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**Will Cap-and-Trade Incite Protectionism?**

By MARTIN FELDSTEIN

CAMBRIDGE – There is a serious danger that the international adoption of cap-and-trade legislation to limit carbon-dioxide emissions will trigger a new round of protectionist measures. While aimed at reducing long-term environmental damage, cap-and-trade policies could produce significant harmful economic effects in the near term that would continue into the future.

Scientific evidence appears to indicate that the accumulation of CO<sub>2</sub> in the atmosphere from the burning of fossil fuels (primarily coal, oil, and natural gas) – mainly in electricity production, transportation, and various industrial processes – contributes to gradual global warming, with long-term adverse effects on living conditions around the world. It is with this in mind that representatives of more than 150 countries are scheduled to meet in Copenhagen in December to discuss ways to reduce CO<sub>2</sub> emissions.

A common suggestion is to impose a tax on all CO<sub>2</sub> emissions, which would be levied on companies that emit CO<sub>2</sub> in production, or that sell products like gasoline that cause CO<sub>2</sub> emissions when used. Such a tax would cause electricity companies and industrial firms to adopt techniques that reduce their CO<sub>2</sub> emissions, as long as the cost of doing so is less than the tax that they would otherwise have to pay.

The higher cost of production incurred to reduce emissions – and of any emissions tax still due – would, of course, be included in the price charged to consumers. Consumers would respond to the tax-induced increase in the cost of the emissions-intensive products by reducing their consumption of those goods and services in favor of goods and services that create smaller amounts of CO<sub>2</sub> emissions.

A carbon tax causes each firm and household to respond to the same cost of adding CO<sub>2</sub> to the atmosphere. That uniform individual cost incentive allows total CO<sub>2</sub> to be reduced at a lower total cost than would be achieved by a variety of administrative requirements, such as automobile mileage standards, production technology standards (e.g., minimum renewable fuel inputs in electricity generation), etc.

Yet we do not see carbon taxes being adopted. Although governments levy taxes on gasoline, they are reluctant to impose a general carbon tax because of public opposition to any form of taxation. Governments have therefore focused on a cap-and-trade system as a way of increasing the cost of CO<sub>2</sub>-intensive products without explicitly imposing a tax.

In a cap-and-trade system, the government sets total allowable national emissions of CO<sub>2</sub> per year and requires any firm that causes CO<sub>2</sub> emissions to have a permit per ton of CO<sub>2</sub> emitted. If the government sells these permits in an auction, the price of the permit would be a cost to the firm in the same way as a carbon tax – and with the same resulting increases in consumer prices. The cap-and-trade system thus imposes a carbon tax without having to admit that it is really a tax.

A cap-and-trade system can cause serious risks to international trade. Even if every country has a cap-and-trade system and all aim at the same relative reduction in national CO<sub>2</sub> emissions, the resulting permit prices will differ because of national differences in initial CO<sub>2</sub> levels and in domestic production characteristics. Because the price of the CO<sub>2</sub> permits in a country is reflected in the prices of its products, the cap-and-trade system affects its international competitiveness.

When the permit prices become large enough to have a significant effect on CO<sub>2</sub> emissions, there will be political

pressure to introduce tariffs on imports that offset the advantage of countries with low permit prices. Such offsetting tariffs would have to differ among products (being higher on more CO<sub>2</sub>-intensive products) and among countries (being higher for countries with low permit prices). Such a system of complex differential tariffs is just the kind of protectionism that governments have been working to eliminate since the start of the GATT process more than 50 years ago.

Worse still, cap-and-trade systems in practice do not rely solely on auctions to distribute the emissions permits. The plan working its way through the United States Congress (the Waxman-Markey bill) would initially give away 85% of the permits, impose a complex set of regulatory policies, and allow companies to buy CO<sub>2</sub> offsets (e.g., by paying for the planting of trees) instead of reducing their emissions or buying permits. Such complexities make it impossible to compare the impact of CO<sub>2</sub> policies among countries, which in turn would invite those who want to protect domestic jobs to argue for higher tariff levels.

There is no easy answer to this problem. But before rushing to impose tariffs, it is important to remember that cap-and-trade policies would not be the only government source of differences in competitiveness. Better roads, ports, and even schools all contribute to a country's competitiveness. No one attempts to use tariffs to balance those government-created differences in competitiveness, and there should be no such attempts if a cap-and-trade system is introduced.

If an international agreement to impose a cap-and-trade scheme is adopted in Copenhagen, the countries there should agree as well that there will be no attempt to introduce offsetting tariffs that would ultimately threaten our global system of free trade.

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