

CARBON TAX AS A CLIMATE POLICY INSTRUMENT: A COST-BENEFIT ANALYSIS

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Abstract

A carbon tax is a climate policy instrument that imposes a fee on emissions of carbon dioxide (CO₂) or other greenhouse gases, with the aim of reducing such emissions. The research method is literature review. The results of the study show that a carbon tax can reduce emissions by encouraging increased energy efficiency and adoption of clean technologies by companies. The economic benefits of a carbon tax include the creation of a new source of revenue for the government, which can be used to fund environmental initiatives and support vulnerable groups. The results also reveal that a carbon tax has the potential to change people's consumption behaviour by internalising the external costs of carbon emissions. Increasing the price of goods and services with a high carbon footprint encourages consumers to choose greener alternatives, thereby increasing demand for green products and fuelling innovation in sustainable technologies.

Keywords: Carbon Tax, Climate Policy Instrument, Cost and Benefit Analysis.

Introduction

Climate change is one of the biggest challenges facing humanity in the 21st century. Rising global temperatures, increased frequency of natural disasters and drastic changes in weather patterns are some of the impacts that are already being felt. One of the main causes of climate change is greenhouse gas emissions, especially carbon dioxide (CO₂) resulting from human activities such as burning fossil fuels (Abeyratne, 2020).

Changes in extreme weather patterns, such as prolonged droughts, floods and typhoons, have threatened food security, water resources and infrastructure security.

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In addition, melting ice in the Arctic and South Pole is causing sea levels to rise, which risks submerging coastal settlements and destroying natural habitats. If not addressed urgently, climate change could trigger a global humanitarian crisis that creates economic and social instability (Ahmed, 2021).

Climate change mitigation is essential not only to protect the environment but also to ensure the well-being and sustainability of future generations. Mitigation efforts involve reducing greenhouse gas emissions, conserving natural resources, and implementing cleaner and more efficient energy technologies (Aiello & Angelico, 2023). These measures not only help slow the rate of global warming, but also provide new economic opportunities through the development of green industries and job creation in the renewable energy sector. Moreover, climate change mitigation supports the achievement of various sustainable development goals (SDGs) that seek to reduce poverty, improve human health and ensure ecosystem well-being (Äimä et al., 2021). Therefore, strong global commitment and sustained collective action are indispensable to effectively address the threat of climate change.

To address this issue, various countries and international organisations have sought to implement various policies and mechanisms to reduce carbon emissions (Akindayomi, 2023). Carbon tax is one of the policy instruments widely discussed and implemented in several countries as a potential solution. A carbon tax is implemented by imposing a fee on carbon emissions, thereby encouraging companies and individuals to reduce their carbon footprint (Aldy, 2020).

The implementation of a carbon tax aims to provide economic incentives for emission reductions, but this policy also has its own challenges and controversies. On the one hand, a carbon tax could encourage green technology innovation and pro-environmental behaviour change. On the other hand, there are concerns about the economic impact on industries and consumers, especially in sectors that rely heavily on fossil fuels (Arendt, 2024). Therefore, understanding the costs and benefits of a carbon tax is crucial to formulating an effective and socially acceptable policy.

This research aims to review the existing literature on carbon tax and analyse its costs and benefits as a climate policy instrument. Through this literature review, it is expected to provide a deeper insight into the effectiveness of carbon tax and its economic and environmental implications. The findings of this study can serve as a basis for policy makers in formulating a more comprehensive and efficient climate change mitigation strategy.

Research Method

The study conducted in this research uses the literature research method. Literature research is a method often used to collect and analyse existing information from published sources. This literature research method will allow researchers to gain a comprehensive overview of the topic under study and provide a strong basis for

evidence-based policy recommendations. (Afiyanti, 2008); (Ainiyah, 2021); (Alaslan, 2022).

Results and Discussion

Definition and Concept of Carbon Tax

A carbon tax is an environmental policy instrument that imposes a tariff on carbon dioxide (CO₂) emissions resulting from burning fossil fuels, such as coal, oil, and natural gas (Baerentzen, 2021). Its aim is to encourage the reduction of greenhouse gas emissions by providing economic incentives for companies and individuals to use clean energy and adopt green technologies. By placing a cost on carbon emissions, these taxes internalise the environmental impact of economic activity, thereby reflecting the true social cost of carbon pollution and promoting more ecologically sustainable practices (Bergh et al., 2021).

