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2008

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MPRA Paper No. 48743, posted 04 Sep 2013 04:09 UTC

2 March 2008

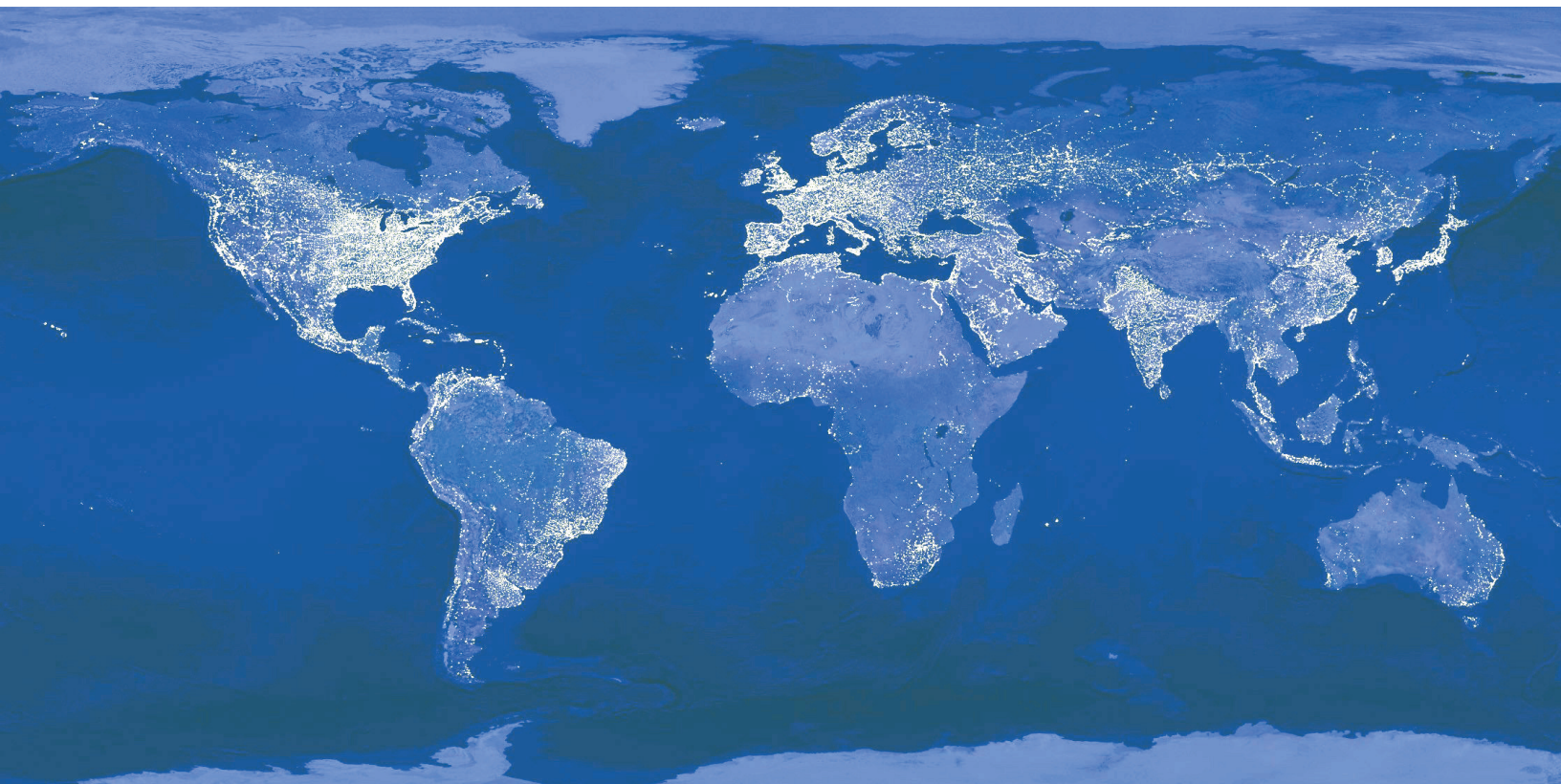
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IBL Special Report

Europe 2020: an Alternative Proposal

by Carlo Stagnaro



Europe 2020: an Alternative Proposal¹

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The reduction of greenhouse gas emissions is the cornerstone of the new European Energy Policy (EEP). If, at a rhetorical level, the Union aims to be and remain a global leader in the fight against climate change,² in practice the environmental issue is one *passe-partout* with which Brussels can penetrate national choices. The other, less effective or direct, is competition policy. In fact, the European Treaty doesn't include energy policy within the community's area of jurisdiction. So, the European Council held in the spring of 2007 and the consequent packet of directives issued on January 23rd, 2008 formulates EEP in function of three environmental objectives: the reduction of consumption by 20 per cent below the baseline, an increment of the renewable energy quota to 20 per cent of total consumption, and a 20 per cent cut in emissions below 1990 levels – all of that by 2020. To define these targets as ambitious would mean using a delicate euphemism, especially if we take into account the brief time that the EU has given itself to reach them (just short of 12 years, including an initial negotiation phase). If, however, in the first two cases – abatement of consumption and renewable resources – Europe basically must imagine brand new instruments, concerning emissions, top trust is put in the Emission Trading Scheme (ETS) implemented since Jan. 1st, 2005.

This paper intends to examine the objective of emission reductions. First we will evaluate the usefulness of this objective from the point of view of its environmental impact and in light of the most recent developments in global negotiations. In the second part we will look at the performance of European climate policies, while in third will be focused on the European Trading Scheme (ETS). Although the available data refer to a very short period, some elements have already emerged and deserve deep reflection. Finally, in the fourth part, we will compare the approach that the EU currently takes – the quantitative one – with an alternative path, that is, the imposition of an environmental tax.

How do we justify these kinds of reflections? After all, the perspective of IBL has always been very critical of the mechanisms of the Kyoto Protocol and their consequent applications to Europe.³ Furthermore, IBL favours the use of long-term global instruments that are consistent with the promotion of competition and markets. To that end, we believe that economic freedom is the best means to obtain a greater efficiency in the use of energy resources, especially in emerging economies.⁴ We could, therefore, quickly dismiss everything that Europe is doing as the wrong solution to a problem that is only partially real. However, it is a fact that the EU has undertaken the path of cutting emissions and that such an objective is not up for discussion. Therefore, the perspective that is adopted here is that of the “lesser evil”. If we need to reduce European emissions by 8 per cent by 2012 and by 20 per cent by 2020 (keeping 1990 as a reference here), what are the most efficient and effective means? The question of efficiency goes well beyond the mere issue of costs – which is certainly not a secondary one. The risk that Europe is facing is that of building a legal and regulatory framework that creates confusing incentives for businesses and that therefore ends up to harm the “old continent”'s economy more than necessary. Furthermore, it is almost universally accepted that the final solution to emission problems must

come from technological innovation. If, however, it could be proven that the short-term reduction of emissions damages the commitment to research and development, it would then be appropriate to rethink Europe's strategies.

From a pragmatic point of view, next to the question of which are the best climate policies at a global level, European member States should also ask themselves what the best policies could be (that is, those that are less expensive and distorting as well as more transparent and effective) to reach their own objectives. It helps to remember – and this will be the first issue of the next paragraph – that the even if European climate policies will work well, this is deprived of any direct relationship with the behaviour of the rest of the world, and therefore with the effective reduction of global emissions. The step is even longer when it comes to obtaining an effective slowdown of the rise in mean global temperatures.

Are European Climate Policies Any Useful?

The objective of the European climate policies is to “adopt the necessary domestic measures and take the lead internationally to ensure that global average temperature increases do not exceed pre-industrial levels by more than 2°C”. For the Commission, “this is technically feasible and economically affordable if major emitters act swiftly. The benefits far outweigh the economic costs.”⁵ This statement – contained in a communication of the Communitarian executive preceding the spring European Council – rests on a previous communication of 2005 (that “demonstrated that the benefits of limiting climate change outweigh the costs of action”),⁶ and also rests on the Stern Report.

The 2005 communication “demonstrates” that the benefits exceed the costs in a succinct 12-line paragraph to which were added two annexes on the effects of climate change (two faces of a sheet of paper compiled into points without even one bibliographic reference even when long-term projections are given) and a cost-benefit analysis (less than three pages where the following quote by IPCC is reported: “comprehensive, quantitative estimates of the benefits of stabilization at various levels of atmospheric concentrations of greenhouse gases do not yet exist.”)⁷ Another reference is the Staff Working Paper,⁸ which supplies all the material behind the communication. This is a more articulate document consisting of 51 pages which, of course, “demonstrates” nothing, as it does not contain anything that is original other than a review of the literature – which, however, does not even mention less pessimistic studies – with the ambition of summing up the body of the scientific and economic knowledge on cause and effect of global warming and costs and benefits of the different policy options. Similar considerations apply to the Staff Working Paper in support of the 2007 Communication,⁹ which picks up and updates the preceding paper.

