Executive Summary

> The government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidise it. ~ Ronald Reagan

The nation is poised to embark upon a major economic reform which will have far reaching consequences for every Australian. The government's carbon tax may well become law but it lacks the credibility of past economic reforms, its timing is poor and the economic pain will not lead to any environmental gain.

The central issue the committee sought to address is not whether a carbon tax is good or bad in economic theory. The question before this committee and before the Parliament is whether Australia should implement such a tax, followed by an Emissions Trading Scheme, at a time of great uncertainty both about the economic outlook and even more so about the nature and extent of the international abatement effort.

These questions are particularly acute for Australia because our prosperity is based on a resource endowment that is highly carbon-intensive. Moreover and importantly, much of that carbon-intensity is not amenable to simple or obvious technological solutions – for instance, there is little that can be done to reduce fugitive emissions in mining.

It is against that backdrop that we need to assess whether it is desirable for us to impose a carbon tax if many other countries, including the world's largest emitters and our major resource competitors, do not.

The government's lack of mandate for a carbon tax

Prior to the 2010 Commonwealth Federal election the Australian people were promised no carbon tax by the Prime Minister, the Hon. Julia Gillard MP. Following a deal with the Greens and the Independents that allowed it to remain in power, the government announced the establishment of the Multi-Party Climate Change Committee. It first met on 7 October 2010, and on 24 February 2011 the Prime Minister announced that a carbon tax would be introduced. No specific details of the carbon tax were released at that time.

Since those events, the government has moved with haste to implement the carbon tax. The initial detail of the tax was released on 10 July 2011, with a complex and highly technical tranche of 19 Bills introduced into the Parliament on 13 September 2011. The government is set to force a vote by the Parliament on these Bills in late 2011. Because of the way they have been drafted there are major concerns about the ability of future governments, of any political persuasion, to amend the system the legislation will put in place.

The Australian community, which did not vote for a carbon tax, has been given little time to consider and comment on the 19 Bills. A rushed process has been compounded by the lack of transparency of the modelling underpinning the reform

process, where the data and models used have not been made public nor released for scrutiny.

Shifting emissions overseas

The government's plan imposes an impost on the competitiveness of all Australian businesses, without the same impost being imposed on our competitors. This will shift economic activity from Australia to countries without a carbon tax or an emissions trading scheme. As the Productivity Commission recently reported 'no country currently imposes an economy-wide tax on greenhouse gas emissions or has in place an economy-wide ETS.'[1]

To reduce emissions in Australia in a way that just shifts them overseas into areas where there will be no carbon tax and where emissions will be higher for the same economic output is pointless. To help overseas emitters take market share from even the most environmentally efficient Australian business is not effective action on climate change; rather it is an irresponsible act of economic self-harm.

As economist Professor Henry Ergas points out:

> ... as well as being pointless, that action would be highly costly. For example, economic analysis shows, and experience confirms, that world minerals supply responds to relative prices, and does so reasonably quickly. If we tax our minerals exports, and competing sources of supply do not, world supply will shift to the untaxed sources, reducing our export volumes compared to the levels they would otherwise have attained. The result will be to reduce Australian real incomes (compared to the 'no tax' world), without yielding any gain in terms of diminishing the risks of climate change.[2]

The carbon tax will have a substantial impact on Australia, given that our economy is based around access to relatively cheap fossil fuels. Many Australian jobs are in industries that are carbon-intensive because our inexpensive access to hydrocarbons is an advantage Australia has on international markets. As the Productivity Commission stated in their submission to the Prime Ministerial Task Group on Emissions Trading in 2007:

> Independent action by Australia to substantially reduce GHG emissions, in itself, would deliver barely discernible climate benefits, but could be nationally very costly. Such action would therefore need to rest on other rationales … Australia's high living standards derive in part from the largely efficient use of an abundance of low cost fossil fuels, reflected in relatively high per capita emission levels. As a result, substantially reducing GHG emissions would be costly for the Australian community, with costs borne mainly by consumers and the owners (and employees) of businesses

