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Internalizing externalities: making markets and societies work better

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Externalities are *impacts generated by one economic actor, which are felt by others, but the market doesn't bring these impact back to affect the actor that originated them*. What I want to note, first, about this term is that the concepts it embraces are shared among a wide range of economists, on the right and on the left, as well as with environmentalists and proponents of social justice. Unfortunately, mutual suspicion among these groups sometimes prevents them from realizing the power of the convergence of their ideas. I often hear environmentalists – or economists whose hearts are green – say things like, "economists marginalize most of the important things in life by putting them down as 'just externalities.'" On the contrary, this concept is one of the strongest cards that socially conscious economists can play against the dogmatic, but influential position of market fundamentalism. In fact, I've never heard an economist of any stripe saying "oh, that's not important, it's just an externality". They all take externalities very seriously, because even the most economistic model cannot escape its own proofs that externalities are signs of market failures. When there are serious market failures, the prescription that markets should be able to solve all human requirements for production, consumption and distribution is open to challenge.

It is very a positive development that the discipline of economics is wrestling with efforts to "internalize" the costs of economic activity that have been "externalized" to the natural world. In order to assess the likelihood that externalities will in future be internalized to a much greater extent than hitherto, we must ask, first, why have they been allowed to remain external up to now? and, second, what has changed so that we can expect the future to be different in this respect?

The principal answer to the first questions is power. The economic actor, X, who can avoid the costs of his/her economic activities by leaving them to be borne by A, B and C, generally has some or all of the following characteristics:

-- X is either a single actor or else a small group, and is able to organize in pursuit of clearly perceived goals.
-- X possesses knowledge, in particular of what is in his/her interest; s/he also knows what s/he is doing (and may deliberately conceal certain actions from A, B and C).
-- X possesses economic power.
-- X possesses political power.

By contrast, A, B and C are apt to be relatively small actors, diffuse, unorganized, ignorant of how they are being affected by X, possessing fewer financial resources, and (largely because of these characteristics) lacking in political power.

This sounds like the way the world has always worked; you might be wondering whether anything has happened that might change this dynamic. I can suggest a few reasons for hope. The environmental movement has taken the lead, first by increasing the knowledge possessed by A, B and C – informing those affected by negative externalities about the ways in which economic actors may be off-loading some costs of their activity in the form of environmental degradation or threats to the health and safety of workers, neighbors, consumers and other stakeholders. Environmental groups and movements, as they work to inform A, B and C, are also taking advantage of the communications revolution to overcome the disadvantages of diffuseness, and are assisting the organization of those adversely affected by economic externalities. The Global Reporting Initiative (see www.gri.org) is a prime example of how environmentalists, working with labor and other socially concerned groups, as well as with socially responsible investors, can change the balance of power with respect to knowledge and information.

However we should note that the environmental movement, even allied with labor and investor groups, has to face the countervailing force of globalized corporations, whose power and scope continues to grow, and to reach ever deeper into the levers of political power. Nevertheless, the convergence of the environmental and social movements with economic ideology on the topic of externalities is so unusual that it gives us some hope. Maybe we are moving toward a global culture that will really believe that each economic actor should pay all costs for which it is responsible.

I'd like to emphasize that this possibility represents a potentially enormous change. If you think back through the history of colonialism and the industrial revolution, about the freedom with which industrialists have polluted, disrupted communities, and absorbed and destroyed resources – even more, if you think back to the plundering of the colonies by the nineteenth and twentieth century colonial empires – you will recognize what a radical proposal is "internalizing externalities". If there is a movement in this direction, we are still at its beginning stages – and, as an economist, I have to warn you that this is not an idea that can be applied in an obvious and simple way in the majority of situations. Still, it is encouraging that so many different groups are converging on the basic idea that it is wrong to make other people pay the costs of actions from which you have benefited.

Economists are often not very good at including the loss of quality of life in their calculations of externalities; it's harder to calculate the costs that have been externalized when workers at a Chinese or Bangladeshi supplier to Wal-Mart are deprived, every week, of all but a few hours of living, aside from work and sleep. Nevertheless, economists do take the whole notion seriously. If a firm benefits from hiring someone, and then causes health or other costs that it doesn't have to pay – and someone else does – the market is not working properly. Other people than economists, hearing about such externalities would talk about it in the more common terms of fairness. The result, in any case, is that here is a rare and precious case where we are all in agreement.

