



Freeing the Market: Accounting for the True Cost (and Benefit) of Doing Business

By Richard Lawton and Rob Lederer

Each day as individuals and businesses, we make choices about how to spend our money. We identify alternatives and weigh trade-offs in evaluating which choice will best meet our needs.

And in the billions of transactions that take place every day, the one factor in this evaluation process that usually carries the most weight is price – “what will it cost?”

Whether we are aware of it or not, we use “price” as a rule of thumb. Price gives us a shortcut since we assume it represents all of the associated costs of a product or service rolled up into one number. This makes it easier for us to make “apples to apples” comparisons in our purchasing decisions, one product or service compared with an alternative – in theory anyway.

PRICES REFLECT ALL COSTS – EXCEPT WHEN THEY DON'T

Another assumption that often goes unexamined is that our economy functions according to free market theory (e.g. people have sufficient information to make informed purchasing and production decisions); or at least it would without government intrusion, as some believe. And one of the key features of a free market economy is that prices reflect all costs so that no “externalities” exist.

Externalities, in economics parlance, occur when one party’s activity causes unintended benefit or harm to another party, and no compensation is provided for the increase or decrease in welfare. Since the party conducting the activity is neither compensated for positive externalities nor charged for negative externalities, these costs and benefits are not taken into account in their decision to pursue the activity.



Uncontrolled carbon emissions alter climate and weather, leading to destructive flooding in some places and droughts in others.

The result is often a distortion in the factors considered when pursuing a given economic activity. Pollution and its harmful health and environmental impacts (e.g. asthma) are negative externalities, for example, costs which the creators of the pollution usually do not bear. If they did, they might find it more economical to pursue a different mode of production or different product to make. Job training or ride sharing programs paid for by private companies are examples of positive externalities in that the costs are borne by the companies while greater benefits (less traffic, lower commuting costs, less pollution) accrue to the broader economy, without providing a direct benefit to the company. The additional economic activity from people spending their earnings, produce further positive externalities through a multiplier effect.

In other words, externalities are hidden costs or benefits that are not included in conventional accounting methods, so are not reflected in prices. Why is this important? If prices are inaccurate in not reflecting true costs, then the basis on which we are weighing trade-offs in our economic decisions is fundamentally flawed. The resulting misallocation of resources leads to what economists refer to as market distortions, or market failures in extreme cases resulting in a “tragedy of the commons.”

EXTERNALITIES: COSTS HIDDEN IN PLAIN SIGHT

Throughout market-based economies, many costs that should be borne by producers are instead transferred to the public who pay for them through such classic externalities as poor health, air pollution (and now climate change), contaminated water, and higher

prices. These market failures create serious distortions in price, delay paying for (and preventing) the cost of environmental degradation, allow dangerous products to enter the market and enable incumbent industries to maintain advantageous market positions even though a free market, where anyone can compete and win, might threaten their hold.

SUSTAINABLE ECONOMY AND BUSINESSES, STRONGER AMERICA

For our economy to be sustainable, externalities must be acknowledged and factored into economic and policy decisions. Prices must be based on accounting practices that reflect the true costs of what it takes to produce, distribute, or use a product or service and include the impacts on all forms of capital: financial, material, social, and natural. Then truer apples-to-apples, price-to-price, attributes-to-attributes comparisons can be made.

The implications of externalities are far-reaching and represent an often under-appreciated aspect of some of the most pressing economic, environmental, health, and social issues facing our country:

• ENERGY

Fossil fuels have made our current economic prosperity possible, but the price of a barrel of oil does not include the cost of carbon emissions and their growing impacts on human health and climate (nor the cost of the portion of our military and foreign policy budgets that protect the petroleum supply chain). Likewise, the price of natural gas production does not include costs associated with methane emissions nor the degradation of an increasingly scarce resource – water.



Industrial pollution and auto exhaust have led to a rise in respiratory problems, which contributes to America’s excessive healthcare costs.

The vast discrepancies in these various estimates show that standard cost-benefit analyses can never precisely account for environmental risks to public health. Given that reality, why should the cost of any uncertainty always fall on the American public, rather than on the industries that create the health risks to begin with?

– “Clean Air Act and Dirty Coal at the Supreme Court,” New York Times editorial, March 23, 2015

Policies that more fully reflect our values would mean that government considers the positive and negative externalities associated with fossil fuel based options versus renewable energy sources when providing subsidies and making tax policy, and estimates the net effect on current market prices. How would the Keystone Pipeline, oil from tar sands, and hydraulic fracking for natural gas stack up against solar, geothermal, and wind energy on an ROI (return on investment) basis if all costs – and benefits – were factored in? What public policies can best address existing pricing distortions?

