

Submission to the Senate Standing Committees on Environment and Communication,  
Parliament of Australia

## **Inquiry into the Australian Government's Direct Action Plan**

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### **Summary**

- The proposed Emissions Reductions Fund under the Direct Action Plan amounts to a scheme of project-based subsidies, funded by taxpayers. The Emissions Reductions Fund approach could be useful to support particular emissions reductions activities, insofar as the budgetary costs can be justified. But it is not a suitable instrument for long-term, broad-based climate change mitigation action.
- The effectiveness and cost-effectiveness of an Emissions Reduction Fund will be limited by fiscal costs and fiscal constraints, by private incentives to overstate emissions savings and to hold back investment unless subsidised, by the relatively short proposed time horizons for payments, by the instrument being confined to specific eligible activities, and by the relatively large administrative burden. It could also encourage continued lobbying by potential beneficiaries.
- Carbon pricing by contrast provides economy-wide incentives to reduce emissions with minimal discretionary intervention. It is cost-effective and creates a fiscal revenue stream. Economic analysis unambiguously shows carbon pricing – in the form of emissions trading or carbon taxes – as the centrepiece of effective and cost-effective climate change mitigation policy. This is confirmed by recent statements by the OECD, IMF and World Bank.
- Major countries have carbon pricing in place or are introducing it. If Australia were to replace carbon pricing with a subsidy approach, this would be against global trends and waste an opportunity for positive influence on international policymaking.
- The longer-term challenge for Australia in a global effort to reduce greenhouse gas emissions is to facilitate comprehensive modernisation in the energy system and industry, and to prepare the economy for prosperity in a carbon-constrained world. To achieve this, carbon pricing along with regulatory interventions will be needed. Abolishing the existing carbon pricing mechanism and related policies and institutions could mean a costly delay on the longer term trajectory. It would also result in continued policy uncertainty for investors in Australia, and diminish opportunities to positively influence policy developments in other countries.

## The Direct Action Plan

The core of the government's Direct Action plan is the proposed Emissions Reductions Fund. It involves government paying for selected emissions reductions activities proposed by businesses, and is thus a project-by-project subsidy approach. This approach may be suitable for specific applications, if the budgetary costs can be justified.

- *Agriculture and forestry.* Subsidising specific abatement options may be a suitable policy option where carbon pricing and direct regulatory instruments cannot be deployed at reasonable cost, or where political and institutional considerations favour a mechanism that allows producers to opt in and places no obligations on them. These conditions are currently given for various abatement options in Australia's agriculture and forestry, potentially including soil carbon. The Carbon Farming Initiative currently in place provides a suitable framework.

The crucial difference would be that the proposed Emissions Reduction Fund would make payments from federal government revenue, thus imposing additional costs on the economy compared to the present approach where emitters buy offset credits.

- *Power generation.* A case could also be made for subsidies for specific large-scale interventions in Australia's power supply, specifically the retirement of highly emissions intensive power stations. The payments from an Emissions Reductions Fund could compensate owners of such assets, where this is seen as a political or legal necessity in order to effect the closure of such power stations.

However, experience with the previous government's proposed 'payments for closure' scheme has shown that the magnitude of required payments may be larger than the proposed budget for Direct Action. If the carbon pricing mechanism were abolished, the required payments would be higher still. Furthermore, such interventions would need to be unambiguously "one-off" in order not to stand in the way of future market-driven decisions for generators to exit the industry.

- *Other activities.* For most other abatement options, the drawbacks of a project-based subsidy approach – as outlined below – mean that carbon pricing and/or direct regulatory approaches are preferable from the point of view of effectiveness and cost-effectiveness.

The Direct Action approach of project-based subsidies suffers limitations in effectiveness and cost-effectiveness that make it unsuitable for achieving large and long-lasting emissions reductions.