The reference to the Stern Report is seemingly more solid. The report was commissioned by the British government to the former World Bank chief economist, Nicholas Stern, with the objective “to understand more comprehensively the nature of the economic challenges and how they can be met, in the UK and globally”.¹⁰ The most shocking and emphasized result of the report – 700 pages of analysis of evidence and studies available on the economic aspects of global warming – is the forecast that, depending on the climate scenario, in the absence of countermeasures, the global mean temperatures growth could bring about economic losses ranging from 5 to 20 per cent of the global GDP. It is a resounding

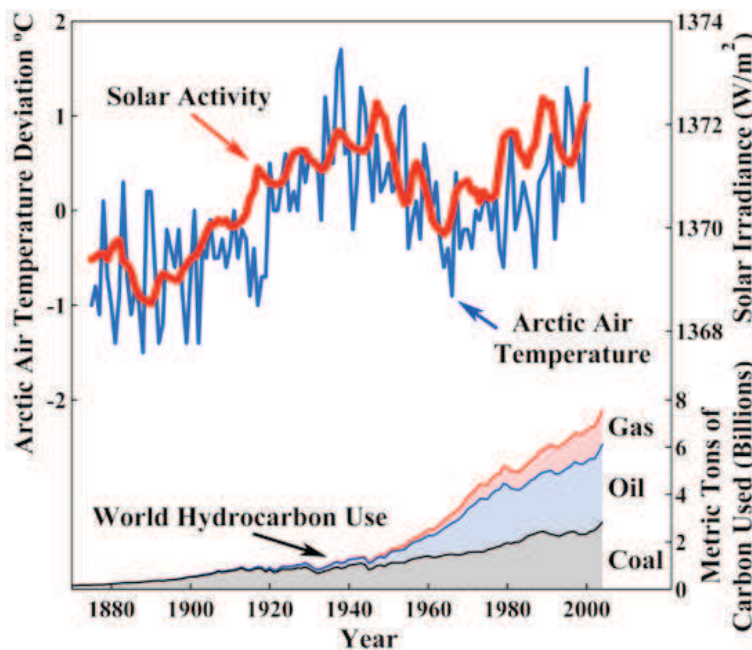
result, as the previous estimates gravitated around one per cent, which is also the order of magnitude of the mitigation costs according to many authors. To get to such a figure, Sir Nicholas makes two singular hypotheses: on one hand, he assumes a discount rate next to zero (0.1 per cent); on the other, he refers systematically to the most alarmistic studies on the possible consequences of global warming. In all cases, by simply adopting a discount rate of 3 per cent – a value typically employed in the literature – the estimated costs of the greenhouse effect effect crumbles, according to the scenario, from 5-20 per cent to 0.4-1.1 per cent of the global GDP.¹¹

But the weakness – or at any rate the selectivity of the calculations used by the European Commission – is not the most exposed flank of the Communitarian strategy. The deepest problem concerns policy objectives, functions, and consistence.

The final goal of the European policies is to contain the increase in global temperatures within the magic threshold of two degrees centigrade. Obviously, this is a symbolic value, because there is no reason to believe that a warming of up to two degrees is harmless, while a greater increase in temperatures, no matter how small, will bring about any kind of disasters. Furthermore, it risks becoming an unrealistic objective. Although Europe is persuaded of the human responsibility for climatic changes, no one can exclude that all or part of the temperature increase is governed by natural dynamics such as solar cycles (see Fig. 1).¹² Therefore, Brussels could have set a target that goes beyond the powers that mankind – leave aside Europe – has today of influencing the environment. In this sense, it would have been desirable to express the objective in terms of stabilization of atmospheric concentrations of carbon dioxide and other greenhouse gases. Furthermore, the ratio

FIGURE 1

Arctic temperature, solar activity and cumulative hydrocarbon consumption.
Source: Robinson, Robinson and Soon (2007)



between CO₂ emissions and temperature variation (which, rather, depends on the concentrations, not on the emissions) is subject to great uncertainties, so there is an extremely high degree of arbitrariness in the definition of the necessary emission reductions and in their temporal displacement to the end of limiting the growth to two degrees – and not 2.01, or 2.1 or 3°C.

The Fourth Assessment Report (AR4) of the Intergovernmental Panel on Climate Change evaluates temperature increase by 2100 in the interval 1.8-4.0 degrees centigrade in the different scenarios. In six scenarios out of seven, the lower end of the fork is equal to or greater than 2 degrees, and in scenario 4 it is even smaller than 1.5 degrees.^{13, 14} That means that there is a good probability – even assuming that the hypothesis and conjectures at the basis of the IPCC scenarios are valid – that the increase of temperature *in the absence of any political measure* stays below the critical threshold of two degrees. This fact in itself should supply a precise policy indication: as it is possible that the European efforts are useless – one way or another – they should be conceived in such a way so as to allow for adjustments in a relatively quick and simple manner as the scientific evidence grows and allows the unveiling of at least some of the many unknowns at the basis of the global warming phenomenon.

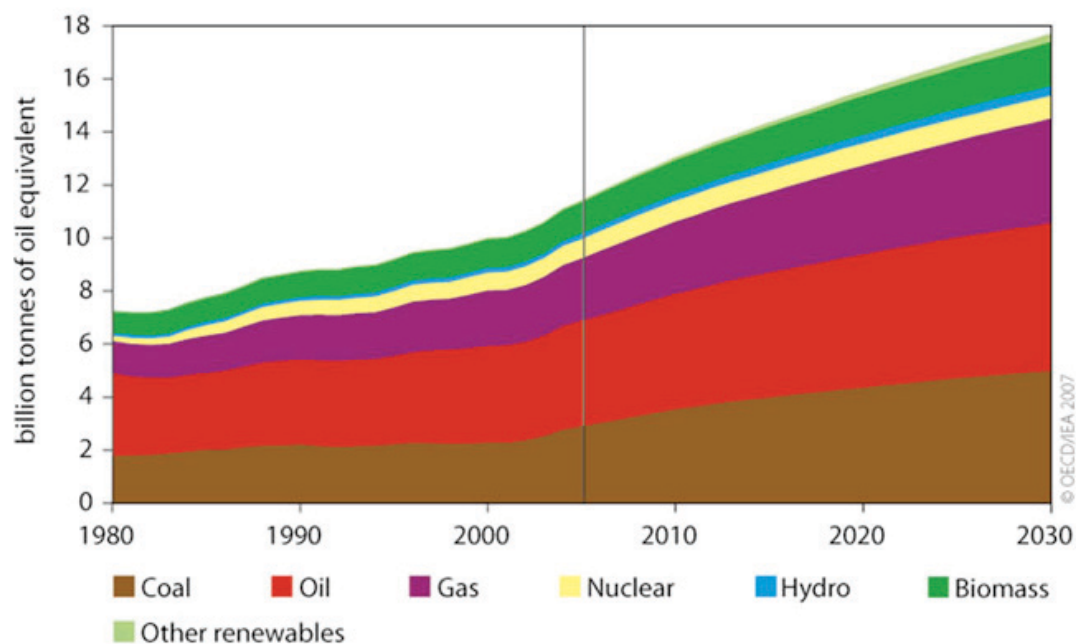
During the Spring 2007 European Council, the leaders of the member States committed to a reduction of emissions of at least 20 per cent by 2020, but also re-launched a further commitment to reduce the emissions by 30 per cent if it becomes possible to find an agreement between all industrialized countries.¹⁵ This is contradictory. If the emissions cause global warming and preventing global warming is the European political priority, then the commitment to reduce emissions should be stronger, as the participation of other countries is smaller. In fact, the presumed cause of global warming comes from global emissions; in the absence of reductions by other countries, Europe should do more, not less, so that the same result is achieved. Why is the Commission not following this simple logic? The answer, which is never given in the official documents of the Union, is that the Commission believes, correctly, that the reduction in emissions represents a ballast for economic growth and which causes a loss of international competitiveness. Europe does not want to push beyond a certain limit which is set arbitrarily, without any preliminary study, and quantified by 20 per cent. That is obviously because it believes that the cost for the European economy would be by far greater than environmental benefits which are uncertain and at any rate remote in time. Therefore, implicitly, the EU reasons about the future with a discount rate which is quite different than the 0.1 per cent used by Stern, and therefore it demonstrates with facts that it does not believe in the studies that it nevertheless calls on to support its policies. Then how do we explain the European choices? It is not the objective of this paper to put intentions on trial, nor to investigate the ideological motivations or economic advantages of some effective and well-organized pressure groups in Brussels, Berlin, London and in other member States that have been pushing hard to set climate policies in motion. To the ends of this reflection, what is relevant is that, in fact, the European Union gives economic weight to “salvaging the climate” and that, regardless of the numbers, it attempts to reconcile the verbal extremism with a series of practical caveats. We can see that in a whole series of details – and anybody knows that the devil’s right there. For example, at the same time as the EU promotes biofuels (even by adopting a specific target of 10 per cent of the market share by 2020), it prevents or discourages, through

customs duties, the import of biofuels coming from tropical countries, which are more economical and characterised by a lower environmental impact as compared to those produced in Europe. In this case, the EU seems to put the creation of a safety net for European agriculture (which is threatened by the reform of the common agricultural policy)¹⁶ before actual climate salvation. But even this risks leading us astray. In fact, regardless of the internal contradictions or perhaps excessive ambitions of European policy, another element exists that dictates the possible irrelevance of this measure: the rest of the world.

Europe, in fact, does not act in a void, but the background of its actions consists in the decisions of other nations. It is of course an ever-changing background that moves in function of endless variables – social, economic and political in the first place – to which Europe itself belongs. That is, European decisions are seen by other actors, which react in sometimes a cooperative and sometimes an opportunistic manner. When we talk about choices in energy policy, however, the influence of the EU on the rest of the world is relatively low, because the time horizon of such decisions is very long. Today, everybody is an heir of the choices made yesterday, and those choices count for more than the acceleration of a certainly important actor (but perhaps less important than European governments might wish) such as the European Union. Therefore, although one can maintain that Europe could lead other nations on the sustainability path by example, so far that does not seem to have materialized, and the EU seems to be a leader without followers. It is therefore reasonable to assume that, at least in the short and medium terms, the other countries will mainly follow domestic logic, and thus, the consequences of European choices must be evaluated within a “business as usual” scenario for the rest of the world.

