

WILL CLIMATE CHANGE BRING AN END TO THE PLATINUM AGE?

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This is the final form of the lecture. It replaces the draft that was placed on the Garnaut Review and ANU websites at the time of the lecture.

The Garnaut Climate Change Review is committed to a process that integrates public participation and stakeholder input and invites interested parties to make submissions in response to the issues raised in this paper. For further information on making submissions please visit the Garnaut Climate Change Review website at www.garnautreview.org.au.

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The interaction between strong and broadly-based global economic growth and risks of climate change is throwing out the defining challenge of our time. Our response to the challenge will shape the prospects for security and prosperity through the twenty first century.

I have been bumping into climate change issues for many years.

My lifelong professional interest in economic development in Asia and the Pacific drew me into conversations with senior policy-makers in Beijing in the early 1990s, about ways in which continued rapid economic growth in China might be reconciled with what was then an emerging international focus on climate change mitigation.

My involvement in development in Papua New Guinea has drawn my attention to the disruption to living standards and established patterns of life amongst the people of the vast lowlands of the southern side of the island of New Guinea, across the Torres Strait and Arafura Sea, from small increases in sea levels that are already occurring.

My work as Chairman of the International Food Policy Research Institute in Washington has made me aware of the high risks of huge disruption to nutrition and more broadly to political stability and economic development in the parts of the world in which most of the world's poor people live.

And as a resident of southern Australia, and participant in the life of the farming communities of the southwest slopes of New South Wales, I have shared the growing anxiety about the drying in recent times.

But all of this was at the margins of my professional life until last April, when the then Leader of the Federal Opposition, Kevin Rudd, and, on behalf of all of the Premiers and Chief Ministers of the Australian States and Territories, then Queensland Acting Premier Anna Bligh, asked me to conduct a national review of climate change impacts and policies.

The Review was in the first instance commissioned by the Premiers and Chief Ministers. We started work in July and have been making good progress within that framework. As envisaged by Kevin Rudd last April, the emphatic election outcome last Saturday has made the Review a cooperative effort of the Commonwealth and State Governments.

The election outcome has brought climate change into the centre of Australian policy-making.

The Review will seek to define a way forward for Australia now, in a world that is taking seriously the challenge of climate change.

Following on from Sir Nicholas Stern's landmark review released last year, my Review will provide an Australian perspective on several issues:

- the impacts of climate change on Australia, both directly, and indirectly through its effects on other countries;
- the policies that are most suitable for reconciling the maintenance of rising living standards in Australia and abroad with effective mitigation, and also adaptation to the climate change that will inevitably occur;
- how Australia's mitigation efforts can support an effective global approach to mitigation of climate change;
- how we can distribute the burdens of mitigation of, and adaptation to, climate change, over time between countries and among citizens in ways that are widely recognised as being fair—for reasons of equity, and to provide a sound domestic and international political foundation for sustained and effective policy effort over long periods;

- how we can develop market-based approaches to mitigation and adaptation wherever these are likely to be effective, and how we can introduce rigour into analysis of the case for other forms of intervention when there is clear evidence of market failure; and
- the appropriate locus of responsibility within the Australian Federation for various aspects of mitigation and adaptation policies.

With the Review Secretariat in Melbourne, I have started work on all of these issues. In this lecture, I will focus on a few of them: the broad theme of reconciling economic growth with effective mitigation; the links between Australian and international mitigation efforts; and some essential characteristics of market-based mitigation policies.

THE INCONVENIENT TRUTH IN THE PLATINUM AGE

Global economic growth over recent years has exceeded in speed, magnitude and breadth, the average economic growth that was experienced in the two beneficent post-war decades that came to be known as the “Golden Age”. The recent experience represents a marked lift in growth rates from the last quarter of the twentieth century.

Elsewhere I have called the early twenty first century the “Platinum Age”.

In historical terms, we are now seeing the extension, into the heartlands of the populous countries of Asia, of the scientific, technological, industrial and commercial revolutions that had their origins in Britain and Northern Europe in the late eighteenth century. These changes spread through Western Europe and its regions of overseas settlement and to Japan through the nineteenth and early twentieth centuries, and to a number of smaller economies in East Asia in the third quarter of the twentieth century.

The Chinese economy has been growing strongly since the Chinese Communist Party committed itself to internationally- and market-oriented reforms in December 1978. China in the early twenty first century has established steadier growth at high rates through the maturing of institutions for managing a market economy, deepening integration into the international economy, and upward shifts in savings and investment rates from levels that were already high by any standards. Sustained high growth over nearly thirty years of reform has now made China a large enough economy for its rate of growth to have a substantial impact on global averages, and also on growth opportunities in other countries.

