Submission

By

Business NZ

To

Inland Revenue Department

On

Implementing the Carbon Tax Consultation Paper

July 2005

PO Box 1925
Wellington
Ph: 04 496 6555
Fax: 04 496 6550

IMPLEMENTING THE CARBON TAX – GOVERNMENT CONSULTATION PAPER SUBMISSION BY BUSINESS NEW ZEALAND[1]

1.0 SUMMARY AND CONCLUSIONS

1.1 Business New Zealand is opposed to the introduction of a Carbon Tax for a number of reasons which are expanded upon below.

1.2 In short, our broad concerns with the carbon tax revolve around the following:

- The Carbon Tax is a selective tax which is in breach of the principles of a good tax system. Moreover, it will be applied inconsistently across greenhouse gas emitters therefore raising distortions, including possibly within sectors.

- The Carbon Tax will penalise New Zealand businesses while many of our international competitors are not burdened by such impositions.

1.3 Despite Business New Zealand's opposition to the implementation of a carbon tax, if the Government pursues its policy decision to introduce a carbon tax then there are a number of other issues in respect to the consultation paper which need further consideration.

1.4 These issues are:

- There is no discussion in the consultation paper of why the carbon tax will commence on 1 April 2007 when the first commitment period does not start until 1 January 2008;

- The potential administration and compliance costs associated with the proposed carbon tax regime;

- The impact on electricity generators with large stockpiles of coal etc to take account of "dry years" (or reserve generation). If such stockpiles are taxed before use then the incentives on generators to maintain large stockpiles may be diminished with potential security of supply issues arising; and

- The incentives on electricity generators and major electricity users to enter into long-term hedge contracts could be jeopardised given the uncertain nature of the carbon tax beyond the first commitment period (2008-2012).

[1] Background information on Business New Zealand is attached as Appendix 1.

2.0 RECOMMENDATIONS

Business New Zealand <u>recommends</u> that the policy decision to impose a carbon tax be reconsidered.

3.0 GENERAL COMMENTS ON THE CONSULTATION PAPER

3.1 Business New Zealand believes climate change is an important issue. The fact that governments around the world, including New Zealand's, are taking climate change so seriously means that the business community must do so as well.

3.2 However, Business NZ has consistently opposed New Zealand's ratification of the Kyoto Protocol for a number of reasons outlined earlier.[2]

3.3 **The Carbon Tax is a selective tax, which defies the principles of a good tax system. Moreover, it will be applied inconsistently across greenhouse gas emitters therefore raising distortions, including possibly within sectors.**

3.4 To an extent, all taxes are distortionary and impact on economic behaviour. Nevertheless, there are a number of principles that are generally accepted as important principles of a good tax system – apart from the obvious one that the tax system ought to be able to raise the amount of tax required.

3.5 It is widely considered that the four basic properties of a good tax system are:

Economic efficiency: the tax system should not interfere with the efficient allocation of resources by favouring one particular sector over another.

Administrative simplicity: the tax system should be relatively easy to administer and comply with.

Flexibility: the tax system should be able to respond to changed economic circumstances.

[2] These reasons have been well canvassed in previous Business NZ Submissions including the Business NZ Submission (June 2002) to the New Zealand Climate Change Project on "Climate Change – The Government's Preferred Policy Package – Discussion Document April 2002"

Fairness: the tax system should be fair in its relative treatment of different individuals. In a taxation sense there are two distinct concepts of fairness: horizontal equity and vertical equity. Horizontal equity considers that individuals and businesses that are the same in all relevant respects should be treated equally irrespective of what legal activity they may be involved in. Vertical equity considers that those in a position to pay more should do so.

3.6 The proposed carbon tax significantly breaches at least two of the major principles of a good tax system that is encouraging "economic efficiency" and "fairness". Moreover, it is also likely to breach the principle of "administrative simplicity", given the many compliance and administrative requirements outlined in the Consultation Paper.

3.7 In short, a carbon tax is a very narrow (selective) tax, which goes against the general principle of broad-based taxes, which minimise distortions between sectors.[3]

3.8 Secondly, the carbon tax is applied unevenly across sectors and even within sectors given the potential for Negotiated Greenhouse Agreements (NGAs) for "at risk" companies, and as stated in para 2.7 of the Consultative Paper, the exemption of emissions of methane and nitrous oxide from animals and soils from the carbon tax in the first commitment period.[4]

3.9 Business New Zealand considers that the discussion in the Consultation Paper only highlights the difficulty of implementing a carbon tax in a fair and efficient manner given the various exemptions, rebates and special treatment provided to various sectors, quite apart from the administrative and compliance costs involved.

