



Webinar 2025

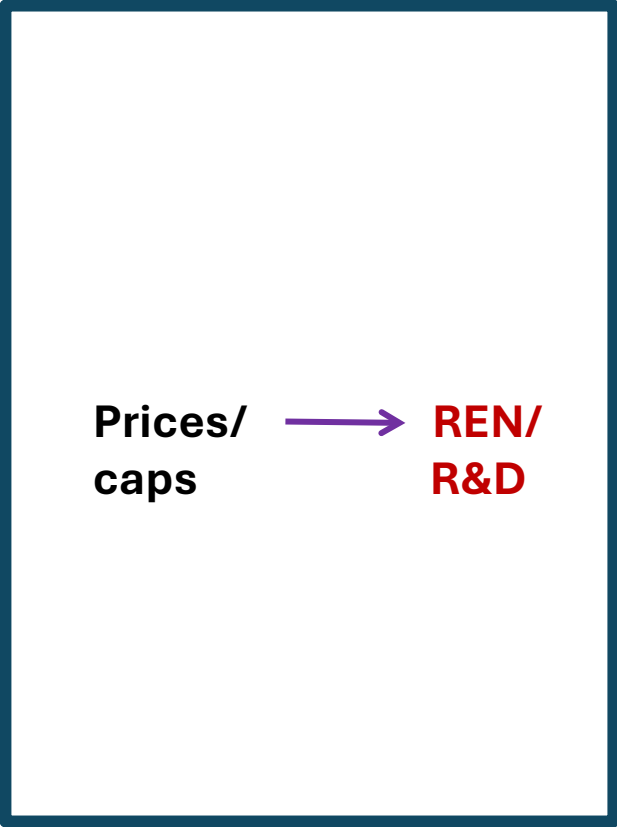
The Political Economy of Carbon Pricing

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Caps/prices => Renewables and R&D

- Prices/caps do not only cut emissions
- They motivate the development of renewable energies and environmentally friendly technologies
- These are beneficial because of tech spillovers
- To motivate more REN/R&D, the prices/caps can be tightened further
- (REStud '12, JEEA '16)



The diagram is enclosed in a dark blue rectangular border. It features the text "Prices/caps" in black on the left, a purple arrow pointing to the right in the center, and the text "REN/R&D" in red on the right.

Prices/caps → REN/R&D



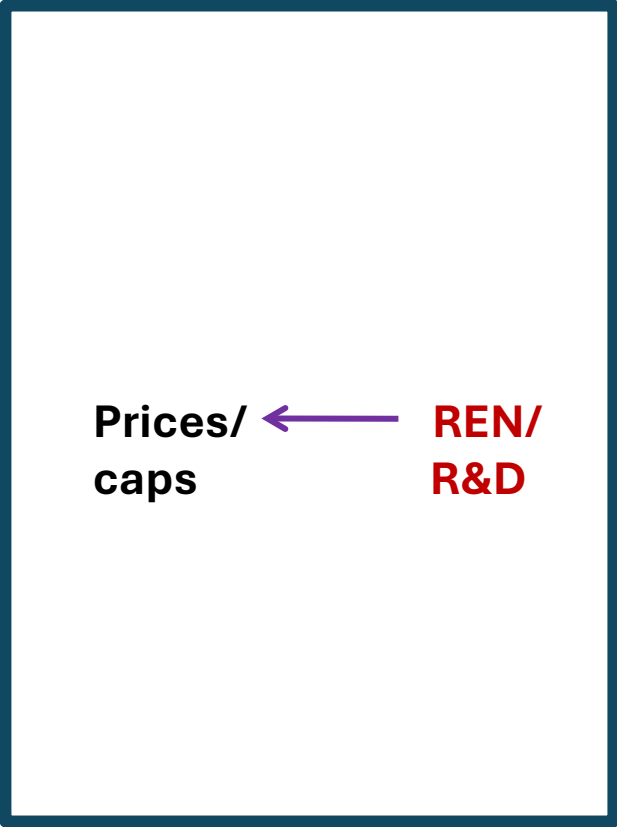
Linking Permit Markets

- Suppose two countries link their permit markets
- By issuing tightening the cap, the price increases in both countries, motivating more R&D and less emission in the future.
- Linkage allows countries to exploit that prices $\Rightarrow$ R&D in the other country.
- (Holtmark and Midttømme, JPUBE, 2021)

Prices/
caps $\longrightarrow$ **REN/
R&D**

Caps/prices $\leq$ Renewables and R&D

- With linkages, and negotiations, past investments in REN/R&D also influence the bargaining outcome.
- Anticipating this, countries may be discouraged from investing
- Unless they have signed **long-term agreements** for future prices/caps
- but countries may **free ride**...