FIGURE 2

Global primary energy demand in the reference scenario. Source: IEA (2007)



According to the reference scenario of the International Energy Agency, “world primary energy demand is projected to grow by more than half between 2005 and 2030, at an average annual rate of 1.8 per cent. Demand reached 17.7 billion toe, compared with 11.4 billion toe in 2005 – a rise of 55 per cent. Global energy intensity – total energy use per unit of gross domestic product – falls by 1.8 per cent per year over 2005-2030.” (Figure 2). The growth will be dominated by fossil fuels that will confirm themselves as the heart of the world energy system: “Fossil fuels remain the dominant source of primary energy, accounting for 84 per cent of the overall increase in global demand between 2005 and 2030.” Although oil remains the most important fuel, its share next to the total mix will decrease from 35 to 32 per cent, settling (in absolute terms) at 160 million barrels a day (37 per cent more than 2006). The use of coal will grow by 73 per cent, going therefore from 25 to 28 per cent of consumption. The share of natural gas will remain almost stable, as, according to the projections, it will go from 21 per cent to 22 per cent of the mix. Next to the other forms of energy, the use of electricity will increase noticeably, as it will grow, next to total consumption, from 17 to 22 per cent. Finally, the greatest part of the foreseen growth is attributed to the developing countries which, thanks to the combination of demographic and economic growth, will be responsible for 74 per cent of the additional demand – and China and India alone will account for 45 per cent. It should be noted that, in the alternative scenario of IEA (which assumes the adoption of iron-fisted and effective measures of energy savings and emissions reduction), in spite of the significant reduction of demand (11 per cent less in 2030), the proportions are not substantially altered. The Agency also elaborates a scenario contemplating high growth – and that can be considered pessimistic from the point of view of the European policy objectives – which is not considered here.¹⁷

If this is the future we are facing, the environmental implication is exceedingly clear: in step with energy consumption, greenhouse gas emissions will increase. Even by limiting ourselves just to the emissions linked to energy consumption, in the IEA reference scenario, China and India will be responsible, respectively, for 42 per cent and 14 per cent of the emission increases, while the rest of the world (of which Europe is just a part, and not even the largest one) will be responsible for 44 per cent. In the optimistic scenario of the Paris-based agency, the rest of the world will cause just 14 per cent of the additional emissions, while China will have the lion’s share with 52 per cent and India will follow with 17 per cent.¹⁸ By 2030, the total increase in emissions will be by 57 per cent next to 2005, or just 27 per cent in the alternative scenario.¹⁹ The European Union – which in 2005 was responsible for less than 15 per cent of global emissions – will see its share eroded down to 12 per cent in 2015 and down to 10 per cent in the reference scenario, that is, to 11 per cent in 2015 and 9 per cent in 2030 in the alternative scenario.²⁰ It is clear that any effort, no matter how intense, will have a relatively small impact on global emissions which, in the last analysis, are the only relevant variable for the phenomenon of global warming. Corrado Clini, Director General of Italy’s Ministry of Environment, writes: “The advantage in terms of the reduction of CO₂ emissions – that can be measured only at the global level – is marginal. The reduction of 20 per cent of the European emissions in 2020 corresponds to a global reduction of less than 4 per cent.”²¹

Almost by definition, a reduction of this size is destined not to have any effect on climate balances. At most, it can slow down by a modest measure the growth of emissions, acting in such a way that – in the reference scenario, and assuming for the sake of simplicity a

linear path between the values of the global emissions estimated by IEA for 2015 and 2020 – we would have in 2020 a level of global emissions which, otherwise, would already have been reached in 2017. The question that arises is whether it is worth committing a significant quantity of economic and political resources – actually, *any* quantity – to achieve such a meagre objective.

Do the European Climate Policies Work?

One could object that there is something more important than the effectiveness of the policies at the global level. By means of its own commitment, the European Union can set an example for the international community and create the conditions for which its allegedly “virtuous” behaviour is followed by others. This is the solution to the prisoner’s dilemma *à la Bruxelles*: the European actor greatly publicises its actions so as to convince others that the problem is so serious that it requires common action in which all must participate, but in the absence of that action, at least something is done by someone. We are back to European leadership. However, to claim one’s own leadership is not enough, as it is necessary for facts to follow words. But from this point of view, the EU does not seem very convincing or determined.

A report published by the European Environmental Agency in December 2007 states that the old continent will be able to reach, if not surpass, the Kyoto objectives – that is, an abatement of emissions of 8 per cent below those of 1990 by 2012. That, however, is true only for the 27-member Union: the new member States are still enjoying the dubious privilege of being former Soviet countries, and as such experienced a sudden and dramatic contraction of emissions after USSR collapse. This, however, is a fact that is not destined to repeat itself, to the point that – as reported by the same EEA – “a first assessment of EU27 aggregated projections for 2020 shows that, even if the additional measures currently planned by Member States are adopted and fully implemented, greenhouse gas emissions will increase between 2010 and 2020, reaching a level approximately 2 per cent higher than in 2005, and only 6 per cent below their 1990 level.”²² This is certainly not an intentional result, and a smile is irresistible when we detect the tone with which the Copenhagen-based agency hails the ephemeral result that (perhaps) will be reached in 2012 – a tone that saturates the press release informing us of the publication of the study, and the title “EU within the reach of Kyoto targets.”²³

The goal that Europe might meet is even less astonishing if we look at the results that have actually been reached by Europe 15, that is, by that part of Europe which has long said that it has made emissions reduction a priority and which acts accordingly. The EU15 emissions in 2005 (the last year for which official data is available) were lower than those of 1990 by 1.5 per cent, that is, at the same levels as 1992 and higher than those of 2000. According to the optimistic forecast of EEA, the 15 member States could, in 2008-2012, further reduce the emissions, dropping to 4 per cent below 1990 – that is, exactly half the Kyoto objectives. The agency, however, states that, if all the additional measures were to be adopted, the flexible mechanisms would be fully exploited and the carbon sinks would be appropriately evaluated, then the EU15 could even exceed the Kyoto objective and get over 11 per cent below 1990. All that rests on a series of assumptions, the plausibility of

which will not be told by history but by the daily news, considering the narrow time horizon that separates us from the time of reckoning:²⁴

- Full achievement of the objectives foreseen with the existing policies;
- Quick adoption and implementation of policies and additional measures;
- Correction of the emissions by taking into account sinks and land-use changes;
- Utilization to the highest possible level of the flexible mechanisms;
- Significant overdelivery by some of the member States;
- Timely observation of the reduction timetable.

All that notwithstanding, at least three member states – Italy, Spain, and Denmark – will not reach the objectives, and probably this is the most accurate forecast of the whole report.

Even more interesting is the way in which the Union has, so far, reduced its emissions. Table 1 reports the yearly variations declared by EEA together with the explanations that,

TABLE 1

Yearly variations of greenhouse emissions in EU15 (1999-2005).
Source: EEA. Economic growth (1999-2005). Source: Eurostat.

Year	Emission Variation (*)	Main reasons supplied	Economic Growth
1999	-4	<ul style="list-style-type: none"> • Measure against NO₂ in France and the UK; • Measures against HFCs emissions in UK; • Shift from coal to gas (Germany and the UK); • Mild winter in Germany, UK, France, and the Netherlands. 	+3
2000	+0.3	<ul style="list-style-type: none"> • Increase in electricity-related emissions; • Increase of coal in UK; • Continuous growth of emissions in Greece, Spain, Ireland, Italy, Belgium. 	+3.8
2001	+1	<ul style="list-style-type: none"> • Cold winter. • Increase in transportation emissions; • Greater use of fossil fuels for heating and electricity generation. 	+1.9
2002	-0.5	<ul style="list-style-type: none"> • Mild temperatures; • Low economic growth; • Shift from coal to gas. 	+1.1
2003	+1.3	<ul style="list-style-type: none"> • Increase of the carbon share in electrical generation; • Cold winter. 	+1.2
2004	+0.3	<ul style="list-style-type: none"> • Increase in industrial emissions (iron, steel, refrigeration, air conditioning). 	+2.3
2005	-0.8	<ul style="list-style-type: none"> • Reduction in the use of coal; • Mild temperatures; • Increase of diesel next to gasoline (Germany). 	+1.6

in its annual communiqués, the agency has supplied to explain the changes. Except for one case (1999), the variation is never attributed to specific policies. In 5 years out of 7, a significant role is attributed to climate conditions – that is, to a factor completely exogenous and which cannot be politically controlled. Then, on and off, the greater or lesser use of coal in the mix is noted, and that mix depends both on industrial choices or long-term policies, and on demand, which in turn depends primarily on the temperature and on economic growth (or lack thereof). It is therefore not an exaggeration to state that if Europe gets more or less close to the Kyoto target, it will depend largely on variables that are independent from climate policies; indeed the single most important variable will be... weather: the warmer (especially by Winter), the lower the emissions will be. The very analyses of the agency therefore show that regardless of the cost, European policies are ineffective, thus inefficient.

Obviously, before the failure of European policies is assessed, a closer look at the European market for emissions rights is needed, which started operating in 2005, a year characterized by mild temperatures as well as by a reduction of emissions as compared to the preceding year. Can we affirm that the European Trading Scheme (ETS) has contributed to the reduction? Or that it had no influence at all? Or that it has worked so poorly as to have slowed down the abatement of emissions? Clearly, the available evidence is bare-bone, and to make a judgement is very complex. However, it is essential to express a first evaluation because from it – and from Europe's ability to identify the limits and strengths of the existing mechanism – depends not only the outcome of the second phase (2008-2012), but also and above all the form of the policy instruments that Europe will provide itself with in view of the ambitious targets set at 2020 and, presumably, the position and credibility of the EU in international negotiations.