1 Productivity Commission, *Carbon Emission Policies in Key Economies*, Research Report, May 2011, p. 50.

2 Professor Henry Ergas, *Committee Hansard*, 10 August 2011, p. 60.

> that directly or indirectly rely on the intensive use of GHG producing energy sources.[3]

Because, as the Productivity Commission points out, reducing Australia's emissions would be so costly, the government's plan relies on purchasing billions of dollars of carbon emission credits from overseas. Indeed, according to the government's own modelling, Australians would have to purchase $791.8 billion worth of carbon credits from overseas to 2050, in today's dollars. By 2050, Australians will be purchasing $59.5 billion worth of credits in just one year.

There remain significant questions over whether existing international carbon trading schemes produce *additional* reductions in carbon emissions. There have also been a number of cases of corruption in these markets. Legislating for a scheme to reduce Australia's emissions in a way which relies so heavily on these still immature markets is premature.

The inefficiency of the government's carbon tax

Professor Ergas also notes that absent concerted and effective international action, including by Australia's resource competitors, a carbon tax would merely be an extremely inefficient form of taxation:

> Estimates from Treasury's climate change modelling allow one to estimate the extent of the inefficiency. Using, for simplicity, a discount rate of zero, those estimates imply the present value of the income loss from the carbon tax and the subsequent ETS is approximately twice the present value of the revenue it raises. In other words, on those estimates, the tax has an average excess burden, defined as the income loss per unit of revenue raised, of 2. This is four times greater than the average excess burden of the most distorting tax identified by the Henry report, i.e. mining royalties and the crude oil excise… In other words, this tax would be more distorting of economic activity than any other tax we impose.[4]

The inefficiency is even starker when one realises that Treasury's estimate of the income loss is based on the assumption that credible international agreement on emissions reduction is reached relatively soon. Indeed, in a reply to questions posed by Professor Ergas, Treasury says that '[t]he modelling does not rely on an assumption that there is a perfectly harmonised global emission trading scheme.'[5] But, it now admits, it does assume there is 'some mechanism' that 'allows individual firms or Government's themselves to trade abatement with other countries.'[6]

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3 Productivity Commission 2007, Productivity Commission Submission to the Prime Ministerial Task Group on Emissions Trading, March, pp viii and 31.

4 Professor Henry Ergas, *"Dealing with Climate Change"*, Crawford School Dialogue: Australia's carbon price: good policy or not?, Australian National University, 5 September, 2011.

5 Professor Henry Ergas, 'Mr Garnaut, climate policy should be questioned', *The Australian*, 30 September 2011, p. 12.

6 Professor Henry Ergas, 'Mr Garnaut, climate policy should be questioned', *The Australian*, 30 September 2011, p. 12.

Professor Ergas commented on this admission:

> What mechanism? No one knows. Where is the legislation that would put such a mechanism in place? No one knows. And what happens to the assessed costs if there is no such mechanism? Again, no one knows. And since the models and data are not public, nor will they, least of all the hoi polloi who will pay the price.[7]

The carbon tax has the potential to undermine wider reforms

Over the past 30 years, the Australian economy has gone through significant reform, which has made the economy open to world economic pressures and has improved the performance of infrastructure delivery, leading to lower electricity prices in particular. The Productivity Commission estimates that National Competition Policy reforms alone increased Australia's GDP by 2.5 per cent.

While delivering broad-based benefits to Australia, these reforms did impose large costs, particularly in the transition phase, on certain towns and communities which had to adjust to the new environment. Unfortunately, the carbon tax is set to have its biggest impact on these same communities. Some of the hardest hit towns from the carbon tax will be the electricity industry in the La Trobe Valley, the automotive industry in Geelong and Adelaide and the steel industry in Whyalla, the Illawarra and Newcastle.

