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Excise Tariff Amendment Bill (No. 1) 2003

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Excise Tariff Amendment Bill (No. 1) 2003

Richard Webb
Economics, Commerce and industrial Relations Group
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Contents

Excise Tariff Amendment Bill (No. 1) 2003

Date Introduced: 29 May 2003

House: House of Representatives

Portfolio: Treasury

Commencement: 18 September 2002

Purpose

To impose excise duty on fuel ethanol at the same rate as the excise on petrol and diesel.

Background

The Bill imposes excise on fuel ethanol—that is, ethanol blended with petrol—at the same rate as the excise on petrol, now 38.143 cents a litre. This is the latest in a series of measures relating to the provision of assistance to the production of ethanol. Issues surrounding ethanol are canvassed in a Department of the Parliamentary Library publication titled Fuel Ethanol—Background and Policy Issues.[1]

Ethanol Needs Assistance to Compete with Petrol

The main problem that fuel ethanol faces is that it costs more to produce than petrol. Ethanol costs around 70 cents a litre compared with around 35 cents (or less) per litre for petrol (depending on world crude oil prices). Consequently, the production of ethanol requires government assistance to compete with petrol. This is true even in the large producers such as Brazil and the United States.

Forms of Assistance

Assistance has taken three main forms:

- zero rate of excise

- bounty payments to producers, and
- excise on ethanol offset by an equivalent subsidy.

Zero-rating (often referred to as exemption) has been the main form of assistance. Zero-rating of ethanol and other 'alternative' fuels—that is, alternative to petrol and diesel—was implemented for fuel security and diversity reasons. In particular, the aim was to reduce dependence on petroleum products.

The Keating Government introduced the bounty, which was additional to the excise exemption. The Howard Government abolished the bounty on the basis of a report that recommended that the bounty cease. The Report concluded among other things that:

> While the Scheme has initiated new production, distribution and use of fuel ethanol, an economically viable industry … has not been developed.[2]

On 12 September 2002, the Government announced that it would impose excise on fuel ethanol. The rate on the ethanol component would be the same as that on unleaded petrol, namely, 38.143 cents per litre, with effect from 18 September 2002 until 17 September 2003. At the same time, the Government introduced a production subsidy of 38.143 cents per litre. The subsidy thus offsets the excise. The excise on fuel ethanol was implemented by Excise Tariff Proposal No.4 (2002). The Excise Tariff Amendment Bill (No. 1) 2003 would give legislative authority to this Tariff Proposal.

The Government also imposed customs duty on imports of 38.143 cents per litre. This, together with the production subsidy that offsets excise, has the effect of protecting the domestic ethanol industry from imports. An importer reportedly incurred a loss of $600 000 as a result of this measure.[3]

Is Assistance Justified?

Given that the production of fuel ethanol is commercially unviable without assistance, the question arises whether assistance is justified.

Three main arguments have been advanced in favour of assistance. They are:

- ethanol's environmental and other benefits
- regional development, and
- fuel security and diversity.

Environment

Environmental benefits claimed for ethanol compared with petrol include:

- ethanol is produced from agricultural crops and so is 'renewable' whereas petrol is produced from crude oil, a non-renewable resource
- harmful emissions (carbon monoxide, hydrocarbons, 1-3 butadiene, benzene, toluene and xylenes) are reduced
- reduced fuel lifecycle emissions of greenhouse gases, and
- ethanol can substitute for methyl tertiary butyl ether, a fuel additive, that can contaminate water supplies.

On the other hand, using fuel ethanol has environmental disadvantages including:

- some harmful emissions [adelahydes (formaldehyde and acrolein) and particularly acetaldehydes] are generated, and
- ethanol has an affinity for water. In certain circumstances, this can lead to vehicle driveability problems and potential engine damage.

Fuel ethanol has other disadvantages:

- some blends are unsuitable for non-automotive use such as aviation, boats, and a range of hand-held devices and lawnmowers
- blends of 20 per cent ethanol are not suitable for some older cars, and
- the use of fuel ethanol results in a loss of fuel economy because ethanol has an energy content about two-thirds that of petrol. The higher the proportion of ethanol in the blend, the greater the loss (a 10 per cent ethanol blend results in a loss of fuel consumption of around three per cent).

