

A Taxing Debate: Climate policy beyond Copenhagen

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**Topic: Rethinking Emissions Policy – The case for a
consumption based approach**

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Thanks David and Michael. Can everybody see those slides clearly? It's important. I need to step back and just quickly go through what the hell we're trying to do here. This next slide summarises what we're trying to do. These seven steps are all components of the global agreement that is required to deliver an effective policy response. The first three steps deal with the science. I'm not going to debate the science, I'm not a scientist. I'll let the scientists punch it out. The next four steps, however, worry me a lot because to boil them down to their most raw, they tell us that we have a zero sum game on. Whatever the global target for emissions abatement is, we've got to divvy it up between all countries. That's going to be hard.

This map is another way of illustrating the point. I'm not this to say that Australia makes very little contribution and therefore doesn't need to do anything. I'm putting this map up, it's out of date anyway, I'm putting this map up to point out that we need to get especially the northern hemisphere on board or everything that we do will count for nothing. That underlines in my view the need, if we're going to Copenhagen and we're serious about getting a result, to make sure we take to Copenhagen a model that minimises impediments to it being adopted by the rest of the world.

You all know what my main message is. There it is. The reason I don't think a CPRS will work is because from the UNFCCC time and especially from the Kyoto time, the notion of non-harmonised national responses to this policy problem has been entrenched in the agreements. Non-harmonised action is the root cause of the evil which I'll now describe to you. I think there is a better alternative. I think it's WTO complied. I think it removes carbon leakage which means we remove a major impediment to getting the world on board.

Stepping back and looking at the sort of models we could choose to deal with this in a broad based way, there's two sets of choices we can make. Firstly for each country what emissions are we going to target? Are we going to target that countries production or its consumption? The second set of choices is, what instrument will be use to deliver the outcome? One option is an emissions trading scheme, a cap and trade approach. The other is a carbon tax. Now the government has chosen options one and four. Then they've messed up one by compromising its integrity out of existence but they've chosen one and four. There are only four choices you can make in this game and I think they've maximised the damage by choosing the worst possible combination.

To see why, let me explain this from a national accounting perspective. Sorry about this. Globally by definition gross domestic product equals gross spending on that product. By

definition it has to be true. We're not trading with other planets yet. It's also true globally that exports equal imports. This tells us that there are actually two emissions targets that we could adopt in adopting a policy to deal with climate change. We could adopt the production approach or a consumption approach. If we all moved at the same time it wouldn't matter. Either choice is fine. We're not moving at the same time and hence national differences become important.

Now let's look at what happens. Nationally exports don't necessarily equal imports and even if they do, a production approach hits exports and excludes imports, whereas a consumption approach does the opposite. Now we see the root cause of the problem of having non-harmonised national action. If we adopt a production approach we effectively put a tax on our exports and we exempt our imports. We effectively deliver negative protection to our industry acting unilaterally on a production based model. I have never heard so much garbage in this country over the last three weeks as relating to this point. The number of times I've heard the words "A carbon tax is protectionist" is just amazing. Ranging from who has been described as the thinking woman's crumpet, Tony Jones, well I can excuse him. All the way through to our very own trade minister, Simon Crean, have expressed this view. It's nonsense. In fact the government's not telling the Australian community that the policy that it's adopting, even with all the carve outs, is delivering negative protection to the Australian economy.

This is the sort of model they want to take to Copenhagen. I mean the Chinese and the Indians must be laughing themselves silly. I mean there's no way that a country in its right mind is going to impose negative protection on its own economy acting unilaterally. The big danger we face at the moment is positive protection. And we've actually got evidence that the government understands this. Look at what they've done to the pure CPRS model. They've carved out exports, not well, not comprehensively, not permanently. They've carved out import competing rather than carving in imports, again not well, not comprehensively and not permanently. They've eaten away at the base for the emissions policy which means that for any given emissions outcome you're going to need a higher and higher carbon price levied on a smaller and smaller section of the community.

