

Article for IPA Review

The Environment

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The new Federal government can neither ignore environmental concerns nor allow them to dominate decision-making. What is more, it has to take decisions without the benefit of a popular consensus on the relative weights to be given to environmental and economic concerns, and without even an accepted mechanism to aid adjudication---a considerable political problem.

The problem is the worse because most of the people who make themselves heard on environmental issues want government power to be used to achieve the outcomes they desire. But since the way government power is exercised is determined by the outcome of political debates, this means that they want to maintain and extend the politicisation of environmental decision-making. This is not necessarily good for the environment, the economy or the polity.

Both market failure and government failure are so common that blind faith in either the market or the government is unwarranted. But there is now no doubt that the market-based economies of the West have done better than the government-controlled economies of the socialist countries: not only at protecting civil liberty and providing high standards of living for the mass of the population, but also at environmental protection and pollution control.

In spite of the abysmal environmental protection record of the command (communist) economies², the debate in Australia is conducted almost entirely in terms of how government should frame and enforce 'environmental standards'.

I can think of three reasons for this tendency to set aside market solutions to environmental problems:

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² See, for example, 'The Poisoned Giant Wakes Up', *The Economist*, 4 November, 1989, pages 25-28. The point is reinforced by East European leaders themselves: Czechoslovakia's President, Vaclav Havel, for example, is reported as saying 'We have the worst environment in the whole of Europe'. (*West Australian*, 31 January, 1990.)

- * The physical and biological scientists working on the environment have no special understanding of social processes. That an ecologist has given a great deal of attention to complexities of the ecosystem does not mean that he or she is equally aware of the complexities of human society and the differing but equally-to-be-considered priorities of millions of fellow-citizens. An economist or a political scientist, on the other hand, is probably more aware of the fragility of the social consensus than the fragility of the ecosystem.
- * The voices of disinterested scientists are in any case now overwhelmed by ecological 'true believers'---people who know they are right. Many are of authoritarian bent, and not a few used to worship at that now discredited shrine of frustrated authoritarians: socialism.
- * The worst environmental problems tend to come in areas where market transaction is not the normal means of exchange. On examination, such market failures usually turn out to involve either government intervention that prevents the market from operating properly, or inadequately defined property rights that mean that not all the costs (and benefits) of economic activity are being taken into account: what economists call externalities. The exceptions usually involve areas in which it is impossible clearly to define property rights, or in which the cost of identifying and dealing with all the parties involved would be prohibitive. In such areas, market processes cannot produce efficient solutions (which is not to say that we can be certain that political processes would do better).

In Australia the economic debate, like the environment debate, is thoroughly politicised. Australian businessmen and workers are more accustomed to licences, awards and other rules---in other words, political 'solutions' to economic problems---than those of most countries.

A situation is thus developing in which two groups of people who see the environmental debate almost entirely as a zero-sum game of conflicting interests, will be trying to bend government to their will. Most Australians will expect government to arbitrate. But since they do not yet agree on the procedures that will give legitimacy to such decisions, dissatisfaction seems inevitable.

If bitter conflict is to be avoided, agreement upon some fundamentals which transcend environmentalism, economic and politics needs to be achieved.

Human success has depended upon our ability to learn and pass knowledge on to future generations by cultural (as opposed to genetic) means. Put another way: when, by chance or experiment, humans discover opportunity or error they can change their current and future behaviour to take advantage of a new situation. Thus humans, alone among species, are in a

position to make choices with some idea of how they will influence the future.