The global story extends well beyond China. High rates of growth are now well established in India. Vietnam—an economy that has more people than any country in the European Union—is growing as rapidly and consistently as India. Southeast Asia as a whole has left the sluggish years after the financial crisis behind it, although it has not returned to the febrile and ultimately unsustainable growth rates of the nineteen nineties before the crisis.

Strong global demand has lifted the terms of trade and accelerated growth of commodity exporting countries everywhere—from Australia, to Papua New Guinea, Russia and the other successor states to the former Soviet Union, Latin America and Africa. The economies of sub-Saharan Africa have been experiencing average growth rates around 5 percent per annum over recent years—for the first time ever over such an extended period.

The evidence is accumulating that the exceptionally high average growth rates of the early twenty-first century are not temporary phenomena.

My own assessment about the future of Chinese economic growth is well known—that there are reasonable prospects for growth rates in the vicinity of ten percent per annum—higher still for a while—to continue for a considerable period, until average Chinese productivity levels and living standards are approaching the range of developed countries in the late 2020s. The new, higher trajectory of Indian growth around 8 or 9 percent per annum is soundly based, and has strong momentum.

This growth has seen an unprecedentedly rapid transition of people from poverty.

It is now clearer than it has ever been that the natural course of global development is for more and more of the world's people to aspire to, and to realise, living standards similar to those in the advanced economies.

The acceleration of global economic growth would be an unambiguously good thing if it were not for the inconvenient truth, that the scaling up of the patterns of life of the developed countries to the populous parts of the developing world is not sustainable without major changes in the relationship between economic activity and the environment.

The inconvenient truth has its origins in the dependence of established patterns of modern economic growth on the utilisation of fossil fuels, especially in the energy and transport sectors.

Global fossil-fuel carbon emissions from 2004 to 2006 grew at an annual rate of 3.1%, a rate in excess of that anticipated in many of the international climate change assessments, including the scenarios outlined by the Intergovernmental Panel on Climate Change (the IPCC) which were used in the modelling for the Stern Review.

While increasing demand in recent years, and limitations on expansion of production, have lifted oil and other energy prices to exceptional levels, impending scarcity is unlikely to provide a substantial constraint on coal and total fossil fuel consumption for the foreseeable future. There is no necessary reason why the relationship between fossil fuel emissions and economic growth will change markedly without effective policy interventions.

The recent effects of higher oil prices are instructive. Two highly emissions-intensive alternatives – coal and synthetic liquid hydro-carbons (derived from coal, tar sands, shale or natural gas) – are expanding their proportionate global roles. The average amount of carbon per unit of energy used has actually been increasing in the large, rapidly growing developing economies.

It is neither desirable, nor remotely feasible, to seek the removal of the risk of dangerous climate change through reduction in global ambitions for higher material living standards. The challenge is to remove the link between economic growth and greenhouse gas emissions.

Enough work has been done by many people for us to be reasonably confident that there are economically and technologically feasible means of removing this link. But the work has also shown that the design and effective implementation of policies that secure the necessary outcomes present immense challenges to national and international polities.

A WORSE AND MORE URGENT PROBLEM THAN WE THOUGHT: THE RECENT ECONOMICS AND SCIENCE

As discussed in a Garnaut Climate Change Review public forum in Melbourne on November 14, the reality of observed climate change in recent years has surprised mainstream scientific opinion, given the increase in emissions concentrations so far.

In addition, the rate of emissions increases has also exceeded that presumed in the most extensively discussed IPCC scenarios. There are three reasons for this: global economic growth, the energy intensity of growth, and the carbon intensity of energy production are all proceeding ahead of expectations.

My work this year suggests that the IPCC's A1FI emissions scenario, which had earlier been thought to be extreme, may be the closest of the IPCC scenarios to the realities of the early decades of the twenty first century.

In Australia, the CSIRO and Australian Bureau of Meteorology's latest projections under this A1FI scenario show warming of 2°C by 2070 is virtually certain for most of Australia, and highly likely for the south coast, while there is a 30% chance of exceeding 4°C in inland areas.

“Business as usual” is carrying the world towards high risks of dangerous climate change faster than seemed to be the case a short while ago. The need for an effective policy response is more urgent than we thought.

CLIMATE CHANGE MITIGATION AS A DIABOLICAL POLICY PROBLEM

As I have worked my way into climate change policy issues over the past six months, the diabolical nature of the policy challenge has become apparent to me, as it has to others before me.

Features contributing to its diabolical nature include:

- the uncertainties surrounding relationships between atmospheric gas concentrations and the timing and extent of dangerous climate change;
- the long lags between emissions and impacts, exacerbated by the temporary masking effects of aerosols—making it difficult to rely on observation of impacts to prompt timely policy change;
- the need for unprecedented international co-operation for successful mitigation alongside powerful incentives for individual countries to free ride on others; and
- the complexity of the income distribution effects of climate change and effective mitigation.

