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Headline: The right incentives for a low-carbon future

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BERLIN—The climate agreement that world leaders reached in Paris last month has been widely celebrated for establishing the ambitious target of limiting the increase in global temperature to well below 2 degrees Celsius above preindustrial levels. But the agreement is just one step, albeit an important one. Policymakers now must figure out how to achieve this goal—no easy feat, especially given that, contrary to the conventional wisdom, steadily rising costs for conventional energy cannot be counted on to propel the necessary shift toward a low-carbon future.

At first glance, the logic of negative economic incentives seems sound. If, say, driving a gas-guzzling car becomes more expensive, people will presumably be less likely to do it. But the impact of changing fuel prices is partial and delayed. While drivers may purchase a more fuel-efficient car in the long run, they are more likely, in the shorter run, to reduce other kinds of consumption to offset the rise in cost. When it comes to resolving a problem as urgent as climate change, John Maynard Keynes' famous dictum—"In the long run, we are all dead"—clearly applies.

Moreover, even if consumers did respond efficiently, fossil-fuel prices are dictated largely by heavily financialized markets, which tend to be extremely volatile. The sharp decline in oil prices over the last 18 months is a case in point. Not only have oil prices themselves failed to spur a reduction in consumption; they have also undermined incentives to develop alternative energy sources. Investing in, say, solar power may have seemed worthwhile when oil cost $100 per barrel, but it looked a lot less appealing when the price dropped below $50.

Conceivably, policymakers could raise taxes to offset such declines. But such hikes sometimes—like now—would have to be huge, and adopting erratic policies that mirror the volatility of the market is never a good idea.

Carbon pricing could experience a similar fate. In the European Union, carbon prices have been low for several years, and for now market participants seem to be following the herd in believing that they will remain so. But there is no guarantee that free emissions trading will not function like other financial markets, producing sharp fluctuations in carbon dioxide prices. Should expectations suddenly change, the herd might turn and run in the opposite direction, causing carbon dioxide prices to soar.

Yet another problem with the price-based approach to mitigating climate change is that it fails to account for markets' potential to create perverse incentives. When the cost of conventional energy rises, new suppliers see an opportunity; thus, before June 2014, when oil prices were high, investors poured resources into developing shale oil and gas in the United States. The additional supply, however, ultimately causes prices to fall, reducing the incentive to invest in alternative energy sources or energy efficiency. This is a normal market reaction, but it does not advance the fight against climate change, which would require steadily rising costs.

The final reason negative incentives alone are inadequate to mitigate climate change may be the most irrational: After some years of rising taxes, the public is staunchly opposed to any policy that may increase energy prices, regardless of whether current prices are high or low. People are so convinced that energy costs are "exploding," despite the recent oil-price collapse, that any new

project implying even slightly higher prices—even if overall energy prices are still lower than they were five years ago—is now exceedingly difficult to initiate.

The implication is clear: When policymakers get to work designing strategies for executing the Paris agreement, they should not rely heavily on rising energy costs to advance their objectives. A strategy that assumes that the market will punish those who do not invest in a low-carbon future is not realistic.

A better approach is possible: Directly reward those who do invest in a low-carbon future, whether by enhancing energy efficiency or developing clean energy sources. For example, governments could implement accelerated depreciation schemes for investment in low-carbon businesses; offer subsidies for investment in energy-efficient buildings; and create policies that favor industrial innovation aimed at reducing emissions and boosting competitiveness. All of this would make fossil fuels less attractive to both investors and consumers.

While an approach based on such positive incentives would be costlier than tax hikes in the short run, the long-term benefits can hardly be overstated. At a time of strong resistance to higher energy costs, this may well be among the most effective—not to mention politically savvy—mechanisms for advancing the goals set out in Paris. Project Syndicate

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