Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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Feedback on Tax Working Group Interim Report

Introduction

Mercury appreciates the opportunity to respond to the Interim Report of the Tax Working Group (the Group). It is evident that the Group has approached its task by prioritising its effort and by obtaining broad based advice.

It is also evident in the approach taken to considering the role the tax system can play in delivering environmental and ecological outcomes that the Group has been mindful of the issues raised in the Mercury submission.

Mercury endorses the established principles of tax policy design

Mercury agrees with the Group that the established tax design principles of efficiency, equity and fairness, revenue integrity, fiscal adequacy, compliance and administration costs, and coherence, remain valid when considering the costs and benefits of tax reform. We commend to the Group an approach where all taxes, including those investigated to address negative environmental externalities and taxing natural resources, are assessed against those principles. We endorse the Group's view that these established principles of tax policy design complement the systems perspective offered by a broader living standards analysis (page 13 of the *Interim Report)*.

Mercury supports the Group's addition of predictability and certainty to the established principles. These additions are especially important when critical economic activities, such as electricity generation, require investors to commit large sums of money to assets which will not return all of that investment for many years or decades. Investors in long-lived assets seek assurance that the rules will not change in ways that are not predictable, otherwise they will require a higher return to reflect that risk (and hence costs to consumers will be higher) or the government may be asked to underwrite some of the risk increasing costs to taxpayers. (Prior to establishing the wholesale electricity market, the taxpayer absorbed cost overruns of hundreds of millions on electricity generation projects such as the Clyde Dam and the Tongariro Power scheme.)

Mercury agrees with the Group that the environmental challenges New Zealand faces mean more profound changes in economic activity will be required and that the transition will take a number of decades. At a conceptual level, we can appreciate how a tax system may in theory contribute to achieving more efficient use of our natural capital. The Group sees potential for taxes to be used as one way of embodying kaitiakitanga into our economic and financial frameworks. If designed well, taxes could advance sustainable development objectives and better societal outcomes as defined by the Treasury's Living Standards Framework. As the *Interim Report* points out, in practice there is much to consider in the design of any such instruments.

It is critical in our view that any proposed environmental taxes be very carefully assessed and tested to ensure the desired outcome is achieved without unintended consequences for the productive sector of the economy or unduly impacting on the equity and other objectives reflected in the established tax design principles.

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Mercury welcomes the discussion on environmental taxation

Mercury welcomes the discussion on environmental and ecological outcomes in Chapter 9 of the *Interim Report*. It was encouraging to see a deliberative approach to water taxes as a possible, medium term endeavour. As the discussion illustrates, the design of an effective environmental tax is a significant technical challenge; it would be easy to do it badly. A comprehensive enquiry is required to assess the practicality and implications of introducing taxes on water pollution or water abstraction. In the case of water abstraction taxes, Mercury would favour market approaches such as water trading over resource rental taxation but we recognise that market approaches rely on a resource management system with different characteristics than what we have currently.

Mercury agrees with the Group's approach to assessing the suitability of taxation as an instrument

We agree with the principles for assessment of suitability of taxation as a policy instrument relative to other instruments:

> Ease of measurement, behavioural responsiveness to price signals, risk tolerance (sufficient time to develop and refine a tax instrument) and the environmental problem is sufficiently large scale to justify administrative costs. In addition, the benefits of environmental taxes would be greater where users have a range of abatement options available.

We would add that any consideration of the behavioural responsiveness to a tax on discharges of contaminants to freshwater or on the use of freshwater would require consideration of several points on the intervention logic:

- Whether imposing a tax would in fact increase the cost of using water and/or discharging contaminants (given regional and seasonal variability in water resources and patterns of water utilisation)
- Whether the increase in price would be significant enough to prompt the desired reduction in discharges or in use (given the elasticities of different types of water use)
- Whether such a reduction in discharge or use would make a material difference to environmental and ecological outcomes
- The costs of compliance and/or incentives to participate in the tax versus seeking alternative means (we note that in the case of water use and discharge there are strong incentives to "cheat" and detection and monitoring can be difficult).