The unusual risks and uncertainties in climate change mitigation derive from the science on the relationship between emissions and consequences, and also from the timing and economic characteristics of emergent technologies.

Uncertainty about the science and technology encourages hesitant policy responses, which slows mitigation and raises its costs.

Climate change presents a classic commons problem where individuals or countries typically gain much more from their own use of the resource (the atmosphere's capacity to absorb emissions without unacceptable risks of dangerous climate change) than they suffer from their own contribution to degradation. At the national level, all countries, except possibly the two biggest, have an incentive to free-ride on the efforts of others, whether or not others are taking effective mitigative action.

Here we are dealing with a genuine international prisoners' dilemma.

If there were a single international negotiation to which each country took its own policy position, developed in its own narrow national interest and in the absence of cooperative communication with others, no country (except possibly the big two) would choose to do anything. The result would be the worst possible outcome for the world as a whole and for most national entities.

In this sense, the international climate change policy problem is less tractable than multilateral trade negotiations, which embody a perceived but not a real prisoners' dilemma. Even though some sectors in some countries would be worse off, all countries as a whole are made better off with trade liberalisation — even if it is pursued unilaterally.

Despite this more benign reality, negotiations for multilateral trade liberalisation have fallen upon hard times in the twenty-first century. This would seem to augur poorly for a favourable global outcome on climate change.

Policies which have large effects on income distribution invite fierce contests between competing interests. Climate change policy has three acute equity dimensions.

- An intergenerational equity question. To what extent should one generation be willing to forego some current consumption to allow greater consumption for future generations? The likely greater prosperity of future generations would seem to argue for slow action. However, we have to come to terms with the possibility of stepwise changes that could fracture central features of human economic and political organisation, and change radically features of the natural environment to which humans currently attach high value.
- An international equity question. The costs both of climate change and its mitigation will differ greatly across countries. In general, costs will be greater for developing countries. Attitudes to international cooperation are complicated by the historical reality, that the current high concentrations of greenhouse gases are overwhelmingly the product of past

actions by developed countries. And annual additions to atmospheric concentrations are much higher per capita from the developed countries—by a factor of 13 (for carbon dioxide emissions) between Australia and India.

- A domestic equity question. The price of carbon which is a central feature of an effective mitigation regime will be mainly passed through to households, and disproportionately to some categories of households that include high proportions of low incomes. Climate change and its mitigation have the potential to force highly regressive changes in income distribution.

Between countries, the difficulties of the “prisoners’ dilemma” are compounded by the international equity issues. The inherent incentives for a developing country to do nothing are reinforced by its confidence that developed countries should take substantial action first.

There are three possible saving graces in the international space. One is the high level of community support for action in many countries including Australia. The second is that a start has been made on international cooperation, and that some countries have taken steps, at some cost, towards reduction of emissions. The third is that international climate change policy is not played out just once in a single game, but is rather played out through interactions over time, allowing countries’ policies to influence each other.

On domestic distribution, the losers will block effective action politically unless the effects of mitigation policies are widely recognised as being broadly fair. Managers and analysts of the first phase of the European ETS recognise that the large and inequitable distribution effects of allocating free permits to established emitters, even when the carbon price was passed on to households, was a fatal flaw.

Questions of distribution are therefore fundamentally important to the environmental integrity of mitigation policy, and not only to distributional equity.

RESOLVING THE TRAGEDY OF THE GLOBAL COMMONS: THE ONLY SOLUTIONS ARE GLOBAL SOLUTIONS

Australia and the world need a mitigation strategy that can manage uncertainties, is widely considered to be equitable, and breaks through the perverse incentives of the prisoner’s dilemma.

On environmental grounds, a global mitigation budget needs to be expressed in terms of a goal of stabilisation of greenhouse gas concentrations at a specified parts per million of carbon dioxide equivalent. This will generate an amount of greenhouse gas emissions—a certain number of gigatonnes of carbon dioxide equivalent—that can be emitted up to a stabilisation date if the risks of dangerous climate change are to be held within acceptable limits. International discussion of an appropriate global budget needs to be informed by scientific estimates of the impacts of different emissions concentrations and based on assessment of the costs of mitigation and of the relative weight that is placed on current and future generations’ welfare.

Currently, the concentration of carbon dioxide equivalent in our atmosphere is 455 parts per million CO₂-e. There is a widespread view, based on the science, that the risks of “dangerous” climate change and the risk of abrupt climate change, are already at unacceptably high levels at this point. Another view argues for an objective of stabilisation at 550ppm CO₂-e, on the grounds that any global target below this level would be impractical. Stern (2006) was inclined to this view.

The movement towards an effective mitigation strategy must begin with a broad international understanding that a global emissions budget is necessary. This should frame the discussion of an appropriate level of ambition in mitigation. The global budget represents the total volume of emissions that can be absorbed into the atmosphere over a specified period without unacceptably high risk of dangerous climate change. The third and most difficult step is to allocate the remaining global capacity to emit greenhouse gases among countries.

