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Treasury should know better about an ETS

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SOMETHING about climate change makes people say silly things. Treasury documents just released under Freedom of Information laws provide telling examples, as they misinterpret the simple economics of carbon taxes v emissions trading schemes.

Carbonic confusion is apparent in advice to the Treasurer justifying an early move to an ETS. Compared with such a scheme, Treasury argues, a tax could not ensure a given emissions reduction target would be met. Rather, at a given level of the tax, emissions might prove higher or lower than the government's objective.

If there were a shortfall, says Treasury, the government, assuming it would not vary its target, might have to purchase abatement from overseas. Rather than run that risk, Treasury prefers directly imposing the desired level of abatement through a quantitative cap, that is, an ETS.

Well, I hope Treasury does better on its macroeconomic advice. A moment's thought will highlight the problem. Assume the carbon tax is set at $20 a tonne with a view to reducing emissions by 5 per cent relative to a benchmark year.

If it turns out that once the low-hanging fruit has been picked, the cost of reducing emissions rises well above $20 a tonne, the target won't be reached.

To you and me, that would seem a desirable outcome: the market is telling us that with available technologies, the cost of reducing emissions rises steeply. Given that information, reasonable people, rather than hurling ever greater resources at reducing emissions, would choose to reduce emissions less, at least in the present.

This is all the more the case as even ardent carbonistas agree that it is cumulative reduction that matters, not when it occurs. Better then to postpone reduction until cheaper technologies allow it at acceptable cost.

Not in Treasury's mind, however. Rather, Treasury's advice is to stick to the target, come hell or high water. Such heroics could guarantee the target was reached. But in hitting the target, Treasury would be missing the point.

That point is not to reduce carbon emissions at any cost. Rather, it is to make good use of resources, taking account of environmental risks. That means balancing the benefits of emissions reduction against the sacrifice it involves.

It is that objective which should determine climate policy. And here economics gives us a general principle guiding the choice between fixing prices, as in a carbon tax, and fixing quantities, as in an ETS, when the precise level of costs and benefits is uncertain.

That principle is simple. If benefits do not change much as volume increases but costs do (as with greenhouse gas reduction), set a price, as the fact that firms won't spend more than that price reduces the risk society will incur costs that exceed benefits. Conversely, if costs are relatively stable, but getting a bit more or a bit less pollution makes a big difference to the benefit (as with highly toxic substances), fix a quantity, ensuring you do not exceed safe concentrations simply for the sake of a small cost savings.

In other words, when choosing whether to fix a price or a quantity, and costs and benefits are uncertain, focus on how they change as you vary the scale of the activity.

Moses must have had this in mind when he brought 10 commandments down from the mount, rather than nine relative prices. Whether we commit one murder or none makes a big difference to welfare; but exercising a bit more or less self-control should not change the cost of knowing right from wrong. Little wonder Moses imposed a quantity target (zero, even for adultery) rather than a tax.

But Australia's carbon emissions aren't like that. Whether we reduce emissions more or less this decade will make little difference to the risks of climate change, all the more as there is no effective global agreement in place and scant prospect of one any time soon. But as our comparative advantage lies in carbon-intensive production, the costs of reducing emissions could range from low to very high, with low costs where cheap electricity encouraged low-value uses and very high costs where large emissions are inherent in exploiting our resource endowments. Purchasing emissions reductions overseas might allow that range to be narrowed, but would impose significant costs of its own, not least in ensuring compliance.

Those facts argue against unilateral action. But if such action there must be, a very low tax, levied on domestic consumption, will be less harmful than an ETS. This is because the fixed target for emissions reduction under an ETS could drive reduction costs to the high end of the range, without any commensurate rise in benefits.

Treasury knows this. Indeed, an internal minute, also released under FoI, sets out the underlying propositions and some of the risks. Why then support an early transition to an ETS?

The best Treasury can say is that an ETS would be consistent with past agreements, including Kyoto. But Kyoto is dead, and any replacement is still to be negotiated. If a proposed new scheme would force large costs on Australian production, we should refuse to go along with it.

Of course, it is hardly sound economics that is driving these decisions. If the "factional thugsters" prefer an ETS, it is not because they were enjoying a quiet knife fight at the Labor Club during the tute on policy design under uncertainty. Rather, it is because an ETS multiplies opportunities for rent-seeking, panders to the financial sector that hopes to benefit from trading in permits and most important, disguises the costs it imposes.

In contrast, a tax at least has the virtue of transparency. And that used to be regarded by Treasury as a substantial virtue indeed.

Pity that has been forgotten. And pity too that another great virtue seems in short supply: the willingness to tell the minister what one is not frightened to tell one's colleagues. That has always been Treasury's job. If it won't do it, who will?