

# **THE COST OF A MARKET SOLUTION: EXAMINING THE GARNAUT PROPOSAL FOR EMISSIONS TRADING**

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There is increasing political consensus in Australia that climate change poses real threats to our economy and society, and that some form of policy action is necessary to address these risks. However, as this consensus has grown, so has confusion and disagreement over the nature of that policy response. What appeared to be growing support for an emissions trading scheme has now collapsed, with the future of even a carbon price in question. This paper examines the case for emissions trading made in the Government's Garnaut Report (2008) to better understand the case for a market response to climate change.

The Garnaut Report remains one of the most important climate policy documents in Australia. It provides a strong case for the use of market-based approaches as the cornerstone of any successful climate policy. In doing this, it criticises a number of alternative approaches it describes as 'regulatory'. Yet, since the Report's release, support for emissions trading, the most important policy recommendation to come from the Report, appears to have waned. While both major political parties advocated an emissions trading scheme in the 2007 election (Coalition 2007; Australian Labor Party 2007), in the recent election both parties moved away from these commitments (Gillard 2010; Morton 2010). Instead, a range of other measures have either been implemented, or have gained political support, including feed-in tariffs and renewable energy targets (NSW Government 2010), direct investment in tree planting and capturing carbon in the soil (Coalition 2010), and investment in public transport (Colvin 2010).

This article examines the Garnaut Report's case for emissions trading as an exemplar of the case for a 'market-based' policy response to climate

change. It begins by providing an overview of the Report itself. While the Report strongly advocates market solutions, it proposes a wide-ranging policy response that involves numerous and diverse interventions. Thus, a key argument of the article is that the distinction made between ‘market’ and ‘regulatory’ responses is largely artificial and unhelpful. Next the article focuses on the substance of the case for market-based policies, which is primarily focused on minimising costs. The article argues that for a number of reasons this approach is misguided and provides a weak justification for favouring any particular policy approach.

Attempting to minimise cost, or maximise output, suggests clear challenges for a report focused on ensuring ecological sustainability, but this also raises broader problems. Aggregate measures do not capture distribution, and this has both equity and political implications. Aggregate measures also fail to account for the uncertainty of outcomes, which can also generate political resistance. The Report deals poorly with these issues, and ironically implores high growth rates partly as a strategy to address the problems of uncertainty and distribution rather than focusing on these more important criteria directly.

Finally, the article returns to the question of distinguishing ‘markets’ and regulation, and the problems of complexity involved in regulating a trading market into existence. This raises political challenges within the policy process that may make emissions trading more susceptible to polluter capture. The Report’s neoclassical analysis also limits a more thoughtful and potentially more fruitful examination of how different policy tools can combine elements of economic incentive and direct command and control to promote sustainability. In this sense, the conceptual tool kit of neoclassical economics prevents the Report from developing more nuanced recommendations, even given an a priori preference for decentralised, incentive-based decision making.

## **The Garnaut Report**

The Garnaut Review was initiated in early 2007, before the federal election that saw Labor win government. Initially supported by state and territory governments, the review was a centrepiece of Federal Labor’s election pitch on climate policy. After the November election, Prime Minister Kevin Rudd committed the Commonwealth to the Review and

linked it to a separate review of the tax system led by Treasury Secretary Ken Henry (2010). Together, these reviews were to set out the substantial reforms needed to lead Australia's transition to a low-carbon economy.

The Garnaut Review was tasked both with examining the economic implications of climate change, as well as possible policy responses. It followed a similar approach to that taken by the British Stern Report, which had been released in 2006. The Review held public consultations and worked closely with state and federal government agencies. The final Report attempted to evaluate the scientific evidence of the likely trajectory of human induced climate change, evaluate the economic costs of climate change to Australia, compare those costs to the costs of mitigation, and to propose a climate policy response. The complexity of climate change, combined with the long time horizons and global nature of the desired policy response made this an immense task.