And it gets worse. We haven't even worried about the trade exposed sector, we've gone further. We even carve out local production consumed locally. I mean it makes a lot of sense, it seems to me, to say that petrol is included in the CPRS but by the way we're going to offset any effect by reducing the excise. I can't understand that at all. In effect, the CPRS as applied by countries that are silly enough to think about it, is being carved away and applied to a smaller and a smaller emissions GTP rump.

More evidence. Look at what's happened since Kyoto's "agreed" in 1997. That's just a few bullet points that I can think of. If that's not symptomatic of dismal failure, I don't know what is. I mean I cannot understand how in 2009, after the experience of 1992 and the experience especially of 1997, we're still bashing our heads against a brick wall. I mean in fact there's a very good David Rowe cartoon in the Financial Review today, you should read it. Or look at it. So where is the world going? Are we going to get an agreement? Well notionally what we want to do is slice up an emissions abatement pie into slices that will be taken by every country.

Now let's suspend disbelief and let's suppose that every country at Copenhagen says yep, we'll sign up for a model precisely like the European model which by the way covers about 40% of its greenhouse gas emissions. Let's suppose, suspend disbelief, let's suppose that actually happens. That would be regarded by the government and by the world urges as a huge success. A huge triumph. That's what it looks like. And that's not going to happen. We're not going to get that. But even if we did, the black hole in the middle is still there on the table to be negotiated. That's all the carve outs which relate to the trade exposed sector. Now who is going to go first on these? After all, these are in the trade exposed sector. No-one is going to go first on these. So even if we got the calamari ring I've got there in Copenhagen, we're still way way behind the eight ball and we're not even going to get that.

That's just a slide, you can read that later for your own amusement. That's my summary of what I think will happen which is basically nothing. I think the Prime Minister occasionally says something that's very accurate and his assessment of Copenhagen, which was not supposed to be reported I think, was extremely accurate. That's about what we can expect in Copenhagen. I think the main point of agreement in Copenhagen will be to meet again.

There are five reasons and I've summarised them here why a consumption approach is better. Ultimately it minimises the chances of not getting a global deal. If you get a global deal you're going to cover all emissions anyway through the consumption route. It's just a tidier way to go. Some say oh yes but if we go down the consumption route, we're out of step with the rest of the world. Don't make me laugh. Most of the rest of the world is not doing anything, we're not out of step with them. The ones that we're in step with only cover 40% of their emissions. Besides, the Europeans are already talking about border tax adjustments in respect of imports from countries that don't adopt a climate policy and so are the Americans. Who is out of step?

Now let's look at evidence-based policy. Before this government came to office it said that it was determined to implement evidence-based policy. I think I got that order the right way around. The senate select committee actually recommended that modelling be done on five additional policy options as well as the CPRS. Of the six options, therefore, five are variants on a production base and one is a consumption base model. But at least the committee came out and said well it's sensible to look at all these models and see which gives us the best cost benefit outcome. That's what good policy is all about. So full tick to the senate for that. The government's response was commendably fast but not very constructive. So we're all waiting for the opposition to see what they came up with. They were a bit slower and a bit more wordy but similarly not very constructive. They've modelled one option effectively rather than the other five.

We do have some evidence, it's very cryptic, but we do have some evidence from the treasury's modelling of the CPRS which appears at page 84. For those that have insomnia, I recommend this report but on page 84 we see this statement about allocations based on production versus those based on consumption. I was quite taken by that statement as you might imagine. But then I keep hearing the climate minister saying that the model that they've chosen is the lowest cost option. I'm just trying to work out how both propositions can be correct. I have got a slide on it but I want to let you know that my old firm, Access Economics, is doing some modelling on the consumption based approach and this has been made possible thanks to the support that we got from David and Michael and Ceda in providing some funding for Access Economics to do this modelling.

