

## **Free Market Environmentalism**

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Controversy over the results of the 2000 presidential election has drawn attention away from a crucial element of the campaign — the introduction of free market concepts, and their utility in policymaking, into the purview of average Americans. While libertarians may argue that the front-runners are merely two sides of the same big-government coin, it is undeniable that the race has elevated awareness about the role of the market in policy-making. Republican George Bush proposed a fusion of market principles and government policy for dealing with Social Security's looming crisis, failures in the education system, and the concerns about the environment. His Democratic opponent, Al Gore, questioned the benefits of such a synthesis. In fact, Gore successfully illuminated common fears about decreasing government involvement in realms presently sheltered from market forces. Does the volatility of the market threaten Social Security's promise to Americans? If public education were to be operated like a business, wouldn't it be vulnerable to the drastic polarization between winners and losers so prevalent in the corporate world? How can companies responsible for damaging the environment be trusted to voluntarily participate in its renewal? Free market economics is largely misunderstood and, as a result, easily labeled risky and exclusionary. However, the failure of status quo programs exempted from market forces is, at the very least, an indication that a search for policy alternatives is warranted. Thus, this paper is an investigation into the viability of the market-based approach to policy-making. A brief theoretical summary of the major free market concepts is included, but the bulk of the paper concen-

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trates on a framework for comprehensive policy analysis and the prudence of the market approach in light of such an evaluation. Specific policy issues are less important to this discussion than the general feasibility of the approach, and are included only for illustrative purposes. As a result, I have limited in-depth scrutiny to environmental issues, specifically preservation of water quality. Ultimately, the evidence presented here should prove — regardless of the ideological inclinations of the reader — to be quite compelling and accommodating to the American principles of independence, personal responsibility, and capitalistic ingenuity.

### **Theoretical Concepts**

An all-inclusive explanation of free market economics could easily fill multiple volumes. Luckily, an exhaustive understanding of the philosophy is unnecessary for the purposes of this paper. The discussion can be narrowed to just four key concepts: intentions, information, incentives, and institutions. The role of intentions is best illustrated by the ‘invisible hand’ metaphor: individual actions directed by self-interest can result in ‘spontaneous order.’ Dr. Steve Horwitz, an economics professor at St. Lawrence University, explains that since most people are acquainted only with their own wants and needs and those of the people closest to them, they usually act in self-interest rather than with grand intentions for general welfare (Horwitz, 2000). Economist Paul Heyne compares market spontaneity with traffic. “The coordination of millions of automobile trips is far too complex for any traffic control system to manage, so we have to let it operate spontaneously within a few specific rules: drive on the right, stop at lights, yield when making a left turn...it would be simply impossible to plan and consciously coordinate” (Heyne in Boaz, 1997).

Some may argue that a world of people operating only in their own self-interest would yield a frightening scenario similar to the Hobbesian ‘state of nature’, yet supporters claim that free market policies generate favorable outcomes. How do free market systems avoid the “poor, nasty, brutish, and short” existence that Hobbes described? Adam Smith, a fundamental free market thinker notes, “by pursuing [one’s] own interest [one] frequently promotes that of society more

effectually than when he [or she] really intends to promote it” (Smith in Doti & Lee, 1991, p.7). Capitalism itself is based on this principle. The business owner’s interest (profit and market share) is inextricably linked to the consumer’s interest (desire for particular goods or services). There is also an indication that non-economic goals like safety and good education systems are sufficiently common such that self-interest and general welfare often concur.

Intentions alone are insufficient to account for the invisible hand, though. Information is the missing link that translates self-interest into collective benefit. Prices are the best example of information in a market economy. While prices may be initially set based on predictions of consumer behavior, market responses cause them to level out to accurately reflect information about what products are in demand, how easily or efficiently they can be produced, if the required raw materials are readily available, and the amount consumers are willing to pay for them (the initial overvaluation and consequent devaluation of Internet stocks is an example). “Although we can never feel affection for — or even meet — everyone in the economy, market prices help us to work together to produce more of what everyone wants” (Boaz, 1997). Lynn Scarlett, executive director of the Reason Public Policy Institute, a non-profit organization that proposes market-based policy recommendations explains that in the context of policy-making, important information comes in the form of ‘local knowledge,’ the particulars of “time, circumstance, and past experience,” which function to clarify policy limitations and prospects (Scarlett, 2000).