Carbon taxes can be categorised into several types based on the way they are applied and the unit being taxed. First, a direct emissions-based carbon tax is a tax levied on the amount of carbon dioxide emissions produced by specific sources, such as industrial plants, power plants, or motor vehicles. This tax is calculated based on tonnes of CO₂ emitted and is aimed at reducing direct emissions from large, major sources of pollution. This provides a direct incentive for producers to switch to cleaner technologies and more efficient energy use (Boulogne & Smit, 2021).

Second, a carbon tax can be applied to fossil fuels, known as a carbon fuel tax. This tax is levied on fuels such as coal, oil and natural gas based on their carbon content. By increasing the cost of fossil fuels, this tax encourages consumers and producers to reduce the use of these fuels and seek greener alternatives, such as renewable energy (Brown & Bogle, 2021). In addition, these carbon taxes can also encourage energy efficiency in the transport and heating sectors, and stimulate innovation in low-carbon technologies. Both direct emission and fuel-based taxes have the potential to generate revenue that can be used to fund environmental initiatives and climate adaptation programmes (Brunner & Seiler, 2021).

In addition to direct emissions-based taxes and carbon fuel taxes, there are also consumption-based or embedded carbon taxes. This tax is levied on final products based on their embedded or embodied carbon footprint during the entire production to distribution process. This approach aims to reduce emissions by ensuring the entire supply chain considers their carbon impact, thus promoting cleaner production practices and more sustainable procurement (Carhart et al., 2022).

Another type of carbon tax is a specific sector-based tax, where taxes are imposed on certain sectors that are recognised as major sources of carbon emissions, such as the aviation, shipping and construction industries. For example, a carbon tax on airline tickets aims to reduce the number of flights and encourage the use of more environmentally friendly modes of transport (Carroll & Stevens, 2021). These sector-

specific carbon taxes can also be combined with incentives such as subsidies for green technologies or tax credits for companies that achieve emissions reduction targets, creating a balance between restrictions and incentives in climate change mitigation efforts (Chateau et al., 2023).

These types of carbon taxes allow for more flexible and context-based policy implementation that can be tailored to each country or region's environmental needs and priorities. Diverse approaches also help ensure that different sources of emissions are effectively addressed, while taking into account the economic and social impacts of the tax (Christians, 2022).

Carbon Tax Effectiveness

Carbon taxes have a significant impact on reducing greenhouse gas emissions through various economic and environmental mechanisms. By imposing a surcharge on carbon emissions, these taxes increase operating costs for fossil fuel-dependent companies, encouraging them to invest in cleaner and more efficient technologies (Cicala et al., 2022). For example, companies might switch to using renewable energy such as wind, solar or bioenergy to reduce the costs associated with carbon emissions. In addition, carbon taxes encourage research and development of green technologies, thereby accelerating innovation in the clean energy sector (Coffman et al., 2022).

In addition to affecting producer behaviour, carbon taxes also impact individual and societal consumption patterns. By increasing the price of goods and services that have a high carbon footprint, the tax encourages consumers to choose greener alternatives. For example, increasing the price of fossil fuels may encourage people to use public transport, cycle, or buy Electric vehicles (Dias & Rocha, 2023). In the long run, these changes in consumption patterns can reduce the overall demand for fossil fuels and lower greenhouse gas emissions. Through a combination of producer- and consumer-level behavioural changes, carbon taxes are effective in reducing overall emissions, driving the transformation to a low-carbon economy, and contributing to global efforts to mitigate the impacts of climate change (Dill, 2023).

The effectiveness of carbon taxes in reducing greenhouse gas emissions is determined by several key factors. One key factor is the level or rate of the carbon tax itself. A low rate may not be enough to drive significant changes in producer and consumer behaviour, while a rate that is too high may generate substantial political and social resistance (Dimitropoulou, 2021). Therefore, setting the right rate, which strikes a balance between incentivising emission reductions and maintaining economic stability, is crucial to the effectiveness of a carbon tax. In addition, the broad scope of the tax, covering a wide range of sectors and emission sources, is also important so that there are no exemptions that could reduce the overall impact of the policy (Dominioni, 2022).

