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Environmental stress from rapid economic growth, particularly in developing countries, will increasingly become a problem and generate considerable economic costs as well. Climate change is one manifestation of environmental stress and an issue that the world needs to urgently address. Another is rapid deforestation, particularly in Brazil and Indonesia. Deforestation causes significant stress on local environments as well as contributing to the global problems of loss of biodiversity and increasing greenhouse gas emissions. Deteriorating environmental quality is also a problem in China, where strong economic growth has rapidly increased energy use. However, it is not inevitable that strong economic growth be associated with deteriorating environmental quality. Well-designed incentives and clarity of property rights can lead to a positive relationship between the two.

The Kyoto protocol illustrates the danger of getting the policy prescriptions wrong. This protocol constructs a global framework that fails to take account of the tradeoffs between environmental outcomes and economic costs. It also does not adequately address the needs of developing countries, which have a long list of development issues to overcome in addition to their concern about the environment. The result is an agreement that sounds good in theory but has rendered a stalemate in global action for climate change because it ignores the uncertainty surrounding economic costs. A different framework that explicitly links the problems of greenhouse gas emissions and economic development is needed. An initial attempt at this is proposed by the Asian Pacific Partnership for Clean Development. This framework, however, has not been effective because it primarily focuses on voluntary actions around technology transfer alone. The problem for policy-makers is not just how to generate technology transfers but also how to build strong institutions and provide incentives for good environmental outcomes within countries.

Issues of environmental degradation often have implications well beyond local borders. Deforestation is an issue that clearly has local as well as global consequences. In developing countries deforestation is driven by the short-term economic gains from

logging and clearing of land for alternative uses. The problem has recently been further exacerbated as countries increase their use of bio-fuels as a solution to high energy prices. The use of bio-fuels in turn raises the demand for land under cultivation and further contributes to deforestation. Overall short-term gains from forest clearing are more certain than any long-term benefits from preserving the forest because of a lack of clear property rights. If forestry and land use are recognised as a sink for carbon then preserving forests would have a clear and immediate economic return. Deteriorating environmental quality, however, is not just a developing country problem. Policies in large industrial countries, such as the US ethanol policy, have effects that spill over into developing countries. Such policies fail to link the problem of climate change to the problem of energy security as well as creating a piecemeal approach to energy policy.

A decentralised system of national climate action built around a clear long-term price on carbon emissions allows domestic issues such as forestry and land use to be brought into the system within countries where this matters. This linking of problems at the national level is difficult under an approach like Kyoto because the Kyoto approach requires agreement from too many countries. However, it is possible to incorporate local problems into climate change policy under a system of national but coordinated carbon markets. In developing countries such as Indonesia and Brazil it is essential that a carbon trading market be established for global climate policy. This can be used to address problems in forestry. A carbon market in these countries would have a long-term goal for emissions that generates a long-term carbon price but with a short-term price cap for carbon to minimise the economic costs. Forestry, land use and other local environmental problems could be recognised as a source of annual permits (to support the price cap) that would be allocated each year once a certified forest was deemed to be a carbon store. If the forest were cleared the option to generate a permit would be lost with clear economic consequences.

Australia has great potential to contribute to a better global environment by proposing and

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encouraging the adoption of policies that promote economic growth and development as well as improved environmental outcomes. Australia may soon be adopting a national carbon pricing system with long-term carbon prices but where the government issues permits to cap the annual price of carbon emissions. The government could also certify that forestry permits from Indonesia may be traded in the annual permit market in Australia with the restriction that this is only possible while the carbon price is potentially rising above the annual safety value price. The existence of the Indonesian market, with verification undertaken for that market, and the fact that some of these forestry permits can also be traded in the Australian market, would greatly reinforce both systems. The payment for forestry permits would be a transfer from permit demanders to Indonesian foresters rather than to the Australian government.

What is not needed is a wholesale linking of markets into a global permit trading system. This could be counterproductive. Policies that recognise that forestry in some economies has externalities that benefit Australia are worth supporting. The Australian government has already started down this path with the recent announcement of a payment of \$50 million for forestry preservation in Indonesia. This could be enhanced by creating a more credible system of property rights within Indonesia over carbon, and by extension over forestry.

Rather than giving aid in the form of direct cash payments, the incoming Australian government needs to focus on building institutions for development that promote good environmental outcomes. Fundamental to this is the promotion of property rights and economic incentives that can enhance the development process in developing countries. A well-designed system based on carbon pricing but which incorporates other environmental issues specific to particular countries (particularly forestry) can lead to improved environmental outcomes that have national and global benefits.