Information and intentions come together to produce incentives, the most important free market concept. When producers are aware of consumer wishes via the demand information found in prices, there is an incentive to respond. Profit serves as the ultimate motivator, reconciling the interests of the producer or retailer with those of the consumer. Similarly, when the consumer receives information by way of prices, reflecting supply and other factors, incentives emerge to alter or maintain their purchasing habits accordingly. Hence, in the end, self-interested actions, determined by intentions, information and incentives, result in common good. Incentives are also crucial to the free market approach to policy-making. Scarlett notes that policy suc-

cess is directly related to the incentive structures within agencies, communities, and firms because these structures shape the actions of everyone involved (Scarlett, 2000).

Finally, institutions are important for the functioning of the market. Many envision the free market approach as one with no rules, save '*caveat emptor*' (buyer beware). However, the market is, indeed, regulated by key institutions. Prices, for example, are based on the conventional rules of supply and demand. Property rights and voluntary association are institutions vital to orderly operation of the market, as is the protection of free and fair competition (which disallows prohibitive transaction costs or barriers to market entrance). The role of institutions is not only structural, but substantive, as well. The free market approach assumes that property rights encourage responsibility; voluntary association promotes accountability; and competition ensures fairness by facilitating honest prices and equal opportunities for participation. Ultimately, the four concepts coalesce in an attempt to achieve common benefit by acknowledging and capitalizing on the human tendency toward self-interest, eliminating the need for central planning or coercion.

### **Policy-Making**

The remainder of the paper is designed to verify the free market approach as a holistic one applicable not only to commercial, but also to governmental, and non-governmental policy. Policy-making is, in essence, problem solving. As such, the process includes identifying the problem, examining the options, and designing an implementation strategy for the agreed upon course of action. The free market approach, characterized here by Lynn Scarlett's research, addresses each step in accordance with market concepts. To identify the problem, a collection of empirical information surrounding the particular issue is required. This information includes the circumstances under which the problem occurred, as well as an in-depth assessment of the performance of current solutions. When thinking about the current policy, incentives, intentions and institutions are also critical. The success or failure of a policy is often directly related to the incentive structure it establishes, which can be ascertained by considering how the specific

implementation of the policy influences the actors involved; whether the enforcement agency is goal-oriented or methodologically motivated; and whether those bound by the policy have a larger incentive to comply with or circumvent the regulations (Scarlett, 2000). Although policy results from the intentions of relevant players, it could hardly be portrayed as spontaneous order. Instead, the most powerful interests often carry the day. Determining who benefits from and who is harmed by specific policies is important in identifying the underlying motivations. The same process is applied when examining alternative options. Essential to the free market approach is primary attention during option scrutiny to the realistic consequences of all policy alternatives. In this method, there is no assumption that original intent will be automatically realized as a result of legislation. So, the information collected initially is a key factor for forecasting the new incentive structures. Remember, comprehensive investigation of the incentive structures created by the policy, and the plausible links between those incentives and performance, is of paramount importance. In fact, Scarlett cites failure to project unintended consequences resulting from incentive structures as a major drawback to conventional policy-making (Scarlett, 2000). Ultimately, the newly formulated strategy reflects the role of intentions, incentive and information, while utilizing market institutions like property ownership and voluntary association. The implementation plan should rely on existing institutions precisely because they capture the essence of self-interest and incentives. Thus, Lynn Scarlett's analytical framework is fitting for the following discussion intended to highlight the inadequacies of policy that ignores realities of the market and human nature, in contrast to the achievements possible with a renewed focus on preventing unintended consequences by streamlining policy with the four market concepts. Logic dictates that policies acknowledging and capitalizing on the significance of self-interest immediately remove key obstacles to success because they facilitate and encourage compliance. In other words, successful policy reconciles the objectives of the program with the interests of those affected by it.

To illustrate the effectiveness of the approach, I have chosen to focus on a major environmental problem and the status quo rem-

edy. Traditionally, business and market values have been viewed as antithetical to environmentalism. Therefore, the issue has the potential to construct an excellent example of the general versatility of the approach. The strength of the market, as purported by believers, is that the contrary interests of two parties can be reconciled into spontaneous order created by well-designed incentive structures.

### **Water Pollution**

Water pollution is attributed largely and, perhaps, correctly to industrial irresponsibility. In the United States, hundreds of land-based industrial and municipal facilities release waste into estuaries and coastal waters; many marine-based operations dump dredge spoils, sewage, and industrial waste into the water; and, additionally, return irrigation flows and urban runoff nationwide produce indirect discharges (Anderson and Leal, 1991, p. 137). In their research, Terry Anderson and Donald Leal found that water pollution has caused reduced harvests in possibly contaminated areas, triggered human illness related to consumption of contaminated seafood, and diminished “aesthetic and recreational values in United States coastal waters” (Anderson and Leal, 1991, p. 138).

