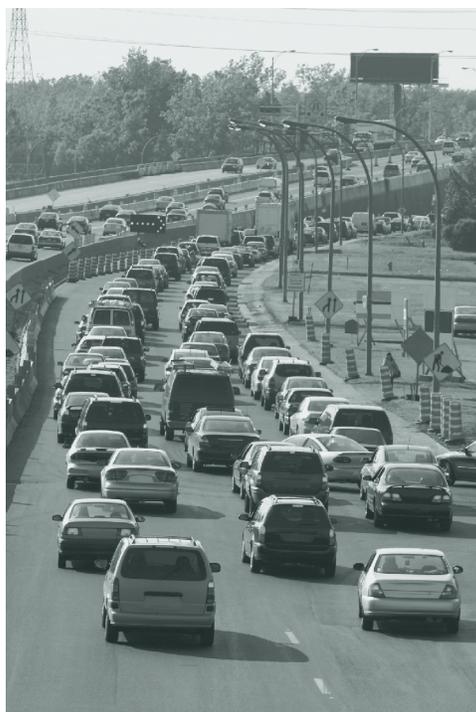


# The Political Context for California's Climate Change Policy

David G. Victor

Although much has been written about the economic impacts of California's AB 32, the most important questions are political. AB 32 and other policies make sense only if they inspire other parts of the U.S., and even other countries, to control their emissions.



Traffic is often congested on California's highways, such as the Los Angeles freeway depicted here. California's AB 32 will enforce new low-carbon fuel and clean car standards.

California is a big state, but in the global picture we are a small emitter of the gases that cause global warming. Californians account for perhaps 1.4% of the world's total emissions—or possibly a bit more when the emissions linked to all the products we import are properly included in the accounting. As we think about AB 32 and the future of global warming policy in the state, we must focus not just on the economics for California but on the political effects of California's leadership on the rest of the country and the planet.

Nearly all of the logic for AB 32 and other state global warming laws is political. It is based on a theory that by starting first in California, we will raise the odds that other jurisdictions will follow. We need to design AB 32 in ways that are economically smart for California, but the most important questions for AB 32 hinge on the political logic of leadership.

## Leading the Way in Climate Change Policy

The political theory works in several ways. State actions help demonstrate that practical emission controls are feasible and not overly costly. The states are also "laboratories" where new ideas are tested. State policies might also help create local jobs, which will amplify political support—although there is little evidence to support this argument. Perhaps most important is that when the states lead, they sow a measure of chaos in the nation's regulatory system which creates political pressure for meaningful federal action.

As analysts, we are guilty of focusing too much on the economics of schemes like AB 32 and not enough on the political theory. How good is

the evidence that the political theory that inspires state action is actually valid? My read is that while the literature on this topic is mixed, it is generally supportive of the political theory. Most studies of regulatory competition show that there is a large role for "races to the top," which suggests that jurisdictions that start first help trigger efforts in other jurisdictions.

California's own experience with triggering such races is uneven. The effort on zero-emission vehicles in the 1990s was largely a failure and might even have distracted serious regulatory efforts from vehicle options that would have been more viable. But the many California-led efforts on broader air pollution regulation have largely been a success, as has much of California's leadership on appliance standards.

The lesson for AB 32 is that the political benefits of moving first will not arise automatically. They must be built into how the state actually implements AB 32. Moreover, the political logic for implementation will often conflict with the economics. Since the underlying rationale for AB 32 isn't as an optimally designed economic policy but rather a political effort to inspire action elsewhere, we in the analyst community must face the reality that the best choices for AB 32 will often be those that violate our sensibilities about the best economic design. I illustrate in four areas.

## Four Criteria Shape a Successful Policy

First is credibility. Most of the global warming problem comes from the energy sector, and most energy infrastructure is long-lived. Thus, investors in energy technologies are particularly skittish when they face the need for

large investments within a regulatory environment that is shifting. The most effective rules in such settings are those that are highly credible because they allow investors to sink capital and other resources with a reasonable expectation of earning a return. Across the nation (and much of the rest of the world), the political momentum for serious global warming policy is evaporating. In that context, the economic logic for doing something in California would seem to weaken because a strict island of policy in California, when the rest of the world economy is a sea of inaction, raises the odds that California will bear unequal and distorting costs.

My view is the opposite. When the rest of the world is losing momentum is a time when efforts by California are most needed—as a way to signal credibility. Investors who back clean energy are in the early stages of what could be a bloodbath as clean energy rules lose momentum in most of the country. If California signals that its own laws aren't credible, then it will take a long time—perhaps a generation—before investors come back.

Second, is the strategy for California's engagement with developing countries. Put differently, what is California's foreign policy on global warming? While most of the political attention on AB 32 focuses on whether this will help inspire action in Washington DC, the questions about foreign policy are ultimately much more important. Every credible forecast for fuel consumption and emissions shows that essentially all the growth in future warming emission will come from developing countries—especially China, but also India, South Africa, and the forest-rich nations such as Indonesia and Brazil.

If the central goal of AB 32 is rooted in a political theory that sees efforts by California spreading to other jurisdictions, then we should evaluate AB 32, ultimately, by whether it helps change the game in the developing world.

