

Evidence to the Treasury Committee Inquiry:

Climate change and the Stern review: the implications for HM Treasury policy on tax and the environment

from Friends of the Earth England, Wales and Northern Ireland.

Question 1 - progress made by the Government on the undertakings set out in its Statement of intent on environmental taxation, published in 1997, and subsequently endorsed in its 2002 paper, Tax and the environment: using economic instruments

Friends of the Earth lobbied for and welcomed the 1997 Statement of Intent on Environmental Taxation with its underlying principle that “*quality of growth matters not just quantity*” and its recognition of the important role to be played by taxation in managing the economy according to that principle.

The statement itself sets out broad undertakings including “*Over time, the Government will aim to reform the tax system to increase incentives to reduce environmental damage. That will shift the burden of tax from “goods” to “bads”; encourage innovation in meeting higher environmental standards*”.

We will look at each of these three in turn.

[a] Increasing incentives.

The Government has attempted to do this in three ways, differentials within a tax, changing the basis for tax relief, and increasing or introducing a tax rate.

The differentials policy has been applied to a number of taxes but only in some of these cases can it be considered to have increased the incentives in a way that led to a substantive impact. It has been used to reduce pollution, other than CO₂, from road fuel. Previously this has been used successfully to remove lead from petrol and since 1997 this policy approach has been successful in speeding the uptake of low sulphur petrol and diesel. In these cases the greener fuel targeted by the incentive policy was commercially available and required no change in vehicle technology or fuel distribution.

The Government has also used the differential approach less successfully in relation to road fuels that reduce CO₂ emissions (for example LPG) that typically require some change in vehicle technology and fuel distribution. Given the changes involved and the consumer perception of the changes involved the scale of the differential needed to be far greater and backed up by a wider policy approach. The low level of incentive and lack of policy integration both have a negative influence of the ability of the policy to stimulate innovation.

The Government has also used this differential approach with VED. Friends of the Earth and other groups had long made the case for the previously flat rate of road tax to be differentiated to provide an incentive to use more fuel efficient cars. The Government's response has been poor in two respects – the differential has been limited to cutting the rates for more efficient cars with no increase in the low top rate for the most inefficient cars and in 2001 weakening the lower rate impact by increasing the engine size it was applied to. Once again although an incentive was installed it is inappropriately weak and therefore prevented from stimulating innovation.

One clear success in increasing incentives was the reform of company car allowances. This installed an incentive by changing the basis for tax relief which for many was a no-brainer. Shifting the basis of this tax relief so that rather than increasing if you drove more it increased according to the efficiency of the vehicle used simultaneously removed an incentive to drive further and installed one to drive cars that emit less CO₂. This clear shift in Government policy in an important market for new cars is likely to have a positive impact on innovation and it is therefore no surprise that the nascent market in hybrid cars is dominated by vehicles that also fit into the company car market.

Incentives have also been increased by raising the rates of existing taxes. Since 1997 the most prominent examples have been road fuel duty and the landfill tax.

With the Landfill Tax the Government has followed a policy of a gentle annual increase in the rate. It has provided an incentive for those waste producers who pay that are hit hard by the tax but this is not many. Research published by Friends of the Earth after the Government's early rounds of increases showed that the modest increases in the rate was failing to encourage more than two-thirds of companies to reap the financial and environmental benefits of waste reduction[1]. It found that a major barrier to the effectiveness of the tax is the small size of the tax in relation to overall company costs (typically less than 0.05% of total costs). Soon after the Government had set a tax escalator to reach £15 per tonne by 2004 the waste industry itself identified a rate of at least £30 a tonne to bring about significant increase in waste minimisation and recycling.

The Government has so far missed the chance to install a meaningful incentive promptly enough that would stimulate innovation. The potential for doing so is highlighted in those few sectors who were significantly impacted upon where companies facing more significant increases and who in general already considered waste as an important cost took a variety of actions including innovation for waste minimisation and seeking markets for recycling their waste products.

