



A MULTILATERAL SOLUTION TO CLIMATE CHANGE IS VITAL

As important as it is to deal with greenhouse issues, introducing a domestic Emissions Trading Scheme (ETS) ahead of a post-Kyoto multilateral agreement on curbing global greenhouse gas emissions must be approached cautiously.

Most economists believe that a domestic emissions trading scheme should be directly linked to a multilateral agreement that includes all major emitters and sets a global target to reduce greenhouse emissions.

Australian policy makers need to be acutely aware that other major economies such as the US and EU are not prepared to act unilaterally without making provision for other countries' inaction.

There are some very difficult policy considerations for Australia to make in the coming years on the subject of greenhouse, and how we respond nationally and globally to proposed emissions trading systems. The environmental and economic issues are intertwined in such a way that this cannot be seen as purely a climate change matter, or a cost issue.

For a country like Australia, with our geography, natural resources and industry profile, while there are costs associated with not addressing greenhouse gas abatement, there would be even more severe costs if we do so in a way that is not evidence-based, measured and globally integrated.

Unfortunately, a domestic ETS not linked to a multilateral agreement runs the risk of harming Australia's international competitiveness and hence our economy.

This is because if we in Australia were to cut greenhouse emissions to zero, it would have minimal impact on the global climate change threat unless the major developing country emitters follow suit.

It is well known Australia currently contributes 1.5% of all greenhouse gas emissions, and this number continues to reduce in the face of dramatic emissions increases in the rest of the world. Developing countries, for example, are forecast to account for more than three quarters of the increase in global emissions between 2005 and 2030.

If Australia were to cap its emissions through the introduction of a trading scheme without similar action occurring in other countries and especially in developing

countries, the cheaper production costs in free rider or non-complying countries, may in some instances result in jobs and industries being 'off-shored' to these lower cost centres.

If this scenario were to occur, there would be a reduced net change to global emissions output and negative economic consequences for Australia – in other words it is possible that a portion of Australia's targeted emissions reduction could become developing country emissions due to shifting production.

A point recognised by the Intergovernmental Panel on Climate Change. It concluded in 2001 that "the possible relocation of some carbon intensive industries to non-annex 1 (developing) countries and wider impacts on trade flows in response to changing prices may lead to leakage in the order of 5-20%."¹

Overseas, these two problems of environmental integrity from developing country inaction and the loss of international competitiveness have been recognized, and policy makers are searching for solutions.

So far the suggested remedies are far from perfect and should be raising concern amongst Australian decision makers.

Recent United States ETS Developments

In the United States, a White Paper prepared by the House Energy and Commerce Committee staff on climate change legislation design asserts the dangers of the US moving unilaterally ahead of multilateral attempts to limit global emissions.

¹ (IPCC, Climate Change 2001: Synthesis Report).

It argues that the only way to overcome the dangers, both environmental and economic, is for a United States ETS to encourage developing countries to reduce their emissions. It states *“on the environmental side, such an approach would have the advantage of committing the US to lessen its contribution to the problem of global climate change, and simultaneously encouraging developing countries to do the same. From an economic viewpoint, such an approach could mitigate the risk that, in the absence of significant developing country commitments, unilateral action by the US could harm the competitiveness of our industries in world markets and result in the loss of American jobs.”*²

Debate in the US is not about whether to include developing countries in a domestic ETS but how to do so in a manner consistent with the rules and regulations of the World Trade Organisation.

On 5 March this year the US Energy and Air Quality Subcommittee of the House Energy and Commerce Committee discussed the WTO implications of three proposals—a carbon border tax, a carbon intensity-based regulation on imports, and imposing conditions or costs on foreign country participation in the US carbon market. The leading United States trade journal *“Inside Trade”* stated that the debate took place due to both the Democratic Chairman of the House Energy and Commerce Committee and the Democratic Subcommittee Chairman on Energy and Air Quality believing that legislation on a United States ETS *“must address imports from major emitters like China and India in order to provide an effective environmental solution and to avoid putting US industry at a competitive disadvantage.”*³

The United States Senate does not seem to differ from the House in its approach either. The primary motivation of the US Senate’s 1997 Byrd-Hagel resolution was: *“the United States should not be a signatory to any protocol ... [which mandates] commitments to limit or reduce greenhouse gas emissions for the Annex 1 Parties, unless the protocol ... also mandates new specific scheduled commitments ... for Developing Country Parties within the same compliance period.”* The resolution was passed 95 votes in favour to 0 votes against.

