

Kluwer International Tax Blog

Should Environmental Taxes be Countercyclical?

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“Green recovery” is one of the key themes of the stimulus packages implemented worldwide in response to the Covid-19-related economic downturn. Traditionally, the answer to economic crises has focused on monetary policy and financial assistance programmes. However, as interest rates get closer to the zero lower bound, alternative stimulus policies are gaining attention in academic and policy circles. Recent research points to the potential role of *countercyclical environmental policy* as an instrument to stimulate a quicker recovery. According to this research, in some circumstances, suspending or scaling back regulations in periods of economic downturn can allow companies to “breathe”, – thereby facilitating a swift economic recovery. The more lenient environmental regulation during recessions should be counterbalanced with more stringent regulation in times of economic growth. In this blog, that builds on [our recent research](#), we have addressed two key questions related to this practice: should we implement countercyclical environmental policy, including environmental taxes? If yes, what environmental instruments (e.g. carbon taxes vs. cap-and-trade) are better suited to stimulate the economy in periods of economic downturn? Below, we provide a summary of our key findings.

Should Environmental policies be Countercyclical?

As the 2008 and 2020 economic crises have shown, periods of severe recession can have significant adverse effects on our lives. Environmental policies often impose costs on households and businesses; therefore, lifting such regulation can reduce pressure on the private sector, potentially reducing the negative consequences of economic recessions. Should we then implement countercyclical environmental law?

Existing research highlights that the macroeconomic benefits of countercyclical regulation are often uncertain. For instance, [Masur and Posner](#) point out that if the costs of regulation have already been incurred and can not be recovered, suspending or scaling back regulation would not help businesses recover. Similarly, lifting regulations can lead to the layoff of workers involved in compliance with the regulation. Thus, it is not always the case that suspending or scaling back regulation during periods of economic recession helps the economy recover.

Our research points to *additional risks* involved in adapting the stringency of environmental policies to the business cycle. In particular, we argue that varying the stringency of environmental policies based on the business cycle poses risks of:

1. Hindering long-term investments because the stringency of the environmental policy become less predictable;
2. Regulatory backsliding because the regulated industry may more easily block an increase in the stringency of the environmental policy after it has been scaled back (*status quo bias*)
3. Reduced innovation (weak version Porter Hypothesis)
4. Potential reductions in competitiveness (strong version of the Porter Hypothesis);

When all these considerations are taken into account, the analysis indicates that policymakers should be careful in adopting countercyclical environmental measures.

Another key finding is that implementing environmental policies that are actually countercyclical can be difficult. This is because, the countercyclical properties of environmental policies often depend on contingent factors not controlled by policymakers.

What environmental instruments are better suited to stimulate the economy in periods of economic downturn?

Cap-and-trade and carbon taxes are crucial policy instruments to reduce negative environmental externalities cost-effectively and have been implemented in many jurisdictions around the world. The academic and policy debate on the relative advantages of these instruments is large, and has recently focused also on their countercyclical effects. Many scholars and policymakers have argued that cap-and-trade would be inherently more countercyclical (i.e., better to deal with the negative consequences of economic crises) than carbon taxes. The reasoning underlying this belief is that under cap-and-trade, the demand for allowances would go down during periods of recession, and so would the price of GHG allowances. Thus, cap-and-trade eases the stringency of environmental regulations during recessions. Instead, carbon tax rates tend to remain stable during economic downturn. Thus, cap-and-trade is inherently more countercyclical than carbon taxes.

In our research, we argue against this belief on three grounds:

1. While we recognize that simple forms of cap-and-trade system can be more countercyclical than simple forms of carbon taxes, hybrid regimes are now in place in many jurisdictions. Under these hybrid regimes of cap-and-trade and carbon taxes it can become difficult to predict which instrument is more countercyclical. In the article, we provide various examples of carbon pricing instruments that have (at least) some elements of a hybrid regime, such as the EU ETS, the California ETS, the Swiss carbon tax and the Portugal carbon tax.
2. Secondly, there are many factors other than the business cycles that affect the price of allowances under cap-and-trade. Thus, it is erroneous to assume that the price of GHG allowances will decrease during economic crises. Indeed, during the Covid-19 related recession, the price of allowances went up in many of the key cap-and-trade systems around the world.
3. Thirdly, linking cap-and-trade systems can reduce the economic stabilizing effects of cap-and-trade. In some circumstances, linking can make cap-and-trade even more pro-cyclical than carbon taxes.

Key policy insights for a Green Recovery

There are five key takeaways from this research:

1. The potential economic benefits of countercyclical environmental policies might be outweighed by the risks of this practice. Thus, policymakers need to carefully consider whether to implement

countercyclical environmental policies.

2. Policymakers interested in implementing countercyclical carbon pricing instruments should not assume that cap-and-trade is always more countercyclical than carbon taxes.
3. Whether carbon taxes are more countercyclical than cap-and-trade may depend on their specific design and contingent factors.
4. Sometimes, it is difficult to understand the drivers of and (automatically) control price changes of carbon pricing instruments. This is a challenge for policymakers interested in implementing countercyclical carbon pricing instruments.
5. Jurisdictions planning to link their cap-and-trade systems should take into account whether their economies are forecasted to follow similar business cycles in the future and adopt price control mechanisms that can mitigate the risks of pro-cyclical carbon prices.

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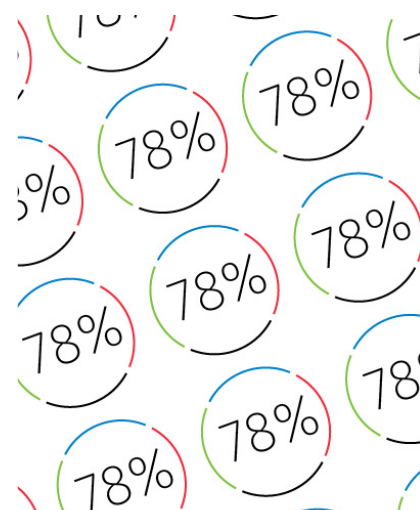
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