7 The best of times

IN 1985, the first big outing for the newly formed Business Council of Australia was the National Taxation Summit. The managing directors of two of our grand old companies, Westpac and WMC, represented the organisation at the summit. The Business Council and its predecessors had been seeking a tax switch for many years—the introduction of a tax on the consumption of all goods and services—to pay for a reduction of taxes that they didn't like. Prime Minister Bob Hawke had called a National Taxation Summit after the 1984 election, and this was the new council's big chance.

Officials of the Treasury and the Department of the Prime Minister and Cabinet had prepared a white paper for presentation to the summit. It included three possibilities, two of which were carefully worked out live options. Option A included the introduction of taxation on a range of activities that the political system had shielded for many years, and hence had increased the burden of taxation on everyone else. These included a tax on fringe benefits, a tax on capital gains, limits on deductions or negative gearing of property, and extension of the normal company tax to income from gold mining (which had been temporarily excluded from taxation in 1922). Option C included all of option A, plus a broad-based retail sales tax to replace the wholesale tax and to help fund large reductions in income tax.

The prime minister invited the meeting to consider carefully the relative merits of the three options before it.

Bob White, the president of the Business Council, was then called to the despatch table of Parliament House by the prime minister. He rose to his feet amid great expectation.

'The Business Council', he said, 'does not support approaches A, B or C.'

A hush fell over the meeting.

White went on to say that option C was unacceptable because it contained option A, but no-one was listening.

The hush turned to murmuring, and then loud voices talking over each other.

History had been made in a moment.

The consumption tax was knocked unconscious, and was not revived for two decades. The various components of option A were legislated progressively from 1985.

What emerged that day in Parliament House was a lesson in how vested interests can make the perfect the enemy of the good. In overreaching for an ideal outcome for themselves if not for the community, the Business Council destroyed a central pillar of tax reform for two decades. They shot themselves squarely in the foot, with the country as collateral damage.

Fast forward to the late 1990s, and the Business Council played a constructive role in building support for a tax reform package that included a consumption tax, by advocating some measures that were important for equity and valued by other groups in the community much more than by Business Council members themselves. The Australian business leadership of that new day dealt itself into serious discussion of policy reform by adopting a national rather than sectional focus.

But fast forward again to 2011 and we find a new generation of the Business Council has reverted to its old type. In April, the chairman of the Business Council, Graham Bradley, visited China alongside a visit by the Australian prime minister. During high-level discussions with senior government and business leaders, Mr Bradley said that the Business Council would not support any carbon tax that would 'discourage investment' in Australia. And there should be no carbon tax on natural gas.

There can be no carbon pricing without structural change. Structural change removes some jobs and discourages some investment. It is not logical to be in favour of a market-based mechanism for reducing emissions, as the Business Council professes to be, and simultaneously be against a carbon price that discourages any investment. It would be as illogical as favouring productivity-raising reform but being against any policy change that discourages any investment.

The proposed carbon price, leading to an emissions trading scheme, is the central element in a set of policies that will secure reductions in Australia's emissions at low cost to the Australian economy. In addition, unlike regulatory measures, a market-based mechanism can collect revenue in a way that is more efficient than some existing taxes, for use in raising productivity or promoting equity.

Using regulatory measures to achieve a similar amount of emissions reductions would raise costs but would not raise the revenue to offset the increased costs. There would be no revenue to remove distorting taxes and offset the regressive effect on income distribution. There would be no revenue to support innovation in low-emissions technologies. There would be no revenue to provide incentives for carbon sequestration in rural Australia. There would be no revenue to support trade-exposed industries even though there may be a public interest case for some assistance.

In reaching for an apparently perfect mitigation solution that appears to have no losers among its members, the Business Council is again making the apparently perfect the enemy of the good. It is elevating the cause of narrow business interests above the many benefits that add up to the national interest.

Hard times for some

While there are contradictions in the resistance in practice of the Business Council to a market-based carbon price, for some of its members there are no contradictions. The most prominent of these is the manufacturer BlueScope Steel. In April 2011, Graeme Kraehe, chairman of BlueScope, said he could not accept a price on carbon. Mr Kraehe's views found an unlikely advocate in his traditional nemesis, Paul Howes, the head of the Australian Workers' Union, whose members work for BlueScope. Mr Howes joined Mr Kraehe in an attack on the carbon price by declaring that his union would withdraw support for the carbon tax if it meant the loss of 'one job'.