The ETS was created with a directive in 2003 and was enforced on January 1st, 2005, slightly over a month before the enforcement of the Kyoto Protocol. However, it helps to remember that the environment in which the Emission Trading Directive matured was profoundly sceptical towards the international climate treaty: up to mid-2004, it seemed destined to the trash bin, as it did not seem possible that the number of ratifying countries would be sufficient to exceed the required 55 per cent quota of 1990 total emissions. That was one of the conditions required by the protocol for its application. It happened only – and surprisingly – in the Fall of 2004, with the announcement and then the ratification by Russia, which in the past was always ferociously critical of Kyoto. The change in Russia's position was due to both the completion of an internal political revolution and external factors. On one hand, President Vladimir Putin managed to move off the main internal opponent of Kyoto, the former economic head councillor Andrei Illarionov, and managed to surround himself with a growing number of former KGB officers. That also played a role in the sudden change of energy policies, and represented the epilogue of the transition that started with the arrest in 2003 of the oligarch Mikhail Khodorkovsky, head of the private oil giant Yukos. The imprisonment of the tycoon and the dismemberment of the company (whose major assets were moved into the hands of state controlled companies including Gazprom) set off a return to direct, heavy public intervention, with the utilization of energy resources to political ends as well. From that moment on, for a western enterprise to operate in the energy sector in Russia became much more complex. In practice, as Massimo Nicolazzi wrote, Putin's design is that the state can draw "resources from the energy lever

and decide whether, if and when, to address them on other sectors.”²⁵ On the other hand, the Kremlin was the focus of effective pressures from Brussels and some time later then president of the Commission Romano Prodi claimed the Russian adherence to Kyoto as his personal success and made it clear that it was the price to pay for European support for Moscow’s participation in the World Trade Organization.²⁶

At any rate, the fundamental point is that when the European Union designed the ETS, it was convinced that this would be a great jump ahead of the rest of the world, as Europe would place itself in the cosmic void created by the sinking of Kyoto, which did not involve a very large part of the planet, ranging from the United States to the largest emerging economies.

ETS identifies two phases of application: a first pilot phase (2005-2007) followed by a second momentum (2008-2012), coinciding with the period of application of Kyoto and during which companies and countries are called to obtain the objective of emission reductions by 8 per cent next to the 1990 level. A large census at the European level identified 12,000 plants operating in four large sectors (energy activities including combustion installations with a rated thermal input exceeding 20 MW, mineral oil refineries, coke ovens; production and processing of ferrous metals; mineral industry including cement clinker, glass and ceramic bricks; and pulp, paper and board activities; from the end of the second phase, aviation will be added to the ETS sectors). At the beginning of each phase, a certain number of emission permits is gratuitously assigned to each of these. The distribution of the permits takes place on the grounds of a national allocation plan with which each member State declares the total amount of the emission quotas that it intends to distribute within itself. On April 30th each year, the plant will have to return a number of permits equal to its emissions. If it is unable to do so, or it did not have a way to buy quotas on the market, it must pay a fine of €40 per ton of CO₂ equivalent for the first phase, and €100 per ton in the second phase. The first phase covers only carbon dioxide, while in the second the other greenhouse gases identified by the Kyoto Protocol come into play.²⁷ Once the fine has been paid, the company’s not exempted from cutting its emissions, so €40 and 100 respectively do not work as a cap on carbon price. Finally, the directive does not allow the banking of allowances and their transfer from one phase to another. If the enterprise that holds emission quotas in excess cannot sell them in useful time, their value crumbles to zero.

From this summary description, the three main elements of political arbitrariness of the ETS project emerge: the inclusion of some sectors and not others,²⁸ the prohibition of banking the permits, their gratuitous distribution at the beginning of each phase on the basis of the historical emission record in a reference period (the so-called grandfathering). Thus, the choice of the reference period becomes crucial to pick the winners and the losers. Keeping all this in mind is fundamental when the third phase is designed, a phase that will unfold over a greater time interval (2013-2020) and that foresees substantial changes, ranging from the inclusion of new sectors to the adoption of a permit auctioning rather than grandfathering system. It must be added that the negotiation between the member States and the Commission on National Allocation Plans (NAP) becomes critical to the proper operation of the mechanism, as the difficulty of the path of emission reductions to which a country will be subject depends on it. A further problem comes from the fact that the data on emissions are made public by the European Environment Agency with about two years

delay. In 2008, the data concerning 2006 will be known. This imposes the design of the third phase without knowing how things are going in the second -- and without being able to know until 2014, the year in which we will know how much reduced the emissions of 2008 have been next to 1990.

Furthermore, the albeit small experience accumulated so far by ETS gives rise to perplexities about how well it is operating. The price of the allowances, which at the beginning of the market went up from the initial €7 per ton to settle around €20-25, suddenly crashed. The crash coincides with the publication of the data on emissions by the ETS sectors. At the end of April 2006, eight member states (Czech Republic, Estonia, Lithuania, Netherlands, France, Spain, Sweden and Slovenia) certified to have generated cumulative emissions lower by 46.6 million tons than the available permits. Within a few weeks, the price of CO₂ fell below €20. The announcement of the data concerning other countries delivered the final blow to the value, which went down progressively starting September 2006, and settled permanently well below €1 per ton, where it stayed until the end of 2007. It then shot up again over €20 at the beginning of the year and the beginning of the second phase. The immediate growth reflects the prohibition of banking of excess permits, which cannot be transferred to 2008-2012.

What is the price trend due to, a trend that has effectively nullified the cost of the quota system? According to a Bologna University Working Paper by Stefano Clò, a phenomenon of “over-allocation” in favour of the ETS sectors has taken place. Clò has defined two different benchmarks to evaluate the market – one referring to the pre-2005 period and the other to the year 2005 – and he concluded that “during the first phase the EU15 member States allocated an aggregated amount of 1,657 million permits, corresponding to the 42 per cent of the EU15 target. This percentage is higher than both the pre-2005 EU15 ETS share (41 per cent) and the 2005 EU15 ETS share (38 per cent)... permits have been on average over-allocated to the ETS sectors belonging to the EU15 member States.”²⁹ In practice, the sectors covered by ETS would have obtained an unfairly favourable treatment, and dumped on the society as a whole the largest part of the cost of reductions. This has two consequences. In the first place, ETS has given little or no contribution to the reduction of emissions during the first phase, thus nullifying – at least in part – that first phase. So, the entire reduction effort will have to be concentrated in the five years that have just started, with a significant impact in terms of costs. In the second place, to achieve this result, ETS will have to be managed with a greater severity and the initial allocation of the quotas demands greater inflexibility. The national allocation plans approved by the Commission for 2008-12 reflect a sensitivity to these issues (Brussels has issued 1,439 permits versus the 1,570 requested), but this – and, in junction, the prices of quotas, which went back to pre-2006 levels – allows to predict that the second phase will have tangible costs for the enterprises and consequently for consumers.

The inherently political nature of the allocation also shows another side, that is, a profound unfairness in the distribution of permits amongst the member states. Countries which are relatively less polluting such as Italy have been punished, while other more energy-intensive nations (above all, Germany) received an excessive number of quotas in the first phase. From this point of view, the second phase does not seem to bring about anything new. It is true that the Commission has cut the proposal of the member states; however, by fairly cutting, it has preserved the lack of fairness. All the European countries obtained

TABLE 2

Net balance 2005 (allocated emissions – verified emissions), energy intensity and carbon intensity in EU15 in 2005.

Source: European Commission 2007.

Country	Balance [Megaton]	Energy Intensity [Tep/M€2000]	Carbon Intensity [Ton CO ₂ /Tep]
Austria	-1.0	150	2.21
Belgium	3.0	203	1.97
Denmark	14.4	105	2.50
Finland	12.0	230	1.59
France	19.1	177	1.40
Germany	21.0	162	2.33
Greece	-0.1	200	3.08
Ireland	-3.1	112	3.06
Italy	-9.5	152	2.42
Luxemburg	0.0	184	2.64
Netherlands	6.1	183	2.17
Portugal	0.4	210	2.32
Spain	-10.8	194	2.36
Sweden	3.0	175	0.96
UK	-36.4	132	2.43

the greater part of the improvement in energy intensity before 1997 (the year when the Protocol was negotiated in Kyoto) and for reasons that are independent of climate policies; but those who have done more are called to a harder commitment than those who instead achieved less. Those who have an energy mix based on gas, the cleanest fossil fuel, do not get rewarded as compared with those who massively depend on coal. And those who have a greater marginal cost of emission reduction do not enjoy any advantage, although that indicates that a tract of the path has been walked already. In this way, we get to the paradoxical situation for which those who are less energy-efficient get, in fact, favourable treatment (Table 2).

Please note that amongst the countries that have recorded an important negative balance (Italy, Spain, UK), Italy is the only one that has recorded, in 2005, a near-zero economic growth rate.³⁰ Unless we take into account the political dynamics behind the initial allocation, the 21 million ton CO₂ excess reported by Germany is not comprehensible. It is true that, in 2005, this country reduced its emissions by 2.3 per cent (23.5 million tons) next to 2004, but that is mainly due to “a shift from coal to gas in the production of public electricity and heat” and by the reduction of “emissions from road transportation and from households and services”. Furthermore, a determining element has been a mild winter and

the consequent low demand during the coldest months of the year.³¹ At any rate, virtually none of that can be attributed to ETS. The same can be said of France, which furthermore produces about 80 per cent of its electricity with nuclear power, which has no emissions.

The substantial failure of the first phase, therefore, implies a greater effort – that is, cost – in the second phase. The simple fact that the value of allowances has gone back to over €20 brings back as valid a series of estimates on the comprehensive impact of the reductions that were implemented before or shortly after the enforcement of ETS. The Brussels-based think tank International Council for Capital Formation has estimated the cost for Italy of reaching of the Kyoto targets into a loss of GDP as high as up to 2 per cent per year below the business-as-usual by 2010.³² Furthermore, the awareness of the substantial futility of the first phase has caused the Commission to pay greater attention to the second phase and, looking ahead, to the third one. And it is on the latter that it is necessary to focus, both because it is late to intervene on dynamics that are already in motion, and because the size of the objective embraced by Europe is much more ambitious: we are talking about 20 per cent less emissions than 1990 within 2020, in the eight years following 2012. If the Kyoto objective were to be reached and thus on December 31st, 2012 the emissions of the EU15 were 8 per cent lower than 1990, Europe should proceed with an average cut of 1.5 per cent per year, which is significantly greater than the 0.9 per cent per year needed during the period 2005-2012.³³

To the need to set up a system of rules that is certain and stable – a need made cogent by the size of the objectives and by the short time span in which they should be reached – and to the need for equity, the observation on the high level of inefficiency of the system as a whole must be added. Stefano Clò writes: “permits over-allocation to ETS sectors implies that these sectors will have a lower need to recur to international credits to be acquired to comply with national emissions reduction target; thus Finance Ministers and tax-payers will pay for these directly, transforming the international Kyoto flexible mechanism in a largely public-funded markets.” And again: “This different treatment [in the various member States] implies that, despite being subjected to the same European regulation, different firms competing in the same market have to bear different environmental costs depending on the State where they are located.”³⁴ This introduces a further dimension of unfairness. The last point concerns the fact that the compliance costs – very low in the first phase and, probably, very high in the second – are just a part of the picture. The administration cost of the ETS must also be considered, and, in particular, the effect that messages that are alternatively reassuring or disturbing about the future regime have on investments. Absent certainty, companies do not invest, and the result is not only that of reducing the reciprocal competitive pressures, but also – especially from the environmental point of view – to reduce the rate of technological innovation and thus, paradoxically, to create an opposite thrust to the objective declared by the policies, that of reducing emissions. The missed or late adoption of innovative and more efficient technologies, in fact, translates into a relative increase of emissions.

