Law and Economic Analysis of the Precautionary Principle

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INTERNALIZING THE EXTERNALITY: INTRODUCTION TO THE EFFICIENT ENVIRONMENTAL REGULATION AND THE PRECAUTIONARY PRINCIPLE

CHAPTER 2
THE EFFICIENT ENVIRONMENTAL REGULATION

1. ENVIRONMENTAL EXTERNALITY: AN INTRODUCTION

This chapter attempts to discuss some instruments aimed at dealing with the problem of environmental externalities. In this context, I would like also to address some basic arguments regarding the choice between liability and regulation from an economic point of view. In addition, it should be noted here that the discussion regarding environmental externality will be complicated once one takes into account the issue of uncertainty and irreversibility. In this regard, two interrelated concepts, Risk Analysis and Cost-Benefit Analysis, will also be discussed.

One part of microeconomics, referred to as welfare economics, has paid a great deal of attention exploring how the market can co-ordinate the decisions of utility-maximizing consumers and profit-maximizing producers so as to spontaneously generate an efficient allocation of resources. This efficiency refers to Pareto Optimality39, a situation where it is no longer possible to reallocate resources in such a way to make one person better off without at the same time making someone else worse off.40 This condition is to be reached under a competitive market without any sort of government intervention.

However, there are some causes that prevent competitive markets from reaching Pareto Optimality, indicating that market failures have occurred. Most

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39 This criteria, however, is quite difficult to meet as it is often the case that one is better off only if others are worse off. Hence, in practice, rather than relying on the Pareto Optimality, economists usually apply the Potential-Pareto, referred to also as Kaldor-Hicks rule. This rule will be picked up later in section 3 of this chapter.