Sub Prime and Carbon: Time for a Rethink?

The sub prime crisis suggests that it is time to rethink the merits of developing markets for carbon trading. Why establish a financial market for trading complex, government determined, property rights, when simpler alternatives exist?

Financial markets play tremendously valuable roles in our modern economy. The prices established can provide valuable signals for efficient investment decisions.

But they can also be subject to instability and crisis when speculation and trading become the dominant motives, and when complexity and opacity prevail. Markets for carbon trading face this risk. Their popularity reflects the quickly waning political influence of financial market traders, investment bankers, and rocket scientists.

Why are markets for carbon trading a potential disaster? First, governments have to decide on the aggregate quantity of permits to be allocated over time. Second, an allocation system has to be determined. Third, incentives for speculative trading and promotion of complex derivative products, is no less for markets for carbon than for sub-prime debt.

European experience with volatility in carbon prices illustrates the problems of setting aggregate size of the market. Political difficulties exist surrounding whether to auction permits, or grant them (in what quantities) to existing producer/polluters.

And exactly what information will prices established in carbon markets convey? Probably expectations of financial market traders about future Government decisions for the market size rather than "fundamentals". Given uncertainty about the speed and effects of climate change, and the possibility (certainty?) of future governments faced with a crisis to resort to "command economy" solutions (think banning of short selling), there is certainly scope for mispricing.

Being able to establish a market in carbon trading, doesn't necessarily mean that we should. Not if there are alternatives which are simpler and potentially more effective.

Economics 101 suggests a simple solution of taxing activities which generate negative externalities (ie carbon). Why hasn't a carbon tax generated support as a possible solution?

One reason is probably the recent dominance of the market paradigm espousing financial markets as the solution to most, if not all, problems. Self interest is indeed a powerful economic force – particularly in financiers sensing opportunities for new financial markets for more trading, product development, and fees.

Another important reason is Government aversion to being seen to be introducing a new tax, and pocketing more tax revenue. But that latter concern can be overcome in a

relatively straightforward, incentive based, manner, by appropriately redistributing the revenue raised back among those taxed.

For example, impose a specific tax rate per unit of emissions produced for companies in a particular industry. Then return (as tax credits or subsidy) the total amount raised from that industry to participants on a scale related to the amount of their output. A firm which had a higher emissions/output ratio would be a net payer of tax, and one with a lower ratio would be a net beneficiary.

Such as scheme could be budgetary neutral. The administration costs should be relatively small. Firms would have an incentive to invest in production processes with lower emissions/output ratios. While the quantity of carbon produced would not be directly controlled, the tax rate could be adjusted over time to achieve the desired reductions in emissions.

The risk management issues for firms operating in the industry become primarily operational ones (emissions /output ratios relative to industry average) affecting tax liabilities, rather than financial market ones related to hedging against short term fluctuations in the price of carbon.

Are we too committed to a financial market solution to consider such a tax solution? Let us hope not.

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