation, and, after all, it is efficiency that is claimed by the neoclassical model, not the complete absence of interaction costs; neither negotiation nor hard coal is sought in and of itself. Indeed, one can rewrite the neoclassical model with transaction cost embedded in it and still deduce from it an efficient allocation of resources. **Transaction cost just shifts supply curves upward** (or demand curves downward, or some combination of both) as would an increase in any cost, and it carries no special implication of inefficiency at equilibrium values of price and output.

As Demsetz shows, if property rights are expensive, they are still just any other cost in the calculation, and therefore it will be efficient in such cases not to allocate property rights. The existence of pollution is not an inefficiency. No matter which way one looks at them, externalities are not a meaningful concept.

What Demsetz has said is so obvious as to be trite, but has been missed by most members of the economics profession. To paraphrase, Demsetz is saying that markets are *not* inefficient when they produce a certain level of soot. First, the idea of zero soot is an impossibility so should be entirely discounted. Second, any technical or cost challenges (including transaction costs) in reducing soot are automatically factored in by markets, in determining the level of soot to be produced (while maximizing output and employment). **A government cannot either deliver zero soot or lower levels of soot without a huge increase in total costs**.

5.2.2 *Coase's bad economics*

Despite an impression that Coase was market friendly and wanted bargains, he was, overall, an advocate of coercion unchecked by a CBA. In 1960 he advocated blunt regulation to manage "nuisance", while Demsetz showed that a cap-and-trade was far better.

> In the standard case of a smoke nuisance, which may affect a vast number of people engaged in a wide variety of activities, the administrative costs might well be so high as to make any attempt to deal with the problem within the confines of a single firm impossible. An alternative solution is direct Government regulation. Instead of instituting a legal system of rights which can be modified by transactions on the market, the government may impose regulations which state what people must or must not do and which have to be obeyed. Thus, the government (by statute or perhaps more likely through an administrative agency) may, to deal with the problem of smoke nuisance, decree that certain methods of production should or should not be used (e.g., that smoke preventing devices should be installed or that coal or oil should be burned) or may confine certain types of business to certain districts (zoning regulations)." (Coase 1960, 17)[112]

[112] https://www.jstor.org/stable/3146538

5.2.3 *Barry Brownstein's explanation*

Barry Brownstein explained this well in his 1980 piece[113]:

> Consider the classic example of the beekeeper adjacent to an apple orchard. The benefits accruing to the apple orchard from the beekeeper's production (pollination) are not considered by the beekeeper in determining his profit maximizing output level.' Therefore, from the point of view of the apple grower the beekeeper is 'underproducing.' Many economists would agree that, since the costs of reaching an agreement are relatively small, this two-person case is not a problem for the government.' The apple grower can simply bribe the beekeeper an amount up to the size of his perceived external benefits and thus induce the beekeeper to increase production.
>
> As the number of beekeepers and apple growers increases, the costs of reaching an agreement on the size of the payment from the apple growers to the beekeepers increase. If the transaction costs remain less than the possible gains from trading, an agreement will be reached. If, on the other hand, the transaction costs exceed the benefits from any trade, an agreement will not be reached. Under these circumstances many economists argue that the market has 'failed' and that government intervention is therefore necessary. However, to argue for the government subsidization of the beekeepers is to ignore the fact that **transaction costs are real costs which must be considered when making a trade. In the real world, when collective action does not take place, all that one can conclude is that the benefits of such action are smaller than the costs involved. In no way does this imply that the market has failed.**
>
> The existence of transaction costs explains why certain trades do not take place in the market. It does not logically follow from the concept of Pareto optimality that the trade should have taken place. Asserting that the trade should have taken place is equivalent to stating that transaction costs are not real costs and somehow should not have been considered by the parties involved. Again we have an example of purely predictive statements (on when a trade will take place) being turned into normative ones (on when a trade should take place).
>
> An analogy at this point might be useful. All of us have wished many times in our lives that we could be instantaneously transported to our destination, be it for work or recreation. Many times the existence of transportation costs (time and money) has led to a decision to stay at home. However, the existence of transportation costs explains why people make certain decisions, and by no means can be used as an argument for government intervention on the grounds of high transportation costs. That is, **it would be incorrect to argue that resource allocation is not optimal because of the existence of these transportation costs. On the contrary, any subsidy payments would alter the pattern of resource allocation, making one course of action seem cheaper than it formerly did.**
>
> The effect on resource allocation is no less when the government subsidy takes place because of high transaction costs. Resources are diverted from the area of their highest possible value, since **subsidy payment makes the activity seem cheaper than it actually is.** Ludwig von Mises writes:
>
> > For every unprofitable project that is realized with the aid of the government there is a corresponding project the realization of which is neglected merely on the account of the government's intervention. Yet this nonrealized project would have been profitable, i.e., it would have employed the scarce means of production in accordance with the most urgent needs of the consumer.

5.3 Market already internalise external effects in a variety of ways

As Joakim Book notes in 2021, 'markets internalize externalities – by land value, by selection, by trade-off along other margins that matter to people'[114]. As he explained:

---

[113] https://cdn.mises.org/4_1_6_0.pdf

[114] https://www.aier.org/article/markets-already-internalize-externalities/

> Brian Albrecht, a fellow with AIER, made "An Argument Only a Crazy Economist Would Make." In his account, "Low-income families are more willing to sacrifice air quality for cheaper rent:
>
> > It's a simple consequence of thinking through price theory and how actions in one area reverberate across different markets. Markets are interconnected. That's price theory 101.
> >
> > It's also about comparing the marginal vs. the inframarginal people: the low-income people are the marginal consumers of the clear-air housing market. They are run out when the price rises. They are inframarginal consumers in the market for housing with pollution; it is a lower cost for them to live with pollution and so they earn rents when there is pollution.
>
> If you're the cash-strapped poor, you're likely to want to trade off along dimensions other than money.[115]

The whole point of the price system (cf. Hayek's paper, "Use of Knowledge in Society") is to internalise (take account of) a vast range of information, including a range of effects. No potential gain from trade remains if property rights are duly assigned.

[115] https://www.aier.org/article/markets-already-internalize-externalities/

6. #4: Pigou confused a 'tax' with the market's normal action (if allowed to do so)

Pigou suffered from a number of confusions. This section explores the alleged "Pigovian tax".

6.1 Example 1: Pigou's congestion (two roads) example

In the 1920 edition of his book, *Economics of Welfare*, Pigou provided this example:

> Suppose there are two roads ABD and ACD both leading from A to D. If left to itself, traffic would be 80 distributed that the trouble involved in driving a 'representative' cart along each of the two roads would be equal. But, in some circumstances, it would be possible, by shifting a few carts from route B to route C, greatly to lessen the trouble of driving those still left on B, while only slightly increasing the trouble of driving along C. In these circumstances **a rightly chosen measure of differential taxation against road B** would create an 'artificial' situation superior to the 'natural' one.[116]

He claimed that a tax would fix the congestion problem. But he was comprehensively wrong. Pigou's blunder was to imagine a government 'solution' to in the two roads case of congestion when all that needed to be done was to allocate property rights to the private sector. Pigou did not allow the market to operate, then blamed the market for creating congestion.

His alleged congestion externality is addressed *automatically* by the private sector when property rights are available to it to do so. Frank Knight pointed out this basic flaw within years of publication of Pigou's 1920 book, but instead of fixing his error, Pigou dug in, but worse – thousands of economists after him continued to believe in Pigou instead of following the path shown by Knight.

A few critically important points are often ignored in the externality literature.

- First, congestion can never be eliminated – it can only be optimized. A level of pollution or congestion or other 'harm' to third parties can at best be *optimal* from the societal perspective, not something to be eliminated.
- Second, under no circumstances is a 'tax' able to deliver lower level of congestion than what the market does on its own, if allowed to do so, without affecting overall output (GDP).

6.1.1 *Frank Knight threw out Pigou's two roads case*

In a 1924 paper, Frank Knight threw Pigou's argument out of the window by when he showed that the so-called Pigovan tax to be imposed by a government to ease congestion is nothing but the charge a private owner of the road would have imposed anyway. Pigou was complaining about the wrong thing. There was no 'externality', instead the problem is that the government had not allowed private ownership of the roads.

In his 1998 book, *Externality and Institutions*, Andreas A. Papandreou wrote:

> Knight (1924) emphasized that decreasing returns are not a cause for alarm. He argued that Pigou's example of external diseconomies resulting from the **congestion** of the better of two roads, as drivers decide at the margin which road to use, is in essence a case of the free use of a scarce resource. … An important aspect of Knight's contribution was that the presence of external diseconomies was shown to be dependent on the institution of **private property**, or more generally, that institutions mattered. …

[116] http://pombo.free.fr/pigou1920.pdf

the Marshall-Pigou position was flawed in treating all upward-sloping supply curves as indicative of inefficiency.

Pigou's two roads example showed clearly that the concept of 'externalities' was being misapplied to the real problem: of the absence of property rights. The markets had not failed since they never got a chance to fix the problem in the first place. There was nothing to 'internalise'. If the market is not even allowed to operate, how can that be a ground complain against the market?

Demsetz explained Frank Knight's refutation in his 2011 piece, thus:

> Pigou offers constructed examples in which private costs (or benefits) are not equal to social costs (or benefits). His examples differ circumstantially, but in their essences are very similar. A favorite example involves the allocation of traffic between two roads, both of which connect the same terminal points. One road is subject to considerable congestion because it is narrow; the other road is wide and escapes much of this congestion but, lacking the directness of the narrow road, its users require a longer time to travel between the terminal points. Pigou claims that traffic will be inefficiently distributed to these two roads because drivers who choose the quicker road will have done so without regard to the cost their action will put on other users of this road by way of increasing the degree of congestion they face. Hence, the narrow road is over-used and the broad road is under-used. The claimed difference between private cost to a driver (which does not include the added congestion cost borne by others) and social cost (which does include the added congestion cost) is a marker for inefficient resource allocation.
>
> So far, so good. But Pigou fails to show that his example is properly placed in the context of a decentralized, private economy. Can a situation that fits this example also fit the conditions that define a (perfect decentralized) private economy? Pigou's failing in this respect was noted long ago by Frank H. Knight (1924) in a brilliant article on social cost. He notes that **Pigou's discussion of the two roads treats these roads as if entry is free to all. Presumably, then, they are publicly provided** and managed open access roads. As such, the example cannot illustrate the inefficiency of an economic system that rests exclusively on private resource allocation. Knight argues that the use of these roads, had they been privately owned (in a competitive setting), would have been priced by their owners so as to achieve an efficient allocation of traffic; the price to use the narrow road would have been raised to levels higher than the price asked to use the broad road. Properly interpreted, **Pigou's example reveals the opposite of what he intended. It shows inefficiency arising from a flaw in *public* or *collective* management of scarce resources.** Public administrators have failed to price the use of these roads so as to achieve an efficient allocation of traffic. I remind the reader that congestion itself is not evidence of inefficiency. Knight's private roads and Pigou's recommended tax-subsidy remedy would result in an optimal amount of congestion and not necessarily its complete absence.
>
> Pigou's other examples are of the same sort. They depict conditions that seem quite removed from how we would describe a decentralized, private-ownership economic system (populated by rational persons). A private person (or the Dept. of Recreation) constructs a park but does not control its use by others; the park is over-crowded as a result. But it must be that the owner of the property takes pleasure from the overcrowding or that he neglects his own interest. In the first case there is no inefficiency, since the pleasure he derives from large crowds must be taken into account; in the second case, this person cannot be a resident of the model being examined by Smith or neoclassical economists. A third type of example involves what we now call an agency problem. An owner of land rents the land to an occupant. Pigou asserts that the occupant will not take proper care of the land because he cannot be monitored closely by the owner of the land. Hence, Pigou calls for legislation to reduce the severity of misuse of property. But there is no reason to suppose the State can monitor the renter more effectively than can the land's owner. It must be then, if the owner is rational, that the cost of monitoring the tenant's behavior exceeds the added value that doing so would bring to the owner's property. Hence, there is no inefficiency. All Pigou's examples that I have examined suffer from this type of failure: they assume faulty behavior or a non-private organizational arrangement (State ownership or the complete absence of ownership) that is precluded by the neoclassical model. Special attention should be given to the last example

> discussed above, the land-owner/land-renter example, for the assumed positive cost of monitoring comes very close to costs that Coase would classify as transaction costs or as being necessary to a price system.
>
> **In response to the inefficiencies that he sees, Pigou turns to the State to levy taxes or confer subsidies that result in equality between private and social cost.** His manner of doing this idealizes the State, which somehow knows the facts and is able to employ them at less cost than could private parties. He writes of idealized State-directed solutions to the problems that, as illustrated above, are likely to have been caused by the State itself. A Nirvana State is a dangerous tool, for it diverts attention from the real underlying problem. Why is ownership lacking or why is an owner not tending to his self-interest? In *The Economics of Welfare* and the doctrine that it spawned, the State is but a magic wand that Pigou waves with no effort to make private and social cost equal – the same State that, through its mismanagement, has caused many of the inequalities between private and social cost that Pigou discusses.

In brief, there is nothing to internalise in a 'congestion externality'. A congestion charge would automatically be imposed by a private road owner. The optimal "Pigovian tax" for road congestion is exactly what a private road owner would set, anyway. The two roads example also shows that assignment of property rights can 'fix' the (non-existent) 'externality' – and effectively foreshadows the much later insights of Coase.

Knight thus proved that there is no market failure, instead there is government failure. The fact that a road is not privately owned is not a 'market failure' but government failure.

Steven Cheung had the following observation regarding Knight's refutation:

> In charging the market with failure to attain the maximum social benefit while disallowing private property rights (upon which all private transactions must be based), Pigou was indeed barking up the wrong tree.[117]

Did Pigou respond to Knight. No (source: Steven Cheung)

> To my knowledge Pigou never replied to Knight's paper, although the example of the two roads was deleted from later editions of *The Economics of Welfare:* the debate was over when it had barely begun.

What did Pigou do when Frank Knight showed his two roads example to be a failure of government (assignment of property rights) – not of markets? He didn't respond but deleted it from further editions.

It is amazing how a truly dangerous branch of economics has emerged from Pigou's monumental blunders.

Knight's refutation

The following is an extract from Knight's 1924 paper, 'Some fallacies in the interpretation of social cost'[118]. (Its summary stated: "Arguments for social interference developed by Pigou and Graham illustrate common misinterpretations of the meaning of cost and its variation with output". He further wrote: "It is probable that all efforts to prove a **continued bias in the workings of competition** as such, along the lines followed by Professors Pigou and Graham, are doomed to failure.")

> In Professor Pigou's study the argument that free enterprise leads to excessive investment in industries having relatively upward-sloping cost curves is developed with the aid of a concrete example, the case of two roads.[119] Suppose that between two points there are two highways, one of which is broad enough to accommodate without crowding all the traffic which may care to use it, but is poorly graded and surfaced, while the other is a much better road but narrow and quite limited in capacity.[120] If a large

---

[117] *The Myth of Social Cost*.

[118] https://www.jstor.org/stable/1884592

[119] *Economics of Welfare*, p. 194.

[120] For simplicity, no account is taken of costs involved in *constructing* the two roads. The aim is to study the effects of the two types of 'cost' — that which represents a consumption of productive power which might have been put to some other use, and pure rent or the payment

number of trucks operate between the two termini and are free to chose either of the two routes, they will tend to distribute themselves between the roads in such proportions that the cost per unit of transportation, or effective result per unit of investment, will be the same for every truck on both routes. As more trucks use the narrower and better road, congestion develops, until at a certain point it becomes equally profitable to use the broader but poorer highway. The congestion and interference resulting from the addition of any particular truck to the stream of traffic on the narrow but good road affects in the same way the cost and output of all the trucks using that road. It is evident that if, after equilibrium is established, a few trucks should be arbitrarily transferred to the broad road, the reduction in cost, or increase in output, to those remaining on the narrow road would be a clear gain to the traffic as a whole. The trucks so transferred would incur no loss, for any one of them on the narrow road is a marginal truck, subject to the same relation between cost and output as any truck using the broad road. Yet whenever there is a difference in the cost, to an additional truck, of using the two roads, the driver of any truck has an incentive to use the narrow road, until the advantage is reduced to zero for all the trucks. Thus, as the author contends, individual freedom results in a bad distribution of investment between industries of constant and industries of increasing cost.

In such a case social interference seems to be clearly justified. If the government should levy a small tax on each truck using the narrow road, the tax would be considered by the trucker as an element in his cost, and would cause the number of trucks on the narrow road to be reduced to the point where the ordinary cost, plus the tax, became equal to the cost on the broad road, assumed to be left tax free. The tax could be so adjusted that the number of trucks on the narrow road would be such as to secure the maximum efficiency in the use of the two roads taken together. The revenue obtained from such a tax would be a clear gain to the society, since no individual truck would incur higher costs than if no tax had been levied.

It is implied that the same argument holds good over the whole field of investment wherever investment is free to choose between uses subject to cost curves of different slope. Take, for example, two farms, one of superior quality, the other marginal or free land. Would not labor and capital go to the better farm, until the product per man became equal to the product to be obtained from the marginal land? If so, it is clear that the total product of all the labor and capital could be increased, as in the case of the roads, by transferring some of it from the superior to the inferior farm. This application of the reasoning will probably suggest the fallacy to any one familiar with conventional economic theory. The statement does in fact indicate what would happen if no one owned the superior farm. But under private appropriation and self-seeking exploitation of the land the course of events is very different. It is in fact the social function of ownership to prevent this excessive investment in superior situations.

