

Market-Based Environmentalism vs. the Free Market*

So-called “market based” solutions to environmental problems, which include the trade or sale of pollution “permits” or “rights,” have been heralded for their presumed reliance on the price system. This approach should not, however, be confused with that of the free market.

People on both the left and right are realizing that direct regulation of production and market activities—“command and control”—is too costly. Yet free markets and the outcomes they are likely to generate continue to be unappreciated. To the extent that policymakers value markets, it is not because markets maximize liberty and social welfare but because they can be manipulated to produce centrally planned ends.

That is the basic argument for market-based environmentalism (MBE). In spite of its calls for decentralized decision-making, the purpose of MBE is to subvert freely made decisions by coercively altering incentives. Thus, most MBE policies should be viewed with suspicion, if not disdain, by those whose primary interest is to advance individual liberty. (MBE should not be confused with free-market environmentalism, which is not subject to these criticisms.)

Markets and the Environment

The standard view of environmental problems is that they are inherent in a free society. If people are left free to pursue their own self-interest—to produce and consume whatever they want, how and when they want it—the result will be polluted air and waterways, littered streets, and depleted natural resources. Pollution and environmental degradation are often cited as evidence that Adam Smith was wrong. People pursuing their own self-interest may not advance the well-being

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of society.

Advocates of MBE fully subscribe to this view. As MBE advocates Robert Stavins and Bradley Whitehead argue, “policies are needed to...harness the power of market forces...to link the... forces of government and industry.”¹

That view, unfortunately found in many economics texts, misunderstands the nature of both a free society and a free-market economy. Environmental problems occur because property rights, a prerequisite of free markets, are not identified or enforced. Problems of air, river, and ocean pollution are all due to a lack of private property rights or protection. Since clarifying and enforcing property rights is the basic function of government in a free society, environmental problems are an example of government failure, not market failure.

In a free society, environmental problems should be viewed in terms of how they impinge on human liberty. Questions should focus on how and why one person’s use of resources might interfere with the planning and the decision-making abilities of others. Since people can legitimately make plans and decisions only with respect to resources that they have rights to, environmentalism that has human well-being as the focus of its analysis must center on property rights.

From this perspective, environmental problems arise because different people attempt to use the same resource for conflicting purposes. This can occur only if the property rights to that resource are not clear or are not being enforced. Two

¹ Robert Stavins and Bradley Whitehead, *The Greening of American Taxes: Pollution Charges and Environmental Protection* (Washington, D.C.: The Progressive Policy Institute, 1992), p. 3.

simple examples can highlight the possibilities. Imagine a community that has a cement factory that emits cement dust into the air. The dust causes people in the community to have to wash their cars and house windows more frequently than otherwise and creates respiratory problems for those who have to breathe it. That is clearly a property-rights enforcement problem. Note that the problem is not that the dust is emitted into the air but that it lands on people’s property—their cars, houses, and lungs—and interferes with their use of it. In this case, ownership rights are clearly defined, but are not enforced.

Another example might involve a public waterway, such as a river. Along the river, there is a factory that dumps the waste from its production process. Downstream are homeowners who use the river for recreational purposes, possibly fishing or swimming. The factory waste renders the river unsuitable or less useful for those purposes. The central problem here is that the rights to the river are not clearly defined. The public policy issue involves who should have those rights or how they should be divided. It should be noted that the idea of privatizing rivers or sections of rivers is not new. Early American Indian tribes had clearly defined and enforced property rights to sections of many rivers. State governments nullified those rights.

Since free markets require well-defined and enforced property rights, the solution to environmental problems lies in extending capitalism, not restricting it.

Altering Incentives

Market-based environmentalism has little in common with this approach. Under MBE, government authorities deem a level of effluent emissions, the amount of recycled paper in grocery bags, or some other outcome a desirable goal. Individual behavior is then manipulated to achieve the goal. MBE policies are meant to control markets by altering the incentive structure—that is, individual decision-making—in order to thwart the outcomes of free-market activity.

