The Australian

Fatal flaw in case for a carbon tax

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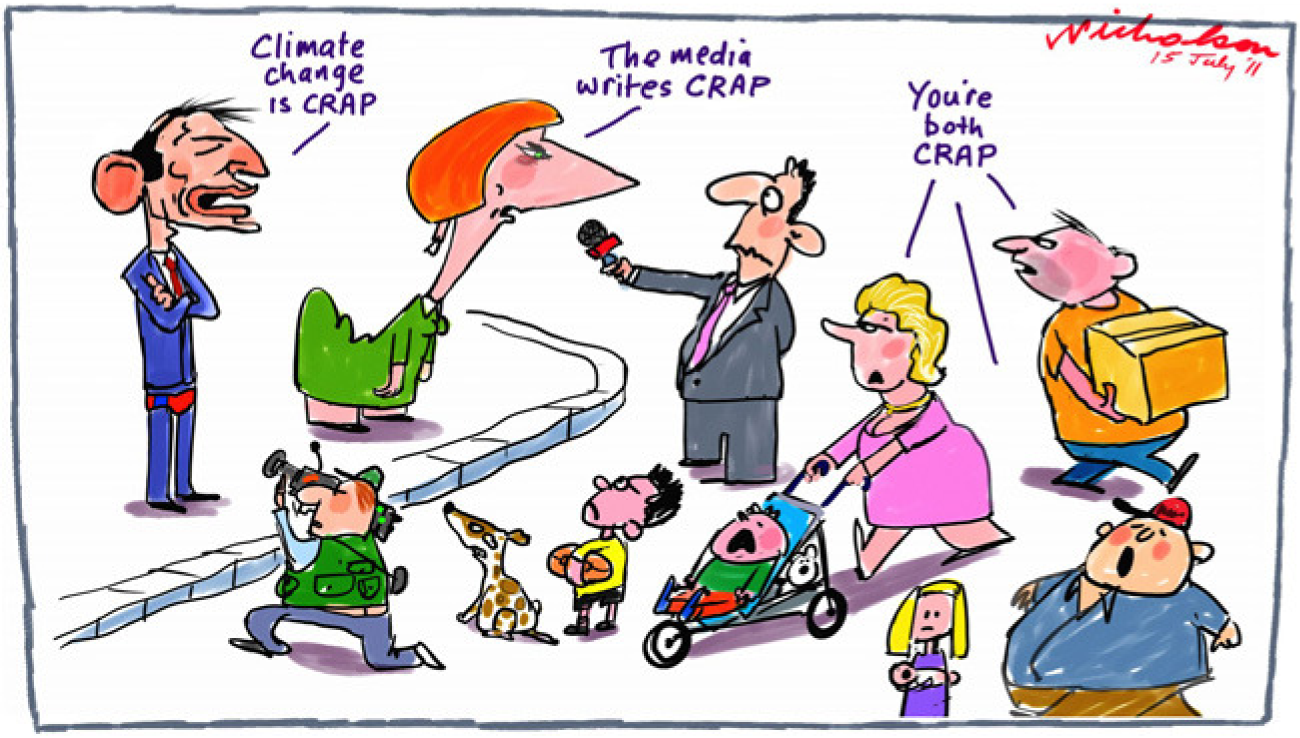

Illustration: Peter Nicholson
Source: The Australian

THE one thing you need to know about Treasury's modelling of the carbon tax is this: it assumes that by 2016, the US and all the other developed economies that do not have carbon taxes or emissions trading systems in place will have them up and running.

This implies that in next year's US presidential election, likely to be fought at a time of high unemployment, the winning candidate will campaign on the basis of introducing a carbon tax that will go from zero to $30 a tonne in a matter of months. And that tax will then not only get through Congress but in record time.

Moreover, that feat accomplished, by 2021 China will sign up too, and with 14 per cent of the world's population and barely 20 per cent of world income, will agree to shoulder 34 to 35 per cent of the costs of global mitigation. As part of that deal, China's leadership will accept a fall in national living standards, relative to business as usual, of between 5 and 10 per cent, while per capita incomes in the far wealthier US and European Union decline by a fraction of that amount. And with China on board, the rest of the world will join the party.