Currently, water pollution is ‘controlled’ under the 1972 Clean Water Act, which requires that the “discharge of pollutants into the navigable waters be eliminated by 1985... [and] wherever attainable, an interim goal of water quality which provides for the protection and propagation of fish, shellfish, and wildlife and provides for recreation in and on the water be achieved by July, 1 1983” (Clean Water Act Amendments 1972). To enforce the act, the Environmental Protection Agency (EPA) set standards to be met by industry based on the “best practicable control technology available” (Anderson and Leal, 1991, p. 141). However, fifteen years after the prescribed deadline, the goal of the policy is yet to be fulfilled.

Using Scarlett’s framework, the flaws of the Clean Water Act can be easily identified. First, the goal of the act, complete elimination of water pollution, is largely unattainable. Although this problem is pointed out in specific reference to the Clean Water Act, it is not unique to it. When policy-makers ignore empirical data concerning time, cir-

cumstance, and past experience with the problem, all of which help to clarify the limits of legislation, then policy abdicates its problem-solving role. Remember, the free market approach is careful to consider realistic outcomes of policy, instead of those possible only by the imaginary power of fiat. These essentially out-of-reach objectives are problematic also because enforcement becomes methodologically oriented rather than goal oriented. As a result, the incentive structure is in opposition to the intentions of the policy: businesses focus not on unachievable quality goals, but on technology requirements, which merely ensure legal protection (companies using unapproved technology risk lawsuits), but not pollution reduction (Grewell, 2000; Anderson & Leal, 1991, p. 144). Again, the drawback is not limited to this particular case; any time a policy structurally shifts the focus to methodology, away from original intent, it no longer serves as a problem-solving mechanism, but as simply as bureaucratic decree.

Second, to comply with the Clean Water Act, businesses must use EPA-approved technology. As a result, less expensive and, perhaps, more effective technology goes undeveloped. Strict methodological requirements undoubtedly preclude innovation; this is an unintended consequence that occurs when incentive structures are not properly anticipated. Market-based policies aim to encourage innovation because advancing technology often improves performance and decreases costs, ultimately easing the burden of compliance.

Third, because the EPA “found it too costly and time-consuming to specify standards over sixty thousand major polluters,” uniform standards were developed for each industry that disregarded the circumstances (namely, their particular polluting habits) of individual businesses within each industry (Anderson and Leal, 1991, p. 142). Anderson and Leal cite studies in Delaware, Wisconsin, New York, and New Jersey that found universal standards for reducing emissions and effluent discharges to be significantly more costly for businesses, but not necessarily more effective (Anderson and Leal, 1991, p. 142-143). Incidentally, some of these studies were conducted after the act passed, but one was done *well before* (1966), again illustrating policy-makers’ inattention to past local experiences. Undue compliance costs should always be avoided because there is a threshold point at which excessive

costs encourage people and businesses to circumvent the law altogether. It makes good sense to align policy with the interests of those bound by it whenever possible.

Finally, and most bewildering, the EPA standards are not specific to the water in question — high quality water bodies are treated exactly the same as those critically polluted. Besides departing from common sense, and wasting clean-up resources, such standards remove the incentive to tackle the most pressing pollution problems. This grave unintended consequence is another testament to the inherent disadvantage of uniform standards.

The failures of the Clean Water Act discussed above were predictable — why were they ignored? Scarlett indicates that unsuccessful policies are not usually the result of ignorance, but can be traced to surreptitious political associations by determining who benefits (*qui bono?*) from an inefficient solution. One of the major advantages of using market concepts as a guide for policy-making is their objectivity. Remember, the goal of policy is problem solving. Rent-seeking (political favors sought by lobbyists) can unduly influence policy to the extent that powerful interests secure advantages for specific constituencies, to the detriment of other actors and achievement of the stated intentions. Market policies are routinely deemed as disproportionately beneficial to business but, actually, the free market approach provides an impartial evaluative process because it is essentially utilitarian: the aim is to assimilate, as much as possible, the interests of everyone involved with the policy goals, increasing compliance and, therefore, success. Spontaneous order occurs when policies facilitate the self-interested behavior of individuals toward a common end. It cannot come about in the context of coerced actions enforced by the power of government.