Professor Pigou's logic in regard to the roads is, as logic, quite unexceptionable. Its weakness is one frequently met with in economic theorizing, namely that the assumptions diverge in essential respects from the facts of real economic situations.[121] The most essential feature of competitive conditions is reversed, the feature namely, of the private ownership of the factors practically significant for production. If the roads are assumed to be subject to private appropriation and exploitation, precisely the ideal situation which would be established by the imaginary tax will be brought about through the operation of ordinary economic motives. The owner of the broad road could not under effective competition charge anything for its use. If an agency of production is not subject to diminishing returns, and cannot be monopolized, there is, in fact, no incentive to its appropriation, and it will remain a free

for situation and opportunity. The assumption adopted is the simplest way of making the separation. The conclusion will not be changed if various types of cost are taken into account, so long as one of the roads has a definite situation advantage while the investment in the other can be repeated to any desirable extent with equivalent results in other locations.

[121] For the edification of the advocates of 'inductive economics' it may be observed that the 'facts' are not in dispute; that what is needed in the case is not more refined observation or the gathering of 'statistics,' but simply correct theorizing. There is, of course, also a large field in which the crucial facts are not obvious.

good. But the owner of the narrow road can charge for its use a toll representing its 'superiority' over the free road, in accordance with the theory of rent, which is as old as Ricardian economics. An application of the familiar reasoning to this case will show that the toll will exactly equal the ideal tax above considered, — tho the application may need to be more careful and complete than that made by many of the expositors of the classical theory.

The owner of a superior opportunity for investment can set the charge for its use at any amount not greater than the excess of the product of the first unit of investment above what that unit could produce on the free opportunity. Under this charge investment will flow into the superior road up to the point where congestion and diminishing returns set in. (It is better in such a simple case to use the notion of diminishing returns than to use that of diminishing costs, since in the large the practical objective is to maximize the product of given resources and not to minimize the expenditure of resources in producing a given product.) By reducing the charge, the owner will increase the amount of traffic using his road (or in general the amount of investment of labor and capital in any opportunity). But obviously the owner of the road will not set the charge so low that the last truck which uses the road secures a return in excess of the amount which it adds to the total product of the road (that is, of all the trucks which use it). This is clearer if we think of the owner of the road hiring the trucks instead of their hiring the use of the road. The effect is the same either way; it is still the same if some third party hires the use of both. The toll or rent will be so adjusted that added product of the last truck which uses the narrow road is just equal to what it could produce on the broad road. No truck will pay a higher charge, and it is not to the interest of the owner of the road to accept a lower fee. And this adjustment is exactly that which maximizes the total product of both roads.

The argument may be made clearer by the use of simple diagrams.[122]

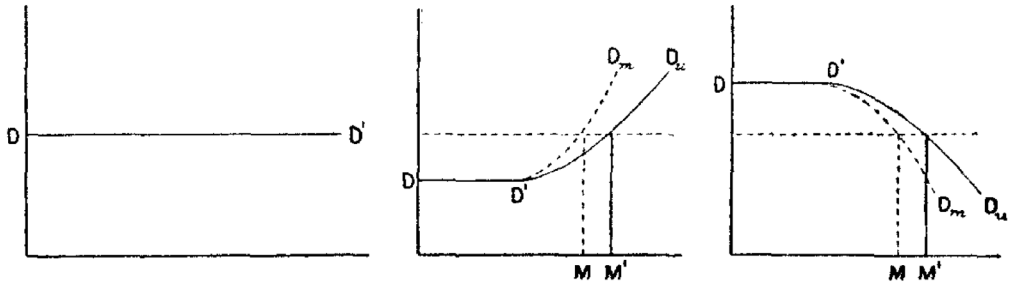


CHART A and B CHART C CHART D

Chart A and B represents the case of constant cost or constant returns, the cost of successive units of output or the return from successive units of investment on the broad road. In Chart C, the curve DD'D. is a cost curve for the narrow road, showing the cost of successive units of output. It starts at a lower level than the cost on the broad road, but at a certain point D', congestion sets in and increasing cost appears. Curve DD'DM is a curve of marginal costs on the narrow road, as Professor Pigou uses the term marginal cost; the marginal cost of the nth unit of product is the difference between the total cost of producing n units and the total cost of producing n 1 units. When costs begin to increase, the marginal cost will increase more rapidly than the cost of the added unit, since the production of each additional unit raises the cost of the earlier units to a level with that of the new unit. It must be observed that the cost of the additional unit is always the same as the cost per unit of the whole supply produced; much economic analysis is vitiated by a spurious separation of these two conceptions of cost.

Chart D represents the same facts as Chart C, but in terms of the product of successive units of investment instead of the cost of successive units of output, that is, as curves of 'diminishing returns' instead of 'increasing costs.' The output begins at a higher level than on the broad road, but at the point D', which corresponds to the point of the same designation on Chart C, the return from investment

[122] Cf. Pigou, op. cit., Appendix iii, pp. 931-938.

begins to fall off. The curve D 'D. shows the actual product of the added unit of investment, and the curve D'Dm its marginal product, its addition to the total. The latter decreases more rapidly, because the application of the additional unit reduces the yield of the earlier ones to equality with its own. The argument is the same, but stated in inverse or reciprocal form. As indicated, the viewpoint of Chart D is to be preferred, and it may be surmised that, if Professor Pigou had put his argument in this form, he would probably have avoided the error into which he was very likely misled by measuring efficiency in terms of cost of output instead of output of resources.[123]

The owner of the road will adjust his toll so that the traffic will take his road out to the point M in Chart C or D. It will not, under conditions of profit-seeking exploitation, be continued to M', as argued by Professor Pigou. **The actual output is the same as the 'ideal' output, but it is the 'ideal' output which is wrongly defined in Pigou's treatment** (p. 937). Evidently, the adjustment is correct when the marginal product of the last unit of investment on the superior road is equal to the product of a similar unit on the free road. Confusion arises in translating this condition into terms of cost and selling price of product. Selling price will be determined by cost on the free road, or at least these two will be equal, however the causal relation is conceived. That is, the money cost of any unit of product is the value of the investment which is necessary to produce it on the free opportunity, where cost is constant, or, in general, at an opportunity margin where rent does not enter. Comparison of the two viewpoints shown by our Charts C and D above shows that under competitive conditions the application of investment to the superior opportunity will be stopped at the point where marginal real cost (cost in terms of the transferable investment) is equal to real cost on the free opportunity. When equal additions to investment make equal additions to output, equal units of output have the same cost. But the condition of equilibrium cannot be stated in terms of money cost and money selling price of product on the superior opportunity, because these would be equal however the investment might be distributed, whatever rent were charged, or whether the opportunity were appropriated and exploited at all. The condition of equilibrium is that the rent on the superior opportunity is maximized as an aggregate. The rent per unit of output is a variable portion of a total unit cost which is fixed.

Extension of the foregoing argument to the general case of land rent involves no difficulties and will not be carried out in detail. The point is that any opportunity, whether or not it represents a previous investment of any sort, is a productive factor if there is sufficient demand for its use to carry into the stage of diminishing returns the application to it of transferable investment. The charge made by a private owner for the use of such an opportunity serves the socially useful purpose of limiting the application of investment to the point where marginal product instead of product per unit is equal to the product of investment in free (rentless) opportunities; and under competitive conditions this charge will be fixed at the level which does make marginal products equal, and thus maximizes productivity on the whole.[124]

6.1.2 *An argument that Knight over-did his claim*

Robin Lindsey observed in 2006 that an argument can be made that Knight overstated his case.

---

[123] It may be noted that Robertson makes the opposite contention, that the concepts of increasing and decreasing costs are to be preferred to those of decreasing and increasing returns. Loc. cit., p. 17. He gives no argument for this position. It seems to me that this is the entrepreneur's point of view, while that of either the investor or society is the inverse one advocated in the text above, and is distinctly to be preferred for general analysis.

[124] It is a theoretically interesting fact that the rent on an opportunity which maximizes the return to its owner and brings about the socially correct investment in it is its 'marginal product,' in the same sense as used to describe the competitive remuneration of other productive factors transferable from one use to another or ultimately derived from labor and waiting. It is exactly the amount by which the product of the whole competitive system would be reduced if the opportunity were held out of use or destroyed, and the investment which would be combined with it were put to the next best possible use. This point is brought out in Professor Young's chapter on Rent in Ely's Outlines of Economics (pp. 409, 410 in the fourth edition). Professor Young also pointed out the essential fallacy in Professor Pigou's argument, in a review of the latter's earlier work on Wealth and Welfare (Quarterly Journal of Economics, August 1913).

As Buchanan (1956), Edelson (1971) and Mills (1981) showed decades later, Knight is correct only under stringent assumptions. Mills provides a helpful summary:

> It has long been known that Knight's claim for the generality of this result was excessive. James Buchanan showed that it held in the road example only because there was an alternative route to the congestion-prone road, and that ownership rights could be conferred without simultaneously, and inadvertently, conferring monopoly power. After describing some alternative institutional arrangements where the result fails to hold, he concluded that private ownership can be relied upon to achieve efficient resource use lo]nly in those cases where the extent of commonality of usage is limited to a relatively small proportion of the total resource supply...' (p.315). That is, there must be a sufficient supply of alternatives to the facility in question to prevent monopoly power from existing if it is owned privately. Later, working with a variation of the road example, Noel Edelson qualified Knight's claim in another way. He showed that it depended on all users of the two roads having the same imputed value of time spent in transit. Otherwise, over- or undercongestion would result. (Mills 1981, 493)[125]

I believe the general point made by Knight and Demsetz is clear enough – that lack of property rights and therefore the operation of the market **can't** be used as justification to argue government 'taxes'. If property rights are expensive to allocate, then it is efficient *not* to do so.

And even if the government were to impose a congestion charge, it would need to be precisely the amount that a private owner of the road would impose. Further, there is typically a "second" road to a tollway, although it is not necessary for there to be so, for Knight's argument to hold. Therefore, there is no variation between social and private cost, merely bad specification of ownership.

6.2 Example 2: Property rights and the 'waste' problem

The issue of waste management is similar in to the congestion example of Pigou. The market generates waste, that doesn't mean that a 'negative externality' has been created for which a Pigovian tax is needed. Instead, this is once again an issue or absence of appropriate property rights.

The following extract from Julian Simon's book, *The Ultimate Resource 2* shows that by privatizing the waste 'problem', it can be efficiently minimised. The government wastes the waste. By privatizing waste, valuable products are extracted from the waste, with the rest of the waste being incinerated – thus reducing the need for large land-fills.

> ***The Theory of Waste and Value: Dump on Us, Baby, We Need It***
>
> Many 'environmentalists' worry that the unintended by-products from humankind's economic activities—the 'externalities,' in the lingo of economics—are malign even if the direct effects of production and trade are beneficial. But a solid case can be made that even activities which are not intentionally constructive more often than not bestow a positive legacy upon subsequent generations. That is, even the unintended aspects of humans' use of land and other raw materials tend to be profitable for those who come afterward.
>
> Hence, population growth that increases the volume of trash may increase our problems in the short run, but improve the legacy of future generations. The pressure of new problems leads to the search for new solutions. The solutions constitute the knowledge that fuels the progress of civilization, and leaves humanity better off than if the original problem had never arisen. That is the history of our species, as we see elsewhere in the book (see especially chapter 4).
>
> **Would Robinson Crusoe have been better off if there had preceded him on the island a group of people who had produced, consumed, and left the trash in a dump that Crusoe could uncover?**

[125] https://econjwatch.org/File+download/111/2006-05-lindsey-reach_concl.pdf

> **Surely he would.** Consider how valuable that dump would have been to Crusoe. If his predecessors had had a low-technology society the trash would have contained sharp stones and various animal remains useful for cutting, binding, and carrying. Or if the preceding society had had high technology, the dump would have contained even more interesting and useful materials—metal utensils, electronics parts, plastic vessels—which a knowledgeable person could have used to get help.
>
> Material that is waste to one community at one time is usually a valuable resource to a later community that has greater knowledge about how to use the material. Consider the 'borrow pits' by the sides of turnpikes, from which earth was taken for road-building. At first thought the pits seem a despoliation of nature, a scar upon the land. But after the road is finished the borrow pits become fishing lakes and reservoirs, and the land they occupy is likely to be more valuable than if the pits had never been dug.
>
> Even a pumped-out oil well—that is, the empty hole—probably has more value to subsequent generations than a similar spot without a hole. The hole may be used as a storage place for oil or other fluids, or for some as-yet-unknown purposes. And the casing that is left in the dry well might be reclaimed profitably by future generations. Or even more likely, it will be used in ways we cannot dream of now.

Like with the problem of congestion, *elimination* of waste is not optimal for society. However, if allowed to, the market *will* solve the problem efficiently.

> During the short span of time during which this edition was being prepared, the United States went from a crisis of too much household waste to too little household waste. The typical newspaper headline in 1992 is 'Economics of Trash Shift as Cities Learn Dumps Aren't So Full,' and the story goes on to present evidence that 'overall, the supply of dump space exceeds demand.' A huge new high-technology dump in an abandoned Illinois strip mine may close because it cannot get enough business, amid statements that 'earlier projections of ever-rising dump fees haven't played out'—just as the theory in chapters 1-3 predicts happens in the long run with all resources. And sure enough, municipalities that face trash 'shortages'—getting garbage to keep their dumps filling rapidly enough to be profitable—are now using legal coercion to prevent haulers from trucking trash elsewhere to take advantage of lower prices. The environmental groups see this alleviation of the supposed problem as bad news, too. 'Kevin Greene, research director for Citizens for a Better Environment, said availability of more landfill space in Illinois] will take pressure off government and industry to employ more recycling and waste-reducing measures . . . 'I'm worried about this glut of landfills', he said.'
>
> **The glut of landfill space** is so severe that the incineration industry is suffering. Waste disposal prices are so low that by 1993 there were too many incinerators in operation.
>
> What happened to abate the landfill crisis? **Firms saw an opportunity to earn profits by opening large modern dumps**. Presto, shortage relieved. And the new dumps are much safer, cleaner, and more aesthetic than the old ones. Should there be another edition of this book in a few years, the topic will probably not deserve mention any more, and readers will have forgotten that it was ever an issue.

In this regard, there is every possibility that the alleged externality problem of waste will be worsened when the government gets involved. Julian Simon explained this:

> In Urbana, Illinois, we had the best and cheapest garbage collection I have ever heard of, each homeowner contracting with any one of the private haulers who worked in the area. They gauged their charges according to how much garbage you put out, the standard rate being augmented by special charges for special hauling. if the service was sloppy or unpunctual, you changed haulers at the end of the month. The hauler in turn made a deal with a private landfill operator. The community could be neutral and inactive, and there were no significant externalities. There is no sound reason why such a system cannot operate almost anywhere.
>
> Problems arise when the community gets involved, either through contracting with a single hauler, or the municipality paying the hauler, or the municipality providing the service directly. There is then no incentive for homeowners to reduce the amount of waste they create, which leads to high waste output. And the community becomes subject to voters who have ideological views about waste and recycling, which distorts the best economic choice.

One of the typical ways by which governments destroy public wealth is by subsidising recycling. In the state of Victoria in Australia a massive 'landfill levy' is imposed based on Pigou's 'principles' – a levy that goes straight into the coffers of the government and funds hugely wasteful recycling industries. Julian Simon explained how recycling is destructive of public welfare.

> **Unnecessary recycling and conservation cannot simply be dismissed as a harmless symbolic amusement. There is a major cost in other activities that are foregone.** People could be building instead of recycling—building roads, public buildings, parks, even improving their own private shelters and spaces.
>
> Another unreckoned cost is **the coerced time of private persons**. When a town calculates the cost of a recycling program, it ignores the minutes spent by householders in separating types of trash, putting them in separate places, and stocking separate containers, and learning where and when the various kinds of trash must be placed for pickup. These are nontrivial costs.
>
> The *Washington Post*, one of the three national and international newspapers of the United States, recommends that apartment dwellers first 'Try peer pressure' and then 'Complain to authorities' if the landlord does not recycle according to law. And there is provision "to report scofflaws to the city's **'trash police,' a team of 10 inspectors** hired to search through trash and identify culprits." Not only are such practices odious (at least to me), but police expenditures are a high cost that surely are not included when an account is made of the total burden of recycling.