The final Report accepted the scientific evidence for climate change and outlined a range of possible scenarios over almost 200 years. It then addressed the implications of climate change for Australia, and examined global efforts to reach agreement on a united policy response. While accepting that any effective response to climate change required global action, the Report argued that Australia had a leadership role to play that justified early action. However, it based its recommendations on international agreement, and thus examined the consequences for Australia based on policies that were broadly replicated around the globe.

There are a number of important questions that lie within this analysis. The connection between Australian and international policy is contentious, and it later turned out to be unfulfilled on both sides. The recommended mitigation paths, which aim to stabilise carbon gas concentrations, have also been criticised as too weak (Hamilton 2008). However, I will take questions of the science, the appropriate emissions levels, atmospheric concentrations and the division of emissions between national jurisdictions, to lie outside the scope of the present paper. Instead, I focus on the nature of the policy response, particularly the strong emphasis on 'market-based' solutions.

The second half of the Report focuses on the economic implications of climate change and mitigation policy, and details what it views as appropriate mitigation policy. Central to this is modelling of the costs of unmitigated climate change, and of mitigation based on the Report's two proposed scenarios of 450 ppm and 550 ppm. The substance of this is

discussed further below, but as the Report states it ‘involves the most complex long- term modeling of the Australian economy ever undertaken’ (2008: 247). The modeling does not include a range of effects that are difficult, even conceptually, to model, such as non-financial costs and the risks of very dramatic effects. Annual GNP is projected to be over 2 percent lower by mid century and over 7 percent lower by 2100, than would otherwise be the case. The cost to real wages is projected to be even higher. In contrast, the cost of mitigation, while significant, is estimated to be considerably lower. In both cases, the costs discussed are monetary costs, based on prices, and exclude a number of important ‘costs’ that are not easily quantified or priced.

The Report identifies the primary policy challenge as correcting for ‘the missing market’ and addressing ‘market failures’ (2008: 303). To do this it clearly identifies what it calls ‘market-based approaches’ as preferable to ‘regulatory responses’ (2008: 308). After outlining a number of potential policy mechanisms to incorporate the externalities generated by carbon emissions into the price system, it proposes an emissions trading scheme as the preferred option. However, it acknowledges that a ‘carbon tax is superior to a poorly designed emissions trading scheme’ (2008: 311). Not only is an emissions trading scheme the preferred option, it recommends this be the stand alone option. The Report concludes that ‘No further measures are required to control national emissions in covered sectors’ (2008: 312).

## **Markets or Regulation?**

The Report’s focus on market solutions as opposed to regulatory approaches can also be confusing. Reading sections of the Report a casual observer would be struck by an apparent contradiction. Alongside the claims that by relying solely on a market-based trading scheme emissions can best be reduced, the reader would also find a series of complementary proposals that appear to be overtly regulatory. The Report also proposes: supporting climate and policy research, research and development for low-carbon technologies, emergency management, the protection of ecosystems and biodiversity, correcting for the distributional impacts of carbon pricing, education and training on responding to carbon pricing for the public and industry, structural adjustment programs in the La Trobe Valley, expanding public transport,

urban planning, deploying carbon capture and storage technology, upgrading energy infrastructure, and planning education and training for the future workforce. It is an extensive list, and there are other areas where the Report sees a limited case for regulation.

These additional measures are not necessarily theoretically contradictory. In each case intervention is justified on the basis of a market failure, including additional market failures beyond the externalities produced by emissions. Yet, the measures proposed, including forms of direct public investment, planning instruments and subsidies for specific technologies, are difficult to reconcile with the strong market rhetoric elsewhere in the Report. One of the difficulties here, which extends to the construction of the emissions trading scheme itself, is the strong distinction drawn in the Report between ‘market’ and ‘regulatory’ interventions.

A growing legal and institutional literature has highlighted the difficulty in separating out ‘market’ and ‘regulatory’ approaches. Here, market approaches are taken to mean those that rely on economic incentives to regulate behaviour, while regulatory approaches involve direct command and control by the state. As David Driessen (1998) outlines, in practice most interventions involve aspects of both approaches. Driessen argues that both emissions trading and traditional command and control policies require similar government actions, in terms of defining legitimate actions and policing those actions, and that in practice both often have similar effects on incentives for innovation.