The Clean Water Act was intended, ostensibly, to benefit the general public, and specifically those who use or value estuaries, oceans, and waterways. However, in order to understand the reasons for the multiple flaws in the legislation, identifying the indirect beneficiaries may be valuable. Because of the dire conditions of many U.S. water bodies, along with heightened environmental awareness that grew out of various movements in the sixties, regulation was inevitable. Yet,

certain powerful interests were able to weigh in, mitigating the damages that government involvement could have caused. Bishop Grewell, a research associate at the Political Economy Research Center (PERC), a free market environmentalism think tank, explains that “part of the push for the Clean Water Act came from companies that did not want to have to deal with common law courts...or state or local regulators” (Grewell, 2000). In common law courts, high punitive judgments could be debilitating, and decentralized regulations could be more stringent in certain areas (with higher pollution). Grewell says “there are indications that industry largely wanted A) uniform standards everywhere, so they did not have to deal with different state bodies regulations and B) they wanted restrictions on competition which largely came in the form of increased transaction and start up costs” (Grewell, 2000). The established companies were better suited to opt for initially high costs that prevent other companies from entering the market, than for local regulatory schemes which, may have smaller initial costs, but austere variable standards.

The role of specific industries in the formulation and passage of the Clean Water Act is not easily verified, and enters the realm of speculation. It is clear, though, that many industries supported the legislation even though it penalized them. Thus, it can be inferred that these industries potentially has something to gain by supporting the legislation. By promoting the necessity of free and fair competition, market-based policies disallow the barriers like artificially high start up costs designed to discourage new businesses from entering the market.

Under the free market approach, there are multiple policy alternatives designed to more effectively reduce pollution, while avoiding unnecessary costs to businesses (the simplest account of the greatest good for everyone involved), one of which is tradable pollution permits. First, a ‘background level’ (a manageable level) of pollution is established individually for each area. Next, local businesses are issued permits authorizing them to create a specific amount of pollution (effluent discharges, for example). The total number of permits is finite and, altogether, allows no more than the optimal level of pollution. Oversight could be best handled locally because of variable standards, but the EPA would be valuable as a high-level enforcement apparatus.

The permits could lawfully be traded or sold because the only purpose of the program is enforcing the cap on total pollution. Which companies are discharging what is unimportant as long as they have permission to do so, and have legitimately gained that permission. Furthermore, the permits can even be bought and retired by the legitimate recipient, reducing the overall ceiling.

Businesses may form independent oversight groups, to ensure that no one is cheating, which would impact all the companies within a given area. Jack Powelson, an political economist that rights from a Quaker perspective, proposes that environmentalist groups and local residents may also get involved by purchasing some permits and retiring them, reducing the total pollution even further below the standard established initially (Powelson, 2000, p. 21).

This option represents a merger of government regulation and free market economics. Technically speaking, such a union is impossible because the two perspectives are mutually exclusive. However, the key to this approach, as presented here, is the recognition that certain realities exist that must be considered if policies are to be effective. Thus far, the inevitabilities of economic factors and human nature have been addressed, but political realities are no less important. There is not a pure free market economy in the U.S. (although there is a relatively open market), so radically libertarian policies are not feasible here. It should be noted, however, that certain problems with the political system, such as corruption stemming from the disproportionate influence of certain industries, groups, or individuals, need not be accepted. This type of power brokering is commonplace, but it is often illegal, and almost always questionable. Ultimately, the only way to reduce back-door-bargaining is to incrementally pass policies that demonstrate the success possible when patronage is not part of the process.

The new system would alter the incentive structure dramatically, and, in so doing, the predictable outcomes, as well. Businesses than able are given the incentive to reduce pollution through innovative technologies, and then sell their permits for a profit. Therefore, these technologies are more likely to be developed, possibly offering even greater environmental benefits. All companies in a given area are

encouraged to monitor others' adherence. Cheating devalues the worth of every permit and risks a collapse of this much less restrictive policy. As noted above, environmental groups and residents have the incentive to play a role, which would have the outcome of an aggregate reduction in pollution that would not otherwise occur — these outside groups remove from circulation permits that would be used by a company in lieu of more efficient technology or restructuring. In this way, a powerful environmentalist group may be able to increase the incentive further for companies to 'clean up their act.'

Examining status quo policies under the free market framework is instructive in two important ways. First, it highlights the fundamental, but common errors of policy-making: habitual disregard of market realities such as the presence of self-interested actors and the impact of incentives. For example, most of the unintended consequences of the Clean Water Act could have been easily predicted by analyzing the available enforcement strategies in terms of the market concepts. More importantly, though, this kind of thorough scrutiny, as part of the preparation process for actual policy-making (past experience is part of empirical data collection), raises awareness necessary to avoid repeating the inadequacies of the old policy and to effectively anticipate predictable outcomes for new ones.

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