# A Free Market Clean Sweep for the Climate Policy Mess

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*By Pieter Cleppe, Editor-in-chief of Brussels Report, and Rod Richardson, President of the Grace Richardson Fund*

**Across Europe, opposition to the EU's climate policies is on the rise, due to the exorbitant cost. Many of those policies are laid down in the "European Green Deal", a wide ranging series of proposals put forward by the von der Leyen Commission**

From a "European climate law" with more stringent CO2 emission reduction targets, to a new central planning regime for agriculture dubbed the "Farm to Fork" strategy, plus an added layer of product regulation with the "Circular Economy Action Plan," to new regulation imposing mandatory renovation of buildings. In case that is not enough, the newly proposed "nature restoration law" comes with yet another round of restrictions on where one can build.

On top of that, an increasingly burdensome European Emission Trading System has provoked lawsuits from member nations such as Poland. Yet because the ETS both harms EU competitiveness, and results in carbon leakage (high carbon manufacturing merely relocates to other nations) the Commission demands a Carbon Border Adjustment Mechanism (CBAM) to correct these failings.

Yet nothing could be a greater admission of failure than the CBAM itself. It's advocates argue we need it because of the economic, strategic, and environmental failures of current policies. The Commission is basically admitting that, with these policies, Europe has shot itself in the foot. Their solution? Shoot everyone else in the foot.

**Meanwhile national climate & energy policies have degenerated into a contradictory mess of governments each picking different winners and losers and interfering in markets at every level, with bans, mandates, state sanctioned monopolies, subsidies and punitive carbon pricing schemes, etc.** With the predictable result of higher prices, poor competitiveness, stalled decarbonization and stalled economies. And a terrible strategic disadvantage in the face of Russian aggression.

The key feature of all of this legislation is that it aims to achieve its ultimate goal – protecting nature – by technocratic forcing, that is, by imposing burdens and barriers, regulation, top down control, and of course wealth transfers that rob Peter to pay Paul. (Paul of course being a political crony dressed up in green.)

It's well worth considering not just the mess we're in, but that there is a tried and true alternative, one that does not force, that lifts burdens and barriers, that does not pick winners and losers, that leads to lower prices, stronger competitiveness, and accelerated decarbonization and prosperity.

**In any case, now that central planning, regulation and a punitive approach, with carbon taxes, carbon tariffs and tradable emission duties is losing popular support, EU policy makers should consider a new approach.**

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**An Alternative Approach**

Suggestions from members of the Climate & Freedom International Coalition can serve as a useful guide. This group of economists, think tanks, scholars and policy makers have workshopped a policy framework, The Climate & Freedom Accord, outlining a set of proposals that delineate an international free market climate agreement.

The Accord begins with two logical observations. First, since all our technologies must improve to deliver both net zero and prosperity, then innovation is the essential tool needed to solve climate change. Second, since freedom has been the main driver of innovation acceleration since the Enlightenment, then freedom and free markets are the key policy needed to accelerate the innovation necessary to solve climate change.

**Studies by coalition members show not only that the free-est economies are the cleanest, but that competition itself accelerates decarbonization.** A recent study comparing competitive versus monopoly US power markets finds that competitive power markets are decarbonizing 66% faster than uncompetitive power markets. The reason is easy to understand: competitive markets drive down costs, allow new innovators easier market access, and allow consumers to demand newer, cleaner, cheaper, healthier, more reliable electricity. Monopolies have no economic reason to innovate or care about consumer desires, or cut costs.

Speakers at the Coalition's September meeting did not suggest how to pick better winners and losers. Instead, they pointed out how, historically, technologically neutral US free market policies in the 1980s and 90s (e.g., free trade, supply side tax policies, deregulation of transportation, telecoms, natural gas and power markets, etc.) adopted at a time when climate change was not a public concern, directly led to strong unanticipated emissions reductions across multiple sectors. All by driving innovation.

For example, **free trade** made possible the Japanese-led reduction of global vehicle emissions at the lowest possible cost. **Deregulation** and **tax reduction** unleashed the innovation and capital flows that powered the massive emissions reductions from both the US fracking revolution, and the productivity gains made possible by the PC, internet and smartphone revolutions. It's no accident that Microsoft, Apple, Oracle, Cisco, and all the Silicon Valley start ups that drove these revolutions were able to go public and innovate new business models after the 1980s Reagan tax and telecom reforms.

