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Oiling the squeaks

Ross Garnaut - *20 December, 2008*

In the course of the work on climate change, members of the Garnaut climate change review team would sometimes ask how we would judge whether our efforts had been successful. Would the main indicator be the extent to which the Australian Government accepted the recommendations of our final report?

"No," I would respond.

"Policy decisions will reflect a range of pressures and constraints which we are not in a position now to assess and about which the Government is elected to form judgments. We will have done our job if the Australian community and Australian governments understand the implications of decisions that are taken."

Whatever pressures and constraints shaped the Government's white paper this week, it has implications for the environment and the economy. Should its policy proposals become law, they will be historic.

They would mark the beginning of comprehensive action in Australia to mitigate the growth in Australian greenhouse gas emissions. Australia would have taken a step where several countries have stumbled and in times that are difficult for the domestic and international economies. It would have taken this step in the context of the most pervasive vested-interest pressure on the policy process since the Scullin Government and of the most expensive, elaborate and sophisticated lobbying pressure on the policy process ever. It will have taken this step in the face of resistance from Her Majesty's Opposition.

The white paper has been greatly criticised by environmental groups for its "soft targets". The Garnaut Review recommended an unconditional commitment to reduce 2000 greenhouse gas emission levels by 5 per cent by 2020. I stand by my recommendation.

It costs much more to reduce emissions in isolation of global action and action in isolation does almost nothing in itself to solve the environmental problem. The purpose of acting at all in the absence of comprehensive global agreement is to keep alive the hopes of an eventual effective global agreement. Australian emissions are significantly above 1990 levels and 2020 is not far off. Our population grows strongly because, for good reasons, we choose to keep our doors open to people from many lands. Our new citizens need transport, a home with Australian accompaniments and access to employment income - all of which generate greenhouse gas emissions. The white paper's 5 per cent unconditional

target is challenging in the absence of an international agreement. To go further would risk a negative influence on others.

The white paper's proposed conditional targets are more problematic.

The Garnaut Review proposes a formula for assessing comparability of effort of various countries towards effective global efforts embodying degrees of ambition. To hold concentrations at 450ppm, Australia's proportionate share of a global effort would reduce emissions entitlements to 25 per cent of 2000 emissions by 2020 and 90 per cent by 2050. At 550 ppm, Australia's proportionate share of a global effort would be to reduce entitlements for 2020 by 10 per cent from 2000 levels and entitlements for 2050 by 80 per cent.

The review analyses the economic and environmental costs of global action to mitigate climate change, with Australia playing its full, proportionate part. It concludes that it is in Australia's interests to seek the strongest possible global mitigation outcome. Australia should indicate its willingness to play its part in a global agreement to bring greenhouse gas concentrations back to 450ppm or eventually to lower levels. Should this not be possible, Australia should play its proportionate part in the best possible outcome. The best possible outcome may turn out to be an effective agreement on 550ppm in the first instance. International success at this level of ambition would strengthen confidence in, and support for, stronger outcomes in subsequent negotiations.

The white paper proposes a variation on this theme. It suggests emissions reductions for Australia up to 15 per cent from 2000 levels, "in the context of global agreement under which all major economies commit to substantially restrain emissions and advanced economies take on reductions comparable to Australia". It proposes that, "in the event that a comprehensive global agreement were to emerge over time, involving emissions commitments by both developed and developing countries that are consistent with long-term stabilisation of atmospheric concentrations of greenhouse gases at 450ppm or lower, Australia is prepared to establish its post-2020 targets so as to ensure it plays its full role in achieving the agreed goal". The Prime Minister's Monday speech to the National Press Club notes Australia would have to reduce its emissions by more than 60 per cent by 2050 within a 450ppm global agreement and that he would seek a mandate at a general election to amend current policy as required.

The white paper refers extensively to the Garnaut Review on these matters. Its Policy Position 1.1 says the "Government accepts the key findings of the Garnaut Climate Change Review"; that "effective global agreement delivering deep cuts in emissions consistent with stabilising concentrations of greenhouse gases at around 450 parts per million or lower would be in Australia's interests"; that "achieving global commitment to emissions reductions of this order appears unlikely in the next commitment period"; and that "the most prospective pathway

to this goal is to embark on global action" that "builds confidence". These sentences are repeated elsewhere.

I did not actually use all of these words. However, pursuit of the approach proposed in the Garnaut Review may lead to the same end point as the white paper: Australia playing its full part in a global agreement to hold concentrations at 550ppm or, say, 520ppm, following Copenhagen and its full part in a more ambitious agreement as that becomes possible after 2020.

The white paper rules out Australia contributing to a global effort to achieve ambitious mitigation targets before 2020. That is a pity. There is a chance, just a chance, that with Barack Obama as American president, high ambition at Copenhagen will turn out to be feasible. Meanwhile, Australia cannot play a strongly positive role in encouraging the global community towards the best possible outcomes if it has ruled out in advance its own participation in strong outcomes. The Government should keep the 25 per cent option on the table.