The new directive

The European Commission is aware of all these criticisms but it finds itself locked by commitments made perhaps too lightly. So, in recent months, we have seen intense work of rewriting of decisions made, culminating in the change of the objective of renewable resources from 20 per cent of *primary* energy consumption to 20 per cent of the *final* consumption (although an Orwellian effort to re-write past decision prevented the Commission to openly state it). This is no small difference. Nor is this decision without repercussions on the target of emission reductions. In fact, as a study by Alberto Clò and Stefano Verde on the feasibility and consequences of the European Energy Policy shows, the cut of emissions by 20 per cent beyond 1990 was a *de facto* objective implicit in the other two that concerned the energy efficiency and green energy quotas.³⁵ The change of coordinates – which significantly reduce the scope of the commitment, although it still remains very ambitious – together with other frictions we have already highlighted, made a rethinking of ETS indispensable.

The new directive introduces substantial changes, some of which are questionable. Its greatest flaw is in the zone of uncertainty which the directive says it wants to eliminate but instead amplifies. Beyond the statements of principle which change nothing (for example, ETS “represents the spearhead and ‘one of the most important instruments’ of EU climate policy due to its ability to achieve absolute emission reductions in an economically efficient manner”),³⁶ right off the bat the directive sets fair general objectives, such as harmonizing the emission market and creating maximum predictability and stability of choices. Furthermore, it is honestly recognized that “the environmental outcome of the 1st phase of the EU ETS could have been more significant but was limited due to excessive allocation of allowances in some Member States and some sectors.”³⁷

The new directive foresees the extension of the ETS to other plants or sectors for which it is possible to monitor emissions.³⁸ A linear path of emissions reductions is foreseen. Starting from the medium value of the second phase, it leads to the target of 2020. Within this general criteria, the directive proposal suggests the overtaking of the national allocation plans, to be achieved by adopting a unified communitarian cap to reach in a time period longer than the five years of the first two phases. In fact, “provides a long-term perspective and increased predictability, which is required for long-term investments in efficient abatement. This can be best achieved by an 8-year trading period until 2020 and a linear reduction of the cap that continues the reduction path beyond

2020, thereby giving a clear message to investors.”³⁹ The other fundamental choice concerning the third phase is about the passage from grandfathering to auctioning in the allocation of quotas, such as to guarantee “efficiency of the ETS, transparency and simplicity of the system and avoids undesirable distributional effects.”⁴⁰

Thus, starting from 2013, all quotas for the thermoelectric sector will be allocated through auctions. This choice seems to collimate with the preferences of the majority of economists, who recognise two advantages in allocation through quota auctioning: less exposure to political whim,⁴¹ and the ability to generate tax income. In fact, the added value created by the permits does not stay with the enterprises but is made available to the collective. This last point is open to interpretation: it is not certain (in fact, the contrary is more likely) that a larger flow of resources to public finances can be considered advantageous, both

from the environmental perspective and that of proper market operation. It is true that the choice of grandfathering creates, due to its very nature, an entry barrier. But, ultimately, it is clear that the barrier exists in an auctioning system as well. The cost of entrance is in any case higher than that of the “deregulation” scenario. For those who enter, there is little difference whether the expenditure must be faced at the beginning of the year, during auctioning, or at any other moment by turning to the market.

The first argument about the greater neutrality of auctioning seems to have better foundations. Such concerns disappear, however, as soon as one goes on reading the European directive on emission trading. In spite of the initial call for harmonization and predictability, the exceptions seem far more numerous than the cases to which the presumed rule is applied. One line after stating that allocation for the thermoelectric sector is to be performed through auctioning from 2013 on, the report adds that, “in order to encourage a more efficient generation of electricity, electricity generators could however receive free allowances for heat delivered to district heating or industrial installations.”⁴² However, the firmness used to pass from free distribution to sale to the highest bidder ends here: for all other sectors, the passage from free distribution to auctioning will take place gradually and in function of several factors.

It should be noted that enterprises are told that, from now to the end of the third phase of ETS, a variable allowances quota will be distributed free of charge. The quota will be different from sector to sector and from year to year, and, within the same sector in a given year, it will change from case to case. But there is more: if the other industrialised countries do not commit to reducing emissions and if (but there is no doubt about this) this establishes a competitive disadvantage for some European enterprises, these will be able to enjoy special free-of-charge quota assignments. To the political uncertainties over distribution of free emission quotas is therefore added the possibility that further free quotas (subtracted from whom? Or are they to delay the reduction objectives?) are assigned to the most energy-hungry enterprises (which ones? And in which sectors?) according to the choices of other sovereign nations. The definition of “certainty” which is in vogue in Brussels apparently includes as a variable the political choices of an undefined number of foreign countries over the next 12 years.

The passage from the report which illustrates the directive proposal that “clarifies” the mechanism – so to speak – deserves to be quoted in its entirety:

For installations in other sectors [other than thermoelectric], a gradual transition is appropriate, starting with free allocation at a level of 80 per cent of their share in the total quantity of allowances to be issued, decreasing by equal amounts each year, arriving at zero free allocation by 2020. In the event that other developed countries and other major emitters of greenhouse gases do not participate in an international agreement that will achieve the objective of limiting global temperature increase to 2°C, certain energy-intensive sectors and sub-sectors in the Community subject to international competition could be exposed to the risk of carbon leakage.⁴³

This could undermine the environmental integrity and benefit of actions by the Community. The European industry should receive a clear commitment that the Community will take appropriate action. The Commission will review the

situation by June 2011 at the latest, consult with all relevant social partners, and, in the light of the outcome of the international negotiations, submit a report accompanied by appropriate proposals. In this context, the Commission will identify by 30 June 2010 which energy intensive sectors or subsectors are likely to be subject to carbon leakage. It will base its analysis on the assessment of the inability to pass through the cost of required allowances in product prices without significant loss of market share to installations outside the EU not taking comparable action to reduce emissions. Energy-intensive industries which are determined to be exposed to significant risk of carbon leakage could receive up to 100 per cent of allowances free of charge or an effective carbon equalisation system could be introduced with a view to putting installations from the Community which are at a significant risk of carbon leakage and those from third countries on a comparable footing. Such a system could apply requirements to importers that would be no less favourable than those applicable to installations within the EU, for example by requiring the surrender of allowances.⁴⁴

Essentially, what can be foreseen is an uncertain, unstable and unpredictable system, as the arbitrariness of the Commission is at its height, and – presumably – the clash of lobbies in future years will rise to its height as well. The Commission's design therefore nullifies yet another of the advantages of auctioning -- that is, the de-politicization of at least that slice of allowances that would be put up for auction. It is not clear how all of this could be effected without distorting the internal market. It seems that the Commission is a victim of the conflict between efficiency and equity that was denounced, in connection with a completely different theme, by the American lawyer Edwin Rockefeller, who wrote on "the impossibility of encouraging winners and protecting losers at the same time".⁴⁵ By the same token, it is not possible to pursue efficient allocation – where the permits actually go to those willing to pay more – which is fair at the same time. By fair, we mean being careful to not allow excessive growth (whatever that means) in the costs for some less substantial actors, whether these are relatively less developed countries or consumers with less available income.

A similar uncertainty concerns the destination of the cash flow from auctioning. Although it remains available to the member states (and is therefore considered normal tax income), "a certain percentage of the proceeds from the auctioning of allowances should be used to reduce greenhouse gas emissions, to adapt to the impacts of climate change, to fund research and development for reducing emissions and adapting, to develop renewable energies to meet the EU's commitment to using 20 per cent renewable energies by 2020, for the capture and geological storage of greenhouse gases, to contribute to the Global Energy Efficiency and Renewable Energy Fund, for measures to avoid deforestation and facilitate adaptation in developing countries, and for addressing social aspects such as possible increases in electricity prices in lower and middle incomes."⁴⁶ Each of these destinations, as well as the relationship between them, implies a huge question mark, as there is a very ample definition which leaves enormous room for political arbitrariness. In some cases, such as incentives for renewable energy resources or the financing of social tariffs – this overlaps existing programs, introduces further distortions to the electricity market, and

potentially creates conflicts with liberalization, since it limits price competition between electricity service suppliers.

It is not the case here to go further into the complex – and, needless to say, arbitrary – mechanisms of the recognition of credits matured through the flexible mechanisms of Kyoto. The Commission states its intention to discourage free riding by companies that operate in nations which have not concluded an international agreement, except for those companies which have their headquarters in third nations or administrative entities connected to the European emission exchange system. Here too, what this means *specifically*, and which behaviours are and are not legitimate, is not and cannot be clear.

In general, there is no indication of effort in the proposed directive to put together a system which is what the Commission says it wants, and which is a clear and predictable mechanism. The very choice of auctioning, with its function of the depoliticising of the initial allocation eliminated or at any rate limited, seemingly reduces itself to an infernal mechanism. On one hand, the mechanism acts as a pre-emptive tax on enterprises, who obviously will attempt to pass the costs onto consumers, in a total absence of transparency. On the other hand, it represents a formidable – as well as invisible to consumers, who rightfully do not care about the costs of the manufacturers – source of income that can be destined to both general taxation, and to a series of public expenditures which interfere with the projects in progress and with the good functioning of the market. All that with a further aggravation: as the price of the emission quotas has been and probably will be volatile, the public proceeds of the initial allocation can hardly be forecast. Consequently, governments from time to time will find themselves with a sort of unexpected treasure in their hands, which can be freely expended, virtually without any criterion – a veritable windfall profit for public finances.