• **AGRICULTURE**

California is the #1 producer of cotton and the #2 producer of rice. In California, largely due to the cost of water, profit margins are razor-thin. Despite recent advances in techniques like drip irrigation, both crops are notoriously water-intensive. Historic farm bill subsidies are the only thing keeping many of

these farms in business, which leads to an unintended consequence: water scarcity. California is facing some very hard choices about water, and in a state where the Agriculture sector consumes 70% of the water, we are solving a problem for a few people, while creating an arguably much larger problem for everyone else. In most places throughout the US, the price of a gallon of water remains irrationally cheap, with policymakers failing to appreciate that it's a finite resource.

• **TOXIC CHEMICALS USE**

Inadequate federal oversight of the introduction of thousands of new chemicals over the past several decades has led to a number of negative externalities. These include soil degradation, water pollution and increased cancer rates. The fact that chemical manufacturers do not bear the full costs for the leaching of their products into waterways or onto clothing creates a series of negative externalities.



Now that the safety of [Monsanto Corp.'s widely-used pesticide] glyphosate is clearly in question [declared a “probable” carcinogen by the World Health Organization], perhaps it’s time to mandate that the corporation – not the taxpaying public – bear the brunt of determining whether it should still be sold. Since the Environmental Protection Agency doesn’t have the resources to test, let Monsanto pay for the necessary, and independent, research.

– “Stop Making Us Guinea Pigs” op-ed by Mark Bittman
New York Times, March 25, 2015

Note: Monsanto’s letter to the editor the next day disputes the WHO finding.

• FAIR WAGES

Society – taxpayers in effect – pay businesses to keep wages artificially low by subsidizing low wage earners through taxpayer-funded social services, rather than businesses paying sufficiently high wages for people to make basic ends meet. Some businesses externalize labor costs to society rather than bearing those costs internally, which favorably distorts their calculation of their (consequently reduced) cost of doing business, the prices they need to charge to pay for their costs and earn profits, and the profits they make.

Low-wage employers, in particular, pay low wages because they can and the main reason they can is that Congress has failed, over decades, to adequately update the minimum wage and other labor standards...That failure has had deep and perverse repercussions, extending beyond harming low-wage workers...When work does not pay workers enough to get by, they are forced to rely on public assistance programs, mainly Medicaid, food stamps and low-earner tax credits.

– New York Times editorial “Picking Up the Tab for Low Wages”, May 1, 2015

THE INTERPLAY BETWEEN BUSINESS STRATEGY AND PUBLIC POLICY

An economy based on conventional accounting methods not reflective of true costs is unsustainable and inefficient. Cultivating a sustainable economy depends upon the constructive interplay between business and government, and upon how each sector deals with externalities within their respective operating realms. The scope and shape of public economic policy is largely determined by prevailing business sector goals and strategies.

The American Sustainable Business Council (ASBC) and its members are committed to creating, in the words of Harvard Prof. Michael Porter, “shared value” for all stakeholders by providing goods and services in financially, socially, and environmentally responsible ways. This has led to innovative models and strategies that go beyond a narrow accounting framework, triple bottom-line businesses that factor not just financial profit but impact on people and planet in their business decisions, for-profit Benefit corporations, social enterprises, integrated reporting, and full cost or full spectrum accounting; these all represent innovative ways of practicing capitalism that is more aligned with free market principles and making markets and society more efficient.

If this way of conducting business were the norm, there would be less need for government regulation.

• TAXES & REVENUES – OFFSHORE TAX HAVENS

An estimated \$100 billion or more in tax revenue is lost every year. Current federal tax policies allow a relatively small number of individuals and companies to hide assets. As a result, responsible businesses and households are required to absorb higher tax rates and bear a disproportionately larger cost of the upkeep of our country’s infrastructure while those who do not pay their taxes enjoy the benefits without paying their proper share.

Some corporations, however, have a very different set of goals and strategies. Those that adhere to a shareholder primacy model whose overriding goal is maximizing short-term profit and share price often pursue strategies aimed at systematically internalizing benefits while externalizing costs and risks to society and the environment.

This more exploitive form of “narrow self-interest” business puts sustainable businesses at a competitive disadvantage and will continue to degrade market efficiency and long-term economic resilience – as well as human health and the environment – if not counteracted by a more robust set of public policy initiatives.

ASBC and its members strive to provide models of sustainable business practices that we hope will be emulated and voluntarily enhanced by a larger segment of the business community.

Short of this, however, smart public policy must also play a critical role in eliminating subsidies and incentives to freeloaders and instead help cultivate a large-scale transition to a more sustainable economy where prices more completely reflect all costs and benefits.