Command and control no substitute for carbon market

Emissions war
Both Coalition and Labor carbon plans are stop-gaps, with no price and therefore no long-term solution.

Richard Holden and Rosalind Dixon

Prime Minister Scott Morrison announced on Monday that his approach to tackling climate change was to double down on the "direct action" policy initiated by the Abbott government.

The re-badged "climate solutions fund" will receive $2 billion over 10 years for carbon avoidance and abatement activities.

On the plus side, this announcement shows the government is mindful of Australia's Paris commitments and realises it will take more than business-as-usual and accounting tricks – like booking 367 megatons of so-called "carry-over credits" from the Kyoto-protocol era. To the extent that the fund involves some tree planting, it might even do a little good.

But the plan has serious problems. First, just like the original "emissions reduction fund" there is no guarantee that paying to stop some emissions won't lead to other emissions taking their place. The "safeguard mechanism" that was part of the ERF involves trying to cap emissions from large facilities.

Former Clean Energy Finance Corporation head and now Kooyong candidate Oliver Yates told ABC News on Monday it was unclear the plan would lead to an actual reduction in emissions because "there's no punishment mechanism".

Moreover, it looks like much more of a stop-gap measure than a real policy to address climate change. As Australian Industry Group chief Innes Willox rightly noted, the plan was not "a comprehensive or permanent approach to climate policy, and it is likely to be expensive and impractical to try to make it so". Well, indeed.

Most worrying of all, it is a thoroughly illiberal, command-and-control approach to climate change. Rather than using the magic of the market's price mechanism to balance the costs and benefits of emissions, it will be up to a bureaucrat's spreadsheet.

Then there's the anticipated but yet-to-be-announced add-ons: energy efficiency measures, an electric vehicle strategy, and more hydro-electric projects. This is government winner picking on a grand scale, just like the array of industry policies of the post-war era, almost all of which failed.

An electric car strategy is another effort by government to pick winners. PHOTO: LOUIE DOUVIS

The government itself offered, as examples of its approach, measures like support for small business to replace lighting, airconditioning and refrigeration systems. It won't be the market that determines which businesses get the inducements, or what sort of lighting and refrigeration qualifies. It will be politics, all the way down.

One need look no further than how these programs worked in the US recently. This included high-profile bankruptcies of companies like Solyndra that were given federal loan guarantees. And, as the *Washington Post* put it, "Obama's green-technology program was infused with politics at every level".

The irony, of course, is that the Labor Party is no better on this score. Their intervention is to mandate an aggressive renewable energy target. They get points for ambition, but it is also command-and-control stuff – an explicit repudiation of the market-based solutions they once championed.

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Any meaningful, long-term policy to tackle climate change has to be just that – a long-term policy, with no obvious gaps, which involves markets.

On these pages in November last year, we outlined one such policy: a plan for an Australian Carbon Dividend — a $50 per tonne tax on carbon returned to all voting-age Australian citizens equally. It would leave about three-quarters of Australians better off, with the average households $585 a year ahead. The bottom fifth of households by income would do better still, more than $1300 a year better off on average, because their expenditures are lower in dollar terms.

This plan was inspired by that of the US-based Climate Leadership Council which recently received the endorsement of more than 3300 economists, 27 Nobel laureates, all four former chairs of the Federal Reserve, and 15 former chairs of the Council of Economic Advisers.

Why are so many economists, not just environmentalists, behind the plan? The tax would encourage consumers and producers to seek out and implement the most carbon-effective, reliable energy solutions. But by returning the proceeds equally to citizens, it would provide progressive compensation and address energy affordability head on.

The Australian Carbon Dividend Plan could also be combined with the kind of shorter-term solutions that both sides of politics are drawn to. If you want to throw a few billion dollars at tree planting and solar panels, go right ahead.

We prefer the level playing field between different types of energy provided by our plan. But an additional investment in renewables – say, like the $15 billion Labor, or $2 billion the Coalition, is proposing – could speed up the market-based transition from coal to renewable energy that our plan provides for.

Australia has done nothing meaningful about climate change for such a long time that a majority of voters are fed up. And the Prime Minister knows it.