This raises the question: do the environmental benefits of fuel ethanol justify assistance?

The Bureau of Transport and Regional Economics, in a report titled Greenhouse Policy Options for Transport published in May 2002—that is, before the Government ended the excise exemption—found:

> The subsidy inherent in the excise exemption of alternative fuels [such as ethanol] probably exceeds the environmental benefits it is meant to target. As the [Bureau of Transport and Communications Economics] observed:
>
> > On the basis of the limited emissions costing available, it appears unlikely that the environmental benefits from most alternative fuels are as large as the existing 'subsidy' they now receive.[4]

The review of the bounty noted above also cast doubt on whether the environmental benefits justify assistance:

> Current production and use of fuel ethanol is not cost effective in reducing emissions of greenhouse gas and environmental air pollutants. There are both positive and negative identifiable pollution outcomes. The evidence, although extensive and complex, is also ambiguous and often contradictory. Under current use and circumstances it is difficult to conclude that there are net benefits from displacing petrol with fuel ethanol.[5]

Regional Development

It has been argued that assisting production of fuel ethanol benefits regional areas including through flow-through effects to input producers.

It is important to distinguish between 'redistributed' economic activity and social benefits resulting from that activity. The level of production of ethanol and employment in regional areas depends on government assistance, that is, activity in ethanol production is largely a consequence of the transfer of income from taxpayers to ethanol producers by means of assistance. In assessing the consequences of its recommendation that fuel ethanol should be subject to excise, the Fuel Taxation Inquiry noted:

> The extent of these impacts is difficult to assess. For some sectors, such as ethanol and biodiesel, where the industries are at an early stage of development, the imposition of excise will affect their future viability, even though it was based on an artificial tax advantage.[6]

A study for the Australian Bureau of Agricultural and Resource Economics of the commercial viability of increasing production of ethanol by the Australian sugar industry concluded:

> It is also clear that commercial viability of both existing and expanded fuel ethanol production is dependent on significant levels of government intervention, including features such as the following:
>
> Continued availability of full exemption from fuel excise (or an equivalent rebate);
>
> Other financial or other assistance that the government may provide from time to time to investment in a fuel ethanol industry (for example, under G[reenhouse] G[as] A[batement] P[rogramme] and other existing or new programs).[7]

This raises the question of whether the benefits of assistance to regional areas are justified. The Fuel Taxation Inquiry noted:

> … no analysis has been undertaken to establish the benefits to rural and regional areas of the tax concessions and whether they could be achieved at lower cost by other means.[8]

Sugar

It has been argued that assistance to ethanol should be increased to help the sugar industry. In particular, a mandated level of ethanol in fuel ethanol has been proposed. However, a Treasury study concluded:

> The only effect on sugar farmers would be that exports would be displaced. The price received for sugar would remain the same and, overall, sugar farmers would be no better off.[9]

Fuel Security

As noted, the Government originally introduced the zero-rating of excise for fuel security and diversity reasons.

Alternative fuels generally and fuel ethanol in particular contribute little to reducing reliance on petroleum products. Ethanol use is equivalent to 0.19 per cent of petrol and diesel use, 0.33 per cent of petrol use, and 1.5 per cent of petrol use in greater Sydney, the main market.

The Fuel Taxation Inquiry questioned the effectiveness of assistance in achieving fuel security:

> Despite the use of taxation concessions to encourage the use of petroleum substitutes over the past 20 years, the energy inefficiency, inconvenience and lack of access to those fuels has restricted their use to a small proportion of transport fuel. This is not expected to change over the next 20 years, by which time a new generation of engine technology, replacing both petroleum products and their substitutes may have emerged.[10]

To increase fuel ethanol's market share, it would necessary to increase assistance. A constraint would be the cost to the Budget.

