Senate Select Committee on the Scrutiny of New Taxes

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Inquiry into a carbon tax

9 June 2011

Question 1

Topic: Carbon tax pricing mechanisms

Chair asked:

CHAIR: I am mindful of the time. I have a final question. Ms Robinson from APPEA earlier said that part of the policy framework that was put forward in the green paper was that there should be some recognition of how a price on carbon in Australia would work if there were an international carbon price. There was an inbuilt assumption of an international carbon price which was going to drive certain design features, which according to Ms Robinson was removed in the transition from the green paper to the white paper. Can you talk us through what the context of that is. If you cannot answer it, maybe you can take it on notice and look specifically at Ms Robinson's evidence on that point. But I am very, very interested in that particular aspect of it.
Ms Quinn: I am not quite clear exactly what mechanism you are talking about, but we are happy to take it on notice, or potentially you could ask the Department of Climate Change and Energy Efficiency later in the afternoon.
CHAIR: I am interested in it in the context of Treasury modelling.

Ms Quinn: Okay.

Answer:

The Carbon Pollution Reduction Scheme White Paper (December 2008) stated that the Government "has decided that one of the key principles underlying the EITE [emission-intensive trade exposed] assistance program will be to support production and investment decisions that will be consistent with a global carbon constraint, by ensuring that assistance to EITE industries is provided in a way that maintains the carbon price signal."

Treasury's modelling results presented in *Strong Growth, Low Pollution: Modelling a Carbon Price* (July 2011) show that the Government's transitional assistance to firms in EITE industries will support output in emission-intensive industries. Output remains as high as, or higher than, it would be without domestic carbon pricing. The modelling assumes comparable carbon pricing in other major economies from 2015-16 and phase out of transitional assistance over five years starting in 2022.

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9 June 2011

Question 2

Topic: Carbon tax pricing mechanisms

Chair asked:

Senator XENOPHON: I have a question on notice for Ms Quinn: going back to Resources for the Future, is it her understanding that the conclusion made by Resources for the Future was that the carbon price was only efficient if combined with other tax reform and if there were no tax reform, the clean energy target was more efficient. Is the government being advised of these potential options? I am happy for that to be on notice.

Answer

The Resources for the Future's report entitled "Moving US Climate Policy Forward: Are Carbon Taxes the Only Good Alternative?" (2011)[1] concludes that

"The revenue or rent created by market-based climate policies is potentially problematic. Ideally, it should be used to substitute for distortionary taxes (or otherwise increase economic efficiency) so that we can be confident that economy-wide carbon policies improve welfare and are significantly more cost-effective than sectoral pricing policies or (smart) regulatory instruments. The best way to do this is to design a carbon tax as part of the broader fiscal system whose overall purpose is to meet a sequence of government revenue targets over time. In fact, a carbon tax of the scale examined here could not be more timely. It would simultaneously kickstart a serious program to ratchet back carbon emissions in the United States, and thereby remove a major impediment to wider global participation in mitigation efforts, while substantially reducing the nation's projected budget deficit (and the need to raise other taxes) out to 2030.

In principle, cap-and-trade systems can be designed to mimic any advantage of a carbon tax, most notably through full allowance auctions. However, even if all allowances were auctioned, legislators responsible for designing cap-and-trade systems may be reluctant to hand over the entire proceeds to the Treasury. Cap-and-trade systems that do not use the rents to cut distortionary taxes are best viewed as combining two policies: a price on carbon, plus an increase in (transfer or other) government spending financed through higher distortionary taxes. The latter component can greatly undermine the overall cost-effectiveness of the program for

[1] Ian W.H. Parry and Roberton C. Williams III (2011), "Moving US Climate Policy Forward: Are Carbon Taxes the Only Good Alternative?", Discussion Paper 11-02, Resources for the Future, Washington DC.

envisioned CO2 reductions over the medium term. Pricing policies or emissions standards focused on the power sector alone perform better than economy-wide cap-and-trade (without the revenuerecycling benefit), but they are distinctly more costly than carbon tax shifts.

It is entirely fair to point out that revenues raised under a carbon tax might not be used to increase economic efficiency. In fact, some evidence suggests that in the past, U.S. governments have spent windfall revenues rather than used them to cut other taxes (e.g., Becker and Mulligan 2003), which may not have always generated efficiency gains comparable to those from cutting other taxes. Alternatively, exemptions to politically influential industries might be granted under a carbon tax, eroding its cost-effectiveness. The case for the carbon tax (or auctioned permits) over other instruments hinges critically on the accompanying legislation requiring offsetting reductions in other taxes (or avoiding tax increases that would otherwise be enacted to meet deficit reduction objectives).

We should always be cautious in taking the policy implications from economic models too literally: our judgment about reasonable parameter assumptions can change, there is always the possibility that models have missed something important, and policymakers may be concerned about criteria other than economic efficiency. Nonetheless, based on the evidence as we see it, there seems to be a solid case on economic grounds for moving ahead with carbon tax shifts in the United States, in preference to any other climate policy instrument."