We are, however, prone to hubris. Even though our intellect is vastly superior to that of other creatures, we cannot see beyond the most immediate consequences of our actions. At the time of writing, it was not possible to predict the course of history in Europe, or the rainfall in Melbourne, as much as a week ahead with confidence. We therefore owe it to our future selves as well as to future generations to avoid doing things that will close off options or reduce freedom of choice. We should not undertake large-scale, difficult-to-reverse experiments with our physical environment, our economy or our culture. Neither should we stifle experimentation, condemning our children to lifestyles which are frozen at today's standards---or, worse, declining because we do not adjust to those changes over which we have no control. (Think how poor our present lifestyles would be if the reactionaries of 100 years ago had actually succeeded in preventing the development of, say, modern modes of transport and agricultural practices.) Instead, any planned changes should start on a small scale, at the margin; and information about the advantages and disadvantages of the changes should feed back to the decision makers as surely, promptly and accurately as possible---feed-back is a function of markets and of democratic elections. The greatest dangers lie in grand schemes, including ones that are designed to stop change.

Whatever the source of change, environmental considerations, particularly some of the means employed to protect the environment, will often be in competition with other important considerations---such as economic growth and the ability to service the foreign debt---or with established political and legal procedures. When these conflicts arise, moral considerations call for the compromise that (as far as we can tell) best serves future generations: that will often be the compromise that maximises future choice. For instance, we should not see environmental protection and foreign exchange earnings as mutually exclusive, but rather ask what combination of environmental protection and increased production of tradable goods will best serve our future selves and our successors. Maximising human well-being in the long run requires developers to 'work with the environment' and environmentalists to 'work with the economy'.

We inherit and pass on to our children our genes, our physical environment and our capital stock and/or debts. And we also hand on our equally important economic and political culture. Australia's cultural environment includes such things as the rule of law; private property and the essentials of the market economy; respect for civil rights; and democratic, limited government. Culture is no more the product of conscious human design than is the ecosystem, and we should stand equally in awe of it. It developed over thousands of years as people who adopted better practices prospered and those who adopted worse practices did not. There are no free and prosperous societies that do not have market exchange among their cultural baggage. Most also have democracy.

We have seen political and economic culture modified radically by such intellectual aberrations as Communism and Fascism. The culture which sustains a free prosperous society is, perhaps, even more fragile than the ecosystem. In any case, where a liberal-democratic culture has been prevented from developing---as in the USSR and Communist Europe---the tendency has been both for the man-made and the natural environment to be despoiled as well, and for less to be done to recover from past mistakes than in the liberal democracies. Where relatively unrestrained political authority has been available for protection of, among other things, the physical environment, or for advancing the economy, it has not had the desired effect. Those who would protect the physical environment should not, therefore, put too much faith in political solutions.

Most forms of economic activity cause some changes to be made to the ecosystem. These changes may be deleterious or beneficial, small or great. Preference for a market economy over a command economy does not, in itself, conflict with preservation of the natural environment. On the contrary, economic theory suggests that deleterious environmental effects are likely to be fewer and less damaging in a market economy with secure property rights and low transaction costs than in any other system we have experienced, except, perhaps, some forms of subsistence economies.³ Market exchange of private property developed by a process analogous to that by which species developed---that is by the unplanned selection of those processes and institutions which better sustained the 'long term' interests of the species, in this case mankind.⁴ It is in countries where market exchange is suppressed that the physical environment receives least care.

Free market capitalism, where it is able to function, preserves and enhances things that are useful to man. Mankind will not run out of energy, for instance. Fossil fuel became an economic resource only when it was discovered, extracted and means found for converting it into energy. As fossil fuels become depleted their prices will rise relative to other goods, causing people to look for ways of using them less, both by making more efficient use of energy (better engines, lighter cars, insulation, etc.) and by looking for alternatives (solar, nuclear, etc.). It was on this simple point---that patterns of resource utilisation are dynamic and flexible in the medium and long term---that the Club of Rome went so badly wrong in its doomsday scenario. Likewise, it is the market that ensures that trees are being planted to satisfy

³ See, for example, Terry L. Anderson, 'The Market Process and Environmental Amenities'; and Walter Block, 'Environmental Problems, Private Property Rights Solutions' both in Walter E. Block (ed.), Economics and the Environment: A Reconciliation, The Fraser Institute, Vancouver, 1989. AIPP plans to publish an Australian edition of this work later this year.

