GRATTAN Institute

Facing up to economic reality in a climate of fear

Published in The Australian Financial Review, page 71, Thursday 22 April 2010

Free carbon permits and subsidies will slow the shift to a greener economy, writes ***John Daley.***

Fear of losing what we have is a primal human emotion. When making the tough choices on tariff reform, we feared that the jobs lost would never be replaced. We need not have worried.

So it's not surprising that responses to climate change have been dominated by concerns that jobs will go, factories will move offshore and businesses will shut. In response to these fears, the draft Carbon Pollution Reduction Scheme bill proposes "free" permits for the industries that emit relatively more carbon, but this would be a $20 billion waste at the expense of the rest of the Australian community.

The rational fear is that a carbon price would result in factories moving offshore to countries where they would emit even more greenhouse gases.

Responding sensibly to fears requires us to face how likely they are in reality. Is it really economic for industry to move offshore from Australia? Will factories offshore really emit more greenhouse gases then they do in Australia? And is this a big deal in the scheme of Australia's economy?

Industry by industry analysis shows that these things are unlikely, so the "free" permit regime both wastes $20 billion and delays adapting Australia's economy to a carbon-constrained future.

Many Australian industries are unlikely to move anywhere even if they pay a carbon price. Their competitive advantage does not depend simply on cheap energy. Australian alumina refining (which turns bauxite into alumina before it is refined into aluminium), Liquified Natural Gas production, and coal mining will all remain attractive even if they pay a carbon price of $35 per tonne of CO_2.

A carbon price might cause production to shift from a small minority of Australian coal mines that contain a lot of methane. However, Grattan Institute's analysis shows that other Australian mines containing much less methane are likely to pick up the slack. Shifting production to emit relatively less greenhouse gases is the precise point of carbon pricing. It gives companies and individuals across the economy incentives to take the cheapest ways to reduce carbon emissions.

A few Australian industries, particularly aluminium refining, might eventually move offshore, but on average they are likely to emit less carbon when they do. According to International Aluminium Institute data, Australian aluminium manufacturing today emits on average two to three times more carbon per tonne of aluminium than other countries. Leading aluminium producers tell their investors that they are planning to locate new factories where they will minimise their carbon footprint. Unfortunately, there is no reason to believe that Australia will develop low emissions electricity cheaper than the rest of the world soon. In the meantime, the "free" permits proposed for the aluminium industry would cost Australia about $160,000 per job per year. There must be more efficient job creation schemes than this. It would be far better to direct some of this money directly to the affected workers and communities to enable retraining, relocation when desired, and helping new businesses to start. Future investment in these communities is much more likely when it is apparent that they have an economically sustainable future that does not depend on assistance that government might rescind at the stroke of a pen.

The fear of pointless job losses is most rational for Australia's cement and steel industries. Australian producers would struggle to compete with imports if Australia imposed a carbon price and other countries did not. After taking freight into account, imports would not result in materially less greenhouse gas emissions.

However, the "free" permits proposed are a clumsy means of preventing carbon leakage. Coupled with the "no windfall gains" provisions they limit the incentives for producers to reduce their emissions. And they will discourage people making economic decisions to use substitutes for steel and concrete such as housing frames using wood instead of steel.

Border tax adjustments would be a more targeted response. Importers should pay a levy equivalent to the carbon price paid by local manufacturers. And the carbon price could be rebated on exports. Provided that local production and imports pay on the same basis, it is likely that this is consistent with WTO international trade law.

The over-arching fear is that carbon pricing will deal a body blow to the Australian economy. However, Australia's experience of other economic reforms over the last few decades puts carbon pricing into perspective. The emissions – intensive, trade – exposed production that Grattan Institute studied, the vast majority of the total, only employs 70,000 people. Most of these jobs are not at risk. By contrast, the electricity competition reforms resulted in industry employment falling by about 150,000 people; and the reduction in industry assistance for car manufacturing and textiles, clothing and footwear were similar. As Australia discovered with both these reforms, individual plant closures made headlines, but a more efficiently structured economy resulted in more jobs in total, and more prosperity.

We need to face our fears on carbon leakage. Australia's carbon emissions are the highest per capita in the developed world. We have more work to do than most countries to adapt. However, the evidence shows that our fears are exaggerated, and the economic changes are manageable. We should not impede restructuring with "free" permits that cost the rest of the economy $20 billion. Over the last two decades Australia showed the rest of the world that it pays off to face your fears and take economic decisions in the interests of the whole community. We should do it again.

John Daley is CEO of Grattan Institute, which has today released a report, "Restructuring the Australian Economy to emit less carbon".

John Daley
CEO, Grattan Institute
Contact: 03 8344 6142 or 0407 004 231