

The Prime Ministerial Task Group on Emissions Trading

An Assessment

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The final report by the Prime Ministerial Task Group on Emissions Trading is a critical turning point in the climate debate in Australia. This report is particularly important for a number of reasons. First, it offers a strategy for climate policy in Australia that moves away from the recent approach of specific subsidies for technology to reduce emissions, and towards a policy of pricing greenhouse-gas emissions so that all greenhouse-gas-reducing technologies are encouraged. More importantly, the Task Group approach offers a new framework for global climate policy to move beyond the approach followed in the Kyoto Protocol.

The broad philosophy of the report is based on the McKibbin-Wilcoxon 'Blueprint' which was outlined in McKibbin and Wilcoxon (1997) and fully developed in McKibbin and Wilcoxon (2002a). The key difference between the approach of the Task Group and the Blueprint in comparison with the Kyoto Protocol is the realisation that aiming for fixed emission-reduction targets, no matter what the cost, is not as viable as an approach that adapts gradually to a combination of clear goals for emission reductions, taking into account the economic and social cost of reducing emissions. Importantly the Task Group approach is from a class of policies known as a price-based approach rather than a quantity-based (or target-based) approach. Setting prices for emissions — and relying on rising longer-term prices, rather than short-term quantitative targets — is argued by many authors to be a more efficient way for tackling climate change than the economic theory of environmental policy design under uncertainty.²

Although the underlying economics of the taskforce report is clear, the proposed implementation of the approach is different from the Blueprint because of political compromises built into the design of the policy. It is important that, to be effective, climate policy have bipartisan support so that the incentives for moving to a lower carbon world are credible. The Task Group report should

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² See Roberts and Spence 1976, Weitzman 1974, Pizer 1997 and McKibbin and Wilcoxon 1997, 2002b and Nordhaus 1993.

form the basis of the policy of both political parties in Australia. To do this requires some movement away from the current proposals in the report towards more credible deep cuts as advocated by the Labor Opposition.

In understanding the Task Group approach, it is useful to compare it to the Blueprint. The approach in the Blueprint is to move away from the philosophy of the Kyoto Protocol of specifying targets and timetables without worrying about costs, to one of setting long-term goals for emissions, with the precise timing of cuts being based on smoothing the costs of emission reduction. Without a mechanism for managing the costs of cutting emissions, the Kyoto approach is subject to problems of lack of commitment. Witness the lack of abatement in most Kyoto-ratifying countries to date. With the Kyoto commitment period, 2008–12, almost upon us, most countries are exceeding their targets for greenhouse-gas emissions by significant amounts because they are unwilling to cut emissions without knowing the costs of doing so. More importantly, major developing countries that will be the major source of growth in greenhouse-gas emissions in future decades are unwilling to take on binding emission-reduction targets. A promise to cut emissions, no matter what it costs, lacks credibility. As countries fail to reach their targets, the global system will ultimately be undermined and the system designed to support the cuts is likely to fail.

Undertaking studies to pick targets in order to minimise costs is important but, in the end, the actual costs of reducing carbon emissions will be determined in the real world, not by computer models which can at best be indicative of the costs. The implemented greenhouse-abatement policy must build in safety valves (that is, mechanisms that limit cost) and flexibility through time so that a least-cost strategy for emission reductions can be found. Under the Blueprint, the key to enhancing credibility of long-term carbon goals is based on the creation of long-term carbon permits equal to the long-term reduction goal (that is, bundles of permits that gradually diminish over time, reflecting the long-term goal of reducing carbon emissions). These long-term permits, once created, should be taken out of the hands of government and issued to key participants, and then traded in a domestic carbon market to set a price of carbon every year into the long-term future.

In the Blueprint, this credibility is achieved by the complete allocation of all long-term permits (reflecting the path of cuts through time such as a Labor-style target) to all households and industry. At set times in the future (five-year steps), a maximum annual carbon price is announced for the next five years as a safety valve against spikes in carbon prices in case there are not enough long-term permits around in any year. The government implements this safety valve by promising to issue as many permits as required by greenhouse-gas emitters at a fixed price. Thus the annual market price is capped at the safety-valve price but it can fall below this price. Note that there is no cap on the long-term carbon

prices but only on carbon prices in the current year. The long-term carbon price is the expected future price of carbon at each year into the future — taking into account the resetting of the safety-valve price every five years.