A broader institutional literature has drawn on Polanyi’s (1944) account of the construction of markets to make a similar point. Fred Block (1994) has highlighted how states are involved in establishing markets through the construction of the rules of the game. Indeed, emissions trading seems particularly well suited to this type of analysis as it involves the construction of an entirely artificial market. Not only are emissions not a commodity in the sense that emissions are not produced for sale, trading schemes do not even trade emissions, but rather trade the right to emit. In this sense, emissions trading transforms the already existing carrying capacity of the atmosphere into a fictitious commodity (also see Lohmann 2010).

The abstract nature of the commodity that is produced, combined with the complex and uncertain nature of the biological system that is being protected, result in the complex regulatory response needed to effectively constitute the market. As Clive Splash (2010) has outlined, constructing

emissions trading schemes has required voluminous reports to be developed by the jurisdictions seeking to implement these reforms. This vast literature is needed to properly define and regulate the new market into existence. However, given this level of complexity, both Splash and Driessen note that the incentive effects of emissions trading markets are not always those predicted by simpler neoclassical models. In Australia, Richard Denniss (2008) highlighted this by showing how emissions trading could create incentives for households not to undertake voluntary action because this would only reduce the cost of permits to industry.

### **The Market as a Low Cost Option**

Leaving aside the difficulties in clearly separating market and regulatory policy options, the Report is clearer in defining how policy is to be evaluated. The Report's defence of market-based solutions is predicated on the ability of these solutions to reduce the cost of transition. Indeed, the much of the Report is focused on the issue of cost. It is on the basis of cost that the Report concludes that policy action to mitigate climate change is justified, and that this action should be market-based. The Report uses elaborate and technically impressive modelling to demonstrate the cost-benefits of mitigation. However, the value of this modelling, discussed below, is somewhat dubious. Its second claim, that markets offer a better model of mitigation, does not involve any formal modelling or comparison of costs. Instead, the Report identifies a number of potential inefficiencies from alternative approaches, suggesting that this would likely raise the cost of mitigation.

Before making a specific case for emissions trading, the Report makes a more general case for mitigation policy *per se*. While most environmentalists would welcome the conclusions of the Report, its methodology reflects its peculiar commitment to neoclassical orthodoxy. The Report's discussion, entitled 'Costing climate change and its avoidance', is largely confined to a cost-benefit (or relative cost) analysis. There is no discussion of either intergenerational equity or the precautionary principle – the two guiding concepts in much of the ecological economic literature on the need to take action to preserve natural ecosystems. These concepts reflect the pervasive importance of uncertainty and the very long time horizons involved in ecological policy, and their absence is consistent with the Report's broader

approach, which assumes a much greater degree of certainty and control then appears warranted.

The modelling that underlies this comparison is indeed awesome in its scope and ambition. Yet it is difficult to place any confidence in the results. General equilibrium modelling has a questionable record of reliability (for example Kehoe 2007), while the general equilibrium project on which it is based has been more broadly discredited (Ackerman 2002). Similar modelling by the key agency involved in the Garnaut Report – the Australian Treasury – of the effects of population ageing has provided estimates that vary considerably over time. Between 2002 and 2010 the Intergenerational Reports revised their estimates for the federal budget deficit in 2041/42 from 5 percent of GDP (Treasury 2002: 57) to just 1.5 percent (Treasury 2010: 40). In comparison, the Garnaut Report identifies the relative benefits of mitigation by 2060 to be just 1 percent of GNP (Garnaut 2008: 267). This benefit increases significantly in the later part of the century, but given the uncertainties involved in making such long-term forecasts, and the poor track record of making such forecasts, it is hard to place any weight on these later findings.