Even the free-market advocate and chairman of President Reagan’s Council of Economic Advisers, Murray Weidenbaum, has argued, “the environ-

mental pollution problem is not the negative task of punishing wrongdoers. Rather, the challenge is a very positive one: to alter people's incentives.²

The two most common MBE approaches are excise taxes and "tradable permits." The excise tax is a direct implication of traditional welfare economics, which argues that pollution is evidence of "market failure" in which prices fail to incorporate the full "social cost" of production; that is, the external costs associated with the pollution are left out. Since, under this theory, markets fail to generate the correct price and output, an excise tax equivalent to the pollution costs would "correct" for the failure. The problem is that this entire analysis is both practically and conceptually unworkable. The concept of social cost, if meaningful at all, would be the sum of the pollution costs experienced by all the individuals in the community. Yet in reality, each person's costs are strictly personal and subjectively experienced. They cannot be measured and certainly cannot be added to the "pollution costs" experienced by others.

Furthermore, because any tax would cause a complete reallocation of resources in the economy, it could not possibly be known whether the tax would end up making society as a whole better or worse off. Such policies ignore not only sound economics but also sound science. The result is proposals that promote the political agenda or aesthetic values of policymakers and interest groups.

For example, the World Resources Institute (WRI) has published a study claiming that the use of automobiles imposes \$300 billion annually in external costs on society.³ That figure includes the "costs" of global warming, even though decades of satellite data actually show mostly global cooling, and such pure aesthetics as the unsightliness of shopping malls and the loss of open space due to urban sprawl. The proposed remedies are all "market based" and meant to "alter people's incentives." They include hefty new taxes on gasoline, user fees for roads, and forcing all shopping malls to charge for parking.

Tradable permits (TPs), while often referred to as a "property rights" approach, are not intended to expand property rights but to rearrange and restrict existing ones to achieve an "environmentally correct" and politically determined result. This

approach begins by identifying an undesirable activity and then restricting it by issuing a fixed number of permits to pursue the activity. The permits then can be bought and sold in a market setting. Firms can boost their revenues by reducing the level of the activity in question and selling permits to other firms that wish to increase their activity beyond what their permits allow. While TPs "harness" market forces to achieve politically determined environmental goals, they are in fact disdainful of truly free markets based on the recognition and enforcement of property rights.

TPs simply legalize trespass to the extent they allow actual rights-violating pollution to continue, for example, allowing cement companies in the example above to pollute without compensation to victims. As Robert McGee and Walter Block have argued, "perhaps the major fault with trading permits is that... they entail a fundamental and pervasive violation of property rights."⁴

In other instances, they simply create new kinds of rights in an attempt to centrally plan industries in the name of envi-

⁴ Robert McGee and Walter Block, "Pollution Trading Permits as a Form of Market Socialism and the Search for a Real Market Solution to Environmental Pollution," *Fordham Environmental Law Journal*, vol. 16 (1994): 58.

ronmental protection. The Progressive Policy Institute, President Clinton's favorite think tank, is calling for tradable permits to promote recycling. The government would issue permits to newsprint companies limiting them to a certain level of nonrecycled materials in their paper. Companies could sell their permits if they increase the recycled content. Those proposals exist, even though, as reported in the *Washington Post* and the *Wall Street Journal*, too much recycling may be causing increased pollution and waste of resources. Such policies are best viewed as an attempt to impose personal attitudes, such as a disdain for landfills, on society.

Market-based environmentalism and the free market are not the same. Free-market policies, even with respect to the environment, would not have "environmental protection" per se as their central focus. Instead the focus would be on resolving conflicts among human beings as they put natural resources to use. An important by-product of that would be a cleaner environment and a more conscientious stewardship of resources.

MBE sees human activity as something that must be harnessed by the government, albeit through market incentives. The conflict, from this perspective, is not among human beings but between them and the natural environment, with human beings wearing the black hats. □

BUSINESS-CYCLE CONDITIONS

With the new year under way, the outlook for business conditions remains positive. The leading indicators point to further expansion and all six coincident indicators are clearly expanding. The lagging indicators show some strengthening, but not enough to suggest bottlenecks.

The outlook for business-cycle conditions over the next few months remains favorable. According to the latest batch of economic statistics, eight of our 12 primary leading indicators are clearly expanding, and six of those eight are at new highs for the current cycle. The six leading indicators at new highs are *M2 money supply*, *new orders for consumer goods, contracts and orders for plant and equipment*, *new housing permits*, *the ratio of manufacturing and trade sales to inventories*, *the average workweek in manufacturing*, *initial claims for state unemployment insurance* (inverted), and *the index of common stock prices* (to adjust for price inflation, stock prices and all other dollar-denominated series are reported in constant dollars). New housing permits and the average workweek in manufacturing both were appraised as probably expanding last month, but the latest data

indicate that both are now clearly expanding. Housing permits reached its new high, despite a drop in the November base data, and the base data for the average workweek rose to 42.3 hours per week — a postwar high.