6.3 Example 3: Meade's bees and the orchard farmers

This is an alleged 'positive externality' invented by desktop economist James Meade that apparently leads to fewer bees and apples. Boudreaux's paper summarises Meade's example:

> Scitovsky recalled an earlier paper by James E. Meade, in which Meade gave the example of apple orchards benefiting from bees, which allowed beekeepers to benefit from apple blossoms, even though the two may not have contact with each other. If one or both of these parties fail to take adequate account of the effects of his actions on the output of the other party, there will be a sub-optimal production of apples and of honey. This divergence from optimality could justify [according to Meade] a subsidy paid by apple growers to the beekeepers to encourage beekeepers to produce more honey.[126]

Further, in their book, *Public Finance and Public Choice* (1998: second edition), John Cullis and Philip Jones note:

> In the theoretical literature on externalities, Meade (1952) uses an example of the spillover that exists between apple growers and honey-producing beekeepers. Meade refers to the 'case of an unpaid factor, because the situation is due simply and solely to the fact that the apple farmer cannot charge the beekeeper for the bees' food, . . (p. 57). The beekeepers, in this way, provide a positive external effect for apple growers. However, there is clearly another way of telling the story; i.e. the externality need not be unidirectional. Bees also create a positive external effect for apple growers in pollinating apples. If bees pollinate apple blossoms and this externality does not figure in the calculations of beekeepers, there is likely to be under-investment in beekeeping. Which of these effects is most relevant is an empirical issue, but the interesting question is whether, in a market situation, side-payments would emerge between these sets of producers to internalize the spillover.[127]

Steven Cheung, not being a desktop economist, demolished this myth, by first observing that apple farmers don't generate honey for beekeepers, and must therefore pay beekeepers to pollinate their trees:

> Cheung (1973) decided to undertake a quite detailed study of this example. In the state of Washington it appeared that there was indeed a long history of both explicit and implicit contractual arrangements, which provided for beekeepers to be compensated for the beneficial contribution made by their bees to

[126] https://www.jstor.org/stable/26617802

[127] page 33, my copy.

the apple crop. As Cheung (1978, p. 61) notes, '**Contrary to what most of us have thought, apple blossoms yield little or no honey**.' In the light of this contractual arrangement, we can illustrate this example by assuming that the direction of the external effect is from beekeepers to apple growers (reversing Due and Friedlaender 1973). What outcome would have arisen if the spillover had not been internalized?[128]

6.4 That different property rights lead to different optima doesn't create a gap (Demsetz)

It is obvious from the above discussion that property rights assignment should be done before claiming any "market failure". But the fact that property rights don't eliminate smoke/congestion does not mean there is any inefficiency involved.

Also, the so-called Coase 'theorem' is in some ways a trivial insight. I like the presentation of the theorem in Demsetz's interview:

> **Demsetz**: He [Pigou] didn't convince at least one person and that was Ronald Coase. Ronald Coase thought that Pigou was ignoring an important consideration, and that is he was ignoring the fact that it costs something to use the price system, it costs something to transact in the marketplace. And therefore, his reasoning went askance.
>
> Well, yes and no.
>
> Coase conjured up two cases. One, in which there's no cost of transacting. You can carry out any transaction as you like without having to pay somebody to be your agent or whatever the case may be. In that case there is no externality. Why, because let's suppose the law says that the steel mill has the right to burn soft coal without paying a tax. In that case the soot comes out and descends on the laundry.
>
> Now look at this whole thing prospectively. This hasn't happened yet. The steel mill is about to open up business, so the launder says, "Oh wait a minute. you're going to make my business worse because they're imposing a cost on me". Steel mill says, "Well, I'm sorry but I have the right to do this". So in that case the guy who owns the laundry goes over and knocks at the CEO's door of the steel mill and says: "I'll pay you to use less soft coal or produce less steel". And how much will he pay? He'll pay an amount that's up to the additional cost that's imposed upon him by the soot (if he didn't eliminate that soot).
>
> **Interviewer Mark Grady:** The damage to his laundry.
>
> **Demsetz:** The damage to his laundry, right. Well, in this way the owner of the steel mill does take into account the damage done to the laundry because if he continues to produce the same amount of steel, he forgoes receiving this payment from the launderer. So, this cost is not external.
>
> **Interviewer Mark Grady:** There's no externalities.
>
> **Demsetz:** The cost is no longer external to the steel mill owners calculations.
>
> **Interviewer Mark Grady:** Now, that depends upon the laundry owner being able actually to go over and to make this.
>
> **Demsetz:** That's the zero transaction cost case. So let's suppose that it costs a hundred dollars to install the smoke precipitator which takes the soot out of the smokestack. So the launderer comes over. If he's willing to pay a hundred dollars or more the soot gets taken out of the air. If he's not willing to pay that much, the precipitator does not get installed and the soot still comes out of the smokestack. So he had these alternatives depending on what the arithmetic is in the case.

[128] page 33, my copy.

> Let's suppose now that he doesn't want to pay $100, so the soot comes out in the air. Now a law student or a law professor jumps up and says: "Oh well, the law should have said that this the owner of the laundry has a right to soot-free air". So now the steel mill can't put that soot out without breaking the law. These are all law-abiding citizens. And if he does put the soot out, he'll have to pay damages. So now to CEO who owns the steel mill goes over to the laundry and says: "Gee my costs are higher as a result of this law. I'll pay you for your permission to put soot up in the air". And the laundry says: "Well, how much are you're willing to pay?" And the steel mill says: "I'll pay you more than $100 dollars, or a hundred dollars anyway". And the launderer stops and says, "Well, the cost that's imposing on me (as we reckoned in the last example) is less than a hundred dollars" so he says "OK it's a deal". So, you get soot in the air no matter which way the law assigns the right.
>
> **Interviewer Mark Grady:** And that's Coase theorem, I think.[129]

Basically, the Coase theorem is a version of tatonnement that occurs when property rights are assigned and there is an arbitrage opportunity or possible gain from trade. If property rights are not assigned or are assigned in different ways, then the market will arrive at different solutions.

However, this is not a major insight. The opportunity set in any potential trade is determined by the range of property rights on offer.

[129] https://www.sabhlokcity.com/2023/12/transcription-of-externality-related-content-from-a-demsetz-interview/

7. #5: A government can't even set the correct congestion levy

Pigou tells us that government bureaucrats can 'rectify' externalities through precise taxes and subsidies that harm no one. We have seen in the previous section that the actual problem is the absence of property rights.

Theoretically, the situation of privatisation of roads is equivalent to the government imposing a congestion levy. If a government were to optimize congestion, all it would need to do is to set a congestion levy of the equivalent amount that a private owner of the road would. Note that this is **not a Pigovian tax**, merely the equivalent of what the private sector would charge. But worse, this 'solution' (which is not a case of "externalities") cannot work in practice. Almost invariably, the government will mess up the situation.

The private road owner (in a competitive road situation) is expected to price the road usage at marginal cost. The owner has an incentive to keep costs down, which a government does not have. The actual mechanics of calculating the congestion charge in the case of private ownership is far more accurate than in the case of government.

7.1 Individual utilities and costs and benefits

The market captures all relevant individual information in determining its allocations. It is a practical impossility for the government to replicate that information pool, as shown above. Victor Fleischer wrote a piece in 2019, 'Curb Your Enthusiasm for Pigovian Taxes'[130]. He has not read Demsetz's 2011 paper which eradicates Pigou's follies. Therefore he does not refute the basic impossibility of inefficiencies from 'externalities'. However, he does hammer many nails in the coffin of Pigovian taxes.

His summary:

> **Policy advocates have often inferred, erroneously, that using a Pigovian approach means that one need not know who is causing harm, where it is occurring, or how much it would cost each firm or individual to reduce the harmful activity**. Indeed, if that were the case, one would only need an estimate of the total amount of an activity and the total social harm that results.
>
> This academic exuberance for Pigovian taxes should be tempered.
>
> … And a Pigovian tax is easy to design—as a uniform excise tax—if one simply assumes uniform marginal social cost across all individuals and firms.'
>
> This assumption of uniform marginal social cost pairs well with the limited information and enforcement capacity of government institutions.' The problem is that when marginal social cost varies, average cost does not equal marginal cost, and Pigovian taxes may not lead to an optimal allocation of economic resources.

What Fleisher is saying is that the knowledge necessary to impose taxes does not exist.

7.2 Coase's refutation of the idea that governments can do better than markets

In his paper, 'The Firm, The Market, and the Law', Coase wrote:

[130] https://scholarship.law.vanderbilt.edu/vlr/vol68/iss6/4/

> **the existence of 'externalities' does not imply that there is a prima facie case for government intervention**, if by this statement is meant that, when we find 'externalities,' there is a presumption that governmental intervention (taxation or regulation) is called for rather than the other courses of action which could be taken (including inaction, the abandonment of earlier governmental action, or the facilitating of market transactions). . . .
>
> . . . it is easy to show that the mere existence of 'externalities' does not, in itself, provide any reason for governmental intervention. Indeed, **the fact that there are transaction costs and that they are large implies that many effects of people's actions will not be covered by market transactions. Consequently, 'externalities' will be ubiquitous.** The fact that **governmental intervention also has its costs** makes it very likely that most 'externalities' should be allowed to continue if the value of production is to be maximized. This conclusion is strengthened if we assume that the government is not like Pigou's ideal but is more like his normal public authority–ignorant, subject to pressure, and corrupt.[131]

7.3 Demsetz rejected Pigou's idea of the Nirvana state

The fact that the market has not solved an *alleged* 'negative externality' is because the **costs** of doing so exceed any benefits. There is no implication of this fact, that a government can eliminate such costs; in fact, the government's costs will always be higher.

In his 1996 paper[132], Demsetz talks about Pigou's "extreme naivete in regard to the state's ability to set the matter right". Demsetz noted that Pigou's analysis "presumes and ideal state", with a "hidden presumption of an omniscient, omnipotent state". To Pigou, "[t]he costs of using the state were implicitly assumed to be zero". Thus Pigou ignored "State-associated costs of errors, implementation, and improper motivation".

In his 2011 paper, Demsetz demolished the idea of the government being able to somehow figure out lower cost solutions than market can:

> In response to the inefficiencies that he sees, Pigou turns to the State to levy taxes or confer subsidies that result in equality between private and social cost. His manner of doing this idealizes the State, which somehow knows the facts and is able to employ them **at less cost than could private parties**. He writes of idealized State-directed solutions to the problems that, as illustrated above, are likely to have been caused by the State itself. A **Nirvana State is a dangerous tool**, for it diverts attention from the real underlying problem. Why is ownership lacking or why is an owner not tending to his self-interest? In The Economics of Welfare and the doctrine that it spawned, the State is but a magic wand that Pigou waves with no effort to make private and social cost equal — the same State that, through its mismanagement, has caused many of the inequalities between private and social cost that Pigou discusses.[133]

7.4 The government doesn't have skin in the game or the right knowledge

Government bureaucrats involved have no skin in the game, hence do not have the right incentives to set the price. Any congestion levy they determine will be politicised, not equivalent to what a private owner would have set. Ethan Bueno de Mesquita notes in a 2017 book:

> Many of the policy recommendations that we have seen—subsidizing activities with positive externalities, taxing or regulating activities with negative externalities, pushing people toward efficient equilibria in coordination games—**depend on the policymaker having a lot of information.** For

---

[131] https://www.perc.org/2013/09/03/coase-on-externalities/

[132] https://www.sabhlokcity.com/2023/12/the-core-disagreement-between-pigou-the-profession-and-coase-in-the-analyses-of-the-externality-question-demsetz/

[133] https://www.sfu.ca/~allen/DemsetzSocialCost.pdf

> instance, in order to figure out the right tax, subsidy, or regulatory limit to impose in an externalities setting, the policymaker must be able to figure out the second best. **This depends on knowing things about the participants' costs, benefits, and so on.** Often such information is dispersed among the interested parties. This presents a problem because these interested parties might not be willing to release the relevant information. Indeed, as we will see, these sorts of informational asymmetries place a fundamental limit on how much good policymaking can do, even in the presence of social dilemmas that, in principle, present opportunities for Pareto improvements.[134]

As pointed out in 2010 by Thom Lambert:

> A scheme of Pigovian taxes and subsidies requires authorities to know, for different activity levels, **the degree to which actors' private costs and benefits depart from the total costs and benefits created by their conduct.** Policymakers, who are often far removed from the conduct at issue and have no way of knowing individuals' subjective preferences, generally lack this information.[135]

Leaving aside the issue that the logic of an inefficient externality does not exist, this highlights the impossibility of "socialist calculation", i.e. knowledge of detailed information.

7.5 Calculating Pigovian taxes and subsidies is similar to socialist calculation

While most economists have by now understood Mises' point re: the impossibility of socialist calculation[136] as far as prices are concerned, they still think that a government bureaucrat can magically increase overall welfare by taxing or subsidising "externalities". They are wrong. A tax to fund a public good (e.g. defence, justice) is vastly different from a tax to "internalise" an externality. The former is the cost of a non-market service. The latter is a price or cost for what would potentially be a market transaction if property rights were available. A government has no way to calculate this "price".

Peter Klein showed that the idea of setting Pigovian taxes and subsidies bring us close to the socialist calculation problem.

> First, the idea of efficient Pigouvian taxes and subsidies ignores subjective value and the Hayekian knowledge problem. How can government officials possibly choose tax or subsidy amounts that compensate for the actual harm suffered by, or benefit enjoyed by, all possible third parties for all activities generating externalities? The problem is several orders of magnitude more complex than what is typically described in the textbooks. As a mechanism design problem, it is as difficult as the general socialist calculation problem itself (and you know how I feel about that).
>
> Second, the Pigouvian approach ignores comparative institutional analysis altogether. What are the efficiency consequences of establishing, empowering, and funding a government agency to compute and implement Pigouvian taxes and subsidies? Where will the tax revenues go? How will the subsidies be financed? What are the effects of these distortions?[137]

As Peter Klein notes in a YouTube lecture, the Pigovian model requires us to determine who is causing the trouble – unlike the insight from Coase that both parties are involved.

> The Pigouvian model says, the wise and **all-knowing government should impose a tax on the steel industry**, thus making the steel industry de-facto pay the full cost.[138]

---

[134] https://press.princeton.edu/books/hardcover/9780691168739/political-economy-for-public-policy

[135] https://truthonthemarket.com/2010/04/19/some-warnings-for-modern-pigovians-from-pigou-himself/

[136] https://oll.libertyfund.org/page/reader-mises-economiccalculation

[137] https://organizationsandmarkets.com/2008/05/05/a-question-for-the-pigou-club/

[138] https://youtu.be/0ORLOIBPizs?si=xxzm1P0gu011n7-G

7.6 What is the government to do with the "Pigovian taxes" it collects?

As Peter Klein notes in a YouTube lecture, Pigou doesn't tell us what the government is supposed to do with the tax it collects:

> Presumably – this isn't always mentioned in the analysis – the government would then take the tax revenue and give it to the farmers to compensate them for the damage. A little bit would leak out, you can take junkets and waste money and other ways the government wastes it.[139]

7.6.1 *Creating a separate bureaucracy for each "Pigovian tax"*

A point entirely ignored by socialist economists is that even assuming one can identify a net negative externality and magically set a perfect Pigovian tax to reduce it, we will then need to create a specific permanent bureaucratic machine to administer the tax. One bureaucratic machine for each Pigovian tax or subsidy.

7.7 No possibility that a Pigovian tax or subsidy won't diminish the total product

Imposing a Pigovian tax always worsens the situation.

7.7.1 *Example: Pigovian tax on guns*

An example which shows how things can go very wrong with a 'Pigovian tax' on guns.

> Consider guns. …The Seattle City Council recently imposed an excise tax of $25 per gun and two to five cents per round of ammunition, citing the economic cost in Seattle and King County of $181 million per year. In the aggregate, there is no question that the social cost of guns far exceeds the private cost of manufacturing a gun. At the individual level, however, where incentives matter most directly, people vary widely in how they use a gun. Some people attend gun safety workshops, practice shooting at the range, and keep guns secure. Others are more lackadaisical, increasing the risk of accidental shootings. And of course, a small number of criminals use guns to commit violent crimes. Making matters worse from a tax design standpoint, this variation in marginal social cost is especially troubling when it is negatively correlated with demand elasticity. [Footnote: The basic intuition is that if those with the highest marginal social cost are least likely to change their behavior, a Pigovian tax set at the level of average social cost will do little to change behavior among the group that causes the most harm, and will change the behavior of those causing little harm, thereby creating deadweight loss.]
>
> Consider the effect that the Seattle excise tax on ammunition would have on two individuals: Eugene, a law professor and Second Amendment scholar, and John, a cocaine dealer. For Eugene, gun ownership causes little or no social cost. He practices regularly at the range and keeps his guns secure in a locked safe. In fact, **his gun ownership arguably creates positive social externalities for his neighbors.** [Footnote: Pigovian taxes may be used to address activities that cause only internal harm. One may imagine one's future self as the party external to one's present self; cognitive limitations may lead us to discount the preferences of one's future self excessively. The case for governmental intrusion into one's personal choices, however, is considerably more challenging than in the case where an individual harms others.]
>
> The case for Pigovian intervention is stronger for John, who carries his gun to protect himself when buying and selling cocaine. Even if John is careful, carrying a gun raises the risk of armed confrontation and accidental or intentional death. [Footnote: Demand for the product in question must be somewhat elastic, allowing for a behavioral response, but it is equally important that close substitutes not create external social cost.] Suppose that the marginal social cost from John owning a gun is $200,000, the marginal social cost from Eugene owning a gun is $0, and the excise tax is set at $10,000 per gun, the average social cost per gun.

---

[139] https://youtu.be/0ORLOIBPizs?si=xxzm1P0gu011n7-G

> Despite the variation in their marginal social cost, Eugene and John each face the same marginal cost increase of $10,000. Under these conditions, **the uniform tax rate does more harm than good.** If John and Eugene each stop buying guns, each one loses utility, but only John was causing harm to others. **Worse yet, if only Eugene stops buying guns, and John buys his illegally, the tax revenue must be balanced against the deadweight loss created when Eugene decides not to buy a gun or, worse, stops going to the practice range**. In light of the negative correlation between elasticity (responsiveness to the tax) and social cost, it is unlikely that a positive tax on guns or ammunition is the optimal government intervention under these conditions.
>
> The inefficacy of the tax in changing behavior or reducing social cost does not necessarily mean that a tax on guns is bad policy. If Eugene (and similar consumers) continue to buy guns and ammunition in spite of the tax, the tax may be a very efficient way of raising government revenue to fund gun safety programs or for more general purposes. An ineffective Pigovian tax may be an optimal commodity tax.[140]

7.7.2 *Example: Victoria's landfill levy*

In Victoria, a landfill levy supposedly based the model of Pigovian tax, merely fills up the coffers of the state government in a "Sustainability Fund" and the moneys are squandered in all kinds of delusional ideas of ministers and bureaucrats. Any detailed investigation of such taxes will expose a huge boondoggle, a financial scandal, all of it at the expense of the taxpayer. The levy is a destroyer of public wealth, with a clear net harm.