As I say, it's not yet complete but it is looking at a couple of scenarios. It's comparing a fully articulated CPRS one, with the CPRS as it is now compromised to buggery and the consumption-based approach. It's looking at those three models relative to business as usual and looking at the economic effects associated with those models. We're still tidying the results up a bit but the results are interesting. I won't talk about the fully blown CPRS because we haven't got that and the way the world is going, we never will. Needless to say we murdered that one. But comparing the CPRS with the emissions intensive trade exposed carve outs with the consumption model, we can show that for the same carbon price for example in 2020 or 2030, so we're comparing the same effort to reduce emissions, same carbon price. The consumption approach produces a lower reduction. By the way, it does produce reductions. These policies cost. Any notion that you can do these policies with no cost is just a lie. People that tell you that ought to take their hands out of their pockets and send one of their hands a Valentines Day card.

The modelling shows that there was a lower reduction in GDP, GNP, employment, investment, household consumption, exports, imports and real wages under the consumption approach than under the CPRS carved out approach. The emissions reduction in absolute terms under the CPRS was larger but it was larger because of firstly, carbon leakage which

means those emissions went offshore. They don't count because we lose the emissions and some other country generates them. Globally that makes no difference. The production model also produced a larger reduction in emissions because it produces lower output. Well duh! The point of the modelling seems to be that we will be able to get a better trade off between the costs of reducing emissions and the emissions reduction that we want to deliver if we follow the consumption approach.

The other interesting thing from the model was the different industry effects. Some industries, such as petroleum products, aluminium, other nonferrous metals, were clearly less adversely affected under a consumption approach than under the government's carved out CPRS. Interestingly, some sectors, chemicals, rubber and plastics for some reason is one that comes to mind, actually do better under the government's approach. I'm not surprised to find that some industries do better, that's just a manifest of the reality that if you use ad hoc special deals to do your carve outs for trade exposure, you're not going to get it exactly right. It's going to be inaccurately calibrated and say you'll have some that do better than they should. Overall though, the modelling results look encouraging.

There is some modelling that has been done in the European community too, I won't go into it in detail because I think I'm running out of time, but it compares carbon leakage for the European Union under a production approach and five variants of a consumption approach. And just look at the left hand side auction and BA full bars. Auction is the production approach, BA full is the closest thing they had to my consumption model. In all three of these trade exposed industry cases. Carbon leakage was smaller under the consumption approach than it was under the production approach.

Final word on emissions trading, just remember emissions trading per se does not reduce emissions by one gram. It's the cap that reducing emissions. Trading just shuffles them. Not surprisingly banks love it and not surprisingly those who trade in these pieces of paper, whether they're banks or not, love it. Remember all this trading does nothing to reduce emissions, it just shuffles them. Politicians love emissions trading because it blurs who is responsible for the price signal that we end up seeing. They don't have to claim that it's their fault even though it is.

So how do we go forward? We've got to get the developing world on board soon on some scheduled timetable, even if not at the same time as the developed world. Without them on board, go back to that map I showed earlier. You can forget this, it's just a waste of time especially for a small, relatively small absolute emitter like Australia. We're not going to get those countries on board or indeed a lot of the developed countries on board if we persist trying to flog around the world a negative protection model that countries have to adopt unilaterally. If we wanted to start again, a good thing to do would be to start with seven core principles for how this agreement should work and I've set them out up here. I think if you read these at your leisure you'll conclude that they're just motherhood. If you couldn't get the WTA membership to agree to these then there's something wrong. And yet I think these sorts of criteria would be important shaping factors in determining which model would be best suited for generating a global deal when countries act at different times. Naturally enough, because I set up these principles, the consumption model passes them with flying colours.

This is a diabolical problem. It's diabolical mainly because the costs come early, the benefits come late. We're not sure what they'll be and we individuals probably won't benefit from them at all, it will be our succeeding generations. But if we want to do something about it now and I'm accepting that we do, if we take to Copenhagen a model that says here you go first and by the way impose negative protection on your economy, we might as well stay home. At least we'll save the carbon in the airfares.

I think I've gone over time so I think I'll get out of here. Thank you very much for your attention.