To fathom the reality behind these comments, we need to understand the broader economic moment. The Governor of the Reserve Bank of Australia, Glenn Stevens, noted in February 2011 that the high prices for Australia's resource exports meant that other industries had to invest and produce less: 'On this occasion, the nominal exchange rate has responded strongly', he said. 'This ... gives price signals to the production sector for labour and capital to shift to the areas of higher return.'

He went on to say that:

> there is going to be a non-trivial degree of structural change in the economy. This is already occurring, but if relative prices stay anywhere near their current configuration surely there will be a good deal more such change in the future … [I]f we have to face structural adjustment, it is infinitely preferable to be doing it in a period in which overall income is rising strongly. If nothing else, in such an environment the gainers can compensate the losers more easily.

In other words, Australia is enjoying a resources boom and for each new coal mine or gas plant that opens up, there must be a cut in jobs and investment in some combination of tourist hotels and restaurants, universities, steel mills, farms and other businesses producing exports or competing with imports. If it is a big investment in gas and coal, a lot of jobs and investment have to go. Prop up jobs in one area, and even more have to go in others.

The Reserve Bank's mechanism for this adjustment is higher interest rates and with them a higher exchange rate. Both will rise until enough investment has been discouraged and enough jobs have been shed in other businesses to make room for the resources boom without generating inflation.

BlueScope is one of those firms caught in this larger market shift. Its profitability is suffering enormously under the strains described by Mr Stevens. The Australian Treasury has demonstrated just how small the carbon-related changes are compared with the effects of the resources boom. With a carbon price of $20 per tonne and assistance arrangements under the government's 2009 proposals, carbon pricing would add on average $2.60 per tonne to the cost of making hot rolled steel from iron ore. This compares to current prices of around $900 per tonne of hot rolled steel. The 7 per cent appreciation of the Australian dollar in 2011 alone (a small proportion of the appreciation since the resources boom began) has subtracted about $50 per tonne from the value of steel sales. Bluescope Steel responded that this ignored indirect carbon costs and the rising price of carbon, but these do not change the basic story in the early years before the introduction of a principled approach to assistance.

When we tally these forces, it is clear that the public utterances and allegiance of BlueScope's capital and labour champions is a claim for protection against the slings and arrows of outrageous fortune, not any soundly based concern arising from the carbon price.

But while it is a good time economically for structural change, the story of BlueScope shows that it is a difficult time politically. The resources boom and full employment are forcing people out of old jobs, and it is easy to blame this on carbon pricing. It is easy to make dramatic claims about jobs being lost in one industry, knowing that not many people will understand that this means that more jobs can be created in other industries.

The introduction of measures to reduce greenhouse gas emissions also causes structural change, albeit on a smaller scale than the resources boom. But at a time when jobs are being lost, so that more can be created elsewhere, the carbon price is a ready scapegoat for those seeking to duck the consequences of the resources boom.

Hard times in resources?

Another industry that joined the 2011 self-interested hue and cry against a market-based carbon tax is mining. In early May, the chairman of BHP Billiton, Jacques Nasser, gave a speech at the Melbourne Mining Club in which he expressed general but not specific support for a market-based solution to carbon and energy management: 'It is difficult to predict winners and losers, with subsidies generally causing distortions as opposed to success.'

Yet, in the press conference following the speech, Mr Nasser also emphasised that his preferred method of reform was a slow 'sectoral approach', beginning with the electricity sector. In short, Mr Nasser was happy to endorse market-based approaches as long as they did not include coal and gas, two large components of BHP's business that would be heavily affected by carbon pricing.

Department of Climate Change and Energy Efficiency estimates provide some perspective on the coal industry's claims of impending ruin as a result of a carbon price. Carbon pricing is estimated to add an average of $2.80 per tonne to the cost of metallurgical coal ($6.70 for particularly gassy mines). But let's not forget that the price of metallurgical coal has varied between $100 and $400 per tonne during the resources boom.

The resources boom has been driven by Northeast Asian economies' growing need for energy, especially coal and gas, and other resources. Demand for gas is magnified by environmental including greenhouse considerations in Japan, China, Korea and Taiwan. So other countries' participation in the global mitigation effort has enhanced the resources boom to some extent—that is, through raised export prices, increased sales volumes and new investment in productive capacity.

The increased demand for gas in Northeast Asia, in turn, has increased the average incomes of Australians. But it has also increased the real exchange rate and reduced the availability of capital to other industries. It has therefore increased pressures for structural adjustment in other parts of the economy. As well, it has increased the difficulty and the costs of Australia meeting the emissions reductions targets that are our fair share of the international effort.

