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COP26 and Negative Externalities

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Jared Diamond, the distinguished geographer and historian, recounts the result of a seminar he was giving about the Polynesian island of Rapa Nui, known to us more commonly as Easter Island. Back in the mists of time the geological record shows that the island was heavily forested. Today there is not a tree anywhere on the island; it is uninhabitable.

A student asked the professor what he thought the native islander was thinking when he cut down the last tree, so ending a culture that depended on trees to make canoes for fishing and sustenance.

The answer came in the form of a book and though Diamond is not a mind reader he came up with five factors that he believed shaped the fortunes of societies; environmental damage, natural climate change, war, weak allies, and the choices societies make in responding to fundamental problems. Economists have a name for this: "negative externalities."

The islander needed wood to make a canoe, so he took it, thereby imposing a lasting cost on all his fellow islanders. In fact, his decision ended life on Rapa Nui as it had been known.

In the week of COP26 it is worth holding that thought in mind.

Another thought coming out of a modern branch of economics – behavioural economics and game theory – is also worth thinking about: The Prisoner's Dilemma.

The dilemma presents two prisoners in solitary confinement. If they co-operate, they both serve a reduced sentence. But, if prisoner A betrays prisoner B, A goes free, and B serves a greatly extended sentence (or vice versa). The "purely self-interested" course of action is for A to betray B so that A goes free, and B serves the longer sentence despite mutual cooperation resulting in reduced sentences for both.

This dilemma leads on to the "free-rider" problem where, if others incur the costs of meeting a problem, I don't need to. If enough people get vaccinated, I won't need to get vaccinated.

Several points drop out of these stories, or game theories, that have important implications for investors in the coming decades.

Firstly, there has recently been disquiet about rising inflation and supply chain problems. As noted by central bankers some of this is transitory. However, it is also increasingly clear that consumers do not pay the full economic and social costs of many of the goods and services they consume. Many "negative externalities" are not priced-in.

It is very hard to persuade institutions and firms to pay for the indirect costs they impose during production and distribution. It wasn't until the Great Stink in 1858, for example, that the City fathers were persuaded to pay for a London sewage system that replaced the free use of the Thames as an open sewer.

In our own day, the environmental costs of manufactured goods, plastics, energy production and travel and tourism are not incorporated into the price of those goods. They give rise to negative externalities that impose an environmental cost but not, yet, a financial one.

As these concerns become more mainstream investors will need to analyse companies not just on the basis of their reported accounts but also on their exposure to legislative change that forces them to account for the costs incurred in the full life cycle of their products and services, including indirect environmental costs. This might include carbon taxes and the cost of rectifying environmental damage(the green battery revolution is surprisingly dependent on esoteric and expensive to mine rare earths), all the way through to the recycling of raw materials as a matter of design and cost at the point of purchase.

It seems unlikely that companies will continue to benefit from the implicit subsidy that the imposition of negative externalities provide. At the very least, our Rapa Nua islander would be forced to bear the cost of planting a tree before he cut down the last one.

In the aftermath of the pandemic, COP26 is a monument to game theory. All participants want to benefit from higher environmental standards. It is supremely rational to cooperate, but in the pursuit of self-interest it is more profitable if other countries pay. China particularly is dealing with an acute economic slowdown and will not wish to hamper economic expansion with stricter rules.

Ultimately, these trends will result in consumer goods and services costing more. In part because in the recent past they have cost too little. As Bill Bryson remarked on a lung-bursting trek up the Mountains of Mourne in Ireland, it was hard to understand the economics of how a bottle of New Zealand water could arrive for sale at the café at the top of a mountain in the wettest country in Europe.

A number of trends have combined following the pandemic that are likely to lead to significant and lasting change: damaged supply chains, China-US “Great Power” confrontation, elevated government debt, accelerating climate change and environmental degradation. It is very likely that the cost of living will begin to rise. Firms will also have to absorb costs that in previous decades they have been able to ignore.

Whether governments at COP26 this week find themselves able to navigate the intricacies of game theory, the prisoner’s dilemma, and legislating away free riders, as always, change brings opportunity. Businesses that adapt, innovate, and absorb these challenges are likely to provide their investors with robust returns. Successful businesses provide long-term protection against inflation since, uniquely, they can pass on rising input prices via higher prices at the point of sale.