

# Organizing emissions trading: the barrier of domestic permit allocation

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## Abstract

This paper uses a barrier model of politics to analyse the issue of permit allocation as a major political obstacle to organizing (inter)national greenhouse gas emissions trading. It is argued that permit allocation constitutes a barrier, because — among other things — various types of emitters have conflicting interests in trying to lobby for as much allocated permits as possible and because international differences in domestic permit allocation procedures are perceived to potentially distort inter-firm competitiveness relations. Permit allocation is circumvented by applying intergovernmental or project-based emissions trading. The project-approach is preferable, in particular because it avoids the trading of ‘hot air’. © 2000 Elsevier Science Ltd. All rights reserved.

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## 1. Introduction

The Kyoto Protocol (1997) to the Framework Convention of Climate Change (FCCC) contains legally binding greenhouse gas (GHG) emissions targets for developed countries. If the Protocol will be ratified, these so-called Annex B Parties shall individually or jointly reduce their overall GHG emission level by at least 5% below 1990 levels in the commitment period 2008–2012 (Protocol Article 3.1). To reach this level Annex B Parties have adopted differentiated Quantified Emission Limitation or Reduction Commitments (QELRCs), such as a 7% reduction for the United States and a 8% reduction for the European Community.

To meet these commitments Annex B Parties may engage in international emissions trading (Protocol Article 17). International emissions trading could lower the costs of reducing emissions since the marginal costs of reducing GHG emissions differ between countries (e.g. Kram and Hill, 1996). An Annex B Party which will emit more than its assigned amount is allowed to buy GHG emission reductions from an Annex B Party which will emit less than its assigned amount. The emission

reduction titles from emissions trading a Party acquires (/transfers) from any other Party shall be added to (/subtracted from) the assigned amount for the acquiring (/transferring) Party (Protocol Articles 3.10 and 3.11). The principles, modalities, rules and guidelines for the trading of assigned amounts are not defined under Article 17. Decisions on the design of an international emissions trading market, in particular on verification, reporting and accountability of emissions trading, will be taken at a future session of the Conference of the Parties (CoP). At CoP4 (1998) in Buenos Aires the Parties drew up a work programme, the ‘Buenos Aires Plan of Action’, which was reinforced at CoP5 (1999) in Bonn, with a view to taking decisions on international emissions trading (and the other Kyoto mechanisms) at CoP6 in The Hague in November 2000.

Several authors have argued that the Parties should allow firms to trade GHG emission reductions directly by developing domestic permit schemes, which could eventually be connected to create an international permit market (e.g. Zhang and Nentjes, 1999). Organizing such (inter)national permit trading schemes inevitably raises the political question of how the allowances should be allocated. Also if Parties would decide to limit the elaboration of Protocol Article 17 to intergovernmental emissions trading, the issue of permit allocation is not necessarily avoided because sovereign states would still have the authority to establish domestic permit trading

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markets. This necessitates governments to carefully think about domestic permit allocation and its possible international coordination.

This paper analyses the issue of permit allocation as a political barrier to the establishment of (inter)national emissions trading schemes. It is argued that permit allocation constitutes a barrier, because — among other things — emitters have conflicting ‘zero-sum’ interests in trying to lobby for as much allocated permits as possible and because international differences in domestic permit allocation procedures are perceived to potentially distort inter-firm competitiveness relations. The analysis will be performed on the basis of a model which pays particular attention to the existence of barriers in the political process.

In particular, in this paper we will try to find answers to the following questions with respect to domestic permit market design in relation to international emissions trading. What conditions must be satisfied to form an international permit market? Who will receive the permits and how will they receive them? What are the distributional implications attached to these design options? Can governments enhance the international competitiveness of their industry by assigning permits? Do domestic permit allocation procedures have to be harmonized internationally? And is it possible to overcome the political problem of permit allocation?

The article is organized as follows. Section 2 briefly sketches a barrier model of politics as a framework for the analysis. Section 3 focuses on the barrier of permit allocation in the decision-making process. Sections 4 and 5 present an overview of the possible consequences with respect to several options and requirements of (inter)national emissions trading design. Section 6 determines the nature as well as the extent of the barriers with regard to deciding on a domestic permit allocation method. Section 7 concentrates on the interaction between design and allocation choices from the perspective of the end-user compensation principle of equity. Section 8 provides a theoretical assessment of the arguments and counterarguments used in the debate on international harmonization of domestic permit allocation. Section 9 discusses the possibilities to overcome the barrier of

permit allocation. Finally, it is concluded in Section 10 that project-based emissions trading is probably the most cost-effective and environmentally sound way to overcome the barrier of permit allocation associated with (inter)national firm-to-firm permit trading.

## 2. A barrier model of politics

The barrier model of politics by Woerdman (1999a), the so-called ‘interaction model’, distinguishes both conflict and stability in the interaction between society and government with respect to policy-making. According to this model (see Fig. 1), the political process roughly consists of three stages: agenda-building, decision-making and policy-implementation. Besides the public support for the political system (which is necessary for its ‘survival’), society presents its preferences to the government, which — in its turn — takes a decision, whereas the administration implements the policy. Drawing upon the work of Easton (1965) and Jones (1970), for instance, this process is not so much linear, but should rather be viewed as a cycle in which society and government interact. Next to an internal policy assessment within the administration, society in particular evaluates the consequences of the implemented policy (output), adjusts its preferences accordingly and presents them to the government again (input) leading to additional decision-making (conversion).

However, this barrier model (Woerdman, 1999a) also recognizes the possibility of delay in or even blockage of the political process. Drawing upon the work of Lindblom (1959) and Bachrach and Baratz (1962), among others, the three stages of the political process can be seen as potential barriers to policy-making. Firstly, powerful actors or society’s political culture, for instance, could prevent that certain issues enter the political agenda. Secondly, democratic decision-making in pluralistic societies typically requires cooperation and compromises between various actors which are characterized, however, by conflicting interests and values on the ends and means of an intended policy. Thirdly, the implementation of the decisions taken, if any, could be hindered, for example, by

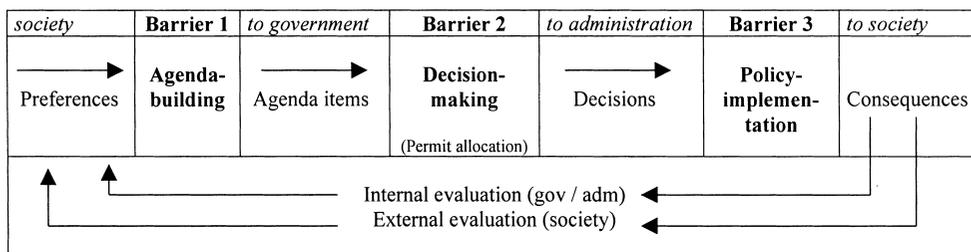


Fig. 1. A barrier model of politics. Based on the ‘Interaction model’ (Woerdman, 1999a: 71).

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