POLICY BRIEF (6.2)

May 2007

Cut damaging subsidies

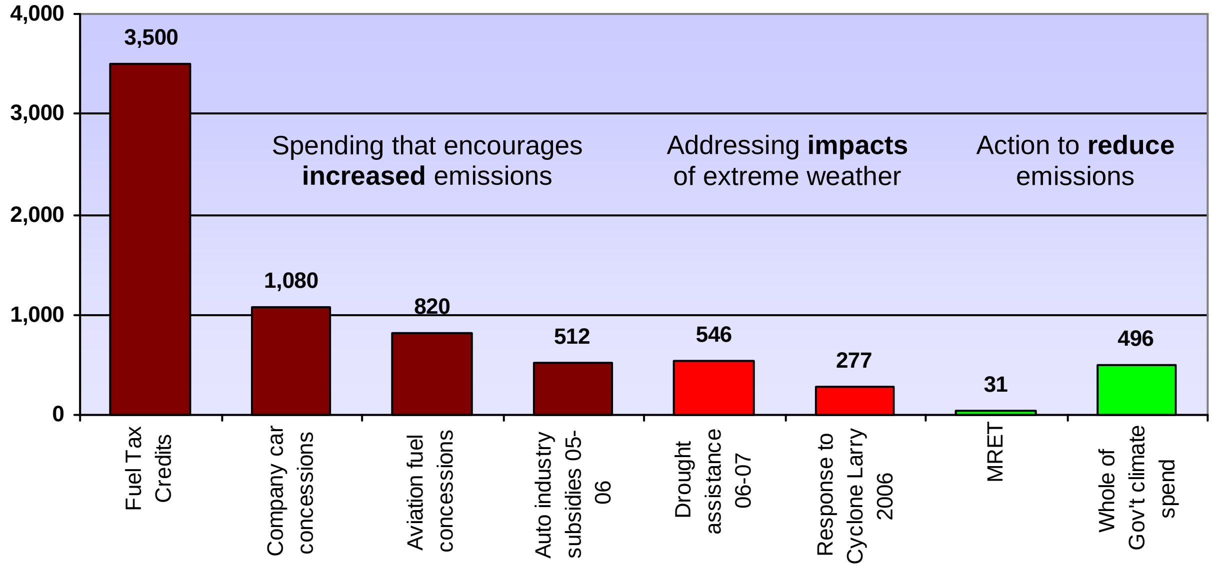
Remove subsidies and incentives for damaging activities under a new wave of national reform, and establish market measures to encourage more sustainable activity.

Rewarding pollution

Every year, the Federal Government spends billions of dollars, directly and by way of tax breaks, to support activities that damage the environment. This distorts behaviour by encouraging excessive energy and fuel use, while discouraging cleaner alternatives. In 2007-08, the whole-of-government budget for climate change initiatives is $496 million (including $80 million in underspend on climate programs carried forward from 2006-07). However, payments or tax incentives that directly subsidise the production or consumption of fossil fuels total at least $6 billion annually.

Increasingly, we're also paying for the damage climate change is already causing. CSIRO predicts climate change in Australia will lead to declining water supplies and more frequent severe weather events. At the Commonwealth level alone, emergency assistance for drought relief reached $546 million in 2006-07, while Cyclone Larry resulted in a further $277 million cost to the Federal Government.

Commonwealth subsidies and climate change expenditure ($million)



In other words, for every dollar committed this year trying to reduce or mitigate climate change, we will spend at least another $12 rewarding the activities that cause the problem in the first place. It's time to stop rewarding pollution and start encouraging efficiency.

Dismantle the 'dirty dozen'
The following twelve policies – the 'dirty dozen' – require immediately policy action. In some cases, these payments are economically, socially and environmentally senseless and should be repealed. In other instances, the legitimate policy goals of the subsidies could be accomplished in other ways that reward efficiency rather than encouraging waste and pollution.

