

THE EU EMISSION TRADING SYSTEM: POTENTIAL IMPACT ON U.S. COMPETITIVENESS

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A Clean Technology Solution”

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Introduction

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to submit this statement for the record.

The American Council for Capital Formation represents a broad cross-section of the American business community, including the manufacturing and financial sectors, fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders, and public finance and environmental policy experts.

The ACCF is celebrating nearly 30 years of leadership in advocating tax, regulatory, environmental, and trade policies to increase U.S. economic growth and environmental quality.

Background

The European Union has a target of an 8% reduction from the 1990 base-year level for the Kyoto Protocol’s 2008-2012 commitment period. The EU has put in place an emissions cap and trade system (ETS) covering only carbon dioxide emission for selected large industry and utility sectors which is intended to help member states meet their emission reduction targets in the Kyoto Protocol. Other greenhouse gases as well as the transport and residential sectors are not included in the ETS system.

The European ETS and U.S. Industry

Some supporters of the mandatory cap and trade approach to emission reductions argue that U.S. firms will be less competitive if the U.S. does not join the EU in implementing this trading scheme. However, as the Hon.Eileen Claussen’s testimony presented at this hearing notes, “Our response to climate change, if not well conceived, could pose a

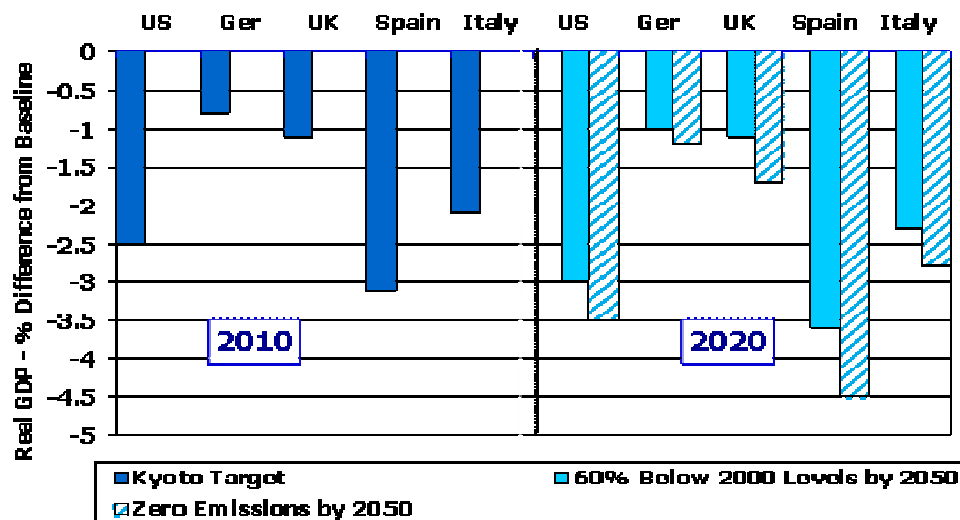
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different sort of economic burden. It is imperative that we...minimize the costs of addressing climate change.”²

In addition, a 2002 Pew Center report notes, “In general, Kyoto would give non- parties such as the United States a competitive advantage to the extent that Kyoto entails significant economic costs. To the extent the Kyoto targets raise energy prices in Annex B countries(now called “Annex II”), U.S. firms would tend to gain an advantage vis-à-vis foreign competitors in those countries, particularly in energy-intensive industries.”³

Further, several different economic analyses show that if the EU were to actually meet its emission reduction targets under the protocol the economic costs would be high. For example, new macroeconomic analyses by Global Insight, Inc. show the cost of complying with Kyoto for major EU countries could range between 0.8% of GDP to over 3 % in 2010. (See Figure 1.)

Figure 1: Impact of Purchasing Carbon Emission Permits on GDP Levels Under the Kyoto Protocol and Under More Stringent Targets On Major Industrial Economies



Source: International Council for Capital Formation “The Cost of the Kyoto Protocol: Moving Forward on Climate Change Policy While Preserving Economic Growth”, November, 2005, (www.iccfglobal.org) and unpublished estimates for the U.S. prepared by Global Insight, Inc.

According to Global Insight, the reason for the significant economic cost is that energy prices, driven by the cost of cap/trade emission permits, have to rise sharply in order to curb demand and reduce GHG emissions. The tighter targets being considered for the post-2012 are also costly, with GDP losses ranging from 1.0 % of GDP to 4.5% for a

² Statement by the Hon. Eileen Claussen, Pew Center on Global Climate Change, November 14, 2005 before The International Economic Policy, Export and Trade Promotion Subcommittee, The Foreign Relations Committee, United States Senate.