Another entirely technologically neutral example, accelerated capital expensing, adopted in 1981, was intended to reduce the cost of investment in new property plant and equipment (PP&E), and so spur new investment, jobs and growth, while driving down inflation. It succeeded. But unexpectedly, it also drove the energy efficiency revolution by making energy efficient investments cheaper, and more profitable. It turns out, when policies reduce the cost of new PP&E, that accelerates the adoption of the newest technologies — always cleaner and more efficient than older dirtier tech, which get rapidly phased out. It accelerates efficient innovation. As a result, US emissions declined per capita, and per unit of GDP in this period.

## A Clean Sweep to Accelerate Innovation

Building on lessons learned, the Climate & Freedom Accord proposes a "clean sweep." **Nations would phase out the current distortionary and costly climate policies that impair markets and innovation, and replace them with a free market approach to decarbonization through innovation acceleration.** Liberalization – freeing the people to unleash innovation – means an end to distortionary subsidies, bans, mandates, crony monopolies, state-ownership of enterprise, carbon taxes, tariffs and offset schemes, which all raise prices, cause stagnation and constrict essential investment.

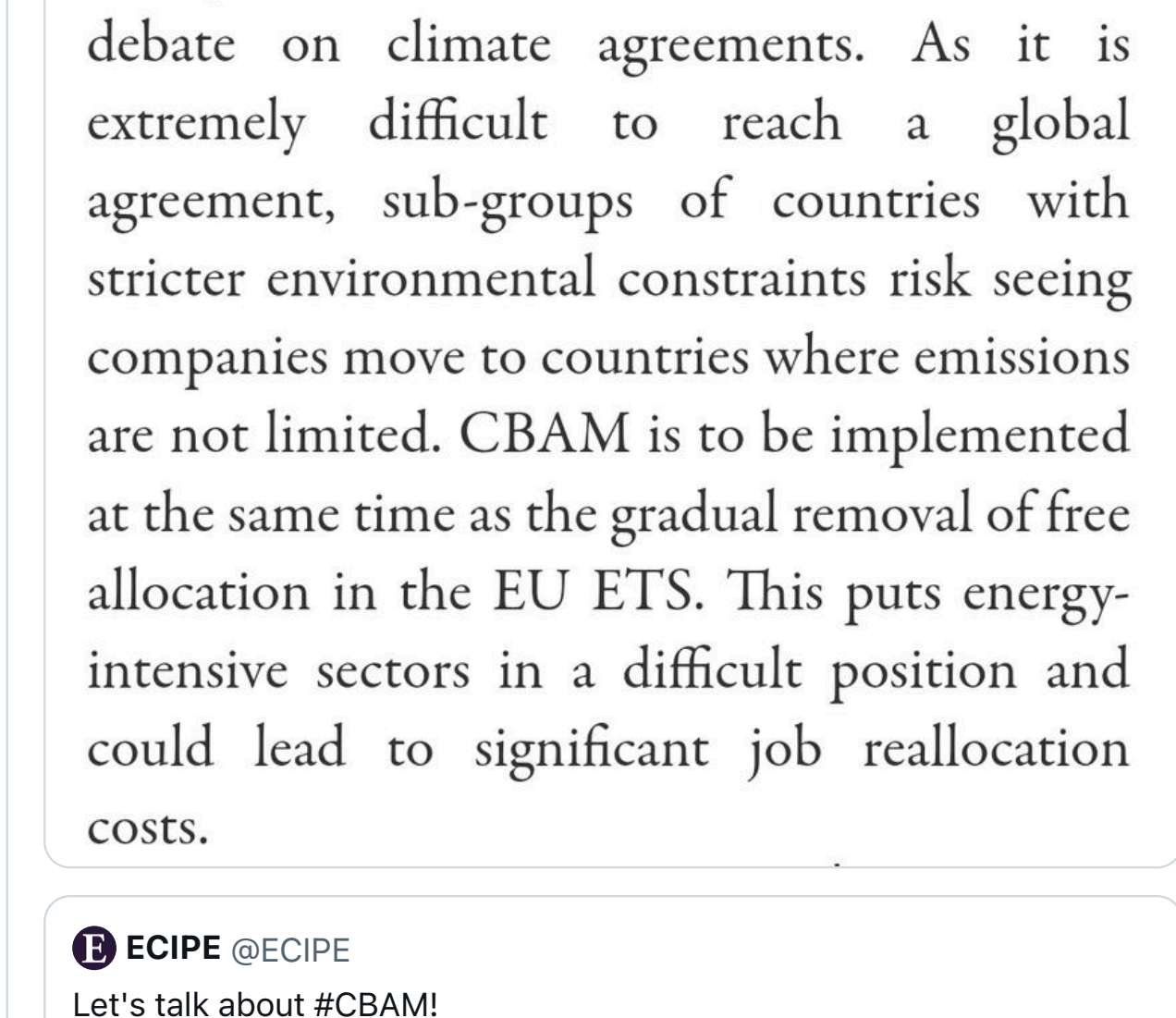
Nations would instead adopt all the historical decarbonizing free market policies described above, plus a few new free market innovations that will even more strongly and intentionally drive growth, innovation and decarbonization. The first of which provides a strong incentive for all free nations to join the Accord.