As a principle, the Group has considered the total revenue that may be raised by an environmental tax but has not commented on the potential use of the revenue raised. If the purpose of a tax was to address an environmental externality, such as the discharge of pollutants into a waterway, it would in our view be more appropriate to use any revenue raised to address the environmental effect on that waterway. A similar logic could be applied to the solid waste levies recommended by the Group. Environmental taxes would seem to be a different form of taxation to income taxes and where resource use is being targeted it would seem appropriate that any revenue raised be directed back in some way to the benefit of the natural resource. If treated as consolidated fund revenue it raises all of the issues identified above as being an additional impost on productive sectors.

The Group should explain and clarify the additional design principles

Mercury seeks clarification of the general principles for design for externality and resource use taxes (set out in the lower half of box 9.1 and in box 9.2 of the *Interim Report*). There is potential, in our view, for the additional principles to cause confusion. The Group may have reasons for adopting these additional principles but in our view it hasn't articulated these reasons well.

Specifically, it would be useful for the Group to

- justify the need for an additional set of principles (that is, in addition to the established tax design principles) to apply to taxing negative environmental externalities or resource use
- articulate more clearly how the established design principles (of efficiency, equity and fairness, revenue integrity, fiscal adequacy, compliance and administration costs, coherence, predictability and certainty) can be "built-off" with the addition of other design principles

- clarify how the additional principles relate to the established principles of tax policy design (for example, the principle that the price of the tax should reflect the full cost of externalities is an ‘efficiency’ principle, whereas the principle for local variation is arguably related to equity and compliance/administration costs?)
- consider adding a first-order principle, that the objective of the externality or resource tax should be clear and unambiguous (in terms of the behavioural goal sought for environmental taxes, or in terms of the revenue goals associated with taxes on natural resource use). Such objectives may relate back to the societal outcomes in the Living Standards Framework
- clarify the fourth principle, price should vary locally according to “impacts”. This principle might be clearer if impacts can be expressed in terms of the objectives for tax.

As with all taxes, Mercury is keen to ensure that there is appropriate consideration of unintended consequences in the design of any environmental tax or tax on natural resource use.

As the Group’s discussion of environmental and ecological outcomes illustrates, determining the objective for any environmental tax is key. If the purpose of an environmental tax on water is to manage externalities of land use from the diffuse discharge of contaminants, then this would suggest a targeted approach for that purpose. If, however, the purpose is to create incentives for changes in patterns of water resource use then the approach would be entirely different, as would be its impact in terms of equity and efficiency.

As noted in our earlier submission, learning from international experience suggests it is difficult to design resource rentals or taxes on the abstraction of water in a manner that is fair and does not result in unintended consequences. Consequences of particular concern to Mercury are the propensity for a tax on the non-consumptive use of water (or other renewable energy sources) to act as a distortionary wealth tax on investors due to the privatisation or partial privatisation of most hydro generation assets; it would be counter-productive to New Zealand’s transition to a low carbon economy to penalise investors in renewable generation assets and raise the cost of generating electricity from renewable energy sources. A tax on renewable energy sources would distort the currently well-functioning electricity market, and negatively impact on electricity prices exacerbating the situation for households who are vulnerable. These concerns were outlined in our previous submission.

Given New Zealand’s substantial investment in hydro-electricity, and our country’s reliance on this source of energy, any tax on water should be very carefully considered in light of the impacts on hydro-electricity. Mercury supports recognition by the Group of hydro-electricity’s non-consumptive nature and availability of water downstream for further efficient use. Any government policy setting should recognise the contribution electricity will play in the transition to a zero-carbon economy.

Mercury is expecting the Group to make specific recommendations on some environmental taxes but not others

Mercury is expecting the February Report will make specific recommendations in relation to solid waste discharge levies, the Emissions Trading Scheme and traffic congestion charges. We agree with the conclusions that the Group has reached in respect of the Emissions Trading Scheme.

We understand it is less likely that there will be specific recommendations for taxes on discharges of contaminants to freshwater or on the use of freshwater. We are not expecting any announcements in relation to freshwater taxes because of the high level of uncertainty arising from other government policy work programmes which relate to the resolution of iwi rights and interests and freshwater policy, as well as the significant design considerations that would need to be resolved before advancing potential water tax instruments. If we have misjudged this, and should be expecting announcements on water-related environmental or resource taxes, we would appreciate the opportunity to comment on any such policy proposals.

Mercury would be happy to discuss directly with the Group any aspect of our feedback on the report. Please contact Nick Wilson [1]

Yours sincerely

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