In the case of road fuel duty the 1997 Government inherited a policy of increasing its rate on an annual basis. It did so partly because of the incentive but because of the income raised – far greater than any other environmental tax to date. It stuck with the escalator while oil prices remained low. But the Chancellor faltered in his commitment to the policy at the point where it started to have a more significant impact upon emissions and in all likelihood innovation. According to the IFS *“a 10 per cent rise in the price of fuel reduces fuel consumption by around 2.5 per cent and the volume of traffic by 1 per cent after a year.”* They show that *“had the real rates of*

duty been maintained at their peak values since 1999, we might expect current fuel consumption to be around 4–5 per cent lower (and as much as 9–12 per cent lower in the long run)."

The other important point about the fuel duty policy was that although in 2002 the Chancellor did commit to using any revenue from future increases in the rate to invest in and stimulate sustainable transport up to that point this was a fiscal stick that neither paid for nor was integrated with any tax or spending carrots.

Finally the Government since 1997 has installed incentives by introducing two new green taxes the Climate Change Levy and the Aggregates Levy.

The climate change levy package has been effective in changing behaviour¹. The tax itself has been designed in a policy package that includes negotiated agreements for sectors to benefit from an 80% rate cut, exemptions for on-site renewable energy, an enhanced capital allowance scheme for investments in energy efficient products and a information and advice provided through a new Carbon Trust. A survey of businesses completed 18 months after the introduction of the Levy found that it had helped increased the use of renewable energy by businesses, helped increase energy efficiency and raised awareness amongst senior managers about the needs to address energy use and climate change. Crucially the survey found that many of these changes had been considered before the Levy but it was the financial incentive that provided the immediate stimulus to take action. Yet despite its success the Chancellor froze the rate.

The Aggregates Levy was reviewed in the 2004 Pre Budget Report which put forward evidence that the Levy was achieving its objectives².

[b] Shifting the Burden of Taxation

In addition to installing specific incentives the statement of intent also commits to the broader aim of shifting the burden of tax off 'goods', or things that need to be encouraged in the economy such as employment and onto 'bads' such as environmental damage that need to be discouraged. This was not a new concept, the Government in 1996 introduced the landfill tax with an equivalent cut in employers' NIC claiming that it was shifting the burden tax from employment to pollution. Both the new environmental taxes introduced since 1997 have also included cuts in employers NIC as part of the design.

Overall, however, since 1997 employers NIC has grown as a percentage of the tax take and environmental tax takes fallen. To use the statement of intent's language the shift, overall and over the ten years, has been off bads and onto goods. Fuel duties accounted for 16% of receipts in 96/97 and 15.1% in 05/06³ for the same period NIC increased from 16.3% to 17%.

¹ Cambridge Econometrics and Policy Studies Institute for HM Customs and Excise cited in Budget 2005, p159; and Ekins, P., Monkhouse, C. and Willis, R., 2002. Next Steps for Energy Taxation: A survey of Business Views. Green Alliance/IPPR, London

² HM-Treasury 2004, Pre-Budget Report Para 7.68 and Box 7.5

³ IFS, 2005. Taxation. Election Briefing Notes, BN 58.

Although the income from environmental taxes increased by 28% in the first seven years since 1997 it increased by 66% in the seven years previous to that. As proportion of total tax take environmental taxes have also fallen from contributing 9.4% in 1997 to 7.7% in 2005⁴. Coincidentally 8 years before 1997 the contribution of green taxes was 7.8% marginally more than it was 16 years later.

[c] Encouraging Innovation

There is a clear body evidence that innovation can be encouraged by achieving higher environmental standards⁵. Since the Statement of Intent of Environmental Taxation however, significantly higher environmental standards have not be achieved most notably in respect to emissions of CO₂ which have increased since 1997. It is worth considering two issues: the importance of clear, strong, ongoing commitment to higher environmental standards from Government for encouraging innovation; and the extent to which the design of environmental tax reforms is aimed at encouraging innovation.

