Thinking Outside-the-box about "Moral Hazard"

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Moral hazard is a fundamental concept in economic theory with which, unfortunately, most people are not familiar. The term refers to a situation where a person or company engages in risky behavior that eventually is likely to cause great harm because they know that the cost of that damage will be borne by someone else.

The term arose about 350 years ago in Europe with the emergence of the insurance industry. Today an example that is commonly used in explanations of the term occurs when a driver drives his car fast and recklessly because he knows that if he collides with another car, his insurance company will have to pay for the damage both to his car and the other one. That's actually a bad example, because an intelligent driver would also know that (a) a high-speed collision could kill him, in which case his insurance wouldn't help him, and (b) if the other driver dies, the driver who caused the collision could be convicted and imprisoned for "vehicular homicide".

A much better example of moral hazard comes from the corporate world, and is connected with the concept of *carbon credits*. Here the idea is that in a capitalist country the private companies are typically under pressure from shareholders and especially from major investors to prioritize rapid, short-term profits, even if that means engaging in behavior that in the long term causes great damage to society — for example, by dumping large quantities of pollutants into the air and nearby waters.

The moral hazard comes into this example when the company's cost/benefit analysis ignores the long-term damage because that will fall on the shoulders not of the company, but of society at large.

In the U.S., a clear example of the difference between short-term and long-term thinking can be seen by comparing two types of private ownership of forest land. Relatively small amounts of land are often held by middle-class people. My wife Ann and I own roughly 150 hectares within a short drive from Seattle. Our priority,

like that of most small-scale forest owners, is to follow practices that enable our forest to continue to thrive for many generations despite the expected changes in the climate. We are not interested in short-term profit. We believe in thinning (resulting in modest profit) and never clearcutting (which would result in a large sudden profit).

We work closely with an environmental organization that will inherit our land when we die and that we chose because of its considerable expertise in sustainable forestry. They have already started experimenting with our land, for instance thinning by different amounts in different stands in order to determine the optimal tree density that gets enough moisture as droughts become more common. Later in areas that lose trees they will start planting seedlings of species from more southern latitudes that are more drought-resistant than the ones that are currently native to our Pacific Northwest region.

In contrast, huge tracts of forest land in the U.S. are bought up by the gigantic hedge funds, which are very popular among wealthy investors who care only about short-term profits. Their strategy is to clearcut everything they can, replant it in as inexpensive a way as possible (not with drought-resistent species), and then sell it. In the coming years the expected increased flooding, windstorms, rainstorms, and droughts will be devastating, eventually leading to massive deforestation in the land that's been subjected to the "slash and burn" philosophy of the hedge funds.

One of the fundamental injustices of capitalism is that private companies in pursuit of short-term profit can create tremendous long-term damage that they will not be required to pay for. The purpose of thinking about moral hazard is to set up a system to make them pay.

A system of carbon credits would start with a government regulation that requires that the company pay an amount to either a non-profit environmental organization, a government agency, or a private "carbon credit company" that's sufficient for them to preserve a carbon source somewhere that would otherwise be lost and would give an environmental benefit that's equal to the damage caused by the company that's paying for the cost of preservation. For example, they could pay a local government in Brazil to hire and equip enough forest

rangers to protect a large tract of land in the Amazon rain forest from intruders who would otherwise illegally clearcut it.

The main flaw in carbon credit systems is that the calculation of the benefits from the company's payments are often based on false or improbable assumptions. For instance, because of fear and corruption the local government in Brazil might use the money not to protect an area that's threatened by illegal loggers, but rather for something else, such as to "patrol" an area that's not threatened.

On the other hand, the idea behind carbon credits is a good one, and it could be implemented correctly if the public becomes concerned enough about global climate change to insist on careful follow-ups inspecting implementation and severe financial penalties for phony implementation.

In addition, practical benefits can be cited to support calls for a well-implemented carbon offset system. For example, such a system could provide employment to many forest rangers, fund environmental cleanup programs, and support government agencies and nongovernmental organizations in their efforts to prevent illegal dumping and pollution, stealing of trees, and poaching of protected animals.

There is widespread agreement among scientists that unless we can greatly slow down the rate of global climate change, we face a not-too-distant future where most of the earth's surface becomes unlivable. The failure to heed the scientists' warnings can be explained by a class analysis. It is the wealthy countries that cause the most environmental damage, but are often in regions that will withstand the worst effects of climate change for much longer than the tropical regions where most of the poor countries are. And within wealthy countries such as the U.S. it's the poorest segments of the population that are most exposed to degraded and polluted surroundings.

Especially worrisome is the growth of racism, xenophobia, and corruption in many of the wealthy countries, most notably the United States. The incoming Trump administration has given out powerful government positions to billionaires such as Elon Musk in return for the hundreds of millions of USD that they gave to get him elected. Trump's conduct is certainly bribery by any reasonable definition, and would be highly illegal in many countries — but not in the U.S., which has very

weak laws dealing with white-collar crime by the wealthy. Trump has organized his supporters around slogans of aggressive nationalism and repeatedly shown contempt for people living in the tropical regions.

Many countries in Asia, Africa, and Latin America are facing incalculable harm caused by the U.S. and some other wealthy countries because of their racism, corruption, and failure to compensate for the damage caused by their contributions to climate change. These countries in South and Southeast Asia, Africa, Central and South America, and the Caribbean need to put aside their differences and unite around the concept of moral hazard. They can start by imposing a carbon credit system on all the international companies that operate in their own country.