This is not to suggest that mitigation policy is unjustified, but it does suggest it is hard to justify on the basis of this type of cost-benefit analysis. The uncertainties are simply too great, and our technical abilities to model such complex systems over such long time horizons much too limited. However, given the limited conceptual tool kit employed in the Report, there is no other option. At least the Report dignifies the sceptics of climate policy with elaborate modelling that identifies specific costs to specific sectors of the economy. There is no such detailed case made against alternative policy prescriptions. Instead the Report is dismissive of what it sees as regulatory approaches. Under the title of ‘Pandering to pet solutions’, the Report suggests that some ‘Detractors of market-based mechanisms’ might argue for additional measures to reduce emissions. However, it suggests ‘They are wrong’ (2008: 317). It goes on to suggest that other policies ‘have no useful role in reducing emissions once the emissions trading scheme is in place’ (2008: 318).

Market-based approaches are presented as providing a high degree of certainty. The Report argues that ‘A well-designed emissions trading scheme (cap and trade) can be relied upon to constrain emissions within

the specified emissions limit (or trajectory)' (2008: 311), and that 'Unless private parties contravene the law without consequence, a comprehensive and well-designed cap and trade scheme ensures that emissions will decline in line with the reduction trajectory (the 'cap')' (2008: 317). In theory this is correct, although in practice the complexity of the market, discussed above, makes this extremely difficult to realise in practice (see Driessen 1998). Also, as the Report itself acknowledges, emissions trading creates certainty over emissions by allowing prices to rise. Graham White (2009) has suggested that these price rises may be considerable, potentially generating broader economic implications, and bringing into question the certainty of maintaining any cap under these conditions. It is notable that the Government specifically precluded allowing prices to rise rapidly, essentially removing the 'cap', for the first 5 years (see Senate Select Committee 2009: Chapter 4).

Where alternatives are entertained, they are dismissed relatively quickly, often based on abstract or generic economic arguments, rather than any attempt to engage with specific policy options. For example, the brief discussion of 'regulatory approaches' that accompanies the much more detailed discussion of various market alternatives concludes that 'Such policy mechanisms have difficulty in responding to the sometimes rapid but usually unpredictable evolution of technology and consumer preferences' (2008: 308). It argues that any direct intervention presupposes 'that government officials, academics or scientists have a better understanding of consumer preferences and technological opportunities than households and businesses. This is generally unlikely and cannot ever be guaranteed' (2008: 317). This statement is somewhat surprising given the Report acknowledges that government action may be needed to inform consumer and business choices in many instances.

In all cases the Report argues that direct regulation is liable to increase the costs of transition, except in those circumstances where regulation is used to correct market failures. In establishing the importance of cost as the rubric for evaluating policy change, the Report acknowledges that any mitigation policy will impose costs compared to a situation where there is neither climate change nor action to reduce emissions. Those costs are conceptualised both in terms of dead weight losses to the industries changing their production processes and in terms of aggregate production that have an economy wide impact. Given the importance of minimising cost the Report therefore concludes that this action 'can only be justified if the scheme enables the least-cost adjustment (in terms of

resource allocation across the economy) to a quantifiable and verifiable commitment to reduce emissions' (2008: 314). In this sense, the Report clearly understands minimising costs, including costs to aggregate production, as its central criteria for evaluating policy alternatives.

### **Is Cost the Main Issue?**

The Report focuses attention on minimising cost. This is primarily conceived in terms of aggregate costs. The Report identifies a net benefit in terms of aggregate costs in undertaking mitigation policy (measured in terms of GNP), and it identifies costs associated with transition, which likely occur as deadweight losses experienced by producers, but which are largely passed on to consumers. Thus, here too, cost is effectively conceived in the aggregate as the costs experienced by consumers in paying more for carbon intensive goods and services. However, it is not clear that aggregate cost (or inversely aggregate production) is the most appropriate measure of a policy's effectiveness. Policies can increase aggregate production while simultaneously producing both winners and losers. While the total cost in GNP terms might be low, the cost to some groups may be high, and it is unclear how we should evaluate such an outcome.