[140] https://scholarship.law.vanderbilt.edu/vlr/vol68/iss6/4/

8. #6: Pareto optimality doesn't permit coercion of the kind Pigou wanted

To achieve Pareto optimality means that no further improvements to society's well-being can be made through a *voluntary* reallocation of resources that makes at least one person better off without making someone else worse off.

The **concept of Pareto optimality is an extreme version of the non-aggression principle**: we can't harm anyone while trying to benefit someone else. The science of economics can at best recommend voluntary action. It can *never* recommend mandates, such as vaccine mandates.

Pigou's ideas of taxation and subsidy make a mockery of this principle by introducing coercion into the picture.

8.1 Definition of Pareto optimality

To be clear that we understand the implication of Pareto optimality, I have provided below the definition of the concept as mentioned in the standard textbook on Intermediate Microeconomics by Hal Varian:

> One useful criterion for comparing the outcomes of different economic institutions is a concept known as Pareto efficiency or economic efficiency. We start with the following definition: if we can find a way to make some people better off without making anybody else worse off, we have a Pareto improvement. If an allocation allows for a Pareto improvement, it is called Pareto inefficient; if an allocation is such that no Pareto improvements are possible, it is called Pareto efficient.
>
> Suppose that we think of all **voluntary trades** as being carried out so that all gains from trade are exhausted. The resulting allocation **must** be Pareto efficient. If not, there would be some trade that would make two people better off without hurting anyone else—but this would contradict the assumption that all voluntary trades had been carried out. An allocation in which all voluntary trades have been carried out is a Pareto efficient allocation.

8.2 Pigou's impossible condition: a government must not harm anyone in the process

Pigou knew that his recommendation for a subsidy for 'positive externalities' was violative of basic economic principles. He admonished his followers that 'funds for the bounty can be raised by a mere transfer that does not inflict any indirect injury on production' (or, likewise, to pay for the tax).

This condition is violated in all cases of Pigovian taxation or subsidy.

8.2.1 *Vaccine subsidisation and coercion*

A person taking a vaccine does so *in his own interest*, regardless of any incidental benefits others might achieve. Any such public benefit (e.g. contribution to herd immunity) is a boon the society should be grateful for. Any subsidization for the vaccine would involve coercive taxation of some people in order to benefit others, and violate Pareto optimality.

Mandatory vaccines don't meet Pigou's criterion, either, since forcing a vaccine into the body of a non-vaccinated person can (subjectively) harm that person, in the attempt to make someone else better off.

8.2.2 *Taxation to deal with road congestion*

If a road is privately owned, the owner will seek to price discriminate, so that those with a higher opportunity cost will pay more for road use. This will lead to optimal pricing in which there is no coercion.

But a government, with political pressures, will not achieve this, and instead, tax indiscriminately, thus reducing overall output and breading Pigou's condition.

8.2.3 *Subsidies do not come for free*

Although not in the context of Pigovian subsidies, Mises wrote this in 1944, which applies perfectly to Pigou's idea of subsidies:

> The government pretends to be endowed with the mystical power to accord favors out of an inexhaustible horn of plenty. It is both omniscient and omnipotent. It can by a magic wand create happiness and abundance. The truth is that the government cannot give if it does not take from somebody. A subsidy is never paid by the government out of its own funds; it is at the expense of the taxpayer that the state grants subsidies.[141]

I'm extracting a short section from Ethan Bueno de Mesquita's 2016 book[142]:

> When an activity imposes positive externalities, a subsidy incentivizes people to do more of it. These kinds of subsidies or taxes are often referred to as Pigovian, after the economist Arthur Cecil Pigou. Examples of such policies include … subsidies for scientific research—designed to expand the creation of scientific knowledge, which imposes positive externalities.
>
> Suppose a subsidy, σ, is paid to each player in our public goods game for each unit of effort she contributes. We must collect revenue through taxation to fund the subsidy. Unfortunately, taxation itself results in some inefficiencies. This might be due to reduced incentives for work, distortions in behavior to focus on less productive tasks that are taxed at a lower rate, the need to build a bureaucracy to collect the taxes, or what have you. We will model this inefficiency in as simple a way as possible. It costs taxpayers $\$\tau > \$1$ for each dollar of revenue the government requires. That is, to disburse $T in subsidies, the government must collect $T x τ in revenues.
>
> Assume that each member of society pays an equal share of the tax burden to fund subsidies for everyone other than herself. For instance, suppose Player i earns a subsidy of e_i x σ. (And so on …)
>
> Suppose Player *i* believes everyone else will use the strategies given by $\mathbf{e}_{-i}$. If the subsidy is σ, Player i's best response solves

$$\max_{e_i} \overbrace{e_1 + e_2 + \ldots + e_i + \ldots + e_N}^{\text{Public Goods}} + \overbrace{e_i\sigma}^{i\text{'s subsidy}} - \overbrace{e_i^2}^{i\text{'s costs}} - \overbrace{\frac{(e_1 + e_2 + \ldots + e_{i-1} + e_{i+1} + \ldots + e_N)\sigma\tau}{N-1}}^{i\text{'s tax burden}}.$$

Further, separately, he writes:

> The workfare example highlights a general challenge for governments. Many of the policy recommendations that we have seen—subsidizing activities with positive externalities, taxing or regulating activities with negative externalities, pushing people toward efficient equilibria in coordination games—depend on the policymaker having a lot of information. For instance, in order to figure out the right tax, subsidy, or regulatory limit to impose in an externalities setting, the policymaker must be able to figure out the second best. This depends on knowing things about the participants' costs, benefits, and so on. Often such information is dispersed among the interested parties. This presents a problem because these interested parties might not be willing to release the relevant information. Indeed, as we will see, these sorts of informational asymmetries place a fundamental limit

[141] https://cdn.mises.org/Bureaucracy_3.pdf

[142] https://press.princeton.edu/books/hardcover/9780691168739/political-economy-for-public-policy

> on how much good policymaking can do, even in the presence of social dilemmas that, in principle, present opportunities for Pareto improvements.

The key points are that a subsidy 'solution' is not costless. Moreover, achieving a Pareto improvement almost always involves detailed knowledge of preferences which a government cannot have (and is difficult, if not impossible to achieve).

This leaves out the other basic problems (that some people genuinely believe the vaccine is a public 'bad', not a good).

8.3 A political 'remedy' to social problems is not about Pareto optimality

When Joseph Stiglitz carelessly referred to a 'free rider' problem to recommend vaccine mandates, he was adopting politics, not economics. Stiglitz imagined that what he wanted was also the society's General Will (cf. Rousseau) and the state should therefore impose *his* will.

A typical economist will say something on these lines:

> almost all economists favor using taxes to reduce a broad range of harmful activities rather than relying on other forms of centralized regulation. Such Pigouvian taxes would make almost everyone better off and could be designed to be revenue-neutral or revenue-raising, depending on concerns about their distributive impacts.[143]

This suggests that Pigovian taxation is less harmful than 'centralised regulation'. The reality is quite the opposite. Sensible regulatory (political) solutions can deliver the maximum welfare for society.

8.3.1 *Vaccine subsidy as part of political action*

The positive societal benefit of one's taking a vaccine is real (herd immunity), and it is possible that a government could think of subsidizing the vaccines in order to increase overall demand (the subsidy shifts the demand curve outward). There are many confounding issues, though, that would need to be carefully considered.

8.3.2 *Cap and trade scheme to reduce pollution*

Likewise, a government could impose in a cap-and-trade scheme to reduce overall pollution in the most economic way. This, again, is a political decision, supported by economics; not a Pareto optimal solution.

The lockdowns showed us the reality of the external effects problem. When factories shut down in India, the skies over Delhi became clear, the air clean. Clear skies via taxes will come at the expense of the livelihoods of millions. There is no free lunch. The level of pollution in Delhi is optimal, given all other constraints.

But politically, if it is decided that a certain level is too high, then the society can pay the necessary cost. There is **always** a cost to pay in GDP and jobs to cut pollution. Unless new technology is incentivised. Regulatory limits on pollution (including cap and trade) will reduce GDP temporarily but will motivate innovation. These are solutions to pollution, not taxes. And even though technology innovations are not necessarily known (their cost and effectiveness unclear), a CBA will show us whether the total (known) cost borne by society of such regulations is lower than expected benefits. The simple CBA holds the key.

Note that such regulations are intended to fix pollution, not "inefficient externalities" – which is a vague and meaningless concept.

---

[143] Book: *Why Government Fails So Often*, By Peter H. Schuck

8.3.3 *Auction of development rights in town planning*

In town planning, Demsetz's insight leads us to the auction of development rights (with a reserve price that captures the offsetting costs of public amenity, e.g. parks). I've written much about this: a sketch at https://www.sabhlokcity.com/2018/05/hayek-supported-market-based-strategies-for-urban-planning-town-planning/

8.4 Steve Kates's explanation of the political response to societal problems

Steven Kates wrote in his book, *Free Market Economics*:

> Amongst the most important examples of market failure is what are referred to as externalities. An externality is a cost imposed on some third party not associated with the purchase and sale of the particular product. The typical example is some form of pollution, where the market will produce more pollution than is socially optimal.
>
> If some resource has no owner – the air, say, or some body of water then businesses will be more likely to dump waste products without regard to the effects on others. Business is thus associated with negative outcomes for the environment.
>
> And while it is perfectly sensible to point such problems out, attention is then given to conceptual solutions so useless in practice, that it is a wonder that they are ever introduced at this level. The core concept is something called 'marginal social costs', which are the additional costs to society as a whole caused by some change in activity.
>
> **Seldom is there a presentation that points out that as wealth has increased across a community, a reduction in polluting forms of activity has arisen naturally in the political response to such problems.** Certainly problems abound, but is not the normal practice to stress that the benefits of a market economy are massive in comparison with the problems that it generates.
>
> Nor is it common practice to stress that it is only because there is private ownership and a price mechanism that realistic solutions to such problems not only can be but have been developed. Given production techniques in the modern world - where the nature of the production process is driven by technological specifications - every economy faces the same problems in dealing with such externalities. But given the origins of such problems, how often is it pointed out that no genuine solution is possible without economies organized around entrepreneurial decision making and the pursuit of a profitable return unless we are prepared to sacrifice massive amounts of our productive potential?

8.5 Barry Brownstein's demonstration that Pigou's taxes and subsidies are not Pareto optimal

In a 1980 paper, 'Pareto Optimality, External Benefits and Public Goods: A Subjectivist Approach'[144], Barry Brownstein wrote:

> The concept of Pareto optimality has been used to draw much of the policy conclusions of modern welfare economics. Much of the allegedly value-free scientific justification for government comes out of this simple statement of economic efficiency. Consider the following statements, all justified by their authors on the grounds of economic efficiency. The Musgraves justify subsidies for anything generating external benefits:
>
> > The consumption or production of primarily private goods can give rise to external benefits. Such benefits are not accounted for in the market and a subsidy is required to correct this defect.

[144] https://cdn.mises.org/4_1_6_0.pdf

Hochman and Rodgers justify income redistribution using Pareto optimality:

> Interdependence among individual utility functions may imply that the market-determined income distribution is not optimal in the Pareto sense.

In an article which would seem to be a parody but unfortunately is not, Geoffry Brennan advocates income destruction:

> Since the most desirable outcome for each individual would occur when all others indulge in mutual income destruction, a problem of free riding . . . arises. Government intervention is thus necessary if the Pareto desirable income destruction for A and B is to occur?

If all of the above statements are correct in a value-free scientific sense, then it becomes clear that much governmental activity can be advocated using Pareto optimality. This section will argue that **such statements do not follow from the concept of Pareto optimality.**

A typical definition of Pareto efficiency would be: 'A given economic arrangement is efficient if there can be no arrangement which will leave someone better off without worsening the position of others.' Thus any exchange or reallocation of resources is only Pareto optimal if the exchange or reallocation will not harm somebody.

It is well known that if perfect competition prevailed throughout the economy and if no externalities existed, the conditions for Pareto optimality would hold. This, however, is quite a different matter from advocating a policy of marginal cost pricing and the internalization of all externalities. By going from statements about the world in a static equilibrium setting if Pareto optimality existed, to statements as to how the world should be, the economist is introducing a value judgment. That is, no matter how one tries, one cannot get normative statements out of positive statements without introducing value judgments. An example at this point will be useful. Economic theory may predict that **a person will act up to the point that the marginal cost and the marginal benefit of an action are equated. However, this is a proposition which can never be objectively tested, since costs are subjective (a topic to be considered in the next section).** Predicting a person's behavior based upon certain postulates is far different from advocating that 'society,' as a matter of policy, should act to equate marginal costs and marginal benefits.

James Buchanan provides a further illustration of this point:

> **Equalities between prices and marginal costs; as objectively observed quantities in full competitive equilibrium, are inferred predictions which depend on the behavioral assumptions upon which the whole theory is constructed. These equalities have no normative significance and they have no direct relationship to allocative efficiency.** The methodological muddle in modern economics is perhaps most closely revealed by the unwarranted crossing of the bridge between the inferential predictions of the genuinely scientific theory and the normative conclusions about efficiency that are so often drawn.

Thus, as Buchanan further points out, nothing can be implied if the predictions that characterize equilibrium are falsified. No potential gains from trade are indicated if these predictions are not fulfilled. No welfare improvements could be expected from arrangements to ensure that the predicted relationships will be produced.'

This, then, is a fundamental problem for modern welfare economics: Policy statements drawn from Pareto optimality turn nonfalsifiable predictive statements into normative statements as to how the world should be.

Therefore we are left with the conclusion that **the policy judgments of modern welfare economics do not logically follow from the definition of Pareto optimality.** Certainly, these policy statements are not made without value judgments and cannot be passed off as scientific statements.

In the next section, we will present other objections to government subsidies when external benefits exist. In part of the next section we will demonstrate that, even accepting Pareto optimality as a definition of economic efficiency, government subsidy payments do not meet this criteria.

9. #7:Positive 'externalities' are a boon, not an entitlement to coerce

Positive externalities have been used to drive coercive actions such as vaccine mandates. There is nothing in economics that permits such an implication. But positive effects are ***not*** inefficiencies. These are not 'market failures', but a bonus we get from our interactions with others.

9.1 What are positive externalities?

According to the encyclopaedia Britannica, 'positive externalities arise when one party, such as a business, makes another party better off but does not receive any compensation for doing so'.

9.1.1 *Doing something can provide an external benefit*

Consider somebody who makes a beautiful flower garden outside his house. He makes the garden for his private benefit. It is true that the value of his house will increase in the market if he builds and maintains a pretty garden, but if he has no intention of selling his house then that work is entirely for his private pleasure. In performing this labour of love, he does not care if passers-by derive a positive benefit from his work. He provides the benefit anyway – like the bee that incidentally pollinates flowers even as it is focused on maximising its stock of honey.

Other examples:

- Building a train station may provide shelter for the homeless when it is raining.
- If a company develops new technology, such as a database programme, this new technology can be implemented by other firms who will gain a similar boost to productivity.
- Tim Berners Lee who developed the World Wide Web, made it freely available, creating a very large positive externality.
- Put many vendors together and you get a farmers market or fair. While people buy individual goods, the entire market provides a positive externality. Every shop provides an externality. The more the shops in an area, the higher the land values.

9.1.2 *Doing nothing can also provide an external benefit*

There are innumerable daily activities that people undertake which provide an incidental benefit to *others*.

- When **tourists** visit a new city, they get a benefit just from watching people of the city being who they are, doing their routine, normal things. The novelty of the new city and its sights, and hustle and bustle, provide utility (positive externality) to the tourist.
- People enjoying a football match and screaming with pleasure creates a positive benefit for observers, and participants
- If children are playing with dogs, people are jogging around or doing tai chi in a park, the entire area achieves a positive benefit.

9.2 On what basis are positive benefits claimed to be a problem?

How can something as benign as this activity of doing something which provides others with a benefit be considered by economists to be a problem?

That's because Pigovian (Fabian) economists have inverted the situation to claim that those who are *not* providing such a benefit (e.g. a flower garden) have created an inefficiency, i.e. society is producing less than is socially optimal.

It is hard to imagine a more topsy-turvy, absurd logic. These people then claim that the government must intervene, including through coercion.

9.2.1 *Walter Block's claim that those who don't provide a positive externality must be executed*

Walter Block would execute those who don't 'save' others by vaccinating themselves. He wants people to be forced to provide a benefit to third parties:

> If you contract XYZ, there is a 100 percent chance you will die a painful death. 40 percent of the people on the planet cannot tolerate the vaccination against it. We know who they are, through a test which is 100 percent reliable. The vaccine will not in any way harm the other 60 percent of the people. This majority will, all with 100 percent probability, contract this disease. They will die from it unless they are vaccinated. Also, again with 100 percent certainty (there is no doubt in this example, none) the 60 percent will spread the disease to the 40 percent vulnerables. The drug costs nothing, works perfectly in preventing the XYZ disease and there are no side effects of it whatsoever, again for sure.
>
> Would I compel the 60 percent to get the vaccination on libertarian grounds? You're darn tootin' I would. Not so much to save them. That would be paternalism. But, rather, in order to save the lives of the 40 percent who are vulnerable. If any member of this 60 percent refused this vaccination, I would execute him as threatening mass murder of 40 percent of the population.[145]

9.3 There is no inefficiency

As shown in the previous sections, there is no inefficiency involved in positive or negative spillover effects. The market (voluntary) solution is always Pareto optimal.