1 **Fuel tax credits** **Annual cost: $3,500+ million**
The Fuel Tax Credits program, which replaced the Energy Grants (Credits) Scheme in 2006, offers rebates on the use of diesel and some other fuels for qualifying road transport and most off-road uses (such as energy generation and mining). Environmental conditions for receipt of credits are minimal for large beneficiaries and non-existent for those receiving less than $3 million in credits per year. While the scheme includes some clean alternative fuels, 99 per cent of credits in 2004 were for diesel, a fuel which releases more greenhouse gases per litre than petrol. Although often pitched as a benefit for farmers, in fact more than half of the funds have gone to the mining and transport industries, not agriculture. Use of diesel should be fully taxed in line with other fuels. Where sector-specific incentives are considered desirable, they should be tightly targeted and decoupled from fossil fuel use.
Costs: 2006-07 Budget, ATO Agency Budget Statement. Fuels and beneficiary data: Auditor-General Report, Australian Taxation Office's Management of the Energy Grants (Credits) Scheme (2004).

2 **Tax concessions for private use of company cars** **Annual cost: $1,080 million**
It is difficult to image a better example of policy dysfunction than the fringe benefits tax concession for private use of company cars. In addition to subsidising the use of motor vehicles by mostly affluent individuals, the rate of the concession actually increases the more kilometres one clocks up each year. This leads to the infamous 'March Rally', where corporate executives take long road trips to reach the next concession bracket. The concessions contribute to increased greenhouse gas pollution and runaway urban traffic congestion. Similar tax benefits are not available for use of public transport or active transport options, such as bicycles. ACOSS, the Institute of Chartered Accountants, Insurance Australia Group and several Parliamentary inquiries have all advocated the repeal of this absurd tax break.
Costs: Tax Expenditures Statement 2006.

3 **Reduced excise for aviation fuels** **Annual cost: $820 million**
Domestic air transport is three to five times as energy-intensive as other forms of intercity transport, such as rail, bus or multi-passenger vehicle. Yet while petrol attracts excise of about 38 cents per litre, aviation fuels are taxed at just over 3 cents per litre. This distorts travel patterns towards polluting air travel and away from more efficient alternatives. Aviation fuels should be taxed at the same rate as petrol.
Costs: Tax Expenditures Statement 2006.

4 **Automobile manufacturing subsidies** **Annual cost: $512 million (2005-06)**
The Federal Government has committed $4.2 billion to the Australian car manufacturing industry over ten years through the Automotive Competitiveness and Investment Scheme (ACIS). Additional one-off payments are made to specific manufacturers periodically, such as a $32.5 million grant to Ford in 2006. A small portion of funding is targeted towards efficiency improvements, but most ACIS payments are simply handouts, and our manufacturers continue to focus on environmentally and economically uncompetitive large models. ACIS payments should be tied to specific environmental improvements.
Costs: Productivity Commission, Trade & Assistance Review, 2005-06.

5 **Exemption from petroleum excise for condensate** **Annual cost: $250 million**

Condensate (liquid hydrocarbons used in the production of petrol and other fuels) that is produced separately from crude oil is exempt from petroleum excise. This exemption was created in 1977, specifically as an incentive to develop the North West Shelf and Cooper Basin gas fields. This subsidy for production of polluting fuels should be repealed.

Costs: Tax Expenditures Statement 2006.

6 **Lower import tariffs for 4WDs and aircraft** **Annual cost: $180+ million**

Most passenger vehicles imported into Australia attract a 10 per cent import duty, but highly polluting four wheel drives are assessed at only 5 per cent. Duties on all imported vehicles are to be equalised in 2010 at 5 per cent, but until then we will continue to reward inefficient vehicles. Equally perverse is the blanket exemption from import duties for aircraft – among the least efficient modes of travel. Import tariffs should be restructured to encourage efficient vehicles.

Costs: Based on one-half of estimated 2003 cost of $360m, when 15 per cent rate applied to passenger vehicles (Michael Priestly, Parliamentary Library Research Note, "The 5 Per Cent Tariff on Four-Wheel-Drive Vehicles").

7 **Enhanced Project By-law Scheme (EPBS)** **Annual cost: up to $50 million**

The EPBS is a program offering tariff concessions on imported capital equipment for qualifying major developments. The benefits are not tied to efficiency improvements and in practice heavily polluting industries such as aluminium have been among the biggest beneficiaries. In 2006, the scheme was extended to cover the pollution-intensive energy generation sector, with no environmental conditions attached. This scheme should be completely overhauled so tariff benefits are tied to environmental gains.

