

Comments on “Instrument Choice is Instrument Design”

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Three Issues to Contemplate

- Targeting prices vs. targeting quantities
- Taxing/limiting production vs. taxing/limiting consumption
- Technical purity vs. political economy



Conclusion I Agree with

Concerning the Debate Between Carbon Taxes and Tradable Permits:

“The gains from improving the design of these systems likely massively outweigh the gains from the choice of instrument”



Prices vs. Quantities

- Not same as tax vs. permits
 - Permits with price floors and ceilings could function a lot like a carbon tax
 - Virtually any design issue could be replicated in either system
- Need to ask what is our objective
- We confront this choice in many contexts
- Pros and cons of each



Measures of Success

<u>Target</u>	<u>Climate Policy</u>	<u>Costs</u>
Inputs	CO2 emissions	Higher prices
Outputs	CO2 PPM	Less energy use
Direct Outcomes	Climate change	Distributional effects
Wider Outcomes	Global economy; health	GDP, economic efficiency



Price vs. Quantity Targeting Choices are Pervasive

- Monetary Policy
 - Target money stock or interest rate
- Government spending
 - Entitlements (cost risk) vs. discretionary (quantity risk)
- Planning for this talk
 - Time budget (quality risk)
 - Quality target (cost risk)



Criteria for explicit targets

- Elasticity of loss function (Weitzman)
 - Favors price target for climate change: MB of emission reduction curve flatter
- Which target is easier to change (q?)
- What can be used to measure progress
 - Quantity reductions better
 - But outcomes hard to measure regardless of targeting
- Targeting the “good” instead of the “bad” (tax reform example)
- Efficiency vs. cost-effectiveness (Dinan, NTJ paper)
 - Efficiency implies price targeting
 - But achieving the cheapest way of getting a specified quantity reduction may involve a combination of P/Q targets.
- A subversive thought – should large sources be targeted explicitly?



Production vs. Consumption

- Much literature treats this as closed economy so it doesn't matter
- But in open economy production does not equal consumption in any jurisdiction
- Consumption should be the target
 - But production sources easier to monitor
- Analogy to corporate taxation



International Harmonization

- Tax harmonization
 - Tax would be source-based unless border adjustments feasible (producing countries capture rents)
 - What happens if country fails to collect?
 - Revenue loss depends on how much domestic production displaced by “rogue” firms
- Quantity harmonization
 - “Tax” would still be source-based because refiners/utilities would have to buy permits
 - But “rents” could be distributed per capita
 - Failure to enforce would help domestic firms, with no revenue loss



Analysis and Political Reality

- “Analysts can only help by making arguments on the merits rather than guesses about political acceptability”
 - Technicians design optimal policies
 - Then try to sell it
- Risks of opposing viewpoints
 - Risk of being irrelevant
 - Risk of rationalizing everything politicians do
 - Limited to drafting legislation and estimating revenues
 - Where to locate?



Climate Change an Unusual Issue

- No visible costs of it yet
 - Strong political influence of “deniers”
- Policies will forestall costs, not produce visible benefits
- If perceived costs of inaction very high, important to assess policies based on likelihood of acceptability
 - Can gains from policy be made visible?
 - Will short-term economic harm (real or perceived) cause climate policies to be scrapped?



Some Implications

- Instead of debating tax vs. permit, focus on how best to design permit system
 - Auctioning instead of giving away
 - Choosing price caps and floors
 - Banking rules
 - Adjusting allowances over time
 - If unilateral, how to do border adjustments
 - If worldwide, many other issues