The only true – and well questionable – advantage of such a system is that, because of its complexity, it will hardly be able to become the object of true public debate. Paradoxically in view of the premises, this allows an extremely high degree of politicization of the system in each of its stages: in the initial allocation of permits, in the possible additional allocations, in the concession of exemptions or facilitated conditions, and in the use of the revenues. Clearly, the supporters of a restrictive policy of control of emissions have a good game in favouring policies the costs of which are not visible to consumers.⁴⁷ It is however natural to ask ourselves whether all this is in the public interest – that is, whether this is effective in the reduction of emissions, and efficient in pursuing this end at a contained cost and with the induction of few or no distortions in the internal market (under the non obvious assumption that emissions reductions are in the public interest, in the first place). All in all, the impression is that the Commission is designing a sort of mechanism which is strongly bureaucratic and politicized, and which has the undeclared purpose and the fundamental function of generating a fiscal income and to create opportunities for rent-seeking for the countries, the industries and the firms that are politically stronger and more aggressive.

An alternative proposal: the carbon tax

The choice of a system of tradable permits, made by Europe at the moment when it launched ETS, responds to many reasonable considerations. The old instruments of command and control proved themselves to be inefficient and often even ineffective. That is even more true in a case such as that of greenhouse emissions, which are created by an extremely high number of sources (virtually any living being emits greenhouse gases and even when we limit ourselves only to human activities, every production process creates CO₂ and other GHGs). The costs of information, and with them those of control and enforcement, are therefore very high. And not only that: to define technological or performance standard, in this case, is very complicated. That is because not all processes can obtain the same results. In some cases, it is technologically and economically possible to pursue consumption or emission reductions, and alternatives are available. In other cases, that does not happen. The number of scientific uncertainties and the necessarily long-term projection of policies – which should take technological progress into account – multiply the risks that regulation will fail.

In such a situation, powers of discretion are indispensable, and they represent a strong temptation for rent-seekers, and make it almost certain that regulators will be captured.

The alternatives to command and control are economic instruments, which “provide an explicit price signal to regulated firms and individuals.”⁴⁸ These instruments consist of instruments based on price and those based on quantity. Because a regulation of quantities assigns an implicit price to the goods subject to regulation – generally, a polluting substance, the emissions of which are the target of reduction – in ideal conditions the result of the two instruments would be identical. It is also possible to conceive hybrid forms, for example, regulation of quantities with a price cap, a price floor, or both.

In theory, and in the abstract, there is no reason to prefer one instrument over the other. This is because they are equivalent under ideal conditions. However, when we descend from theory to practice, things change. There are several issues to confront that can direct the choice in either one or the other direction. The main themes concern the efficiency of the policies in the real world, the relative risk of regulatory capture, the extension of uncertainties, and also more general questions such as transparency, the distorting effect of the market, and political acceptability. Finally, considerations concerning transaction costs underlying the creation of an explicit market within a regulation of quantities are of importance. To this end, we will consider here two options: the ETS on one hand – which assigns a cap to greenhouse emissions and allows a market for emission quotas – and the carbon tax on the other, which should reduce consumption (and thus emissions) through an increase of the prices of products or services which are suspected of contributing to global warming, that is, fossil fuels.

From a theoretical point of view, the only thing that we can say is that – in a situation of uncertainty about marginal costs – a price instrument is more, or less, efficient than an instrument of quantity when the curve of marginal benefits is relatively less, or more, steep than that of marginal costs.⁴⁹ In the case of global warming, as Cameron Hepburn observes, “suppose the marginal cost of reducing emissions increases quickly as we move from eliminating the cheap, ‘low hanging fruit’ on to more difficult sources of emissions (e.g. aviation transport). Suppose also that, because damages from climate change are a func-

tion of the stock of greenhouse gases in the atmosphere, they are only a weak function of emissions over short periods (e.g. 5 years), so that the marginal benefit from abatement is relatively flat. In such circumstances, a price instrument – a carbon tax – is the appropriate instrument to use.”⁵⁰ These assumptions are consistent with the available evidence.

In fact, the marginal costs of emission abatement are clearly growing with a relatively steep curve. In the more energy-efficient countries, such as Italy, to cut the emissions is far more expensive than in countries that are less energy-efficient, such as Germany, let alone countries that are far less efficient such as the emerging economies, including China and India. Think, for example, that the efficiency of a coal-powered plant in Europe exceeds 40 per cent, while in China the average efficiency is around 20 per cent. If it were possible to export European technology to China for all new installations, it would be possible to obtain, at a relatively low cost, a much more substantial result of the objectives of the Kyoto protocol, assuming that they are reachable and that they are actually materializing later. According to the projections of David Montgomery and Sugandha Tuladhar, the adoption of an American technology (less efficient than the European technology) for the new investments in the electric sector in China and in India could determine, in 2012, an emission savings more than four times greater than the domestic objectives of the European Union.⁵¹

Conversely, the marginal benefit of emission reduction grows with a very mild curve, as the forcing of climate grows logarithmically next to the atmospheric concentration of greenhouse gases.⁵² William Nordhaus writes: “the structure of the costs and damages in global warming gives a strong presumption to price-type approaches. The reason is that the benefits of emissions reductions are related to the stock of greenhouse gases, while the costs of emissions reductions are related to the flow of emissions. This implies that the marginal costs of emissions reductions are highly sensitive to the level of reductions, while the marginal benefits of emissions reductions are insensitive to the current level of emissions reductions.”⁵³

In these conditions, an instrument of price regulation seems preferable to one of quantity regulation.

To these considerations on mere efficiency we can add one concerning the proper operation of the policies. From the institutional point of view, the creation of a market for emission quotas such as ETS – destined to have a growing level of complexity and inclusiveness – implies a commitment, that is, a mobilization of resources for the managing and the maintenance of the necessary administrative infrastructures which is far superior to that of a carbon tax.⁵⁴ That indicates a criticality in the European structure: the Union has decided to give birth to a new bureaucracy that administers a system from which the destiny of a large part of European productive activity depends. The decisions never have an exquisitely technical nature, but come from political evaluations or from difficult and unstable balances of power between lobbies and member States, and within each of these groups. What is worse, the boundaries between these components of the decisional process are totally fuzzy and indistinguishable. All in all, it is virtually impossible to know whether a certain decision – for example, to include a sector in the ETS, allocation of gratuitous quotas, distribution of binding objectives – comes from the work of one or more

technical study groups, or from the persuasive arguments presented to policy-makers in smoke-filled rooms.

This uncertainty about the future – and about the decisions that will ensue – provides a valid argument in support of a carbon tax. Because of its nature, a carbon tax guarantees top transparency. Everyone knows that for each ton of CO₂ produced, they will have to pay, say, €25 (just to indicate an amount in line with the forward prices of the emission quota on ETS which is consistent as we shall see with the suggestions of climate economists). To obtain maximum transparency it would be appropriate to imagine a system of transferability, so that the tax is entirely passed on to the consumer. That meets the need to give the consumer the function of allocating the emission reductions in the most efficient way, that is, a way that responds on one hand to a cost criterion and on the other to the relative replaceability of products at greater emission intensity. In this way, the market would be free to operate, although under a substantial bond turned to penalize those productive processes that are the most energy intensive and, upstream, the fossil fuels. The transferability of the tax demands, of course, the traceability of the emissions. But that is possible with relatively low costs, as almost all the reducible emissions come from carbon combustion. Thus, the monitoring must concern only the fuels and the path that they follow to reach the final consumer.

Apparently, the transferability of the tax lends itself to a substantial objection: it could discourage innovation in processes or products that cut the emissions. In fact, the cost of innovation falls on the enterprise, while the saving (the tax that is reduced or cancelled because of the effective reduction of emissions) goes to the advantage of the consumer. In part, this problem solves itself: although the direct advantage goes to the consumer, the ultimate result is that the retail price of the product in question is lower and thus – all other conditions being equal – the demand increases and the market share of the innovative enterprise grows as a consequence. But even if this were not enough – that is, if the additional profits from the greater sales were not sufficient to cover, in a reasonable amount of time, the cost of investments – the system could be reinforced by recognizing a tax credit or other forms of write-offs of the investments employed to reduce emissions. It is obvious that this foresees a spread and sharing of information especially concerning benchmarking to evaluate the innovative contents of the investments, but it certainly defines a more linear, predictable and certain system than that which is strongly bureaucratic and built around ETS.

By the same token, a carbon tax seems less distorting of the market than the current “cap & trade”, because of a smaller administrative structure and greater predictability. It is true that a tax, just like the emissions ceiling, can be reviewed at any time and increased, thus nullifying the projects of enterprise that were based on the earlier tax. In the case of ETS, however, to the possibility of more or less occasional changes in the structure of the system, we can add a *certain amount of uncertainty* on how the ETS will be applied, which sectors will be actually called to contribute, in what way the gratuitous quota will be allocated, etc. To all that, two further elements must be added. In the first place, a system like ETS required the assignment of sectoral targets, and thus not only does it imply a significant degree of arbitrariness, but also, due to its own nature, it creates continuous clashes of lobby groups. In the second place, and more importantly, a carbon tax is the only way to call all sectors to contribute in the most efficient way to emission reductions. Besides

its internal limitations, ETS is also limited to a few sectors, and therefore covers only part of the parties involved in emission reductions. As a result, ETS adds itself to other public policies – which can be of the command and control type but also subsidies or regulatory incentives of various kinds – which in turn induce distortions and high costs. Conversely, a carbon tax because of the way it works would substitute for all that and require, if not a total cancellation (which would be desirable nevertheless), at least a process of resizing, rationalization and simplification of the subsidies, particularly as concerns renewable energy sources.