- *Fiscal costs.* A subsidy approach draws on the budget, and requires taxes to be levied in order to pay for it. In public discourse, Direct Action is sometimes presented as superior to carbon pricing on the grounds that it does not impose a taxation burden. This is untrue as any payments from an Emissions Reductions Fund need to be financed from the federal budget, and paid for by taxpayers.
- *Fiscal constraints.* Available analysis (for example by The Climate Institute) suggests the proposed budgetary allocations for the Emissions Reduction Fund are likely to be insufficient to achieve even the 5% emissions reduction target at 2020. Increasing the budgetary allocations would no doubt be difficult, especially in the context of tighter overall fiscal settings. It is therefore questionable that the policy can achieve Australia's current 2020 emissions target. An emissions trading scheme by contrast can automatically achieve a given national target, through access to overseas emissions units.

- *Overstated emissions savings at the project level.* As in offset mechanisms connected to emissions trading schemes, payments under an Emissions Reductions Fund would be made for the difference between actual emissions and a (higher) counterfactual baseline of emissions. Any approach that allows flexibility in defining baselines provides project owners with an incentive to overstate the baseline. There may even be projects that receive payments for activities that would have occurred anyway (no 'additionality'). These problems with inflated baselines and additionality have plagued the Clean Development Mechanism, the international offset scheme under the Kyoto Protocol. At the project level, their effect is inflated payments to project owners. In the aggregate, the effect is that overall emissions savings are smaller than the sum of claimed emissions reductions under each project, reducing the cost-effectiveness of the mechanism.
- *Perverse incentives to withhold investment.* By the same token, a subsidy approach can also create incentives to hold back investments that reduce energy use or emissions unless they are subsidised under the mechanism. This in turn has economic costs through suboptimal investment and skewed investment patterns.
- *Short time horizons.* The proposed payment period for the Emissions Reductions Fund is five years. Project proponents will have no realistic expectations that further payments would be made beyond the initial five-year period. Therefore, only investments with payback periods of less than five years at a given payment per tonne of claimed emissions reductions will be commercially viable. This will exclude many abatement options that involve long-lived equipment, as is usually the case in energy and industrial investments.
- *Confined to specific eligible activities.* By its very nature, an Emissions Reductions Fund can only provide incentives for activities that can be defined within a project boundary, and that have an identifiable project owner. This excludes many abatement options in broader changes in production practices, and any abatement options through changed consumption patterns such as end-use energy efficiency. This limitation has been borne out in experiences with the Clean Development Mechanism.
- *Large administrative burden.* A project-by-project approach involves a comparatively large administrative burden on the part of government as well as participating businesses. A large share of the costs will be fixed and independent of project size, thereby putting smaller projects at a severe disadvantage. At the international level, experiences with the Clean Development Mechanism have shown that the transaction costs tend to make smaller projects unviable, and procedural costs account for a not insignificant share of overall payments.
- *Lobbying costs.* Any subsidy approach encourages continued lobbying by potential beneficiaries. The experience with the setting up of the Carbon Pricing Mechanism has shown that Australian industries are prepared to mount a large and sustained lobbying effort in order to influence the design of climate change mitigation measures. This is unsurprising. In the case of an Emissions Reductions Fund, there is a danger that the lobbying effort will extend beyond the phase of mechanism design to the entire period of operation, with the aim of getting additional project categories included.
- *Rent seeking.* More broadly, any discretionary subsidy approach is in danger of fostering a culture of rent seeking with its adverse impacts on the overall economic policymaking framework.

## Carbon pricing

Carbon pricing, in particular emissions trading, would allow Australia to meet the unconditional national emissions target (a 5% reduction at 2020 relative to the year 2000) at low economic cost, and international trading in emissions permits would allow Australia to achieve a more ambitious target at little additional cost. This has been established by Treasury modelling, the Garnaut Review, and numerous studies by universities and think tanks. The conclusion is reinforced by a lower outlook for international carbon prices, as shown in recent work by the Climate Change Authority as well as Vivid Economics. The notion that emissions pricing – in particular an emissions trading scheme – is the best principal instrument for climate change mitigation is firmly established in the Australian policy community, and was accepted successive Australian governments from the 1990s.

