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**Submission to  
The Joint Select Committee on  
Australia's Clean Energy Future Legislation**

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## Overview

I thank the Committee for the opportunity to make a submission on this matter – though I doubt that it will be particularly welcome to any of the major protagonists in this debate. I have not been able to give the time to it that I would have liked given the very short deadline and the fact that I have been travelling since last Friday and had a full week before that. I am submitting this from Washington where I am attending the IMF/World Bank AGM and speaking at the Bank's Civil Society Forum on ethics and leadership in governance reform.

The first time I had to think about this issue was in 1999 when I was invited to think about the ethical and governance problems surrounding the issues of global warming – giving the opening keynote to a World Council of Churches colloquium on carbon trading. My views on carbon trading were informed by recognizing:

- (a) The value of well governed markets and the effectiveness of clear price signals. Putting a price on carbon could have dramatic effects on the decisions of consumers, investors and providers of goods and services.
- (b) That markets involve the trading of property rights and the 'initial distribution' of those property rights was irrelevant in some theories of market operation but vitally important as a matter of ethics and justice.
- (c) Economic incentives are extremely important governance tools but, like all governance tools, they are most effective as part of a package of ethical standard setting, legal regulation and institutional reform and such packages are necessary for major reforms to succeed (Sampford, 1990, 1992). The primary ethical question is not about how the economic incentives are activated but the overall values major reforms they seek to secure.

Not for the first time, I started to think that the primary issue is fundamentally ethical, providing a critical part of Peter Singer's fundamental ethical question – how should I live my life and the institutional version of that question – how should we live our lives together. While the economic push was critical it had to support an ethical pull. The argument went like this:

- (a) The fundamental problem was that an unsustainable 'high carbon' version of the 'good life' had been developed in the west and was increasingly sought by the rest. Resource-intensive, high-carbon, western lifestyles are frequently criticized as not only unsustainable but deeply unsatisfying – i.e. not 'good'.

There can be no solution to climate change until sustainable conceptions of the good life are developed that Westerners want to live and which others might want to adopt. For this we need a dialogue between East and West in imagining such conceptions of the good life. Fortunately, many of the things that human beings value most do not require huge investments of energy and an unsustainable use of resources – for example: companionship, conviviality, conversation.

Many still want to cling to unsustainable western lifestyles and may be attracted to one of three dead ends

- coercing low-emitting countries to cap their carbon emissions (which is not possible even if it were morally acceptable) and
- bribing elites in less developed countries to commit their countries to cap their emissions. While there is a long tradition of such corrupt deals, they should not be contemplated here because they are unsustainable for both parties to such deals.
- paying those countries to cap their emissions (which is self defeating while unsustainable images of the good life prevail, because one way or another, those being paid to live more sustainable lifestyles will seek the unsustainable 'good life').

Accordingly, low carbon versions of the good life that both the west and the rest wanted to live were essential to solving global warming – requiring an "Ethical Pull." This could be assisted by putting a price on carbon (preferably through carbon taxes) an "Economic Push."

- (b) For the last fifteen years, the wealthiest countries have been pressing for carbon trading schemes because all such schemes allocated them more *per capita* rights to emit to themselves than to others. This proposal effectively created property rights in unsustainable activities (emitting carbon) and allocated most of those

to the countries which had already contributed most to the problem. This outcome was obviously unfair. For those to whom fairness is irrelevant there is the more powerful point that it is not likely to be agreed by the less developed countries.

- (c) The wealthiest countries wanted to buy some of these limited rights from less developed countries. However, if the latter still sought high carbon lifestyles the extra resources would be expended on high carbon activities.
- (d) Part of the ‘good life’ involved meaningful and rewarding work and we should look to stimulate low carbon or no carbon industries that would provide such work. Carbon taxes would help promote low carbon industries.

In the intervening decade, I have not returned to this theme in the same holistic way although some elements have been included in other papers and publications and new arguments made about the advantages of a ‘carbon added tax’ and similarities between the problems of water trading and carbon trading (UNU workshop). TI invited me to write the general background paper for its 2008 IACC on *Global transparency, corruption and sustainability*. During this time, there are growing concerns about carbon trading schemes

- Problems with constructed markets – surprisingly unfazed by GFC
- Concerns about corruption in carbon markets
- Developing countries were just not buying the deal.