Costs: AusIndustry, media releases 7/8/2002 and 9/5/2006.

8 **Tax concessions for car parking** **Annual cost: $42+ million**

Car parking benefits provided by an employer are not taxed at the full fringe benefits tax rate and for some employers (such as small businesses and charities) parking benefits are entirely exempt from tax. Again, these tax breaks are not available for more sustainable methods of transport, such as public transport or bicycles. The tax concessions should be repealed for all but a few categories of genuine justification, such as disabled parking.

Costs: Tax Expenditures Statement 2006.

9 **Discounted tax value for stand-by air travel** **Annual cost: $20 million**

Employees of the airline and travel industries are not required to cost fully the value of stand-by flight benefits for fringe benefits tax purposes. This skews travel choices towards energy- and pollution-intensive air travel options. The concession should be repealed.

Costs: Tax Expenditures Statement 2006.

10 **Tax exemption for taxi travel to and from work** **Annual cost: $10+ million**

Travel by taxi to and from work that is payed for by an employer is entirely exempt from fringe benefits tax. Similar exemptions are not available for employer provision of public transport or active transport packages. This exemption distorts travel choices towards options that add to pollution and traffic congestion. The exemption should be repealed.

Costs: Tax Expenditures Statement 2006.

11 **150 per cent deduction for petroleum exploration** **Annual cost: $1-10 million**

To encourage development of new petroleum fields, the Federal Government allows a deduction of 150 per cent of certain exploration expenses. Similarly generous deductions are not available for development of clean energy sources or energy efficiency. This supports

the short-sighted view that the solution to our energy problems is more exploration, rather than reducing use and encouraging alternatives. The tax break should be repealed.
Costs: Tax Expenditures Statement 2006.

12 **Negative tax treatment of efficiency improvements** **Annual cost: n/a**
Several features of the taxation system discourage investment in energy and resource efficiency. For example, if a business installs an air conditioner, the installation attracts accelerated depreciation as machinery, whereas improvements to premises such as double glazing receive the lower depreciation rate for capital expenditure. The rules for depreciation and deductions for maintenance, plant and premises improvements should be realigned to promote environmentally sound choices.

Reaping the double dividend of environmental tax reform
Australia needs to shift to a system of taxation that systematically encourages job creation and protection of the environment and discourages consumption of scarce resources and generation of waste. A growing body of economic evidence suggests such a process of environmental tax reform can pay a 'double dividend'. Lowering taxes on work creates more jobs. Increasing taxes on pollution and waste helps protect the environment and conserve scarce resources. David Gee, of the European Environment Agency, has set out the goal of environmental tax reform as follows:

> *"Ecological tax reform involves shifting a large proportion of taxation off the value-adding activities of people (employment, enterprise and investment) and onto the value-subtracting use of energy and resources and associated creation of wastes and pollution."*

Environmental taxation thus ensures activities are priced at a level that fully takes into account the those activities' real societal and environmental costs. The purpose is not to punish, but to create proper incentives to minimise environmental damage. Most European nations have undertaken some degree of environmental taxation reform. Notably, Germany initiated a reform process in 1999 that increased fuel taxation, with the revenues being directed to employee pension contributions. The result: lower labour costs that offset the higher energy costs.

A 2005 study by Ecologic and the highly-regarded German Institute for Economic Research[1] concluded that, over seven years, the environmental tax reform package reduced greenhouse gas emissions by 2.6 per cent, increased employment by 0.5 per cent and increased Germany's GDP by 0.3 per cent over the business-as-usual baseline. Far from damaging the economy, the shift to environmental taxation stimulated economic development.

Australia should develop and implement a comprehensive package of environmental tax reforms, including increased pricing of pollution, waste and resource consumption, with corresponding reductions in taxation of labour, productivity and savings.

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[1] Report available (in German only) at http://www.diw.de/deutsch/dasinstitut/abteilungen/stt/projekte/projekt_oekologische-steuerreform.html