Mild increases in the Consumer Price Index (CPI) during 1997 helped the index of common stock prices reach new highs over the year. During 1997, the CPI rose just 1.7 percent, compared to 3.3 percent in 1996. This is the smallest annual increase in the CPI since 1986 when it increased just 1.1 percent. The core CPI (CPI less food and energy prices) rose 2.2 percent for the year, the smallest annual increase since 1965. We use the CPI to adjust our stock price series (and the personal income coincident indicator) for price inflation.

Fewer purchasing managers are reporting slower deliveries. The base data for

² Murray Weidenbaum, "Reforming Government Regulation to Promote Prosperity," *The World and I*, August 1992, p. 497.

³ James MacKenzie, Roger Dower, and Donald Chen, "The Going Rate: What it Really Costs to Drive," World Resources Institute, June 1992.

vendor performance, the percentage of purchasing managers reporting slower deliveries from their suppliers, declined in December to 53.6. This pulled down the moving average to 54.6 — enough to warrant downgrading the series' appraisal from clearly expanding to probably expanding.

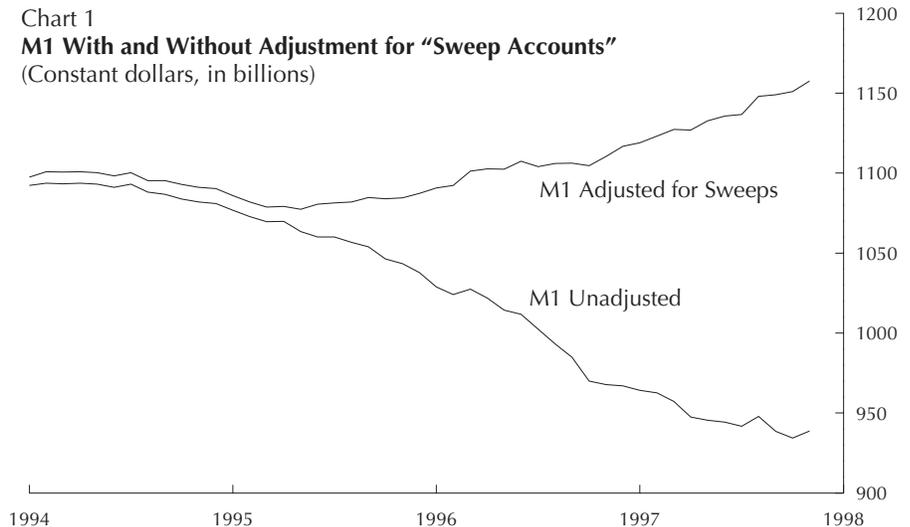
The latest data for the 3-month change in sensitive materials prices do not help to identify a trend in the series. The recent stability of this typically erratic series makes it impossible to identify its cyclical status, which remains indeterminate.

Are consumers starting to pay off some of their debt? Although it is too soon to identify this potential trend, the raw data (i.e., the outstanding debt) used to calculate the 3-month percent change in consumer debt declined for the first time since May 1993. As a result, both the base data series and the moving average series dropped. Although this is the first drop in the raw data for some time, it is not enough to warrant downgrading the cyclical status of the series. We must wait to see if this is the beginning of a new trend or a one-time anomaly in the data. The series remains appraised as probably contracting.

M1 money supply rose slightly this month, but it was not enough to suggest a reversal in the series' trend and M1 remains appraised as clearly contracting. Previous numbers of these Reports have discussed at some length the current problems involved with the components of M1, and one focused specifically on the possible effects of the recent use of sweep accounts on M1 (*Research Reports*, May 12, 1997). In effect, sweep accounts move idle funds out of certain types of checking accounts that are a component of M1 and place them into higher-interest earning savings accounts that are not a component of M1. In doing so, purchasing media are removed from what have typically been considered transaction accounts and placed in savings accounts, even though they are still likely to be considered transaction balances by the depositor. These transfers have important consequences for the Federal Reserve, which attempts to estimate how much money is swept out of M1 each month. Interestingly, when the Fed's estimates of sweep account activity are added back into M1, its trend turns from negative to positive. Chart 1 shows M1 unadjusted and adjusted for sweep accounts (both adjusted for price inflation). Although the reliability of the Fed's estimates is somewhat questionable, the adjusted series does seem to reflect current economic conditions more accurately than does the unadjusted series.

