The Green switch: Liberal Democrat proposals on environmental taxation

Chris Huhne MP
Liberal Democrat Shadow
Environment Secretary

Vincent Cable MP
Liberal Democrat Shadow
Chancellor of the Exchequer

Julia Goldsworthy MP
Liberal Democrat Shadow
Chief Secretary to the Treasury

May 2006

Foreword

The Liberal Democrat Tax Commission is currently examining the structure of the tax system, and will bring forward proposals shortly.

However, the party has had to react to the Chancellor's proposals in the budget, and has also set out alternative clauses in the debates on the Finance Bill. This paper pulls this work together and sets out some key principles and proposals ahead of the recommendations of the Tax Commission.

The use of the price mechanism – whether through taxes or 'cap and trade' schemes like the European emissions trading scheme – is one way of influencing our collective behaviour as a society in a sustainable direction. Other policy instruments are also valid and important, including regulation, voluntary agreements, and outright prohibitions.

This paper, though, deals with green taxation as it is one of the most controversial elements of any green package. Since the fuel duty protests in 2000, the Government has been reluctant even to raise green taxes in line with inflation so that their yield has been steadily falling as a percentage of gross domestic product from 3.6 per cent to 3 per cent. We believe that this trend must be reversed if Britain is to make an effective contribution to tackling the problem of climate change.

Green taxes will continue to yield substantial sums to the exchequer if they do their work properly, and there must be a clear understanding that this revenue is handed back to the taxpayer in tax cuts on activities that we are not trying to penalise such as work effort.

This is why the Liberal Democrats have argued for fairer and green taxation, but not for higher taxes overall. Any increase in green taxes would merely pay for a reduction in taxes on income. We call this the green tax switch, because it moves taxation from good activities like work onto bad activities like carbon emissions.

Chris Huhne MP
Liberal Democrat Shadow Environment Secretary

Vince Cable MP
Liberal Democrat Shadow Chancellor

Julia Goldsworthy MP
Liberal Democrat Shadow Chief Secretary

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Summary

Liberal Democrats have always placed the environment at the heart of our thinking. That is why we were the only party with a Green Action section in every chapter of our last General Election Manifesto, integrating environmental thinking into every area of policy. This also reflects our belief that environmental policies are essential to enhancing the general standard of living, for example by reducing poverty and improving health.

A key aspect of this integrated approach is using economic incentives which go with the grain of markets to influence behaviour in the most cost effective way. The tax system is one important way of doing this. An alternative form of economic instrument is a 'cap and trade' approach in which overall emission levels of a pollutant are fixed and then progressively reduced, with individual companies allowed to buy and sell permits within the overall cap.

Of course, we recognise that other policy instruments such as regulation will also be needed to ensure a sustainable future. It is essential that incentives be given to a range of renewable fuels, energy saving measures and fuel efficient vehicles.

To achieve a coherent overall approach to environmental tax reform, and identify reforms that could be 'revenue neutral', we propose to launch an Environmental Incentive Programme, examining tax reforms and other economic instruments that will reduce pollution and protect the environment, on the clear principle of taxing differently, not taxing more. This programme will include:

1. ***An increase In Green Taxes As A Share Of National Income.*** Green taxes have fallen from 3.6 per cent of GDP in 1999 to just 3 per cent of GDP, and we are committed to reversing this trend. Revenue would be used to cut taxes elsewhere so that this is a green tax switch, not a rise in taxes.

2. ***Reform The Climate Change Levy:*** The Climate Change Levy is a positive step forward but is too complex and bureaucratic. It should be restructured as a tax on carbon across the economy, but we support the Government's intention for the first time to raise it in line with inflation. That should be the norm, not the exception.

3. ***Raise Vehicle Excise Duty On Polluting Cars:*** The Chancellor has increased Vehicle Excise Duty on high polluting vehicles by less than the cost of half a tank of fuel. If it is to be effective as a measure to reduce emissions and encourage greener transport, VED will have to be radically redrawn to penalise emissions and reward clean cars. The top-rate of VED should be significantly higher than at present at £2000 a year for high emission cars.

4. ***Keep Fuel Duty In Line With Inflation:*** Incentives to save fuel depend in part on developments in the oil market, but duty on fuel should normally keep track with inflation rather than decline in real terms. The failure to raise fuel duty since 1999 has led to a rise in emissions, and we support the Chancellor's intention to raise fuel duty in line with prices in September.

5. ***Tighten Allocations in The EU Emissions Trading Scheme, And Auction 10 Per Cent Of The Permits.*** The recent fall in the price of carbon for industrial users reflects the unambitious overall cap set by the EU, together with the failure to allow national governments to hold back a part of the national allocation for sale to the highest bidder at auction. We will press for both reforms and for auctioning the maximum 10 per cent of permits currently allowed for 2011.