Neoclassical economics has traditionally resolved this issue through the Pareto welfare criteria (see Coleman 1979). This allows a 'weak' value judgement that simply approves of changes that increase the welfare of some without decreasing the welfare of any. Markets are thought to achieve this through free exchange, which ensures that all parties see themselves as beneficiaries of the exchange. However, policy interventions invariably lead to some redistribution, either directly or indirectly, and so violate the Pareto criteria (see Calabresi 1991).

To account for this, neoclassical economists have increasingly justified using aggregate measures of production and cost-benefits analysis, based broadly on the Kaldor-Hicks criteria (see Coleman 1979), often with the proviso that additional redistribution should take place to compensate losers. Thus, if the total product is higher, the benefits enjoyed by the winners can be partially redistributed to ensure there are no losers (see Farrow 1998). Such an approach holds some appeal. Unfortunately, in practice many economic reforms either do not implement adequate compensatory arrangements, or else produce ongoing dynamics that can

gradually widen inequalities over time, beyond what may have initially been envisaged.

The Garnaut Report acknowledges some of these risks. Indeed, it claims to follow a more stringent distributive criterion, stating ‘It is accepted that income has diminishing marginal utility—that is, an extra dollar has more utility to the poor than to the rich’ (2008: 393). This is used to justify compensation to low-income households proposed in the Report. The majority of this compensation takes the form of changes to taxation and social security arrangements that would provide low-income households with additional income. In addition there is a more modest provision proposed for targeted assistance for those unable to afford the capital investments necessary to reduce their carbon footprint.

However, the compensation is not entirely ‘redistributive’. After all, the introduction of the emissions trading scheme generates new costs, which are proportionately higher for low-income households (see Garnaut 2008: 386). The compensation then offsets this effect. Overall this may leave some low-income households a little better off, and result in higher income households paying the bulk of the cost, but the central rationale does not appear to be a broader redistribution of income, but rather compensation for the costs imposed by policy change. In contrast, policy proposals to deal with water scarcity have focused on limiting particular kinds of water use deemed less socially necessary and which are more common amongst high-income households. Policy based on this principle would seem to have more resonance with the principle of diminishing marginal utility of income than emissions trading.

The fact the Report treats these payments as if they do constitute a more substantive form of redistribution appears to reflect a broader assumption in the Report that the imposition of a new market framework onto emissions is not really changing the distribution of income, merely enacting what is already implicit. In other words, the Report largely treats the post-emissions trading situation as the baseline, as if the market always did exist, and that new policy measures simply enforce what has always (implicitly) been the case – that pollution constitutes a breach of property rights. This naturalization of the market conceals an active privatization of resources, one that has traditionally been advocated for solving the ‘tragedy of the commons’ (see Harvey 2007: 65), but now is simply assumed. Again, alternative approaches, such as carbon rationing that seek to allow each individual to consume carbon intensive goods to

the same level, would seem to better embody the equity principles the Report espouses, and would ensure the privatization of nature is at least undertaken on the basis of equal shares, rather than shares that reflect the existing distribution of income, as does emissions trading (see Spratt 2007).

The discussion of distributional impacts of emissions trading, however, is largely confined to this discussion of relative price changes, tax and social security payments. As a result, the discussion of distribution is focused on comparing income deciles. This overlooks important aspects of distribution that are likely to be more significant in determining overall income inequality, in forming an ethical judgment of whether the reforms leave people as a whole better off and in meeting the political challenge of gaining community acceptance. From both an ethical and political standpoint it is individuals and their communities – not income deciles – that must be assured they are no worse off. From a distributional perspective, the change to the distribution of market income, through changes in wages, the structure of employment between industries and the rate of profit, all have potentially larger impacts than those discussed in detail in the Report.

