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CARBON TAX PROPOSAL – POSSIBLE SOLUTION TO MULTIPLE PROBLEMS?[1][2][3][4][5]

INTRODUCTION

The Ministry of Finance is promoting the introduction of a carbon tax as a means of both facilitating a move away from Indonesia's over-reliance upon fossil fuels and raising much needed additional Government revenue.

The proposed carbon tax is to be part of a larger group of amendments to the tax law intended to place the Government in a stronger financial position as it seeks to deal with the Covid-19 pandemic and the ongoing economic, medical and social crises facing Indonesia.

Various industry groups have advocated delaying the introduction of a carbon tax for several years and until the Indonesian people are better placed to bear the increased costs that are claimed will inevitably flow from a carbon tax.

In this article, the writer will review the carbon tax proposal and its prospects for success against the backdrop of reduced living standards for many Indonesians and possible growing opposition to economic reform.

BACKGROUND

In May 2021, the Fiscal Policy Agency of the Ministry of Finance ("**MoF**") issued a document entitled "*Macro Economics Framework and General Fiscal Policies for the Year 2022: Economic Recovery and Structural Reform*" ("**2022 Macro Economics Framework and General Fiscal Policies**").

The 2022 Macro Economics Framework and General Fiscal Policies outline, for discussion and planning purposes, various fiscal proposals advocated by MoF as a response to the Covid-19 pandemic. One of these fiscal proposals is that Indonesia introduces a "*non-market based carbon pricing instrument in the form of a levy on carbon*" ("**Carbon Tax**"). The proposal for a Carbon Tax is dealt with in Section VIII.3 of the 2022 Macro Economics Framework and General Fiscal Policies.

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[5] An earlier version of this article appeared in the July – August 2021 edition of Coal Asia Magazine.

The 2022 Macro Economics Framework and General Fiscal Policies highlight that a Carbon Tax can be imposed on emissions produced by economic activities (**i.e.**, supply-side approach) or on emission source objects/products (**i.e.**, demand-side approach). Countries such Japan, Singapore, France and Chile adopt the supply-side approach and impose a Carbon Tax on emissions generated by the use of fossil fuels, with the rate ranging from USD3 to USD49 per ton of CO_2e. This supply-side approach, to the imposition of a Carbon Tax, typically has the greatest effect on **heavy industry**, **power generation**, transportation and buildings. Other countries impose a Carbon Tax on the use of fossil fuels being, primarily, coal, diesel and gasoline. This demand-side approach, to the imposition of a Carbon Tax, typically has the greatest effect on the buyers/users of products produced by carbon-intensive sectors such as the **pulp and paper industry, the cement industry, power generation and petrochemicals**.

The 2022 Macro Economics Framework and General Fiscal Policies go on to outline two main claimed benefits, for Indonesia, from the introduction of a Carbon Tax. First, the reduction of greenhouse gas emissions through reduced or more efficient fossil fuel use. Second, the utilization of the revenue raised from a Carbon Tax to fund environmentally friendly investments and improve the welfare of Indonesia's poor and vulnerable. MoF acknowledges that the introduction of a Carbon Tax will, directly or indirectly, result in additional costs for some parties. With this in mind, MoF suggests that any introduction of a Carbon Tax in Indonesia requires accompanying policies in the form of strengthening people's purchasing power so as to reduce opposition to the Carbon Tax and deal with "*unexpected impacts*" of the Carbon Tax.

Finally, the 2022 Macro Economics Framework and General Fiscal Policies explain the two strategies available to Indonesia in introducing a Carbon Tax. The first alternative is to use existing tax instruments at (i) the Central Government level such as excise tax, PPh, PPN, PPnBM or PNBP and/or (ii) at the Regional Government level such as motor vehicle tax and motor vehicle fuel tax, to incorporate a Carbon Tax element. The second alternative is to introduce a standalone and entirely new Carbon Tax instrument, which alternative would require the amendment to Law No. 6 of 1983 re General Provisions and Procedures in respect of Tax ("**1983 Tax Law**").