As we saw in Chapter 2, the resources industries, especially gas and coal, are responsible for around half of the extraordinary increase in Australian emissions that is anticipated in the absence of strong mitigation policies. If baseline emissions in 2020 are going to be 24 per cent above 2000 levels as supposed by the Australian Government—and that estimate from late 2010 preceded announcements on several gas export projects—then Australians will have to pay for the extra entitlements or reduce emissions elsewhere.

Despite these realities, the liquefied gas export industry is demanding exemption from a carbon price. It has based this on the claim that the beneficial effects of gas exports in reducing emissions in other countries mean that the gas industry should be exempted from responsibility for its emissions within Australia. Australia still has to meet its targets if emissions rise because of the expansion of gas and coal production.

The gas export industry is richly rewarded for the beneficial effects of its emissions being low compared with coal (although high compared with energy sources that do not rely on fossil fuels). It is rewarded in the strong demand and high prices that are driving the current investment and export boom. Some Australians have to pay for the gas industry's emissions. But why should all Australians carry the costs of the gas industry's exceptional expansion and prosperity? Why should the education, farming, tourism and manufacturing industries pay for the extra emissions that have come with the exceptional prosperity of the coal and gas industries, when their own prospects have been damaged by the resources boom?

Australian gas and coal have been the beneficiaries of a once-in-a century (or, more accurately, once-in-history) boom in demand for energy but want other Australians to pay for the resulting emissions.

Reform in the public interest is impossible in these circumstances unless there is an informed centre of our political community that understands the issues and has no sectional interest that leads it to oppose the national interest. If the independent centre of our political community is to embrace carbon pricing, it must also understand the resources boom and the 21st century collapse of productivity growth in Australia.

Booming incomes and slumping productivity

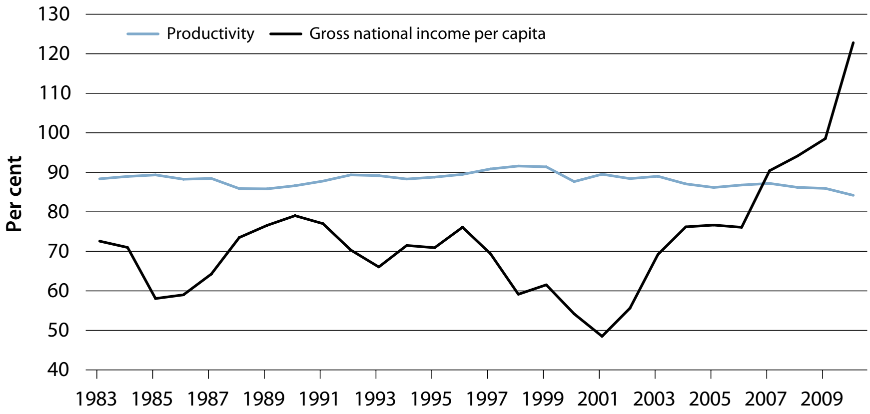
Australians are enjoying the best of times in our material standards of living. Over the past two decades we have enjoyed the longest period of rising living standards unbroken by recession in history—our own, or that of any other developed country.

We are back near the top of the world's league table for average incomes. For the first time in a century, average incomes in Australia rose above those of the United States in early 2008 (see Figure 7.1). Australian incomes have bounded ahead since then as the Great Crash of 2008 sent the US economy into the doldrums and left Australia relatively unscathed. This long boom began with, and was supported by, Australian economic reforms from 1983 to the end of the 20th century. These reforms lifted our productivity growth relative to that of the rest of the developed world higher in the 1990s than it had been since our Federation. Much higher. For a while we were at the top of the productivity growth world table of developed countries, after being at the bottom with New Zealand, on average, for over eight decades.

The lift in productivity came from improvements in the efficiency with which we used all resources—labour and capital together—and not just from using more and more capital with each worker. This increase in total productivity was the basis for sustainable increases in living standards.

