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The Advantages of the Division of Labor also Apply to Economic Policy: The Green New Deal

Even in times of the corona pandemic, environmental and climate protection are among the dominant topics in the economic policy debate. This is justified. Global warming is one of the greatest challenges of our time. Tackling it requires a transformation of the economy. CO₂ emissions must be reduced, and we need to adapt to the climate change that has already occurred or will occur despite all efforts. European policy-makers have set out to drive this transformation under the banner of the Green New Deal. The objectives of the Green New Deal are shared by a large majority of the population. But it is controversial how and with which instruments these goals should be pursued. There are two opposing concepts. One sees climate protection primarily as a task for environmental and energy policy. Targeted regulations, taxes and new infrastructures should ensure that CO₂ emissions are reduced. The other concept calls for all policy areas to be geared to climate protection. This approach is becoming increasingly popular. In particular in financial market regulation and monetary policy, there is currently an intense debate about an orientation towards climate protection.

Which Concept is Preferable?

To clarify this, it is important to understand what the first approach, which focuses on environmental and energy policy, can achieve. The focus here is on CO₂ pricing, especially the European CO₂ emissions trading system ETS. Anyone who emits greenhouse gases is required to buy emission permits. The overall quantity of available permits is reduced every year in line with climate protection targets. This works if all sectors of the economy are covered. So far important sectors, in particular road transport and buildings, have been excluded. In addition, a rising CO₂ price may put a high burden on many households and businesses if no complementary measures are taken. If petrol becomes significantly more expensive, people living in rural areas, for example, who depend on their cars, will need alternatives. These alternatives could be a more developed public transport system or affordable electric cars. However, electric mobility will only work if the infrastructure is properly developed, with charging points, more efficient electricity grids than we have today and a reliable and climate-friendly energy supply. High CO₂ prices can also affect the competitiveness of European companies in domestic and international markets if other countries price CO₂ lower or do without climate protection altogether. This is where compensation measures are needed. There are also areas where CO₂ price signals work imperfectly or not at all. One example is building insulation in rented housing. If rents are regulated and

landlords are not allowed to pass on the costs of insulation to tenants, but the tenants benefit from reductions in heating costs, the CO₂ price signal is not sufficient and additional support is needed.

CO₂ Pricing Alone is Not Enough

All of this implies that CO₂ pricing alone is not enough. It needs to be complemented by infrastructure investments and other measures. Nevertheless, CO₂ pricing should be the core of climate policy. Further measures should always be coordinated with it. The main advantage of this climate policy instrument is that CO₂ is saved where it can be saved at the lowest cost. Sector-specific regulations such as CO₂ ceilings for car fleets can and should then be avoided. CO₂ pricing intelligently combines government regulation with innovation-friendly and cost-efficient market processes.

Currently the European Green New Deal policy is much broader. It extends climate policy to many other policy areas. This process is particularly advanced in financial market regulation. Here the EU has decided that in future all economic activities will be classified administratively according to whether they serve climate protection or not. This classification is done in the so-called 'Sustainable Finance Taxonomy', which is a comprehensive list of activities classified as 'green'.

Goals of a Sustainable Finance Taxonomy

To date, an expert group has identified and described 70 activities that counteract global warming and a further 68 activities that promote adaptation to climate change. This list is to be continuously expanded. Further lists on other sustainability issues will be added later. Why this taxonomy? For the time being, it is only intended to provide more transparency and information. Companies will be obliged to report on the basis of the taxonomy what proportion of their activities can be classified as 'green'. This is intended to help investors who want to put their money into climate-friendly projects. There are already certifications and quality seals for sustainable investments. However, they are not considered to be reliable and informative enough. Whether this will be improved by adding another complex list and extensive bureaucracy remains to be seen. It is unlikely however that this policy will remain a mere provision of information. There are already demands on the table to privilege activities classified as green by a 'green supporting factor' in banking regulation. The European Banking Federation has called for laxer capital requirements for banks financing green investments.

A Central Planning Approach

What should we think of this? The basic problem lies in the fact that the taxonomy is ultimately a central planning approach, an attempt to divide economic activities administratively into 'green' and 'non-green' and to steer capital flows accordingly. This could do more harm than good. Firstly, economic reality is too complex and dynamic for such management. Innovations constantly generate new economic activities not covered by the taxonomy. Secondly, opinions can differ widely as to which activities are helpful in terms of climate policy and which are not. The production of modern, fuel-efficient combustion engines and the construction of new nuclear power plants can contribute to climate protection, but whether these activities are to be promoted as 'green' is likely to be controversial. Thirdly, it is neither sensible nor necessary to try to promote activities that serve climate protection in this way. It is much easier and more targeted to burden climate-damaging behaviour by pricing CO₂ emissions. If this is achieved, further support of green activities may lead to efficiency losses without any contribution to climate protection. This happens when the amount of total CO₂ emissions is given by the quantity of ETS permits. Additional subsidies for investments saving CO₂ emissions will then only result in CO₂ permits becoming cheaper. This will induce industries which do not receive the subsidy to invest less in CO₂ reduction. As a result, the subsidy fails to reduce overall CO₂ emissions and increases the cost of achieving the climate target.

What Financial Market Regulation can Contribute

Does this mean that financial market regulation should ignore climate change? Not at all. If insurance companies or banks are threatened with losses because global warming will lead to more hurricanes or storm surges, then financial supervision needs to ensure that provision is made for these risks. The same applies to the risk that certain business models will no longer work because of climate change or CO₂ pricing. Those who finance coal-fired power plants should prepare themselves for the fact that the investment will have to be written off if rising CO₂ prices drive this technology out of the market.