In addition, these communities are often at the frontline of the so-called 'two-speed' or 'patchwork' economy. After becoming more internationally competitive and resourceful from the opening up of the Australian economy, they are seeing hard–won markets disappear due to a higher Australian dollar and higher input costs, partly exacerbated by the mining boom. Imposing a carbon tax on top of these pressures threatens to kindle an already smouldering situation.

Accordingly, the carbon tax has the potential to undermine the hard–fought acceptance of the economic reforms that have broadly benefited the Australian economy over the past 30 years. Such a reaction can already be seen in the calls for renewed industry assistance to the steel and manufacturing industries. Large–scale renewal of industry assistance would be a retrograde step.

Yet, imposing a carbon tax now gives renewed potency to those who would seek to resurrect such protections.

The overall impact on the economy – $40,000 from every Australian

Unlike previous reforms, there is no broad economic bounty from a carbon tax that can be redistributed to offset disproportionate costs.

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7 Professor Henry Ergas, 'Mr Garnaut, climate policy should be questioned', *The Australian*, 30 September 2011, p. 12.

In total, under the government's own modelling, the carbon tax is likely to impose a $1 trillion cost on the Australian economy. As economist Professor Henry Ergas explained to the committee:

> … the costs Treasury estimates are anything but trivial. Indeed, discounted at the Garnaut discount rate, they have a present value equal to $1 trillion—that is, one year of Australia's GDP.[8]

This $1 trillion figure is about equal to the total output of the Australian economy in one year. Or, to put it in other terms, the carbon tax will cost every Australian, on average, $40,000.

This is likely to be an underestimate given that Treasury's modelling relies on the assumption that other countries will act in concert with Australia to reduce emissions.

The government has provided no evidence that its policy provides benefits commensurate with these costs. Indeed, without global action, a carbon tax in Australia cannot do anything to mitigate the effects of climate change. A carbon tax will be all economic pain for no environmental gain.

The need for a credible international agreement

Professor Ergas also notes that this assumption (of early global transition to a mechanism for setting a uniform carbon price) now plays a greater role in Treasury's modelling than it did for the CPRS:

> Treasury has assumed away the problem. Indeed, it has done so even more starkly than in its work on the Rudd government's Carbon Pollution Reduction Scheme. Then, the base case (against which the costs of the CPRS were assessed) involved a world without abatement targets. This time, however, the modelling starts from the premise that global abatement efforts are in place, even after the commitment period for Cancun pledges ends. So the costs for Australia are only assessed assuming global abatement will occur and persist.[9]

As a result, Treasury's estimates of the economic costs of the government's proposed scheme are likely to be a substantial underestimate. In effect, were global agreement not reached but Australia nonetheless imposes a carbon tax, the income loss could be two to three times greater than Treasury's estimates suggest. This would make the carbon tax's average excess burden eight or more times higher than that of any other tax we impose. As Professor Ergas has explained:

> ... for every dollar of revenue this tax raised, [the carbon tax] would reduce income by eight or more dollars, whereas raising the same dollar of revenue by our current most distorting tax would only cost some 70 cents of income

8 Professor Henry Ergas, *Committee Hansard*, 10 August 2011, p. 61.

9 Professor Henry Ergas, 'Mr Garnaut, climate policy should be questioned', *The Australian*, 30 September 2011, p. 12.

> loss. And all that for no benefit, as unilateral abatement by Australia has no effect on the likelihood of dangerous climate change.[10]

In short, unless there is credible, comprehensive action on a global scale, it is difficult to see why we would impose such a tax.

Flaws in the government's approach

The government and its advisers have simply evaded this obvious conclusion. Rather, their approach has been to argue that the rest of the world is acting to deal with climate change.

It is true voluntary commitments have been made, but the quantum of those commitments is highly uncertain, as is whether they will be implemented. There is deep scepticism that any legally binding agreement to reduce emissions can be reached before 2020 even by those involved in carbon trading markets. As a World Bank survey of market participants recently reported:

> Survey respondents were not optimistic that a binding international agreement could be achieved in the short term.[11]

While much has been said about China, there is no doubt that the subsidies China provides to emitters are very much greater than any measures it imposes to reduce emissions. Moreover, despite the glowing endorsement of China's efforts in the Garnaut report, it is interesting to note that while Treasury's modelling in 2008[12] assumed (at pages 82 and 86) that China would join a world effort in 2015, its latest modelling assumes (at page 42), (without even noting, much less explaining, the change) that China will only join that effort in 2021 (at page 32). There is little realistic prospect at this point of significant action by many of our major resource competitors.