[3] Business NZ Notes that The Tax Review 2001 (the "McLeod Report") stated that in an increasingly open economy, raising revenue through taxes involves significant costs. In this respect a broadly based low-rate revenue raising strategy is an appropriate way of lowering those costs. The Tax Review 2001 noted in respect to eco-taxes that *"…our view is that the appropriate burden of proof on those advocating eco-taxes should be identical to the burden placed on those seeking concessionary tax treatment for particular activities or sectors. We consider the initial presumption should always be against the introduction of selective taxes." (p.65).*

[4] Appendix 3 in the Consultation Paper states that around 49.2% of greenhouse gas emissions come from the agricultural sector, with New Zealand being very unusual internationally amongst OECD countries in having such a large portion of its emissions associated with agriculture.

3.10 Notwithstanding the above, Business NZ would like to stress that there are sound reasons for the Government taking into account the impact of “at risk” industries and the fact that there are few cost-effective initiatives that can be taken on-farm to reduce emissions from livestock without a considerable downside. The point Business NZ wishes to stress is that other sectors and companies (those not involved in farming or those not able to negotiate NGAs) will also be significantly affected by competition from international competitors not subject to such taxes, yet will be required to bear a disproportionate burden of the carbon tax. Obviously some of the costs will likely be passed on to consumers but in some cases businesses may reduce output or even cease operating, as international competitors do not face the same cost constraints.

3.11 It would be naïve to assume that New Zealand could move to increasing renewable energy without adding significantly to the overall cost of electricity. While renewable energy is an option being pursued by some, contrary to popular opinion New Zealand does not have low-cost renewables that can substitute for current non-renewable energy supplied.

3.12 In sum, all sectors will face significant costs of reducing emissions. Moving away from greenhouse gas emissions is not a costless exercise, irrespective of what sector the greenhouse emissions come from.

3.13 Despite Business New Zealand’s total opposition to the introduction of the selective carbon tax, a more preferable path forward (if the government is committed to a carbon tax regime) is for the costs of such a regime to be funded out of general taxation. In this respect, the costs associated with meeting the government’s target would be spread amongst the whole community of taxpayers rather than a selected few, and negate the need for what some might consider to be “special” treatment for some sectors and businesses within certain sectors.

3.14 **The Carbon Tax will penalise New Zealand businesses while many of our international competitors are not burdened by such impositions.**

3.15 Many of New Zealand’s trading partners (including Australia and the United States) have not ratified the Kyoto Protocol and therefore will be exempt from taking action to reduce greenhouse gas emissions over the first commitment period (2008-12). While some countries, including Australia and the United States, have committed to taking voluntary action, it is at a pace which will not adversely impact on the competitiveness of their industries.

3.16 New Zealand, in contrast, is taking action through a carbon tax which will impact on the international competitiveness of New Zealand businesses. New Zealand's total greenhouse gas emissions amount to around 0.2% of world emissions, which means anything New Zealand does to lower its current emissions will have a negligible, if any, impact on total world emissions. Nevertheless, the imposition of the carbon tax could have significant implications for the business sector.

3.17 The Kyoto Protocol does not require parties to impose a carbon tax yet the Government has chosen to implement a carbon tax when other less invasive options are available (e.g. funding the purchase of emission reduction units out of general taxation). While some countries have introduced climate change-related taxes, this has not been consistent across the board.

3.18 The Government has made much of the statement both within the Consultation Paper and elsewhere (e.g. the Budget 2005) that revenue from the carbon tax will be "recycled" by reducing other taxes by the amount expected to be collected. How this will allegedly be achieved was announced in the Budget 2005 (19 May 2005).

3.19 Despite the Government's so-called commitment to recycling, the details of tax measures announced in the Budget could not be considered tax reductions per se. Issues surrounding faster depreciation rates etc simply reflect a change in the timing of taxation and rectify current problems in this area. For example, the Minister of Finance stated in the Budget that changes to the depreciation rates *"remove the depreciation bias against investment in short-life assets.."* Any consideration that the Budget provided for offsets to the introduction of a carbon tax needs to be seen in this light.

3.20 Secondly, and perhaps more importantly, so-called "recycling" of tax takes no account of the compliance and administrative costs associated with tax collection, quite apart from the deadweight costs associated with taxation where resources are deployed away from their most highly valued uses.