Under the Task Group approach, some medium-term permits (or, in the taskforce's parlance, a bundle of permits of different duration) are partly handed out, initially to industry, with the rest auctioned by the government. Every five years, a review of emissions is conducted and new bundles of permits of different duration are auctioned. This is argued in the report to be more politically palatable because it gives government a chance to effectively change the target because the science has changed, the international debate has changed or industry has been effective in lobbying for the release of more permits. The problem with this added flexibility, relative to the Blueprint, is that it reduces the credibility of the long-term carbon constraint and therefore increases the uncertainty of the long-term carbon price.

This strategy is not as robust as the Blueprint because, in order to minimise the economic costs through time, there needs to be a rising carbon price signal. The expectation of rising future carbon prices gives strong incentives for investment in carbon-reducing technologies. It is much better to partly tie the hands of future governments by putting the long-term target reduction in the hands of the people, to build a constituency for real carbon abatement. This also addresses the problem of the time consistency of carbon policy where future governments have an incentive to change policy once the private sector has made investment decisions.³ A safety valve takes care of any excessive short-term economic costs. There is no need to have a continuous process of medium-term permits being issued. This policy also undermines the credibility of the medium-term target since there is no guarantee a large quantity of future permits might be issued if industry was effective in lobbying for it.

The second aspect of the Task Group report that is important (coinciding with the Blueprint approach) is the idea that climate policy should be built up at the national level and coordinated across countries, rather than designing policy at the global level and forcing countries to adopt a global framework that may not be perceived to be in their national interest. Implementing policy at the national level but coordinating across countries on key features such as the short-term global carbon price is critical. With a common short-term carbon price (achieved when countries are at the safety-valve price), there is no need to trade carbon permits across countries because the price is already equalized. Thus the market does not deliver the price of emission but it delivers the amount of differentiated abatement across countries at a common price. With a tight enough target path for longer-term emissions, the safety-valve price is likely to

³ See McKibbin and Wilcoxon 2002a.

be the binding constraint on economies and thus the system becomes one of a common carbon price. This is much like a uniform carbon tax but with most of the revenue going to owners of longer-term emission permits and the marginal revenue going to the government for the sale of safety-valve annual permits. This is also known as a 'hybrid' policy of permit trading and carbon taxes.

The third issue that needs to be addressed if the Task Group approach is to be adopted globally is the problem of the existence of current subsidies to greenhouse-intensive activities. In a somewhat dated study, Anderson and McKibbin (2000) found that reducing existing subsidy and tax distortions in world coal markets would reduce greenhouse emissions by more than a fully effective Kyoto target, and raise global GDP in the process. The issue of existing distortions that encourage greenhouse-gas emissions in the Australian context also needed to be addressed as part of the implementation phase of the new Task Group approach to climate policy.

Finally there is the issue of when a permit-trading market could be implemented in Australia. The timeline of the Task Group is to have a prototype in place by 2011 and trading by 2012. This can be done more quickly. The mechanics of setting up the carbon-trading infrastructure has been well understood since the publication of the very good Australian Greenhouse Office working papers (1999) on carbon trading. An effective market could be in place by 2010. It could only be that the politics of Kyoto with a 2012 end date is a complicating factor in when the market would be launched in Australia.

The Task Group report is a valuable document on which to build a better approach than that taken by Kyoto. In implementing the report, the government could improve on the recommendations by making a stronger longer-term commitment to the goal of emissions reduction and thereby generate less long-term price uncertainty. Households should also receive a substantial allocation of longer-term permits: both because it is fair and because widespread ownership of long-term emission permits in superannuation funds and in the balance sheets of major corporations would raise the awareness of the importance of carbon dioxide emissions throughout society.

The Labor Opposition should blend the taskforce ideas around the announced policy of deep cuts by implementing the deep cuts through a Blueprint-style, long-term permit allocation with a safety valve to manage the timing of cuts. If both political parties followed this strategy, there would be convergence on an approach with credible deep carbon cuts but with more short-term flexibility than is possible with precise timetables. The outcome of moving back towards the Blueprint would be bipartisan support for a sensible climate policy. Such a strategy would lead the world and drive the current debate on where global climate policy should be after the Kyoto Protocol.

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