It is not likely that a sound agreement on a global emissions budget will emerge from a negotiation in a single, large, multilateral, inter-governmental meeting. The incentives facing individual delegations in such a negotiation are all wrong. Each representative is under pressure to secure a “better deal” than others.

The prospects are better from a “messier” process in which individual countries and groups of countries address the need for the ambition of, and the allocation of, a global budget in many fora. Principles are articulated by some players and are embodied in policy by some. Successive multilateral negotiations allow countries to learn what others are prepared to do. The game theory problem then becomes that of a repetitive game with signalling and learning.

This is no small mercy. Formal game theory analysis of prisoners’ dilemmas has shown that with sufficiently sophisticated, but not overly complex, strategies, it is possible for cooperative, rather than mutually harmful, behaviour to emerge as a stable equilibrium (Axelrod, 1984).

Successful strategies require some countries to move in directions that deliver mutual benefits ahead of others; to reward cooperative responses by others by going further, and to punish uncooperative behaviour; and to be clear about their strategies.

In the circumstances of climate change policy, it is impossible to avoid the imperative that effective action will first be taken by developed countries. This is widely recognised as being fair, and given realities of historical responsibility and existing capacity to support the necessary investment, was the only basis on which early steps towards mitigation could be taken. The decisions not to ratify the Kyoto agreement by the United States and Australia after the election of the Bush administration seven years ago was of historic importance in disrupting an international approach. Australia’s return to the international fold following the election of the Rudd Labor Government is an important corrective measure.

It is an equally important reality that there will be no adequate global mitigation unless the major developing countries soon become part of the global mitigation effort. Their inclusion, after early action by developed countries, is an urgent matter.

With developed countries starting to act, participation in trade in emissions permits and in the benefits of developed countries research and development can provide important incentives for developing countries to follow. These add to the central incentive: the shared interest in a successful outcome.

However, responses to transgressions or non-cooperation must be carefully considered and measured when implemented. There is no need, and it would be undesirable, for “punishment” in response to others’ non-cooperation to be based on retreat on mitigation policies by cooperating countries; far better for “punishment” to be applied outside the climate change mitigation sphere. There is already influential talk in the United States (amongst those supporting firm mitigation policies at home) and the European Union, of trade sanctions against non-cooperating countries. This is likely to become part of the framework of enforcement of cooperative behaviour on mitigation. I myself worry about the risk of capture by other interests favouring protection for other reasons. Withdrawal of opportunities for trade in greenhouse gas credits and development assistance would seem to be less problematic instruments of “punishment”.

What sorts of principles might guide the allocation of a global emissions budget across countries? To be widely accepted as being reasonable the principles will need to be simple, transparent and readily applicable.

In the end, they will need to give much weight to equal per capita rights of emissions. They will need to allow long periods for adjustment towards such positions—within the over-riding requirement to stay within an environmentally responsible global emissions budget. One possible way of bringing these two elements together would be the “contraction and convergence” approach that has been discussed favourably in Germany and India at times in the past.

The world will need to provide headroom for emissions growth in rapidly growing developing countries, within a general principle of sharing the adjustment burden. The headroom may

take the form of challenging emissions intensity targets - for example, with emissions intensity of output falling by more than half of GDP growth rate – for developing countries growing too rapidly for it to be possible for them to hold to a budget tied mechanically to “contraction and convergence”. The principles will need to embody developed country commitment to investment in research and development and the subsequent diffusion of technologies to developing countries.

A limit would need to be placed on the provision of headroom for rapidly growing developing countries. For example, if the “contraction and convergence” approach were to be accepted as the first organising idea, and an “emissions intensity” alternative introduced for rapidly growing developing countries, the “headroom” could be withdrawn at the point where the developing country’s rising emissions per capita reach a benchmark trajectory in per capita emissions. This benchmark trajectory would be based on an average of the emissions profiles of moderately emitting developed countries (e.g. Europe, Japan, New Zealand), which would be expected to be much lower than at present at the point where the two trajectories intersect.

The proposals for equitable allocation of a limited global emissions budget are at an early stage of development. Australia’s proximity to the rapidly developing countries of Asia, while being one of the three exceptionally large per capita emitters itself, gives us important perspectives to bring to the international discussion of these matters.

The keys to the eventual emergence of an acceptable basis for allocating a global emissions budget would be the widespread acceptance that it is essential to reach an agreement; that the allocation formula is simple; and that it is impossible to cover every valid special case.

The costs of living within global and national budgets would be lower if the allocation of rights to emissions were tradable between countries, under principles that are adumbrated below.

AUSTRALIA’S INTERESTS

What should Australia aim for as the world discusses a global emissions target?