Where Government clearly has a commitment to higher environmental standards it helps to convince firms of the opportunities to be had in investing in innovation to meet those standards and ensuring existing innovation programmes recognise the reality of higher environmental standards. Over the ten year period the Government's commitment has been put in question as it has reduced the rates of environmental taxes at consecutive Budgets. The opportunities that Government can help unlock for UK businesses is also recognised by the Corporate Leaders Group: "*We think that the transition to a low-carbon economy could have a profound impact on British businesses*" said Neil Carson, Chief Executive of technology company, Johnson Matthey. "*As Stern points out, "the innovation associated with tackling climate change could trigger a new wave of growth and creativity in the global economy". Britain should be at the crest of this wave"*.

The design of environmental tax policies is crucial. We have already given several examples of where the rate of the tax is simply been set to low but two other points need to be made. First, the price mechanism, powerful as it is, on its own will not the most efficient approach to stimulating innovation in the majority of cases. Tax breaks and spending that help investment and research and increase information flows also help. The climate change levy is an example of how different elements can be packaged together. Second, in deciding on the levels of a tax rate or conditions of a tax relief it is no good for innovation if those are defined by existing commercially available technology. BP for example when setting up their own internal carbon reduction programme took the total of all actions they knew they could take and then made the target 10% tougher because they knew that innovation would deliver the gap. Yet when the Government negotiated its agreements for tax relief on the climate change levy it simply took the available technology figure.

⁴ <http://www.statistics.gov.uk/statbase/tsdintro.asp>

⁵ Aldersgate Group, 2006. Green Foundations: Better Regulation and a Healthy Environment for Growth and Jobs. London, Aldersgate Group.

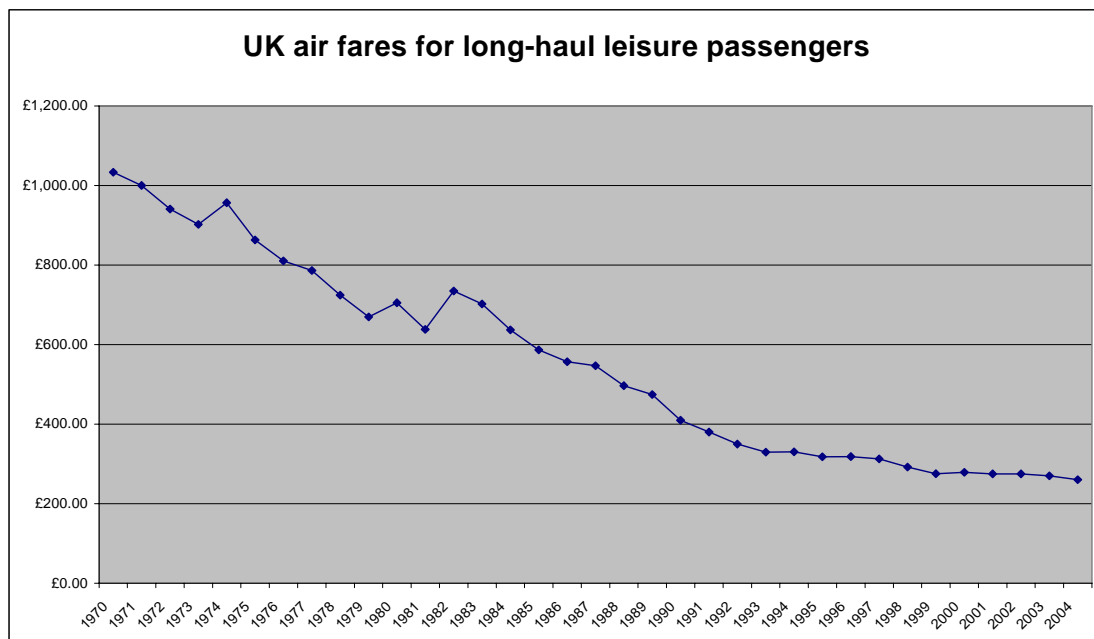
Question 2 – Government’s use of environmental taxes to tackle climate change