If no one is monetizing the positive benefit they provide, that's because it is not worth doing so. For a government to improve the situation (Pareto optimality) through subsidies the following conditions are among the many, that need to be met:

a) Everyone agrees that the good is actually a public good, not a 'bad'

b) Different people value it differently

c) If people actually paid their true value (particularly those who value it most), the public good would emerge on its own

d) Strategic behaviour dominates, i.e. free riding, thereby people don't disclose their true value, so the public good doesn't get 'built'

e) A subsidy is targeted individually (government must know everyone's utility function) and magically eliminates strategic behaviour

f) The tax collected for the subsidy is less than the willingness to pay for the public good by the person who values it least

g) There is no efficiency loss from raising taxes, and the government coordinates costlessly the building of the public good (i.e. no government failure)

Even if (a) is met, i.e. we have a 'clean' positive externalities (in which all agents agree to its being a public good), achieving Pareto optimality is fraught. The subsidy 'solution' suffers from the following failures:

- the assumption that a government knows individual utility functions for a public good is not even remotely valid, since there is no market-based mechanism to assess. Surveys are susceptible to strategic behaviour.

[145] https://cdn.mises.org/jls_24_1_block.pdf

- different people may value a 'public good' differently, some of them positively rejecting it (public bad). So what is the social marginal 'benefit' function?
- any subsidy to those who dislike a public good (e.g. a vaccine) will likely not shift their preference significantly
- subsidy is not manna: it is derived by taxing all people, including those who would have a paid a higher price, and those who don't want the 'good'.

In general, there is **no possibility** of identifying a Pareto optimal solution for goods like vaccines (herd immunity). Even for things like a road, all that can be hoped for is that the tax is equal to the *lowest amount* that someone was willing to for the road. Else Pareto optimality can't prevail.[146]

9.4 Enjoying a free benefit is not the same as free riding!

The claim of a 'free rider' is considered sufficient 'proof' by economists to force people to provide the 'social benefit' at the point of a gun. Thus, in public health, free riding is the basis for vaccine mandates.

How can providing social benefit become a problem? Apparently, those who don't provide it are free riding and are therefore the problem. It surely takes the most convoluted brain to convert a social benefit voluntarily provided by a few, to be a problem.

Let's consider a few examples:

Flower garden

If I have a flower garden that you enjoy, it is not 'free riding'. It is a benefit you *don't need to pay for*. Free riding is only applicable when one has to pay for a public good but doesn't, leading to under-supply.

There are people who argue that free riding on 'positive externalities' is not just sufficient to motivate subsidies, it is sufficient to motivate mandates. If I produce a positive externality from my flower garden, then those who don't have a nice flower garden are told that they producing a negative externality, causing harm! Therefore, everyone is forced by this logic to create a flower garden like mine.

Vaccines:

Likewise, my being vaccinated might help others in some way. But that is a boon, not a birth right of others to force everyone to vaccinate themselves. It does not give anyone a right to force others to be vaccinated.

Likewise, if I choose to remain unvaccinated, it is not good reason for me to be vaccinated that someone else wants me to do so. I must benefit *privately* from the vaccine. If necessary, 'society' must pay me to be vaccinated (subsidy). Coercive vaccination is nothing but communism.

Heritage laws

Heritage laws deny equal property rights to persons who happen to build a beautiful building. The society seizes his property rights just because the politicians (government) 'likes' that building. A claim is made that the building provides a positive externality to society, hence the owner cannot demolish it.

Compulsion to save drowning person

Imagine someone is drowning and you might be able to save that person at some risk. There exists a moral obligation to save the drowning person, but it is not something that a government can coerce us into doing.

[146] https://www.cis.org.au/commentary/opinion/positive-externalities-vs-public-goods/

9.5 Thoughts of economists on positive benefits

9.5.1 *Ludwig von Mises*

Mises pointed out[147] that the fact that someone's 'project also benefits other people will not prevent him from accomplishing what promotes his own well-being'.

> The case of external economies is **not simply the inversion of the case of external costs.** It has its own domain and character.
>
> If the results of an actor's action benefit not only himself, but also other people, two alternatives are possible:
>
> 1. The planning actor considers the advantages which he expects for himself so important that he is prepared to defray all the costs required. **The fact that his project also benefits other people will not prevent him from accomplishing what promotes his own well-being.** When a railroad company erects dikes to protect its tracks against snowslides and avalanches, it also protects the houses on adjacent grounds. But the benefits which its neighbors will derive will not hinder the company from embarking upon an expenditure that it deems expedient.
> 2. The costs incurred by a project are so great that none of those whom it will benefit is ready to expend them in full. The project can be realized only if a sufficient number of those interested in it share in the costs. **[Sanjeev: e.g. a road]**
>
> It would hardly be necessary to say more about external economies if it were not for the fact that **this phenomenon is entirely misinterpreted in current pseudo-economic literature.**
>
> A project P is unprofitable when and because consumers prefer the satisfaction expected from the realization of some other projects to the satisfaction expected from the realization of P. The realization of P would withdraw capital and labor from the realization of some other projects for which the demand of the consumers is more urgent. The layman and the pseudo-economist fail to recognize this fact. They stubbornly refuse to notice the scarcity of the factors of production. As they see it, P could be realized without any cost at all, i.e., without foregoing any other satisfaction. It is merely the wantonness of the profit system that prevents the nation from enjoying gratuitously the pleasures expected from P. [**Sanjeev: this is precisely how most 'economists' think if herd immunity from vaccines, that it is a cost-less good**]
>
> Now, these short-sighted critics go on to say, the absurdity of the profit system becomes especially outrageous if the unprofitability of P is merely due to the fact that the entrepreneur's calculations neglect those advantages of P which for them are external economies. From the point of view of the whole of society such advantages are not external. They benefit at least some members of society and would increase 'total welfare.' The nonrealization of P is therefore a loss for society. As profit-seeking business, entirely committed to selfishness, declines to embark upon such unprofitabIe projects, it is the duty of government to fill the gap. Government should either run them as public enterprises or it should subsidize them in order to make them attractive for the private entrepreneur and investor. The subsidies may be granted either directly by money grants from public funds or indirectly by means of tariffs the incidence of which falls upon the buyers of the products. [**Sanjeev: now, one can, in some**

[147] https://www.sabhlokcity.com/2023/10/von-mises-on-why-positive-externalities-should-not-be-used-to-justify-government-intervention/

cases agree to this subsidisation proposal, but generalising a role for government is a huge leap of faith]

However, the means which a government needs in order to run a plant at a loss or to subsidize an unprofitable project must be withdrawn either from the taxpayers' spending and investing power or from the loan market. The government has no more ability than individuals to create something out of nothing. What the government spends more, the public spends Iess**. Public works are not accomplished by the miraculous power of a magic wand. They are paid for by funds taken away from the citizens.** If the government had not interfered, the citizens would have employed them for the realization of profit promising projects the realization of which they must omit because their means have been curtailed by the government. For every unprofitable project that is realized by the aid of the government there is a corresponding project the realization of which is neglected merely on account of the government's intervention. Yet this nonrealized project would have been profitable, i.e., it would have employed the scarce means of production in accordance with the most urgent needs of the consumers. From the point of view of the consumers the employment of these means of production for the realization of an unprofitable project is wasteful. It deprives them of satisfactions which they prefer to those which the government-sponsored project can furnish them.

The gullible masses who cannot see beyond the immediate range of their physical eyes are enraptured by the marvelous accomplishments of their rulers. They fail to see that they themselves foot the bill and must consequently renounce many satisfactions which they would have enjoyed if the government had spent less for unprofitable projects. They have not the imagination to think of the possibilities that the government has not allowed to come into existence. [1]

These enthusiasts are still more bewildered if the government's interference enables submarginal producers to continue producing and to stand the competition of more efficient plants, shops, or farms. Here, they say, it is obvious that total production is increased and something is added to the wealth that would not have been produced without the assistance of the authorities. What happens in fact is just the opposite; the magnitude of total production and of total wealth is curtailed. Outfits producing at higher costs are brought into existence or preserved while other outfits producing at Iower costs are forced to curtail or to discontinue their production. The consumers are not getting more, but less.

There is, **for instance**, the very popular idea that it is a good thing for the government to promote the agricultural development of those parts of the country which nature has poorly endowed. Costs of production are higher in these districts than in other areas; it is precisely this fact that qualifies a large part of their soil as submarginal. When unaided by public funds, the farmers tilling these submarginal lands could not stand the competition of the more fertile farms. Agriculture would shrink or fail to develop and the whole area would become a backward part of the country. In full cognizance of this state of affairs profit-seeking business avoids investing in the construction of railroads connecting such inauspicious areas with the centers of consumption. The plight of the farmers is not caused by the fact that they lack transportation facilities. The causation is the other way round; because business realizes that the prospects for these farmers are not propitious, it abstains from investing in railroads which are likely to become unprofitable for lack of a sufficient amount of goods to be shipped. If the government, yielding to the demands of the interested pressure groups, builds the railroad and runs it at a deficit, it certainly benefits the owners of farm land in those poor districts of the country. As a part of the costs that the shipping of their products requires is borne by the treasury, they find it easier to compete with those tilling more fertile land to whom such aid is denied. But the boon of these privileged farmers is paid for by the taxpayers who must provide the funds required to defray the deficit. It affects neither the market price nor the total available supply of agricultural products. It merely makes profitable the operation of farms which hitherto were submarginal and makes other farms, the operation of which was hitherto profitable, submarginal. It shifts production from land requiring lower costs to land requiring higher costs. **It does not increase total supply and wealth, it curtails them, as the additional amounts of capital and labor required for the cultivation of high-cost fields instead of low-cost fields are withheld from employments in which they would have made possible the production**

of some other consumers' goods. The government attains its end of benefiting some parts of the country with what they would have missed, but it produces somewhere else costs which exceed these gains of a privileged group.

The External Economies of Intellectual Creation

The extreme case of external economies is shown in the 'production' of the intellectua1 groundwork of every kind of processing and constructing. The characteristic mark of recipes, i.e., the mental devices directing the technological procedures, is the inexhaustibility of the services they render. These services are consequently not scarce, and there is no need to economize their employment. Those considerations that resulted in the establishment of the institution of private ownership of economic goods did not refer to them. They remained outside the sphere of private property not because they are immaterial, intangible, and- impalpable, but because their serviceableness cannot be exhausted.

People began to realize only later that this state of affairs has its drawbacks too. It places the producers of such recipes–especially the inventors of technological procedures and authors and composers-in a peculiar position. They are burdened with the costs of production, while the services of the product they have created can be gratuitously enjoyed by everybody. What they produce is for them either entirely or almost entirely external economies.

If there are neither copyrights nor patents, the inventors and authors are in the position of an entrepreneur. They have a temporary advantage as against other people. As they start sooner in utilizing their invention or their manuscript themselves or in making it available for use to other people (manufacturers or publishers), they have the chance to earn profits in the time interval until everybody can likewise utilize it. As soon as the invention or the content of the book are publicIy known, they become 'free goods' and the inventor or author has only his glory.

The problem involved has nothing to do with the activities of the creative genius. These pioneers and originators of things unheard of do not produce and work in the sense in which these terms are employed in dealing with the affairs of other people. They do not let themselves be influenced by the response their work meets on the part of their contemporaries. They do not wait for encouragement.[2]

It is different with the broad class of professional intellectuals whose services society cannot do without. We may disregard the problem of second-rate authors of poems, fiction, and plays and second-rate composers and need not inquire whether it would be a serious disadvantage for mankind to lack the products of their efforts. But it is obvious that handing down knowledge to the rising generation and familiarizing the acting individuals with the amount of knowledge they need for the realization of their plans requires textbooks, manuals, handbooks, and other nonfiction works. It is unlikely that people would undertake the laborious task of writing such publications if everyone were free to reproduce them. This is still more manifest in the field of technological invention and discovery.

The extensive experimentation necessary for such achievements is often very expensive. It is very probable that technological progress would be seriously retarded if, for the inventor and for those who defray the expenses incurred by his experimentation, the results obtained were nothing but external economies.

Patents and copyrights are results of the legal evolution of the last centuries. Their place in the traditional body of property rights is still controversial. People look askance at them and deem them irregular. They are considered privileges, a vestige of the rudimentary period of their evolution when legal protection was accorded to authors and inventors only by virtue of an exceptional privilege granted by the authorities. They are suspect, as they arc lucrative only if they make it possible to sell at monopoly prices.[3] Moreover, the fairness of patent laws is contested on the ground that they reward only those who put the finishing touch leading to practical utilization of achievements of many predecessors. These precursors go empty-handed although their contribution to the final result was often much more weighty than that of the patentee. It is beyond the scope of catallactics to enter into

> an examination of the arguments brought forward for and against the institution of copyrights and patents. It has merely to stress the point that this is a problem of the delimitation of property rights and that with the abolition of patents and copyrights authors and inventors would for the most part be producers of external economies.
>
> [1] Cf. the brilliant analysis of public spending in Henry Hazlitt's book *Economics in One Lesson* (New York, ly46), pp. 19-29.
>
> [2] See above, pp. 138-140.
>
> [3] See above, pp.360-361

In terms of vaccines, the recipient of 'herd immunity' (even though he might have natural immunity, like Novak Djokovic), is criticised for being an ingrate, thief, and free rider. Soon, thereafter, the gun is pointed at him (e.g. blocking Novak's entry into Australia).

Further, Ludwig von Mises wrote

> If the results of an actor's action benefit not only himself, but also other people, two alternatives are possible:
>
> 3. The planning actor considers the advantages which he expects for himself so important that he is prepared to defray all the costs required. **The fact that his project also benefits other people will not prevent him from accomplishing what promotes his own well-being.** When a railroad company erects dikes to protect its tracks against snowslides and avalanches, it also protects the houses on adjacent grounds. But the benefits which its neighbors will derive will not hinder the company from embarking upon an expenditure that it deems expedient.[148]

The test for this type of externality is that the person should perform the action *in his own interest*, regardless of the fact that it also benefits others.

9.5.2 *Murray Rothbard*

Likewise, Murray Rothbard provided (in his 1962 book, *Man, Economy, and State with Power and Market*) a rebuttal of the idea that positive externalities can be fixed by government intervention. From *Man, Economy, and State with Power and Market*:

> **Positive externalities**
>
> We come now to the problem of external benefits—the major justification for government activities expounded by economists. Where individuals simply benefit themselves by their actions, many writers concede that the free market may be safely left unhampered. **But men's actions may often, even inadvertently, benefit others.** While one might think this a cause for rejoicing, critics charge that from this fact flow evils in abundance. A free exchange, where A and B mutually benefit, may be all very well, say these economists; but what if A does something voluntarily which benefits B as well as himself, but for which B pays nothing in exchange?
>
> There are two general lines of attack on the free market, using external benefits as the point of criticism. Taken together, these arguments against the market and for governmental intervention or enterprise cancel each other out, but each must, in all fairness, be examined separately. The first type of criticism is to *attack A for not doing enough for B*. The benefactor is, in effect, denounced for taking his own selfish interests exclusively into account, and thereby neglecting the potential indirect recipient waiting silently in the wings. The second line of attack is to *denounce B for accepting a benefit without paying A in return.* The

[148] https://www.sabhlokcity.com/2023/10/von-mises-on-why-positive-externalities-should-not-be-used-to-justify-government-intervention/

recipient is denounced as an ingrate and a virtual thief for accepting the free gift. [Sanjeev: the term used is free rider] The free market, then, is accused of injustice and distortion by both groups of attackers: the first believes that the selfishness of man is such that A will not act enough in ways to benefit B; the second that B will receive too much 'unearned increment' without paying for it. Either way, the call is for remedial State action; on the one hand, to use violence in order to force or induce A to act more in ways which will aid B; on the other, to force B to pay A for his gift.

Generally, these ethical views are clothed in the 'scientific' opinion that, in these cases, free-market action is no longer optimal, but should be brought back into optimality by corrective State action. Such a view completely misconceives the way in which economic science asserts that free-market action is *ever* optimal. It is optimal, not from the standpoint of the personal ethical views of an economist, but from the standpoint of the free, voluntary actions of all participants and in satisfying the freely expressed needs of the consumers. Government interference, therefore, will necessarily and always move *away* from such an optimum.

It is amusing that while each line of attack is quite widespread, each can be rather successfully rebutted by using the essence of the *other* attack! Take, for example, the first—*the attack on the benefactor.* To denounce the benefactor and implicitly call for State punishment for insufficient good deeds is to advance a moral claim by the recipient upon the benefactor. We do not intend to argue ultimate values in this book. But it should be clearly understood that to adopt this position is to say that B is entitled peremptorily to call on A to do something to benefit him, and for which B does not pay anything in return. We do not have to go all the way with the second line of attack (on the 'free rider'), but we can say perhaps that it is presumptuous of the free rider to assert his right to a post of majesty and command. For what the first line of attack asserts is the moral right of B to exact gifts from A, by force if necessary.

