

State of denial

The impact of the CPRS on state government budgets

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Introduction

The Australian policy response to climate change has been dominated by debate around the Rudd Government's Carbon Pollution Reduction Scheme (CPRS), with federal, state and local governments all affirming that the CPRS will be the 'centrepiece' of the Australian response.

The CPRS is known to have a number of serious design flaws. These include:

- Emissions reduction targets that are inadequate to achieve the government's stated goal of ensuring that atmospheric concentrations of greenhouse gases do not rise above 450 parts per million.
- Design features that prevent efforts to reduce emissions by individuals, local governments or state governments from actually having any impact in that this scenario will simply allow other polluters to increase their emissions.
- Excessive compensation to polluters, including generators of electricity, which are not even 'trade-exposed'.

This paper focuses on an additional design flaw. Between the various levels of government, the demarcation of responsibility for responding to climate change is inappropriate and will result in a substantial reduction in the ability of state governments to provide services, such as health and education, to their citizens. The paper concludes that while the Commonwealth will receive a windfall of more than \$10 billion per year in revenue from auctioning pollution permits, state and local governments will transfer more than \$2 billion a year to the Commonwealth Government. In addition, the states will be liable for tens of billions of dollars-worth of expenditure associated with adapting to climate change because the federal government, which is giving away more than \$10 billion in compensation to households and polluters each year, will not be providing state governments with any financial assistance to meet either the direct costs of the CPRS or the need for urgent investment in adaptation infrastructure.

In short, although it is the responsibility of the federal government to solve climate change, the bill for addressing the problem is being sheeted home to state governments. The less ambitious the Commonwealth Government is in setting emissions reduction targets, the greater will be the amounts that need to be spent by state governments on adaptation. The more money the Commonwealth provides in compensation to big polluters, the less money will be available to assist the states to prepare for rising sea levels, the upgrading of infrastructure and the need to spend more on health and emergency services.

This situation poses a simple question to state premiers. Given that the impact of the CPRS on energy prices will increase state government expenditure and, in turn, budget deficits by more than \$2.1 billion a year and that the cost of adapting to climate change is likely to be in the tens of billions of dollars, will the state premiers be increasing taxes or reducing the quality of services?

Background

The scientific and economic challenges of responding to climate change are both profound and complex. Similarly complex, if not profound, are the roles of both the Australian constitution in delineating the respective functions of state and federal governments and the High Court in interpreting the constitution. Unfortunately, while ministers and the media show a clear preference for simple solutions, the nature of some problems often prevents simple solutions from delivering efficient and equitable results. This would appear to be the case where the Rudd Government's attempt to tackle climate change is concerned.

The CPRS is the centrepiece of the federal government's response to climate change. The development of a national scheme, which can meet Australia's international obligations effectively, is important but it is essential for any such scheme to be well-integrated into Australia's constitutional structures. In particular, a national scheme must supplement the efforts of state and local governments as well as equitably distributing risks and responsibilities between the various levels of government. This paper argues that the CPRS has failed to harness the capacity of sub-national governments effectively. If it is implemented, all the revenue from climate-change mitigation will accrue to the Commonwealth while the responsibility for funding climate-change adaptation will primarily accrue to state and local governments.

Commonwealth/state division of responsibilities under the proposed CPRS

The CPRS is the first attempt to introduce a national, and binding, approach to tackling climate change in Australia. It relies completely on the federal government to do all of the following:

- set national caps on the level of emissions
- issue permits to pollute
- collect substantial amounts of revenue from the auctioning of some of those permits
- provide financial compensation and free permits to groups of its choosing.

