

# Bridging the gap in the context of the financial crisis

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# A Missed Opportunity

- The central problem facing the global economy today is lack of aggregate demand
- Lack of demand is causing weak growth in the US, near-stagnation in Europe, slowdown in Asia
- Retrofitting the global economy to face the challenges of climate change would have stimulated the economy, improving growth and employment
- And in doing so would have helped address one of the other major challenges of our time—increasing inequality

# Finance

- Before the financial crisis, private financial markets (especially in US) showed that they were good neither at managing risk nor in allocating capital
  - Investing in shoddy homes in the middle of the Nevada desert and other wasteful investments were not the best uses of global capital
  - Examples of a large discrepancy between social and private returns; social and private risks

# Savings glut

- Bernanke (Chairman of the Federal Reserve) blamed *a savings glut*
  - Excessive savings in Asia
- But there is not a savings glut or a dearth of good investments
  - There is a huge need for climate investments
  - As well as infrastructure investments
- The failure is in our private financial markets to bring savings and these investment opportunities together
  - This is *supposed* to be one of their central social functions
  - They failed in this, as they failed in so many other dimensions
  - This failure too has long run consequences

# The Good News: New Institutions

- The creation of new development banks (The Brics Banks and the Asian Infrastructure Bank)
- Discussions about creating new facilities in the World Bank and a Global Infrastructure Investment Platform
- These institutions and facilities can help recycle surpluses
  - Not only from reserves
  - But from the trillions of dollars in Sovereign Wealth Funds
  - Some of which have a longer run focus than the short run focus of private markets and have more sensitivity to the social importance of climate investing

# The Economics of Climate Negotiations

- This poses a more difficult challenge
- Basic economic problem: the atmosphere is a global public good—everybody wants to receive benefits, nobody wants to pay costs
  - Key issue: how to share the burden
- Making matters worse: rich countries have contributed most of emissions in the past (and on a per capita basis continue to contribute more); but adverse consequences are likely to be felt in developing countries

# Externalities

- In principle, with externalities, every country could be made better off by controlling externalities
- Two problems
  - Without adequate transfers from the rich countries to the poor, burden would fall unduly on developing countries
    - It is unacceptable both because it was the developed countries that have contributed most to the increase in atmospheric concentration
    - and it seems morally wrong to ask poor to sacrifice their development while the rich continue in luxury
    - Such a solution will be politically unviable
  - Distributional burdens within countries have to be dealt with

# Current approaches failing

- Standard cap-and-trade (Kyoto) approach entails allocating rights to emit worth trillions of dollars
  - Inevitably contentious
- We are even having trouble getting and implementing a global agreement not to *subsidize* fossil fuels
- Clear ethical principles—give more to poor countries (per capita), taking into account past contributions of each to atmospheric concentrations of greenhouse gases
  - But the US will not subscribe
  - Even unwilling to agree to on equal per capita emission permits
  - Let alone division of “carbon space” on an equal per capita basis
  - Let alone a basis taking into account past contributions
  - With so much money on the table, ethics are put aside



# Inherent problems with caps

- Suppose the US were willing to transfer large amounts to poor countries. That would mean high (non-binding) caps, so they could sell the excess permits.
  - This would be seen as paying them to do nothing. US taxpayers would revolt at this.
- And often, just as Russia did nothing, with permits to spare, they would do little or nothing (in spite of the price of permits).

# Further problems with Caps

- Alleged advantage: could grant emission rights to firms within country as a way of compensating them for costs of reducing emissions
  - Getting political support for cap and trade system
- Has turned into a problem: granting emission rights highly political—effectively giving away money
  - Presented difficulties in best performing countries, with good governance
  - Would be source of enormous corruption in others

# Caps Are Just Too Risky

- If China had accepted a non-binding cap in 2000, based on best prediction
- It would have ended up paying other countries at least \$100B a year for pollution rights in 2010 (predicted 1.5Bt turned into 7Bt actual)
- But the carbon price on Chinese industry would not have been held down to the global price, so not much effect on the level of pollution

# Voluntary approach unlikely to work

- Basic principle of a global public good: voluntary solutions don't work
- Evidence is that it has not been working
- No enforcement even of “offers” made

# Alternative—uniform carbon price

- Most economists agree: creating a carbon price best way to curb emissions
- A low-carbon economy could be achieved through the imposition of a moderate carbon price, which would raise substantial revenue and allow a reduction in other taxes, thereby keeping the overall deadweight loss small (or even negative).
- Basic economic principle: better to tax bad things than good things
  - Cost to many countries negative
  - Costs to others close to zero

# Alternative approaches *within* carbon price system

- A global price commitment could be met by
  - Local cap-and-trade markets, e.g. the EU's ETS.
  - Taxes on gasoline, coal etc.
  - Fee and rebate (bonus malus) on low and high mileage cars.
  - Etc.
- So countries can design their own policies.

# With a Price: Keep Your Money

- Unlike international carbon permit trading.
- With a price, a country keeps all the carbon revenue it collects.
- This looks much cheaper.
- The real cost is far less than the revenue collected!

- A fully voluntary agreement likely cannot include countries that export a significant amount of fossil fuel
- Even a voluntary agreement needs to be enforced—need to impose cross-border taxes
  - Such taxes are WTO legal
  - Such taxes change the political economy: provides incentives to join agreement



# Need for A Green Fund

- Both to finance mitigation and adaption
- Costs of climate change may be especially great for developing countries; least able to bear costs
- A green fund financed by allocating say 20% of carbon revenues collected in developed countries could be used to implement “differentiated responsibilities”
- And rich countries would only pay if the poor country joined the coalition and priced carbon the same as all others

# Concluding Remarks

- Creating a “green economy” is not only consistent with economic growth, it can promote economic growth—especially when there is a lack of aggregate demand, as in the aftermath of the financial crisis
  - Even more so if we measure growth correctly (as suggested by the Commission on the Measurement of Economic Performance and Social Progress)
- An agreement about an *enforceable* carbon price among a “coalition of the willing,” enforced through cross-border carbon taxes, holds out the best promise for a way forward