Compulsory thrift, or attacks on potential savers for not saving and investing enough, are examples of this line of attack. Another is an attack on the user of a natural resource that is being depleted. Anyone who uses such a resource at all, whatever the extent, 'deprives' some future descendant of the use. 'Conservationists,' therefore, call for lower present use of such resources in favor of greater future use. Not only is this compulsory benefaction an example of the first line of attack, but, if this argument is adopted, logically no resource subject to depletion could *ever* be used at all. For when the future generation comes of age, *it too* faces a future generation. This entire line of argument is therefore a peculiarly absurd one.

The second line of attack is of the opposite form—a denunciation of the recipient of the 'gift.' The recipient is denounced as a **'free rider,'** as a man who wickedly enjoys the 'unearned increment' of the productive actions of others. This, too, is a curious line of attack. It is an argument which has cogency only when directed against the first line of attack, i.e., against the free rider *who wants compulsory free rides.* But here we have a situation where A's actions, taken purely because they benefit himself, *also* have the happy effect of benefiting someone else. **Are we to be indignant because happiness is being diffused throughout society?** Are we to be critical because more than one person benefits from someone's actions? **After all, the free rider did not ask for his ride.** He received it, unasked, as a boon because A benefits from his own action. To adopt the second line of attack is to call in the gendarmes to apply punishment because too many people in the society are happy. In short, am I to be taxed for enjoying the view of my neighbor's well-kept garden?

One striking instance of this second line of attack is the nub of the Henry Georgist position: an attack on the 'unearned increment' derived from a rise in the capital values of ground land. We have seen above that as the economy progresses, real land rents will rise with real wage rates, and the result will be increases in the real capital values of land. Growing capital structure, division of labor, and population tend to make site land relatively more scarce and hence cause the increase. The argument of the Georgists is that the landowner is not morally responsible for this rise, which comes about from events external to his landholding; yet he reaps the benefit. The landowner is therefore a free rider, and his 'unearned increment' rightfully belongs to 'society.' Setting aside the problem of the reality of society and whether 'it' can own anything, we have here a moral attack on a free-rider situation.

The difficulty with this argument is that it proves far too much. For which one of us would earn anything like our present real income were it not for external benefits that we derive from the actions of others? Specifically, the great modern accumulation of capital goods is an inheritance from all the net savings of our ancestors. Without them, we would, regardless of the quality of our own moral character, be living in a primitive jungle. The inheritance of money capital from our ancestors is, of course, simply inheritance of shares in this capital structure. We are all, therefore, free riders on the past. We are also free riders on the present, because we benefit from the continuing investment of our fellow men and from their specialized skills on the market. Certainly the vast bulk of our wages, if they could be so imputed, would be due to this heritage on which we are free riders. The landowner has no more of an unearned increment than any one of us. Are all of us to suffer confiscation, therefore, and to be taxed for our happiness? And *who* then is to receive the loot? Our dead ancestors, who were our benefactors in investing the capital?

An important case of external benefits is 'external economies,' which could be reaped by investment in certain industries, but which would not accrue as profit to the entrepreneurs. There is no need to dwell on the lengthy discussion in the literature on the actual range of such external economies, although they are apparently negligible. The suggestion has been persistently advanced that the government subsidize these investments so that 'society' can reap the external economies. Such is the Pigou argument for subsidizing external economies, as well as the old and still dominant 'infant industries' argument for a protective tariff.

The call for state subsidization of external economy investments amounts to a *third line* of attack on the free market, i.e., *that B, the potential beneficiaries, be forced to subsidize the benefactors A, so that the latter will produce the former's benefits*. This third line is the favorite argument of economists for such proposals as government-aided dams or reclamations (recipients taxed to pay for their benefits) or compulsory schooling (the taxpayers will eventually benefit from others' education), etc. The recipients are again bearing the onus of the policy; but here they are not criticized for free riding. They are now being 'saved' from a situation in which they would not have obtained certain benefits. Since they would not have paid for them, it is difficult to understand exactly *what* they are being saved from. The third line of attack therefore agrees with the first that the free market does not, because of human selfishness, produce enough external-economy actions; but it joins the second line of attack in placing the cost of remedying the situation on the strangely unwilling recipients. If this subsidy takes place, it is obvious that the recipients are no longer free riders: indeed, they are simply being coerced into buying benefits for which, acting by free choice, they would not have paid.

The absurdity of the third approach may be revealed by pondering the question: Who benefits from the suggested policy? The benefactor A receives a subsidy, it is true. But it is often doubtful if he benefits, since he would otherwise have acted and invested profitably in some other direction. The State has simply compensated him for losses which he would have received and has adjusted the proceeds so that he receives the equivalent of an opportunity forgone. Therefore A, if a business firm, does not benefit. As for the recipients, they are being forced by the State to pay for benefits that they otherwise would not have purchased. How can we say that they 'benefit'?

A standard reply is that the recipients 'could not' have obtained the benefit even if they had wanted to buy it voluntarily. The first problem here is by what mysterious process the critics know that the recipients would have liked to purchase the 'benefit.' Our only way of knowing the content of preference scales is to see them revealed in concrete choices. Since the choice concretely was *not* to buy the benefit, there is no justification for outsiders to assert that B's preference scale was 'really' different from what was revealed in his actions.

Secondly, there is no reason why the prospective recipients *could* not have bought the benefit. In all cases a benefit produced can be sold on the market and earn its value product to consumers. The fact that producing the benefit would not be profitable to the investor signifies that the consumers do not value it as much as they value the uses of nonspecific factors in alternative lines of production. For costs to be higher than prospective selling price means that the nonspecific factors earn more in *other* channels of production. Furthermore, in possible cases where some consumers are not satisfied with the extent of the market production of some benefit, they are at perfect liberty to subsidize the investors *themselves*. Such a voluntary subsidy would be equivalent to paying a higher market price for the benefit and would reveal their willingness to pay that price. The fact that, in any case, such a subsidy has

not emerged eliminates any justification for a coerced subsidy by the government. Rather than providing a benefit to the taxed 'beneficiaries,' in fact, the coerced subsidy inflicts a loss upon them, for they could have spent their funds themselves on goods and services of greater utility.

9.5.3 *Simon Cowan*

Simon Cowan wrote this in 2017:

> A note on positive externalities
>
> Universal or quasi-universal payments such as parental leave and childcare rebates could potentially be justified on the basis they generate a benefit for the public. At times this argument is used interchangeably but incorrectly with the characterization of these payments as 'public goods'. This misnomer is perhaps not an accidental one. A public good is a product or service that is non-excludable (an individual cannot easily be prevented from accessing it) and non-rivalrous (use by one person doesn't limit the use by others).4 The benefits accrue to everyone generally, not one person in particular. The most obvious example is national defence. These characteristics lend themselves to public provision of those goods, paid for through taxation, rather than private provision paid for by fees for use or access.
>
> Childcare, paid parental leave and other welfare payments do not have the characteristics of public goods. They are money or services provided directly to individuals who qualify, and as such are obviously excludable and rivalrous (no other person can have the money provided to the recipient). Their benefit flows directly to the person who receives the payment or service.
>
> What these payments and services (arguably) generate are positive public benefits in addition to that private benefit. That benefit is called a positive externality and is secondary to the primary benefit, which accrues to the person receiving the payment or service. Education is an example of a positive externality: the main beneficiary of a child receiving an education is the child himself, but there are additional 'spill-over' benefits to society that come from its citizens being educated (eg higher expected lifetime tax receipts).
>
> The distinction between public goods and positive externalities is important. Government is reasonably expected to fund and provide public goods, however government should only fund positive externalities if two criteria are met:
>
> 1. the benefit of the positive externality would not be received without government funding; and
>
> 2. the cost of government funding does not exceed the benefit received.
>
> In short, government intervention should occur only to maximize the benefit from the externality. Incentive payments should be targeted to minimize the payments made to those who would undertake the activity anyway. There is no general cause for taxpayers to compensate people for the generation of positive externalities, even if that person incurs a financial cost to do so.
>
> In practical terms the difference in cost may be substantial: for example if paid parental leave were a public good, government would be expected to provide it for all citizens. As a positive externality, the government would fund parental leave only for those who couldn't fund such leave themselves, in the absence of intervention — and only then if the benefit exceeded the cost of doing so.
>
> Given this substantial difference in funding obligations, it would be surprising if the misuse of the term 'public good' by those who want increased government funding was an accident.
>
> More importantly, in the welfare space, being unable to meet the cost is far and away the most likely reason someone who would otherwise generate a positive externality, through childcare or paid parental leave, would not be able to do so. This makes 'need' quite a good proxy to test when looking at

subsidies for positive externalities; suggesting that paid parental leave and childcare should fit into the welfare model above.[149]

9.6 Markets provide a huge positive boon to society

9.7 The folly of claims that education requires subsidy due to positive externalities

One of the areas of bad policy is education. Bad economists claim that education provides positive externalities, so it must be subsidised. By all means have vouchers for the poor, but we need to be aware that virtually all education benefits are captured privately.

School education is another area where much song and dance is made re: positive externalities and an alleged role for the state. J.S. Mill considered the role of government in his 1859 book, *On Liberty* and argued for compulsory education (coercion). Implicit in Mill's argument for compulsory education was the idea of positive externality ('education fitting [the child] … to perform his part well in life ***towards others*** and towards himself').

> Consider, for example, the case of education. Is it not almost a self-evident axiom, that the State should require and compel the education, up to a certain standard, of every human being who is born its citizen? Yet who is there that is not afraid to recognise and assert this truth? Hardly any one indeed will deny that it is one of the most sacred duties of the parents (or, as law and usage now stand, the father), after summoning a human being into the world, to give to that being an **education fitting him to perform his part well in life towards others** and towards himself. But while this is unanimously declared to be the father's duty, scarcely anybody, in this country, will bear to hear of obliging him to perform it. Instead of his being required to make any exertion or sacrifice for securing education to the child, it is left to his choice to accept it or not when it is provided gratis! It still remains unrecognised, that to bring a child into existence without a fair prospect of being able, not only to provide food for its body, but instruction and training for its mind, is a moral crime, both against the unfortunate offspring and against society; and that **if the parent does not fulfil this obligation, the State ought to see it fulfilled**, at the charge, as far as possible, of the parent.
>
> Were the **duty of enforcing universal education** once admitted, there would be an end to the difficulties about what the State should teach, and how it should teach, which now convert the subject into a mere battle-field for sects and parties, causing the time and labour which should have been spent in educating, to be wasted in quarrelling about education. If the government would make up its mind **to require for every child a good education**, it might save itself the trouble of providing one. It might leave to parents to obtain the education where and how they pleased, and content itself with **helping to pay the school fees of the poorer class of children, and defraying the entire school expenses of those who have no one else to pay for them**. The objections which are urged with reason against State education, do not apply to the enforcement of education by the State, but to the State's taking upon itself to direct that education; which is a totally different thing. That the whole or any large part of the education of the people should be in State hands, I go as far as any one in deprecating. All that has been said of the importance of individuality of character, and diversity in opinions and modes of conduct, involves, as of the same unspeakable importance, diversity of education. A general State education is a mere contrivance for moulding people to be exactly like one another; and as the mould in which it casts them is that which pleases the predominant power in the government, whether this be a monarch, a priesthood, an aristocracy, or the majority of the existing generation, in proportion as it is efficient and successful, it establishes a despotism over the mind, leading by natural tendency to one

[149] https://www.cis.org.au/wp-content/uploads/2017/06/op156.pdf

> over the body. An education established and controlled by the State, should only exist, if it exist at all, as one among many competing experiments, carried on for the purpose of example and stimulus, to keep the others up to a certain standard of excellence. Unless, indeed, when society in general is in so backward a state that it could not or would not provide for itself any proper institutions of education, unless the government undertook the task; then, indeed, the government may, as the less of two great evils, take upon itself the business of schools and universities, as it may that of joint stock companies, when private enterprise, in a shape fitted for undertaking great works of industry, does not exist in the country. But in general, if the country contains a sufficient number of persons qualified to provide education under government auspices, the same persons would be able and willing to give an equally good education on the voluntary principle, under the assurance of remuneration afforded by a law rendering education compulsory, combined with State aid to those unable to defray the expense.

J.S. Mill was entirely mistaken in his call for compulsory universal education. In his defence, he partly rectified his error by calling for 100% privatised education. (He did made an exception for backward countries, in particular India where he called for government funding for Sanskrit in his 'refutation' of Macaulay's minute (which also called for government funding – for English – both being wrong to promote government schools).

Half-baked economists who never go into any detail continue to claim that education provides positive externalities and so it must be subsidised for everyone. That is entirely incorrect, since virtually all education benefits are captured privately. By all means have vouchers for the poor, but that's part of social insurance and a

Claims about positive externalities in education were destroyed by James Tooley in his pioneering work, *The Beautiful Tree*. He showed that the poorest parents in the remotest village of India work very hard to educate their children. Their story is found in Tooley's book, but I have personally engaged with many such schools and can confirm that they deliver the amazing results at the lowest possible costs. I believe such low-cost private schools can do far better if they receive funding via school vouchers. That is why in my 2008 book, *Breaking Free of Nehru*, I advocated an **entirely privatised school education system**, with a role for government (at most) only as a co-regulator of standards, and funder of the poorest via school vouchers. I do not agree with having any government school, since these have turned into indoctrination factories for communism and environmental extremism. **I believe that J.S. Mill was broadly right with his school education model – of 100 per cent privatisation.**

> The second major reason why private education wasn't the way forward for the poor had to do with 'market failure.' Development experts tend to use this term synonymously with education being a 'public good,' and there being 'externalities' of education that need to be taken into account. At issue here, perhaps surprisingly given the complex way it is often described, seems something rather simple. The UNDP puts it like this: Governments should 'finance and provide' primary education because 'market prices alone' would not capture its 'intrinsic value and social benefits.' Why not? Because basic education 'benefits not only the individual who gains knowledge, it also benefits all members of society by improving health and hygiene behaviour and raising worker productivity.'
>
> The basic idea, then, is that there are social benefits to be had from people being educated. If a parent educates his child, this child, so the theory goes, will contribute to society by being healthier, by being more productive at work, by being literate, and so on. But these public benefits, it is claimed, are not reflected in the market price of education, so there will be 'market failure.' That is, in the absence of the state's providing and financing education, not enough people will buy enough education, of the right sort, to provide these social benefits. That's what the conference critic was claiming about my position.
>
> I've wrestled with this, and it seems to me that it's not as powerful an objection as the development experts imagine it to be. …
>
> the poor parent also knows that there are private benefits from being educated —especially for a poor person, as precisely the development experts also argue, it's one of the best routes out of poverty. And the child will not only be able to get a middle-class job with education but will also likely assist her parent as she gets older. So instead of the pessimistic conclusions reached by the development experts, a much more favorable outcome emerges: Because these private benefits are so great, she'll pay fees to educate her child, even if it means sacrificing other goods. But so will many other parents, and so all will

> enjoy the social benefits this brings, even though they weren't a significant part of their initial decision to educate their children. [Tooley, *The Beautiful Tree*]

Consistent with his advocacy of reason, Bastiat opposed government intervention in education. He wrote:

> When law and force confine a man within the bounds of justice, they do not impose anything on him but a mere negation. They impose on him only the obligation to refrain from injuring others.
>
> But when the law, by the intervention of its necessary agent, force, imposes a system of labor, a method or a subject of education, a faith or a religion, its action on men is no longer negative, but positive. It substitutes the will of the legislator for their own will, the initiative of the legislator for their own initiative. They no longer have to take counsel together, to compare, to foresee; the law does all this fox them. Intelligence becomes a useless accessory; they cease to be men; they lose their personality, their liberty, their property.
>
> Try to imagine a system of labor imposed by force that is not a violation of liberty; a transfer of wealth imposed by force that is not a violation of property rights. If you cannot do so, then you must agree that the law cannot organize labor and industry without organizing injustice.[150]

9.7.1 *Summary of perspectives on school education*

I have summarised various perspectives on school education in a Google spreadsheet at: https://docs.google.com/spreadsheets/d/1zwsCMGTlGyQ2mGDm7k3Cxv9e3jnwovogc-BrNmsLBpc/edit?usp=sharing

9.8 Folly of claims that vaccines provide a positive externality so must be subsidised

I received the smallpox vaccination when I was a child. Today, if a terrorist releases the virus in public, I will not catch it. So, who's the main beneficiary? Me!

The existence of benefits for third parties is never sufficient proof for intervention.

9.9 Knowledge externalities (R&D etc.) do not motivate a government subsidy

We stand on the shoulders of giants. Without the massive positive externalities (mainly knowledge) from previous generations, our life expectancy and standard of living today would resemble the stone age man's.

Are these positive externalities a problem? No, merely a boon. Consider this extract from Julian Simon's *The Ultimate Resource 2*:

> IN 1948, John Bardeen, Walter Brattain, and William Shockley invented the transistor. If a person or a corporation were able to collect the money value of that invention in just a single year now, the net value of the goods made with that invention (a calculation that involves the cost and value of similar products that would have been made with technology that does not utilize the transistor) is greater than the value of all the two billion ounces of gold that now exist in the world, worth now perhaps a trillion (a thousand billion) 1996 dollars.
>
> Furthermore, the salary of Bardeen, in the last year before he retired in the mid-1970s, was $46,500, and in the year when the transistor was invented he earned much less. The difference between what society pays people like Bardeen, Shockley, and Brattain, and the benefit we get from such people, is a measure of the gain to the rest of us in our standard of living due to the advance in knowledge caused by the growth in population those inventors represent.

