Price signal is the key to fighting industry emissions

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In this newspaper Danny Price of Frontier Economics accused 59 economists who signed a letter in support of carbon pricing of "groupthink" ("Why Direct Action on carbon is better than a price," AFR July 30).

His argument is flawed to the core. Economics 101 shows a price on carbon as the most economically efficient way of reducing emissions, and it can displace other, more distorting taxes. The government's "direct action" subsidy scheme that Price favours instead is less effective, more costly and requires other taxes to be increased to pay for it.

A carbon tax or emissions trading scheme gives incentives to consumers and producers to shift to lower-carbon, energy-efficient equipment and practices. You put a price tag on carbon, and thereby make other choices relatively cheaper. The incentives go right throughout the market system.

Price's argument boils down to two assertions: that a carbon price carries a large "excess burden" on the economy; and that emissions reductions can be achieved also by paying emitters to cut carbon, as per the government's direct action scheme.

The first part of this argument is bogus because it ignores that a carbon tax raises revenue for government, and that other forms of taxation also impose costs on the economy. Governments need to raise revenue one way or another. The second part ignores the limitations and problems of direct action.

A carbon tax, or selling permits under emissions trading for that matter, is a better way of raising revenue than many of the alternatives. It can be used to cut other, more distorting taxes. The now-abolished carbon price was accompanied by income tax cuts to low-to-middle-income earners. You could also use the money to cut company taxes, or any other fiscal purpose.

Think back to the introduction of the GST. It was big picture tax reform. It allowed less efficient taxes to be lowered, and avoided increases in other taxes. It probably increased efficiency in the Australian economy and it created greater fiscal stability. No one ever refers to it as a "$50 billion brake on the economy".

The proposed direct action policy goes the opposite way. It is a subsidy scheme that requires other taxes to be increased to pay for it.

Abolishing the carbon price means losing revenue of perhaps $20 billion over the remainder of the decade. Meanwhile $2.5 billion is promised for direct action subsidies, which need to be paid for.

To be sure, a carbon price needs to be well designed to be fully effective, efficient and politically sustainable. Bipartisan support is needed to fully hit those goals. And additional policy instruments are needed, especially targeted support for R&D, along with regulation such as energy efficiency standards. Direct Action costly and limited

And yes, direct-action-style policies could be effective to some extent. But they are costly and limited. Direct action is inevitably narrow in scope because only what can be framed as a "project" can be eligible. The evidence with similar schemes, such as the clean development mechanism in developing countries, shows plenty of red tape, high administrative costs and the risk of handouts for projects that would have happened anyway.

Even among Australia's business community most seem at best lukewarm on direct action. So the principle stands: carbon pricing is the central plank of sensible climate policy. If this was "groupthink" we're talking about a very large group. Not just the 59 economists who signed last month's letter, but the large majority of economists in Australia and the world – along with the OECD, World Bank and IMF, and the Treasuries of many countries, ours included.

Whether or when Australia will reintroduce a carbon price is impossible to know. The latest fashion in Parliament is to demand that Australia wait until our major trading partners have a carbon price. Europe has had emissions trading for a long time. China is clamping down on coal use, investing in renewables, and has emissions trading pilot schemes covering more than 200 million people, and is preparing a national trading scheme as well as a carbon tax. Several US states and Canadian provinces put a price on carbon; at the federal level regulation seems the only politically viable option.

Clive Palmer suggests that we wait until India introduces emissions trading. Really? We should calibrate our economic reform to that of a poor country with a record of policy logjam, whose understandable overriding priority is fighting poverty?

The big question is how we deal with our high-carbon systems in the medium to longer term. The major countries are right now deciding their emissions targets for the next decade and the policy instrument to meet them.

Australia will be called on to make a pledge on an emissions target for 2025 or 2030. All countries are required to put their targets on the table early next year, on the road towards a new international climate agreement. The US, China and Europe are all taking it seriously.

And don't count on them forgetting about us. Australia made quite a splash internationally, as the only country ever to have removed a carbon price. The world's eyes are on us.

Our emissions pledge will be scrutinised, in the knowledge that Australia has better opportunities for renewable energy and carbon sequestration than most other countries. And we will be asked how we are planning to achieve it, now the carbon price is gone.

Perhaps we'll just tell them to stop the groupthink?

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