

Impact of the carbon tax on the Australian economy and markets

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Key points

- The macro economic impact from the Government's Clean Energy Future plan is unlikely to be large. The price effects will probably be minor, at around 1% and the Reserve Bank of Australia (RBA) is likely to look through them. There might be a slight near-term, negative impact on growth as a result of continuing uncertainty, but this is likely to be reversed next year as compensation payments are received. Longer-term, the impact on economic activity is expected to be minor as the economy adjusts and the clean energy industry grows in importance.
- It's hard to see major investment implications at an asset class level. However, carbon pricing will have a significant impact at the sectoral and stock specific level in the share market. A company's level of carbon emissions are becoming an additional factor investors can't ignore.

Introduction

The government has provided details on how its carbon tax will work. This note looks at the implications for the Australian investment markets and the economy in general.

Overview

There were no great surprises in the Government's Clean Energy Future plan, which carbon tax is a part of. The key aspects are:

- The carbon price will start July 2012 at \$23 a tonne, increasing by 2.5% per annum over the next two years.
- From July 2015, this will move to a 'cap and trade' emissions trading scheme (ETS), whereby the government will issue carbon permits that are capped, based on how much the government wants to reduce carbon pollution. Businesses will have to buy carbon permits or permits from international markets, with the trading price determined by supply and demand. The Government has set an initial minimum price of \$15 per tonne and a maximum of \$20 per tonne above the international carbon price.
- The carbon tax is to be paid by the biggest 500 polluters. It does not include agriculture and fuel used by passenger and light commercial vehicles.
- More than half of the revenue raised will be used to assist households through tax cuts and direct payments. The carbon tax will result an estimated \$9.90 per week increase in average household spending but, according to the government, will be offset by an average assistance payment of \$10.10 per week. Specifically, low to middle income households will be over compensated, 10% of households won't receive any compensation and a third will be worse off.
- Emissions intensive trade exposed industries (EITEs) will receive compensation equivalent to 94.5% of the industry average baseline for heavy emitters and 66% for lower emitters, with compensation being reduced by 1.3% per annum.

- The plan will raise \$27.3 billion over the first four years and will cost \$31.6 billion, resulting in a net cost to the Commonwealth budget of \$4.4 billion. Of this cost, \$2.9 billion is loaded into this financial year, as a result of one off benefit payments to households, scheduled for next May and June.

Pros and cons of the plan

Key positives from the Government's carbon reduction plan are:

- It should help reduce some of the uncertainty around carbon pricing, both in terms of how it will work as well as associated assistance and compensation.
- It should set Australia on a path to a low carbon future, which is the direction the rest of the world is moving in.
- By raising the income tax free threshold, it has reduced the disincentive to work for very low income workers.
- It provides significant support for households and industries to adjust.

By the same token, it has some potential downsides, such as:

- It is focused on only the top 500 emitters and excludes agriculture and transport, which are responsible for 15% of emissions each. This puts more pressure on the parts of the economy which are included, creating distortions in the economy.
- Uncertainty still remains around the carbon price once the ETS commences in 2015, but this is unavoidable as uncertainty surrounds most market determined prices.
- It contains elements of 'direct action' by setting up a Clean Energy Finance Corporation to pump money into green power and green technology. The Productivity Commission has found this to be a high cost way to reduce carbon emissions.
- It combines income redistribution from high to low income earners, which if combined with other moves such as the flood levy and means testing of the private health insurance rebate, could start to reduce incentives for high income earners and could see our deteriorating productivity performance worsen.
- It will result in a further increase in the budget deficit, albeit minor, of 0.2% of gross domestic product (GDP) this year. However the budget is still on track for a return to surplus in 2012-13.

Economic impact

According to the Australian Treasury, the carbon tax will boost prices by 0.7% in 2012-13, then by another 0.2% in 2015. This is partly due to higher household energy prices with the remainder coming from the pass through of higher business costs.

The price impact will be approximately a third of what it was when the GST was introduced in 2000. While this will boost headline inflation to around 3.5% during 2012-13, we expect the RBA will look through it as a one-off price adjustment, but be on the lookout for further impact on inflationary expectations. In the case of the GST, these were non-existent. And it's unlikely to be an issue this time around, with the over compensation for low to middle income earners likely to head off any boost to wage pressures.