The next question is, what should be done about it? The economist's answer is: Internalize the externalities – that is, find some way to ensure that the economic actor that creates costs has to pay them all. The environmentalists have a more appealing term for this: the Polluter Pays Principle. Economists would like it if little changes could be made at the edges of the market so that internalization of externalities would become automatic, with minimum extra-market interference. Self-regulation and self-policing is popular, for this reason, among economists as well as in corporations.

I don't want to knock self-regulation; regulation by entities outside of a corporation can only go part way to prevent it from externalizing its costs. But self-regulation works better in a culture that honors integrity and concern for others at least as much as it respects success in making money. Unfortunately, our culture has drifted away from that position, making outside regulation more necessary.

This brings me to a related topic, with the less familiar term, meta-externalities. Meta-externalities are *unwanted side-effects of the whole economic system on its physical and social contexts* – externalities in which the economic culture fouls its own nest, if the "nest" is understood broadly as all the contexts in which we humans live. Critical meta-externalities show up in the impact of the economic system on the social context. Productive enterprises need a workforce that has been socialized to be able to defer gratification, to think independently and sometimes creatively, and to be honest and responsible. Citizens and politicians need to care about the long run, and to be able and willing to address intelligently the myriad highly complex issues that face modern societies. But the sales efforts within modern enterprises are focused on a different set of requirements. From the sales point of view, the self-interest of business is served by a consumer-oriented culture of instant gratification and simplified thinking that urges material purchase as the answer to any discomfort. The strongest influence from the economy to the culture is motivated by corporations' desire to increase short-term profits and sales, achieved through advertising, ownership of news media, and purchase of political influence. Selfishness, short-term thinking, cynicism, and impatience with complexity are cultivated in the populace at large – even though these are not the characteristics that will best contribute to a healthy society or a healthy economy.

So now we have three headings under which to examine corporations' impact on the economies and societies of the world: pure market effects, simple externalities, and meta-externalities.

The pure market effects come out of a company that has done just what it was supposed to do. Wal-Mart can demonstrate an impressive history of reduced waste, streamlined delivery, and other contributions to efficiency, with all the good, resource-saving and price-reducing effects the textbooks expect. In some areas – or from some points of view – the benefits seem to outweigh the costs. For the purpose of this discussion, however, I'm focusing on what goes wrong when competition is too unregulated.

Wherever Wal-Mart's effects come from their pricing policy, that's probably a market effect. The popularity of their stores, the fact that other stores can't compete with their prices – on the face of it, that is nothing but the market working as it should. Some people would say that unions ask for too much, going beyond basic needs. They might say it's okay that so many unions, and unionized grocery stores, have been swept away by the march of Wal-Mart. But there's a fine line between just being so much smarter and more efficient that you cause the bankruptcy of competing chains, like Kmart, Ames and Bradlees, and going beyond the pale – creating situations that forces your competitors to drive wages below the poverty line, so that the public sector has to step in to make the difference. When firms that don't offer a living wage have a justifiable claim, "the market made me do it," or "I was forced to it by competition," then the time has come to reinforce the regulations that were put in place in the early 20th century, when it was believed that a reasonable portion of the benefits of increasing efficiency and productivity should go to workers.

We have been led astray by an implicit assumption, supported by economic theory, that all that matters is the benefits that go to the consumers and the investors. Low prices and good stock returns are only two parts of the story: the part that has been missing is the workers' well-being. Some of us are stockholders; all of us are consumers; and most of us, for some significant part of our lives, are workers. The theory and practice of competition have missed the third piece of human experience.

Now I'll take a last look at some of the meta-externalities generated by our corporate culture in general.