The fact that there are these huge positive externalities has been used by some bad economists to argue for government funding of science. Terence Kealey refutes this claim with extensive evidence.

---

[150] https://oll-resources.s3.us-east-2.amazonaws.com/oll3/store/titles/956/0181_Bk.pdf

Economists argue that science is a public good. Anyone can freely read the scientific journals, so why should a private individual or company invest in research when they will preferentially benefit others, including competitors, enemies and the unborn?...

So, the economists say, private companies will not fund science because others (the 'social' return) will benefit preferentially. Therefore governments must fund science – especially the pure or 'basic' science that the economists still suppose to be the basis of applied science. The classic expression of this belief was made by the celebrated US economist Paul Romer:

> Research has positive external effects. It raises the productivity of all future individuals who do research, but because this benefit is nonexcludable [ie, enjoyed predominantly by others], it is not reflected at all in the market price [ie, which is too low to incentivize research].

As another prominent US economist, William Baumol of the universities of Princeton and New York, writes:

> . . . government's financing of basic research, whose spillovers are particularly large [ie, whose benefits are enjoyed predominantly by others], is quite appropriate.

Yet companies do, in practice, fund science, including pure or basic science, extensively. Repeated surveys, even those of the Science Policy Research Unit at the University of Sussex (a leading UK lobbyist for government money for science), show that some 7 per cent of all industrial R&D worldwide is spent on pure science. A recent study of British industrial R&D (produced again by SPRU at Sussex) revealed that some UK companies, including ICI, SmithKline, Beecham, Wellcome and AEA Technology, each published more than 2,000 papers between 1981 and 1994, exceeding the output of medium-sized universities.

Indeed, the quality of science performed in industry is startling. The Times Higher Education Supplement's 2005 research survey showed that Harvard University is the institution whose science papers are the most cited globally (20.6 citations per paper on average), but coming in second was IBM (18.9), outranking all other universities and research bodies.

What most economists effectively do is to gaslight us all. They churn out theoretical, fuzzy claims and mathematical models on the basis of which they insist that the government has a role in our life. Their work has no relationship with reality.

10. #8: Incorrect attempts to retrieve the concept of externalities

10.1 The 'net externalities' argument is irrelevant

I have been guilty of making this argument myself, but adding 0 to 0 or subtracting 0 from 0 is still zero. There is no externality that is actionable by any government, only defects in allocation of property rights.

Examples of this (bad) argument, below.

10.1.1 *Steve Kates's claim that net externalities matter*

In his book, *Free Market Economics*, Steve Kates writes:

> Amongst the most important examples of market failure is what are referred to as externalities. An externality is a cost imposed on some third party not associated with the purchase and sale of the particular product. The typical example is some form of pollution, where the market will produce more pollution than is socially optimal.
>
> If some resource has no owner - the air, say, or some body of water then businesses will be more likely to dump waste products without regard to the effects on others. Business is thus associated with negative outcomes for the environment.
>
> And while it is perfectly sensible to point such problems out, attention is then given to conceptual solutions so useless in practice that it is a wonder that they are ever introduced at this level. The core concept is something called 'marginal social costs', which are the additional costs to society as a whole caused by some change in activity.
>
> Seldom is there a presentation that points out that as wealth has increased across a community a reduction in polluting forms of activity has arisen naturally in the political response to such problems. **Certainly problems abound, but it is not the normal practice to stress that the benefits of a market economy are massive in comparison with the problems that it generates.**
>
> Nor is it common practice to stress that it is only because there is private ownership and a price mechanism that realistic solutions to such problems not only can be but have been developed. Given production techniques in the modern world - where the nature of the production process is driven by technological specifications - every economy faces the same problems in dealing with such externalities. But given the origins of such problems, how often is it pointed out that no genuine solution is possible without economies organized around entrepreneurial decision making and the pursuit of a profitable return unless we are prepared to sacrifice massive amounts of our productive potential?

While this argument is an improvement over the typical elaborations on this topic, it still allows for externalities to exist – and when they do, a busybody economist is sure to work out a convoluted way to impose a Pigovian tax or subsidy as a 'remedy'. The correct position as we have seen earlier, is to reject the idea of externality altogether. Instead, any property rights misallocations should be addressed, mainly by privatizing previously public lands/property.

Thereafter, it is self-evident there *are* effects of economic growth which could require separate consideration, things like excessive pollution. But these are *not* externalities, merely the natural output of an efficient market system. These effects definitely can't be fixed with Pigovian taxes and subsidies, but require innovative solutions, instead, such as trading of pollution permits.

10.1.2 *Steven Cheung's airport example*

As Steven Cheung wrote:

> It is evident that an airport introduces noise and pollution in its locality. Yet almost without exception the values of properties adjacent to an airport *rise* with its inception.[3] Presumably no-one enjoys having dishes vibrating on the dinner table or babies screaming in the middle of the night. But the airport also produces such neighbourhood *benefits* as an increase in business activities and a rising demand for lodging. To the extent that the beneficial effects outweigh the detrimental effects in value, the property values rise. If the aggregate value of all the uncontracted effects generated by the airport is positive, and if increasing air traffic leads to further increase in this value, any public policy adopted to curb the air traffic implies a movement away from the Pareto condition. Thus there is no defence on efficiency grounds for citing only the *harmful* uncontracted effects of airports and ignoring the *beneficial* ones. (In the United States this has been the dominant view popularised by the champion of consumers, Mr Ralph Nader.)[151]

10.2 The argument that 'only the actual externality' should be taxed

It is claimed that a way should be found to only tax externalities, not the output. That is an impossibility, as we have already discussed.

> Subsequent examination of externalities taxes have shown that the tax should not be placed on the output (such as steel) but on the externality (such as sulfur dioxide). This is because the output should not be directly discouraged, because the output yields benefits.3 It is the externality that generates the additional social costs, and so it is the externality that should be taxed.[152]

10.3 Empty boxes: various classifications of "externalities"

A wide range of classifications of "externalities" have been attempted. All of them are irrelevant. There is simply no inefficiency involved. The more we try, the more we will end up with empty boxes.

10.3.1 *Buchanan "policy relevant/ irrelevant" argument*

Mark Pennington explained Buchanan's analysis in a 2010 blog post:

> Recourse to this argument in an educational context is widespread yet it rests on a failure to understand a distinction originally made by Buchanan and Stubblebine between policy-relevant and policy irrelevant externalities. Externalities are **policy relevant** when the 'supply' of a positive external effect is determined by the ability or inability to charge for the relevant units. Thus, a 'landscape entrepreneur' may not invest in constructing a public park if she is unable to profit by charging for access to the grounds. Externalities **are policy irrelevant** when the externality is supplied *irrespective* of the capacity to exclude non-payers. The decision of a householder to provide a rose-garden for her personal enjoyment may not, for example, be affected by the capacity to charge onlookers for 'viewing rights'. The distinction between policy relevance and irrelevance here depends on whether the externalities are ***infra-marginal***. This scenario refers to externalities that exist, as in the case of the rose garden, but where interventions *would not produce marginal improvements to the level of supply*. Thus, if the government subsidises gardeners to increase the production of roses the externality is infra-marginal when the subsidy exceeds any value placed on the additional roses by passing members of the public who may not register the existence of a few extra flowers. In other words, the externality is infra-marginal because for purely private reasons the gardener is already taking into account (albeit unintentionally) the interests of external beneficiaries.

---

[151] The Myth of Social Cost.

[152] Kahn, James R, *The Economic Approach to Environmental and Natural Resources*, MY COPY, p.41

> Buchanan and Stubblebine's analysis suggests that owing to the social nature of life **externalities are *ubiquitous* but most of them are *irrelevant* from a policy perspective.** Purely private decisions to adopt a rigorous skin care regime or to attend fitness classes to maintain the interest of one's spouse may, for example, generate positive externalities for others who appreciate the beauty of the human form and may benefit 'society' as whole by improving the aesthetic ambience in which we all live. It is unlikely, however, that a more satisfactory level of supply could be induced by government encouraging people to spend additional resources on their appearance. Indeed, to do so might be to transfer resources away from what are potentially more valued uses.[153]

All "externalities" are policy irrelevant because there is no inefficiency involved. If there is an absence of property rights, then that should be looked into.

10.3.2 *The "minor/major" externality argument of William Nordhaus*

William Nordhaus makes a similar futile argument, which Joakim Book refutes:

> At a different passage he also explores which externalities one ought to care about: "Nations cannot and should not regulate every minor externality, such as a messy yard or burping in public."
>
> I'm glad to hear that too, but the bad news is that Professor Nordhaus is not in a position to distinguish which negative externalities are major and which are minor. It might seem obvious that burping is fine and polluting rivers isn't, but that's the all-knowing technocrat speaking—not the acting man making subjective valuations under conditions of uncertainty. A central planner cannot know.[154]

10.3.3 *'Expected' vs 'unexpected' externalities (D. Boudreaux)*

In an extensive 2019 paper, "Externality: Origins and Classifications", Donald J. Boundreaux and Roger Meiners proposed a difference between expected and unexpected externalities.[155]

But much the same argument as above applies. Empty boxes.

---

[153] https://pileusblog.wordpress.com/2010/12/15/the-irrelevance-of-educational-externalities/

[154] https://mises.org/wire/why-interventionist-economists-love-talk-about-externalities

[155] https://core.ac.uk/download/pdf/217647035.pdf

11. #9: CBA of regulatory solutions to societal problems

While inefficient 'externalities' do not exist, societal problems do exist. Pollution is a problem, waste is a problem. There are also things called public goods, which I will cover in the next section.

We have identified in this paper that using 'Pigovian' taxes or subsidies is both illogical and harmful. Instead, allocating property rights (such as privatising a road) can set up the incentives to maximise production at least societal cost.

The remedy is typically political, i.e. it involves harming some to benefit the society as a whole. There is an economics tool available to assess the validity of such political remedies: a cost-benefit analysis.

11.1 Assessing all effects (the Bastiat-Hazlitt manoeuvre)

Any policy action must necessarily consider all aspects. Julian Simon explains that we can't assess a technology simply by considering one side of its effects. Consider all effects.

> Economics also teaches the habit of searching out unintended, diffuse, and long-run consequences of immediate actions—the way of looking at problems that we may call the **'Bastiat-Hazlitt maneuver.'** This is the central issue in the study of population economics, and of this book. A pollution example: CFCs, chemicals used in refrigerators, are being phased out with the aim of protecting the Earth's ozone layer and reducing skin cancers. Whether this direct effect would occur is itself an open question. But there are indirect and unintended effects that should also be considered. For example, might this ban lead to higher prices of refrigerators and hence lower the use of them in some poor parts of the world? And might this lead to increased spoilage of food and hence increased disease, which would work in the opposite direction from any skin cancer reduction?
>
> Ralph Keeney and Aaron Wildaysky have shown that any government intervention—environmental rule, safety requirement, or conservation regulation—that saves lives at a sufficiently high cost in reduced economic growth would have a more-than-offsetting indirect negative effect on health and mortality, because lower income causes poorer health.?
>
> The Bastiat-Hazlitt maneuver insists that **when assessing a technology or policy, one should see the benefits as well as the costs, the hidden effects as well as the obvious ones**. Automobiles not only cause air pollution and accidents and become junked cars; they also reduce the number of horse carcasses in the streets-15,000 per year in New York City alone at the turn of the century, deaths from horses and runaway carriages-750,000 injuries a year in 1900 when the population was much lower than now—and pollution from manure in the streets—forty-five pounds per day per horse. And one should factor in such matters as the increased personal liberty that autos provide, which enables a person to select from a wider geographic range of jobs and places to shop, and hence lessened control by monopoly employers and merchants.[156]

11.1.1 *Example: Noise effects of a new runway*

Before considering any noise effects of a runway, the overall effect of the runway on economic value must be assessed. It is clear that the runway provides positive net value since land prices around the runway typically increase.

---

[156] *The Ultimate Resource 2.*

In this case, while some effort should be invested in asking the industry to work out technical methods to reduce airplane noises, there is no problem to solve.

<table>
<tr><td colspan="2">Underlying discrete unit: One can't have half a runway. It has to be either/or. If we just think about the added noise (as some economists seem to do) we are doing very bad economics.</td></tr>
<tr><td colspan="2">Private costs/benefits</td></tr>
<tr><td colspan="2">• The airport only takes into account its cost of capital and expected receipts from additional gates
• The airlines do their own calculations based on the cost of capital and the number of passengers
• The new runway will only come into existence if the airport thinks it will be profitable to do so
• The extra runway will facilitate more tourists, higher levels of population growth and increased level of business in the airport's catchment area. Most of this would be factored into the calculations of the airlines and of the airport.</td></tr>
<tr><td>Positive spillover effects</td><td>Negative spillover effects</td></tr>
<tr><td>There are huge agglomeration (network) effects of a higher population that will increase productivity in the airport's entire catchment area. More specifically, the airport will create new jobs in the area directly adjoining the airport – thus increasing land value.
As more people move to air travel instead of travelling by road, overall accidental deaths are reduced (roads have a higher death rate than air travel).</td><td>The extra runway will increase noise in the area just below the planes, thus reducing the demand for housing in that area.
Additional air planes could cause greater harm to local birds (environmental harm).</td></tr>
<tr><td colspan="2">Net effect: Land values reflect the net externality. In most cases land values rise, to reflect the net positive effect of the new runway.

- People who bought land around the airport knew that one day it will have another runway, and they can't complain about the added noise. However, they can sell off at a profit to commercial businesses and move their house to a different place.
-New residents are aware of the noise but choose to move in because the net private benefits offered from that move that are greater than costs.
- Undoubtedly, any cost-effective attempt could be made to reduce the noise from the planes, but elimination is not an option.</td></tr>
</table>

PUBLIC GOODS WITH STRATEGIC BEHAVIOUR

12. The public goods case with strategic behaviour

The public goods case of "positive externalities" is indeed potentially valid where strategic behaviour is involved. I have illustrated in the Introduction with Demsetz's example in his interview[157].

12.1 Demsetz agreed that strategic behaviour can prompt government intervention

Demsetz agreed that strategic behaviour for a non-excludable indivisible good does create a problem. This concept is **not**, however, an *externality* in the sense promoted by Pigou.

> Strategic behavior problems associated with indivisible goods may be the only category of problems calling for State action in the cause of efficient resource allocation. I do not view strategic behavior as an externality problem, but the name of the category of problems in which we place it is not very important. The important point is that the category of problems that we call externality problems now includes a great many that are not strategic in nature. The preceding parts of this essay were meant to convince readers that these other 'problems' should not be associated with inefficient allocation of resources. The literature of externality problems, from Pigou to Coase, makes it seem as if they are associated with inefficiencies, but they are not. The strategic behavior problem, however, seems to me to associate properly with claims of inefficiency if State coercion (unavailable to private dealings) is thought to cost less (socially) than is the gain to be realized from applying coercion to resolve indivisible goods problems.[158]

However, whether a government should get involved requires far more analysis.

12.2 Most 'public goods' are club goods

Property rights assignments lead to innovative ways to extract payment for any value provided. A good example is a lighthouse, which was said in the past to provide a 'positive externality' hence something to be subsidised by the government.

12.2.1 *Lighthouses*

In a 1974 paper[159], Ronald Coase demolished the idea that lighthouses are public goods. He studied lighthouses in Britain from the 17th to 19th centuries and showed that it is possible to charge port fees to pay for lighthouses. This is such a common-sense concept but it escaped most desktop economists.

12.2.2 *Whether something is a public good is often determined by state of technology*

Excludability is not an innate characteristic. What is a public good today can become a private one tomorrow (e.g. postal service/ telecom/ railways).

> There is nothing in principle to prevent excludability—there is only a lack of a past history of market operation in this area and the limited powers of imagination on the part of economists.[160]

---

[157] https://www.sabhlokcity.com/2023/12/transcription-of-externality-related-content-from-a-demsetz-interview/

[158] https://www.sfu.ca/~allen/DemsetzSocialCost.pdf

[159] https://www.journals.uchicago.edu/doi/10.1086/466796

[160] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

This point was picked up by Hayek when he referred to the level of technology determining the classification.

