# Emissions trading – if it's broke, fix it, don't ditch it

**By Stephen Boucher**

A YEAR on, the EU emissions trading scheme (ETS) is running into teething problems. Prices have fallen abruptly from more than €30 per tonne of carbon dioxide ($CO_2$) to less than €10. Business complains that the scheme harms the competitiveness of EU industry, while non-governmental groups (NGOs) argue that it should be stricter. Concluding, however, that the system is a failure would be a mistake.

Behind the collapse in the price of credits lies a simple economic rule: the number of allocations granted by EU member states to industry exceeds their reduction goals. In fact, through a combination of conservative baseline estimates and generous allocations, all but five EU member states over-allocated $CO_2$ credits. Three key lessons can be drawn.

First, member states need to get serious about the scheme, which covers some 45% of EU $CO_2$ emissions. They should improve their measurements and reduce the number of credits handed out. And the European Commission should be stricter in rejecting slack national allocation plans.

Second, this "learning by doing" phase should not detract from the fact that the market is functioning: companies received sudden information about credits and rationally adapted their buying and selling strategies. Such market volatility, as evidenced by the equivalent but earlier US $SO_2$ scheme, is a growing pain that will gradually lessen. The EU ETS has become the leading carbon market in the world. It accounted for €7.2 billion out of global carbon market transactions worth €9.4 billion in 2005.

Third, national monitoring and reporting of emissions should be more frequent and further harmonised. Spot-checks on reports of emissions would help raise the standards of national verifiers. Unlimited banking, which allows credits to be transferred from one accounting period to another, will be allowed as of 2013. This should be extended to current trades.

If Europe really wants to prepare its industry for the fight against global warming, member states should also expand the scheme's coverage to new sectors and other greenhouse gases, where efficient. As expressed by a Commission expert who gets more visitors from around the world to study the system than he can meet, "a global carbon market may emerge out of all these 'bottom-up' initiatives rather than a 'top-down' international approach". The EU should therefore engage in a strategy to export the scheme, by talking to other initiatives – in Norway, Canada, Switzerland, a number of Australian states, and some states in the northeastern part of the United States – in order to ensure that they are compatible.

More generally, the EU ETS proves that international regulation through market-based mechanisms works. The Commission and national authorities should consider applying market-based instruments to other international policy problems, such as water pollution, the promotion of renewable energy and emissions of other chemical pollutants. The time has come to fix the EU ETS, not ditch it.

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