Resource Allocation

Assistance to fuel ethanol may be a misallocation of resources. Resources such as land, labour and capital are said to be allocated 'efficiently' when they are used to produce the goods and services that consumers want most and are employed in the most productive industries. Industry assistance can 'distort' the efficient allocation of resources by interfering with decisions as to which goods and services to buy and which industries to invest in. The Fuel Taxation Inquiry concluded that:

> … the use of fuel taxation concessions to encourage the production and use of alternative fuels has significant resource allocation effects that can no longer be justified.[11]

Recent Policy Decisions

Content Cap and Labelling

In April 2003, the Government announced that it would set a 10 per cent limit on the proportion of ethanol in blended fuels and amend the *Fuel Quality Standards Act 2000* to require labelling of the ethanol content of blends.[12]

These decisions were in response to claims—many exaggerated and ill-informed—about the alleged damage to car engines caused by high levels of ethanol in blended fuel. These claims led to a fall in consumer confidence over the use of fuel ethanol and so damaged the industry. Labelling should help restore confidence to consumers. On the other hand, the cap will reduce the demand for ethanol as some fuels sold contain more than 10 per cent ethanol.

Budget Proposals

In the 2003–04 Budget, the Government announced that it proposes to extend until 30 June 2008 the existing arrangements—that is, excise plus equivalent subsidy—for ethanol (these arrangements are due to expire on 18 September 2003). The cost of the subsidy is estimated at $27 million in 2003–04, $45 million in 2004–05, $61 million in 2005–06, and $62 million in 2006–07.[13] On 1 July 2008, ethanol will be subject to a new rate of excise. This rate will based on ethanol's energy content relative to a fuel such as diesel or petrol. The new rate is yet to be determined. The new rate will be phased in. Grants will be paid to importers and producers that reduce the 'effective' rate of excise—that is, excise less the grant—below the new rate. The grants will be reduced in five equal annual instalments from 1 July 2008 to 1 July 2012, when the new rate will apply.

If implemented, these proposals would result in the withdrawal of assistance, resulting in a contraction of the ethanol industry.

Views of Interested Parties

The Manildra Group is the largest ethanol producer. Manildra manufactures ethanol from wheat waste at Nowra in New South Wales. As a beneficiary of existing arrangements, Manildra naturally supports them.[14]

The Australian Democrats welcomed the Government's decision to rebate the excise on domestically produced ethanol because of the benefit to local industry and the environment. The Democrats also advocate mandating the use of ethanol in petrol.[15] The ALP Shadow Minister for Regional Development, Transport and Infrastructure, Mr Martin Ferguson, criticised the Governments' support of the ethanol industry on the grounds that:

> Only the ethanol industry stands to gain from ethanol in fuel, not the consumer or fuel companies. The ethanol industry is primarily comprised of Dick Honan, great friend and donor to the Coalition parties. It is expected that the ethanol excise rebate will

> continue for another five years and give Mr Honan and the few other ethanol industry players another five years of special treatment.[16]

Main Provisions

The Bill amends the Excise Tariff Act 1921 notably section 6G. This section deals with how the duty payable on excisable blended petroleum products (such as fuel ethanol) is determined. The Schedule to the Act contains definitions of goods and the rates of duty that apply to them. The references to item 11 of the Schedule to the Act relate to the imposition of excise on petrol, diesel and other fuels, while item 12 of the Schedule relates to excisable blended petroleum products. The reference to goods with a lead content not exceeding 13 milligrams per litre is, as a practical matter, to so-called 'unleaded' petrol. 'Denatured' ethanol is ethanol rendered unfit for human consumption.

Item 2 of **Schedule 1** repeals subsection 6G(2) and inserts a **new subsection 6G(2)**. This provides that the duty payable on a blended product is worked out on the basis of a formula if:

- the fuel the ethanol is blended with is classified to item 11 or 12 of the Schedule to the *Excise Tariff Act 1921* [**paragraph (2)**]
- the fuel the ethanol is blended with is used in internal combustion engines but not aircraft engines [**subparagraph (2)(a)(i)**]
- the fuel that the ethanol is blended with has a low lead content (less than 13 milligrams per litre, for example, unleaded petrol) [**subparagraph (2)(a)(ii)**] and
- the blend includes denatured ethanol as set out in item 11 of the Schedule to the *Excise Tariff Act 1921*.