Working out the growth impact is more problematic

In terms of the short-term impact there are several conflicting influences:

- Since the government's clean energy plan raises less in revenue than is spent as compensation and assistance, it could be argued it will be slightly stimulative to the economy, to the tune of about 0.2% of GDP over the current financial year. In particular, the benefit payments to low and middle income households in May and June 2012 will likely provide a kick to growth in the June 2012 quarter.
- The big unknown is the impact on business and consumer confidence, both of which have been soft going into the government's announcement of the carbon tax plan. On one hand, greater detail around compensation and assistance could help reduce uncertainty, although, uncertainty about the workings of the carbon tax and scepticism about compensation may remain a negative for growth in the months prior to May and June 2012. A third of households will be worse off and many households will worry they will be in this group, which are the households that undertake more discretionary spending. This is coming at a time when upper income households are already being hit with the flood levy and possibly a reduction in the private health insurance rebate.
- On top of this, while businesses face certainty about the carbon price over the next few years, the transition to an emissions trading scheme in 2015 will create uncertainty around price. It could conceivably be anywhere between the initial floor of \$15 a tonne and \$60 a tonne in 2015, rising to much higher levels by 2020. Numerous reviews in 2014 and the ability of the government to make legislative changes will only add to the uncertainty about long-term carbon pricing. This could all affect investment decisions.

Of course much will depend on how well the Government sells the package over the next few months, as well as the opposition's response, as the political debate could have an impact on confidence.

All up we see no reason to change our GDP growth forecasts at this stage, which will see growth this year of 2%, followed by 4% next year, however the risks are still on the downside for this year and possibly on the upside for next year.

Over the long-term, Australian Treasury estimates that real GDP will only be lowered by 0.3% by 2020. While there are numerous uncertainties in the short-term, over the long-term there is a good chance the economic impact will be minor:

- Over time, with a price put on carbon pollution, investment in clean energy and growth in clean industries will likely offset reduced investment and slower growth in dirty energy and sectors.

- Businesses and households will use the price signal from the carbon price to reduce energy consumption. In fact it's likely there are a lot of easy wins to be had on this, such as increased use of energy efficient light bulbs, light switches that turn off automatically after a set time and more. Typically, when I arrive home from work I find lights on in most rooms of my family home, with everyone in the kitchen or dining room. It's pretty easy for me to see scope to reduce my electricity bill. The actual rise in energy bills over time will likely not be as much as the 10% or so projected, as energy consumption is likely to reduce.
- Problems of air pollution, such as sulphur pollution, smog, acid rain, chlorofluorocarbon (CFCs) and the depletion of the ozone layer have all been dealt with globally over the years, and arguably faster and cheaper than feared. This has not resulted in the economic ruin many foresaw at the time. While the shift to a low carbon future is a much bigger issue, the same is likely to apply.

Investment implications

The run up to the commencement of the carbon tax may see high levels of uncertainty, serving to maintain the relative underperformance of the Australian share market versus global shares since April last year, which has occurred as a result of rising interest rates, the strong Australian dollar, worries about China and general political uncertainty in Australia.

It's hard to see significant asset allocation implications. The macro economic implications are not particularly big; the impact of overall share market earnings is likely to be less than 1%, it's unlikely to change the path of interest rates and while there will be pressure on property owners to make buildings more energy efficient, it won't be enough to significantly change the return potential from commercial property.

Where it will have a big impact on investors is at the level of sector and stock selection. Obviously the short-term impact of the carbon tax on heavy carbon emitters will be offset by various forms of assistance. However, as this phases down over time, the carbon tax and eventual ETS will work in favour of sectors and businesses which are carbon neutral and use clean energy. It's clearly a big positive for cleaner energy providers of wind, solar and, to a lesser extent, gas. It's probably neutral for the finance sector as many large finance companies have already gone carbon neutral and the sector might actually benefit from carbon trading. It's clearly a negative for coal fired electricity generators.

The bottom line is, a company's carbon emissions are becoming an additional factor investors can't ignore.

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