Australia is likely to be damaged more than any other developed country by climate change:

- Our environment is dry and highly variable already. This will be exacerbated with climate change, with the effect on agriculture and water supplies being particularly pronounced. The climate models tell us that the reduction in precipitation within global climate change is likely to be especially pronounced in the latitudes of southern Australia, where most Australians live.
- Our location means we are surrounded and affected by developing countries which would be disproportionately affected by dangerous climate change.
- Our terms of trade are more favourably affected than those of any other developed country by the maintenance of the strong Asian and global economic growth of the Platinum Age.

At the same time, Australia is well placed to do well as part of an effective global mitigation effort.

- We have exceptionally rich resources for solar, geothermal, and wind energy and possibly for biofuels from the savannahs that currently make minor contributions to food production.
- Our large livestock industries are less emissions-intensive than our competitors in Europe, northeast Asia and North America.
- We have large resources of high quality (that is, low emissions per unit of energy) coal, which means that our share of the global coal supply would rise under an effective global mitigation regime.
- We have large deposits of natural gas and uranium, the exports of which would increase in a world of major and effective mitigation.

- We have an exceptional endowment of favourable sites for carbon capture and storage, the best of the known resources being favourably located in relation to the coal-using industrial centres of southeastern Australia.
- And we have an exceptional human resource base in engineering, management and finance related to the resources sector, which places us well for competitive participation in innovation in the emerging, low-emissions energy industries.

All of these Australian strengths facilitate, and render less costly, domestic mitigation. Within an appropriate policy environment, they will provide a basis for new export opportunities, especially in the context of effective global action on mitigation.

To date, Australians have been encouraged to concentrate on an unhappy part of the reality: that mitigation is a risk for Australia due to the disproportionate importance of our trade-exposed, exceptionally emissions-intensive industries.

Without an adequate international framework to deal with these industries, domestic action may lead to movement of these industries overseas, reducing to some extent the value of Australia's economic output and in the worst of circumstances perversely affecting global emissions. The political economy of rent-seeking behaviour converts this possibility into a compelling argument in every country, whether or not it has real substance in particular cases. There is a resulting tendency for systematic exclusion from mitigation disciplines of the most emissions-intensive industries, raising the cost of mitigation for the economy as a whole.

The solution is to ensure that the exceptionally emissions-intensive trade-exposed industries—non-ferrous metals smelting, steel, cement and a small number of others—are subject to similar disciplines in major producing economies for each commodity, comparable in effect to the application of the general mitigation regimes being applied by major economies.

Objective analysis of the policy regimes applied to the emissions-intensive industries in other major economies including China suggests that the world is much closer to this point now than is acknowledged in the Australian discussion of mitigation policy.

Taking everything into account, it is strongly in Australia's interest to encourage effective global approaches to mitigation around ambitious global targets.

Australia can move towards securing its interests in a number of ways.

First, ratification of Kyoto will strengthen Australia's voice in global discussion, first of all in Bali next month.

Second, leadership could be shown by supporting the emergence of understandings in Bali and beyond on incentives for reducing emissions from deforestation; on the need for an ambitious global budget; and for principles for allocation of the global budget amongst countries.

Third, Australia can ensure that its own mitigation regime fits productively into the international regime which we judge to be feasible for the future. Our own announced emissions targets should relate approximately to the emissions budget that we judge to be likely to emerge from a global discussion of principles for allocating rights among countries. A complementary step would be to work with others, including developing countries in our region, to encourage their own development of internationally compatible mitigation policies, encouraged by opportunities for trade in permits and technological exchange.

Australia, alone or with others could usefully act on the basis of principles that it judged to have prospects of being part of an eventual global understanding on allocation of emissions rights. We are too late to be one of the first to move amongst developed countries, but we can cease to be a laggard. Australia's own adoption of an efficient mitigation approach, carefully designed to encourage others to move towards effective contributions to global mitigation, can play an important international role. Our action would be a step towards resolution of the repeated prisoners' dilemma.

Finally, Australia has a vital interest in the acceleration of the development of new clean energy technologies. It has an especially strong interest in carbon capture and storage from

coal. It shares this interest with other economies with large or politically-sensitive coal endowments, including in the European Union and China, which provides a strong basis for international cooperation. Australia can usefully take a lead in promoting this cooperation.

LIVING WITHIN AUSTRALIA'S EMISSIONS BUDGET

At the centre of a mitigation strategy is the setting of a price on emissions, paid by anyone who emits greenhouse gases. The price is meant to reflect the environmental costs of the emissions that would not be paid by the people whose decisions generate them. Once the price is in place, individuals' and firms' private decisions in their own interests can be expected to establish the socially appropriate balance between environmental and other interests. It will lead to market decisions that keep Australia's emissions within its national budget.

Establishing the right price is a complex matter. Today I will only raise some of the issues. A public forum within the Review, early in 2008, will address the issues in detail.