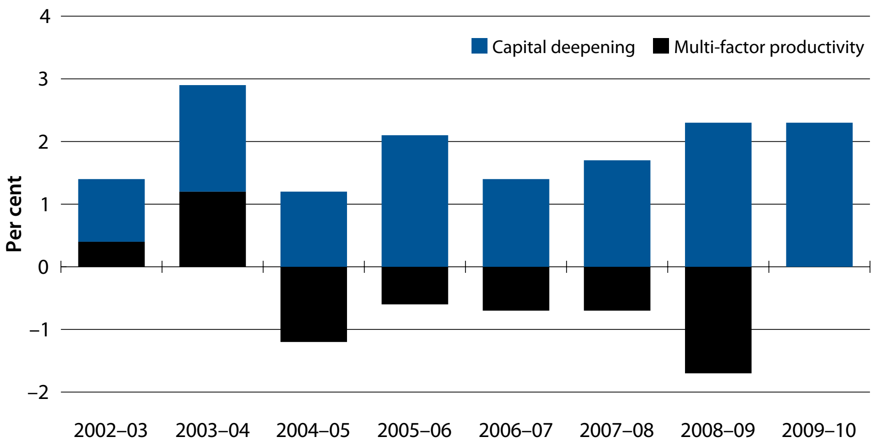
As we entered the new millennium, and zeal for reform faded, so too did the surge in productivity (see Figure 7.2).

Figure 7.1: Labour productivity and gross national income per capita (Australia as a percentage of the United States)



Sources: US Bureau of Economic Analysis 2011; Australian Bureau of Statistics 2011; Conference Board Total Economy Database, September 2010.

Figure 7.2: Sources of higher labour productivity



Source: Australian Bureau of Statistics 2010, *Experimental estimates of industry multifactor productivity, Australia: detailed productivity estimates*, cat. no. 5260.0.55.002.

For some years after 2001 we boosted incomes unsustainably through a rise in offshore borrowing for housing and consumption. That boom would have ended in tears except for the timely arrival of the largest sustained jump in our terms of trade in our long history as an exporter of commodities. It still would have ended in tears with the Great Crash, if the federal government had not taken the unprecedented action of guaranteeing the banks' wholesale debt—eventually to the tune of around $170 billion. The high terms of trade were then quickly restored, and continue today. It helped that we did not have a recession during and after the Great Crash—a product of superior institutions as a result of late 20th century reform, as well as deft policy at home and in China.

It is impossible to overstate the significance for productivity growth and future economic performance of the reversion to pre-reform Australian political culture that came in the early 21st century. In such a culture, economic reform is impossible if there is any prospect of there being a loser, no matter how large the gains for the community as a whole. In such a culture, economic reform is impossible if it requires any restraint on present incomes, no matter how large the benefits for the future. Productivity-raising economic reform—reform to protect society against future losses in productivity—is therefore impossible.

The future prosperity of Australians depends on us now breaking this great Australian complacency of the early 21st century.

Boom, bust and carbon

In the mining business, the ideal is for the highest economic value ('rent value') resources to be developed first and economically marginal resources last. Australia has its share of highly valuable mineral and energy deposits, so current high prices are driving a high level of investment in Australia.

Two other factors also encourage the current boom. Australia's fiscal regime for the resources industries place lower burdens on marginal investments than those placed on competing suppliers of energy and metallic minerals to international markets. In addition, sovereign risk is lower in Australia than in competing exporters of resources. This means that some poorer Australian resources jumped the queue and were mined relatively early. Some better resources in developing countries were held back while uncertainties in policy and national governance were resolved. But mined they will be, leading to a time when developing countries will be host to a higher and Australia host to a lower share of global resources investment.

Resources booms don't last forever. Eventually, high prices encourage investment in many resource-rich countries and not only in Australia. Prices for commodities fall. The growth in new global investment in mines and then the level of investment fall—and most of all in countries like Australia, which enjoyed more of the early boom. There is downward pressure on the exchange rate and incomes.

The economically wise approach to managing such episodes is to ensure that national savings are especially high through the boom, so that expenditure can be maintained in the subsequent slump in incomes. This requires higher collections of taxation revenue, higher budget surpluses in the boom times, and wise investment of the surpluses outside the domestic economy.

Restoring productivity growth

Reducing emissions through carbon pricing has a small negative effect on productivity for a while. But the alternative to an efficient approach to reducing emissions through carbon pricing isn't to take no action at all. It is rather the adoption of jerky regulatory interventions, one after another. Each will become more costly and intrusive as governments react to concern that Australia is nowhere near approaching targets for reducing greenhouse gas emissions that have been agreed with the international community, and to persistent electoral pressure. The experience with regulatory interventions so far in Australia and elsewhere is that their cost is many times the cost of securing similar emissions outcomes through general carbon pricing.