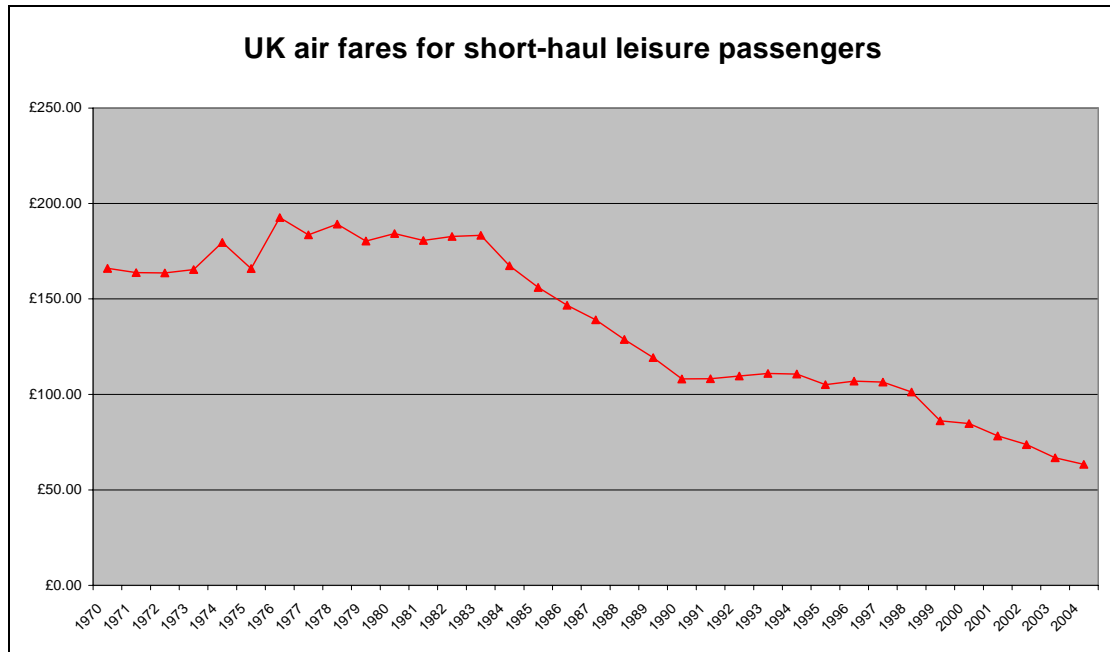
Overall, we believe that the Government’s progress, after some real achievement in 1997-2000, has stalled and in many areas gone into reverse. The bottom line is that taxes are a major component of a successful strategy to tackle climate change, yet in 10 years emissions have not fallen. It is our belief that the Government has been paralysed by unsubstantiated claims that action would be bad for the economy (which the Stern Review roundly refutes), and by fears of political back-lash. Where it has introduced measures it has failed to back them up, and in general leadership has been lacking. Of course, increased taxes have the potential to be politically difficult, but they have not been sold well. In particular, the link between tax rises and either tax cuts or increased spending elsewhere has not been made. The Government continues to be extremely timid, even when – as now- there is increasing public acceptance that climate change must be tackled. We hope that the Stern Review’s conclusions will give the Treasury in particular the confidence to implement a strong, positive strategy to cut carbon emissions – as Stern says, it is imperative that this starts now.

Use of taxes in specific sectors:

Aviation

Aviation emissions have risen heavily in recent decades, continue to rise, and are predicted to rise way into the future. Total emissions doubled from 1990 to 2004, and are predicted to more than double again by 2030. This is because demand growth for flights heavily outstrips technological improvements to plane efficiency. Demand growth is in turn heavily influenced by flying falling in price (see graphs below). These low and falling prices are in large part due to aviation’s continuing exemption from many taxes – notably the zero tax on aviation fuel and exemptions from VAT. Both are anachronisms, but have proved difficult to remove.