This leads to another, two-fold basic theme: what is the purpose of a tax? It is obvious that, in a realistic perspective, and beyond the reasons that justify its imposition, a tax has the sole purpose of creating public revenues. In this case, however, and as Johan Albrecht explains, “Environmental taxes can, however, be installed with the purpose to change behaviour or with the purpose to collect revenues... Consequently, the tax revenues will also shrink with the tax base.”⁵⁵ It is probable, however, that the consumption reduction will take place slowly, given both the scarce elasticity of the demand for energy products in a broad sense (transport included), and the long times of the investments return in capital-intensive industries. Thus, the concerns for the reduction of income should not lead to any particular decision in the short term. Albrecht suggests (and this is consistent with the proposal here advanced on transferability of the tax) inserting environmental tax (including a carbon tax) in a general reform of consumption taxes. In the second place, what is to be done with the income of the carbon tax? Should the member States use it, as the European Commission would like to do with a part of the income from the auctioning of permits, to finance environmental programs (whatever could be included under this label, read: anything) does not seem a reasonable solution, as it causes distortions. Furthermore, the carbon tax assigns an implicit advantage to sources and technologies that are “clean”, but also puts them all on the same level. Conversely, incentive programs assign differentiated subsidies, further misrepresenting the operation of the market. Since one of the effects of

TABLE 3

Simulation of price increases of some energy products with a €25/ton CO_{2eq} carbon tax in the absence of an environmental tax reform.

(*) Emissions due to combustion alone; 7-10 per cent should be added to take into account the emissions concerning refining and transport.

(#) Cycle combined with 50 per cent efficiency.

(°) Steam turbines, counterpressure/condensation/conventional with 38 per cent efficiency.

(§) Steam turbines, counterpressure/condensation/conventional with 37 per cent efficiency.

Source: IBL elaboration from various sources.

Product	Emissions	Carbon tax €25/ton CO ₂
Transportation	[kg CO ₂ /litre]	[Euro cent/litre]
Green gasoline(*)	2.35	5.87
Deisel(*)	2.60	6.50
Electric generation	[kg CO ₂ /kWh]	[Euro cent/kWh]
Natural gas(#)	0.40	1.00
Oil(°)	0.73	1.82
Carbon(§)	0.91	2.27

a carbon tax – and the main one from the point of view of consumers – is the increase in the prices of consumption goods including some that are widely used and considered indispensable, such as electricity and transportation fuels, it seems that the request to cut the reform of environmental taxation to fit the principal of fiscal neutrality makes sense. Table 3 shows the increase that some products would undergo in the absence of a reform of the environmental tax if a €25 per CO₂eq ton carbon tax were imposed (in line with the ETS prices, but much greater than that which Nordhaus considers to be the optimal short-term tax in the event of global participation).⁵⁶ The choice of such a high tax is justified both by the coherence with the indications from ETS (which does not reflect the optimal objective, but the administrative one of reducing the emissions by 8 per cent below the 1990 level by 2012), and by the fact that Europe is alone in its effort is not and probably will not be part of an inclusive global strategy.

Clearly, we are talking about significant figures, which must be handled with extreme caution. The double observation that, on one hand the carbon tax erodes the buying power of income and that on the other hand it is appropriate that the tax is transmitted to the end consumer so as to obtain the most efficient allocation of the reductions, supplies us with an indication as to how to utilize the “little treasure.” It can be profitably employed to reduce the income tax rates, which in turn is a strongly distorting tax. Nordhaus argues: “If the carbon constraints are imposed through taxes, and the revenues are recycled by reducing taxes on other goods or inputs, then the increased efficiency loss from taxation can be mitigated, so that there is no necessary increase in deadweight loss.”⁵⁷

The reduction of income taxes (personal and corporate) is, in a country such as Italy, a priority regardless of climate policies.⁵⁸ If this road could be pursued, the impact of European climate policies would be more tolerable. And not only that: a (difficult) strategy of comprehensive overhaul of the fiscal system that puts together the introduction of carbon tax with the reduction of the income tax and the rationalization and significant reduction of subsidies of renewable energy sources could, paradoxically, and although the causes are certainly debatable, determine an improvement of the fiscal and normative environment in Europe, and certainly in Italy. At least the deadweight loss would be reduced, which is due to the co-existence of several taxes, all of which more distorsive than a carbon tax. This would be done by introducing certainty and transparency and by truly delegating to the market – although altered by an emission tax – the task of allocating emission reduction. Furthermore, by inducing general relief of fiscal pressure, the carbon tax could represent an important element in the restoration of competitiveness on the old continent. Of course, such a restoration would not be absolute, but it would be effective if part of a comprehensive project and related to the current situation.

Both the carbon tax and a cap & trade system have the effect of increasing the final prices of a series of products. But, while the cap & trade seems to proceed down mysterious paths, the tax acts in visible mode. This visibility establishes two consequences. In the first place, it allows greater price transparency and gives less grounds for vaguely populist protests, while offering fewer reasons for policies heavily oriented towards price control in moments when, for the most disparate reasons, the prices go beyond a level that is arbitrarily considered too high. In the second place, even the regressive effects of the carbon tax – which are, in substance, the same as the cap & trade – are more visible. The impact

on society becomes, therefore, equally visible, and the need to upgrade the fiscal system becomes more felt even from the political point of view.

Conclusions

This paper does not have the purpose nor the expectation of changing European climate policy. Complex programs such as ETS are difficult to implement and even more difficult to remove. At least up to 2020, then, the European Union will probably follow the road officially taken with the 2003 directive.

The objective of this work is different. It consists in a first examination of the European system of emissions trading, attempting to evaluate its effectiveness, efficiency, and sustainability. It also is intended to contribute to keep a debate alive that, both in Europe and in Italy, has so far been latent, if not completely suppressed. This debate involves three aspects, here listed in order of scope.

The first aspect has to do with the posture of ETS in the third phase (2012-2020). In particular, the choice of assigning quotas through auctioning, which in theory is not totally wrong, has been translated into a system of regulations that is confused, unstable, and ultimately such as to leave a great discretionary power to the Commission and to the governments of the member States. It is not possible to understand how this can be compatible with the objectives of the Lisbon strategy to bring Europe back on the path of an innovative growth that can be sustained, given that political arbitrariness is perhaps the main deterrent of growth. Nor can it be understood where it is that Europe wants to go, given that the targets that it has assigned to itself are – in the almost unanimous judgement of the experts – extremely difficult if not impossible to realize.

The second aspect, which is a direct consequence of the first, concerns both the definition of the binding objectives and the ways those objectives are implemented. In this paper, the objectives concerning renewable resources and energy efficiency have not been examined, but in substance the considerations on the reduction of the greenhouse gases apply to them as well. The quantification of the objectives has not been preceded by an evaluation of how much was possible to obtain, nor by an estimate of the costs and impacts on the European energy and economic system. By the same token, a discussion of the possible alternatives is missing. Not so much and not just to replace ETS *now*, but to judge its operation through time as compared to other instruments that could have been adopted and which, in spite of the little attention they have received in Brussels, could perhaps have obtained better results at lower costs. Specifically, the carbon tax option has a series of practical and theoretical advantages, not last the fact that, if the total impact on the European economy is in principal the same as the cap & trade, the administrative costs and the political risks are lower.

As to the third aspect, thinking about the costs of climate strategies means thinking about their benefits as well, and therefore the opportunity of imposing binding domestic targets. This is particularly important in light of both the scientific uncertainties that still remain and are quite substantial – on the global warming phenomenon and on the high probability that will remain politically isolated in the short term in the effort to reduce emissions. From this stems the substantial practical uselessness of the European policies, even if

they were justified, effective and efficient, because Europe represents an important but nevertheless minority and decreasing (in relative terms) fraction of global emissions.

Strictly connected to these questions is the issue of the political feasibility of climate policies. There is virtual unanimity amongst the experts that, from the political point of view, a cap & trade system is easier to launch than a carbon tax, and the European story provides further evidence about that. However, the price of the lesser political resistance is a system that is both opaque and arbitrary. From a certain point of view, therefore, the lesser political feasibility, due to the difficulty of harvesting consensus on a tax and the need to substantially reformulate the fiscal system, is a further advantage of the carbon tax. The lesser political feasibility guarantees, in fact, not only that the measure will be taken only when a truly large portion of the population is openly willing to pay more to obtain a certain environmental goal. For the same reason, it will be easier to abrogate the tax – a move that is politically less difficult than cancelling regulations as encrusted with lobby activities as they are obscure to most people – when and if it becomes evident that the European strategy is not sustainable, or that the global warming is a less severe problem than what is believed today.