Standard economic theory, and common business practice, have exclusively focused on maximizing two things: profits and consumer purchases. I can't tell you how many articles I've read that started off stating that the author was going to show how some activity can be proven to maximize utility – that's the economistic term for well-being – and then went on, "*since utility is not measurable, consumption will be used as a proxy for utility. This paper will show that such-and-such a policy maximizes consumption.*"

Consumption and profits are very closely allied: the more consumer purchase you have, the greater the opportunities for profits. For this reason it's hard to imagine corporations starting a campaign to reduce consumption of anything. On the contrary, all of the corporate impact on the society is aimed at encouraging people to spend more money on more marketed goods and services. However, at the same time there is a whole area of research that is showing with increasing force and persuasiveness that this is not making people happier or healthier. In fact, a major meta-externality shows up in the fact that increasing materialism and worse eating habits are resulting in growing mental and physical health disorders. The resources of the United States, and other relatively wealthy countries, could be used to bring about a far happier society.

Much of this discussion has implicitly raised the question: what is the purpose of an economic system? Economics courses have an implicit answer to that question: The purpose of an economic system is to maximize the possibilities for consumption in a society. More precisely, it should maximize what can be consumed that has been produced and distributed through market mechanisms. With that assumption for the system, then it can be assumed that the purpose of economic theory is to teach how to achieve maximum productive efficiency, so as to maximize output and therefore consumption.

I have been working with others to develop a different system of economic theory, which we call contextual economics. We begin our textbooks, *Microeconomics in Context* and *Macroeconomics in Context* (the second of these is available for free download on our website: http://ase.tufts.edu/gdae/) with an overt, rather than an implicit, inquiry into the goals of both the economic system and the theory that supports it. We propose that, in fact, economic systems should be designed to maximize sustainable human well-being. In the situations where more consumption contributes to that final goal, then that is a valid and important intermediate goal. But the U.S. has enough material goods and productive capacity to provide a high level of security, health, education, self-actualization, comfort, and stimulation to all of its people. We do not need to create a culture that makes people believe – against the evidence of their senses as well as the results of good research – that happiness is usually or best achieved by more stuff. The great challenge before us is how to glide off of our present path, in which our whole society is organized around the need of business to sell more things, onto a different path where business success is tied to achieving the social goal of sustainable well-being for all.

Some of this can be achieved by a stringent insistence on internalizing negative externalities. Some of it can be achieved by returning to more equitable systems of taxes, along with appropriate laws and regulations on work conditions and environmental impacts. But in addition we must pay more attention to the meta-externalities that emanate from the whole system.

The hardest question is how corporations can be viable without being destructive to their cultural surround. This question directs us to look at what firms produce – is the product useful, usually harmless, or usually harmful? Over recent decades our society has succeeded in creating, in relation to tobacco products, a very helpful model which I call "legal but hassled." This is a model that might be applied to other especially questionable products, such as small arms. In particular, the "legal but hassled" tobacco model might be a good place to start on the especially knotty issue of advertising. It has been accepted that tobacco products are a serious health hazard, and their advertising is now circumscribed by the international convention on tobacco, as well as by a variety of local regulations. There have been more or less successful efforts to do the same with liquor advertising, as also with firearms. Scientific evidence doesn't seem always very meaningful these days, when contrary conclusions can be bought. However, we can anticipate a slowly growing consensus around clear evidence from the biological and social sciences on the connections between certain kinds of advertising and anorexia, obesity, teenage and adult anxiety, depression, and suicide, and some of the other ills of our society.

Another useful input to discussion on the cultural impact of corporations is a growing understanding in the social sciences regarding the ways that a switch of emphasis, away from status and status goods, could produce a happier, healthier society. None of this resolves a core problem. Our economy is predicated on growth; we fall into recession or depression, with the traumas of unemployment and bankruptcy, when the economy stops growing. Yet we know that the planet cannot accommodate an indefinitely growing population – especially one that consumes at the U.S. level. And it seems likely that we can actually be happier, healthier, and better protect our environment by producing and consuming less stuff. There appears an inherent conflict between a fairly clear vision of a better world, where people enjoy life and preserve and heal our natural environment, and the requirements of our economy. Yet perhaps in that last sentence lies the solution to the conundrum; there is so much work to do in cleaning up and healing our environment – perhaps that could be the growth industry that would, for some years or decades, allow us to go on raising GDP through healthy activities.