3.21 The Consultation Paper states that a carbon tax will apply from 1 April 2007 and continue until the end of the first commitment period (31 December 2012). Policy for the second commitment period will be developed before the end of the first commitment period.

3.22 The potential exists for New Zealand businesses to face significantly harsher obligations in the second commitment period with no knowledge of what those commitments might mean. This makes it difficult for businesses to plan ahead with any confidence, quite apart from the incentives on investors to invest in non-renewable or renewable generation. The danger is that investors will sit on their hands until the investment climate is more certain. This could have dire consequences for the future security of New Zealand's electricity supply.

3.23 The need for New Zealand to review its policy position on the carbon tax is even more important since the announcement in June 2005 that New Zealand will likely have a net deficit of 36.2 Mt (under a "median" scenario) as opposed to a projected 32 Mt surplus last year for the first commitment period (2008-2012).

3.24 While Treasury has valued the estimated liability at around $307 million over the first commitment period (Financial Statement of the Government of New Zealand for the eleven months ended 31 May 2005), this is based on a carbon price of $US6 per unit which even in today's trading environment appears unrealistically low – let alone future projected rises in the price of carbon. Some estimates now put New Zealand's liability at well over $1 billion for the first commitment period.

4.0 OTHER ISSUES WHICH NEED TO BE CONSIDERED

4.1 Despite Business New Zealand's opposition to the carbon tax, if the Government pursues its policy decision to introduce a carbon tax then there are a number of other issues in respect to the Consultation Paper which need further consideration.

(a) The rationale for applying the proposed carbon tax from 1 April 2007 is unclear and potentially limits flexibility for New Zealand.

4.2 The consultation document has no discussion on why the carbon tax will commence on 1 April 2007 when the first Kyoto Commitment period does not start until 1 January 2008. The rationale for this decision needs to be clearly spelt out particularly given the wildly inaccurate estimations of New Zealand's greenhouse gas emissions (liabilities) to date.

(b) The administration and compliance costs of the carbon tax to businesses could be significant.

4.3 The discussion document states (para 3.4) that *"Products will generally be taxed as early in the supply chain as possible, since this will usually result in the smallest number of liable parties, ensure comprehensive coverage and minimise the administration and compliance costs of the tax".* Despite the above, there will be significant compliance and administration costs to some individual businesses (e.g. those with Negotiated Greenhouse Agreements (NGAs)) required to provide data on what their emission are.

4.4 Secondly, there is no consideration of actual emission mitigation systems used by various individual firms when imposing the carbon tax. This raises significant issues surrounding the fairness of such a tax and the incentives for firms to invest to emission mitigation systems.

4.5 Thirdly, tax assessed by IRD is generally open to an appeal process. There appears to be no process in place if businesses disagree with the tax levels assessed. Similarly there is no mention of enforcement or penalties for non-compliance.

(c) the impact on electricity generators with large stockpiles of coal etc to take account of "dry years".

4.6 If such stockpiles are taxed before use then the incentives on generators to maintain large stockpiles may be diminished with potential security of supply of electricity issues arising.

(d) The incentives on electricity generators and major electricity users to enter into long-term hedge contracts could be jeopardised given the uncertain nature of the carbon tax beyond the 1st commitment period (2008-2012).

4.7 The Consultation Paper raises the issue of long-term energy supply contracts and the potential implications of the introduction of the carbon tax (paras 3.29 to 3.32). The obvious danger with the introduction of the carbon tax is that participants in the market will be wary of entering into long-term energy contracts for fear that the price of carbon will increase. Energy suppliers will likely build these potential costs into contracts in the future, thereby potentially increasing the cost of long-term hedge contracts with implications for the costs of electricity to business and individual consumers.

4.8 Any real or perceived increase in risk will be factored in to long-term contracts. The greater the uncertainty of future obligations on producers, the greater the risk margin, which will be built into contracts. Alternatively, businesses will rely more heavily on the spot market with the added uncertainty this will have on their day-to-day business costs.

4.9 Business New Zealand could not, however, approve the government overriding contracts negotiated in good faith between willing parties to allow pass-through of the carbon tax for suppliers who, although they had entered into long-term supply contracts with consumers, will unfortunately be hit by the carbon tax in 2007.

APPENDIX 1

BACKGROUND INFORMATION ON BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 56-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.

The health of the economy also determines the ability of a nation to deliver on the social and environmental outcomes desired by all. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.