

Reference: 20150090

22 April 2015



Thank you for your Official Information Act request, received on 24 March 2015. You requested the following:

“What work, if any, has the Treasury done on a possible carbon tax? Can you please provide all papers, memos, emails, and advice that Treasury has done as background work on a carbon tax for New Zealand and any work done on the Green Party’s proposal for a carbon tax.”

On March 31, a Treasury official contacted you to further clarify the scope of the request. You confirmed that the revised scope was to include the following:

“All papers, memos, emails and advice that Treasury has done as background work on a carbon tax for New Zealand and any work done on the Green Party’s proposal for a carbon tax, since 1 January 2014”

Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	18 June 2014	FEC Briefing: Climate Change Issues	Release in part
2.	3 July 2014	Emissions Trading Versus Carbon Taxes: Refreshing Treasury’s View	Release in full

I have decided to release the relevant parts of the documents listed above.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Melody Guy
Manager, Natural Resources

Information Being Released

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Climate Change Issues: FEC –18 June 2014

[Information not within scope]

- Treasury does not support the Green Party proposal to replace the Emissions Trading Scheme with a **\$25 carbon tax**. If Ministers want to further reduce emissions, we would recommend increasing prices in the ETS by introducing a price floor, removing the two-for-one rule, or reducing free allocations.

[Information not within scope]

Carbon Tax

- **Treasury does not support replacing the ETS with a carbon tax.** We think the ETS is preferable to a carbon tax, because it can provide certainty about the level of domestic emissions. This fits well with our international obligations, which set a limit on total emissions. Emissions trading schemes are also easier to link with other countries, which helps ensure that the lowest cost abatement opportunities are taken between countries.
- **If further emissions reductions are needed, we recommend increasing prices in the ETS** by introducing a price floor, removing the two-for-one rule for emitters, or reducing free allocations.

[Information not within scope]

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Emissions Trading versus Carbon Taxes: Refreshing Treasury's View

Context

Public debate about the merits of carbon taxes compared to emissions trading schemes has reopened in 2014. This renewed discussion has been prompted by low carbon prices in the New Zealand Emissions Trading Scheme (ETS), and concerns around arbitrage opportunities in the scheme. This is therefore a good time to refresh Treasury's view on the relative merits carbon taxes and emissions trading schemes.

Previous Treasury position

Treasury supported the introduction of an ETS over a carbon tax when the scheme was introduced in 2007. Treasury Secretary John Whitehead noted at the time that an ETS was chosen because trading schemes are "*more flexible than a tax*", and are "*becoming the norm internationally*". He also noted that government consultation had demonstrated wide support for the trading scheme.¹

Relative merits of carbon taxes and emissions trading

Pricing Emissions

Carbon taxes and trading schemes both place a price on emissions, incentivising firms to reduce their emissions until any further abatement would cost more than the emissions price. Carbon taxes and trading schemes both deliver the same amount of emissions reductions at a given carbon price, and therefore have the same effect on firms' abatement levels and costs for a particular price.

Certainty

The main difference between the two approaches is that carbon taxes provide certainty about the price but leave total emissions uncertain, while trading schemes allow the price to adjust to deliver a certain level of total abatement.

We think that certainty about total abatement levels is more important than price certainty, because our international obligations require us to achieve specific amounts of emissions reductions. ETS's are well-placed to achieve these quantitative targets.

Conversely, using carbon taxes to meet international targets leads to fiscal risks. If the tax is set too low to achieve a target, the Government needs to purchase extra international units to meet our obligations. On the other hand, setting the tax higher than necessary to meet our target generates additional Government revenue, but also imposes unnecessary costs on firms. In general, it would be more efficient to generate this additional revenue through broad based corporate or personal taxes.

For individual firms however, the price certainty under a carbon tax has benefits. It allows investment decisions to be made without the risks and information costs associated with predicting future prices in an ETS.

¹ <http://www.treasury.govt.nz/publications/media-speeches/speeches/emissionstrading>

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Emissions trading schemes can also offer a mix of certainty over price and quantity, through the use of price caps and floors. Trading schemes therefore allow a choice across the spectrum from certain abatement to certain prices.

Linking with other countries

Emissions trading schemes can be easily linked internationally, giving access to cheaper abatement opportunities overseas. This allows the market to find the lowest cost mix of domestic and international abatement to achieve an abatement target. This is particularly important for New Zealand, given that we have limited low-cost domestic abatement opportunities.

It could also be possible to allow international units to be used as a deduction in a carbon tax regime. However, this would lead two potential outcomes, neither of which have significant benefits. If international units were cheaper than the carbon tax, all firms would buy units instead of paying the tax. This would deliver more units than are needed for our international target, resulting in an unnecessary transfer to other countries. Conversely, if international units are more expensive than the carbon tax, none of the units would be used.

Carbon taxes could also be harmonised with other jurisdictions, to ensure equality of marginal abatement costs across countries. This would be difficult though, as each country would need to agree on and apply any changes to the tax rate at the same time. Harmonised tax rates would also not help New Zealand meet international targets, as it would not facilitate the purchase of overseas units.

Transition costs and Implementation

There would be transition costs from switching from our current ETS to a carbon tax, although a carbon tax would have lower administration costs over the long term. Implementing a carbon tax would not be particularly difficult, given that systems are already in place to account for emissions across most industries in New Zealand.

Fiscal and distributional impacts

The fiscal and distributional impacts are broadly similar under both policies. An ETS should generate the same amount of revenue as a carbon tax for a given carbon price, presuming that all units are auctioned at market value. Distributional choices can also be made under each policy, as sectors can be protected by free allocations in an ETS, or by tax exemptions in a carbon tax.

Tax exemptions could be set up in the same way as free allocations are in an ETS, with the exemption only covering emissions up to a given level, to maintain incentives for reducing emissions at the margin.

One issue that emerged in the ETS was arbitrage caused by the difference between the prices of domestic and international units. This issue should be avoidable in the future. As long as any domestic units given freely by the Government have the same eligibility criteria as international units, their price should remain equal.

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Conclusion

Carbon taxes and emissions trading schemes have many similarities, and can both achieve a given amount of abatement at the lowest potential cost. However, trading schemes have a number of benefits over taxes, particularly for New Zealand. An ETS is well placed to deliver the specific quantities of abatement that New Zealand will probably have to meet under future international targets. The ability to link an ETS internationally is also important, given the limited amount of cheap abatement opportunities available domestically

We therefore conclude that an Emissions Trading Scheme is the most appropriate way to meet New Zealand's climate change obligations.

This conclusion would need to be revisited if there was a significant change in the structure of international action on climate change, and binding quantitative emissions targets were no longer the norm.

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