States can't set emission targets

The role of state and local governments in the CPRS is far less significant, in policy terms at least. State and local governments will be unable to contribute to emissions reductions greater than those chosen by the federal government because any reduction in emissions from one jurisdiction will simply free up additional permits for polluters in other jurisdictions. In the words of Ross Garnaut:

The introduction of the CPRS means that there is no longer any value in state and territory governments setting their own binding targets for reducing statewide emissions.¹

Despite the CPRS design making sub-national emissions reduction targets redundant, some jurisdictions have continued to entertain hopes that their efforts can make a difference. The ACT legislative assembly is, for example, currently holding an inquiry into the appropriate size for an ACT emissions reduction target. The ACT Minister for Environment, Water and Climate Change, Simon Corbell, appeared to go out of his way to demonstrate his lack of understanding of the proposed CPRS by stating:

We take seriously the threat to our environment from climate change and have decided to adopt a long-term goal of zero net greenhouse gas emissions for the ACT.

We recognise that this is an ambitious goal but it sets a clear vision for the ACT and will help to drive the changes needed across the Territory to arrest the current growth in emissions and move towards a carbon neutral future.

Achieving the vision will involve costs, but the costs of failing to address climate change will be far greater.

¹ Department of Premier and Cabinet, Victorian climate change: Green Paper, Melbourne, June 2009, p. 07, at [http://www.climatechange.vic.gov.au/CA256F310024B628/0/28321D94532B1FA7CA2575CA00112B3B/\\$File/Climate+Change+Green+Paper.pdf](http://www.climatechange.vic.gov.au/CA256F310024B628/0/28321D94532B1FA7CA2575CA00112B3B/$File/Climate+Change+Green+Paper.pdf)

We will work to minimise costs wherever possible, acknowledging that not acting, or even not acting with sufficient speed to counter carbon emissions, will carry significant costs in mitigation and adaptation.

The Government will determine interim legislated targets, following completion of the inquiry, which is to report its findings by 30 July 2009.²

This lack of understanding of the implications of a national emissions target is not, however, shared by all states. The Victorian Government has recently conceded that its previous ambition of a state emissions target is rendered pointless by the CPRS.

While Victoria has been a leader in setting emissions targets, the introduction of the CPRS means that a binding emissions reduction target set by the Victorian Government would distort the operation of the scheme by mandating that a set level of reductions should take place within the State, regardless of the efficient allocation of national emission reductions that should be achieved through the CPRS market. Accordingly, the Government does not see any benefit in legislating for a state-based emissions reduction target that is inconsistent with a national target.³

It is interesting to note, however, that as late as March 2009, the Victorian Government was still talking about the role of its now-abandoned state-based emissions target.

States can't reduce emissions through investment in renewables or energy efficiency

In addition to preventing state governments from reducing emissions by setting sub-national targets, the CPRS also prevents them from reducing emissions by investing in renewable energy and public transport or driving energy efficiency in households. Again, any reduction in energy use in one jurisdiction simply frees up additional permits for polluters somewhere else in the economy.

In the words of the NSW electricity regulator IPART:

Under an emissions trading scheme, the quantum of allowable emissions will be fixed. The limit on emissions will apply to all emissions sources covered by the scheme. Additional measures to reduce emissions in sectors covered by the scheme would not result in an increase in emissions abatement – under the global cap, the emissions avoided through undertaking an additional measure would result in an equivalent increase in emissions elsewhere. How and/or where emissions are reduced changes, not the amount.⁴

Again, this design feature does not appear to be widely understood by state and local governments across Australia. For example, during the 2009 Queensland state government election, the Premier of Queensland, Anna Bligh, when launching a new state government subsidy for solar hot water systems, stated:

This Solar Hot Water Program will more than double the number of solar hot water systems in the State. It will cut Queensland household energy costs by up to \$96 million and reduce carbon emissions by up to 640,000 tonnes over three years.⁵

² John Stanhope, 'Labor Government sets zero net emissions target for Canberra', Press Release, 12/05/09 (<http://www.chiefminister.act.gov.au/media.php?v=8001>)

³ Department of Sustainability and Environment, loc. cit.