Prices/
caps ← **REN/
R&D**



Chapter 5

On international cooperation

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THE POLITICS OF GLOBAL PUBLIC GOODS

Handbook of Political Economy

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1. INTRODUCTION
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3. TWO-LEVEL GAMES
4. STRATEGIC DELEGATION
5. LOBBYING
6. POLARIZATION AND TURNOVER
7. ELECTIONS AND REELECTIONS
8. LINKAGES, TRANSFERS, AND HARMONIZATION
9. VOTING RULES FOR A GLOBAL DEMOCRACY
10. GLOBALIZATION AND DEMOCRATIZATION

The PE of carbon pricing

- 1) Governments prefer to protect/compensate mobile/weak/connected firms?
 - Distorts incentives/efficiency
 - Harstad and Eskeland (JPUBE, 2010)
 - 2) Lobbying for weak policies?
 - Time inconsistency problems
 - Maggi and Rodríguez-Clare (JPE, '98)
 - 3) Elections and political turnover
 - Will opponents reverse future policies?
- ❖ All these PE-concerns raise the demand for commitment



Present bias and self-committing treaties

- By signing a treaty, it will be more costly to deviate from one's pledges later.
 - This influences what future policymakers will do
 - Participation is more beneficial if the “time inconsistency problem” is severe
 - Treaties can exploit domestic PE problems
 - ... especially if future (not present) decisions are negotiated.
 - Harstad and Kessler (JPUBE, 2025)