The Report does acknowledge there will be impacts on employment and on regional communities. However, in most cases it concludes this does not justify any specific policy response. Only in the La Trobe Valley does the Report see a case for structural adjustment assistance (2008: 398-9). In part this reflects a belief in the viability of carbon capture and storage technology to allow the continuation of the coal industry (see 2008, Chapter 18). However, the Report does acknowledge the likelihood of widespread job losses, so it is not clear that the viability of any given technology is crucial in the final assessment. For example, the Report acknowledges the potential for significant impacts on agriculture, but does not consider this a justification in itself for regional assistance, stating;

Regions with emissions-intensive agriculture may be severely affected by the emissions price but have the options to diversify towards less emissions-intensive production or to seek alternative employment for their labour force. (2008: 397).

More broadly, the Report also acknowledges that industrial restructuring is central to the income distribution impacts of emissions trading. It

acknowledges that some regions are more vulnerable to these effects, and that these regions have already had to deal with significant economic restructuring.

A significant proportion of the income distribution effects of climate change and climate change policy will come from changes in the industrial make-up of the economy over the longer term. Regional communities and industries are likely to be more vulnerable to these impacts than urban centres, due to their reliance on agriculture and other natural resource-based industries, and low levels of infrastructure stock. Regional communities, in particular farming regions, have already been subject to structural change to a much greater extent than metropolitan centres in recent history (Productivity Commission 1998) (2008, p.400).

While the Report acknowledges that these impacts are likely to be significant, and have been significant in the past, it offers no constructive policy advice to address the concern. The above passage ends by stating ‘These are issues for policy in the longer-term future’ (2008: 400). Instead, it suggests that the ‘main guarantor of equity during rapid structural change is maintenance of economic growth and full employment within a flexible economy’ (2008: 385). The possibility of localized (if not more generalized) recession leading to both costs in aggregate production and equity, are not discussed.

As a result there is no meaningful discussion of the uncertainties of transition and the likelihood that this will leave some workers, regions and industries substantially worse off. This is the least credible aspect of the Report’s commitment to flexible markets given the recent experience of prolonged high unemployment in the regions badly effected by previous rounds of economic reform (for example Smith 2001). It also brings more fundamentally into question the Report’s evaluation of the costs imposed and the distributional impacts of its policy recommendations, as both rely heavily on the ability of flexible markets to ensure the transition does not entrench unemployment, or lower paid employment.

It is useful to reflect on the importance of growth in the Report’s evaluation of the market. First, growth in production, as measured by GNP, is taken an important indicator of ‘cost’ and therefore of economic welfare. This is despite the broad acceptance of the deficiencies of GNP

as a measure, and the potential contradictions, even in principle, of unlimited growth and sustainability. Second, high growth is also a necessary condition of transition because it helps to reduce the uncertainties and potential losses and inequalities generated by economic restructuring. Indeed, growth also allows for the new tax imposed through a carbon price to effectively be paid without reducing the real income of those paying it.

It is an unconvincing account. The magnitudes involved, while sizeable at the economy level are not insurmountable. A reduction in income of 1 percent over a forty-year time horizon, let alone the failure of incomes to rise by 1 percent, is not so large as to simply rule out in principle any alternative policy response, as the Report does. Instead, the real threat posed by transition is not the magnitude of the costs, were they to be shared equitably, but rather the distribution and uncertainty of those costs. As Galbraith (1987) once observed, and the Report comes close to conceding, the real purpose of promoting increased production is not for the sake of the production itself, but rather as a means to resolve the tensions generated by inequality and insecurity within a market economy. In the same way, one suspects the goal of maximizing growth in the Report is not important in itself, but rather it is the mechanism by which these real concerns might be addressed without bringing into question the broader economic framework. Yet, by doing this in such an unconvincing manner, the Report seems to magnify equity and security concerns, rather than addressing them directly.

## **Implementing Emissions Trading**

The focus on cost, rather than on distribution or security, raises practical challenges, as does the abstract and complex nature of the policy intervention itself. This focus also tends to obscure the extent of complexity and uncertainty. This potentially undermines both the desirability and the political feasibility of the Report's recommendations. The uncertain nature of the distribution of costs can create increased political resistance from those fearful they will suffer losses. The complexity of the scheme also makes it difficult to engage with, and potentially undermines the influence of broad public opinion compared with the interests of those with greater incentives to intervene in the policy process.