Rather, the most realistic assessment at this point is that we will continue to see costly, ineffective and inefficient abatement measures adopted by a number of countries. As a result, good sense suggests Australia must take account of the possibility that comprehensive agreement will not be reached, and factor that into the decision. This suggests that to act now, while the global prospect is so uncertain, is reckless.

The cost of acting now

To this, the government's reply has been that acting now is less expensive than acting later. This claim is frequently made in Treasury's report on its modelling but no evidence was presented by Treasury to this committee that would substantiate it. Indeed, even on Treasury's own numbers, the opposite appears to be true, as Treasury's estimate of the income loss involved in meeting emissions abatement

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10 Professor Henry Ergas, *"Dealing with Climate Change"*, Crawford School Dialogue: Australia's carbon price: good policy or not?, Australian National University, 5 September, 2011.

11 World Bank 2011, *State and Trends of the Carbon Market 2010*, Washington DC, (June 2011, p. 17.

12 http://www.treasury.gov.au/lowpollutionfuture/report/downloads/ALPF_report_consolidated.pdf (accessed 4 October 2011).

targets seems, for the core policy scenario, some 30 to 40 percent lower now than it was at the time of the CPRS.

A further argument put by the government is that we need a carbon tax to reduce the uncertainties facing investors, for instance in electricity generation. However, as Professor Ergas and others noted in their presentations to this committee, while investors do face uncertainties, including those associated with the future international framework for climate change, those uncertainties cannot be wished away by an Australian government. Rather, they are a fact of the current global situation. The carbon tax does not eliminate these global uncertainties in any way; it merely shifts them on to the community. It is by no means obvious that the community is better placed to bear those risks than are global capital markets and electricity consumers. Imposing such a tax as a means of reducing investment risk in electricity is a case of using a sledgehammer to crack a nut.

The government, echoed by Treasury in its appearance before this committee, also argues that the tax will replace more distorting alternatives. But an important effect of the substantial revenue raised by the tax is to reduce the opportunity cost to government of pandering to rent-seekers. As Professor Ergas has noted:

> It is consequently unsurprising that the government is not proposing to dismantle the many forms of direct action in which it is currently engaged; on the contrary, it proposes to greatly scale them up, throwing many billions of dollars raised by the tax at a range of rent-seeking projects. Now, simple 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; and if introducing the tax actually leads to the other distortions being scaled up, then outcomes are worse again. As a result, the supposed superiority of the tax is far from assured. And the problems are all the more acute with an ETS, where the costs of rent-seeking are lower and the benefits greater.[13]

Finally, the government has argued that the carbon tax is a form of insurance. But insurance makes the community better-off when adverse events occur. In contrast, this tax will make us worse off should our abatement efforts prove ineffective because other, far larger, emitters continue to increase their emissions, as seems likely. As a consequence of being worse off, we will be even more poorly placed to adjust and adapt to harmful climate change, should it occur.

In other words, this is not a tax that helps achieve our goals but compromises them; that rather than make our prosperity and future safer, endangers it; and that is merely an instance of politics seeking to triumph over prudence and sensible economics.

Uncertainty in the global economy

Since the announcement to introduce the carbon tax on 24 February 2011, the world economy has re–entered a period of uncertainty and pessimism driven by sovereign debt concerns in Europe and the United States of America. As just one example of this

13 Henry Ergas, *"Dealing with Climate Change"*, Crawford School Dialogue: Australia's carbon price: good policy or not?, Australian National University, 5 September, 2011.

increasing gloom, the Australian stock market has lost almost a quarter of its value since the government announced the carbon tax. Despite the re–emergence of a troubling global economic outlook, the government appears determined to press ahead regardless of the risk to the Australian economy from another tax.

