

8 of 112 DOCUMENTS

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1 - All-round Country Edition

A case where the climate cure is more costly than the disease

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The Garnaut report's trouble is it costs the problem but not the solution, observes **Henry Ergas**

DEMOCRACY, as Arthur Balfour said, is government by explanation: but the explanations must be good ones. The Garnaut report was to explain the basis for the Government's climate change policy.

Unfortunately it leaves open more questions than it answers.

This is because the encyclopedia Garnaut and his team have produced does everything except what it was supposed to do: cost a target for greenhouse emissions reductions.

That, we are told, will come later, with the delay being due to difficulties in the modelling of emissions reductions and their economic costs.

That a delay would occur is hardly implausible.

But given that the primary purpose was to present those estimates, why didn't Garnaut simply delay the completion of his report?

Surely the public, having ordered the steak, would hardly find it satisfactory to be served only the vegetables, with a promise that the steak would come with dessert?

The failure to present any estimates of the cost of emissions reductions is important because it makes the report unbalanced.

Working on the principle that a risk perceived is a risk indeed, the damage climate change could cause is explained at length, but there is no corresponding discussion of the costs and risks involved in action to prevent climate change from occurring.

The absence of costings lets the report off the hook.

Since it doesn't weigh up the probable costs and benefits to Australia of alternative policy options, it isn't forced to grapple either with the likelihood of effective international agreement actually being reached or with the consequences of implementing an ETS if it isn't.

As these risks, and the costs of going ahead regardless, are not properly weighed in the balance, the report too often reads like a call to arms, rather than objective policy analysis.

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This feature of the report is accentuated by its one-sided presentation of material.

Nowhere is this clearer than in the report's discussion of the harm climate change could do the living standards of future generations of Australians.

Estimating the extent of that harm is fraught with judgments and assumptions, and some will think the report understates the costs, while others will think the opposite.

But what is important about the report's estimate is the one thing the report never mentions: which is that it is hardly a huge number.

If one accepts the report's estimates of the real income loss consequent on adverse climate change, then fully offsetting that income loss would require putting aside each year an amount that would be about 0.7 per cent of Australia's GDP in 2008, and which would decline to less than one-third of 1 per cent of GDP by mid century.

This assumes a real global rate of return on investment globally of 6 per cent, which is reasonable by historical standards and consistent with the strong economic growth projections set out in the report.

Given a government committed to a budget surplus in the order of 1.5 per cent of GDP over the economic cycle, this level of saving could be achieved with little or no sacrifice to consumption. Indeed, one could readily double the report's estimate of the loss (say, to even more fully reflect non-monetary losses) without that conclusion being in any way undermined.

This is important not only because it puts the issue in perspective, but especially because it sets a ceiling on the acceptable costs of an ETS.

Any ETS that costs us more than the precautionary savings set out above would be difficult to justify, as it would impose a larger sacrifice than needed to preserve future living standards.

Indeed, given the risk that our own abatement efforts will have little consequence, and that global agreement will not be reached or will prove ineffective, the amount we should be willing to spend on an ETS ought to be even lower than that ceiling, thereby freeing up some income for the precautionary saving we will need should harmful climate change occur. The report could and should have explained this much, but it doesn't. Nor does it explain as directly as would have been desirable the consequences of its preferred approach to allocating permits globally, which is on a per-capita basis.

Australia will continue to have a very small share of world population and hence, under a per-capita allocation, would obtain a small share of global emissions permits.

At the same time, our comparative advantage means that we should specialise in emissions-intensive industries, such as agriculture, minerals and energy. Given per-capita allocation of emissions permits, to do so we would have to buy permits from overseas, which would partly transfer to foreigners the gains from our resource endowment.

Perhaps this wealth transfer is desirable; but it is no less desirable for the public to understand that such a wealth transfer would occur, potentially on a very significant scale, were the report's recommendations accepted.

This tendency to understate problems with the preferred approach is also apparent in the report's treatment of the transition to an ETS. The report acknowledges that there may be a case for a "slow and low" start, with a capped emissions price being set for a two-year period.

What it does not explain is why the uncertainties that make such a gradual start sensible would be materially reduced after merely two years.

By the end of 2012, it will still not be clear whether an effective global regime will come into place; and

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even the response of the Australian economy to an ETS will remain highly uncertain, as the adjustment processes will take many years to work.

In the meantime, new shocks will emerge, as the world economy itself continues to change.

All of these uncertainties are best dealt with by retaining a capped carbon price that reflects the benefits of abating later rather than now. Such a capped price would ensure that even after 2012 the costs of any abatement do not exceed the benefits, which especially in the near term, are likely to be very modest. Yet this too the report does not confront, other than by assuming that uncertainties will melt away.

Finally, there are the instances where there is at least the semblance of partisanship.

Garnaut's response to calls from the Opposition for the fuel excise to be reduced should an ETS be imposed is a case in point.

Any such reduction, he suggests, would send the wrong signal to developing countries, especially those which continue to heavily subsidise fuel consumption, and would in any event be economically unjustified.

However, there is no more virtue in unduly taxing a commodity than there is in unduly subsidising it: both distort relative prices and reduce efficiency. Fuel prices are already trebly taxed: by the excess mark-ups arising from the OPEC cartel, by the fuel excise and by the GST. Compounding the distortion by adding a fourth tax, without adjusting the others, would be both inefficient and inequitable.

In short, this is a report that costs the problem, but says little or nothing about the costs of its proposed solution. As for its proposed solution, it does not even seek to systematically compare it with alternatives: rather, it acts as if the only options were complete inaction on the one hand, or its version of an ETS on the other. And for all of its 500-plus pages, it is at times uncomfortably thin on analysis, appealing to fears and hopes rather than likelihoods and realities.

Yet the policy decisions the report calls for are of huge consequence: they cannot be made on the basis of romanticism and generous impulses.

To claim those decisions must be made immediately is as reckless as it is nonsensical: rather, what is needed is a far more careful testing of the facts.

That the Opposition has been debating these issues is therefore hardly worrying; what would be terrifying is if the Government were not to.

For without such a full debate, the greatest threat to Australia's future prosperity will lie not in the climate, but in ourselves.

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