Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

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Dear Tax Working Group

Submission to the Tax Working Group on environmental taxes and related matters

Thank you for the opportunity to make this submission on the Future of Tax.

The Royal Forest and Bird Protection Society of New Zealand (Forest & Bird) is New Zealand's largest independent conservation organisation. It is independently funded by private subscription, donations and bequests. Forest & Bird's mission is to protect New Zealand's unique flora and fauna and its habitat. Key matters of concern therefore relate to the protection our unique biodiversity and ecological values, and the sustainable management of New Zealand's natural resources.

The crisis that New Zealand faces from worsening climate change, loss of indigenous biodiversity and freshwater quality, soil erosion, marine habitat destruction and fish stock depletion, etc., is not only a serious issue for our environment, but is also a considerable threat to our primary industries, the wider economy and the future health of our society.

Many of these environmental problems are being driven by long established, unsustainable economic practices that have put little value on recognising the fundamental importance of the natural environment. These practices often encourage the unsustainable use of natural resources for private gain while externalizing the environmental costs of that use.

Forest & Bird is therefore encouraged that the Terms of Reference of the Tax Working Group (TWG) include the consideration of:

- *What role the taxation system can play in delivering positive environmental and ecological outcomes, especially over the longer term.*

The Treasury's recently announced Living Standards Framework focuses on 'investing for wellbeing'. This is based on the recognition that intergenerational wellbeing relies on the growth, distribution, and sustainability of the four capitals: natural, social, human and financial/physical capital. This is an important shift from a traditionally narrow view of our economy, with its focus on the management of financial and physical capital, to a wider view of how the country needs to manage and invest in its four capitals. It is very opportune that this tax review coincides with this shift as it provides an

opportunity to also widen our tax system to better invest in, manage and sustainably grow all four capitals – particularly natural capital on which the other three capitals are dependent.

Forest & Bird supports the use of environmental taxation in combination with regulations. Such taxes have the potential to improve environmental and ecological outcomes while also diversifying the tax base. Environmental taxation and related measures can support a range of policy goals such as:

- Internalising the environmental costs of resource use
- Providing income from the exclusive use of common/public resources
- Creating incentives to alter behavior in favour of environmentally sustainable practices
- Raising revenue for environmental programmes
- Making adjustments at the border
- Diversifying the tax-base

Environmental consumption tax

In 2015 the Environmental Defence Society published a book on the biodiversity crisis facing New Zealand called "Vanishing Nature"[1] . One of the potential responses to the biodiversity crisis that was considered by the authors was the introduction of an environmental consumption tax.

An environmental consumption tax could be an effective way to shift from taxing the production of private wealth, via income, company and capital gains taxes, towards taxing consumption of public wealth. It would push economic growth away from sectors that depend on the depletion of natural capital for commercial viability toward activities that use and grow intellectual and social capital to achieve commercial success.

An environmental consumption tax system could most heavily tax unsustainable natural resource consumption such as intensive landuse, while areas of intact ecological function would entitle landowners to a rebate. The highest per-hectare tax rate would apply to land with impervious built surfaces, with lower tax rates for land retaining greater levels of ecological function. Rebates would be available for areas retaining their natural values through protection and management. In a similar way high tax rates could apply to activities that significantly reduce water quality.

Environmental consumption tax rates should be substantial so that other taxes that are harmful to economic growth can be significantly reduced or eliminated. In this way the private interest in natural resource consumption can be brought towards alignment with the multiple but divergent public interests in economic growth, a fair and internationally competitive tax system and maintenance of biodiversity and ecosystem services.

The strength of an environmental consumption tax is its potential to facilitate long-term economic growth while incentivizing the maintenance of biodiversity and ecosystem services (natural capital), particularly on private land. This system could encourage economic growth by incentivizing investment in businesses that add value from natural, social and intellectual capital (because of lower environmental consumption taxes tied to lower income and company taxes) and by improving the international competitiveness of our tax system.

[1] Brown, M; Stephens, T; Peart, R; Fedder, B; 2015 Vanishing Nature, facing New Zealand's biodiversity crisis. Environmental Defence Society, 196pp.