Of course there are advantages to minimizing total costs. To the extent that most of these costs are imposed on the public sector reducing costs also reduces the need for spending cuts, tax increases or increased debt. Lower costs may reduce the need for compensation to losers and may reduce the number of losers and the size of their losses. All of these effects do have real political impacts, as there is generally greater resistance to experiencing losses than to receiving new benefits (see Pierson 1994). There are also some potential winners, including renewable energy industries and potentially the finance sector, which will ultimately manage much of the new market (see Windsor & McNicholas 2009).

However, generating lower total costs, but costs that are concentrated and uncertain in their distribution, can significantly increase political resistance. Unlike some other policy options, the impact of emissions trading is difficult to predict, even at the industry or regional level, let alone at the level of the firm (Garnaut 2008: 315-6). To introduce these costs without ensuring complementary measures to provide greater certainty and equity is likely to substantially reduce political support. Research in the United States that has examined why market-based environmental regulation has not been introduced more widely, given the strong support for this type of solution amongst experts, has identified the uncertain distribution of costs as a key explanation (Keohane et.al. 1998: 360-361). This is potentially reinforced by the recessionary bias of instruments that deal with emissions by raising costs for existing industries, rather than providing subsidies for new employment (Spies-Butcher & Stilwell 2009).

A particular challenge in implementing a trading scheme, as opposed to a tax, which also influences relative prices, is its abstract and complex character. Unlike most of the measures proposed in the Garnaut Report, which attempt to address market failures, the implementation of an emissions trading scheme extends to constructing an entirely new market – what the Report refers to as the ‘missing market’. It is an interesting choice of language, suggesting that there implicitly exists a market that has yet to be regulated into existence.

In some ways this reflects the broader popularity of market models and quasi-markets in Australian policy making (Manne 2010; Pusey 1990). In numerous social policy contexts governments have introduced quasi-markets as a way of providing economic incentives to service providers

(see Le Grand 1997). Elsewhere I have argued that this can be an effective tool in advancing principles of social justice where the competitive pressures of the market are mobilized to undermine producer power and improve access to needed services, as was the case with the introduction of Medicare (Spies-Butcher 2009).

It is true that market mechanisms can also overcome some ideological opposition to government intervention, by cloaking what essentially remains a regulatory intervention in the guise of 'market' deregulation. However, emissions trading goes considerably further. In instances like Medicare, quasi-markets are strongly regulated and ensure significant monopsony power is retained by the state. These policy approaches minimize risk, and focus that risk on targeted producer groups. While this does prompt resistance from producers, often a clear objective of government is to undermine producer power, and markets do this in a less visible way than alternative policy instruments. By contrast, emissions trading creates large, economy-wide risks more comparable to the introduction of competition policy than to individual quasi-market interventions. Also, rather than simply reversing aspects of decommodification that have taken place in social policy areas as a result of the advance of the welfare state (Esping-Andersen 1990), emissions trading requires the construction of entirely new and highly abstract markets.

The complexity of policy instruments like emissions trading increases the costs associated with effectively engaging in policy formation and debate. In general this is likely to reduce the number of people engaged in the policy process, with those with the most resources and those facing the greatest potential costs or benefits from change being the most likely to remain. In the context of the current policy debate, that is likely to mean the dominance of large high-emissions industries. This appears to be exactly what has happened, with extensive evidence of large investments by polluting industries in intervening in the policy process (Pearse 2007; Hamilton 2007). Alternatively, it is extremely difficult for even engaged citizens to properly monitor the debate. In Australia it is likely this contributed first to modifications to the proposed emissions trading scheme that substantially undermined its potential effectiveness, and then to widespread public confusion about the efficacy of the proposed scheme.