Other factors affecting the effectiveness of carbon taxes include government support and oversight as well as public acceptance. Carbon tax policies should be supported by a strong regulatory framework and monitoring mechanisms that ensure compliance with the tax's provisions (Dzagoeva, 2022). In addition, transparency in the use of carbon tax revenues can also increase public acceptance. Allocating tax funds to green projects, such as investments in renewable energy infrastructure or assistance programmes for communities most affected by the tax, could provide additional support for the policy. When people see the direct benefits of a carbon tax, public support tends to increase, which in turn helps the long-term success of the policy (Felis & Gołębiowski, 2021).

Cost of Implementing a Carbon Tax

The implementation of a carbon tax results in a range of direct and indirect costs that governments and economic actors must consider. Direct costs include increased operating costs for companies that produce greenhouse gas emissions. These companies must pay a tax on every tonne of carbon they emit, which can increase their production costs and the selling price of their products (Fouquet & O'Garra, 2022). In addition, there are administrative costs associated with implementing and monitoring carbon tax policies. The government needs to allocate resources to oversee companies' compliance with the policy and ensure that the tax is collected effectively (Fraundorfer & Rabitz, 2020).

On the other hand, there are also indirect costs arising from the implementation of a carbon tax. One of them is the impact on the price of goods and services, which is ultimately felt by consumers. Increased production costs are often passed on to consumers in the form of higher prices for goods and services that have a high carbon footprint (Garcia, 2021). In addition, there are potential impacts on employment, especially in sectors that rely heavily on fossil fuels. Companies may need to reduce labour or defer investments in response to rising operational costs. However, it should be noted that while there are direct and indirect costs, the long-term benefits of reducing emissions, such as mitigating climate change impacts and improving public health, can far outweigh the initial costs of implementing a carbon tax (Ghafouri & Rudolph, 2021).

Implementing a carbon tax can have significant economic impacts on both industry and consumers. For industries, particularly those that rely heavily on fossil fuels such as energy, transport and manufacturing, a carbon tax could lead to increased operating costs. Such additional costs may encourage companies to reduce emissions through various initiatives, such as improving energy efficiency, switching to renewable energy sources, or adopting cleaner technologies (Glazebrook, 2022). However, these adaptations may require substantial initial investments. In addition, companies may also face competitive challenges, especially if the carbon tax in their country is higher than

in other countries that do not implement similar policies, which may affect their international competitiveness (Gordon, 2024).

On the consumer side, the implementation of a carbon tax may lead to an increase in the price of goods and services, especially those with a high carbon footprint such as fuel, electricity and fossil fuel-based products. This increase in the cost of living is often more pronounced for low-income groups who have a greater proportion of expenditure on basic needs (Green, 2021). On the other hand, revenues from carbon taxes can be used to subsidise renewable energy or social assistance programmes, which can help reduce the economic burden on consumers. Moreover, these price changes may also encourage consumers to change their behaviour, for example by reducing their consumption of fossil fuels or switching to more environmentally friendly products and services, which overall supports the goal of reducing carbon emissions (Huber, 2020).

In conclusion, the introduction of a carbon tax has significant economic impacts on both industries and consumers. Industries that depend on fossil fuels may face increased operational costs, prompting them to adopt cleaner technologies and improve energy efficiency. Meanwhile, consumers may experience an increase in the price of goods and services, especially those with a high carbon footprint, which could further burden low-income groups. However, with proper utilisation of carbon tax revenues, such as investment in renewable energy and social assistance programmes, these negative impacts can be partially offset. In addition, a carbon tax can stimulate behavioural change at both the industry and consumer levels, towards emissions reduction and long-term environmental sustainability.