This weakness of the white paper could be corrected without substantial unpicking of the policy package. The Garnaut Review argued that an effective global agreement including developing countries would need to allocate emissions entitlements on a per capita basis, converging to equal per capita entitlements at some time around the middle of next century. This in itself would be favourable to Australia in comparison with the developed and transitional countries with low immigration and slow or negative population growth.

But we cannot expect our advocacy of a new and superior approach to allocating emissions entitlements across countries to be internationally effective if we accept only implications that favour us (taking population growth into account), but not other implications (converging towards equal per capita entitlements).

Three elements of the white paper proposals lead towards large transfers from the general community to particular interests and to fiscal and environmental risks.

There is no public policy justification for \$3.9 billion in unconditional payments to generators in relation to hypothetical future "loss of asset value". Never in the history of Australian public finance has so much been given without public policy purpose, by so many, to so few. The best that can be said is that these are once-for-all payments - unless the spectacular success of investment in lobbying inspires repetition and emulation.

There is large risk to the public finances in the five-year price cap for emissions permits. The cap is to be set at an Australian-dollar price that is likely to be exceeded by international prices at some point in the first five years of the scheme. When that point is reached, the Australian taxpayer will have to fund the purchase permits from other countries at international prices and to underwrite

the difference between the cap and international prices. At that point, there will be powerful commercial incentives for market participants to buy at capped prices and to hoard standard permits for future use or sale. This increases the risk to the national budget.

The proposed issue of free permits to trade-exposed, emissions-intensive industries raises different issues. Like free permits to generators and the price cap, it carries risks to the public finances. In this case, the risks are much bigger. Unlike the other instruments of transfer from the general community to particular interests, it is based on a sound public policy objective.

The problems arise from the fact that the white paper contains no sound conceptual basis for payments. Section 14.5 of the Garnaut Review's Final Report sets out the principle upon which payments should be made to trade-exposed industries: compensating firms for the disadvantage they suffer from the absence of comparable carbon constraints in other countries. The Government's white paper acknowledges that this is the correct principle but does not seek to apply it.

The consequences of not having a principled basis for the issue of payments are profound.

Wherever the partial application of a carbon constraint in other countries is having an effect on international prices, there can be over-compensation of Australian producers. Carbon constraints are being applied in many developed countries, including most states in America and in developing countries including South Africa and China. They will increase in importance.

Sound principles would lead to the automatic withdrawal of payments as carbon constraints emerge in other countries. With political bargaining determining payments, as in the white paper, there is no obvious point at which payments would be partially or completely withdrawn. Further, even if there were a comprehensive international agreement that completely removed the case for payments, five years' notice would need to be given for withdrawal.

The July green paper proposed placing a cap of 20 per cent on value of permits issued to trade-exposed enterprises outside agriculture, or 30 per cent including agriculture. As indicated in the Final Report, these are reasonable upper limits to principled initial claims.

A principled approach to payments to trade-exposed industries would generate an early and continuing decline in the proportion of payments to trade-exposed industries as carbon constraints were extended elsewhere. In contrast, the white paper's approach would see, on conservative assumptions, the proportion of permit value given free to trade-exposed industries rising to 45 per cent in 2020.

The ratio would rise well beyond 45 per cent if trade-exposed sectors grew more rapidly than the rest of the economy or if reductions in emissions were greater than 5 per cent.

The ratio could rise to 65 per cent with an emissions reduction target of 15 per cent and with trade-exposed industries growing twice as rapidly as the rest of the world. With similar relative growth rates and an emissions reductions target of 25 per cent, three-quarters of permit value would be transferred to trade-exposed industries.

And yet the revenue pool from sale of permits is exhausted at 45 per cent, by the household compensation arrangements proposed in the white paper. Already there is nothing left for increases in payments to households as the carbon price rises over time. Little is left for incentives to research, develop and commercialise low-emissions technologies, which are essential components of the domestic and international mitigation efforts.

Nothing is left for systematic support for overcoming information and contractual market failures inhibiting energy-saving in low-income households.

What happens as the claims of trade-exposed industries rise above 45 per cent? This is a big risk to future budgets. To the extent payments to trade-exposed industries exceed those necessary to compensate for the absence of carbon constraints in other countries, they introduce distortions in international trade.

One justification for unexpectedly high payments to trade-exposed industries in both Europe and Australia - and presumably other countries - is the global recession.

The Smoot-Hawley tariff in the United States in the 1930s, and the competitive increases it inspired in protection in other countries, made the Great Depression much deeper than it would otherwise have been. Will the treatment of trade-exposed industries become the Smoot Hawley tariff following the Great Crash of 2008?

The introduction of a sound basis in principle for trade-exposed industries is an urgent matter for the restoration of global prosperity, as well as for Australian fiscal integrity, and for the avoidance of high risks of dangerous climate change.