Environmental consumption taxes could help diversify the economy and reduce our dependence on primary industries that rely on unsustainable intensive land and other natural resource use. It would also have the potential to provide for a more equitable sharing of the tax burden. As the Working Group's background paper indicated, the present proportion of the tax burden carried by wage and salary earners is among the highest in the OECD, while the tax burden on landowners is amongst the lowest.

Taxation and climate change.

Environmental consumption taxes would have the indirect effect of putting a price on greenhouse gas emissions that would complement the Emissions Trading System. Not all economic activities that impact greenhouse gas production will be part of or easily responsive to the ETS. Greenhouse gas emissions are broadly correlated with land-use intensity while carbon storage and sequestration are associated with natural areas and their restoration. Tax rebates could be available to landowners providing carbon storage and sequestration services.

<u>Emissions Trading Scheme reform</u>

The Emissions Trading Scheme needs significant improvement. There is no rational reason for excluding sectors from the ETS as by definition it is a trading system – firms that cannot cost effectively reduce emissions should source cost effective emission reductions through the market. The ETS should operate with greater reliance on auctioning to provide financial flows to the private sector to address the regressive aspects of emissions pricing and to provide funds for investment in the transition to a low carbon future.

Recommended ETS improvements that would increase revenue flows to the Crown and improve the efficiency of the scheme are:

- Immediately increase the price cap (the ability for emitters to pay the Government a fee instead of surrendering carbon units) above $25. With prices for spot NZUs hovering between $21 and $22, we are very close to the point where the cap is suppressing prices. There is also an incentive for entities receiving units (owners of post-89 forests and EITEs - emissions-intensive, trade-exposed industries) to arbitrage, by paying the fee and banking the units. This behavior will effectively transfer emissions liability to the Crown (ie the Crown will have to find emissions reductions to meet New Zealand's international emissions reduction obligations).
- If the price cap is to stay, it needs to be balanced with a price floor, so that the carbon price operates within a band, in much the same way inflation is kept within a band under the Reserve Bank Act.
- Provide long-term certainty of prices by giving information about how that price band will be adjusted up over time. Logically, this would tie in with the carbon budgets to be set by the proposed Climate Change Commission.
- Start phasing out the allocation of free credits to EITEs and make it a requirement that credits given to them under the Industrial Allocation provisions must be surrendered at the next emissions return, ie, close all potential for arbitrage at the expense of taxpayers.
- Make the agricultural sector liable for its emissions, to encourage the most efficient forms of land use and investment. Balance this with the ability for landowners to opt-in to the

scheme as the point of obligation, providing a direct incentive for land-use practices that reduce emissions (e.g. retiring steep country from grazing and allowing carbon-sequestering native forest to regenerate).

- Reviewing the rules about what constitutes a carbon forest to encourage and reward other types of planting that sequester carbon and provide other environment co-benefits (e.g., riparian planting, commercial crops like fruit etc.).
- Review the rules to allow regeneration or vegetation management, such as pest control that sequester carbon and provide other environment co-benefits, to qualify for NZUs.
- In pre-1990 native forests, recognise the additionality of pest control and other management practices that, by increasing plant biomass, increase the amount of carbon being sequestered.
- In light of NIWA's work indicating that native ecosystems might be storing some 50 per cent more carbon than previously thought, the factors used for calculating carbon storage in native forests should be reviewed and adjusted.
- Because of the massive environmental co-benefits of native ecosystems, including improved water quality, reduce soil erosion, increased biodiversity and better resilience to the impacts of climate change, consideration should be given to making credits from native ecosystems of greater value than those from exotic forests.
- Consideration could also be given to recognising emissions reductions through other forms of technologies, e.g. LanzaTech's ability to remove carbon emissions from steel mill stacks, and CarbonScape's Green Coke technology (using current-cycle carbon in the steel-making process instead of fossil carbon). While it could be argued that avoiding carbon costs is an incentive for industrial processors to adapt to this technology, issuing credits for avoided use of fossil carbon would help capital flow into the development of such technologies.