Carbon pricing provides a consistent framework of price-based incentives for greenhouse gas emitters as well as the businesses and consumers who use their products to reduce emissions up to the same marginal cost. It also can create significant amounts of fiscal revenue, available to assist households with higher energy costs. Carbon pricing can become a source of net fiscal revenue, replacing other – and potentially more economically distortionary – forms of taxation. These desirable features of carbon pricing have led the OECD, IMF and World Bank to recommend carbon pricing to the world's governments. Direct regulatory approaches can supplement carbon pricing where they are more effective or more feasible institutionally.

Broad-based emissions trading has been adopted in the European Union and California. China is trialling emissions trading in seven large cities and provinces, and has made clear its intention to introduce national emissions pricing in the form of emissions trading and possibly also a carbon tax. South Korea and other countries are preparing national emissions trading schemes. Carbon taxes have been in operation for many years in several European countries, and are likely to come into force in Mexico and South Africa. Many other countries are investigating options for carbon pricing, including under the Partnership for Market Readiness program convened by the World Bank.

## The longer-term mitigation task

Strong global action on climate change is in Australia's national interest given Australia's vulnerability to climate change. The best way for Australia to help attain this outcome is to make a commensurate contribution to the global effort. This will require Australia's greenhouse gas emissions – potentially net of trading of international emissions allowances – to be much lower than current levels by the middle of the century. In the context of a growing economy, this means rapid de-carbonisation of Australia's economy.

As shown by many analyses, such rapid and comprehensive emissions reductions are technically feasible, and can likely be achieved without any significant sacrifices of economic growth. The prerequisite however is sound economic policy settings that facilitate a comprehensive transition to a lower-carbon economy. The proposed Direct Action approach will not be able to achieve this. If such an approach were scaled up, it would likely result in high economic costs.

The proposed replacement of the Carbon Pricing Mechanism with Direct Action would likely result in a delay of overall investment in lower-carbon options. This in turn would increase the cost of meeting any given longer term emissions target, or of staying within a given emissions budget.

Furthermore, the proposed change perpetuates the uncertainty over climate policy that has been an adverse factor for investment in Australia's energy sector and some industrial activities.

### **Australia's international role**

Australian policymakers need to be mindful of the signalling effect that Australian policy choices have internationally. The development of climate policy over recent years has been keenly observed by governments all over the world. The Carbon Pricing Mechanism – along with related policies and institutions such as the Clean Energy Finance Corporation and Climate Change Authority – are well known internationally. Elements of these have been seen as possible models for new policy in many other countries. Australia has the opportunity to positively influence other countries by setting an example of sound economic policy for emissions reductions, just as Australia has done in other areas, such as trade liberalisation. The proposed rollback of carbon pricing and introduction of a subsidy scheme however would serve as a negative example.

Australia's global importance in climate change issues is illustrated by Australia's inclusion as one of twelve countries representing over 70 per cent of global emissions participating in the global 2050 Deep Decarbonisation Pathways Project, an initiative of the United Nations Sustainable Development Solutions Network. The project will support preparations for the United Nations Climate Change Summit in New York in September 2014 and the 21st Conference of the Parties to the UNFCCC in Paris in December 2015. ClimateWorks and the Australian National University are jointly leading Australia's contribution to this work. The project will investigate Australia's options to transition to a low-carbon economy while remaining economically prosperous, alongside corresponding work for the major economies of the world.

The fact that this high-profile global project is focussed on pathways to 2050 outcomes, rather than nearer-term emissions targets, highlights the importance of designing policy frameworks that are suitable for the long term. It is incumbent on Australian policymaking to put the longer term national interest first.

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