If the price is established at the right level, there is no need for other policy measures to tip the balance of private decisions on supply and use of fossil-fuels towards low-emissions technologies. But for as long as the price, now and expected in future, is insufficiently high to ensure that Australia lives within the national emissions budget, a case can be made for other measures, such as a mandatory renewable energy target, during the transition to an environmentally and economically rational emissions price.

There are two ways of setting an emissions price. (Because we are mainly talking about carbon dioxide emissions, I will use the term "carbon price"). One is through a carbon tax. The other is to set a limit on carbon emissions, now and in future, to require a permit to emit carbon dioxide, to allocate permits up to that limit, and to let the market set the carbon price (an emissions trading scheme "ETS").

An ETS and a carbon tax are both market-based approaches to confining emissions within a specified budget.

The essential differences between a well-designed and credible ETS and a well-designed and credible carbon tax are not as large as is often supposed. Many economists prefer a carbon tax because they hold the view that the alternative is not a well-designed and credible ETS, but a distorted one, surrounded by uncertainty about key parameters. It could be said that they have experience to date from the established carbon ETS schemes on their side.

Those who prefer an ETS compare its ideal qualities with a carbon tax.

The international community of developed countries, and Australia, have opted for an ETS. I am comfortable with the Australian decision, so long as we are clear in our minds about the conditions that are necessary for an ETS to achieve its environmental objective at optimally low economic cost.

There are two important advantages of an efficient ETS. First, allowed to do its job without political limits or adjustment, it can be relied upon to constrain emissions within the specified total budget. Second, it sets the current and future prices directly, without bureaucratic clairvoyance about the many relevant and continuously changing influences on the supply and demand side for emissions permits. The task is to establish in Australia a well-designed and credible ETS.

It should be noted at the beginning that for some countries, and probably all developing countries for the time being, an efficient ETS is probably impractical, and a market-based mitigation effort would need to be built around a carbon tax. Ways can be defined to secure mutual gains from international trade in emissions rights between ETS and carbon tax regimes.

First of all, an efficient ETS would be built upon a firm and credible greenhouse gas emissions budget, covering the many future years that will be affected by current decisions. The size of the budget would relate appropriately to the global budget that Australia would like to see

established and enforced, and to the principles for allocation of that budget that Australia judges to be a reasonable and feasible basis for ultimate international agreement.

The games theory considerations, discussed earlier, argue for multiple carbon budgets: one representing what Australia is prepared to do initially as part of the developed country contribution to start the game on a favourable basis; and the others representing what Australia would be prepared to do in the context of an effective, global agreement. There is negligible risk that an emissions reduction schedule culminating in a 60 per cent reduction from current, or Kyoto 2008-12, levels by 2050, will be more restrictive than would be required as Australia's contribution to enforcement of an environmentally satisfactory global budget. Such an emissions reduction schedule may turn out to be a reasonable first step, within the context of what other developed countries (including the United States after 2008) are prepared to do.

The likelihood of a tightening of the Australian emissions budget after the establishment of the ETS is a challenge for credibility of the system. The possibility of change, its extent, and the circumstances under which it would occur would need to be defined as tightly as possible at the time the ETS is established.

The binding budget, or budgets, should be specified as the total amount of emissions over a long period of time. Short and medium-term targets, like the 2050 goal of reduction in 2000 emissions by 60 per cent, can usefully be announced as a guide to market price formation, and to the timing of release of permits. But an efficient ETS will allow flexibility in the timing of the use of permits within a firm total budget.

The problem of allocating a fixed, multi-decades budget of greenhouse gases over time at the lowest possible cost is familiar from resource economics as one of optimal depletion of a finite resource. A free and credible market in units of the resource would establish a spot price, and a forward price curve that rises at the relevant interest rate. The spot price would not be low from the perspective of current Australian discussion, and the long-term price would be high. Together, the spot price and forward prices would be high enough to cause Australia to live within the total emissions budget.

The spot and forward prices would adjust together in response to new information. For example, new information that suggested improved prospects for low cost carbon capture and storage ten years from now would lower the whole price curve, spot and forward, with the price still rising at the interest rate from the new, lower level. The lower price would reduce pressure for abatement from other sources, now that there was greater confidence in future abatement through carbon capture and storage.

On the other hand, a disappointment of expectations about the future prospects for low cost carbon capture and storage would raise the whole price curve, still with the future prices rising at the interest rate from the new, higher spot price. The higher price would increase pressure for abatement from other sources.

The market for gold illustrates how a perfectly competitive, deep and mature market for an exhaustible resource results in a forward price curve, with price rising at the interest rate. This price curve provides fundamental stability to the market, providing opportunities for hedging price risks, and adjusting quickly to new information.

The central challenge is to establish credibility.