MoF clearly favours the second alternative; namely, a standalone and entirely new Carbon Tax instrument. However, the reasons for MoF's preference are not made clear in the 2022 Macro Economics Framework and General Fiscal Policies.

It is important to understand that the Carbon Tax is only one of several fiscal proposals put forward by MoF that, if adopted, will involve amendments to the 1983 Tax Law. These proposed amendments have been included in a draft bill to amend the 1983 Tax Law ("**Draft Tax Bill**") prepared jointly by the Government and the House of Representatives ("**DPR**").

On 6 July 2021, the Draft Tax Bill was included in the Prioritized National Legislation Program and is currently being deliberated by the DPR.

ANALYSIS AND DISCUSSION

1. Treatment of Carbon Tax in Draft Tax Bill

1.1 **Relevant Article**: The Carbon Tax is dealt with in Article 44G of the Draft Tax Bill.

1.2 **Approach Adopted**: The Carbon Tax is to be imposed on any company, individual or other legal entity which (a) buys goods/products containing carbon or (ii) engages in activities producing carbon emissions. In other words, it is presently envisaged that Indonesia will adopt both a demand-side approach and a supply-side approach to the introduction of a Carbon Tax.

1.3 **Tax Rate**: The Carbon Tax rate is presently set at Rp75 per kilogram (or Rp75,000 per ton) of CO2e.

1.4 **Payment Point**: The Carbon Tax is to be payable at (i) the time of purchasing goods/products containing carbon, (ii) at the end of a certain period of activity involving the production of carbon emissions or (iii) at other times.

1.5 **Procedures for Calculation and Payment of Carbon Tax etc**: The (a) procedures for the (i) determination of the applicable Carbon Tax rate, (ii) changing the applicable Carbon Tax rate, (iii) calculation of the Carbon Tax amount due and (iv) payment of the Carbon Tax amount due and (b) intended allocation/utilization of Carbon Tax collections are to be dealt with in an implementing regulation to be issued by MoF following consultation/co-ordination with other relevant ministries/agencies.

1.6 **Stated Purpose of Carbon Tax**: The stated purpose of introducing the Carbon Tax is to:

> "*control greenhouse gas emissions to support the achievement of Indonesia's Nationally Determined Contribution ("**NDC**")*."

The NDC is Indonesia's commitment to helping manage global climate change in order to achieve the goals of the so-called "Paris Agreement re The United Nations Framework Convention on Climate Change" ("**Paris Agreement**").

1.7 **Intended Use of Carbon Tax Collections**: The intended use the Government will make of Carbon Tax collections is stated as being, at least in part, "*climate change control*".

2. Opposition to Carbon Tax Now

2.1 **Overview**: Opposition to a Carbon Tax for Indonesia has quickly appeared from various sources. The opposition is not necessarily to a Carbon Tax per se but, rather, to the introduction of a Carbon Tax now and during the current economic crisis brought on by the Covid-19 pandemic.

2.2 **Employers' Association ("APINDO")**: The Chairman of the APINDO Tax Committee, Siddhi Widyaprathama, was recently quoted, in the 26 June 2021 edition of Tempo Magazine, as saying:

> "*After the economic recovery in the next 2-3 years, maybe we can talk about it again (carbon tax). We admit that this is a noble intention."*

APINDO's stated concerns with MoF's proposal for a Carbon Tax now are at least three in number. First, relevant industries need to be given time to accept the idea of a Carbon Tax. Second, a Carbon Tax would be inflationary. Third, the Government needs to provide industry with environmentally friendly renewable energy alternatives before it is fair to burden industries, reliant upon fossil fuels, with a Carbon Tax.