Air Passenger Duty (APD) could be used as an environmental tax – as a proxy for VAT and fuel taxes. It affects the cost of flying to the consumer and as such affects marginal flights. We note however that APD rates have been low. On EU flights APD was introduced at £5 for economy flights in 1994, raised to £10 in 1997, dropped to £5 in 2001, and raised to £10 again as from Feb 2007. The DfT’s December 2006 Progress Report on its Aviation White Paper notes that current rates of progress on taxation will not stop the massive predicted growth in flights. Oxford University’s Environmental Change Unit states that APD escalators will be needed to stem this growth – ie far greater progress than the occasional increase every fifth year. We note that, contrary to Government pronouncements, such escalators would not stop people flying, but would stop the growth in flying. Moreover it does not “price poor people off the airlines” – the evidence of the last 5 years is that the falls in the cost of flying in that period have led to more flights by richer people. The average household income of people flying from Stansted is £50,000. Taxing aviation is progressive taxation.

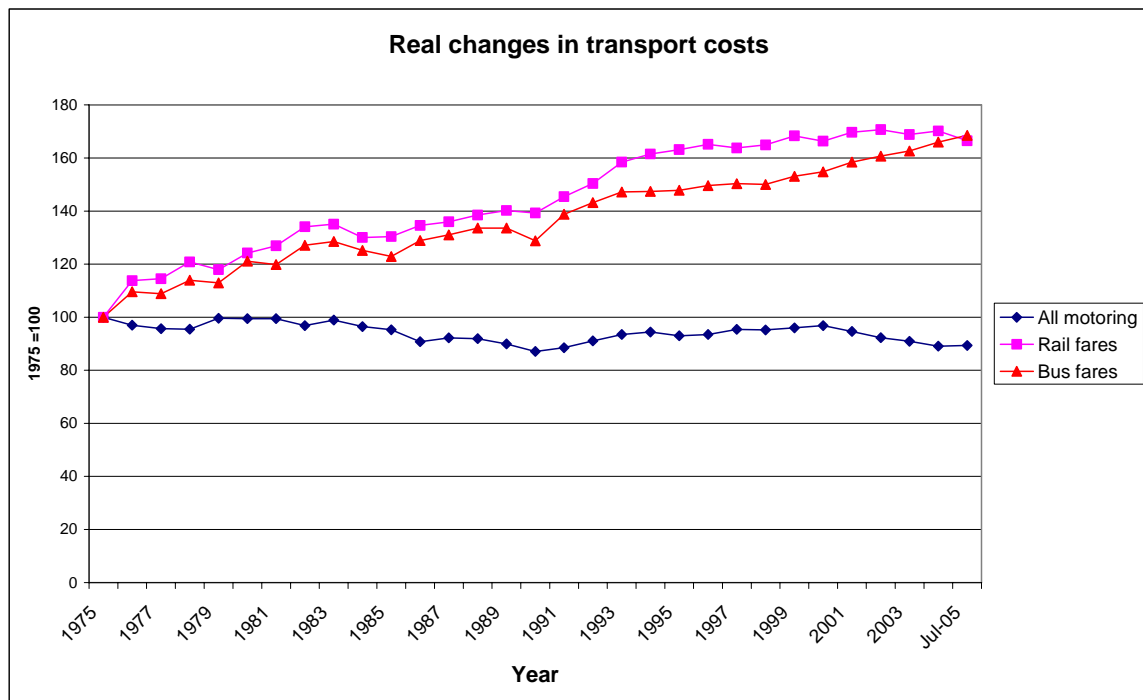
Green Cars

The Government’s decision to differentiate Vehicle Excise Duty (VED) levels by carbon emissions should in theory give an incentive for people to buy less-polluting vehicles. However, in practice the difference between these levels is far too low to make any practical difference to people’s purchasing patterns. The difference between Band F and Band G is £20 – around the cost of replacing one windscreen-wiper. The decision to make the least-polluting Band A pay zero VED is welcome, but the differentials, particularly between the higher bands, need to be made far wider for the policy to be effective.

Fuel Duty

Fuel Duty is the largest and most controversial green tax. The Fuel Tax Escalator, introduced by Norman Lamont in 1993 and increased by Kenneth Clarke and Gordon Brown, had a clear environmental effect. The Treasury reported in 1999 that it “...has given a clear signal to motorists and manufacturers to design more fuel efficient vehicles, avoid unnecessary journeys and consider alternatives to the car”. Gordon Brown scrapped the escalator in November 1999, and the received wisdom is that the fuel tax protests of 2000 are a major cause of the freezing (and hence real-terms fall) in fuel duty in almost every year since. This has been a major contributory factor to the cost of motoring falling in recent years, and to the increase in road transport emissions.

