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Irony in Advocating Financial Reform and Cap and Trade

Testifying before Congress following the collapse of such major Wall Street institutions as Bear Stearns and Lehman Brothers, former Treasury Secretary Henry Paulson noted "we have not in our lifetime dealt with a financial crisis of this severity and unpredictability." Yet, mere months after delivering those cautionary remarks, Mr. Paulson gave another talk in which he joined many congressional Democrats in advocating the creation of a large new market, a cap-and-trade market for carbon-emissions permits, that would be inherently volatile and potentially very destabilizing.

Mr. Paulson's about-face isn't entirely surprising, considering that the list of cap-and-trade boosters reads like a Who's Who of Wall Street. Nor is that surprising, given the fees and profits which Wall Street firms would collect from trading and speculating in the climate-emissions permits. The irony is that many of the same financial institutions that lined up for bailouts last year now lobby Washington to create this new market, with the potential to generate an even more perilous bubble than the one which nearly destroyed them all.

Let's be perfectly clear: These problems are particular only to a cap-and-trade approach to climate, and not to others. Directly or indirectly, all climate change programs place a price on carbon and related emissions in order to encourage businesses to develop less carbon-intensive fuels and technologies and to ensure that industry and households adopt them. Most of such investments in a safer climate -- whether undertaken by companies or families -- will come about only if the policy approach produces a clear and predictable price for carbon. And that's precisely what cap-and-trade cannot do.

Under a cap-and-trade system, the federal government would create a certain number of emissions permits to be auctioned or given away to emissions producers. The precise number to be issued each year would be determined by projections of energy demand and the trajectory of emissions reductions required to once again to stabilize the climate system. Such projections are almost always wrong, because growth turns out to be greater or less than expected, or the summer is hotter or the winter colder than expected. Just think of this past winter, when snowfalls and cold

temperatures set records up and down the East Coast. When any of these eventualities occurs, the price of the permits will rise or fall sharply because those prices were based on estimates of energy demand that would quickly become outdated.

This is the precise volatility seen in the prices of the permits issued for the Acid Rain program. Over the last 15 years, the price of those permits has varied by an average of 18% per month. It's the same story with the European Trading Scheme (the EU's own cap-and-trade program) which saw the prices of its permits move up or down an average of 20% per month, with daily shifts as great as 70%.

The inherent volatility of cap-and-trade programs could pose serious economic damage. The volatility would affect the prices of the underlying assets, which here would be all of the energy the American economy uses. Moreover, this volatility would tend to reinforce the existing volatility in international energy prices, making it even more severe. It not only would dampen investment in the climate-friendly fuels and technologies needed to address climate change -- since who could say what the price of carbon would be next month or next year.

Cap-and-trade would also be an invitation for insider trading, since large energy companies and utilities would inevitably know about emerging shifts in demand before the markets. And after the recent Wall Street carnage, it is painfully clear that the SEC simply lacks the means and capacity -- and perhaps the inclination -- to effectively police complex, fast-moving markets involving many, many thousands or millions of trades, every day.

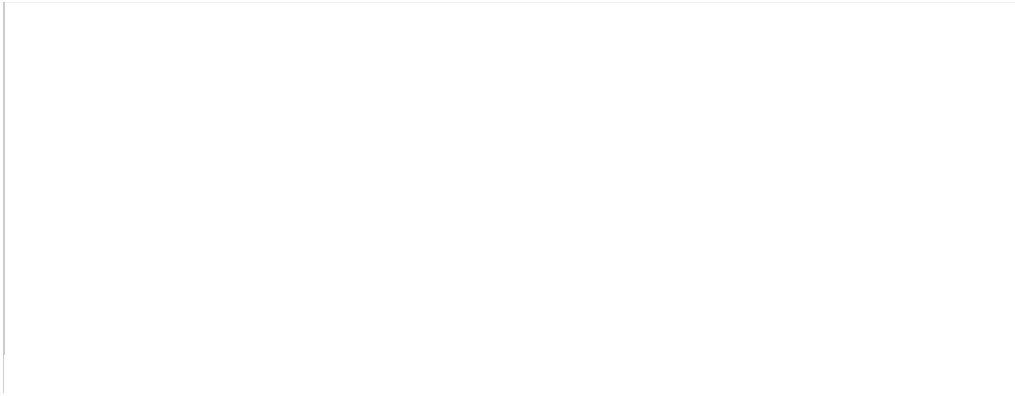
These sobering thoughts come to mind especially clearly these days, as the White House and many in Congress push for stricter (and smarter) regulation of financial institutions and commodity markets, including the proposals recently offered by Senate Banking Committee Chairman Christopher Dodd. Paired up with cap-and-trade, Dodd's efforts could amount to taking a step forward on a path that circles back around to where we started. So even as lawmakers try to reign in Wall Street, many are simultaneously working to create a new, highly complex, opaque and volatile market vulnerable to insider trading and perhaps manipulation.

It should be painfully clear that we need an alternative approach to climate issues. Since the essence of any effort to control these emissions is to set a steady price on carbon emissions, most economists have concluded that a straight-forward carbon-based tax would be the most effective approach. By directly raising the price of fuels and technologies based on their carbon-intensity, the approach would encourage firms to develop less carbon-intensive fuels and technologies and spur companies and households to adopt them.

The certainty of a stiff, direct tax on carbon emissions in the United States -- especially while Europe continues to use cap-and-trade - also could make America the center of a fast-growing global market for those fuels and technologies. And adopting a direct carbon tax and then using the revenues to fund reductions in payroll or other distorting taxes would allow us to protect growth in people's incomes and the overall economy even as we address climate change.

The past few months should remind us of the huge costs which Mother Nature can levy on any society. Those costs could be small, however, compared to the potentially devastating consequences of widespread climate change. To head off those costs, we need a smart and stable policy for reducing greenhouse gas emissions. A cap and trade program would almost certainly fail this test, while a carbon-based tax with recycled revenues should pass it easily.

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