Opinion

Messing up with climate change

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For decades, climate change was not happening or, if it was happening, next year would be a good time to think about it. Over the most recent past, a succession of heat waves and burning forests along with typhoons and powerful floods have made it impossible to be a climate denier, unless of course you believe that Trump won the 2020 election and that Covid vaccines can destroy virility. Procrastination has been replaced by climate urgency.

Hundreds of thousands of action proposals have blossomed, ranging from the arbitrary simple, like culling cow herds, to broad ideological views, like promoting negative growth. Much like climate change denial was rejecting sound science, the current policy wave often ignores economic principles. In both cases precious time is lost and much money is being wasted. This is bad, because failing to deliver will not only make climate matters worse, it will also further strengthen populism as is the case whenever the elites go visibly wrong.

Since early work by Nordhaus in the 1970s, economists have understood that there is a simple and all-encompassing solution: adopt an upward sliding carbon tax path and, based on the century-old Pareto principle, use the proceeds to compensate the losers. They have failed to convince the politicians and, more generally public opinions. Instead of making polluters pay, policymakers are now bent to subsidizing them if they reduce pollution. In theory, this is equivalent to a tax, unfortunately it is an impossible task.

Subsidies and budget constraints

To start with, it is mindbogglingly difficult to assert which measures are effective, not to mention how much should be spent on each one of them. In addition, public debts have been allowed to grow to highly uncomfortable levels, so that climate change subsidies face a tight budget constraint. As a consequence, the difficulty of identifying the most effective subsidies triggers a fierce competition among pressure groups, from well-intended do-gooders to self-interested businesses, to capture whatever money is made available. The probability of doing things right is zero, while the probability of spending huge amounts of money is one hundred percent.

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One way to circumvent direct budgetary costs is to take the route of top-down arbitrary interdictions. This is politically attractive as it demonstrates will and promises to eliminate one source of pollution. It usually satisfies a vocal group of advocates while penalizing a diffuse large number of silent people. And it is free, but only apparently.

A good example is the decision announced by the European Union to ban sales of fossil fuel cars after 2035. To make it possible, governments must guarantee the availability of charging stations, for electric vehicles, either through subsidies or through providing them publicly. It is not even sure that the supply of electricity can be increased at sufficient speed. In addition, these vehicles are currently expensive, which may require targeted subsidies to the less well-off. The costs of using such a blunt instrument are unknown, not even acknowledged. The probability that it is an efficient choice is remote.

What exactly ist ESG?

Another approach is bottom-up. It involves supporting interest groups that campaign for voluntary measures. A good example is the encouragement of ESG investments. It is gradually emerging that this approach is fraught with difficulties. The label itself is imprecisely defined. Many firms find it easy to misrepresent their activities in order to qualify for the ESG label. More fundamentally, there is no evidence that non-ESG investment is being weakened, at least enough to effectively constrain brown activities.

Recently, large financial institutions that initially spearheaded the effort have retreated. More generally, it is likely that profitable brown productions will always find enough investors to carry on. Adopting green communication is seen currently as good marketing for businesses, but it remains to be seen whether it is more than that. A good bet is that potential customers will not be swayed durably. Already, the hardening of some green advocacy groups, including the spoiling of masterpieces in museums or blocking traffic, is generating a backlash.

Economists find themselves in a difficult position. Advocating again and again a carbon tax has failed so far. Supporting clever subsidies is attractive, but clearly not enough. The next step is to identify the most effective objectives at any point in time. This is a highly complex task. It consists in estimating the costs and benefits of a myriad of measures over the very long run, looking not just at direct effects but also at indirect effects, accompanying measures, and the chain of behavioral reactions by firms and households.

Incalculable innovation

Another major difficulty is to factor in technological innovation, which stands to make current calculations obsolete and matters greatly for the proper implementation sequencing. One clear risk is to go wrong and to waste both time and resources. Another risk is to be captured by interest groups, often without being aware of it. In addition, developing new programs systematically involves expanding the size of the administration, a cost which is rarely evaluated ex ante.

In addition, the financing of subsidies is a daunting challenge. Calling for more public indebtedness is logical since fighting climate change is a long-term investment likely to have a high return, if it is well designed. But that is not guaranteed and probably unreachable. Years of debt buildup is a reminder that governments often use this argument to defend subsidies that are found afterwards to have been unjustified. Piling up further deficit financing may one day turn out to have been a historical mistake.

Fortunately, in Europe at least, carbon taxes are quietly on the rise through permit exchanges and, hopefully soon, border tax adjustments. Hopefully, the combination of visible effects of these taxes and of the strain from financing doubtful subsidies will gradually shift policymakers' views.

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