2.3 **Cement Association ("ASI")**: According to ASI's technical adviser, Lusy Widowati (also quoted in the 26 June 2021 edition of Tempo Magazine), a Carbon Tax is simply beyond the financial capacity of the local cement industry to bear at this time. This is because:

> "*The cement industry is oversupplied by 55 million tons, factory utilization is only around 62 percent on average, and new plants are even only 50 percent. This condition is exacerbated by the pandemic. So that cement growth in 2020 will be minus 10.4 percent.*"

ASI's technical adviser also suggests that MoF's Carbon Tax proposal is problematic for two other reasons. First, it would reduce the competitiveness of the local cement industry, in regional and global markets, because:

> "*In ASEAN we have big cement competitors, Thailand, Malaysia, Vietnam. They do not apply a carbon tax.*"

Second and, perhaps, most importantly ASI's technical adviser suggests MoF's Carbon Tax proposal would be a burden to the public, saying:

> "***So the community's potential will decrease to build houses and infrastructure***."

2.4 **Coal Mining Association ("APBI")**: APBI's Executive Director, Hendra Sinadia, argues that the imposition of a Carbon Tax will have a significant impact on local industry and, so, MoF's Carbon Tax proposal requires extensive discussion with relevant business actors before the Carbon Tax becomes a reality. Mr. Sinadia was quoted as having told Bisnis.com on 11 July that:

> "*The carbon tax will definitely have an impact, not only for the coal industry but also for [all] emitters such as cement, plastic, ceramics and so on.*
> ***Moreover, the [impact on the] electricity sector is certain***."

3. Assessment of Carbon Tax Proposal

3.1 **Need to Reduce Greenhouse Gas Emissions and Increase Government Revenue**: Indonesia is (i) the 8th largest emitter of greenhouse gases, accounting for approximately 2% of the world's greenhouse gases and (ii) the 4th largest coal producer in the world with budgeted 2021 coal production of 625 million tons. At the same time, (i) coal dominates the energy mix in Indonesia accounting for approximately 66.3 % of the total power generated in 2019 and (iii) renewable energy accounted for only 15.6% of Indonesia's energy mix in 2019. According to the so-called "Energy Balance Report", published by the Ministry of Energy & Mineral Resources, the contribution of renewable energy to Indonesian electricity generation, over the period 2015 to 2019, increased but less than the increase in the contribution of coal to Indonesian electricity generation over the same period.

In early June 2021, the Government announced its intention to revise the 2021 to 2030 National Electricity Supply Plan or "RUPTL" so that the contribution of renewable energy to electricity generation would increase to 48% from 30% as provided for in the 2019 to 2021 RUPTL. Notwithstanding this ambitious goal, no one could seriously question that Indonesia needs to do a whole lot more to reduce its greenhouse gas emissions and increase the contribution of renewable energy to electricity generation.

Government revenue is under great pressure from several sources. First the Government is running a substantial fiscal deficit estimated to be 5.5% of GDP this year and which fiscal deficit it is required, by law, to be cut back to not more than 3% of GDP by 2023. Second, tax revenues have declined significantly as a result of the economic contraction since 2020. Finally, the Government's costs in dealing with the Covid-19 pandemic keep growing alarmingly. Accordingly, it is hard to credibly dispute the Government's need to find new and increased sources of revenue.

Given the above, it is not surprising that most opponents of MoF's Carbon Tax proposal (including APINDO, ASI and APBI – see 2 above) have focused their criticism on (i) the proposed timing of the introduction of a Carbon Tax in Indonesia and (ii) the financial capacity of various industries, as well as of the Indonesian people, to absorb a Carbon Tax **<u>at this time</u>** rather than disputing the inherent merits of Indonesia introducing a Carbon Tax **<u>at some time in the future</u>**.

3.2 **Complexity of Carbon Tax Proposal**: On 18 May 2021 and soon after the 2022 Macro Economics Framework and General Fiscal Policies were released, the Secretary General of the Organization for Economic Co-operation and Development was quoted as saying, in response to the announcement of MoF's Carbon Tax proposal, that:

> "*I hope they [**<u>i.e.</u>**, the Indonesian Government] **<u>put a big fat price on carbon</u>***."