⁴ IPART (Independent Pricing and Regulatory Tribunal), Review of NSW Climate Change Mitigation Measures: Other industries—Issues paper, IPART of New South Wales, December 2008, p. 20, at <http://www.ipart.nsw.gov.au/files/Review%20of%20NSW%20climate%20change%20mitigation%20measures%200-%20Issues%20Paper%20-%20December%202008%20-%20APD%20Website.PDF>

⁵ Anna Bligh, 'Solar Program To Slash Power Bills', Press release, 18 March 2009, at http://www.qld.alp.org.au/01_cms/details.asp?ID=505

What she presumably meant to say was that as a result of the subsidy, the household sector would reduce its emissions by 640,000 tonnes and, in doing so, free up 640,000 pollution permits to facilitate increased emissions in other states and sectors of the economy. Misunderstanding about the states' abilities to 'reduce emissions' can be found all around Australia, for example:

The Victorian Government plans to spend \$100 million to help build a solar power station as well as fund a range of subsidies to increase the uptake of Photo Voltaic (PV) solar panels by households.⁶

What's left for state and local governments to do?

State government efforts to introduce emissions reduction targets, encourage investment in renewable energy, invest in public transport or promote behaviour change will have no impact on Australia's emissions once the CPRS sets a national emissions target. As already pointed out, some states do not appear to understand this while others have recently developed alternative explanations for their pursuit of such policies, including job creation or promoting research. It is important to note, however, that if the objective of spending hundreds of millions of dollars on such programs is job creation or research promotion these projects need to be assessed against the job creation ability of employing more teachers and nurses or the research output of investing in universities.

In the absence of any legitimate role for state governments in climate-change mitigation, their only rational response is to prepare for the country's probable failure to prevent dangerous climate change. That is, under the proposed division of responsibilities inherent in the CPRS, state governments will be obliged to take responsibility for adaptation measures designed to combat likely climate change.

The Victorian Government acknowledged this in its recent climate-change Green Paper:

One of the strongest roles for the Victorian Government in climate change policy will be in the area of adaptation.⁷

Adaptation is defined by the Department of Climate Change as:

... [A] response in natural or human systems to actual or expected changes in the climate or their effects. Adaptation can either reduce the harm anticipated as a result of climate change impacts or exploit opportunities for benefit.

Examples of adaptation can be as simple as reducing water use by saving and reusing grey water from washing machines for watering gardens or lawns, or harvesting stormwater for watering playing fields and public gardens in local communities.

Adaptation can include planning for more severe and intense bushfires as a result of less rainfall and drier conditions. It can be planning coastal developments so that sea level rise, storm surge and coastal erosion do not impact on them.⁸

Given their role as the primary providers of services and infrastructure, it could be argued that it is appropriate for state and territory governments to take primary responsibility for dealing with climate-change adaptation. But the design of the CPRS makes this demarcation quite problematic. The CPRS ensures that all the revenue associated with the auctioning of permits accrues to the

⁶ ABC News Online, 'Vic Govt puts forward plans for solar power station', 11 March 2009, at <http://www.abc.net.au/news/stories/2009/03/11/2512909.htm>

⁷ Department of Premier and Cabinet, loc. cit.

⁸ Department of Climate Change, 'Adapting to Climate Change', Fact Sheet, December 2008, at http://www.climatechange.gov.au/impacts/pubs/climate_change_and_adaptation.pdf

Commonwealth Government, yet the costs associated with adaptation are expected to be borne by the states.