Accord nations would gain access to vast tax-advantaged international capital flows for investment and development, via a new kind of internationally reciprocal leveraged supply side tax cut designed to accelerate innovation, growth, decarbonization and the expansion of free markets. Any kind of private debt used to finance PP&E or conservation investments would be tax exempt in all Accord nations, meaning no tax on interest. That reduces the cost of debt perhaps 30%. In every Accord nation, developers, entrepreneurs, banks, hedge funds, mutual funds, financiers of all kinds could raise tax exempt debt of any kind – let's call these **CoVictory bonds, loans, even savings accounts** – then pool the funds and reinvest them in any accord nation in private PP&E or conservation projects. **CoVictory Funds would accelerate private capital flows between free nations, to finance conservation and ever-cleaner development projects, providing a strong incentive to join a free market framework.**

These tax exempt CoVictory funds would have exactly the same kind of tech neutral, decarbonizing benefit as does capital expensing. They lower the cost of capital for PP&E, accelerating the transition to the newest, cleanest technologies, without picking winners or losers. CoVictory Funds actually make clean technologies cheaper. They also increase the return on equity, attracting investment not only to the tax exempt debt, but also the taxable equity.

**CoVictory funds have the added benefit of being internationalizable, useful for driving international capital flows through inclusive investment opportunities for everyone, from billionaires to anyone who has even a bank account.** By contrast, traditional tax equity subsidies, like those in the US IRA, both create trade barriers, and benefit the largest investors the most… so often exclude smaller entrepreneurs, thus holding back innovation. Picking winners and losers means, actually, you pick a lot of losers.

By contrast, without favoring some over others, **CoVictory Funds can be used as a new kind of easy to use, highly democratic and inclusive international incentive to expand free markets. Or replace the CBAM with an engine of global growth and innovative decarbonization. Or strengthen the energy security ties between nations of the free world. Or help rebuild the war shattered infrastructure of Ukraine. Or Israel. Or Gaza.**



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Despite a looming recession, the EU continues with its plans for a protectionist climate tariff #CBAM, which would not only hit energy-intensive sectors and cost jobs, but may also violate WTO rules:

**Competitiveness and CBAM: Green at what cost ?**

Competitiveness is a crucial issue in the debate on climate agreements. As it is extremely difficult to reach a global agreement, sub-groups of countries with stricter environmental constraints risk seeing companies move to countries where emissions are not limited. CBAM is to be implemented at the same time as the gradual removal of free allocation in the EU ETS. This puts energy-intensive sectors in a difficult position and could lead to significant job reallocation costs.

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## Multiple CoVictories, indeed.

In addition, they are **more cost-effective** than any equity-side tax incentive, because as a debt-side incentive, they take advantage a financial leverage. Capitalists typically use debt to finance capital expenses (PP&E) because the average cost of debt is normally less than the average return on equity. In the last decade, in the US, the average cost of debt was about 4%, and the average return on equity around 13.6%. So by way of illustration, if we use those numbers, and consider an energy development project financed half with tax exempt debt, half with taxable equity, then governments would take in about 350% more revenue on the equity side than they give up in tax expense on the debt side. A good deal. Especially if they displace the wasteful subsides and regulatory costs of current EU climate policies.

## A Level Playing Field Plus Innovation Acceleration Tax Cuts

So far as described, **the Accord establishes two things: a very large free market, a level playing field without costly distortions, where anyone can freely invest, trade, innovate and compete. And second, it offers a fiscal engine for accelerating investment to every nation, financing the newest most innovative and efficient technologies.** That engine being basic supply side tax policies plus internationally tax exempt and harmonized CoVictory Funds.

Lastly, the Accord adds a few other supply side measures ("**clean tax cuts**") designed to drive innovation, competition, growth and decarbonization in specific sectors where we face the highest emissions, and the most difficult challenges.

Four economic sectors drive 80% – 90% of GHG emissions: electric power generation, transportation, real estate and industry.

We can drive emissions lower in the first three with a simple "performance bonus" supply side tax cut tied to emissions reduction. This does not replace basic supply side tax policy, but merely adds a small bonus rate reduction, say five percentage points, for firms that achieve the greatest emissions reductions. **For example in the automobile industry, sustainability can be summarized in one number: the average vehicle fleet emissions. So the lower the emissions, the lower the tax rate on business and investor income.** This provides a simple method of aligning corporate behavior with a goal of emissions reduction. From the board room to the shop room floor, every investor and employee owns stock in the company, which gets more valuable as emissions and the tax rate is reduced.

