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Australia should delay a carbon tax until the rest of the world acts

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Australia should delay a carbon tax until the rest of the world acts

Abstract

The big question about the carbon tax is not whether it's a good or a bad idea in theory. The major issue is whether it makes sense for Australia to implement it at a time of great uncertainty, both in terms of economic outlook and the extent and nature of international action. To my mind a carbon tax is not desirable. Australia's prosperity is based on a resource endowment that is carbon intensive, both in terms of our mineral and our agricultural sector. Moreover, much of that carbon intensity is not amenable to technological quick-fixes. For instance, there is little that can be done to reduce fugitive emissions in mining. Global warming is a global problem. Unless major emitting countries engage in abatement efforts, action by Australia is pointless. As well as being pointless, that action would be highly costly. Economic analysis shows - and experience confirms - that the world's mineral supply responds quickly to relative prices. If we tax our mineral 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.

Keywords

world, should, australia, acts, tax, until, carbon, rest, delay

Disciplines

Engineering | Science and Technology Studies

Publication Details

Ergas, H. (2011). Australia should delay a carbon tax until the rest of the world acts. *The Conversation*, (02 September),

2 September 2011, 2.24pm AEST

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Disclosure Statement

Henry Ergas does not work for, consult to, own shares in or receive funding from any company or organisation that would benefit from this article, and has no relevant affiliations.

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Provides funding as a Member of The Conversation.

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Planting the idea: Opposition Leader Tony Abbott opposes a carbon tax. AAP Image/Julian Smith

The big question about the [carbon tax](#) is not whether it's a good or a bad idea in theory.

The major issue is whether it makes sense for Australia to implement it at a time of great uncertainty, both in terms of economic outlook and the extent and nature of international action.

To my mind a carbon tax is not desirable.

Australia's prosperity is based on a resource endowment that is carbon intensive, both in terms of our mineral and our agricultural sector.

Moreover, much of that carbon intensity is not amenable to technological quick-fixes. For instance, there is little that can be done to reduce [fugitive emissions](#) in mining.

Global warming is a global problem. Unless major emitting countries engage in abatement efforts, action by Australia is pointless.

As well as being pointless, that action would be highly costly. Economic analysis shows – and experience confirms – that the world's mineral supply responds quickly to relative prices.

If we tax our mineral 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.

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

There are a number of points commonly used to argue against that conclusion. I want to address six of them.



Is Gillard's carbon tax worth the pain? AAP

Is the world really acting?

The first argument for the carbon tax is that the rest of the world is acting. True, voluntary commitments have been made, but it is uncertain those commitments will be implemented.

For instance, while much has been said about [China](#), there is no doubt the subsidies China uses which end up encouraging emissions far exceed any of its measures to reduce emissions.

The Garnaut report gives a glowing endorsement of China's efforts.

But while Treasury [originally assumed](#) China would join the global effort to reduce emission by 2015, it's [latest modelling](#) now suggests 2021.

And there is little realistic prospect at this point of significant action by many of our major resource competitors.

As a result, it is prudent to take account of the possibility that comprehensive, global agreement will not be reached and factor that into the decision.

That makes it all the stranger to see advocates of the precautionary principle acting as risk-lovers when it comes to the carbon tax.

Our action will not encourage others

A second argument is if we act, this will encourage the rest of the world to follow.

Experience suggests that is doubtful, all the more so as it is contrary to the logic of [free-riding](#), frequently invoked both by the [Garnaut report](#) and by [Treasury](#) as underpinning the difficulties of the current international discussions.

After all, that logic would suggest that if we impose a unilateral tax on our exports, that only increases the gain to our resource competitors from staying out of any global agreement.

But even if it were true that our action would positively affect outcomes in the rest of the world, any such effect would be slight at best and could hardly justify the costs and risks unilateral action creates.

Costly now, more costly later?

A third argument is to say that acting now is less expensive than acting later. However, it would surely be even more costly to take action now only to discover later it was futile.