The threat that the 21st century return of the anti-productive Australian political culture will be longlasting is much greater if regulatory approaches are taken to reaching emissions reduction targets. The opportunities for vested interests to influence the policy process are much greater because the government must negotiate individual solutions to mitigation challenges as they arise. The difficulties of establishing a basis for international trade in entitlements are greater. The technical difficulties of assessing assistance levels through objective and independent processes are greater. And the danger that vested interests in other countries will persuade their governments to punish Australia for not doing its fair share in mitigation is greater.

The largest cost of mitigation through regulation is the damage that it will do to productivity-raising reform. Expansion of regulatory intervention will entrench the pressure of vested interests on the political process and the anti-productive political culture of the early 21st century.

Strong productivity and flexible markets are the cushions upon which the eventual bust will fall. We need, therefore, to be mindful of the choices for mitigation that we make during the boom so that we do not ultimately make the bust far worse.

The central choice is about which policy instrument we should use to reduce greenhouse gas emissions—carbon pricing or direct action? Beyond that central choice, future Australian productivity will be greatly affected by choices of rules for assistance for trade-exposed industries, and for trade in emissions entitlements.

It is essential to move quickly to place assistance for trade-exposed industries on a principled basis. Entitlements to assistance must soon be determined by a credible, independent and well-resourced institution, applying transparent analysis based on clear principles derived from analysis of the national interest.

The principled approach would be to provide assistance to the extent that product prices would be higher if all countries had Australian carbon constraints. Logically, there would be a levy in industries in which carbon constraints elsewhere exceeded those in Australia, but that would be a bridge too far.

The disciplines imposed by the Tariff Board and its successors provided important support for the emergence of a political culture in Australia in the 1980s in which productivity-raising reform became possible. Similar disciplines are going to be important to protect climate change mitigation from old Australian patterns of resistance to necessary structural change.

Second, Australia should move strongly to establish frameworks for legitimate international trade in entitlements. Trade could be conducted first on bilateral and regional bases, which can link as soon as possible to mitigation efforts in other countries and regions. This will provide early opportunities for deep international trade in emissions entitlements. Trade in entitlements will lead to convergence over time in carbon prices, which removes arguments for assistance for trade-exposed industries.

Not all countries will be open to deep participation in trade in entitlements, even if they are making strong steps to reduce emissions at home. The United States may be such a country for a considerable time. This will delay the emergence of a truly global carbon price. This, in turn, will increase the risk of distortive interventions to enhance the position of trade-exposed industries. Beyond the damage that this will do to the integrity of national policy making, there is a serious danger of a breakdown of the rules-based international trading system. It is possible that Australia and New Zealand would be damaged more than any other countries by such a breakdown, unless it were clear to a prejudiced observer that they were doing their fair shares in the global mitigation effort.

Finally, there are several ways in which economically efficient reduction in greenhouse gas emissions may positively contribute to the end of the stagnation of Australia's productivity. Concerns highlighted in the debate over carbon pricing have opened the way for reform of electricity price regulation, with potentially significant effects on the productivity of capital use. Incentives for biosequestration may accelerate the use of farm management approaches that raise productivity, including through reducing vulnerability to drought. The use of carbon revenues for tax reform could increase efficiency in the labour market.

Conclusion

An emissions trading scheme, initially with a fixed price on carbon, will be introduced at a time of great prosperity in Australia—a time of full employment but also of emerging structural pressures from the resources boom. With Australia's exchange rate against the US dollar at its highest level in about 30 years and its real (inflation-adjusted) exchange rate possibly the highest since Federation, we are living through the largest reallocation of resources outside the two world wars in our national history. Developing countries' accelerated global industrial development will drive and restructure the Australian economy in the years ahead. There will be bumps in the road—but these will probably be less painful than they would have been in any other circumstances. And the bumps will be on a road that is, for the foreseeable future, heading in directions that are favourable for Australia, determined by the concentration of global growth in economies that are highly complementary to Australia, and in our neighbourhood.

It makes no sense to resist this change with policies that seek to hold in place the structures of the past. On the other hand, it makes good sense to ensure that policies pursuing different objectives are all consistent with continued increases in productivity and rising living standards after the current resources boom has run its course. That means adopting approaches to reductions in greenhouse gas emissions that have the lowest possible costs. It means using the revenues from carbon pricing for tax reform to increase labour force participation and productivity at the same time as we meet important equity goals.

Adapting to the inevitable climate change in the remainder of this century requires the same efficient markets and flexible economic structures that will be necessary for efficient reduction of emissions and for restoring productivity growth as we live through the continued rise—and then the fall—of the resources boom.

The old Australian political culture, which was resistant to structural change, and which responded to private and sectional rather than public and national interests, is inimical to success in this historic national challenge.