

---

# Costly consequences

## Cap and trade is not a market-based solution

*Diane Katz*

AMERICANS should keep an eye on Canada, as key provinces begin to impose stricter limits on emissions of fossil fuels to combat climate change under the so-called “cap and trade” system. Cap and trade is frequently described as a “market” solution to pollution. But in reality, there’s not much that is market friendly about cap and trade, and no amount of rhetorical masquerading can conceal the costly consequences that enactment would inflict on both provinces.

Details of the regulations have yet to be finalized, but the leaders of Ontario and Quebec signed a memorandum of understanding on June 2 that calls for “strong, immediate and sustained action ... to minimize the risks posed by climate change” (Ontario, 2008). Their ultimate goal is emissions reductions of carbon dioxide to 1990 levels—a slightly lower target than that of the Kyoto Protocol, but extreme nonetheless.

Given the considerable uncertainties about climate change, it can reasonably be argued that the premiers are acting with undue haste. They compound the error by touting cap and trade as a “flexible, market-based mechanism.”

Under a cap-and-trade program, the government sets an overall limit (cap) on emissions. Based on that cap, quotas are imposed on individual sources of emissions, such as utilities and factories. The government allocates “allowances” to each facility that represents the volume of their quota. A facility must either reduce emissions to meet the quota

or purchase allowances from those that have exceeded their required reductions (trade).

Europe adopted cap and trade in 2005 and the results were far from stellar, according to a variety of reports. The *Washington Post*, for example, described it as “a bureaucratic morass with a host of unexpected and costly side effects and a much smaller effect on carbon emissions than planned” (Mufson, 2007, Apr. 9).

### ***Government rationing of carbon-based emissions should not be confused with voluntary conservation options.***

“Cap and trade” does sound friendlier than “CO<sub>2</sub> rationing” or “carbon taxes.” But at its core, this regulatory regime encompasses both. It is based on the creation of a scarcity by government fiat (the cap on CO<sub>2</sub> emissions) and the rationing of remaining supply through government-imposed quotas. The cost of compliance constitutes a tax by raising the cost of carbon-based fuels to curtail use.

The precise levels at which the overall cap and the quotas ultimately are set are wholly arbitrary. No matter what politicians or the media claim, no one knows the amount of emissions that make a difference in global temperatures. Therefore, there is no “correct” cap to address climate change. That leaves politicians and lobbyists for all sorts of special interests—transportation, manufactur-

ing, utilities, and agriculture—to haggle over the quotas. And that makes cap and trade a political mechanism, not a market mechanism.

We are thus left to hope that regulators make a small mistake instead of a big one. For example, a low cap (requiring significant emissions reductions) would be costlier and thus create economic hardship throughout the economy. Conversely, a high cap (requiring smaller emissions reductions) would waste resources because the cost of emissions reductions would be greater than the benefit—to the extent that there is any benefit at all.

Big corporations are likely to weather the regulations better than small firms—especially if the government allocates emissions allowances free of charge. The cost of emissions control technology or the purchase of additional allowances would likely be paid by consumers in the form of higher prices. But there’s no additional product or service provided in return, nor are the emissions reductions likely to produce any tangible benefit. Consequently, cap and trade constitutes a massive wealth transfer from consumers to businesses. Some companies will even make a killing by brokering emissions credits. Indeed, Enron was not driven by altruism in ardently championing cap and trade.

The worst effects will likely be felt by those trying to break into the market after cap and trade is launched. Newcomers will face a competitive disadvantage before they even open their doors; having not obtained free allowances from the government, their costs will be greater

---

than those of their competitors. Simply put, cap and trade raises barriers to entry in a most un-market-like fashion.

Proponents point to the use of cap and trade in reducing emissions of sulfur dioxide as proof of its utility. But there are significant differences between the two applications. In the case of sulfur dioxide, the technology for capturing emissions was commercially available when the cap-and-trade program was imposed—unlike emissions controls for carbon dioxide. Moreover, the emissions strictures were imposed on only one sector—power plants—unlike the CO<sub>2</sub> limits which would encompass all segments of the economy.

Because control technologies for CO<sub>2</sub> are nascent, the actual costs of emissions reductions are unknown and likely to fluctuate over time. This will create volatility in the price of allowances, thereby adding greater uncertainty to investment decisions. Most economists recognize that uncertainty repels rather than attracts investment.

The market is already responding to claims of climate change with hybrid cars, green power programs, voluntary emissions reductions, and the like. Government rationing of carbon-based emissions should not be confused with voluntary conservation options. The principle difference is that under cap and trade, the government would not offer citizens the choice of participation and would force us to pay the cost. That's not how the market works.

## References

- Mufson, Steven (2007, April 9). Europe's Problems Color US Plans to Curb Carbon Gases. *The Washington Post*. A1.
- Ontario, Office of the Premier [Ontario] (2008). *Memorandum of Understanding Between the Government of Ontario and the Government of Québec: A Provincial - Territorial Cap and Trade Initiative*. Government of Ontario. <<http://www.premier.gov.on.ca/news/Product.asp?ProductID=2281>>. □