As climate risks can build up over long periods of time, financial supervisors should also look at how banks and insurance companies ensure that their managers have a sufficiently long-time horizon. However, taking these risks to financial stability into account is different from trying to channel capital directly into uses classified as green. In particular, the call to allow banks to operate with less equity when

financing green projects should be rejected. The idea of the green supporting factor is reminiscent of the 'social supporting factor' policy in the US, which has led banks to give mortgages to people who cannot afford them. These subprime loans ultimately led to the global financial crisis of 2008. We should not repeat this mistake with the Green New Deal.

Is Climate Change a Task for Monetary Policy?

Financial market regulation is not the only policy area increasingly geared towards climate policy. ECB President Christine Lagarde, who is actually responsible for monetary policy, has announced that she wants to explore every available way in which the ECB can also contribute to climate protection. Here, similar problems arise as with financial market regulation. To actively channel capital flows with monetary policy instruments into climate-friendly economic activities would do more harm than good, in particular if these activities are already covered by CO₂ pricing. The instruments of environmental policy are more targeted.

This does not mean that climate change should play no role for the ECB. It is important that central banks consider the consequences of global warming and climate protection measures on economic development, financial market stability, the effectiveness of monetary policy instruments and thus also price level stability in their analyses. The right conclusions for monetary policy need to be drawn from this. When buying corporate bonds, for example, it should be taken into account that climate change entails growing risks for certain business models. But taking this into account is quite different from providing targeted financial support for activities classified as green.

The ECB is currently being accused of undermining climate protection with its monetary policy instruments, particularly through its corporate bond purchases. Mainly large companies finance themselves through such bonds, including companies with high CO₂ emissions. It is true that monetary policy should avoid privileging certain sectors over others, and it should be investigated whether the current policy deviates from this objective. However, concluding from the bond purchases that the ECB currently prevents climate protection seems premature. First, whether companies that finance themselves through bonds contribute more or less to climate protection on average than smaller companies is an open question. Second, the ECB not only buys corporate bonds, it also provides cheap liquidity to banks, which use it for lending. This means that small companies, which finance themselves more through banks, also benefit from the ECB's liquidity provision.

As far as the supply of liquidity to different sectors of the economy is concerned, the central bank should ultimately be neutral. This is only possible to a limited extent. Interest rate cuts, for example, necessarily benefit capital-intensive sectors more than less capital-intensive ones. However, this does not imply that the ECB should pursue policy objectives outside monetary policy by channelling investments into specific uses.

In this context one should also note that the independence of the ECB should be accompanied by a correspondingly narrow interpretation of its mandate. Climate protection is a highly political issue. For example, the contribution of nuclear energy or the role vehicles with combustion engines may play in the future, are highly disputed. A steering of capital flows by the ECB would have to take decisions on these issues that are reserved for parliaments. From a purely legal point of view, the ECB's mandate is to support the objectives of the European Union, provided that this does not jeopardise price stability. But this does not mean that the ECB should intervene in or reinforce policy decisions made by governments as it sees fit. The EU has many objectives - besides protecting the environment, these include, for example, technical and scientific progress and social security. But the ECB would not come up with the idea of specifically promoting research projects or the expansion of the welfare state. Such interventions would be arbitrary, calling into question the independence of the ECB in the long run. Occasionally it is also claimed that parliaments and governments in Europe are not doing enough for climate protection, so the ECB is needed. This argument is deeply undemocratic. If governments and parliaments decide not to do certain things, not everybody may agree, but it is not the task of the central bank to correct such decisions at its discretion.

Political Intervention With a Sense of Proportion

In a market economy, it is primarily private investors who decide on the uses to which capital is put. There are good reasons for this. Private investors have incentives to take care that capital is invested where it generates the highest returns, because they are liable for it. However, costs of pollution must be charged to the polluters, otherwise private investment decisions are inefficient. In the case of global warming, the best instrument for this is the CO₂ price. If, on the other hand, lists put together in political negotiations determine which activities are financed, this can only lead to an expensive misuse of capital. The experience of planned economies shows this. Central planning by the government usually fails to provide proper incentives to ensure the best possible use of capital, and it lacks the relevant information because that information is scattered

among the individual market participants. Instead, there is a risk that special interest groups will push through their objectives under the banner of environmental policy, at the expense of the common good.

Given the tremendous importance of global warming, it seems obvious at first glance to call for all policy areas to be geared towards the goal of climate protection. But that is counterproductive. To make the Green New Deal project a success, policymakers should combine targeted policy intervention with market-based processes in such a way that a consistent overall strategy emerges. In this context, environmental policy should provide guidance with the CO₂ price. The other policy areas should integrate climate policy to the extent that it affects their respective core tasks, but they should not compete with environmental policy in fighting global warming.

There are now even calls for competition policy – a core competence of the EU – to be geared towards climate policy goals. Competition Commissioner Margarethe Vestager recently reacted to this as follows: "We won't be competing to win 'applause, by single-handedly making Europe green. Instead, we want to find the right place in the team". That is diplomatically put. In plain language this means that it is popular to claim that one joins the fight against global warming. But competition policy has other important tasks. Combating global warming is important, but it will not work better if all policy areas make it their priority. Division of labour and clearly distributed responsibilities lead to better economic policy even in times of climate crisis.

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