We believe that fuel duty increases would be far more politically palatable, and environmentally effective, if they were linked to increases in spending on providing decent and cheaper alternatives to motoring. Bus and Rail prices increase heavily every year – it is no surprise that emissions of transport rise when the Government’s use of its economic instruments mean that the two more polluting modes (air and cars) get cheaper, while the two less polluting modes (bus and rail) get more expensive.



Climate Change Levy (CCL)

The CCL is the Government’s environmental tax success story. A survey of businesses completed 18 months after the introduction of the Levy found that it had helped increase the use of renewable energy by businesses, and helped increase energy efficiency. Many senior managers had been considered before the Levy, but it was the financial incentive that provided the immediate stimulus to take action. The

CCL has saved millions of tonnes of carbon, and its use of a package of measures – taxes, rebates, information provision – is one that we believe should be replicated across other sectors. The rate of the CCL has however been frozen in recent years – albeit with an inflation-based rise announced in this pre-budget. It would be even more effective if the Chancellor were to announce a series of increases in the levy over the next 5 years, to further increase efficiency, cut emissions, and boost the take-up of renewable energy.

Domestic Energy

Simple increases to taxes on domestic energy to cut carbon emissions suffers from two main problems – doing so would not distinguish between types of energy, and would exacerbate the major problem of fuel poverty. The clear priority for the domestic sector is a major package of measures to improve energy efficiency of the UK's housing stock, which is among the worst quality in Europe. The Government has some schemes here, such as Warm Front and LESA, but overall a far greater investment is required. It would have twin benefits – tackling fuel poverty and carbon emissions.

The Government could use the tax system far more to incentivise energy efficiency – and we advocate for example the use of council tax rebates for people who install cavity wall insulation or loft insulation. A £1.4 billion fund could help all the 14 million households in the UK currently without these basic measures.

With a major effort on energy efficiency, targeted at the poorest households, it may be possible in a number of years to implement a domestic carbon tax. Dresner and Ekins (2006) argue that if the revenues raised were recycled at least partly in the form of increasing pensioner's winter fuel allowance, higher income support, and working and child tax credits, etc, then a carbon tax can be progressive while reducing carbon emissions.

Waste

The treatment of waste does have a large impact on climate change, as for example recycling saves massive amounts of carbon from not having to mine, process and transport virgin resources. Such savings wouldn't accrue to the UK carbon accounts (as it would save carbon emissions in other countries), however they are still carbon savings, and UK policy should – in line with its waste hierarchy – try to incentivise reduce, reuse and recycling above worse options such as incineration and landfill.

The Landfill Tax Escalator is having an effect on reducing the proportion of waste going to landfill. However, we note the Environment Secretary's letter to the Chancellor from October 2006 stating that "*our analysis suggests a rate of £75 per tonne by 2013 makes alternatives to landfill sufficiently financially attractive to tip behaviour significantly*". To get to this rate from the current £21 per tonne needs a higher escalator than £3 per year.

Question 3 – behaviour change or revenue raising?

We believe that too often green taxes are used solely to raise revenue, and this can backfire spectacularly, as was seen with the 2000 fuel tax protests. We believe that Government must use green taxation as part of an overall strategy, involving packages of measures, to meet its environmental goals while also tackling distributional effects. There are two main reasons for this.

First, tax measures will be far more effective as part of integrated policy packages, as has been seen with the Climate Change Levy. However simply increasing taxes without linked measures is almost guaranteed to be unsuccessful. This was the case with the fuel duty escalator – tax rises at the same time as allowing the price of alternative transport modes to rise far higher, with the revenues just accruing to general Treasury coffers.

Second, linking taxes with spending on specific linked measures makes taxes far more politically acceptable. 2006 MORI polling showed that 60% of people support increased taxes on air travel for environmental reasons; this increases to 73% if the money were to be spent on improving the environment.