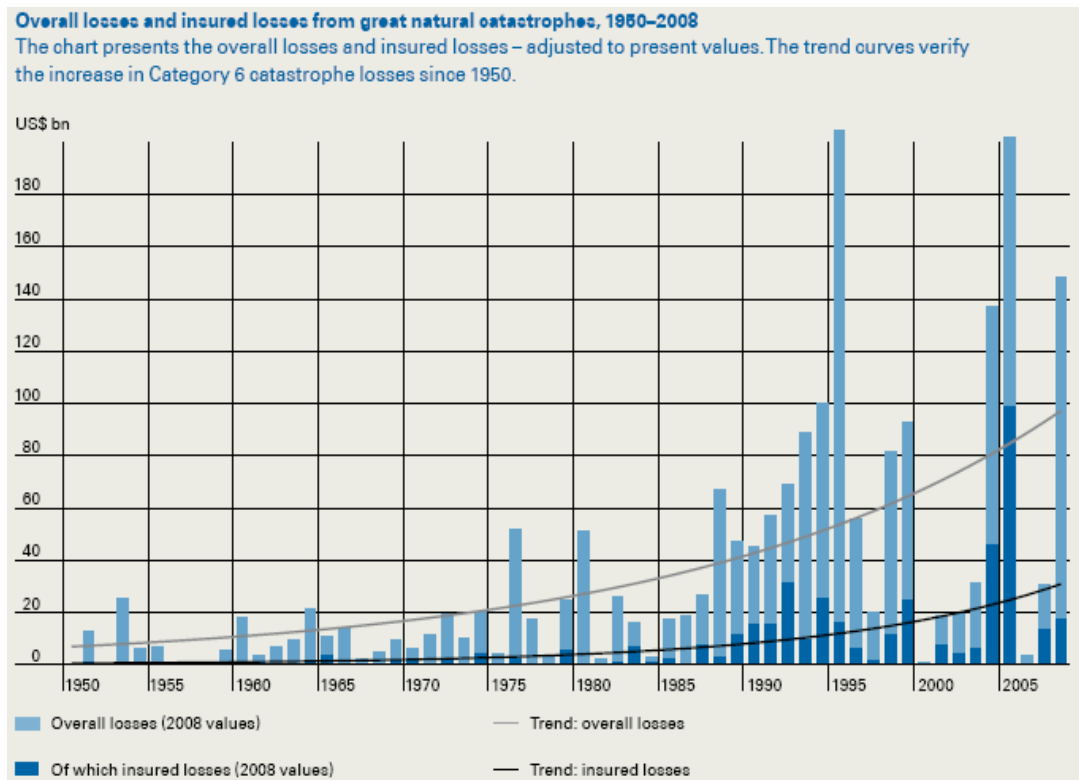
The costs to the states of climate change adaptation

Climate change will impose substantial financial, social and environmental costs. For state governments, the direct costs of adaptation are likely to include:

- upgrading of infrastructure, such as railway lines, to protect it from extreme temperature events like the string of hot days in early 2009 that shut down Melbourne’s transport system
- installing new infrastructure, such as sea walls, to protect existing housing and infrastructure from rising sea levels
- increased expenditure on services, such as health, when vector-borne diseases like dengue fever become more prevalent
- increased expenditure on emergency services, such as ambulances and fire fighters, to cope with the advanced likelihood of climate-change-enhanced events like heatwaves, bushfires and flood.

While it is difficult to quantify the costs associated with adaptation, they are likely to be substantial. For example, Figure 1 shows the trend in the cost of natural catastrophes in Australia between 1950 and 2008. The frequency, and the cost, of extreme events such as hail storms, floods and cyclones is increasing, suggesting that the expense to state governments and their citizens is likely to be substantially greater in future.

Figure 1: Frequency and cost of natural catastrophes, 1950–2008



Munich re, *Natural catastrophes 2008: Analyses, assessments, positions*, Knowledge series: Topics geo, Munich, p. 39.

As the figure above makes clear, state governments will probably experience a material increase in the budgetary cost of dealing with climate change. Furthermore, the cost of protecting infrastructure, such as roads in low-lying areas, will be very large.

However, not only does the CPRS do nothing to redirect the revenue from the sale of pollution permits to state governments to assist with adaptation funding, it actually imposes increased costs on to those state governments. It will result in a considerable transfer of money from state governments to the Commonwealth Government at precisely the time the Commonwealth should be transferring money to the states.

The direct cost of the CPRS to state budgets

In August 2008, The Australia Institute published research suggesting that the increases in energy costs associated with the introduction of the CPRS would have an adverse impact on state government budgets of more than \$1.4 billion per year.⁹ The cause of this increase in costs is associated simply with the fact that state governments are significant consumers of energy because institutions, such as schools and hospitals, are significant users of energy.

In a surprising demonstration of public cohesion, there were no overt calls from state premiers for increased funding from the Commonwealth and, as a result, there has been no mention by the Commonwealth of the need to provide compensation to offset the impact of the CPRS on state government budgets.