Achieving policy change is usually difficult. There are substantial pressures towards inertia. Achieving policy change that has widespread implications for employment, industry structure and the distribution of income, whether this aids or hinders equity and sustainability, is an extremely challenging task. There are few examples of this being achieved. In recent history the two most prominent examples are the construction of the welfare state and the implementation of economic reform. Each requires mobilizing political coalitions and resources, often over long periods. However, while the former example is associated with mass support across broad social classes (for example Esping-Anderson 1990; Baldwin 1990), the later has almost exclusively been an elite project (Pusey 1990). It is unfortunate that the Garnaut Report appears to be advocating such an approach to such an important reform. It also raises the prospect of the sort of political resistance and backlash that has accompanied economic reform. And it is ironic that such a reform remains the main policy alternative in a context of increased domestic support for nation building and international skepticism towards neoliberalism.

## **Conclusion**

Emissions trading remains the most prominent single climate policy initiative in the Australian debate. While many other initiatives have been both proposed and enacted, it continues to be the focus of considerable attention and policy activism. That focus has been driven in part by expert initiative. From an early stage Australian policy makers have explicitly favoured emissions trading (see Australian Greenhouse Office 1998), while more recently the expert Garnaut Report has also recommended in its favour. This expert support has been strong not only in the sense of placing emissions trading on the policy agenda, but also in promoting it as the central, or even only, policy response. Thus, expert opinion has often suggested that emissions trading would reduce or eliminate the need for other complementary measures – or even make such measures undesirable.

This strong expert policy consensus has been driven by a strong commitment to neoclassical economics. The Garnaut Report, the single most influential Australian climate policy document, is an exemplar of this. The Report's policy recommendations rely heavily on neoclassical

arguments that favour markets in general, and it specifically rejects policy proposals that do not fit into its framework of either establishing the 'missing market' for emissions, or else correcting for other market failures. Despite this, in practice the Report recommends numerous regulatory interventions, reflecting the sheer complexity of the issues and the limitations of the market/regulation divide.

The primary rationale for favouring market-based responses is to minimize the cost of transition. However, this argument remains unconvincing. Emissions trading imposes a range of new costs that would disproportionately effect particular industries, regions and income groups. The Report argues that emissions trading lowers these costs, at least in the aggregate. The Report suggests maximizing growth is also necessary to reduce the costs of transition and ensure retrenched workers and adversely affected regions can secure market income. Yet, it does little to genuinely address the uncertainties generated by transition. The costs of transition remain small on average, rather it is the uncertainty of their incidence, and the likelihood of those costs being concentrated, that is of primary concern, and the Report does little to address this.

This raises a number of political challenges in advancing emissions trading. Imposing large and uncertain costs potentially increases political resistance. Implementing a trading scheme would also require a complex legislative process that is difficult to explain to a mass audience. This potentially makes it more difficult to build the institutional and sustained political support needed to overcome policy inertia and entrenched political interests. It also creates an incentive structure that provides the greatest benefits for engaging in policy development to those with the largest interests and most resources, creating a real potential for polluter capture of the policy process.

All of this is not to dismiss 'market-based' approaches. Indeed, it is perhaps more useful to question the current use of the market/regulatory dichotomy. Instead it is to argue in favour of a more nuanced approach to policy development that seriously engages with a range of policy options and is sensitive to the political, as well as economic challenges, of policy making. Doing this would mean engaging in a more holistic debate about costs, which does not reduce to a cost-benefit analysis measured solely in the metric of GNP. It would mean seriously addressing the uncertainties created by transition, and addressing the potential for localized or more generalized deflation. It would also attempt to make the policy

development process transparent and relatively simple, to maximize the engagement of the public and the influence of pro-mitigation public opinion. It would also be open to a range of complementary measures that allowed for incremental change, and that helped to forge and build the institutional political alliances necessary to overcome inertia and powerful opposing interests. None of this is likely to emerge from the current neoclassical approach that dominates elite policy discussion. However, building this alternative is becoming increasingly urgent.

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