The ETS will only work as the main instrument for achieving abatement targets if the greenhouse gas budget and the ETS structure are credible—if the market accepts that they will not change over time in response to adjustment difficulties and political pressures. Much thought needs to be given to expedients that contribute to credibility: to legislative entrenchment of the budget and the system; to securing the property rights of holders of emissions rights; to administration of the system by a well-resourced independent authority.

An efficient ETS will separate the distribution of the value created by making emissions permits scarce, and the allocation of permits. The economically efficient as well as transparent way of allocating permits is to sell them through a competitive process.

On the basis that this major environmental reform is not meant to arbitrarily increase the proportion of the economy under the control of the public sector, the proceeds of the sale of permits should not be available for general purposes of government, but should be separately identified for return to the community.

On the basis that this major environmental reform is not meant to have large and arbitrary effects on the distribution of income—and in particular not to redistribute income away from people on low incomes—that part of the carbon value that is secured by sale of permits that is passed on to households could be returned to households in an equitable and economically efficient way. Any part of the carbon value that is associated with demonstrated compression of profit margins in the business sector in the early years of the ETS could be returned in an economically efficient way to relevant parts of the business sector.

As already noted, there are good reasons for special treatment of exceptionally emissions-intensive, trade-exposed industries during the transition to widespread and broadly comparable international carbon pricing.

The carbon price that emerges from an efficient market would force enough structural change to achieve the emissions budget.

Finally, it is worth discussing the difference between the price of carbon and its cost to the economy.

The cost to the economy is not, as some have suggested, the carbon price set for emission permits. It has been a fallacy of the Australian discussion to date to equate the carbon price to economic cost.

In the same way that, following the introduction of the GST, the Australian economy did not contract by the amount raised by the GST, so too will be the economic impact of an emissions trading scheme in Australia. To understand the reason for this, we need to trace the impacts of a carbon price as it flows through the economy.

There is no cost to the overall national economy from that part of the carbon price that is absorbed by business or passed on to households. The only overall cost to the economy is the expenditure on substitutes, net of existing higher costs imposed through mandatory schemes.

The Stern Review estimates that the cost of stabilisation of greenhouse concentrations at an acceptable level would total around 1% of world GDP. Cost estimates for Australia are in a range that covers that number. These costs do not of course mean a reduction from current income levels, just smaller future increases in incomes. A 3% GDP impact at 2050 would mean that Australia's GDP would treble by 2051 rather than 2050.

So if the price of emission permits is not all a cost to the economy, where does this price impact go? The part that is not used to pay the costs of more expensive alternatives in supply or demand, goes to whoever receives the value embodied in the permits. Most of the price impacts, especially in the early period, is likely to be passed through to households. So the value is not lost – it is simply transferred in this case from household to whoever receives the value from the permits. If the scarcity value of the permits is collected by Government and passed back to households in appropriate ways, there is no negative income effect on households.

Similarly, that part of the price of permits that does not pay for the higher costs of substitutes, and is not passed on to households may compress profit margins in energy-intensive businesses (whose energy is derived from emission intensive sources). Again, if the scarcity value of the permits is collected by Government and passed back to exceptionally impacted businesses in appropriate ways, there is no exceptionally large effect on the profits of energy-intensive industries.

The overall redistribution of income may be large by any standards—including redistribution away from low-income households. Without appropriate policy responses, the redistribution of income will lead to political resistance to economically and environmentally efficient carbon prices. For these reasons, efficient distribution of the value of the permits is essential to the efficiency of an ETS, as well as to equitable distribution of its impacts.

CONDITIONS UNDER WHICH INTERNATIONAL TRADE IN EMISSIONS RIGHTS WILL HELP TO REDUCE THE COSTS OF AUSTRALIAN AND GLOBAL MITIGATION

The cost of Australia and other countries living within a specified carbon budget can be reduced by international trade in permits. Careful thought must be given to the conditions under which genuine gains from trade will be achieved. The conditions would include:

- all countries having a similar definition of a carbon unit;
- all countries having monitoring and enforcement mechanisms of a minimum standard;
- each country having a defined budget over the period during which the trade is to occur and for which the permits will be valid, with only the “savings” from the defined budget being available for trade; and
- countries not having individual price caps or floors – otherwise one country could flood the market with additional permits, or be forced to buy up permits without limit.

Some countries may opt for an ETS while others might adopt a tax, or direct regulation. The alternative paths are more likely to be chosen in developing countries in which the application and administration of a tax is more feasible than that of an ETS. In such cases, international trading of emissions allowances would still be possible, perhaps through a national gateway, as long as the basic conditions about defining units of emissions are met.

Considering the question of when different national schemes should be linked is more difficult. Any established system will attract vested interests around the status quo, making it better to establish a multi-country system from the beginning, than to cause surprise while the ETS is operating.

