AUSTRALIA’S CARBON PRICE: GOOD POLICY OR NOT?

Professor Henry Ergas
SMART Facility, University of Wollongong and
Senior Economic Adviser, Deloitte Access Economics

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Global climate change is a global problem

- Without credible global action, unilateral action by Australia is pointless….
- And extremely costly:

<table>
<thead>
<tr>
<th>Tax</th>
<th>Average Excess Burden</th>
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<tbody>
<tr>
<td>Carbon tax</td>
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<tr>
<td>Treasury modeling</td>
<td>2.0</td>
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<tr>
<td>Unilateral action</td>
<td>8.0~12.0</td>
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<tr>
<td>Mining royalties and crude oil excise</td>
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<td>Insurance taxes</td>
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<tr>
<td>Payroll tax</td>
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<tr>
<td>Corporate income tax</td>
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<tr>
<td>Labour income tax</td>
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<td>GST</td>
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As a result, we should “wait and see”
Criticisms

1. Despite lack of global agreement, the rest of the world is acting
   a) Yes, but falls far short of what is needed and even then is uncertain .. and is accompanied by many subsidies to emissions
   b) We are likely to see more costly but ineffective abatement measures, pandering to coalitions of ‘green’ rent-seekers and environmentalists
   c) But the same global forces that have caused the slow death of the Doha round will impede effective action on climate change
Criticisms

2. If we act, it will encourage the rest of the world to follow
   a) Implausible on its face: our trade liberalization in recent decades had no effect on international outcomes
   b) Is contrary to the logic of free-riding
   c) Even if there were some such effect, it would likely be small relative to costs and risks
   d) There are likely to be more cost-effective ways of advancing international agreement
Criticisms

3. **It is cheaper to act now than later**
   a) Inconsistent with Treasury’s own modeling, which finds meeting the objective beginning now is lower cost than doing so at the time of CPRS
   b) The efficient rate of mitigation, \( z \), grows over time according to
   \[
   \frac{dz}{dt} = \left( \frac{(r + a)}{\gamma(z)} \right) \frac{1}{z(t)},
   \]
   where \( r \) is the risk-adjusted discount rate, \( a \) is the rate of technical progress in mitigation and \( \gamma(z) \) is the elasticity of mitigation costs with respect to the amount of mitigation (the inverse supply elasticity). If \( a \) is large and \( \gamma(z) \) low, it is efficient to postpone mitigation
   c) Even more important, if it is very costly to dismantle the scheme once it has been implemented, then it is wise to wait
Criticisms

4. **We need a carbon tax to reduce the uncertainties bearing on investors**
   
a) Those uncertainties are a fact of life, inherent in the current global situation – **introducing a carbon tax does not reduce the uncertainties, it merely shifts them on to the Australian community**
   
b) It is by no means obvious that the Australian community is **the least cost bearer of those risks** – i.e. can bear them at lower cost than international capital markets and electricity consumers
   
c) Indeed, if international markets can spread those risks across countries, they may bear them more cheaply
   
d) But even if the Australian community were the least cost bearer of say the climate-change related risks associated with investment in base load power generation, **there are likely to be more cost-effective ways of managing those risks than implementing an economy wide carbon tax**
Criticisms

5. **We are in any event committed to a 5% abatement target and a carbon tax is the most efficient way of achieving it**

   a) We should be willing to reconsider the target given the uncertainties surrounding the international context – unilateral abatement is futile

   b) But even if the target is retained, it is by no means obvious a carbon tax is the most efficient way of achieving it

   c) For example, such a tax could be efficient if it was a substitute for more distorting measures

   d) But an important effect of the revenues raised by the tax is to reduce the opportunity cost to government of making concessions to environmental rent-seekers

   e) It is therefore no surprise that far from abandoning “direct action”, the Gillard government proposes to greatly scale it up

   f) But basic economics shows that like turning up the volume on a faulty amplifier, adding a tax to other distorting interventions more often makes things worse than better

   g) And if the tax leads to the other distortions being scaled up, then outcomes are worse again
Criticisms

6. Treasury’s modelling shows the costs are low, so we should adopt the carbon tax as a form of insurance
   a) Treasury modeled the scenario in which the rest of the world adopts such a scheme and we do too; and the somewhat irrelevant case in which the rest of the world acts and we do not. But it has not modelled, or if it has modelled has not released, the scenario in which we impose such a scheme and our major competitors do not
   b) Even so, at one year’s GDP, Treasury’s estimate of the costs is anything but low
   c) Treating those costs as a form of insurance makes no sense: insurance transfers income from states of the world where its marginal utility is low to those where it is high, while this does the opposite – technically, this is anti-insurance: it increases our exposure to risk
Other than the government’s political convenience, there are few cogent arguments for proceeding now.