Resource rentals

Resource rentals are a useful way of encouraging efficient uses of public resources, particularly when there is exclusive commercial use of the resource. While theoretically resource rentals and resource trading should have a similar effect in encouraging people to properly value private use of a public resource, in practice trading is likely to increase income and wealth disparities whereas resource rentals will provide a financial flow from private use of the public resource back to the public. This financial flow can then be deployed to address regressive aspects of charging or to recycle revenue into reducing environmental harms.

New Zealand does impose royalties on the extraction of natural resources such as minerals mining, however, it does not do this in any systematic way. The Background Paper notes that an alternative approach to using royalties that usually are set as a percentage of the revenue or profit generated by a miner, is to charge a resource rental which attempts to estimate the "rent" – the profit generated by the resource use over and above a reasonable economic return – and to directly apply a tax to that rent.

<u>Freshwater</u>

An obvious candidate for such a resource rental is the extraction and use of water for commercial gain. At the moment the only costs to those extracting and using water for commercial purposes

that is paid to public agencies is the cost of applying for a resource consent and in some circumstances the costs associated with monitoring the implementation of the consents. The costs of acquiring resource consents are relatively small and will vary little in respect to the amount of water use that is applied for.

Marine fisheries

Marine fisheries could be suitable for a resource rental, but this is complicated by the de-facto privatization of fisheries under the Quota Management System. Considering the use of a resource rental in marine fisheries would likely require a renegotiation of the Treaty of Waitangi fisheries settlement to ensure that Maori rights were protected in any transition. On the flip side, new technology in real-time fisheries monitoring will enable more sophisticated fisheries management including innovative use of incentives and levies.

There is already a Conservation Services Levy where the industry contributes to the cost of managing its environmental impact through the provision of fisheries monitoring.

Border conservation levy

Managing tourism demand

In 2008 New Zealand had approximately 2.5 million overseas visitors, and on present trends this number will have doubled to 5 million per year by 2023. This means that we will see another million visitors in just the next five years. There is every indication that the tourism industry is expecting this exponential growth to continue into the future. However, this rapid increase in demand has caused problems for local services and for the management of the conservation estate. The "volume not value" growth strategy of the tourism industry is threatening to destroy the very basis of the New Zealand 'clean-green un-crowded and natural' tourist product.

To have a manageable impact on controlling international tourism numbers a tourist border levy would need to be reasonably high. Such a border levy could be used to not only control demand, but also to incentivise the tourism industry to provide a tourist product focussed on high-value rather than high-volume. A tourism border levy could be hypothecated to provide a source of revenue that would be invested in conservation outcomes and in providing regional tourism infrastructure.

New Zealand's tourism sector is highly seasonal. Demand peaks during late summer with a second winter spike in demand in ski resort areas such as Queenstown and Wanaka and the central North Island. One consequence of such seasonal demand is that capacity is stretched during peak periods (especially accommodation, but also in high-demand conservation areas). However, because capacity is very under-utilised in off-peak times, there is little incentive for private investment in more peak supply because of the cost of maintaining off-peak supply. This suggests that a tourism border levy could differ by season to encourage greater off-peak visitation.

Funding Predator Free New Zealand.

One of the conservation outcomes a tourism border levy could be directed to is the initial funding of New Zealand's Predator Free goal which is this country's largest long-term conservation program.

Hypothecating environmental taxes and levies

Forest & Bird supports linking the spending of revenue from environmental taxes and levies with fixing the problem for which it has been created. This has two benefits. Firstly, the tax or levy can be adjusted to the scale of the problem it is intended to address and secondly such linking is likely to generate greater public buy-in.

One key risk associated with cost recovery and levies that should be avoided is the possibility that the industry under regulation might end up holding intellectual property in the information required to regulate the industry's activities. This clearly has the potential to distort the information that is made available to the regulator and therefore its ability to manage the activities. This has been a problem with the cost recovery model applied to fisheries.

Land taxes

While the Background Paper identified some advantages of a comprehensive land tax it encouraged submissions on what the appropriate treatment of Maori land might be when that land is a toanga asset. This encouragement recognized the potential difficulties of taxing a cultural 'asset' that its owners would not be intending to generate income from.

