MICROECONOMICS AT WORK EXERCISE

EXTERNALITIES AND THE MARKET SYSTEM

REFERENCE: 'Traders of nothing' (by Craig Saunders), *Australian Financial Review*, January 18-19, 2003, pp.45-6.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 2, 15.

OVERVIEW

A classic form of negative externality is that of carbon emissions – popularly referred to as pollution (p.345). Among the remedies for pollution is the use of the market to limit pollution and help achieve certain standards (pp.355–6). This article is about *emissions trading* as a mechanism for lowering pollution – trading in both *permits* to create a certain amount of pollution, and in *credits* for *not* doing so. Such a market is established when government in some form establishes mandatory standards but at the same time permits emissions trading. The adoption by the majority of countries of standards established by the Kyoto Protocol is significant (and will in fact establish a *global* market in emissions trading), but even in the US (which does not support the protocol) standards set by the US Environmental Protection Agency have resulted in a system that allows the trading (buying) of permits to pollute on the one hand, and on the other allows organisations to obtain *credits* when their efforts exceed the minimum requirements. Companies have emerged as emissions 'brokers', facilitating trade in carbon emissions – allowing some firms to *buy* rights to pollute, others to *sell* their success in *not* polluting. A good deal of trading in the US economy at the moment occurs in the *expectation* that the US will at some stage become party to some form of international agreement and commit itself (and its corporations) to meeting minimum standards. Such trading can be seen as an exercise in preparation for when it will be necessary – in 'learning how to do it'. The essential point is, however, that whatever the standard and however it is imposed (or agreed upon, or accepted), a *market* is created – whether it be in pollution or in *non-pollution* (i.e. 'nothing') .

QUESTIONS

1. Explain the notion of 'carbon emissions trading'.

2. What is the role of the 'Kyoto Protocol' in the establishment of an emissions market?

3. Why has emissions trading taken place even before the Kyoto Protocol has come into force?

4. What is meant by the concept of 'pollution reduction' as a 'major industry'? Do you think that pollution reduction would be a good business to develop?

5. What are the pros and cons of a company building up a bank of emissions credits?

6. How does emissions trading serve to encourage a reduction in pollution?