6. ***Tax Emissions Not Passengers:*** We have led the way in calling for reform of the way air travel is taxed. Instead of Air Passenger Duty on each passenger, airlines should pay an emissions charge per flight. This would reward flights that were full and penalise those wasting a full tank on a few passengers.

7. ***Provide Help Where Cars Are Essential.*** In sparsely populated rural areas, cars are essential due to the lack of public transport. To reflect this need, we proposed an amendment to the Finance Bill introducing a 50 per cent discount on all but the top rate of VED for one car registered in such rural households.

Introduction

There have been two major problems with past efforts at so-called ‘green taxation’. The first is that so-called green taxes have often been used as stealth taxes to boost general government revenue, rather than used to cut other taxes. An example of this would be the Tories’ Aircraft Passenger Duty, which was introduced as a panic tax-raising measure in a financial crisis. The second is that they have been tried piecemeal with no overall coherence of approach.

A central dilemma in approaches to green taxation is how to target behaviour effectively and how to achieve long-term strategic change in the way the economy is organised. Considerable skill and judgement is required to identify the key decision-making points at which a tax or other intervention will be effective. As with other policy interventions, green taxes should aim to 'internalise the externalities' of economic activities, wherever private or corporate action affects the common good.

Despite the Labour Government’s apparent commitment to environmental taxation, the proportion of GDP accounted for by environmental taxes has in fact been declining from a peak of 3.6% in 1999 to 3.0%. This is not as a result of reduced pollution, but rather decisions to freeze fuel duties and the climate change levy in a number of budgets since then. The announcements in the recent budget will do nothing to reverse this trend: indeed, vehicle excise duty will raise less in cash and real terms.

There is considerable misunderstanding in the green movement about green taxes. In principle, green taxes should be set so that they encapsulate the social costs of the activity being taxed. However, such fine calculations are not always easy, and it is therefore sensible for the Treasury to proceed in the right direction of travel rather than be overly concerned about the precise distance of travel.

Some also argue that green taxes are bound to decline as they discourage the activity at which they are directed. This misunderstands the nature of incentives: the congestion charge in London, for example, has not caused a continued year on year fall in traffic. A continuing yield from the charge is necessary just to ensure that the one-off step reduction in traffic is maintained. Similarly, fuel duty does not stop people driving but merely provides an incentive to cut out more marginal journeys and to step up investment in fuel economy. Continued tax pressure is necessary to ensure continued behaviour change.

Current Proposals

To establish a coherent overall approach to environmental tax reform, and identify reforms that could be ‘revenue neutral’, we have proposed a Treasury-led Environmental Incentive Programme, examining tax reforms and other economic instruments that will reduce pollution and protect the environment, on the clear principle of taxing differently, not taxing more. We want fair and green taxes, not higher taxes.

However, we are also committed to increasing the share of total tax take and GDP represented by environmental taxes – with offsetting tax cuts in other areas. The details of this rise and the offsetting cuts will be proposed by the Tax commission and decided by the autumn conference. However, broad lines are clear:

- A commitment to increasing green taxes in real terms, so that they continue to bear down on the activities that pollute or create climate change. This covers the overall package of green taxes notably the climate change levy, air passenger duty, landfill tax, aggregates levy, duty on hydrocarbon oils, VAT on duty and hydro-benefit. But extra revenue from green taxes would cut taxes on income, and would not involve a higher tax burden overall.

- Replacing the existing air passenger duty with a pollution charge based on the emissions of each flight. This will be charged on the operator rather than individual passengers. The present Air Passenger Duty has raised 8 per cent less revenue in the four years from 2000 despite a 35 per cent rise in passengers.

- The existing climate change levy should be reformed into a universal carbon tax. A new carbon tax should include household emissions as well as business emissions with appropriate provisions for the less well off. In the meantime, the climate change levy should be raised in line with inflation as proposed by the Chancellor in the Finance Bill.

- Reforming Vehicle Excise Duty (VED) on new cars purchased in future so that it is much more sharply graduated according to CO_2 emissions, with the most emitting vehicles paying as much as £2000 per year. The new rate would cover high emission vehicles (emitting more than 225 grammes of carbon per kilometre) such as the BMW 7 series, Bentley Continental, and four by fours like the Porsche Cayenne and BMW X3.

  The proposal for a dramatically more progressive Vehicle Excise Duty will shift patterns of car buying and tackle the source of greenhouse gases from transport. Research from the Energy Savings Trust and the Department of Transport shows that a top rate of £2000 a year would help change behaviour and cut CO2 emissions. At present nearly 200,000 cars – or some 8 per cent of the total – are sold in this category. If people choose to purchase the most polluting cars they must recognise the environmental cost.

