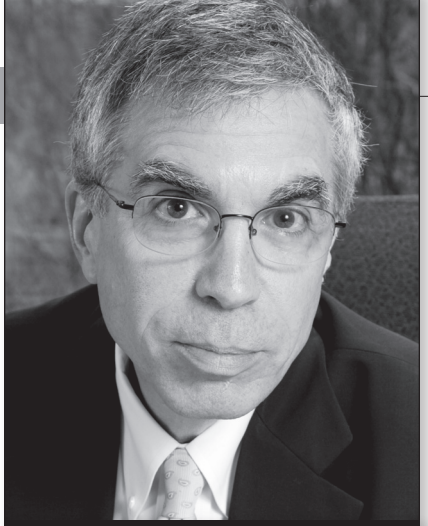
Cap-and-Trade: How California Can Lead on Climate Policy



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The past year has been a crucial time in international climate negotiations. In December in Paris, negotiators established an agreement on the next round of targets and actions to succeed the Kyoto Protocol, which was signed in 1997 and will effectively close down in 2020. Negotiators set up a new and meaningful agreement for multinational action through individual country Intended Nationally Determined Contributions. The Paris round was crucial, because it expanded the coalition of contributions from countries responsible for 14 percent of global emissions under Kyoto (Europe and New Zealand) to 187 countries responsible for 96 percent of emissions.

California sent a delegation to the Paris talks. While not officially a party to the negotiations, government officials from Sacramento attended to show support for broad and meaningful action. For many years, spurring action beyond the state's borders has been the key rationale for developing a California-based climate policy.

This began 10 years ago with Assembly Bill 32, the Global Warming Solutions Act of 2006. Initially, the focus was on encouraging action within the United States, including federal legislation, state-level action, and multi-state compacts, but subsequent domestic response turned out to be much less than anticipated. As a result, California's focus shifted to the international domain.

This is a good time to consider how the state can best demonstrate leadership on this global stage. Action by all key countries, including the large emerging economies — China, India, Brazil, South Korea, and South Africa — will be necessary to meaningfully address the climate problem. Significant multinational contributions will be necessary to avoid having California's aggressive in-state actions be for naught. Absent such multilateral action, ambitious state policies do little or nothing to address the real problem.

But California can play a very important role by showing leadership, in two key ways. One is to demonstrate a commitment to meaningful reductions in greenhouse gas emissions. In this regard, California has more than met the bar, with policies that are as aggressive as — if not more aggressive than — those of most countries.

The other way is to show leadership regarding how reductions of GHG emissions can best be accomplished — that is, in regard to progressive policy design. California has a sophisticated GHG cap-and-trade system in place, which, while not perfect, has many excellent design elements. Countries around the world are now planning or implementing cap-and-trade systems, including in Europe, China, and South Korea. These countries are carefully watching decisions made in Sacramento. California's system, possibly with a few improvements, could eventually be a model for even larger systems in other countries.

The state's system could be a model for even larger systems in other countries

Unfortunately, California's climate policy has not relied heavily on its cap-and-trade system to achieve state targets. Furthermore, rather than increasing reliance on this innovative market-based climate policy over time, recent proposals have doubled-down on the use of less efficient conventional policies to achieve GHG reductions. While some of these so-called "complementary policies" can be valuable under particular circumstances, they can also create severe problems.

An example of this is the attempt to employ aggressive sector-based targets through technology-driven policies, such as the Low Carbon Fuels Standard. In the presence of the cap-and-trade regime, the LCFS has the perverse effect of relocating carbon dioxide emissions to other sectors but not reducing net emissions — at the same time driving up statewide abatement costs and suppressing allowance prices in the cap-and-trade market, thereby reducing incentives for technological change. That is bad news all around. These perverse outcomes render such policies of little interest or value to other regions of the world.

While reduction in transportation-sector emissions is clearly an important long-run objective of an effective climate policy, if the approach taken to achieving such reductions is unnecessarily costly, it will be of little use to most of the world. Most countries have much less financial wealth than California, and will therefore be much less inclined to follow the lead on such expensive policies.

With China now the largest emitter in the world, and India and other large developing countries not very far behind, policies that achieve emission reductions through excessively costly means will fail to encourage other countries to follow. On the other hand, by increasing reliance on its progressive cap-and-trade system, California can succeed at home and be influential around the world.

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