Carbon Tax Benefits

A carbon tax has a number of significant benefits, particularly in the context of reducing greenhouse gas emissions. Firstly, a carbon tax provides an economic incentive for companies to reduce their emissions. By imposing a fee on every tonne of carbon released into the atmosphere, the tax encourages companies to seek more efficient and innovative ways to minimise emissions, such as improving energy efficiency, adopting clean technologies, or switching to renewable energy sources. This not only helps mitigate the impact of climate change, but also supports the development of green technologies that can be a driver of economic growth in the future (Huo et al., 2022).

Second, a carbon tax can serve as a new source of revenue for the government. The revenue raised from this tax can be allocated to fund various environmental initiatives, such as investments in renewable energy infrastructure, green technology research and development programmes, and reforestation projects. In addition, these revenues can also be used to reduce the economic burden on low-income households that may be affected by rising prices of goods and services. By subsidising renewable

energy or cash transfers, governments can ensure that the transition to a low-carbon economy is fair and inclusive (Ibarrola, 2021).

Third, implementing a carbon tax can help change people's consumption behaviour. By imposing additional costs on goods and services that have a high carbon footprint, consumers are encouraged to choose greener alternatives. For example, rising fossil fuel prices may encourage more people to switch to public transport or electric vehicles. This change in consumption patterns not only helps reduce emissions directly, but also increases market demand for green products, which in turn drives innovation and cost reductions in green technologies. Thus, a carbon tax can be an effective tool to encourage more sustainable behaviour in Society (Kim et al., 2024).

Fourth, a carbon tax can improve economic efficiency by internalising the external costs of carbon emissions. Greenhouse gas emissions cause various negative impacts, such as environmental damage, health problems, and climate change impacts that are detrimental to the global economy. Carbon taxes help ensure that these costs are factored into the price of goods and services associated with carbon emissions, ultimately creating incentives to reduce fossil fuel use. In this way, carbon taxes help allocate resources more efficiently and create a more sustainable economy in the long run (Lilly et al., 2022).

Fifth, a carbon tax can provide a strong signal to the market about the importance of transitioning to a low-carbon economy. With consistent and long-term policies, a carbon tax can help create certainty for investors and businesses, encouraging them to invest in sustainable technologies and infrastructure. This could accelerate the development and adoption of green technologies, such as renewable energy and energy storage solutions, which are essential for tackling climate change. Policy certainty can also help reduce investment risks and open up new economic opportunities in innovative sectors (LIN & JIA, 2020).

Finally, a carbon tax can strengthen environmental diplomacy and international collaborative efforts to address the climate crisis. By implementing a carbon tax, a country can demonstrate its commitment to emissions reduction, which can encourage other countries to take similar steps. Policy alignment between countries can strengthen international agreements and promote more effective global co-operation in combating climate change. In addition, countries that have implemented carbon taxes can share experiences and best practices, helping other countries design and implement effective climate policies (MA & SANG, 2024).

Overall, carbon taxes offer a wide range of economic, social and environmental benefits that can help drive the global transition to a more sustainable and low-carbon future.

Conclusion

A carbon tax is an effective climate policy instrument with significant benefits in reducing greenhouse gas emissions. Firstly, it provides strong economic incentives for companies to reduce emissions through improved energy efficiency and adoption of clean technologies. As such, a carbon tax helps steer industries towards more sustainable and environmentally friendly operations.

In addition, a carbon tax is potentially a new source of revenue for the government that can be used to fund environmental initiatives and support low-income households. With proper revenue allocation, governments can ensure that the transition to a low-carbon economy is fair and inclusive, mitigating any socio-economic impacts that may arise.

Carbon taxes also play an important role in changing people's consumption behaviour by internalising the external costs of carbon emissions. Increasing the price of goods and services that have a high carbon footprint encourages consumers to choose greener alternatives. This, in turn, drives market demand for green products and supports innovation in sustainable technologies.

Finally, implementing a carbon tax can strengthen international co-operation in tackling climate change by providing a consistent and long-term policy framework. Countries that implement a carbon tax can demonstrate their commitment to emissions reductions, encouraging similar actions from other countries and strengthening environmental diplomacy. With these benefits, a carbon tax could prove to be an important tool in the global effort to achieve a more sustainable and low-carbon future.

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