Today, I will concentrate on the major issue of today – the form of economic push that is most likely to succeed. I will maintain the minority opinion that carbon taxes are better than carbon trading and that a particular form of it is vastly superior as an effective, credible, long term form of economic push. I will hence argue that it is OK to start with a Carbon Tax but that it is not the ideal form of carbon tax and that the transition should not be to a Carbon Trading scheme but to a better form of the tax. If the world does go for a carbon trading scheme then it will probably be better to join with a sub-optimal plan that is agreed than to stick solo to a much better scheme. I say probably because the scheme I suggest can be pursued by a single country and might even become a global exemplar.

I am happy to appear before the Committee to answer questions or provide further information. I also support the submission by my co-editors of a book on topic in press (Ken Coghill and Tim Smith).

### **Concerns about Carbon Trading Schemes**

While the ultimate solution to climate change is the development of low carbon lifestyles, it is important that economic incentives support and stimulate that search. The sustainable versions of the good life provide an ethical pull. The incentives provide an economic push. The currently favoured approach is to set a cap and then cut total emissions with the trading of emission rights to provide incentives to those who can most efficiently cut their carbon and minimize the cost. This approach is unsurprisingly popular in states emitting the most carbon because it effectively gives them a property right to emit, something that is acknowledged in the literature.<sup>1</sup> However, where an activity is shown to be harmful and unsustainable, it is not immediately obvious that the appropriate response is to create property rights to continue the harmful activity and to give the greatest property rights to those countries or corporations who have done the most harm and have been externalising the costs on others who have suffered and continue to suffer from the harm done. This idea is popular in the West and with those who would profit by the operation of those markets. It is unpopular with non-Western countries which would be given less rights. Indeed, why would they agree? Those who spent the last decade worrying about how to persuade the USA to take part do not seem to have appreciated this obvious objection and seemed to be surprised at the forcefulness of developing countries in the lead-up to Copenhagen.

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<sup>1</sup> ‘Issuing permits free of charge (or at low cost) explicitly recognises the property rights which emitters have had in the past.’ (Cornwell & Gunasekera, Essential Elements of Tradable Permit Schemes. *Trading Greenhouse Emissions: Some Australian Perspectives*, 11, 17 1998, p. 17)

Wherever large amounts of assets are found, so will there be attempts to appropriate them. When a very large body of assets is created, the temptation/corruption risk is correspondingly, very large. This point is frequently made about carbon offsets (for example, Daphne Wysham at a plenary session of the 14<sup>th</sup> IACC). However, the value of the carbon permits is likely to be several times that of offsets. If they are all auctioned, this may be less of a problem. But most proposals suggest giving away most of these valuable assets. If these permits go to the major polluting corporations and companies, it will be a greater private appropriation of public assets than the enclosure of the Commons or the Russian privatisations of the early 1990s.

This approach of creating property rights in unsustainable activities also has the perverse effect of encouraging market players to look for the next unsustainable activity in which they can invest to benefit from 'grand fathered' rights. It will then be in their interests to maximise the harmful activity to maximise the property rights given when the harm is recognized. This approach rewards polluters, exacerbates pollution and creates perverse incentives for those who know about pollution to invest in it rather than expose it.

Faith in carbon markets may be misplaced in this case, just as was sorely tested in the current global economic crisis. The relevant commodity – carbon – is not well understood, and knowledge will thus be asymmetric, allowing market players many opportunities for arbitrage and taking advantage of the ignorance of those who need to access the market to continue their businesses. This process leads to increased costs and risks of doing business (as the market for carbon can fluctuate wildly)<sup>2</sup> so that much of the extra cost of doing business will end up in the hands of market players rather than consumers or producers who have to pay higher prices. There is also the possibility that everybody loses. New markets often get it wrong.

#### *'Beware of Merchant Banks Bearing Gifts'*

The creators and 'market makers' for derivatives have been very keen to enter into carbon trading. While many are now wary of entrusting them with the contents of their piggy banks, it is unlikely that they will be entrusted with the future of the planet: there are many fresh and vivid memories of the way in which new markets are prone to fluctuation and profiteering from asymmetric knowledge.