An alternative approach was adopted by the community sector. In September 2008, The Australia Institute also revealed that the introduction of the CPRS would cost the community sector (for example homeless shelters, meals on wheels and aged care homes) more than \$800 million a year.¹⁰ In response to its demands for compensation, the Rudd Government made specific provision for the need to assist the community sector to cope with the CPRS via the Climate Change Action Fund.

Although state premiers have remained publicly silent, they have, through the Council for the Australian Federation, commissioned their own assessment of the impost of the CPRS on their budgets. The results of the analysis by Access Economics, presented in the table below, show that the earlier Institute estimates were quite conservative. The total cost to state government budgets is estimated to be more than \$2.1 billion a year in 2013–14, rising to more than \$5.4 billion a year by 2020–21.

⁹ D Richardson and R Denniss, *The Impact of an Emissions Trading Scheme on State Government Budgets*, Research paper, The Australia Institute, August 2008.

¹⁰ D Richardson, *Who are the (un)intended losers from emissions trading*, Research paper, The Australia Institute, September 2008.

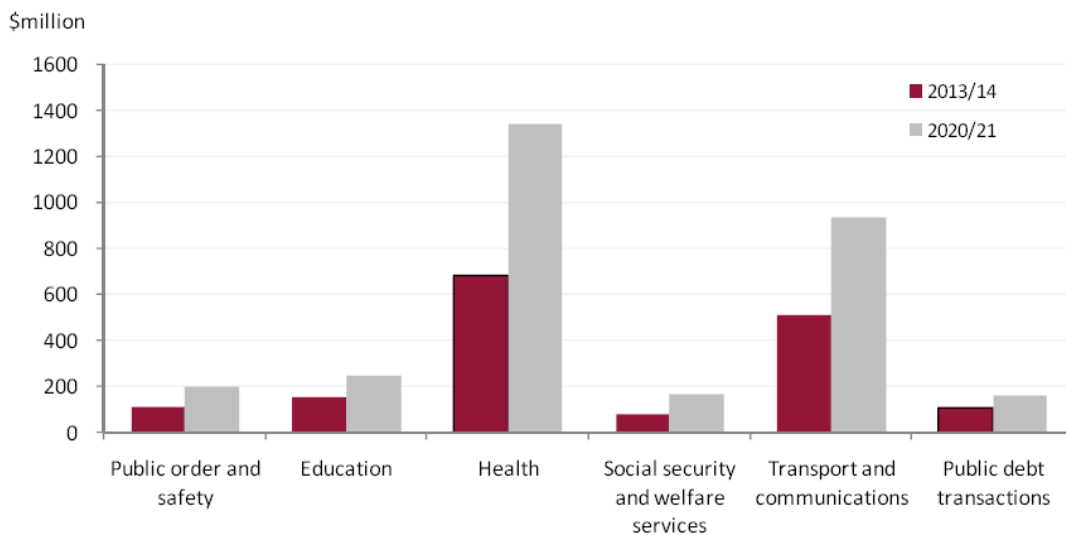
Table 1: Costs to state government budgets of the CPRS

2013/14	NSW	VIC	QLD ¹	SA	WA	TAS	ACT ²	NT	AUS
Revenue (\$m)	-406	158	-377	91	52	89	-1	15	-379
Expenditure (\$m)	456	595	80	183	254	110	17	96	1792
Net operating balance (\$m)	-861	-438	-457	-92	-202	-21	-18	-82	-2171
% of GSP	-0.18	-0.12	-0.15	-0.09	-0.09	-0.07	-0.06	-0.37	
% of revenue	-1.21	-0.84	-0.88	-0.54	-0.77	-0.41	-0.40	-1.60	
2020/21	NSW	VIC	QLD ¹	SA	WA	TAS	ACT ²	NT	AUS
Revenue (\$m)	-860	150	-1646	214	-179	106	-8	12	-2211
Expenditure (\$m)	858	1013	253	424	290	207	35	166	3248
Net operating balance (\$m)	-1718	-863	-1899	-211	-469	-102	-43	-154	-5459
% of GSP	-0.25	-0.16	-0.42	-0.16	-0.14	-0.26	-0.09	-0.48	
% of revenue	-1.70	-1.16	-2.48	-0.89	-1.22	-1.46	-0.68	-2.10	

Source: Access Economics Pty Ltd, Report 1: Impact of CPRS—Fiscal Report, May 2009, p. iii.

