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## CHAIRMAN'S BACKGROUND DOCUMENT 4

### **Subject: International Competitiveness and flexible mechanisms**

4. The implementation of the Kyoto Protocol targets will impact industry, as all other economic and societal actors (consumers, workers, etc.) and sectors. European industry has raised concerns, that emission trading and other flexible mechanisms, based on an absolute cap (or target), could hamper international competitiveness of energy-intensive European companies. Furthermore, some believe a consequence could be that some companies choose to shift production or even relocate. This would trigger job losses within the EU and undermine the environmental objectives of the Kyoto Protocol.
  - 4.1 The main issue on which Working Group 1 needs to focus is whether emissions trading makes such undesired effects at company, sector, Member State, or Community level more or less likely to occur, in comparison with other policies and measures which the Community could use to implement its (absolute) Kyoto commitment. Obviously, one needs to keep in perspective the targets and instruments competing businesses in other Annex B countries are faced with. Furthermore, it is a fact that for the time being only industrialised (Annex B) countries have accepted commitments to limit or reduce greenhouse gas emissions.
  - 4.2 Absolute inflexible caps do not apply 'individually' at company or plant level, but only 'collectively' to all emission sources covered by a trading scheme. Individual companies can and should have plenty of flexibility to meet this collective target. This is to say the (absolute or relative) number of permits given to or bought by a company at the start of a permit scheme, does in no way compel the company to limit its emissions to exactly this level. A company or plant rather has the choice to emit more or less than that amount, as long as it surrenders a sufficient number of permits to cover the actual emissions over a compliance period.
  - 4.3 A well designed emissions trading scheme will ensure that emission reductions are undertaken where they are cheapest. Other things being equal, emissions trading (as an economic instrument) makes the cost-effective (minimum cost) sharing of actual reduction responsibilities more likely than alternative less flexible policies and measures.

- 4.4 With regard to the concern that climate policy may result in shifts of production to facilities outside the EU a number of aspects need to be taken into account. Most of foreign direct investment over the last decade flowing out of the European Community has gone to other Annex B countries, i.e. those that also face absolute targets under the Kyoto Protocol. This is in spite of the fact that levels of taxation, and energy and labour costs are typically higher in developed than in less-developed countries. Hence, if concerns about migration are valid, we should already be detecting such patterns. So far we have though no evidence from our constant monitoring of economic activities and developments.
- 4.5 Maintaining and strengthening international macroeconomic competitiveness calls for policy decisions to adhere to the principle that the prices of resources (capital, labour) reflect their value to society so that they are allocated in a way which achieves the proverbial “greatest good for the greatest number”. An economic instrument like emission trading creates continuous incentives for businesses to seek cheaper reductions and strive for an optimal resource allocation.
- 4.6 Businesses are faced with a constant need to adjust, because of many factors like technological change (IT revolution) or changes in consumption patterns, to cite only two prominent examples. Climate policy adds another factor to this set. Furthermore, such adjustments provide as many opportunities as risks to business and society at large.
- 4.7 **Conclusion:** The above induces us to conclude that emission trading will in practice have less effect on international macroeconomic competitiveness, if any, than many other policies and measures to achieve a given climate policy objective. In fact, emission trading and other flexible instruments can be a solution to the challenge that to maintain competitiveness while still implementing the Kyoto Protocol.