ENDNOTES

1. I wish to thank Andrea Giuricin, Corrado Clini, Salvatore Zecchini, Stefano Clò, Stefano Verde, Massimo Ramunni, Massimo Nicolazzi, Piercamillo Falasca for their valuable suggestions and help in writing this paper. The usual disclaimer applies.
2. So said European Commission President José Manuel Barroso, who – in a statement released on December 15th, 2007 – attributed to Europe’s “leadership” the “successful outcome” of Bali negotiations. See <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1941&format=HTML&aged=0&language=EN&guiLanguage=en>.
3. See, for example, Kendra Okonski e Carlo Stagnaro (a cura di), *Dall'effetto serra alla pianificazione economica* (Soveria Mannelli, CZ: Rubbettino e Facco, 2003); Nigel Lawson, “L’economia e la politica del cambiamento climatico. Un appello alla ragione”, *IBL Occasional Paper*, no.36, 22 dicembre 2006, http://brunoleonimedia.servingfreedom.net/OP/36_Lawson.pdf; Richard Lindzen, “Il riscaldamento globale è la religione dei nostri tempi”, *IBL Focus*, no.51, 14 marzo 2007, http://brunoleonimedia.servingfreedom.net/Focus/IBL_Focus_52_Lindzen.pdf.
4. See, as an example, Margo M. Thorning, “Kyoto e le sue alternative”, in Carlo Stagnaro (a cura di), *Sicurezza energetica* (Soveria Mannelli, CZ: Rubbettino e Facco, 2007), pp.152-165; Mario Sechi e Carlo Stagnaro, “Clima. Vogliamo far gli amerikani”, *IBL Briefing Paper*, no.28-29, 19 marzo 2006, http://brunoleonimedia.servingfreedom.net/BP/IBL_BP_28_Stagnaro_Sechi.pdf. See also David W. Montgomery & Suganda D. Tuladhar, “The Asia Pacific Partnership: Its Role in Promoting a Positive Climate for Investment, Economic Growth and Greenhouse Gas Reductions”, *Cra International*, 28 giugno 2006, http://www.iccglobal.org/pdf/APP_Paper_Final.pdf.
5. European Commission, “Limiting Global Climate Change to 2 degrees Celsius”, COM(2007) 2, http://europa.eu/press_room/presspacks/energy/comm2007_02_en.pdf, p.2.
6. *Ibid.*, p.4.
7. European Commission, “Winning the Battle Against Global Climate Change”, COM(2005) 35, http://ec.europa.eu/environment/climat/pdf/comm_en_050209.pdf, pp.4 and 12-16.
8. http://ec.europa.eu/environment/climat/pdf/staff_work_paper_sec_2005_180_3.pdf.
9. http://ec.europa.eu/environment/climat/pdf/ia_sec_8.pdf.
10. http://www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/sternreview_backgroundtoreview.cfm.
11. Marzio Galeotti & Alessandro Lanza, “Il rapporto Stern tra allarmi e allarmismi”, Lavoce.info, 12 dicembre 2006, <http://www.lavoce.info/articoli/pagina2485.html>. Among the comments to the Stern Report see also Partha Dasgupta, “Comments on the Stern Review’s Economics of Climate Change”, 11 November 2006, <http://www.econ.cam.ac.uk/faculty/dasgupta/STERN.pdf>; William D. Nordhaus, “The Stern Review on the Economics of Climate Change”, 3 May 2007, http://nordhaus.econ.yale.edu/stern_050307.pdf; Richard S.J. Tol, “The Stern Review of the Economics of Climate Change: A Comment”, 2 November 2006, <http://www.fnu.zmaw.de/fileadmin/fnu-files/reports/sternreview.pdf>;
12. Willie Wei-Hock Soon e Steven H. Yaskell, *Maunder Minimum and the Variable Sun-Earth Connection* (Londra: World Scientific Publishing Company, 2004).
13. http://www.oism.org/pproject/GWReview_OISM150.pdf.
14. Ipcc, “Summary for Policymakers”, in *Climate Change 2007: The Physical Science Basis. Contribution of Working Group I to the Fourth Assessment Report* (Cambridge, UK e New York, NY: Cambridge University Press), http://ipcc-wg1.ucar.edu/wg1/Report/AR4WG1_Print_SPM.pdf, p.13.

15. Presidency Conclusions, Brussels European Council, 8/9 March 2007, 7224/1/07, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/93135.pdf. At §§ 31 e 32 is stated that: “the European Council endorses an EU objective of a 30 % reduction in greenhouse gas emissions by 2020 compared to 1990 as its contribution to a global and comprehensive agreement for the period beyond 2012, provided that other developed countries commit themselves to comparable emission reductions and economically more advanced developing countries to contributing adequately according to their responsibilities and respective capabilities. It invites these countries to come forward with proposals for their contributions to the post-2012 agreement,” and that “The European Council emphasises that the EU is committed to transforming Europe into a highly energy-efficient and low greenhouse-gas-emitting economy and decides that, until a global and comprehensive post-2012 agreement is concluded, and without prejudice to its position in international negotiations, the EU makes a firm independent commitment to achieve at least a 20 % reduction of greenhouse gas emissions by 2020 compared to 1990.”
16. See Corrado Clini, “Energia pulita pronto uso”, *Limes*, no.6, 2007, pp.139-144. See also Carlo Stagnaro, “Biocarburanti: energia pulita o inefficienza agricola?”, *Energia*, no.1, 2007, pp.52-55.
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18. *Ibid.*, p.198.
19. *Ibid.*, p.192.
20. *Ibid.*, p.199.
21. Corrado Clini, “I pro e i contro dell’unilateralismo europeo”, *Aspenia*, no.38, 2007, p.119.
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23. <http://www.eea.europa.eu/pressroom/newsreleases/eu-within-reach-of-kyoto-targets>.
24. European Environment Agency, “Greenhouse gas emission trends and projections in Europe 2007”, pp.6-7.
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26. Nick Paton Walsh, “Putin throws lifeline to Kyoto as Eu backs Russia joining Wto”, *The Guardian*, 22 maggio 2004, <http://www.guardian.co.uk/international/story/0,3604,1222190,00.html>.
27. CH₄, N₂O, SF₆, PFC and HFC.
28. The ETS sector accounts for roughly one-half of the total European emissions. Other industries, such as agriculture, transportation, services and building are subject to specific regulations aiming to curb emissions. Society at large, moreover, is targeted by a number of broader policies.
29. Stefano Clò, “Assessing the European Emissions Trading Scheme Effectiveness in Reaching the Kyoto Target: An Analysis of the ETS 1st and 2nd Phase Cap Stringency”, *Working Paper*, Università di Bologna.
30. In 2005 Italy’s economy grew by 0,1 per cent, as opposed to 3,6 per cent in Spain, 1,8 per cent in the UK, and an average growth rate of 1,6 per cent in the EU-15.
31. <http://www.eea.europa.eu/pressroom/newsreleases/eu-greenhouse-gas-emissions-decrease-in-2005>.
32. Ibl-Iccf, “Il protocollo di Kyoto e oltre. I costi economici per l’Italia”, Special Report, 3 November 2005, http://brunoleoni.servingfreedom.net/Papers/IBL_report_iccf.pdf, p.6.

33. In early 2005 the emissions of the EU-15 were 0,9 per cent below the 1990 level. In the period 2005-12 (covering the first two implementation phases Directive) the EU-15 were thus required to achieve a further reduction of 7,1 per cent.
34. Stefano Clò, “Assessing the European Emissions Trading Scheme Effectiveness in Reaching the Kyoto Target: An Analysis of the ETS 1st and 2nd Phase Cap Stringency”.
35. Alberto Clò & Stefano Verde, “20-20-20: il teorema della politica energetica europea”, *Energia*, no.4, 2007, p.6.
36. European Commission, “Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community”, COM(2008)16, 23 gennaio 2008, http://ec.europa.eu/environment/climat/emission/pdf/com_2008_16_en.pdf, p.2. Note that there is no agreement on this particular point. For an overview of the several positions, see John Norregaard e Valerie Reppelin-Hill, “Taxes and Tradable Permits as Instruments for Controlling Pollution: Theory and Practice”, IMF Working Paper, no.13, 2000, <http://www.imf.org/external/pubs/ft/wp/2000/wp0013.pdf>.
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38. *Ibid.*, p.4.
39. *Ibid.*, p.7.
40. *Ibid.*, p.7.
41. Si veda Paul L. Joscow e Richard Schmalensee, “The Political Economy of Market-Based Environmental Policy: The US Acid Rain Program”, *Journal of Law and Economics*, vol.41, no.1, 1998, pp.89-135.
42. European Commission, COM(2008)16, p.8.
43. Namely, moving offshore any businesses involving the transfer of greenhouse emissions from the EU to third parties.
44. European Commission, COM(2008)16, p.8.
45. Edwin S. Rockefeller, *The Antitrust Religion* (Washington, DC: Cato Institute, 2007), p.52.
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47. See Robert N. Stavins, “What Can We Learn from the Grand Policy Experiment? Lessons from SO₂ Allowance Trading”, *Journal of Economic Perspectives*, vol.12, no.3, 1998, pp.69-88.
48. Cameron Hepburn, “Regulation by Prices, Quantities, or Both: A Review of Instrument Choice”, *Oxford Review of Economic Policy*, vol.22, no.2, 2006, p.228.
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50. Cameron Hepburn, “Regulation by Prices, Quantities, or Both: A Review of Instrument Choice”, p.232.
51. W. David Montgomery & Sugandha D. Tuladhar, “The Asia-Pacific Partnership: Its Role in Promoting a Positive Climate for Investment, Economic Growth and Greenhouse Gas Reduction”, International Council for Capital Formation, <http://www.iccglobal.org/pdf/APPsummary.pdf>, p.4.
52. Once a very low threshold is passed (about 50 ppm in volume), each doubling of the concentrations determines an equal increase of the forcing, about 3,7 watts per square meter. Thus, if we move from a CO₂ concentration of 280 ppmv (that of the pre-industrial era) to 560 ppmv – double – the forcing grows by 3,7 watts per square meter; if we go from 560 to 1,120 ppmv, the increase of forcing is still 3,7 watts per square meter (today, the concentrations are about 380 ppmv). It follows that, no matter the complexity of relation between emissions (a flux) and

concentrations (a stock), each emission unit saved determines a smaller increase of the forcing less than was due to the previous unit, which instead was sent into the atmosphere.

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54. Si veda Dieter Helm, “Economic Instruments and Environmental Policy”, *Economic and Social Review*, vol.36, no.3, 2005, pp.205-228.
55. Johan Albrecht, “The use of consumption taxes to re-launch green tax reform”, *International Review of Law and Economics*, vol.26, 2006, pp.89-90.
56. “In the ideal world, the carbon price or carbon tax would be \$27 per metric ton in 2005 in 2005 prices. (If prices are quoted in prices for carbon dioxide, which are smaller by a factor of 3.67, the optimal tax is \$7.4 per ton CO₂)” William Nordhaus, *The Challenge of Global Warming: Economic Models and Environmental Policy*, p.23.
57. *Ibid.*, p.129.
58. See, as an example, Oscar Giannino, *Contro le tasse* (Milan: Mondadori, 2007).

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