Carbon trading is one such example. In promoting volatility in currency, traders benefited at the expense of those who needed to exchange currencies to conduct business through a combination of asymmetric knowledge and outright manipulation. Although some risks could be hedged (generating major profits for the market players), long term risk was uninsurable. By increasing the risk of doing other business, it discouraged what would be an otherwise profitable investment. It is almost universally true that stability is good for industry, volatility is good for traders.<sup>3</sup> Those who will cash in on the volatility are rent seekers, pushing inefficient financial structures that will provide them with profits.

The more enthusiastic merchant bankers are about carbon trading the more we should be wary of it. I can see why believers in the efficient markets hypothesis, strengthened by the success of SO<sub>2</sub> trading schemes might have been enthusiastic for carbon trading schemes in the past. However, the experience of the GFC with complex financial instruments should make us very wary of trying to create a complex market for current and future carbon credits. While CDOs, CDFs and ETFs once looked solid and now look virtual (sometimes in the sense of being non-existent), future carbon credits may seem just so much 'hot air'. I tend to think that if the GFC had preceded the Rio Conference, nobody would have suggested carbon trading. Now that we have seen the effects of the GFC, it is strange that it has persisted so long.

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<sup>2</sup> I recognize that the European carbon market has settled down so that the maximum prices are only about double the minimum prices and that these make it less volatile than many commodity prices. However, there are many artificial aspects of the European carbon market, including the fact that most of the carbon permits required by those who need them are given them for free.

<sup>3</sup> My understanding of this is not merely theoretical. I have been a Director of a medium sized family company importing high end white goods into Australia since 1976.

## **Revisiting Carbon Taxes in a New Form: ‘Carbon Added Tax’**

The clearest alternative approach to carbon trading involves the taxation of unsustainable activity rather than granting rights to it. For the last four years, I have been suggesting a ‘carbon added tax’ (CAT) to operate like a value added tax (VAT). If a CAT operates like a VAT, carbon taxes will be ‘passed on up the line’ until they are ultimately paid by the consumer of the relevant goods and services. The VAT treatment of imports means that those who keep outside the system of carbon taxes would still face the CAT when the goods are imported into a market within the system.<sup>4</sup> It also means that the burden is on those countries which consume high carbon goods and services rather than those who produce them.

This strategy involves the harnessing of the power of markets – though by using a direct and controlled price signal which inhibits high carbon industries and stimulates low carbon industries and provides clear signals to where future entrepreneurs can make their fortunes. It closes off two other ways in which individuals and corporations can make money – through lobbying (and worse) to get free carbon credits or through leveraging asymmetric knowledge and resources to profit from an immature market.

As indicated above, volatility is good for traders and not for those engaging in long term business decisions. A decision to adopt a carbon tax over a carbon trading scheme provides incentives to channel entrepreneurial talent into the new industries without which we cannot grow our economies in ways that provide a sustainable good life for this planet’s peoples. The next group of great entrepreneurs are those who will have new ideas of how sustainably to provide goods and services that consumers want in ways that provide a decent living for those who work in them. This approach will involve new ways of providing old goods and services and new goods and services that meet human needs. A decision to adopt carbon trading makes investment in low carbon industries more risky by reducing the certainty of the price advantage that sustainable goods and services can be provided. In so doing, it increases the required rate of return for the investment to be made.

### *Some details*

The design of such a tax is a major, if not necessarily complex, matter. If imports and exports are dealt within the same way as GST/VAT, it is possible to introduce it in a single country without affecting that country’s competitiveness. CAT would be levied on all imports and a CAT credit given for all exports. Accordingly, goods and services produced within Australia would not be at a disadvantage against imports in our own markets or against goods and services in other markets.

This approach emphasises that it is the consumption of high carbon products and services that is the problem and that the burden should fall on the consumers rather than the producers. This reflects the genuine (but rarely expressed) concern that countries which produce high carbon goods or components are treated as just as much of the problem as those who consume them. Much of the manufacturing, mining and smelting that was once done in the West is now done, for example, in China or Australia. A carbon tax will address both consumption and production but the burden of a carbon tax should be on the ultimate consumers not the producers. This approach does not remove the price incentive from producers as high carbon products will be less competitive in export markets.

Note, it could be argued that price elasticity within countries means that the ultimate consumers will not pay – something that is rarely argued for VAT. However, as each country imposes a tax on the carbon included within imports, it becomes certain that the countries whose populations consume the most carbon intensive goods and services will have to pay.