In such a case, the amount of excise payable is the volume of ethanol multiplied by the blending rate less previously paid duties. For example, if the volume of ethanol were, say, 10 litres and 90 litres of petrol, the amount of duty payable would be 100 times 38.143 cents less previously paid duties [**paragraph (2)(b)**]. The insertion of previously paid duties is necessary to avoid double payment of duty. If, for example, duty has already been paid on unleaded petrol but is subsequently blended with ethanol, imposing excise on the blended fuel would result in the double payment of excise on the unleaded petrol component of the blend.

Comparable provisions are contained in the Customs Tariff Amendment Bill (No. 2) 2003.

Concluding Comments

The main function of assistance to ethanol production—of which this Bill is an integral component—seems to be to transfer income to regional and rural Australia. Indeed, the industry's existence is based on 'an artificial tax advantage'. There seems to be little justification for continuing assistance. As judged by the Fuel Taxation Inquiry and others, the environmental and other benefits of alternative fuels including ethanol are not so great as to justify their continued subsidisation. Moreover, assistance has done little to achieve fuel security or diversity away from petroleum products, the original justification for subsidising ethanol.

Endnotes

1 *Fuel Taxation Inquiry Report*, March 2002.

2 Department of Primary Industries and Energy, *Portfolio Evaluation for the Ethanol Bounty Scheme*, Canberra, August 1996, p. 1–6.

3 J. Koutsoukis and I. Howarth, 'The ethanol dream runs on empty', *Australian Financial Review*, 3 June 2003, p. 61.

4 Bureau of Transport and Regional Economics, *Greenhouse Policy Options for Transport,* Report 105, 2002, p. 87. The reference in the quotation is to: Bureau of Transport and Communications Economics, *Alternative Fuels in Australian Transport*, Information Paper 39, AGPS, 1994, p. 213.

5 Department of Primary Industries and Energy, *Portfolio Evaluation for the Ethanol Bounty Scheme*, Canberra, August 1996.

6 *Fuel Taxation Inquiry Report*, op. cit., p. 22.

7 B. Naughten, *Viability of Sugar Cane Based Fuel Ethanol*, Australian Bureau of Agriculture and Resource Economics Report to the Department of Agriculture, Forestry and Fisheries, Canberra , October 2001, p. 34 at: http://www.affa.gov.au/content/output.cfm?ObjectID=C966A946-0DB8-4BD3-9EE73220FF10D630

8 *Fuel Taxation Inquiry Report*, op. cit., p. 17.

9 J. Koutsoukis and I. Howarth, op. cit.

10 *Fuel Taxation Inquiry Report*, op. cit., pp.42-43.

11 ibid.

12 Hon Dr David Kemp, Minister for the Environment and Heritage, 'Federal Government to Set 10 Per Cent Limit', media release, K0076, 11 April; 2003 at

13 Sources: Budget Strategy and Outlook 2003–04, Budget Paper No. 1, pp. 1-23 and 1-24; Budget measures 2003–04, Budget paper No. 2, pp. 40-42 and 222-224; Hon. Peter Costello, treasurer, 'Fuel Tax Reform for the Future', press release 31, 13 May 2003; Hon. Peter Costello and Hon. Dr David Kemp, Minister for the Environment and Heritage, 'Incentives to Promote Cleaner Fuels', press release 30, 13 May 2003; and Hon. Dr David Kemp, 'New Package to Support Uptake of Biofuels', media release KB11, 13 May 2003.

14 J. Koutsoukis and I. Howarth, op. cit.

15 For example, the Democrats advocate that fuel ethanol should have an ethanol content of two per cent by 2008. Senator Lyn Allison, 'Welcome boost for Ethanol', press release, 12 September 2002.

16 Mr M. Ferguson, 'Anderson Goes the Full Monty For Ethanol Mates', media statement, 11 May 2003.