These assumptions are central to Treasury's analysis, not least because they ensure that by the time Australia moves to an ETS, there is a fully functioning world market for emissions permits. That world market makes it possible for permits bought overseas to contribute two-thirds of the mitigation we achieve during the period to 2020. In contrast, were the market as it is today, with more than 80 per cent of permit trading occurring within the EU, Australian demand for permits would significantly drive up prices, increasing Treasury's estimated abatement costs.

The only uncertainty Treasury envisages with respect to global action is whether it might not prove even more ambitious in seeking cuts in emissions. There is, in other words, no likelihood of the world not reaching comprehensive, credible agreement, nor is there any possibility of backsliding from the strictly voluntary pledges made at Cancun.

Why these assumptions are plausible, much less compelling, is never explained in Treasury's report. All it says by way of justification is that a "co-ordinated international policy framework is ultimately in all countries' best interests". Perhaps, but so are perpetual peace and global free trade. And history shows it is rarely wise to confuse aspirations for reality.

Rather, sensible analysis requires examining what happens if one's hopes do not eventuate. That, however, is the one outcome Treasury does not consider. It discusses the scenario in which the world acts and we act with it and that in which the rest of the world takes vigorous action while Australia free-rides. But the scenario in which we act while our main competitors do not is never analysed.

That this will be viewed as a glaring omission is plainly not lost on Treasury. It therefore advances a startling proposition: that "if global action is less than assumed, Australian mitigation costs will be lower, not higher, than reported".

Taken at face value, such a claim seems implausible. After all, in the absence of global agreement, action by Australia would be an exercise in futility. As a result, even if unilateral cuts in emissions required fewer resources than needed to achieve comparable cuts on a co-ordinated basis, the fact they were pointless would mean their costs, properly defined, were greater, as good money was being poured down the drain.

But Treasury's point may be subtler: that if we have decided to reduce emissions by some amount, regardless of whether it is futile or not to do so, we might use fewer resources in achieving it when we go it alone.

This, Treasury suggests, is because buying permits overseas would be cheaper under unilateral action, as there would be less demand for them. Perhaps, but the supply of permits would also be far lower and the market in which they are traded less developed and poorly integrated. Additionally, Treasury argues, weaker global action would strengthen world demand for resources compared with Treasury's reference scenario. And indeed it would. But if we act and large parts of the world do not, more of that higher demand will shift to our untaxed or less taxed competitors. With resource prices higher than they would otherwise be, each tonne of coal thus displaced implies a greater loss of Australian income.

As a result, Treasury's claim is hardly compelling. And the fact Treasury provides no modelling to support its assertions does not inspire confidence.

Moreover, if we are indeed committed to reducing Australia's emissions, regardless of whether doing so will make any difference, the policy issue would be how that goal could be achieved at least cost. Imposing a large and steadily rising tax on our exports, as will happen under the government's plan, is surely unlikely to meet that test.

Rather, the approach of former senior Treasury official and co-founder of Access Economics, Geoff Carmody, which involves a carbon tax that, like the GST, exempts exports but taxes imports, would seem a superior option. And Tony Abbott's plan, which does not tax exports to anywhere near the same extent as the government proposes, could also be far cheaper in a world where our main resource competitors do not follow our lead. But those are possibilities Treasury simply ignores.

Yet Treasury's analysis, whatever its flaws, should focus us on a central question: how can it make sense to commit to an enormously costly reduction in emissions when, in the absence of comprehensive, global agreement, we have no reason to believe it will make any difference?

Why should the 5 per cent target be a sacred cow, unchallenged as the prospects for international action recede?

And if mitigation could merely lead to economic losses while leaving global emissions unchanged, would it not be better to instead devote greater resources to preparing for possible adaptation to climate change?

Treasury's report does not address any of these issues. Rather, it starts from implausible assumptions to reach conclusions that are no less implausible for being rigorously derived. That may suit the government, which determined the scope of Treasury's work.

But it is not what proper policy analysis requires. And it is not what the community, as it grapples with these issues, demands and can legitimately expect.