³ Pew Center on Global Climate Change, “Implications for US Companies of Kyoto’s Entry into Force without the United States,” January 2002

reduction to 60% below 2000 levels of emissions in the year 2020. Even the EU Commission for the Environment admits that emission reductions could cost as much as 1.3% of GDP by 2030. The fact that the European Environmental Agency projects that the EU will be 7% above 1990 levels of emissions in 2010 (instead of 8% below) demonstrates that the mandatory ETS system as currently structured is not working – and therefore the boost in energy costs noted by the Pew report could well be substantial.

- The 2002 Pew report goes on to note that multinationals with commercial operations or subsidiaries in Annex II parties will move GHG emitting activities from Annex II parties to developing countries or to the United States.⁴ Thus, U.S. firms' competitiveness should be enhanced—not impaired—by the higher energy cost faced by facilities located in the EU if EU member states actually impose measures to force overall emissions down to the target level.

Another argument raised by supporters of the Kyoto Protocol is that U.S. firms with GHG-emitting subsidiaries in the EU could be subject to Kyoto's emission reduction targets despite U.S. non-party status. Since the U.S. is not a signatory to the Kyoto Protocol, U.S. firms could not take advantage of “low-cost” emission reduction opportunities in their U.S. operations to meet these requirements since Kyoto does not recognize emission reductions achieved in non-parties.

- However, EU-based companies also could not count “low-cost” emission reduction actions taken at U.S.-located facilities against their EU emission reduction obligations. Hence, there is no difference in the treatment of U.S.-located facilities owned by U.S. or EU-based companies.
- Additionally, many U.S. firms are directing new investment outside the EU where economic growth is faster into countries that are not bound by the emission reductions required under the Kyoto Protocol, including countries like China, India and the Pacific Rim..
- Also, since U.S. companies can allocate new investment to wherever the expected return is highest, they can gradually adjust their country allocations and leave the European firms to try to comply with the ETS, which imposes added costs.

In addition, Kyoto Protocol proponents argue that U.S. firms that specialize in emission reduction technologies (renewables or energy efficiency) could be disadvantaged if the U.S. does not take domestic measures to reduce emissions since this would reduce home market opportunities.

- This argument for Kyoto is implausible. First, even without mandatory emission reduction targets, the high prices for fossil fuels are creating a strong demand in the U.S. for energy efficient equipment and for cost-effective renewables, e.g. solar power in Arizona or windmills in areas with steady wind which are near the electric grid.

⁴ Ibid; page 2

- Additionally, in a global market place, U.S.-based companies could respond to the demand for more costly emission reduction technologies from European located facilities – unless of course the EU attempts to erect new trade barriers.

Finally, as new study by Dr. David Montgomery of CRA International shows, a global emission trading system is not workable.⁵ Emission trading will work only if all the relevant markets exist and operate effectively; all the important actions by the private sector have to be motivated by price expectations far in the future. Creating that motivation requires that emission trading establish not only current but future prices, and create a confident expectation that those prices will be high enough to justify the current R&D and investment expenditures required to make a difference. This requires that clear, enforceable property rights in emissions be defined far into the future so that emission rates for 2030, for example, can be traded today in confidence that they will be valid and enforceable on that future date. The international framework for climate policy that has been created under the UNFCCC and the Kyoto Protocol cannot create that confidence for investors because sovereign nations have different needs and values. Therefore, it seems likely that the ETS system which the EU is trying to implement will fail to spread to other parts of the world and will eventually be replaced with a more practical approach to climate change policy. The Hagel-Pryor Climate Amendment to the Energy Bill (Title XVI) focuses on reducing emission intensity, technology transfer and trade barrier reduction can help provide the practical assistance that is needed for a global approach to emission reduction.

Conclusions

There are many urgent global problems such as lack of food, sanitation and potable water which are daily imposing hardship and death on the world's least fortunate citizens. Energy use and economic growth go hand in hand, so helping the developing world improve access to cleaner, more abundant energy should be our focus. Near-term GHG emission reductions in the developed countries should not take priority over maintaining the strong economic growth necessary to keeping the U.S. one of the key engines for global economic growth. Establishing an ETS system in the U.S. would impede, not promote, U.S. progress in reducing emissions intensity. U.S. climate change policies should continue to strive to reduce energy intensity as the capital stock is replaced over the business cycle and to develop new, cost-effective technologies for alternative energy production and conservation and encourage the spread of economic freedom in the developing world. This approach is likely to be much more productive than having the U.S. adopt an ETS and thereby sacrifice economic well-being and job growth with little or no long-term impact on global GHG emissions.

⁵ International Council for Capital Formation: *Climate Change Policy And Economic Growth: A Way Forward to Ensure Both*; page 65-79. April 2005(see www.iccfglobal.org).