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Trade or Tax? How to Get Rid of Greenhouse Gases

With climate change high on the public agenda, everyone wants to cut down on greenhouse gas emissions. It is no longer whether, but how to penalize polluters. Trade or tax - which is the better option?



Carbon dioxide is the most important greenhouse gas - cutting back on it the only way of avoiding a climate catastrophe.

"Can markets save the world?" asks UK secretary for the environment David Miliband on his blog. The answer he received at a dinner of business leaders at the World Economic Forum in Davos was straightforward: "No!" Recently, executives from ten major carbon intensive U.S. companies sent a letter to President George W. Bush and called for mandatory carbon caps.

There are not many people left who still believe markets will solve the problem of greenhouse gas emissions by relying on voluntary measures alone. So it is back to whether emissions should be curbed by way of a system of tradable quotas, such as the EU's Emission Trading Scheme, or through taxes that penalize excessive carbon dioxide output?

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The question is not new. Before signing the Kyoto Protocol in 1997, the European Union (EU) pushed for a carbon tax as opposed to emissions trading backed by the United States. To reach consensus, the EU finally gave in and accepted the U.S. proposal. Quite ironically, ten years later the EU is running the world's biggest emissions trading system, while the U.S. is yet to ratify the Kyoto agreement.

Incentive to decarbonize

Now, with the widely discussed Stern report on the costs of climate change suggesting both tax and trade, carbon taxation seems to be undergoing a revival. Nicholas Stern, the report's head author, said in January 2007 at the World Economic Forum in Davos that ruling out so-

called green taxes is "a risk we cannot take." He argues that a trading system alone will not be enough to reduce carbon dioxide by the roughly 40 percent necessary to avoid catastrophic climate impacts. "We must establish a carbon price via tax, trade and regulation – without this price there is no incentive to decarbonize," he said.

According to EU Commissioner for Energy Andreas Piebalgs, emissions trading will do the job. Without the market incentives implied in trading, companies would rather buy their way out than reduce emissions, Piebalgs told the press in Davos. "If you go through carbon taxes, you can create funds, but you have a role for governments and not much private sector involvement," he said.

For Ingo Ramming, head of emissions trading at Dresdner Kleinwort, it boils down to a simple question: who can react more easily to changes - the state or the market? "The problem with a tax is that is extremely inflexible", says Ramming. The EU wants to cut emissions back by eight percent until 2012, he says. However, decisive parameters could have changed until then."

We don't know how much the economy will grow until then; we don't know about the technical innovations to come. We won't be able to adapt with an inflexible tax." Ramming favors trading systems that enable companies to decide how to deal with growth and emissions. "We should use the flexibility of the industry to cope with a changing environment," says Ramming.

Trading for the industry and taxes for individuals?

A more balanced view is what WWF Finance and Energy specialist Matthias Kopp calls for. "The questions should always be: which tool is effective for which sector? The energy sector is responsible for the biggest amount of emissions and a trading scheme is the best available instrument to curb those." The same holds for the aviation industry, which has only a limited potential to reduce emissions due to a lack of new technology.



Infographic (click the image to enlarge)

The aviation industry could reduce emissions by way of a trading scheme. See how emissions trading works

A trading system, as favored by Kopp, would provide a meaningful instrument to control the absolute emission level and it would, if structured right, allow airlines to buy certificates from sectors that can cut emissions at an affordable price. On the other hand, exposing individuals to a cap and trade system is, according to Kopp, "theoretically beautiful, but unrealistic." It would be intricate and inefficient, he says.

But in July 2006, the UK Minister for the Environment David Miliband

caused some stir by openly discussing the idea of making British households accountable for their carbon dioxide output by giving them an annual allotment of carbon emissions from energy consumption. "Trading is potentially better than carbon taxes," says Miliband. "A carbon tax does not guarantee a certain emissions reduction - it depends on the level of tax and peoples' response to the tax."

"We are just too rich", explains Charlotte Streck, co-founder of the carbon market consultancy Climate Focus and former senior legal counsel at the World Bank's Carbon Finance Business. "If you have a carbon tax it needs to be very high to produce a result in rich countries," says Streck. "Think of gasoline. Despite the fact that the prices went up and up there was no significant change in behavior in the last years. People are willing to pay a lot more before they change."

Streck highlights the pros and cons of both solutions. "Emissions trading really works where you have a limited number of people that pollute in an industrial fashion," she says. "But you can hardly apply it to consumers or trend sports where you have much more defused sources. Comparatively, a carbon tax would be easier here."

The indifference of existing green taxes

A number of governments are already applying some sort of carbon tax, albeit in a controversial way. For example, the German "ecotax" is levied on gasoline and electricity. It does not correspond to the level of carbon dioxide emitted by a certain car or power plant. The tax simply increases the price for these commodities. The same rings true for the recent increase in air taxes for all flights from British airports.

Gordon Brown, the UK's Chancellor of the Exchequer, defended his decision in an interview with the BBC, saying that airlines should pay more for damaging the environment. The tax, however, is not correlated to actual emissions. Whether an airline uses a modern, efficient fleet or outdated kerosene guzzling models is irrelevant.

The issue of carbon taxes has also recently surfaced in trade negotiations between the EU and the U.S. Günther Verheugen, EU Commissioner for Industry, and French President Jaques Chriac called for import taxes on carbon intensive U.S. products. They hope a carbon import tax could make up for the competitive disadvantage European producers face due to the EU's strict environmental laws.

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