At that point, high costs would already have been incurred, not least in harming our export industries. Added costs would have to be incurred to dismantle whatever system had been put in place.

Indeed, the extent of those costs was strikingly highlighted by Parliamentary Secretary for Climate Change, [Mark Dreyfus](#), when he said that any repeal of emissions permits would require expensive compensation under [section 51 \(xxxi\)](#) of the [Australian Constitution](#).

In making that point, Dreyfus was merely confirming that implementing this scheme before the global framework is clear will impose very substantial risks on taxpayers.



The public protests against the carbon tax AAP

Business uncertainty won't go away

A fourth point is to say that we need such a scheme to reduce the uncertainties facing investors, for instance in electricity generation.

I agree they face uncertainties, including those associated with the future international framework for climate change. Unfortunately, those uncertainties cannot be wished away. Rather, they are a fact of the current global situation.

Imposing a scheme such as the one proposed, merely so as to reduce the cost of capital to electricity generators, only shifts the risk on to the community (who may not be the party best placed to bear it). This is using a sledgehammer to crack a nut.

Is it the most cost effective way to reduce emissions?

The fifth point is that we are in any event committed to reducing emissions by 5% and this scheme is the least costly way of doing so.

Generally, it is my view that we should be willing to reconsider the [5% commitment](#) if there is little sign of credible, comprehensive, global agreement.

However, even if one takes that 5% commitment as given, it is hardly obvious that imposing such a unilateral tax, while throwing many billions of dollars at a range of rent-seeking projects, is an efficient way of meeting the goal.

Rather, before leaping to that conclusion, one would want to see systematic modelling of alternatives.

Insurance or anti-insurance?

This brings me to the sixth and last argument, which is to say that Treasury's modelling shows the costs of such a scheme are low, so we should adopt it as a form of insurance.

The notion that such a scheme is a form of insurance makes very little sense. Insurance is an arrangement that ensures some measure of compensation if adverse events occur.

In more economic terms, it transfers income from states of the world where its [marginal utility](#) is low to states of the world where its marginal utility is high.

But in this instance, the relevant adverse event is that attempts at global mitigation fail and we suffer the consequences of global warming.

Were that scenario to eventuate, a unilateral carbon tax, far from making us better off when the harm occurs, would only mean we were poorer, and hence even less well-placed to adapt.

To that extent, such a scheme comes closer to being anti-insurance – reducing income (relative to the “in case of” scenario) in states of the world where its marginal utility is high.

Alternative scenarios need modelling

Weighing up all these issues would be easier if we had comprehensive modelling of their economic consequences. Treasury has modelled a scenario in which the rest of the world adopts such a scheme and we do too; and it also models the somewhat irrelevant case in which the rest of the world acts and we do not.

But it has not modelled (or at least, not released) the most relevant scenario; the one in which we impose such a scheme and our major competitors do not.

Moreover, Treasury's modelling is based on a range of assumptions that need to be tested – for instance, that we will be able to borrow permits from the future, and that such borrowing helps the world meet global abatement targets.

Even with all those assumptions – and especially assuming the industrial countries all abate at a uniform price by 2016 – the costs Treasury estimates for the government's proposal are anything but trivial.

Rather, discounted at the Garnaut discount rate, they have a present value of \$1 trillion – about one year of Australia's GDP.

And that relies on the assumption of global action.

In saying this, let me emphasise that it is absolutely fair for Treasury to have made those and other assumptions – that is in the nature of modelling.

But it is also fair for there to be an opportunity to assess the implications of varying those assumptions.

Indeed, the ability to undertake such sensitivity testing is one of the greatest strengths of economic modelling and is obviously vitally important where decisions of huge significance are at stake.

So there is more work to be done before any decision can be taken. That work needs to be done transparently and independently: ideally, by the Productivity Commission. Until then, proceeding with the government's scheme is little more than reckless.

Professor Henry Ergas will be speaking on Monday 5 September at the Australian National University's [Crawford School Dialogue - Australia's carbon price: good policy or not?](#) in Canberra.