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