This type of remark does not adequately address the multiple difficulties facing Indonesia in getting the Carbon Tax right once it is introduced. The success or otherwise of MoF's Carbon Tax proposal involves a great deal more than just putting "*a big fat price on carbon*".

One may readily accept that, **<u>in theory</u>**, a Carbon Tax is the most cost effective way for Indonesia to encourage local industry and consumers to move away from activities and products that have a high carbon footprint. Whether or not, however, this is what happens, **<u>in practice</u>**, will depend upon how the Carbon Tax is designed and implemented. At the moment, we know very little about how MoF will seek to ensure that the design and implementation of the Carbon Tax realizes its intended benefits.

The Draft Tax Bill provides almost no details regarding the proposed Carbon Tax other than (i) the fact that the Carbon Tax will be directed at both the demand side and the supply side and (ii) the initial rate of the Carbon Tax will be set at Rp75 per kilogram (or Rp75,000 per ton) of CO2e. With virtually all the details of the mechanics of the Carbon Tax to be dealt with in later implementing regulations, as is the custom in Indonesia, it is impossible to form a considered view on whether or not, if the Draft Tax Bill becomes law and still includes the Carbon Tax, the Carbon Tax (**<u>as implemented</u>**) will be a net positive development for Indonesia. This highlights one of the inherent weaknesses of the Indonesian approach to law making; namely, the need to accept that Indonesia's bureaucrats will, somehow and despite numerous examples of this often not having happened in the past, get the implementing regulations right for what otherwise may seem like a promising legislative initiative such as the Carbon Tax.

Given the above, industry observers are surely correct to highlight the complexity of designing and implementing a successful Carbon Tax in Indonesia. As a consequence, the need to make very sure MoF has (i) correctly identified and properly quantified all of the cost and financial implications of a Carbon Tax for both industry and product users and (ii) prepared suitable policies to alleviate the impact of a Carbon Tax on financially vulnerable industry sectors and individuals becomes of paramount importance. This is something that requires time and careful consultation with all interested parties. Ideally, that should happen **<u>before</u>** the Carbon Tax becomes a reality, **<u>not</u>** after the event and as part of "rolling out" the implementing regulations for the already introduced Carbon Tax.

Indonesia's extremely poor handling of the implementation of the domestic processing and refining obligation in respect of metal minerals ("**DP&R Obligation**"), included by the DPR as part of the 2009 Minerals & Coal Mining Law, provides an excellent example of what can happen in Indonesia when a legislative initiative, which has the potential to change the structure of an entire industry (or several industries in the case of the Carbon Tax), becomes law "**<u>because it seemed like a good idea at the time</u>**" and without any thorough analysis of its likely economic and other implications for all stakeholders or any carefully thought through plan for implementing the same. Successive Governments have now spent the last 12 years "playing catch-up" in terms of trying to make the DP&R Obligation work in practice and without totally alienating both domestic and foreign investors in the local mining industry. The seemingly endless revisions to the associated export ban on unprocessed metal minerals and the timetable for smelter construction have forever been "enshrined", in Indonesian political jargon, as the "flip flop approach to policy making". Many of the problems subsequently encountered with implementation of the DP&R Obligation could surely have been avoided if only a comprehensive study of the economics of domestic processing and refining of all metal minerals had been carried out by the then Government **<u>before</u>** the DP&R Obligation became law. Indeed, it may well be that the DP&R Obligation would never have become law at all if only such a comprehensive study of the economics of domestic processing and refining had been carried out at the right time. At the very least, successive Governments would have avoided endless embarrassment and a huge loss of credibility with both domestic and foreign investors. The current Government needs to be very careful that the Carbon Tax and its implementation do not become a repeat of the DP&R Obligation and its seriously flawed implementation.