The same issue arises for land that is held for environmental and conservation purposes. Would DOC, councils (for their public parks and reserves) and charities such as Forest & Bird (for their nature reserves), or those with QEII covenants be taxed on that land that is being held for conservation purposes and the provision of environmental services to the wider community? One of the perverse outcomes from a comprehensive land tax could be the incentives it would produce to destroy indigenous biodiversity and undermine the provision of other environmental services such as water quality.

Much of New Zealand's historic environmental damage was caused by economic incentives to 'develop' marginally productive land. A comprehensive land tax could generate perverse incentives to repeat this sort of environmental vandalism.

Trade related aspects

Like other aspects of the tax system, environmental taxes could face challenges due to the way the wider global economy is run, as well as facing specific challenges from the countervailing effect of subsidies. The four policy measures that are important to strengthen the durability of environmental taxes are:

- Removing subsidies that contribute to environmental harms that the Government may wish to reduce. This also includes removing hidden or indirect subsidies that are not readily apparent.
- Establishing enforceable 'not-lowering-standards' clauses in trade agreements or similar clauses aimed at reducing the opportunities for investors to shop around for low-standard countries in which to locate production.
- Prevent 'regulatory chill' by exiting from investor-state dispute resolution, especially where it enables legal challenges on indirect expropriation

- Establishing border tax adjustments to equalize the level of environmental tax applying irrespective of where products or services sold in New Zealand are produced

Examples of subsidies applying in New Zealand include:

- Free allocations under the emissions trading scheme, including the current 100% free allocation to the agriculture sector for agricultural gases. There is no economic basis for free allocation to the agriculture sector. Under emissions trading, emission reductions should happen at the locations of least cost, therefore if it is not cost effective for the agriculture sector to reduce its emissions (because of technical barriers for example) the agriculture sector should source lower-cost emission reductions from elsewhere

- Irrigation subsidies, which are being scaled back presently.

- Legislated below-market rentals for Crown pastoral lease and a valuation system that privatises public value in Crown pastoral lease without fair compensation to the Crown through tenure review

- Fossil fuel production subsidies.

Housing affordability – environmental versus tax considerations

New Zealand has a tradition of unimaginatively dealing with a mismatch between supply and demand in markets by increasing supply through policies that ignore environmental limits. One example of this is the constant pressure to relax the protection of environmental limits set under the Resource Management Act. As a consequence New Zealand is approaching and in some cases breaching environmental limits associated with land management (see for example the most recent OECD assessment of New Zealand's environmental performance).

The recent State of the Environment report from Stats and MfE examining the country's use of land recorded a 10% increase in the total size of our towns (between 1996-2016) – much of it on some of our most productive soils. Unfortunately New Zealand has a very poor record of low density housing which makes the supply of associated infrastructure very expensive – both financially and environmentally.

New Zealand needs to consider more creative ways of managing supply and demand, including changing the tax system for housing to limit urban expansion and encourage higher density housing.

Consideration should also be given to the impact of expanding the urban foot print on the ability of people to respond to emissions pricing signals. Excessively dispersed urban form will lead to unavoidable emissions as people are forced to travel longer distances to workplaces and services making it difficult to respond to emissions price increases.

Tax system unintentionally causing environmental harms.

Addressing limitations caused by inelastic demand

Elasticity of demand: when considering the role of environmental taxes it is important to also consider the limitations of taxes in changing behavior where people's circumstances mean that they are not responsive to price. For example, if public transport is unavailable then increasing the price of fuel may not lead to lower use of vehicles as people are constrained by the requirement to reach their workplace or shopping locations. Consideration should be given to complimentary measures that reduce barriers to changing behavior (on-farm advice for example). These measures could include the provision of information and support to change, assisting with capital costs where they act as a barrier to change (e.g. home insulation assistance) or the provision of alternatives (such as public transport).

Dealing with regressive aspects to environmental taxes

Environmental taxes can be regressive in character as costs get distributed through the economy via prices. This means there is a risk that for some taxes those least able to pay may contribute a relatively higher proportion of their income in tax than those on higher incomes. This can be corrected by making the income tax system more strongly progressive.

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