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'The Struggle for Market Mechanisms: Superiority of Tradable Permits. Presentation of Benefits and Exploration of Reasons for Failure to Employ Economic Instruments in Reduction of Pollution'.

SIMPLISTIC LAYOUT

Ways of tackling through the market instruments. Analysis of shareholders.

Economic instruments in environmental policy have been hardly popular in the past, whereas command and control measures were extensively used. More recently, the number and scope of ecological taxes as well as tradable permits increased and many voluntary agreements have been implemented. Analysing shareholders involved in traditions of the Public Choice approach the reasons of wider acceptance of economic instruments are explored. The rationale behind every approach in its every variation: command, tradable permits and voluntary agreements. It is concluded that the use of market based instruments in environmental policy is currently on the rise and, given its efficiency and effectiveness, is likely to become the chief strategy. Thus on the evidence disclosed the market mechanisms (tradable permits) provide the best results. Therefore this paper presents a plethora of practical implications for policy makers as well as wider academic and scientific community.

In the Kyoto process internationally tradable permits were intended to play a major role in international environmental policy, together with other (but related) market based instruments like 'Joint Implementation' and 'Clean Development Mechanism' projects. Thus, there seems to be an increasing willingness to apply market based instruments. This has been forced by the United States which up till now is the only country where tradable permits play a major role.

At the moment we witness an increasing use of 'voluntary agreements'. A closer look at this instrument shows that voluntary agreements are typically agreed on if there is a threat that otherwise the government would use other, especially command and control measures. They are not 'voluntary' in the real sense of this word, but an attempt to evade stricter environmental measures.

There are at least two groups of arguments, which are given as possible reasons of why despite ample evidence in favour of market based instruments the actual environmental policy still reflects the 'bureaucratic instruments' of command:

- (i) Many objection the neo-classical model and the homo economicus concept .
- (ii) Some authors dislike the assumption of (pure) self-interest usually employed in discourse. In their view politicians hesitate to apply environmental policy instruments which use (monetary) incentives because these might crowd out environmental ethics.

These arguments will be duly addressed.

In accordance with the Public Choice approach is the different groups of actors engaged in environmental policy making will be singled out and their interests in the application of the different instruments examined. The list of actors includes the following: (i) the voters, (ii) the politicians, (iii) the public bureaucrats, and (iv) the 'economy', i.e. the owners, managers and employees of the polluting industries and their interest groups.

Electorate. Voters approval of ecologically sustainable policies should be becoming more probable. However, it should be taken into account that ecological objectives 'compete' with other interests, especially with 'pure' economic objectives of the voters. Assuming that the improvement of the environmental quality is a national (or, as in the case of the reduction of CO₂-emissions, even an international) public good, the most relevant

question regarding the behaviour of voters is: Who will pay the costs? If the price elasticity of demand is low and/or if the supply elasticity is infinitely elastic the majority of voters directly pays for such a policy. But if price elasticity is high, only a small part of the burden of an environmental measure which increases the production costs of a good can be passed on to the consumers. Thus, the producers and shareholders have to bear the costs. Consequently, the resistance to environmental programs might be higher in regions with a high share of producer interests which oppose such a policy, because a higher burden can lead to reduced profits, wages and employment in these regions.

Thus in Germany some empirical evidence was found for a trade-off between the reduction of unemployment and ecological objectives.

Political Agents. If voters demand effective tackling of environmental issues, a government which wants to maximise its re-election probability gets incentives to provide a better environmental quality of life under the qualification that there is no considerable resistance from neither the bureaucracy nor the interest groups. Besides it is possible to present environmental taxes as acceptable measures to the voters, if these taxes are characterised as 'punishment' for polluting the environment and if they are applied mainly to industrial polluters. But it is more difficult to sell the creation of a market for tradable permits to the voters because these can be considered as 'licences to pollute the environment'.

Bureaucracy. Many members of the public environmental bureaucracy are in strong opposition against the application of market based instruments of environmental policy. They rather prefer the use of command and control. In most cases they favour policies which increase their wellbeing.

The economy. As long as a policy of command and control is pursued, the business shareholders have considerable leeway for negotiations with its environmental protection agency. In these negotiations it has an informational advantage; it knows the processes and the potential costs if the emissions have to be reduced by a certain amount, and it can threaten with a reduction of employment or even with the displacement of the firm if the regulations are too strict. Further, if any, 'grandfathering' of pollution rights is preferred, as it creates a barrier to entry against new firms. Thus, it is no surprise that the existing companies as well as their interest groups favour the 'grandfathering' of tradable permits. There are at least five main reasons why the interest groups are better organised than environmental interest groups.

Given the efficiency of market solutions within individual countries, a global grand strategy may be proposed along these lines. Indeed global warming is a true global public good, and the damage caused by CO₂-emissions is independent of the location of the emitting source. But the main question is how to allocate the CO₂-emission rights before the trading. The natural way would be to distribute them per capita: each human being has the same right to pollute the atmosphere. This would, however, result in a huge redistribution from the North to the South. From a social point of view this might be acceptable, but industrial countries are unlikely to accept such redistribution, because this would lead to a tremendous loss of real income. The alternative is 'grandfathering' to nations, where at the starting point every country gets pollution rights according to its actual pollution. But this would largely impede the opportunities of developing countries. Moreover, an international institution (like a stock exchange) is missing which not only organises the trade but, what is much more important, also has the power to enforce that CO₂ is only emitted by a country if it owns the necessary permits.

What can be done at best at the moment is an international agreement like the Kyoto protocol where the industrialised countries constrain themselves to reduce their CO₂-emissions and the developing countries are allowed to somewhat increase them. If this is agreed on, tradable permits may still play a considerable role.

A system of tradable permits has been introduced in Swiss cantons. However, this was a complete failure. The main reason was that the conditions under which the trading should take place were very restrictive; in addition the firms might have had not enough trust in this system. In such situations, the use of tradable permits at the international level might improve the chances for their acceptance at the national level. But at the moment, it is still

open whether these instruments will ever be applied at a large scale at the international level at all.

The following three suggestions can be proposed in order to make the use of incentive orientated environmental instruments more attractive:

- (1) Decentralised environmental policy using the principle of subsidiary.
- (2) Employment of direct voting.
- (3) Compensation the additional burden of ecological taxes and tradable permits through general tax reductions.