But voters should not confuse direct action for the right kind of action. We urgently need a new approach in this area, but one that is long-term, market-based and takes compensation seriously.

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There are surprising answers to the puzzle of stagnant wages

Payday blues
Part of the problem with wages comes from how we measure them. But there is no substitute at all for rising productivity.

Stephen Kirchner

The wage price index rose 2.3 per cent through 2018. After subtracting the inflation rate of 1.8 per cent, real wages grew a modest 0.5 per cent, below recent growth in productivity. Weakness in both nominal and real wages growth is widely considered a puzzle, not least in official policymaking circles.

Reserve Bank governor Philip Lowe has gone so far as to call it a "crisis".

Craig Emerson wrote in these pages on Tuesday that "workers continue to struggle on flat wages" – and warned of a rising political cost.

Other commentators have questioned whether Australia's labour market institutions are really effectively in translating productivity growth into growth in real wages. Some have even called for a return to national wages policy or centralised wage fixing.

The weakness in wages growth has been broad-based across different industries, different states and territories, job levels, and in both the public and private sectors. Measures of dispersion in wages growth have been declining. Not coincidentally, the dispersion of labour productivity growth across industries has also decreased.

Australia is not alone in experiencing subdued wages growth in recent years. There has been a long-running debate in the US about the link between wages and productivity growth that pre-dates the 2008 financial crisis and is linked to debates over income inequality that have informed populist politics on both the left and the right.

US research points to a number of considerations that have been missing from the Australian debate and which offer explanations for the local wages "puzzle".

The first concerns the relevant definition of wages for productivity. In the US, the focus has been on total compensation rather than wages, recognising the growing importance of non-wage benefits.

In Australia, this means focusing on national accounts measures of employee compensation that include superannuation benefits rather than narrower measures such as the wage price index.

> *A return to centralised wage fixing would almost certainly lower productivity.*

US research also highlights the importance of inflation adjustment. Adjusting wages for consumer price inflation is relevant when measuring consumer purchasing power. But workers are compensated on the basis of what they produce, not what they consume. When comparing real compensation and productivity, the output deflator is the more relevant measure to adjust for inflation.

The US data also shows the importance of lags in the compensation-productivity relationship. US economists Martin Feldstein and Larry Summers separately find that allowing for lags of up to two years strengthens the statistical association between compensation and productivity.

When these considerations are taken into account, the supposed disconnect between workers' compensation and productivity largely disappears, both in the US and Australia. Another way of looking at the relationship between worker compensation and productivity is through the labour share of income.

If employee compensation is not keeping pace with productivity, then the labour share of income should fall and the capital share should rise, all else being equal.

Compared to earlier decades, the labour share of income has declined in both the US and Australia.

This has been widely interpreted as a decline in workers' bargaining power and symptomatic of income inequality.

But this interpretation does not stand up to scrutiny. Because capital income is more volatile than labour income, overall income typically falls by more than labour income during recessions, so that the labour share of income rises. In other words, the labour share is counter- rather than pro-cyclical.

In Australia, the labour share of income is negatively correlated with the labour under-utilisation rate. The labour share rises when workers' bargaining power is at its weakest given the increased slack in the labour market. Real wages in Australia are also counter-cyclical.

The decline in the labour share relative to earlier decades has another explanation. US economist Matt Rognlie shows that the associated increase in the capital share in the US and other G7 economies is entirely explained by housing.

Australia has seen a similar trend to the US, with housing's share of total factor income rising from 2.4 per cent in 1960 to 8.2 per cent most recently. Housing accounts for about 40 per cent of the increase in the capital share in Australia since 1960.

This reflects the increased scarcity of housing as new residential land and dwelling construction is limited by a growing burden of regulation even as the demand for housing increases.

Although the dwelling stock is largely owned by households, this is small comfort to those locked out of home ownership by high house prices.

The lesson from the US and Australian experience is that those concerned about the labour share of income and its implications for income inequality should turn their attention to the supply of housing rather than workers' bargaining power.

Raising productivity is still the best way to boost workers' wages. A return to centralised wage fixing would almost certainly lower productivity and break the productivity-compensation nexus, as it did in previous decades.

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