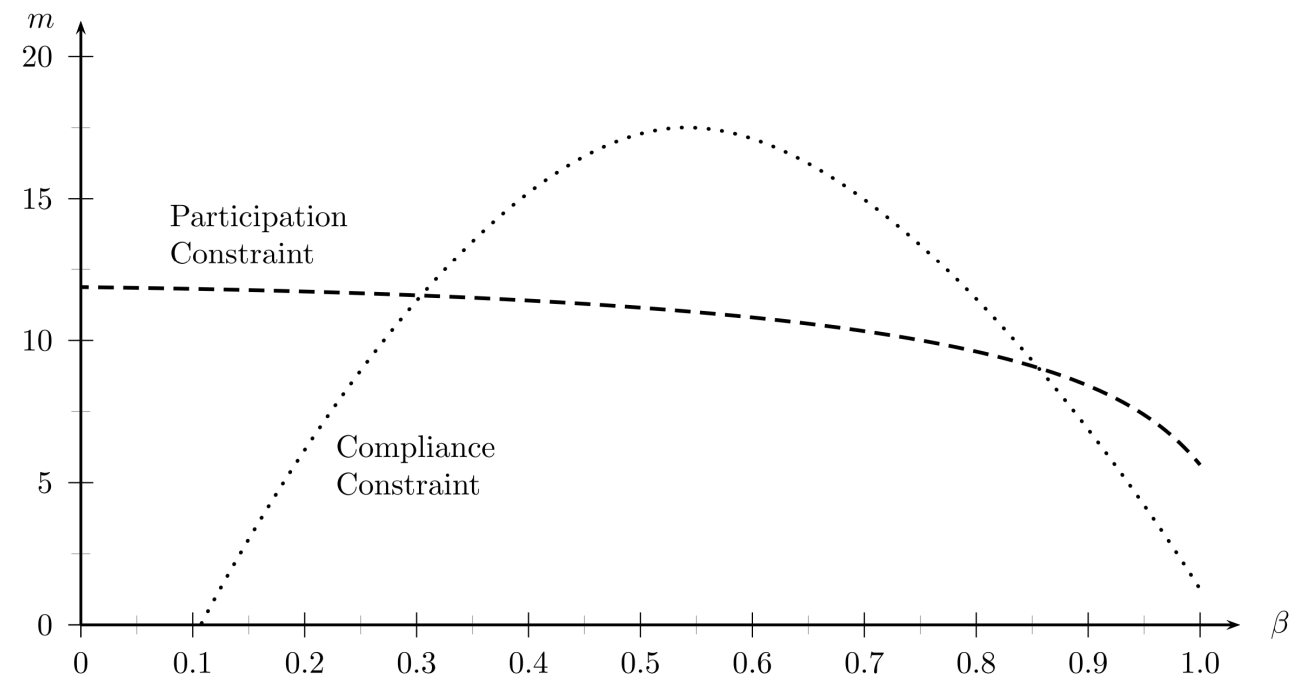




Present bias and self-committing treaties

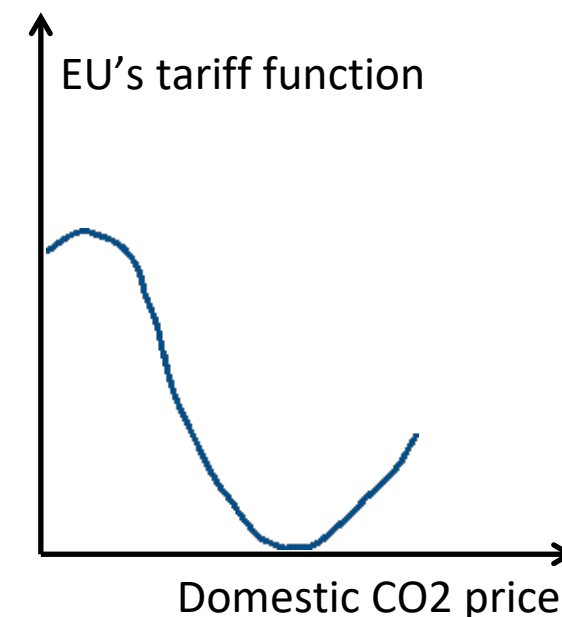
B. Harstad and A.S. Kessler

Journal of Public Economics



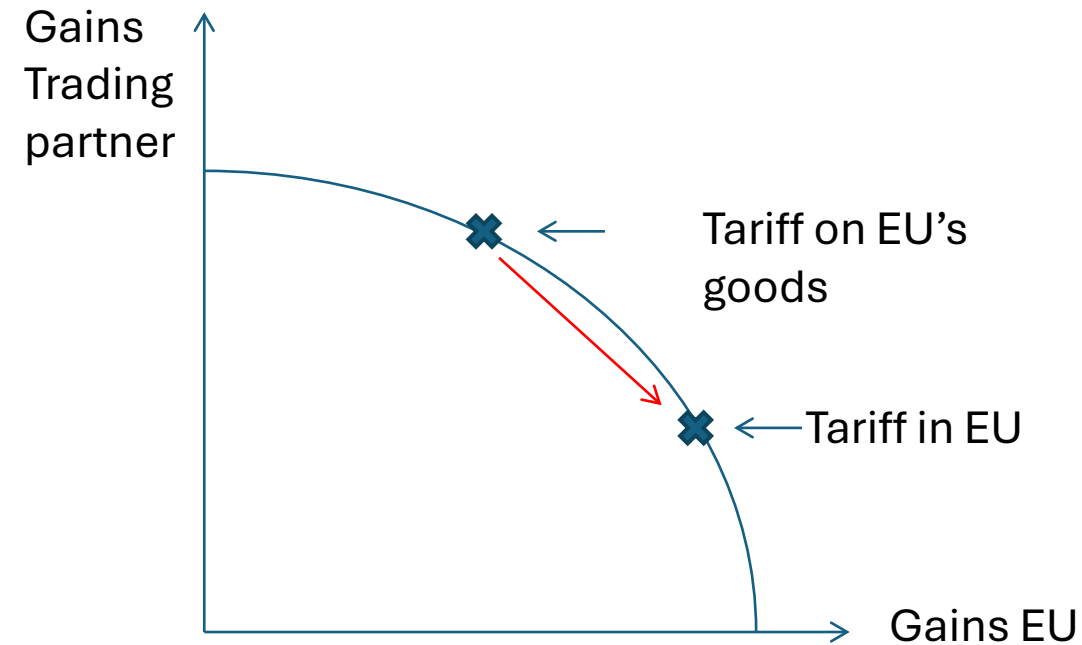
Trade Policies as Carrots and Commitments

- Connecting trade and IEAs can relax both participation constraints and compliance constraints
- Idea goes back to the previous century (Ludema and Wooton '94, Carraro and Siniscalco '95; Cesar and Zeeuw '96, Barrett 97, and earlier)
- Unilaterally: EU's CBAM can incentivize other countries
- The “optimal conditions” (for low tariffs) that motivate carbon pricing (or forest conservation) can improve upon CBAM.
- Multilaterally: The ability to “pre-commit” unnecessary.



