

## **Climate change policy built on shaky foundation**

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The Garnaut draft report on a national emissions trading scheme is a good summary of a debate that has been under way in Australia for more than a decade. Unfortunately it is not clear that the review's proposed approach is what the country needs to tackle climate change.

Its basic premises are a matter of considerable debate. The Garnaut review starts from the same basic assumptions as the Stern review: that the science of climate change is almost completely resolved, and that there should be a global binding carbon target or - in the case of the Garnaut review - a global carbon budget that should be imposed on Australia. Given this target, the role of economics is to deliver this target at low cost.

If the premise on scientific certainty is correct, then the approach of the Garnaut review is reasonable. However, most experts in the climate change area acknowledge the science is still uncertain on what the precise target for greenhouse emissions should be. The Garnaut review also acknowledges this, but critically fails to adequately incorporate it into designing the policy response.

What matters for climate change is the concentration of carbon in the atmosphere from all sources - not the emissions in a particular period from Australia. No one knows if the concentrations should be 400, 450 or 550 parts per million. The problem is one of managing the risk associated with various outcomes over time.

The economics literature establishes that under uncertainty, the appropriate policy response is to set a clear price on carbon (through a tax or a hybrid approach such as the McKibbin-Wilcoxon Blueprint), which reduces emissions gradually at low but rising cost. A less desirable approach is to have a precise carbon target for each year with a cap-and-trade emission trading system delivering an uncertain price, since we have little idea what this cap should be and there are many target paths that can deliver the same concentration level at some future date.

The best way to proceed is to choose a path that can be transparently adjusted over time to achieve a concentration level at lowest economic cost. An inflexible quantity target for each year is not good policy. A quantity target expressed as a carbon budget (as in the Garnaut review) is better policy but still subject to the same basic criticism.

The second major issue in the draft report is the question of permit allocation. Garnaut is correct that the allocation does not change the economics associated with a carbon price. It is a philosophical decision on wealth transfers.

Under a review set up by state Labor governments, of course the report would give all the revenue from permits to the government, which would then wisely spend this on the best programs to reduce emissions. Although theoretically a reasonable idea, I fundamentally disagree with this philosophy because of the revealed inability of governments to use this potentially large revenue wisely in practice. The permits should be bundled and allocated once off to all citizens and affected companies, as compensation for short-term economic pain and to create a political constituency in support of the policy. Once these property rights are trading in a well-designed long-term permit market, the market will direct revenue into the areas that give most carbon-reduction bang for the buck. Giving the revenue to government to be reallocated each year is a recipe for rent-seeking and mismanagement.

Transparency provided by a well-designed market trading in long-term carbon assets is, in my view, a better way to proceed, with a small volume of short-term permits auctioned to generate some government revenue over time when needed to stabilise fluctuations in the short-term carbon price.

The similarities between the Stern review, which emerged from the politics of the European Union, and the Garnaut review, which was born in the heat of a federal election campaign, are unfortunate. Under the circumstances of its creation, the Garnaut review could not endorse the more sensible approach of the Prime Minister's Task Group on Emissions Trading.

That is the basic flaw in the process that needs to be corrected. The politics of climate change is clear but the Rudd government should be careful not to expose the Australian economy to the risks of short-term economic volatility that may ensue from the proposed approach of the Garnaut review.

The review is correct that short-term carbon price volatility can be handled by industry - but this will be at a cost. Why impose a cost when the volatility can be removed in the design of the system?

Climate policy should be run like monetary policy; a clear long-term goal for policy with a central bank of carbon in control of the short-term price of carbon, just like the Reserve Bank controls the short-term price of money.

While part of this is endorsed by the Garnaut review, the core part - on managing the price of carbon in the short term - is rejected outright. This is a mistake with potentially significant consequences for the Australian economy.

It is time that politics was excised from the climate debate. Bipartisan support for a sensible climate policy is what is needed. Sensible climate policy is only partly found so far in the deliberations of the Garnaut review.

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