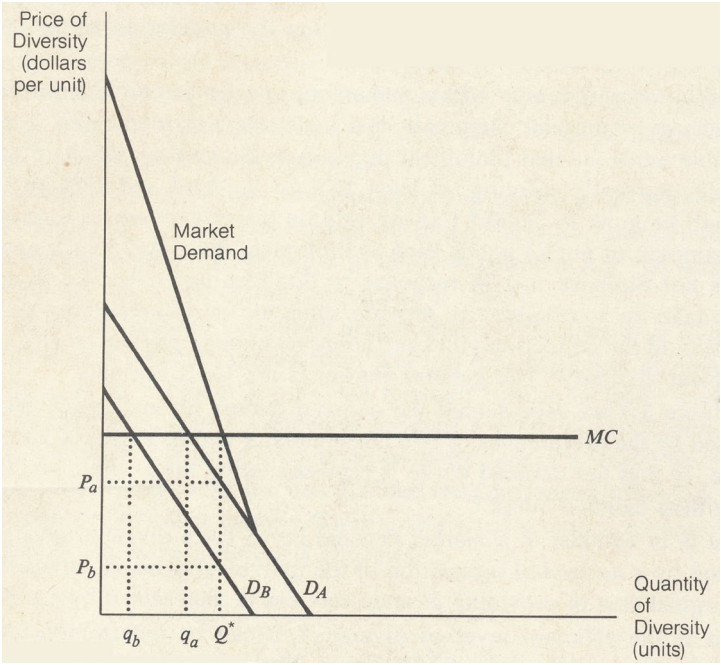
12.2.3 *Subsidization of public goods not always justifiable*

Walter Block wrote in 1983:

> IX. One Man's Meat Is Another's Poison
>
> Let us consider now a shortcoming, previously alluded to, in the public good view: that tastes differ and that what may be viewed as a benefit by one person may be seen as something to be avoided by another.
>
> A person for whom a good or its presumed external benefits are in fact disadvantageous will actually lose by its subsidization. To the confirmed pacifist, for example, the expenditure of ever more billions of dollars for military purposes leads to increased disutility. And to add insult to injury, Samuelson's argument is used to justify taxing the pacifist, supposedly for his own benefit, to cover the costs of those increasing expenditures. What we have, then, is a situation which forces a person to pay for the provision of a good that he regards as a 'poison.'[161]

12.3 Pareto efficiency requires charging each party their willingness to pay

Tom Tietenberg's Environmental and Natural Resource Economics book (my copy) explains:



> One further insight can be gained from [the figure above]… The efficient market equilibrium for a public good would require different prices for each consumer. [The Figure shows that] if consumer A is charged P_a and consumer B is charged P_b then both consumers would be satisfied with the efficient allocation (the efficient allocation would have maximized their net benefits given the prices).
>
> Furthermore, the revenue collected would be sufficient to finance the supply of the public good (since $P_b \times Q^* + P_a \times Q^* = MC \times Q^*$). Thus, while an efficient pricing system exists, it is very difficult to

[161] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

> implement. **The efficient pricing system requires charging a different price to each consumer**, and, in the absence of excludability, consumers may not choose to reveal the strength of their preference for this commodity. Therefore, the producer could not possibly know what prices to charge.

This is the basic problem with funding public goods.

12.4 Government failure in public goods provision

Walter Block (1983) about how government involvement in roads can fail:

> government, unshackled by any market test of profitability, may so expand the scope of road building that a resultant overinvestment may ensue. If so, a new misallocation will emerge, with an overinvestment substituted for an underinvestment. Further, even if government action results in the correct amount of total road mileage, government management of its domain may be so inept as to erase any allocation gains. If any of these eventualities obtains, and there is little reason to think not, then the argument fails.[162]

12.5 Philipp Bagus – not all public goods justify intervention

Why 'Public Goods' Don't Justify Government Intervention

https://mises.org/wire/why-public-goods-dont-justify-government-intervention

> The theory of public goods is one of the main arguments that is usually employed to justify economically the existence of the state.
>
> There are some dangers in employing neoclassical terminology, as it systematically drives thinking away from sound economics. Nevertheless, for the sake of the argument, let us accept the two defining characteristics of a public good according to mainstream text books.
>
> First, a public good can be consumed by additional consumers without any additional cost. This characteristic is known as nonrivalrous consumption. For instance, once a lighthouse is built, it lights the way for other ships without any additional costs.1
>
> Second, consumers cannot be excluded from consuming the public good once it has been produced at a reasonable cost. For instance, a ship owner who does not want to pay for the services of the lighthouse cannot be excluded from it, because when the lighthouse is turned off no one can see it, not even the ships that paid for it. As a result there emerges the so-called free rider problem: consumers, even though they would like to enjoy the service of the public good, do not help finance it, but try to free ride on the contributions of others. Because anyone will try to free ride on anyone else's contribution, public goods, so the orthodox story goes, would be underproduced in a free market. The government has to step in, tax the free riders, and finance the public good with the tax receipts.
>
> Critiques of the Theory of Public Goods
>
> These claims sound reasonable enough, yet there have been many powerful critiques of the public goods argument:
>
> First, there is no clear and objective dividing line between a private good and a public good. Many public goods are produced privately, such as street music in a pedestrian precinct.2 And many goods produced by the government, such as the postal service, do not fit into the category of public goods. Most importantly, goods have a subjective character. The characterization of a thing as a good is not objective nor eternal. The street musician's song can be considered a public bad if someone detests the performance. As Walter Block has provocatively pointed out, **socks may be regarded a public good once people care about the color of the socks that other people wear. Moreover, socklessness could negatively affect health and thereby affect third parties.**
>
> Second, rivalry in consumption is also something subjective. When someone prefers to listen to the street musician exclusively, there is rivalry in consumption.

[162] https://mises-media.s3.amazonaws.com/7_1_1_0.pdf

Third, the possibility of exclusion is not objectively given, either. From a dynamic point of view, innovation does bring forward new ways to exclude free riders. For instance, in the case of dikes in northern Germany, entrepreneurs envisioned new business models to exclude nonpayers.

Fourth, it does not follow from the fact that the free market doesn't produce something in the quantity desired by some observer that it should be produced by the state. In order to reach that conclusion one would need to develop an ethical theory first, a norm that would justify violence to produce public goods is normally not provided. In fact, as Hoppe shows in his 1933 'Fallacies of the Public Goods Theory and the Production of Security,' such a norm would essentially allow for a war of all against all.

Fifth, state production of public goods implies less production of private goods. State intervention makes economic calculation impossible. The utility that is lost due to the tax financing of public goods can only arbitrarily be compared with the utility gained from their production. Hence, it is as justified to speak of public bads as it is to speak of public goods.

Finally, the amount of public goods production by the state remains arbitrary.

State Intervention Hampers Production of 'Public Goods'

There is another point about public goods and free riding that I want to emphasize in this article.

The state often prevents or sabotages the private production of public goods in the market. More specifically, the state makes the solution of the voluntary free rider problem more difficult by taking resources from citizens.

For instance, inflationary monetary policy incentivizes people to indebt themselves more than they would do in a sound money system. When one is overindebted one must focus on monetarily paid work and will do less volunteer work than otherwise.

Taxes work in the same way. The more people are taxed, the less free time they have for voluntary work ceteris paribus. Voluntary work is essential to the private production of public goods such as helping the poor, patrolling on a neighborhood watch, participating in school meetings, or caring for a beautiful garden. Due to taxation, people also have less resources at their disposal, whose use can also benefit third parties (for example, the installation of lights on one's property that also illuminate the street, or of security devices that deter criminals).

Sometimes government decrees hamper the private production of public goods even more directly. The possession of arms in a population deters criminals and may increase safety. It is possible to free ride in an armed population. Not everyone has to spend money on arms and training. Some can rely on others financing the public good.3 Unfortunately, in many countries the government sabotages the production of this public good through prohibitions.

The Free Rider Problem

A more harmonious society due to voluntary aid, a safer society due to volunteer watchmen, a more beautiful society due to well-kept gardens and illumination—all fit the public good definition. They also show that the free rider problem can be overcome. When there is a market, business models will evolve that provide the services demanded. However, due to taxes, inflationary or not, living standards are lower and less public goods are produced on the free market than would otherwise be.

Social, religious, or political movements provide another answer to the free rider problem. Jeffrey Hummel points out that the American revolutionaries exerted positive externalities on others who could free ride on the actions of the revolutionaries who were risking their lives. Similar free riding occurred during the Crusades. Crusaders risked their lives to ensure Christian pilgrims a safe trip into the Holy Land, while other Christians free rode on these efforts.4 In general, through education and assistance to the poor, religious movements produce public goods such as a more peaceful harmonious and educated society. Everyone can free ride on these efforts.

Similarly, those who contribute to institutions that defend our freedom, such as the Mises Institute, are financing the production of a public good. If you give money to the Mises Institute, you get a freer society than otherwise. Everyone benefits; no one is excluded. In other words, people can free ride on the contributions to the Institute. In spite of this the Mises Institute exists and is thriving. Certainly it could thrive more if taxes were lower and people richer and able to contribute more.5 In this way, government reduces the production of public goods.

Today, protesters against the infringements on liberty due to 'stay-a-home' orders are in a similar situation. If there are enough protests against the lockdown and sufficient civil disobedience, the infringements will not be sustainable.6 In this way, the protests can exert positive externalities on the rest of the population.

However, there can also be free riders. Instead of spending time protesting and risking penalties, people can just stay aside (or inside). If all resisted and disobeyed the police, the lockdown would not be enforceable. If, however, too many people free ride, knowingly or not, the public good of liberty will not be achieved. Naturally, the failure to produce the public good of liberty is not a market one, because without the state civil disobedience to achieve liberty would not even be necessary. It is the government that with the threat of the police force suppresses the production of this public good.

In sum, there are public goods that would not be produced without the government, but there are also public goods whose production is made impossible by government. Due to state intervention, there is an overproduction of some public goods and an underproduction of others, such as coronavirus herd immunity.

Which public goods are more important? The ones the government produces or the ones it destroys? Finally, which public goods shall be produced? There are two basic ways to decide. Politicians can arbitrarily decide which public goods are produced and which are not, or individuals voluntarily interacting in a free market can decide which goods are produced.

13. Touching upon other Fabian smears of the market system

There is literally no end to the socialist attack launched by Pigou and advanced by a range of Fabian sympathisers. I briefly touch upon a few of these attacks, below. These issues will be addressed in much greater detail on my book (under preparation), *Economics, not Ideology*.

13.1 Monopoly

Fabian ("neo-classical") economics complain about monopoly but forget that almost all monopolies are in the government sector (or authorised by government).

E.g. Why is NHS the only body to provide health services in the UK? At a minimum, it should be split into 3-4 competitors.

A single NHS assumes a single "best" (efficient, effective) way for the government to supply health services. That's a false assumption.

Only through competition and innovation can better ways be found.

As a first step, all major government monopolies must be split.

13.2 Minimum wage

13.3 Market failure

13.4 Almost completely ignoring government failure

Covid lockdowns were the biggest "government failure" in history, costing around $15 trillion globally.

But this is now new. A 2006 study found that in the name of fixing "market failure", the US government was burning up billions of dollars each year.

> government policy to correct market failures is characterized by two major flaws—that is, government failures—that cost the U.S. economy hundreds of billions of dollars a year. First, government policy has created economic inefficiencies where significant market failures do not appear to exist,
>
> Second, in situations where market failures do exist, government policy has either achieved expensive successes by correcting these failures in a way that sacrifices substantial net benefits or in some cases has actually reduced social welfare.[163]

[163] https://www.brookings.edu/wp-content/uploads/2016/06/20061003.pdf

14. Conclusion

[DN: to be fleshed out at the very end]

In 1776, Adam Smith essentially anticipated and rejected Pigou's "divergence" nonsense - which called for special taxes/subsidies. He showed that any such extraordinary encouragement or restraint would cause great harm to society.

> It is thus that every system which endeavours, either by extraordinary encouragements to draw towards a particular species of industry a greater share of the capital of the society than what would naturally go to it, or, by extraordinary restraints, force from a particular species of industry some share of the capital which would otherwise be employed in it, is in reality subversive of the great purpose which it means to promote. It retards, instead of accelerating, the progress of the society towards real wealth and greatness; and diminishes, instead of increasing, the real value of the annual produce of its land and labour.[164]

It is by now abundantly clear that Pigou's "contributions" have harmed, not enhanced human welfare.

14.1 External effects are not inefficient, but a feature of our existence

Everything we think of or do, has an external effect. There can be four types, as per Bentham:

> It is to be observed, that here, as well as henceforward, wherever consequences are spoken of, such only are meant as are material. Of the consequences of any act, the multitude and variety must needs be infinite: but such of them only as are material are worth regarding. Now among the consequences of an act, be they what they may, such only, by one who views them in the capacity of a legislator, can be said to be material, as either consist of pain or pleasure, or have an influence in the production of pain or pleasure.
>
> …The consequences of an act are events. A circumstance may be related to an event in point of causality in any one of four ways: 1. In the way of causation or production. 2. In the way of derivation. 3. In the way of collateral connexion. 4. In the way of conjunct influence. It may be said to be related to the event in the way of causation, when it is of the number of those that contribute to the production of such event : in the way of derivation, when it is of the number of the events to the production of which that in question has been contributory : in the way of collateral connexion, where the circumstance in question, and the event in question, without being either of them instrumental in the production of the other, are related, each of them, to some common object, which has been concerned in the production of them both: in the way of conjunct influence, when, whether related in any other way or not, they have both of them concurred in the production of some common consequence.[165]

These types of effects, which are not an inefficiency, must be considered in a CBA.

---

[164] https://archive.org/details/inquiryintonatur02smit_0/page/286/mode/2up?ref=ol&view=theater

[165] https://archive.org/details/worksofjeremyben01bent/page/38/mode/2up?view=theater

14.2 Demsetz's 2011 paper must rank far higher than Coase's work

I've come to the view that Demsetz's 2011 paper, "The Problem of Social Cost: What Problem?"[166] must rank far higher than the work of Coase, and potentially compete with Hayek's "Use of Knowledge in Society" as one of the most important papers in economics.

The paper truly brings back the original power and strength of classical economics and overthrows the shallow, ill-thought-out, market failure arguments of "modern" economics. In brief, there is no evidence, except with the presence of strategic behaviour, that a government can help.

The theory of externalities bears strong comparison with sleight of hand in magic. From nothing but smoke and mirrors, a socialist fable is woven that markets fail and that government can fix these "failures".

Without Demsetz's razor sharp mind, we'd never have understood.

14.3 My previous work on externalities has been extremely flawed

Having been brainwashed by standard textbooks, I have found it hard to understand and internalize the razor-sharp arguments of Demsetz. But by now things are clearing up in my mind. And it looks like a lot of what I wrote would need to be revised (there's probably never going to be an opportunity to do so), such as this extract from my 2008 book, *Breaking Free of Nehru*:

- **Pigovian taxes**: To the extent that polluters cannot be individually identified, ~~Pigovian taxes will be imposed on the activity that approximates most closely the activity undertaken by the polluters.~~ A range of incentives-based solutions, such as trading of permits within limits to pollute, will ~~also~~ be used. ~~In particular, carbon taxes will be imposed in a phased manner on electricity produced from coal. The revenue so collected will be used as follows:~~
  - to provide (compensatory) subsidies to companies to increase plantations and forests. These subsidies will be paid based on the actual growth of these forests confirmed through satellite imagery;
  - to fund Indian investors to build nuclear power stations while meeting the world's highest standards of safety and security under international supervision; and
  - if funds remain, to fund industry and universities, based on demonstrable results, to increase research in non-polluting technology.

But I'm wrong entirely, since CO2 is NOT a pollutant!!

~~In the *Online Notes*[21] I have also discussed the international ramifications of carbon pollution and how the West will be asked to deploy carbon taxes both to increase the developing world's forest cover through private plantations (see Chapter 2 on how this can be done) and also to significantly increase their own forests.~~

14.4 Externality socialism must go

Socialism was always a plan for the people at the top to grow ultra-rich at the expense of the poor. Now "externality" socialism has become the way for the ultra-rich and corrupt to grow even richer at people's expense. The government now borrows without limit to fund the rich. In the name of climate change, EVs are

[166] https://sfu.ca/~allen/DemsetzSocialCost.pdf

subsidised up to $7,500 in the USA, but the poor drive around with cars worth $1,000. They can't dream of buying an EV, even as the subsidy comes out of essential funding/infrastructure, but worse, converts into inflation for the poor since the subsidy money is borrowed.

14.5 The takeover of textbooks by the Fabians

He who controls the textbook controls the world. The Fabians took over economics textbooks not by explicitly stating their intent, but through subterfuge - which is their signature strategy. All that was needed was some kind of plausibility. That was good enough to brainwash millions of "economics" students.

Whereas Nazi textbooks explicitly put Hitler on the pedestal, Fabian textbooks (known these days in 1984 doublespeak as "economics") place the government on the pedestal. same thing, except that Hitler is temporary but the government is permanent.

The greatest battles are not for territory but for the textbook, which is the "hill" that "intellectual generals" fight for, to occupy. Once occupied, the textbook generates an army of brainwashed "soldiers".

Pigou's Fabians have occupied the hill and thrown out real economics.

PART FIVE **Competitive Markets 399** — So far, so good. This is REAL ECONOMICS. The Invisible Hand.
CHAPTER 12 The Partial Equilibrium Competitive Model 401
CHAPTER 13 General Equilibrium and Welfare 449

PART SIX **Market Power 489** — 80% Fabian economics
CHAPTER 14 Monopoly 491
CHAPTER 15 Imperfect Competition 525

PART SEVEN **Pricing in Input Markets 573** — 60% Fabian economics
CHAPTER 16 Labor Markets 575
CHAPTER 17 Capital and Time 599

PART EIGHT **Market Failure 631** — 90% Fabian economics
CHAPTER 18 Asymmetric Information 633
CHAPTER 19 Externalities and Public Goods 683

15. Appendix: Some of Pigou's examples

15.1 Examples

Although Demsetz has looked through Pigou's examples and finds them basically meaningless, I wish to distinguish external effects from inefficiencies.

Here is a list of some of his examples. Time permitting, I'll disentangle the underlying issue/s in each of these cases.

> Pigou gives several examples of disservices, including: building developments that remove play areas, injure the "health and efficiency of families living there", crowd out existing properties and reduce air quality; running of motor cars that wear out the surface of roads; production and sale of intoxicants causing extra costs in terms of policemen and prisons; wars waged to obtain foreign trade and investment returns; and women doing factory work while pregnant impacting on the health of the child[167].

[167] https://research.wu.ac.at/ws/portalfiles/portal/19013123/sre-disc-2021_01.pdf