

Carbon Trading: Who's got the time machine?

December 12, 2009

Tax vs trade - or maybe it is politics vs sense.

Is taxation a better way of managing CO₂ emissions than trading? Or could there have been an even better solution than both of these put forward and adopted at the outset of the emissions management debate?

Last week BRAVE Partners put forward the notion that for the CO₂ trading market to do more than just drift and remain inefficient, the number of financial investors involved (as opposed to compliance investors) needs to increase. We highlighted the barriers to this happening.

This week we reflect on what the alternative – or the bolster - to trading might be.

We conclude that the most widely proposed alternative – taxation – is no more of a clear cut winner than trading.

We further conclude that politicians may have put the cart before the horse at the outset of the emissions management debate by proposing trading and/or taxation solutions to the problem. It's possible that we may have found ourselves in a stronger position now had politicians focused on the establishment of a strong and binding wholly international legal agreement in the first instance, allowing for the introduction of trading once the market created by trading could no longer be influenced to the extent it is now by political uncertainty.

As it is, existing but unsatisfactory trading and taxation schemes are now obfuscating the path to the most important end goal of all which should be a wholly international legal agreement on the extent to which emissions are capped and reduced. Once this is achieved, anything is possible. Until it is achieved, barriers remain to effective emissions control. Can it be achieved? We discuss below.

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The Alternatives

A little know fact (apart from among those who shared a Latin teacher with BRAVE Partner Christopher Cloke-Browne) is that the Latin word alter / alteris, from which alternative is derived, means on or the other of TWO. Thereby technical purists only have two alternatives.

It has been widely accepted that the two main options for putting an international price on CO₂ emissions are CO₂ trading and CO₂ taxes. Both approaches have had problematic starts and have uncertain futures.

In the red courner: taxes

A CO₂ tax sets the price of a unit of CO₂. A regime of taxation allows the quantity of CO₂ emissions to fluctuate instead of the price (in contrast to trading where the price fluctuates whilst emissions are fixed).

One of the advantages of taxation is therefore the clear fixed price signal it sets, which assists in the making of investment decisions. Taxation is also considered to be relatively simple to administer as well as being more flexible than trading as it is easier to abolish a tax than to disband a trading scheme. In addition, tax raises revenues for governments. And given the current fiscal challenges of the UK and USA (just as examples) such revenue could be of considerable benefit. Nevertheless trading schemes involving auctions can also generate similar (albeit probably less predictable) revenues to taxes.

The disadvantage of taxation is that total emissions are not capped, so creating the potential for unlimited environmental damage. However if the price is fixed at the right (sufficiently high) level, this disadvantage should be minimised. Otherwise, some observers have put forward the notion that it's possibly easier to get international agreement on a globally-linked trading scheme than on a global carbon tax. But the reality is that both are hard to achieve end goals.

Scandinavia does it first

As for mankind's experience with CO₂ taxation, CO₂ taxes have been levied in most Nordic countries since the early 1990s with mixed results in terms of emissions reductions.

Moreover, the Nordic case illustrates that an approach to emissions reductions which isn't cohesive may lead to tax regimes in different countries undermining each other. Indeed given that CO₂ taxes differ in structure across the Nordic region, there have been problematic issues raised with regard to competitiveness.

In any event, since it has not yet been possible to achieve successful cohesion on tax in the Nordic region, we're left with limited hope for adoption of a unified approach on a global scale.

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Critically, without an extremely broad level of international consistency, the benefits of either trading or taxation policies at a global level will always be significantly reduced.

As we have discussed this week and last, both trading and taxation have been problematic and are likely to continue to be. So what, if anything is the alternative?

The third way

Some have proposed hybrid schemes involving both trading and taxation in parallel. However with one of the main challenges to both trading and taxation on a separate basis (never mind a combined basis) being broad international agreement, achieving such an amalgamation would seem to be something of a tall order.

But all in all I can't help wondering whether politicians have shot themselves in the feet by attempting to put the cart before the horse at the outset of the emissions management debate by proposing trading and/or taxation as early stage solutions to the problem.

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Herding cats

There are international laws in relation to other pollutants. Indeed, since the harmful effects of pollution often extend to areas beyond the country where the pollution originated, the international legal system has become an important means of controlling it. Just as an example, an international liability system for pollution damage from oil spills has been in place for over 25 years.

Taxation and trading are all very well. But shouldn't we have attempted to establish a strong, binding, wholly international legal framework first? Without this, complimentary solutions are doomed to be problematic. Did we just over complicate the emissions management issue in its early stages back in an era when complex financial solutions were de rigueur?

At BRAVE Partners we're not so naïve as to think that it would have been easy to have achieved broad international consensus on a legal format either. But at least there was something of an existing international legal precedent to build on.

As it is, existing but unsatisfactory trading and taxation schemes are now obfuscating the path to the most important end goal of all which should be a wholly international legal agreement on the extent to which emissions are capped. Once this is achieved, anything is possible. Until it is achieved, barriers remain to effective emissions control. Can it be achieved? We are sadly sceptical.

As we all know it is Dr Who? that has the time machine.

However the die is cast and we're thus resigned to the notion that trading will continue – however inefficiently. So check in for our next bulletin which will be an investor's guide to CO₂ related products.

BRAVE Partners services

BRAVE Partners is an advocate, for liquid, mature carbon markets. However, the current state of the political process makes the firm skeptical that these will emerge for a number of years.

Interaction

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- *BRAVE Partners believes that political uncertainties are dominating carbon markets.*
- *The firm believes that this situation will persist until broad international agreement is reached on carbon emissions.*
- *Despite its skepticism BRAVE Partners LLP is seeking to work to develop carbon markets and carbon pricing.*
- *The firm believes that strong carbon markets are a critical element to reducing emissions.*

enquiries@bravepartners.com

www.bravepartners.com