



20 January 2014

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SUBMISSION TO THE STANDING COMMITTEE ON ENVIRONMENT AND COMMUNICATIONS

INQUIRY INTO THE GOVERNMENT'S DIRECT ACTION PLAN

I am an Economist at the Australian National University's Crawford School of Public Policy. My research fields include energy economics and environmental economics. I teach postgraduate-level courses in Environmental Economics and Microeconomics.

From an economic perspective, a scheme of subsidies for carbon abatement, such as under the "Direct Action Plan", is unambiguously inferior to carbon pricing. The Direct Action Plan has numerous problems which make it an intractably ineffective and inefficient policy. Here I list twelve:

1. **Not least-cost:** Firms will not apply for subsidies for many of the least-cost emissions reduction possibilities. This is because: (1) Many low-cost abatement possibilities may be small in nature or not in line with Direct Action requirements; and (2) There are costs and uncertainties of applying for subsidies. Many of the "lowest hanging fruit" of emissions reductions will therefore be missed. The OECD (2013) estimates that subsidy approaches can involve an economic cost per unit of emissions reduction that is more than 10 times higher than can be achieved using price-based approaches.
2. **Business-as-usual baselines are impossible to reliably estimate:** Any estimates of business-as-usual emissions trajectories will be subject to sizeable uncertainty and contestability. Without accurately knowing emissions baselines, it is not possible to accurately assess the net reduction in emissions achieved by any Direct Action project. Historical emissions levels are not a reliable baseline for the future. Using historical emissions as a baseline could contribute to a degree of economic stasis if expanding or new businesses face a penalty whereas established businesses have access to Government subsidies.
3. **Can't identify genuine emissions reductions:** Companies are likely to apply for funding for energy efficiency and other emissions-reducing projects that they would have implemented even without Government support. It would often be impossible to identify whether projects are actually additional.
4. **Leakage:** Without a cap on total emissions, there is no guarantee that emissions reductions in a specific project will not be offset by additional emissions elsewhere.
5. **Time-frame:** The Direct Action Plan proposes to fund projects for five years. Long-term projects may be incompatible with this type of funding arrangement. There is also the issue of emissions rebounding after project completion.
6. **Subsidy culture:** The Direct Action Plan would invite firms that have good ideas to look to the Government for funding, which runs against the basic tenets of capitalism. Instead of requiring the Government to "pick winners", carbon pricing automatically provides firms and others with an

incentive to reduce emissions: if they reduce their emissions, they can increase their profit (by avoiding paying the emissions price). Carbon pricing is the free market solution.

7. **Fiscal burden**: Direct Action subsidies involve net costs to the budget, as they must be paid for by other taxes. Carbon pricing, on the other hand, provides net revenues. There is no reason to think that collecting revenues from carbon pricing involves larger costs to the economy than collecting revenues from other taxes. The Government has to tax something, and taxing greenhouse gas emissions makes sense because doing so simultaneously achieves both revenue and emissions objectives. Given our existing fiscal deficit, it is inadvisable to take on a costly new scheme like Direct Action, particularly as it is likely to provide questionable abatement benefits.
8. **Complexity**: Direct Action would be much more administratively complex than carbon pricing because it requires Government assessments of each abatement project and of business-as-usual baselines. Carbon pricing is a much more decentralised approach, with much lower information requirements for the Government: abatement projects under carbon pricing face a market test rather than a Government assessment.
9. **Uncertainty**: The prospect of transitioning to a new emissions abatement approach has introduced considerable uncertainty to low-carbon investment decisions. The uncertainty is bad for our economy and is making the transition to a low-carbon energy system much bumpier than it need be.
10. **Precedent**: It is a bad precedent to be subsidising the producers of what economists call “negative externalities”. Doing so may provide a perverse signal in other contexts (e.g. emissions of other pollutants) that producing negative externalities may eventually be rewarded by subsidies.
11. **Not scalable**: Addressing climate change is a long-run policy challenge, and Australia will need to achieve sizeable emissions reductions to make an adequate contribution to limiting global climate change. The costly nature of Direct Action means that it is not able to be easily ramped up to achieve deep emissions cuts.
12. **International signal**: Countries such as China, South Korea, Thailand, Vietnam and South Africa have proposals for emissions pricing. The worst signal Australia could provide these countries would be for us to dismantle our own successful scheme. Doing so would be a setback to global mitigation efforts.

Australia's carbon price is working well (electricity-sector emissions are down; inflation is low) and does not have any of the above weaknesses. There is a strong consensus among economists and international organisations (World Bank, OECD, International Monetary Fund, International Energy Agency) that a broad pricing mechanism is the best policy approach to reducing greenhouse gas emissions. A gradually increasing carbon price would see Australia transition to a low-carbon economy at low economic cost. Other taxes could be reduced at the same time in a revenue-neutral way if desired.

On the basis of the above, my strong recommendation is that Australia should not proceed with the dismantling of carbon pricing or the introduction of a Direct Action abatement subsidy scheme.

I would be happy to give evidence on this at a public hearing.

Yours sincerely,

Dr. Paul J. Burke

Reference

OECD (2013) *Effective Carbon Prices*. Organisation for Economic Co-operation and Development, Paris.