California could have a big impact here—in part by generating pressure for more credible action at the federal level that will, in turn, make the U.S. Government a more effective negotiator with foreign countries. But, so far, there isn't much evidence that will happen soon.

**Good economic design is important. But the ultimate success of AB 32 must be measured in terms of leverage. Is California changing the game in the rest of the United States and the world?**

The biggest foreign policy leverage that California has is rooted in how the state implements its rules for emission offsets. By far, the largest scheme for international emission offsets is the Kyoto Protocol's Clean Development Mechanism (CDM). To date, the experience with the CDM has been disastrous. A large fraction of CDM credits are not genuine—they reflect investments that would have happened anyway and wrongly earn credit as “additional.”

The scheme is designed to reward relatively small projects that are discrete and relatively easy to measure and assess. Yet all the evidence suggests that the really big reductions in emissions from developing countries will come not from little projects that tinker at the margins, but from bigger schemes that alter these countries baselines—such as schemes to introduce more advanced, efficient coal-fired power plants in India, or schemes to make natural gas-fired electricity more viable in China. Serious leverage in the developing countries will come from engaging with how these nations actually plan and implement their industrial policies.

California can help alter the political incentives for developing countries to control emissions by opening

part of the AB 32 market to international offsets. Success on this front will require navigating between the local pressure here in California to make offset rules generous (and thus help local companies comply with AB 32's emission limits), and the political goal of using the California market to gain leverage on emissions around the world. The former suggests that transaction costs should be low and rules as generous as possible.

Indeed, most discussions of offsets around U.S. federal legislation have pointed in this direction, with such generous rules for offsets that the problems already evident in the CDM are likely to get even worse under a U.S. scheme. My view is that California should look in the other direction—it should set tough offset rules so that the California market (which will be the largest carbon-trading market in the U.S.) triggers a race to quality. Not only will this help ensure that offsets awarded in California are high quality, but it will demonstrate to other jurisdictions a better way to manage an offsets scheme.

Third, the same logic I have spelled out for California's foreign policy on global warming can also guide how the state deals with other states. If AB 32 is successful, then other states might create their own cap-and-trade systems. A few are already far along in the effort, and the Northeastern states already have a somewhat odd cap-and-trade system in place. Should these state systems be linked? Good economic policy would say “yes” because linked markets create more opportunities for trade and thus offer more potential for lowering costs and increasing leverage on emissions.

But good politics suggests the answer should be “maybe.” California should be wary about too much linkage. Linking to states that have lax or flaky rules will create the carbon equivalent of Gresham's law, and political support for serious efforts

in California will evaporate if people see their money flowing to other states where the effort isn't genuine.

When cheap, bogus emission credits are allowed into a trading system, then investors will focus on earning those credits and their efforts will drive high-quality (and more expensive) credits out of circulation. There is already evidence that under the Kyoto Protocol's Clean Development Mechanism, such behavior is appearing; with it, the credibility of emission offsets is increasingly in question.

Instead of welcoming all linkages, California should make links conditional on serious actions in other states and on solid administration of state markets. That approach will raise the odds that AB 32 will trigger other states to adopt serious policies because it will offer a bigger reward to states that meet California's conditions. I worry that, at present, we here in California have not yet articulated a conditional linking policy for other states—nor much grappled with other practical issues surrounding linkage such as the troubles lurking in the Commerce Clause. With the federal government in gridlock, the need for such a policy is rising quickly.

Fourth, and briefly, what happens here in California might help provide practical models for progress in international negotiations. Those negotiations are largely stalled today because they involve too many countries and issues and are not anchored in practical realities. They are based on targets and timetables that many countries can't honor. California and like-minded jurisdictions—such as the EU—can offer practical examples of real actions, around which more credible international coordination can emerge.

## Concluding Remarks

California has dodged its biggest threat to AB 32 to date—Proposition 23, which would have halted AB 32 and a

lot more. I sympathize with the economic logic that inspired Proposition 23, and the many voters who backed it are a reminder that AB 32 must stay aligned with the burdens that the California public is willing to bear. Indeed, the economic logic of one state acting alone is hard to fathom. That is because most of AB 32 isn't about economics—it is about political leverage on emissions outside California. As we shift into actually implementing AB 32, it is important to keep that fact at the center of whatever we do.

Good economic design is important. But the ultimate success of AB 32 must be measured in terms of leverage. Is California changing the game in the rest of the United States and the world? Answering that question in the affirmative will require ensuring that AB 32—along with the rest of California's efforts on global warming—rewards the jurisdictions that move forward with California.

Success in gaining leverage around the world will require that California implement AB 32 in ways that will often be seen as economically inferior, such as by segmenting California's offsets markets and being picky about which states we allow linkage through carbon markets. The result will be something very different from the emission markets we learn about in economics textbooks. It will be fragmented and filled with transaction costs. It will reward jurisdictions that make real reductions in emissions, while not linking to many markets that risk triggering Gresham's law. And these markets will exist alongside a large array of regulatory policies that may be economically inferior, but are politically attractive because they hide the real cost of action. All of this will be a horror to those of us who like transparent, broad, and efficient markets. We should get used to the horror because it is unavoidable when the main objective is political leverage rather than economic efficiency.

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