The Australian

Climate adviser misses the point

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IN his recent report on Weighing the Costs and Benefits of Climate Change Action, Ross Garnaut argues that urgent action to reduce emissions by setting a carbon price would be in Australia's national interests.

To reach this conclusion, the report considers the costs and benefits to Australia of emissions reduction. It should be commended for doing so, as that brings vital discipline to the debate. Yet even accepting the report's account of the science, its assessment overstates the benefits of immediate action and understates its costs and risks.

The difficulties arise even if one assumes that effective international agreement on mitigation is reached, allowing Australia to reap long-term benefits from mitigation efforts. As the report recognises, it would still need to be established that those benefits outweighed costs.

Whether that test is met is affected by how costs, incurred now, and benefits, decades away, are converted into a comparable measure in the present. There are no easy answers as to how this should be done. It is obvious, however, that no one would accept an offer to invest $1 today in a project that would return only $1 70 years from now.

The compelling reason for rejecting that offer is its opportunity cost: were that $1 invested in government bonds, its value in 70 years (assuming, as per Australian experience, inflation-adjusted annual returns of 3.5 per cent) would exceed $11.

As a result, $1 in 70 years is only worth some 9c today: because a sacrifice of merely 9c can secure a riskless claim on $1 in the distant future. And if the relevant alternative yields higher risk-adjusted returns than government bonds, the offer is worth even less.

Future benefits must therefore be discounted in line with returns on alternative investments. Doing so need not involve placing less weight on future generations' welfare than on our own. Even if equal weight were placed on the welfare of all generations, opportunity costs would still be crucial.

Consider mitigation action costing $1 billion today but yielding an environmental benefit valued in 2111 at $50bn. Assume also the $1bn could instead be invested at an expected annual return of 6 per cent. Future generations would not want us to undertake that mitigation, as the alternative would yield over $300bn, compensating them six-fold for the foregone environmental gain. Choosing the mitigation investment would therefore be unethical and irrational.

This is not to deny it can be appropriate to discount long-term net benefits at a lower rate than net benefits next year. For example, future returns may be uncertain: the alternative might yield not 6 per cent but only 2 per cent. If the 6 and 2 per cent outcomes are equally probable, the correct discount rate gets closer to the lower value the further in the future one goes.

But even taking that into account, the report's discount rates are far below opportunity costs, especially if mitigation diverts resources from other investments. The effect is to greatly overstate the value today of mitigation's future benefits.

The report tries to justify this by reference to what it calls a normative approach to the discount rate. But there is nothing particularly normative about ignoring opportunity costs; nor does the report address the many distortions ignoring opportunity costs creates.

Rather, the report suggests that even if higher discount rates were used, mitigation could still be worthwhile if it reduced the likelihood of catastrophic outcomes. True, the possibility of catastrophic outcomes creates a case for insurance. But the question remains whether unilateral mitigation in fact provides that insurance.

This question is especially acute if two points are accepted: first, that it is uncertain whether effective international agreement will be reached; and second, that whether Australia imposes a carbon price may have some impact on prospects for international agreement but that impact is hardly decisive.

A scenario must therefore be considered in which we engage in unilateral mitigation, as the report recommends, but international agreement is not reached, and the catastrophic outcome it fears eventuates.

In that scenario, unilateral mitigation would certainly make us poorer. That is undesirable in itself. Additionally, by impoverishing us, it would diminish the resource pool on which we could draw in responding to the catastrophic outcome and increase the welfare cost of adjustment.

Unilateral mitigation would, in other words, be anti-insurance: it would increase the cost of the very risks the report paints. Faced with that possibility, the report's own logic, of maximising net benefits to Australia taking account of uncertainties, would command a prudent decision-maker not to undertake unilateral mitigation.

This is all the more the case as postponing mitigation allows costs to be avoided, but will have little effect on benefits.

That is obviously true in the scenario in which mitigation is and would remain unilateral, as in that scenario, mitigation cannot yield benefits. However, even in the alternative scenario, in which there is eventual agreement, delay will be worthwhile so long as the costs of mitigation do not increase more rapidly than the return on alternative investments.

Historically, annual returns on capital in Australia have been around 8 per cent real. Given continued rapid progress in low emissions technologies, delay is unlikely to cause Australia's mitigation costs to rise more quickly than that, particularly if the delay is relatively short.

Taking into account these benefits of postponement both in the scenario in which agreement is reached and in that in which it is not, the report's logic would again tell against unilateral action.

The report avoids this conclusion by not modelling costs and benefits in the scenario in which we abate but the world as a whole does not. It ignores that scenario altogether.

This is inconsistent with the risk assessment framework it rightly recommends.

The report's conclusions are therefore not properly made out. Until they are, its calls for immediate unilateral action, with all its costs, remain unconvincing.

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