3.3 **Likelihood of Achieving MoF's Stated Objectives**: It is way too early to tell whether or not, if it becomes law, MoF's Carbon Tax proposal will realize either of the claimed benefits of a Carbon Tax highlighted in the 2022 Macro Economics Framework and General Fiscal Policies; namely, (i) the reduction of greenhouse gas emissions through reduced or more efficient fossil fuel use and (ii) the generation of significant additional government revenue that can be used to fund environmentally friendly investments and improve the welfare of Indonesia's poor and vulnerable.

In the case of the first MoF highlighted benefit of reducing greenhouse gas emissions, the Institute for Essential Services Reform ("**ESRI**") has argued that MoF's presently proposed Carbon Tax rate of Rp75 per kilogram (or Rp75,000 per ton) of CO2e (being the equivalent of about US$5 per ton of CO2e) is far too low to produce a material drop in the level of Indonesia's greenhouse gas emissions. ESRI points out that the High-Level Commission on Carbon Prices has recommended a Carbon Tax rate of at least US$40 per ton of CO2e initially, increasing to US$50 per ton of CO2e by 2030. Likewise, the International Monetary Fund proposed that Indonesia set its Carbon Tax rate at US$35 per ton of CO2e if it wanted to ensure that it meets its Paris Agreement NDC of reducing the country's greenhouse gas emissions by 29% not later than 2030 and without any support from the international community or by as much as 41% by 2030 with support from the international community. As quoted in The Jakarta Post on 16 June 2021, ESRI's executive director said:

> "*so what is it [the Carbon Tax] for? We could go with [a Carbon Tax rate of]US$5 to US$10 [per ton of CO2e], but that would not be effective in forcing a transition for a high carbon to a low carbon economy.*"

In fairness to MoF, however, its proposed Carbon Tax rate of Rp75 per kilogram (or Rp75,000 per ton) of CO2e, as provided for in the Draft Tax Bill, will presumably only be the initial rate of the Carbon Tax if it becomes law. Indeed, Article 44G of the Draft Tax Bill expressly mentions that one of the things that will be dealt with in the implementing regulations is the procedure for changing the Carbon Tax rate. It is probably quite sensible for MoF to start with a very modest proposed Carbon Tax rate so as to both (i) maximize the chances of the DPR approving the Draft Tax Bill with the Carbon Tax included and (ii) minimize the immediate cost impact of the Carbon Tax on apparently "struggling" industries such as the cement industry as well as on the Indonesian public which is unquestionably suffering financially during the ongoing Covid-19 pandemic and resulting economic crisis. Once the Carbon Tax is introduced and it becomes accepted (albeit, most likely, with considerable reluctance) by industry and the public as a reasonable way to try to control Indonesia's greenhouse gas emissions, MoF will be much better placed to, over time, raise the Carbon Tax rate to a level at which it becomes an effective incentive to relevant parties to move away from high carbon footprint activities and products.

It should not be lost on any reader that there is considerable irony in the Government proposing a Carbon Tax to reduce greenhouse gas emissions when some of the largest emitters of greenhouse gasses in Indonesia are State-owned Enterprises ("**SOEs**"). As the owner/operator of numerous coal fired power plants, the State electricity company

("**PLN**") is a particularly egregious example of a business actor engaged in activities that produce seriously high levels of greenhouse gas emissions. PLN's long-standing reluctance to offer an economic tariff, for electricity generated from renewable energy sources, has also unquestionably been a major impediment to the realization of Indonesia's potential as a major "green energy" country. This latter point was surely what APINDO was alluding to when it highlighted the need to, first, provide industry with cost effective, renewable energy alternatives before it would be "fair" to impose a Carbon Tax on industry which currently has little or no choice but to use electricity generated from coal.

With regard to the second MoF highlighted benefit of generating more Government revenue, IMF modelling has previously indicated that a Carbon Tax rate of US$35 per ton of CO2e would generate additional revenue of about 1%. This being the case, clearly a Carbon Tax rate of only Rp75 per kilogram (or Rp75,000 per ton) of CO2e will generate additional government revenue that is hardly material at all in terms of the likely cost to Indonesia of alleviating the adverse effects of climate change.