In the absence of prior agreement, there would be value in announcing at the beginning of the ETS the conditions on which international trade in permits would be introduced. The announcement should include details of the timing of expansion of opportunities for trade, and the conditions that would need to be met before the scope for trade would be expanded.

THE ROLE OF GOVERNMENT BEYOND THE ETS

The over-exploitation of the atmosphere as a global commons is the primary climate change market failure. But there are several other sources of market failure which need to be corrected if private decisions within a market context are to lead to minimum-cost realisation of abatement objectives.

These fall into three broad areas:

- Research and development;
- Infrastructure provision, and
- Information.

The presence of large external benefits from private expenditure on research and development, and more generally on innovation, mean that putting a price on carbon alone will not lead to economically optimal levels of activity.

The case for Government support for research and development is well established. The challenge for policy makers is to set up institutional arrangements that allocate scarce public resources as efficiently among areas of potential investment in R&D. The Review will articulate relevant principles.

There are also market failures in the transaction space — that is, the market alone may fail to create the opportunities for transactions to take place. There may be a need for government participation in establishment of efficient networks for electricity transmission, gas transportation, and the agglomeration of carbon dioxide for sequestration.

The third group of market failures arise from information failures.

The implications of climate change are so complex and pervasive, that consumers can hardly be expected to gather complete information.

There are also market failures on the adaptation side of the climate change challenge. Whilst I have not spoken much of this today, adaptation policy is vitally important. We will face an uncomfortable degree of climate change regardless of the success of mitigation efforts. How governments and communities plan for adaptation will influence strongly the social and economic costs of climate change.

WILL CLIMATE CHANGE AND HUMANITY'S RESPONSE TO IT END THE PLATINUM AGE?

There are several ways in which climate change could end the Platinum Age.

Climate change itself could seriously disrupt economic life and political stability in some major economies, to an extent that undermined the foundations of sustained, rapid, internationally-oriented growth.

On the scenarios defined by the IPCC that have drawn most attention, the main impacts of inadequately mitigated climate change would come after the completion of most of the Chinese transition to a developed economy; but there are large statistical variations above and below the central expectations, and the business-as-usual rate of growth in emissions is and is likely to be far more rapid than assumed in the standard projections. The odds are higher that climate change itself would disrupt the extension of high living standards to other parts of the developing world after the substantial completion of the Chinese transition.

Major shocks can affect economic activity beyond the immediate and direct economic impacts.

The effects of the 1890s depression in eastern Australia, and of the global Depression of the early 1930s, were magnified many times by the changes in attitudes to economic institutions and policies that emerged from them. The financial crisis in Indonesia in 1997 and early 1998 was converted into a catastrophic decline in output and incomes by its interaction with a fragile political system.

These are amongst the effects to be watched from unexpectedly large climate change impacts. It is worth keeping in mind that carefully designed adaptation policies can reduce the chances and impacts of major shocks.

The Platinum Age could also be disrupted by poorly thought out approaches to mitigation.

Stern has presented the results of work that suggests that the global costs of effective mitigation need not be large. On the basis of the application of this analysis to the central forward-looking scenarios of the IPCC, the continuing costs of holding global emissions to levels that greatly reduced the risks of dangerous climate change would be about one percent of GDP, or a modest fraction of one year's increase in global output. The costs would be somewhat greater if, as I think likely, the underlying rates of emissions growth in the Platinum Age are much greater than presumed in the IPCC scenarios and the Stern Report.

But the costs of mitigation in practice would depend on the nature of the policies applied to it, and the manner of their implementation. Costs would be minimised within steady policies over long periods that provided incentives that placed with private parties the full external costs and benefits of decisions taken by people and businesses everywhere. Such approaches would allow private decisions within market contexts efficiently to shape the processes of change.

Poor design, or tardiness in implementation, would increase the costs of mitigation immensely, and compromise the mitigation effort.

Progress that is later judged to be inadequate is likely to be associated with policy panic, instability and belated concentration of adjustment into disruptively short periods. And there is the ever-present danger of mitigation policies, with their potential to have large effects on the distribution of incomes, being encrusted with the usual political economy of rent-seeking behaviour by vested interests, and becoming intertwined with the familiar distortions in public policies related to trade and investment. For individual countries, and for the world as a whole,

such policy distortions can make the difference between strong economic growth and stagnation.

Income distribution effects will need to be taken into account in design of policies. It is important that there is analytical rigour in design and discipline in implementation of policies designed to secure equitable distribution of the effects of mitigation. Inefficient distribution—an indiscriminate spraying of “compensation” towards interests that press strongly for it—would greatly increase the ultimate costs of mitigation.

Climate change and poorly designed responses to it could bring the Platinum Age to an end. But if they do, it will represent failures in the design and execution of policies.

Australia can play a significant role in the international community avoiding failure.

I look forward to your active engagement with and contribution to the Review, so that together we can explore options that increase the chances of success.