Overall, 82 percent (9 out of 11) of the primary leading indicators with apparent cyclical trends are expanding. This is un-

Chart 1
M1 With and Without Adjustment for "Sweep Accounts"
(Constant dollars, in billions)



changed from last month and indicates further expansion over the next several months. The cyclical score, AIER's purely mathematical assessment of the leading indicators, rose to 85 from last month's revised score of 82. The cyclical score also indicates more growth over the first quarter of 1998. Inasmuch as these two aggregate measures of the leading indicators currently tend strongly to confirm one another, it seems highly probable that the economy will continue to expand, at least in the near future.

Once again, all six of the primary roughly coincident indicators are at new highs, and all six are appraised as clearly expanding. Nonagricultural employment increased by 370,000 new jobs, bringing total nonagricultural employment up to 123.9 million. The recent job growth is fairly widespread throughout the economy, but the largest proportion of new employment has continued to occur within the services-producing sector. The table on the next page shows the employment growth for the nine major sectors of the

Statistical Indicators of Business-Cycle Changes

Change in Base Data				Primary Leading Indicators	Cyclical Status		
Sep.	Oct.	Nov.	Dec.		Nov.	Dec.	Jan.
-	-	+		M1 money supply	-	-	-
+	+	+		M2 money supply	+	+	+
-	-	-		Change in sensitive materials prices	?	?	?
+	-	-		New orders for consumer goods	+	+	+
+	+	+		Contracts and orders for plant and equipment	+	+	+
+	+	-		Index of new housing permits	?	+?	+
+	-	-		Ratio of manufacturing and trade sales to inventories	+?	+	+
-	-	+	-	Vendor performance	+	+	+?
+	+	-	+	Index of common stock prices (constant purchasing power)	+	+	+
+	+	+	+	Average workweek in manufacturing	+?	+?	+
+	+	-	+	Initial claims for unemployment insurance (inverted)	+	+	+
-	+	-		Change in consumer debt	-	-?	-?
Percentage expanding cyclically					80	82	82
Primary Roughly Coincident Indicators							
+	+	+	+	Nonagricultural employment	+	+	+
+	+	+	+	Index of industrial production	+	+	+
+	+	+		Personal income in manufacturing	+	+	+
+	+			Manufacturing and trade sales	+	+	+
-	+	+	+	Civilian employment to population ratio	+?	+	+
+				Gross domestic product (quarterly)	+	+	+
Percentage expanding cyclically					100	100	100
Primary Lagging Indicators							
-	-	+	-	Average duration of unemployment (inverted)	?	?	?
+	+			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
-	+	-		Ratio of consumer debt to personal income	-	-	-
+	+	+		Change in labor cost per unit of output, manufacturing	-?	-?	?
-	+	+	+	Composite of short-term interest rates	?	?	+?
Percentage expanding cyclically					50	50	75

nc No change. [†] Revised.

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

economy as well as the total number of jobs in each sector. The lion's share of new jobs, in both absolute and relative terms, came from the services sector. This sector includes business services, auto repair, health services, legal services, computer services, hotels and restaurants, etc. 1,406,000 new jobs, or about 44 percent of the total last year, came from this sector. Companies that sell computer related services were responsible for one in every 20 new jobs created in 1997.

To illuminate current employment trends in the two major sectors of the economy, Chart 2 shows the cyclical recovery for the private services-producing sector and the private goods-producing sector. The chart reveals that the services-producing sector recovered much more quickly from the trough of the July 1990-March 1991 recession than the goods-producing sector. As the chart indicates, the goods-producing sector continued to contract well into the current expansion. Not until July 1994 did the level of jobs in the goods-producing sector rise above its level at the beginning of the overall expansion. While job growth in the goods-producing sector continues to trend upwards, it is doing so at a markedly slower rate than in the services-producing sector — as illustrated in the chart by the widening gap between jobs growth in the two sectors.

Although motor vehicle production decreased slightly, the *index of industrial production* rose 0.5 percent in December. For the year, industrial production increased 5.9 percent.