Question 4 – looking forward, the role of environmental taxation

We believe that the implications of the Stern Review require a major overhaul of the Treasury's policy on climate change. Stern argues strongly that urgent action is needed, now, that policy instruments on taxes, spending, regulation, other market mechanisms and information are all required to do this job, and that action is needed at the national as well as international levels. This contrasts with the current Treasury approach which is largely piecemeal, with some good measures (eg CCL), major holes in some areas (eg domestic and aviation sectors) and stagnation in others (surface transport). Overall, UK carbon emissions are not falling, despite repeated commitments to emissions cuts and repeated statements that climate change is "the greatest challenge we face". A large part of this failure is down to weak or misdirected economic signals throughout almost all sectors of the economy.

The overwhelming priority is for the Government to have an overall strategy, setting out annual cuts in carbon emissions, carbon budgeting, and annual reporting on this strategy. The Treasury has a key role to play in delivering these annual cuts, using packages of measures, in which taxes have a major role.

In specific sectors, we advocate

Aviation

- the use of APD escalators to prevent the planned growth in flights. EUETS may be an important element of a strategy to reduce emissions, however aviation's inclusion will not happen for a number of years, and interim measures are urgently needed.
- The use of revenues to fund necessary spending measures for carbon cuts elsewhere in the economy

Domestic sector

- A massive expansion in funding for energy efficiency measures, particularly for poorer households, funded by increases in aviation taxation.
- Medium-term development of carbon taxation, with policy design's first focus to avoid regressive effects.

Surface transport

- The reintroduction of the fuel duty escalator, with funds explicitly used to improve the cost, reliability, safety and attractiveness of less polluting alternatives – rail, bus, tram, cycling and walking
- A major increase in the differentials on Vehicle Excise Duty, to kick-start a massive switch away from gas-guzzling vehicles

Industry

- Increases in the Climate Change Levy, with funds recycled to business through tax cuts on employment, and schemes for further increasing energy efficiency.

Waste

- Steeper landfill escalator, and also an incinerator tax to ensure that waste diverted from landfill gets recycled in preference to incineration. Recycling delivers far higher carbon savings than incineration.

Question 5 Stern Review

We believe the Stern Review provides a strong imperative for a new strategy to use economic instruments, including tax, to deliver major cuts in the UK's carbon emissions.

One particular piece of the Stern Review could have major implications for UK policy making. Currently, the Government routinely uses the Social Cost of Carbon (SCC) in policy and project appraisal. It has a major effect in determining what level of carbon emissions to allow in specific policies or projects. For example in the last six months, the determination of appropriate Building Regulations; levels of recycling in the Waste Strategy; whether airports expansion is acceptable.

The figure currently used for SCC is £70 per tonne of carbon. The Stern Review is recommending a figure three times this high – using this figure would have a major effect on policy making, and on carbon emissions in the UK. At present, in a parliamentary answer from John Healey, 18th December 2006, the Treasury is “*in the process of re-examining the issue of the social cost of carbon*”. The detail of this process is not clear; we advocate that it should be resolved before Budget 2007, used for policy and project appraisal at Budget 2007 and beyond, and applied retrospectively to major policy areas to determine whether policy review is needed.

The new proposed SCC figure is in essence down to three changes:

- It is based on more up-to-date science – the £70tC figure is many years old.
- It is based on a lower discount rate. We note that this is not a “scientific” issue, but an “ethical” one. The Stern Review states that the lower rate used reflects “*the view that this rate should be based largely on the probability that future generations exist, rather than their having some more lowly ethical status*”.
- It covers a broader range of impacts. The 2002 review was based on a literature review of studies which only cover a small range of the total impacts of climate change

There still remain difficulties with using SCC – not least that it institutionalises the trade-off of different policy objectives, which is conflict with the Government’s Sustainable Development strategy that policy objectives should be integrated. However, this higher SCC gives a more accurate reflection of the actual damage from climate change, and is far more appropriate than the current £70tC figure.

ENDS

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