The committee is opposed to the carbon tax, but not to action in relation to climate change. The committee's view is that this is not the time to proceed with the tax and certainly not in its present form.

The publicly available information from the Treasury modelling that underpins the carbon tax, as well as modelling commissioned by the governments of New South Wales, Victoria, Queensland and Western Australia, all point to reduced growth and a hit to employment. Despite the potential cost to the economy and the uncertain global economic environment, the government is determined to proceed.

The evidence provided to the committee paints a compelling picture. The views of Australian businesses gathered by this inquiry present a gloomy picture of the impact of the government's carbon tax. The industries that generate our nation's prosperity in mining, agriculture and manufacturing will be hit with a tax that their competitors will not be paying.

Under the government's carbon tax, Australian businesses will bear a cost impost that is self–inflicted and will add to the pressure for them to relocate, most likely to where such a tax is not payable and where production methods lead to higher emissions.

In the absence of a truly effective global agreement, Australian businesses and those that depend on them will pay the price as jobs and investment move offshore. Countries that opt out of contributing to tackling climate change will be the gainers, while Australian businesses battling global economic uncertainty, a high dollar and ever rising taxes will face challenging times.

Treasury modelling

If all this was not enough, in the course of the inquiry, the committee has been made aware of a number of quite significant shortcomings with the modelling conducted by Treasury:

- it has not modelled the quite probable scenario where Australia imposes an economy-wide carbon tax and other countries, particularly its resource competitors, do not;
- the modelling significantly underestimates the costs of the tax, by not modelling the transactional macroeconomic costs of the tax;
- it has not performed a cost-benefit analysis of the effect of imposing a carbon tax or completed a proper Regulatory Impact Statement as required by best practice;
- it assumes that the economy will maintain full employment;
- its estimate of the effects of changes to the Renewable Energy Target scheme is at odds with analysis conducted for the New South Wales and Queensland governments;

- the decision not to release modelling of the impact of a carbon tax on specific regions of Australia, unlike the modelling released by some State governments; and
- it has not allowed public scrutiny of its full models, datasets and specifications, in contrast to the approach taken by the Productivity Commission with its modelling.

Recommendations

Recommendation 1

It is the Committee's view that the carbon tax should be opposed and the legislation defeated in the Parliament as:

- **there is no electoral mandate for the carbon tax;**
- **the modelling that supports it is based on a number of highly contestable assumptions;**
- **it is likely to undermine Australian businesses' ability to compete in the global economy;**
- **it will have significant adverse effects on particular sectors and regions, with a particularly disproportionate impact on regional Australia;**
- **the effect of the policy on the cost of living, and on jobs is likely to be higher than the government's current estimates indicate;**
- **there is considerable evidence that the carbon tax will not result in any real environmental gain, despite imposing a significant cost on the economy over the next thirty years.**

The Committee recommends that the carbon tax be opposed by the Parliament.

Recommendation 2

The Committee recommends that if the Parliament believes that it should proceed with the carbon tax, any provisions in the legislation designed to bind future governments seeking to prevent them from amending or rescinding the scheme be removed.

Recommendation 3

The Committee recommends that if the Parliament believes that it should proceed with the carbon tax, that it does so once current global economic circumstances have improved and there is a legally binding global agreement on tackling climate change.

Recommendation 4

The Committee recommends that, should the government remain committed to proceeding with its carbon tax, before any vote the Senate should demand that:

- **the government release all of its modelling, including the actual models, datasets and specifications used by the Treasury, to allow third party review;**
- **the government establish an Independent Expert Panel to review its modelling approach and framework;**
- **the Productivity Commission be asked to undertake a cost-benefit analysis of the proposed carbon tax;**
- **the legislation should be amended to ensure that any increase in the tax or lowering of the emissions cap be made a disallowable instrument and to ensure that carbon permits are not private property.**