Recent EU ETS Developments

The situation is not too dissimilar in Europe. While more advanced than the US on its draft legislation for a second phase ETS (it was presented to the European Parliament on 23 January 2008, but will go through a lengthy process before entering into force), the EU has also left open the possibility of border measures.

Speaking in the European Parliament on the day the second phase ETS was presented, European Commission President Jose Manuel Barroso stated, *“There is no point in Europe being tough if it just means production shifting to countries allowing a free for all on emissions...if our expectations about an international agreement are not met, we will look at other options such as requiring importers to obtain allowances alongside European competitors, as long as the system is compatible with WTO requirements.”*

Academic work in the EU also suggests that a CO₂ border tax adjustment can be both feasible and compatible with WTO constraints. In a working paper for the Department of Applied Economics at the University of Cambridge, authors Ismer and Neuhoff conclude that a border tax adjustment for an ETS is an economically viable approach to address the risk of leaking emissions and jobs, profits and tax revenues and *“should be compatible with World Trade Organisation laws.”*⁴

The Need for Immediate Action

What then should the Australian policy makers do?

First, they need to account for the inherent risks in developing a domestic ETS ahead of a post-Kyoto agreement.

Second, they should ensure all modelling undertaken on the economic impact of climate change accounts for carbon leakage by detailing the migration of production, jobs and taxes to developing countries due to their non-requirement to commit to simultaneous targets.

Third, they need to recognise that the US and the EU are taking an approach that suggests they will not take on significant domestic reduction commitments unless the issue of competitive disadvantage with respect to those large developing country emitters who are not required to take on domestic reduction targets is dealt with.

Fourth, they must make conclusion of a post-Kyoto multilateral agreement Australia’s top priority at the United Nations. This is the best way to prevent domestic economic dislocation if we move to far or too fast in a unilateral manner. It would also be the way to stop dangerous unilateral trade measures from being adopted in the future by the EU and the United States.

Fifth, our policy makers should begin planning the type of relationship a post-Kyoto multilateral environment agreement should have with the WTO and what trade

2 (Source: Climate Change Legislation Design, White Paper, Competitiveness Concerns Engaging Developing Countries, Prepared by the Committee on Energy and Commerce staff – January 2008).

3 (Source: Inside US Trade, Vol 26, No. 10 – March 7 2008).

4 (Source: Border Tax Adjustments: A Feasible way to Support Stringent Emission Trading, R. Ismer and K. Neuhoff, University of Cambridge, Department of Applied Economics).

restrictions, if any, a post-Kyoto agreement would allow for.

Finally, we need widespread recognition that Australia's trade interests are central to discussions on developing an ETS. A good starting point is to examine the arguments that multilateral trade rules can explicitly allow for the distinction of products based on their greenhouse gas emissions.

Conclusion

Introducing an ETS ahead of multilateral climate change negotiations without addressing international competitiveness concerns and engaging developing countries, carries significant risks. Without these risks being addressed, Australian economic activity stands to lose, and the global environmental would gain little given our overall contribution to global greenhouse emissions.

We also need to be aware that United States and European policy makers have realized this dilemma and are considering border tax measures as part of their ETS. Such measures are very much a second-best solution behind a multilateral climate change agreement, do not effectively target either competitiveness or developing country action and have the potential in a worse case scenario to lead to open trade disputes between developing and developed countries harming Australia's commercial interests.

It is vital that Australian industry works with our policy makers and our environmental scientists to develop policy and practical solutions consistent with our national interest and global responsibilities. Australia does have the opportunity of developing a world leading ETS framework yet in the absence of meaningful international commitments it must be realistically phased, have achievable targets and feature a sensible approach on compensation issues. This is one area where policy misjudgement, here or overseas, can have major impacts for our nation, its economy and environment.