After leveling off in the middle of 1997 (at one point last year we had to downgrade the series' appraisal to probably expanding), *civilian employment as a percentage of the working-age population* has recently regained its upward momentum. Currently, the ratio of employment to population is at a historical high of 64.06 — meaning that over 64 percent of the population over the age of 16 is employed. Throughout 1997 there was no doubt about the cyclical status either of *manufacturing and trade sales* or of *gross domestic product*. Both of these series were appraised as clearly expanding throughout the year and remain appraised as such. Overall, 100 percent (6 out of 6) of the roughly coincident indicators with apparent cyclical trends are expanding.

The same two primary lagging indicators that reached new highs last month reached them again this month. They are *manufacturing and trade inventories* and *commercial and industrial loans*. Both are appraised as clearly expanding.

The appraisal for the *percent change from a year earlier in manufacturing labor cost per unit of output* was upgraded

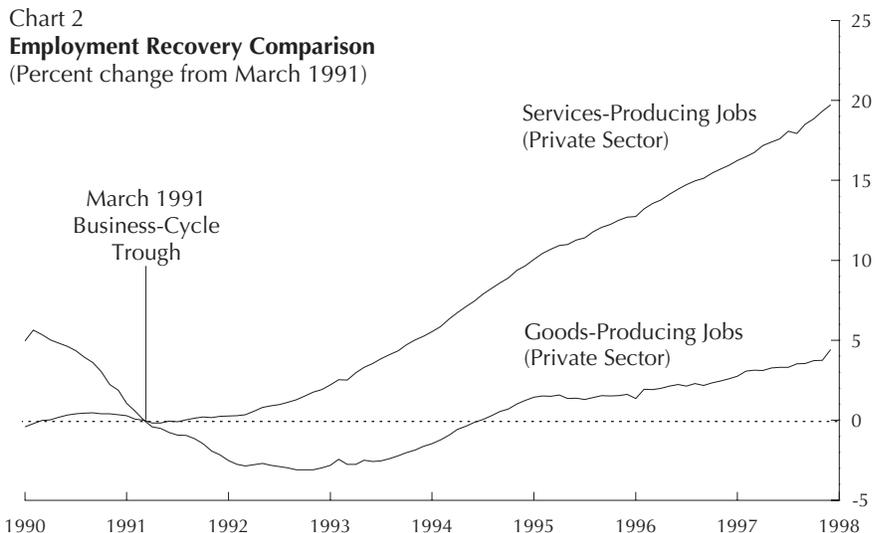
1997 Employment Growth by Major Sectors

(Numbers in thousands)

	Absolute Change Dec.-96 to Dec.-97	Percent Change Dec.-96 to Dec.-97	Total Jobs as of Dec. 1997
Goods-Producing			
Manufacturing	230	1.2	18,678
Construction	209	3.8	5,730
Mining	1	0.2	572
Services-Producing			
Services	1,406	4	36,290
Retail Trade	513	2.3	22,425
Government	270	1.4	19,784
Transp. and Public Utilities	200	3.2	6,488
FIRE*	193	2.8	7,155
Wholesale Trade	184	2.8	6,743
Total	3,206	2.7	123,865

*Finance, Insurance, and Real Estate. Source: Department of Commerce, BLS

Chart 2
Employment Recovery Comparison
(Percent change from March 1991)



this month. Previously, it appeared that this series was probably contracting, but new revisions to the data threw the cyclical status of the series into question and it now is indeterminate. Unchanged from last month at 16 weeks, there also is no identifiable trend for the *average duration of unemployment* (inverted).

The *composite of short-term interest rates*, however, now appears to be probably expanding. For several months short-term rates had no identifiable trend, but this month's increase to 5.8 percent was enough to suggest that short-term rates may be trending higher. The only lagging indicator with a clearly contracting trend is

the *ratio of consumer debt to personal income*. Since its peak 13 months ago, the debt to income ratio has slowly trended downward and most recently fell to 17.52 percent.

Overall, 75 percent (3 out of 4) of the primary lagging indicators with apparent cyclical trends are expanding — up from last month's 50 percent. We continue to watch the lagging indicators for signs of bottlenecks. For example, inventories grew faster than sales this month — which could become a concern if such changes persist. But for now the threat of bottlenecks appears slight. By most current indications, the outlook for business conditions in 1998 seems positive. □

PRICE OF GOLD

	1996 Jan. 25	1997 Jan. 23	— 1998 — Jan. 15 Jan. 22	
Final fixing in London	\$406.60	\$348.00	\$282.50	\$293.80

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