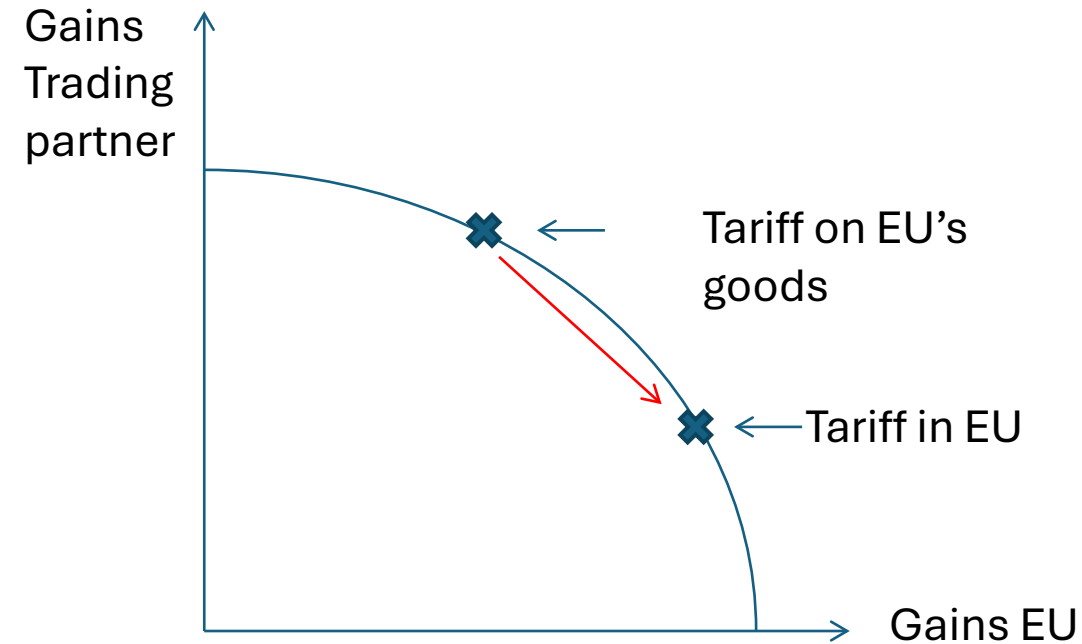
Contingent Trade Agreements

- The CTA can state that with the «ideal» policies, there is no tariff in EU (while trading partner can set certain tariffs on EU's goods).
- If the partner's policy worsen, this is reversed.
- If the tariff difference is sufficiently large, the ideal policy can be implemented.
- Note: The «stick» is credible – there are no gains for renegotiation later, given that the utility pair is on the Pareto frontier.



Contingent Trade Agreements

- Dynamic theory in (AER: Insights, 2024)
 - Motivated by EU-Mercosur trade deal
 - Negotiated in 2019 but still not ratified.
 - Demands for environmental provisions.
 - Contingency suggested by France and Netherlands in 2020.
 - US policies cause recent push for (premature?) ratification.
- Calibrated to EU-Merocus (r&r, 2025):
 - EU-Mercosur FTA can raise agric area by 5%
 - or by 0% with CTA.





Takeaways

- ✓ Carbon pricing does not only cut emissions, but also motivates REN/R&D.
- ✓ International free-riding interacts with domestic political economics.
- ✓ Domestic time inconsistency problems can be *exploited* by treaties that help countries to commit ... if they specify *future* commitments.
- ✓ **Trade policies** can provide carrots and international commitments.
- ✓ “**Contingent Trade Agreements**” strengthen incentives.
- **Geopolitics** can protect (and not only harm) the environment.