⁴ F.A. Hayek, The Fatal Conceit: The Errors of Socialism, edited by W.W. Bartley III, [Collected Works, Volume 1], The University of Chicago Press, Chicago, 1989.

future timber wants and that the fertility of privately-owned agricultural land is being improved.

There is no such automatic and effective feed-back through price where free market capitalism cannot function, or is not allowed to function. In its absence assets, such as clean air and pollution-free river systems, are less likely to be well preserved.

High standards of living and strong economic growth are not, *per se*, inimical to the environment. Indeed it is in the Sahel, Eastern Europe and parts of Latin America, where economies are failing, that the most obvious environmental problems are to be found.

In the strong economies, such as the United States, the laws which damage the economy are often also those which damage the environment. For example the laws in the US that kept the price of motor spirit down thereby wasted fuel, crowded the roads and polluted the atmosphere. And the Australian Treasury has explained how the underpricing of electricity, the subsidisation of dairying and rice production, the undercharging of heavy road haulage, and the inefficiencies of coastal shipping and the waterfront all contribute to the greenhouse effect.⁵

This is not to say that the market alone can deal satisfactorily with every legitimate environmental concern. It does, however, suggest that properly functioning markets can and often do benefit the physical environment and that environment-protection policies should, so far as possible, not hinder the function of markets.

Similar considerations apply with even greater force to the rule of law and to open government and democratic procedures. In the protection of the environment, as in everything else, the government must proceed only by due process and ultimate sovereignty must rest with members of the public, rather than with an elite who are presumed to have superior knowledge or wisdom. There is a wealth of difference between using experts' knowledge, and giving control to experts.

In designing environment-protection legislation, as in everything else, we must start from:

- * the rule of law;
- * secure and well-defined property rights;
- * democracy; and
- * market transaction.

Where the costs of a degraded environment are born by the relevant economic decision-makers or the benefits of an

⁵ Economic Round-up, November 1989, pages 16 and 17.

enhanced environment enjoyed by them, the decision makers have an appropriate incentive to look after and improve the environment---as is the case, for example, with a farmer dealing with the soil structure and fertility of his own land. However, when the costs or benefits are experienced by third parties, no such incentives exist. In these cases we may say, without departing from normal economic methodology, that environmental degradation is caused by a particular form of market failure, 'externality'.

Externalities can be positive---e.g. public transport systems may take people off congested roads to the benefit of remaining road-users---or negative---e.g. a factory may pollute a neighbourhood, imposing costs on the residents. The environmental debate has most often been concerned with negative externalities.

Externalities, of both types, can often be corrected by regulation. We must bear in mind, however, that 'regulation failure' is also common, and that market failure is often caused by inappropriate regulation.

If it cost nothing to find out about costs and benefits, to clarify everybody's legal rights, and to negotiate and enforce contracts, then there would be no such thing as an externality. This is because a person suffering injury would always be able to make the deal with the creator of the nuisance that maximised their combined wellbeing. Potentially every member of society would negotiate until all the externalities had been 'internalised'. Then no further gains could be made by allocating the costs and benefits differently.

Perfect markets are figments of the imagination. Nevertheless, by contemplating them we discover an important way to make economic decision-makers consider environmental costs: namely, do whatever is possible to reduce transaction costs.

In summary, Governments contemplating regulation to protect the environment should, so far as they are able, first identify the circumstances in which free-market transactions are likely to involve environmental costs which are not taken into account by buyers and sellers---that is, where there are externalities. Then they should proceed only with caution, respecting both democratic and rule-of-law procedures, to correct for the market failure. Even the best intentioned politicians and their advisers do not have the knowledge to foresee all of the consequences of the regulations they enact.⁶

⁶ For an outline of procedures to take due account of these not very startling conclusions, and which are a practical modification of existing Federal Government procedures, see the AIPP publication: *After the Election...Policy Priorities for 1990-91*.

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