Projections of additional Government revenue from a Carbon Tax likewise need to take into account that, given the Government is ultimately responsible for the losses of PLN and other SOEs, the Government will not generate any additional Carbon Tax revenue from SOEs, including PLN, no matter how much greenhouse gas emissions they are responsible for. This is one of the downsides, in the context of MoF's Carbon Tax proposal, for the Government when Indonesia has an economy where heavy industry, in particular, is dominated by SOEs.

3.4 **Possible Growing Reluctance to Pursue Economic Reform**: The World Bank recently downgraded Indonesia from an Upper Middle Income Economy to a Lower Middle Income Economy. Consistent with this downgrading, the World Bank has reported that the impressive gains in poverty reduction, which Indonesia made between 1999 and 2020, have started to be reversed by the effects of the Covid-19 induced economic crisis. According to the World Bank, Indonesia's national poverty rate actually increased from 9.78% to 10.19% during the period March to September 2020 with the number of poor people rising from 26.42 million to 27.55 million. It seems probable that the number of poor people in Indonesia will have continued to increase steadily from September 2020 to July 2021 as Indonesia's expected economic recovery has been put in considerable doubt by the widely spreading Delta strain of Covid-19 in Indonesia.

Heightened concern about the potential for social unrest has clearly dictated much of the Government's response to the Covid-19 pandemic. The best evidence of the social unrest factor at work has been the Government's great hesitancy in taking any steps that might materially restrict economic activity such as strictly enforced and widespread lockdowns. This is notwithstanding rapidly spiraling Covid-19 infection numbers which, taken alone, would otherwise have made strictly enforced and widespread lockdowns the only sensible course of action for the Government to pursue.

Given the concern about social unrest and with poverty on the rise in Indonesia, it would perhaps be understandable if the Government's enthusiasm for any economic reforms, involving even short-term additional costs for an increasingly vulnerable population, is fast ebbing away. This could prove to be a major obstacle to the Carbon Tax still being part of the Draft Tax Bill once it becomes law. Even though the Government may accept that MoF's Carbon Tax proposal is, in principle, a sensible one and has the potential to be a solution to multiple problems facing Indonesia, the temptation to postpone the introduction of a Carbon Tax for now could be very strong. There can be little doubt that this is precisely why ASI highlighted the potential additional burden on the public that would follow from introducing a Carbon Tax.

SUMMARY & CONCLUSIONS

MoF's Carbon Tax proposal has generated considerable criticism from industry associations and other sources.

At least some of the industry associations' criticism might reasonably be regarded as nothing more than a self-serving attempt to minimize the operating costs of their members and postpone the introduction of some sort of Carbon Tax for as long as possible. Industry associations, however, are unquestionably right to highlight the need for the Government to move very carefully in introducing a Carbon Tax because of the structural and procedural complexities of designing and implementing a Carbon Tax that actually delivers, for Indonesia, the claimed benefits of a Carbon Tax. The Government's past track record in implementing complex policy initiatives does not necessarily engender much confidence that it will make a success of the Carbon Tax, at least without a great deal of preparation.

Assuming the Draft Tax Bill, inclusive of the Carbon Tax, becomes law, it may also be a long time before either Indonesia's current level of greenhouse gas emissions is significantly reduced or the Government generates sufficient additional revenue from Carbon Tax collections to fund much in the way of amelioration of the adverse effects of climate change on Indonesia. The Government, however, needs to start somewhere in beginning to tackle these problems.

The greatest obstacle to a Carbon Tax being implemented any time soon is probably the Government's inevitable concern that, during the ongoing economic crisis in Indonesia, the cost impact of a Carbon Tax on vulnerable industries and individuals may make it politically unwise to pursue this initiative, at least until better economic times return. Keeping social unrest under control, rather than reducing greenhouse gas emissions or finding a solution to Government revenue problems, is almost certainly the overriding priority from the Government's perspective.

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