The figure below indicates the areas of state government budgets that will suffer the largest increase in costs as a result of the proposed CPRS. The largest increases are likely to occur in the health portfolio, with the cost of providing health services forecast to increase by over \$700 million in 2013–14 and by more than \$1.3 billion a year by 2020–21.

Figure 2: State government budget increases as a result of the CPRS



Source: Access Economics Pty Ltd, Report 1: Impact of CPRS—Fiscal Report, May 2009, p. 10.

There are only three ways for state governments to respond to this sizeable increase in their costs. The most obvious strategy is to emulate the approach taken by the trade-exposed industries and the community sector and seek direct compensation from the Commonwealth. However, since the premiers have, to date, refrained from publicly pressuring the Commonwealth for such assistance, the only two remaining options are to increase their state taxes or to provide lower-quality services to their citizens. From information publicly available, it is not possible to determine which of these two options is being considered by the various states.

The direct cost of the CPRS to local government budgets

Just as the increase in the cost of electricity will impose significant costs on state government budgets, local government budgets will be similarly affected. In a paper published by the Australia institute in 2008 it was estimated that the costs to local governments associated with the introduction of the CPRS would be \$344 million per year.¹¹

Responsibility without control or revenue

In a well-designed system, it is essential for decision-makers to be accountable for the consequences of the decisions they make. Indeed, the whole notion of ‘user pays’ is based on the principle that, unless individuals pay the full cost of their decisions, they will make inefficient choices. This principle is entirely absent from the demarcation of responsibilities between the state and federal governments in the proposed CPRS. While it is the federal government that determines the extent of climate-change mitigation, it is the state governments that are expected to meet the costs of climate-change adaptation.

The Commonwealth has accepted the argument that it should compensate electricity generators for the impact the CPRS will have on the value of their generation assets. But it has not accepted any responsibility for compensating state and territory governments for the likely destruction of their assets because of its own timid approach to climate-change mitigation.

It is understandable that the Commonwealth might seek to use all the revenue from the CPRS to solve its political problems by providing generous assistance to households and big polluters. But it is difficult to comprehend why state governments would not object to the introduction of a system in which the Commonwealth does little to prevent climate change and demands, meanwhile, that all the costs of adapting to climate change become the responsibility of the states. The fact that the CPRS actually transfers money from state governments to the Commonwealth makes their silence even harder to explain.

Conclusion

The Rudd Government’s CPRS allocates the responsibilities for responding to the threat of climate change in an inefficient and inequitable manner, effectively preventing state governments from reducing Australia’s emissions below the level set by the federal government. Yet it imposes all the costs of adapting to the impacts of climate change on the states, a situation entirely at odds with the principle that decision-makers should be responsible for the costs of their decisions.

While the advantages of such an arrangement are obviously beneficial for the federal government, it is unclear why state premiers appear so willing to accept responsibility for the costs of climate-change adaptation while not receiving any of the revenue collected from the sale of CPRS permits.

When the direct costs associated with the introduction of the CPRS are factored into state budgets, the willingness of state premiers and the citizens they represent to support such arrangements are even more difficult to explain. There can be no doubt that the introduction of the CPRS in its current form will force state governments to either increase their tax rates or provide fewer services to their citizens.

It is of course possible to modify the CPRS to overcome these problems. There is no reason that state and local government action could not result in a reduction in the national level of emissions.

¹¹ David Richardson, loc. cit.

All that is required is a formal mechanism to ensure that if state governments reduce their emissions, the Commonwealth Government will issue fewer pollution permits in the following year.

The other change that is required is for the Commonwealth Government to spend much less money compensating big polluters in order to free up substantial amounts of money to assist the states to meet the inevitable costs of climate change.