The same kind of clean tax cut can be applied across the transportation sector, and also to manufacturers of energy efficient home appliances and industrial equipment. **Also in the electric power sector: the lower the emissions of the electricity sold, the lower the tax rate on business and investor income.** The same idea can drive lower emissions in oil and gas production. Real estate is also quite similar.

Monopolies pose a special challenge in the energy, transportation and electric power sectors. Either state-operated, or more commonly a politically chartered public/private company, both kinds of monopoly inhibit competition, innovation and decarbonization. Often through political influence.

The Accord incorporates a solution: D**emonopolization Tax Cuts. These reward monopoly investors for selling their assets into a competitive framework by making such a sale tax free for a short period of time, say one or two years after Accord adoption. Monopoly investors therefore have a window of opportunity to exit their investment more profitably than otherwise possible, reducing their political opposition.** The mere proposal creates a profit opportunity for activist investors even before the ratification of the Accord. Since monopoly stock price will rise as Accord ratification and tax exemption become more likely, that creates a market dynamic which builds investor support for a pro-competition cash out.

Some industries, such as steel or concrete, require a different kind of clean tax cut targeted at the emission intensity of the production process or plant. Investors are often reluctant to build an expensive new kind of plant which may carry unknown risks, making it very difficult to find funding for the first few plants employing a new technology. One way to accelerate adoption of such innovation is the **First Three / Four Free** proposal. The first three plants employing a new technology capable of reducing industrial emissions by 20% or more, as demonstrated by a pilot project, would be entirely tax free for their first 4 years of profitability. This would greatly increase the potential reward from innovation adoption, favorably changing the risk/reward ratio for early investors.

Similarly, for the most difficult breakthrough innovations that would eliminate a majority of emissions, the Accord proposes **Game Changer Tax Cuts.** For instance, profitable zero emission fuels, and machines that run on any fuel with zero emissions, could eliminate 75% of global GHG emissions. Game Changer Tax Cuts would provide 15 years of tax exemption on income from such a game changer, for the first firms to achieve that breakthrough.

There's more than this. But we'll leave the rest for another day.

**For now, just imagine two countries. One pursues decarbonization through higher taxes, carbon tariffs, bans, mandates, subsidies, monopolies, and trade restriction, all of which raise costs and constrict the economy and investment flows. The other pursues decarbonization through free market innovation acceleration, which reduces the barriers and tax burdens placed on innovation, conservation and new investments, to decrease costs and accelerate capital flows to the newest, best innovations.**

**Which do you think will accelerate investment to decarbonizing innovations faster? Which firms will be more prosperous? Which will dominate the low carbon economy of the future?**

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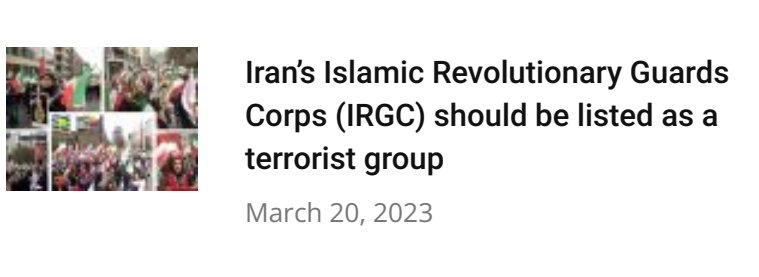

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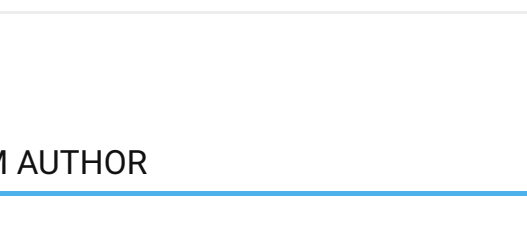

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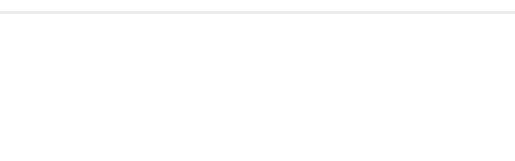

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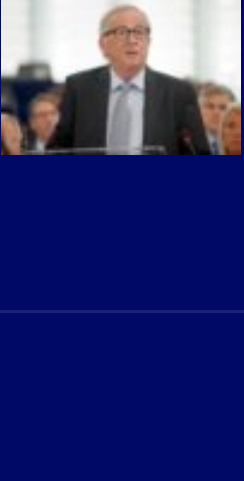

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