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<sup>4</sup> Some might question how the carbon emitted in producing imports is calculated. This is a reasonable question – though the question of measurement is an issue for goods produced locally and for carbon trading systems as well. The answer for carbon taxes is a simple one. The carbon emitted by producing particular classes of goods would be estimated on the basis of traditional practice and it would be open to any importer (or manufacturer) to demonstrate that they emit less carbon than that standard. If the cost of proving the lower carbon emissions is greater than the tax benefits to be gained, then they will run with the estimate.

Concerns of the inflationary effects such a tax or the increase in government revenues can be addressed by returning revenue to individuals through cuts in consumption tax (either across the board or targeted to produce more socially equitable outcomes – for example, zero-rating classes of goods typically consumed by lower income groups). A CAT provides both negative and positive price signals as low carbon products actually decline in price (though slowly enough to avoid deflation of low carbon products). In general, the point is that there should be a move from taxing consumption to taxing carbon. The gradual substitution of carbon for standard consumption taxes provides room for huge price signals and incentives for reducing green house and other emissions without affecting inflation. (However, in countries where there is a risk of deflation, the inflationary effects might be particularly valuable to keep the general price level increasing. The proceeds could then be distributed to citizens or residents as a per capita payment.)

If CAT rose to replace consumption taxes at current rates (10–25 percent are typical leading to revenue from the tax at between 5–15 percent of GST), the price signal could be made much greater than the carbon trading schemes contemplated. The government could announce a schedule of carbon tax increases over the next decade with a warning that the rate will be increased until carbon consumption was reduced to sustainable levels. This approach has the virtue of allowing industries to change, providing predictability but a clear message that the government has the determination and a relatively easy means to increase taxes on carbon until emissions targets are met. As carbon taxes became more effective, the CAT take might shrink and VAT could then be gradually returned without any effect on inflation or taxation as a share of national income.

The distributional effects of carbon taxes do need to be considered. They are likely to be regressive in developed countries where the poor tend to live away from city centres, their work and public transport. This is certainly the case in Australia where the poorer Australians now live in outer suburbs and are more dependent on motor vehicle transport. This is one reason why it is important that taxes that are cut should be regressive taxes (like GST) rather than progressive taxes such as income tax.

I am not political – as can be seen from the fact that I am advocating a position that has not been endorsed by either party. I am happy to avoid current debate but a few comments might be appropriate.

I take a lot of issues seriously that are dismissed by other sides, including the potential effects on inflation, exports and the problems of designing a system for one country. It is very true that the amount is small compared to GST and compared to changes in exchange rates. However, I do not want Australian goods to be at a disadvantage because we put a price on carbon and others do not. If Australian producers use a lot more carbon than others, they should ultimately suffer. If they use less then they should prosper. I also think that wildly fluctuating exchange rates are a problem. It is not a problem for currency traders and not a great one for importers. But it is for those who make long term investments in the production and productivity of Australian primary, secondary and tertiary industries.

There is the issue of future increases in carbon tax by which the economic push can rise to drive down carbon emissions to an average of two tonnes per person. We need the capacity to increase carbon. If we have to go through this process to do so, our credibility in claiming that we will put a price on carbon will be seriously damaged. This is something that can be done in one country. It can be an example to other countries.

I must emphasise that taxes are not sufficient. We need as well:

- An Ethical push above
- Institutional reform leading to a Global Carbon Integrity System, and
- Individual action

However, this is not the place to discuss them and I have written about these elsewhere (Sampford 2008a).

### **Some of my other relevant work**

- Sampford, C. (2000). *Ethical Standard Setting for Global Incentives: Towards an effective regulatory philosophy of global greenhouse response (Opening Plenary)*. Paper presented at the World Council of Churches Consultation on the Global Atmospheric Commons.
- Sampford, C. (2002). Environmental Governance for Biodiversity. *Environmental Scie & Policy*, 5(1), 79–90.
- Sampford, C. (2008a). *Global transparency: Fighting corruption for a sustainable future: From National Integrity Systems to Global Integrity Systems*. Paper presented at the 13 IACC, Athens, November.
- Sampford, C. (2008b). Water Rights and Water Governance: A Cautionary Tale. In Llamas, Cortina,. Mukherji (Eds.), *Water Ethics*. The Netherlands: CRC Press.
- Sampford, C. (2010). Re-conceiving the Good Life: Key to Sustainable Globalisation. *Aust J of Soc Issues*, 45(1), 13–24.