  Where the purchase of a new 4x4 is necessary, for example by a farmer, options do exist that mean avoiding the top rate of VED. There are four by four working vehicles like the Land Rover Freelander that have lower emissions than the top category, and would therefore avoid the full tax. This proposal is aimed at Chelsea tractors, not vital rural vehicles for example the Land Rover Freelander 4x4 2.0 Td4 Adventurer Estate (Diesel)- CO2(g/km) 205 and the Subaru Forrester 4x4 (Diesel) C02 (g/km) 220.

- Fuel duty should rise in line with inflation, so that there is no real decline from year to year. We therefore support the proposed revalorisation this year in line with inflation.

- Where cars are essential for the survival of communities in sparsely populated rural areas (defined by the Countryside Agency as the least densely populated 5 per cent of the country), the first car for a household (excluding second homes) would benefit from a 50 per cent discount in VED for all bands but the top band.

We remain committed in due course to a scheme of road user pricing that would charge vehicles according to their use of congested roads, and also according to their emissions. We welcome the Government's plan to proceed with development of this scheme, which has the potential to replace both fuel duty and vehicle excise duty.

Blue-sky thinking

There is a range of incentives that are applied in other countries that have an impact on environmental behaviour, and the Tax Commission and the Environmental Incentive Programme will consider the experience of such schemes. They include promoting environmental behaviour with regards to:

- Batteries (Italy and Denmark)
- CFC and Halons including the industrial green house gases HFCs, PFCs and SF6 (Denmark)
- Chlorinated Solvents (Denmark)
- Pesticides (Norway) and Fertiliser (Sweden): differentiated according to the environmental and health risk they present. Revenues have been reinvested in programmes to help farmers switch to organic farming
- Plastic Bags (Ireland)
- Packaging (Finland)
- Refrigeration and Air Conditioning (Austria)
- Sulphur in fuels, including shipping at a European level
- Trichloroethylene (TCE) and Perchloroethylene (PER) (Norway)
- Volatile Organic Compounds (Switzerland)

The EU Emissions Trading Scheme

'Cap and trade' schemes like the EU emissions trading scheme (ETS) are potentially the most effective way of influencing behaviour, as they provide a benefit to participants who reduce their emissions below their entitlement. By selling their surplus permits, they can reap a direct reward. Overall, emissions are likely to be cut in those areas where it is easiest to do so (because the marginal cost is lowest) or where participants least value the activities.

In order to maintain incentives under the EU ETS, however, there must be a significant price for carbon, and recent developments that have seen the price per tonne fall below €9 are worrying. Liberal Democrats believe that the best means of ensuring an incentive is the reduction of allocations across EU member states, and the auction by national governments of the maximum 10 per cent of permits allowed under the scheme from 2011.

There are likely to be many activities, however, that cannot easily be brought within the EU ETS including private road transport, so that it makes sense to use green taxes as another way of signalling the social costs of emissions. Green taxation is about changing the price of activities that collectively harm our future, so that our individual urges become compatible with a sustainable future.

Appendix A

Government revenues from environmental taxes, 1999 to 2004 *All values in £ million*

	1999	2000	2001	2002	2003	2004
Energy						
Duty on hydrocarbon oils	22391	23041	22046	22070	22476	23412
Including						
Unleaded petrol[1,3]	11952	12269	1980	0	0	0
Leaded petrol/LRP[2]	1630	286	245	239	233	242
Ultra low sulphur petrol	-	1162	10800	11149	10857	11303
Diesel	1274	32	60	0	0	0
Ultra low sulphur diesel	7338	9061	8754	10465	11155	11614
VAT on duty	3918	4032	3858	3862	3933	4097
Fossil fuel levy	104	56	86	32	0	0
Gas levy	0	0	0	0	0	0
Climate change levy	0	0	585	825	828	768
Hydro-benefit	35	42	46	44	44	40
Road vehicles						
Vehicle excise duty	4873	4606	4102	4294	4595	4800
Other environmental taxes						
Air passenger duty	884	940	824	814	781	856
Landfill tax	430	461	502	541	607	674
Aggregates Levy	-	-	-	213	340	328
Total environmental taxes	**32635**	**33 78**	**32049**	**32695**	**33604**	**34975**
Environmental taxes as a % of:						
Total taxes and social contributions	9.8	9.3	8.7	8.8	8.6	8.3
Gross domestic product	3.6	3.5	3.2	3.1	3.0	3.0

Source: http://www.statistics.gov.uk/STATBASE/Expodata/Spreadsheets/D5688.xls