On Monday the opposition leader, Tony Abbot, said to reporters "Just ask yourself what an emissions trading scheme is all about. It's a so-called market in the non-delivery of an invisible substance to no one."

As an economist that statement didn't make a whole lot of sense to me, but heeding Mr Abbot's admonition I took some time, "asked myself what an emissions trading scheme is all about," and compared my answer to his.

An emissions trading scheme basically involves the allocation of "permits" to firms that allow them to pollute a certain amount (typically an amount of carbon dioxide). These permits can be freely traded between any would-be polluters. The basic law of supply and demand dictates that in such a market the highest-value polluters will be prepared to pay the highest prices for the permits, thus meaning that firms that can most easily avoid pollution or adopt alternative "green" technologies have an incentive to do so.

Such a scheme in fact *creates* a market that is generally missing—the market for pollution. This is important because we need to balance the pros and cons of pollution. Pollution causes environmental harm—such as climate change—but provides important benefits, including all the goods and services we consume. Cars, air travel and electricity are all important, but hurt the environment to some degree. How to balance the pros and cons is as tricky as it is important. The market's price mechanism provides a clear answer, based on the law of supply and demand. If the market price of the ability to pollute is higher than the benefit I can generate to consumers then I will not pollute. Similarly, if you can generate more consumer value with your idea or technology I will sell my permit to you, generating both private and social value. Nobel laureates Kenneth Arrow, Gerard Debreu and Ronald Coase all pointed out how the creation of such "missing markets" can be hugely beneficial to society.

Indeed, if anything, a trading scheme is much more market-based than a fixed carbon price. It lets supply and demand from firms and consumers determine the price, rather than some bureaucrat staring at a spreadsheet. Contrary to Mr Abbot's other statements on the mater, there is plenty of a difference between a "fixed" and "floating" price. The latter squarely puts more faith in market forces.

What about Mr Abbot's comment about the "invisible substance?" It is true that carbon dioxide is not detectible to the human eye. But so what? Does that mean it cannot do harm? Nuclear radiation is not visible, but most people like to avoid it. Carbon dioxide's related compound, oxygen, is also tough to see but is rather important for humans. The visibility of the end product of what is traded in a market is irrelevant. Anyone who is familiar with a stock option, a futures contract, or a patent knows that.

To be fair, perhaps Mr Abbot's statement about invisibility was not about pollution itself, but the consequences of it. Perhaps he was trying to say that climate change is fiction—that the overwhelming majority of both the scientific community and the Australian public are wrong. That's a fringe position, but at least not an incoherent one.

All in all, an emissions trading scheme involves the epitome of a market, where a very tangible good—a permit allowing a firm to pollute—is traded between buyers and sellers at a price determined by the law of supply and demand. It is a price paid in cash—buyers write sellers checks for the right to pollute. This is exactly the kind of market that the heroes of free-market economics, like Adam Smith, Milton Friedman and Friedrich Hayek championed. It is not a "so-called" anything. It has the prospect of making the magic of the market work for the social good of a cleaner environment, a more sustainable future, and a planet we can bequeath our grandchildren in good conscience.

The only thing that is invisible in all of this is Mr Abbot's understanding of basic economics. That should be quite visible to everyone.

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