Adam Smith Would Want Higher Power Prices

20 November 2018 | Chad Slater, Morphic Asset Management

Adam Smith, the author of The Wealth of Nations and arguably the first modern economist, famously said:

"It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."

Which brings me to the "climate wars" that have torn apart the Liberal party. It is embarrassing that we have reached a point where a party with a history steeped in liberalism, free markets and economics has thrown away not just Adam Smith but another influential economist, Arthur Pigou.

Pigou, whilst at Cambridge University in 1920 published *The Economics of Welfare,* which was the first attempt at modelling externalities. Within economics there are what are called "externalities" – these are effects that are not captured in market pricing. Common examples include the costs to the public health system for cigarette smokers and alcohol-related deaths. But it can also include positive externalities: it's one reason why the government subsidises university fees. There is nothing at all "socialist" about pricing externalities.

There is a broad consensus amongst the scientific community that there are externalities associated with burning fossil fuels. The obvious one is carbon and the resultant global warming, but there is increasing evidence that air pollution from particulate matter causes a range of effects on cognitive abilities. Or put another way: there is really only an argument over the size of the externality rather than the direction.

One of the great myths of the climate wars is that since Australia is small in the world, why should we do something if no-one else does?

It misses the nature of pricing externalities. The consequence of externality taxes is that it changes the relative price signal. The price signal is telling you to consume less. A tax on carbon, with the revenue raised being returned in tax cuts, is cost neutral to you as a consumer. If the price of power goes up by $400, but you get a $400 tax cut, there is no net effect on you. What you probably will do is try and think of ways to use less power where you can. Be it installing roof-top solar or buying a more fuel-efficient car: your self-interest – the one Smith refers to – helps everyone.

And it works: the UK has quickly succeeded in lowering its level of carbon emissions by implementing a carbon tax four years ago. It is also why whilst it's a global problem, that is no impediment to Australia pricing it. In the same way wine is exported, coal and gas exports have nothing to do with a local carbon tax. It doesn't make an industry "uncompetitive": government can simply rebate the exported amount and tariff the imported carbon.

And the market implications? Here's the rub with free markets and why I quoted Smith at the start: it's not always obvious who the winner is and Governments are notoriously bad at "picking winners". It could be hydropower – a peaking power source with fast dispatchability and zero carbon costs. It could be large scale battery. It may not be roof-top solar if the subsidies are removed. Who knows?

This is also why the current model of blindly subsidising roof-top solar is also wrong. It puts pressure on the grid, a cost that is not borne by the user who installed the roof-top solar. It's also making an assumption that this is the best way to reduce carbon emission. It may be, but without pricing carbon correctly, it's hard to know.

I'll leave the last, optimistic, word to Smith:

"How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it."