General discussion

Discussion opened with questions to Professor Stavins about the proposed Australian emissions trading scheme (ETS): should the scheme aim to reduce the *production* of emissions; or should it aim to reduce the *consumption* of emissions? In other words, should exports be exempt and imports included, or *vice versa*? What's happening in other countries and does it matter if Australia were to go in a different direction?

Professor Stavins replied that, while he was unable to comment on the domestic Australian debate, a starting point was not to think of the regulation of carbon emissions, but the upstream carbon content of fossil fuels at the mine mouth, as well as at the point of import. Under an allowance trading system, all fossil fuels brought into the economy, including imports, would be subject to an allowance allocation, and exports would be exempt.

Professor Stavins predicted that a significant issue would be political pressure from private industries subject to international competition, concerned about imports of carbon-intensive bulk goods such as aluminium, bulk glass, cement, rolled steel and bulk paper. He observed that in the United States, the Lieberman-Warner bill[1] included an import allowance requirement specifically for these products which was equivalent to a border tax. Furthermore, as there is an extremely strong protectionist stream in US politics, there was a risk that the cure might be worse than the illness. He noted that the European Union had indicated that it was opposed to import allowance requirements. If, however, the United States were to implement such a scheme, then the European Union would likely retaliate.

While an aim of the import allowance requirement — which would only apply to countries that do not have domestic climate policies commensurate with those of the United States — was to encourage developing countries to adopt such policies, it was doubtful whether this outcome would be achieved. He raised the example of

[1] *Editor's note:* The America's Climate Security Act of 2007, also known as the Lieberman-Warner bill, was introduced to the United States Senate in October 2007. The bill proposed a national cap-and-trade scheme for greenhouse gas emissions (in the electric utility, transportation, and manufacturing industries) in which polluters would mostly be allocated right-to-emit credits based on how much greenhouse gas they currently emit. The cap would get tighter over time, until by 2050, emissions would be reduced to 70 per cent below 2005 levels. In June 2008, the bill was defeated.

China, which is the largest producer of cement in the world. Ninety-seven per cent of its cement production is for domestic consumption. The question was whether China would adopt policies that affect the cost of all its cement production, in order to protect the 3 per cent that is exported to the United States.

In another question from the floor, Suzi Kerr asked panellists to comment on how the current silo-based approach to environmental policy and institutional arrangements could be overcome, so that the inherent conflicts and tensions across different environmental issues could be better resolved. Wendy Craik replied that the Murray Darling Basin Commission recognised the importance of this issue and undertakes reviews of the interactions between various policies, but only on a case by case basis — for example, interactions between salinity and Living Murray policies were assessed. There was little evidence, however, of this being done anywhere in a formalised, structured manner.

Professor Stavins agreed that this was an important issue. In the environmental sphere, policies that solve one problem may make another problem worse. In the United States, there is much concern about national energy security, which means reducing imports of petroleum and liquid fuels. These concerns can be addressed by developing biofuels or through the liquification of coal — but these are horrible for climate change. When there were multiple market failures (that is, multiple social problems that merit being addressed), multiple policy instruments were required. In the case of climate change, for example, it was important to get the climate policies right, recognising that there will be both positive and negative impacts, and then develop policies to address the negative impacts, rather than playing around with climate policy, because this blunts the instrument and nothing is achieved.

Professor Libecap asked if there had been any studies on the sensitivity of emissions trading systems to macroeconomic effects; and whether, given the potential for rent seeking, it made sense to auction allowances, or whether it would be better to grandfather them.

Professsor Stavins replied that the environmental performance of cap-and-trade systems was not affected by the business cycle, with the possible exception of an extremely strong economic contraction when the cap could become non-binding.

In answer to the second part of Professor Libecap's question, Henry Ergas said that analysis by Bovenberg and de Mooj of the general equilibrium impact of an ETS showed that because an ETS accentuates the distortion associated with the tax wedge on labour, efficiency will be maximised if the revenue raised from an ETS was used to at least partially offset that distortion. Research by Fullerton and Metcalfe showed the same effect with Pigovian taxes. So a credible commitment to using ETS revenues to reduce distorting taxes in the economy was important. The

problem was that it could create a new political economy around those with an interest in driving up carbon prices.

Professor Stavins commented that while it would be meritorious to use revenues from either a carbon tax or from the auction of allowances to cut distortionary taxes, it was important to recognise that ‘there is no way in heck the political process is going to cut the distortionary taxes in the way that every one of those models assumes. They won’t even come close … Political systems just aren’t going to do it. They are more likely to use the revenue to provide tax credits for favoured industries.’