# The role of tax in getting to net zero

## ICAS briefing

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ICAS

## The UK’s Net Zero Strategy

In 2019 the UK put into legislation a requirement to bring all its greenhouse gas emissions to net zero by 2050. This is a very ambitious target. Ahead of the COP26 conference in November 2021 the UK Government published its strategy for Decarbonising Transport and its Net Zero Strategy: Build Back Greener, setting out plans for how this ambitious target is to be achieved.

## Should tax be part of getting to net zero?

It could be argued that tax should not be used to further environmental policy, not least because it is likely to add complexity to the tax code. There are other approaches that the Government could adopt, such as regulation or non-tax incentives (including grants), to pursue its ambitious objectives. Should tax be neutral?

In practice, however, tax can be highly effective at changing behaviour and has long been used as a mechanism for discouraging certain types of environmentally damaging behaviour and encouraging ‘green’ investment. Landfill Tax is a clear example of the stick approach; on the carrot side there have been various capital allowances for investment in ‘green’ plant and machinery.

Tax certainly cannot do everything, but it can be a vital part of the package of measures needed to deliver net zero. What is missing from the Government – and from the October 2021 Net Zero Strategy - is any clear overarching tax strategy to support the transition.

## How might tax support the delivery of net zero?

The obvious answer is by increasing the tax burden on behaviour which damages the environment and decreasing it on environmentally ‘virtuous’ behaviour. The tax system can also give incentives for green investment. However, there are some constraints and some pitfalls to be avoided.

Given the behavioural changes (intended or otherwise) which are driven by tax, it would at least be helpful if the tax system did not encourage or facilitate behaviour and business practices which are at odds with the Government’s environmental goals. For example, the VAT system can currently disincentivise the renovation and repair of existing buildings even though from an environmental perspective it would be preferable to refurbish old buildings rather than demolishing and building something new.

## Complexity

The UK tax system is already extremely complex. Creating new taxes, such as the Soft Drinks Industry Levy (the ‘sugar tax’) and the Plastic Packaging Tax, inevitably increases that complexity. Wherever possible it would be preferable not to keep on introducing new taxes/levies or new tax reliefs. New taxes should only be adopted where there is no better way to achieve the objective and they must be well designed. Collection and administration should not impose disproportionate administrative burdens or excessive costs.

VAT is an obvious candidate for an existing tax which could be tweaked to encourage or discourage certain behaviours. As noted earlier the current rules can disincentivise the renovation and repair of existing buildings. In some limited circumstances the reduced 5% rate may be available (for example, residential properties empty for 2 years or some residential conversions) but there is clearly scope to incentivise more refurbishment and reuse of older buildings through extending the availability of the reduced and zero rates. The Government appears to recognise the potential for using zero-rating as an incentive to greener behaviour; the Spring Statement announced that for five years the zero rate would apply to the installation of energy saving materials, including insulation and low carbon heating.

From the tax reliefs perspective, there are many existing reliefs which could be amended to support the move towards net zero. Enhanced capital allowances were mentioned earlier. R&D reliefs, Patent Box, EIS and VCT could all be amended to favour the development and expansion of green technologies.

## Perverse incentives and unintended consequences

With any new reliefs or new taxes it is important to try to minimise the creation of perverse incentives and unintended consequences. The National Audit Office, in its report on environmental taxes, points out that whilst Landfill Tax has reduced the use of landfill sites significantly, it has also incentivised more illegal waste disposal. Between 1998 and 2014 the standard rate of Landfill Tax increased by 700% in real terms. The increase contributed to a 65% fall in total waste to landfill by 2014, and a doubling of tax revenue. However, higher rates also incentivised the disposal of waste in environmentally harmful ways to evade tax.

Company car taxation has been amended to favour lower emission vehicles – which has changed behaviour. However, some of the change in behaviour may reflect a shift to purchasing cars with higher emissions personally, rather than via a company.

The Government will also need to bear in mind what is happening globally. Without global agreement on tackling emissions and environmentally damaging behaviour, there is a risk that damaging activities will simply be shifted around the world, with no overall reduction in the harm to the environment.

## Carbon pricing

Many jurisdictions now have some form of carbon pricing, either using carbon taxes or emissions trading systems. This is an area where a global approach is important, to deter businesses from shifting their activities to other jurisdictions with lower costs. The UK Emissions Trading Scheme (ETS) came into force on 1 January 2021 – replacing the EU system which the UK had previously participated in.

UK ETS was established by the UK, Scottish and Welsh Governments and the Northern Ireland Department of Agriculture. It broadly applies to energy intensive industries, aviation and the power generation sector (although Northern Ireland electricity generators remain in the EU system under the Northern Ireland Protocol).

Meanwhile the EU is proposing to introduce a Carbon Border Pricing Adjustment Mechanism (CBAM) – expected to be implemented from 2026 (with a transitional information collection phase from 2023 to 2025). The aim of the CBAM is to avoid carbon leakage from the EU and promote the reduction of emissions elsewhere. Initially, it is expected to cover sectors with high emissions, cement, fertilisers, iron and steel, aluminium, and electricity, but the scope could quickly be expanded.

In its March 2021 Industrial Decarbonisation Strategy, the UK Government stated that in the immediate future its preferred method for mitigating the risk of carbon leakage would continue to be "free allocation of UK ETS emissions allowances" but noted that in the longer term, particularly in the 2030s and 2040s a range of wider measures could be deployed to address leakage risks. The House of Commons Environmental Audit Committee launched an inquiry into carbon border adjustment mechanisms in October 2021. The final evidence session was held in February 2022 and amongst other things looked at how the Treasury is addressing the risk of carbon leakage and the potential impact on the UK of the proposed EU CBAM. No report had been published by the committee at time of writing.

## Taxing sin, untaxing virtue – changing behaviours but reducing revenues

A successful tax from an environmental perspective is one which changes behaviour. Arguably, environmental taxes should never be primarily intended to raise revenues; the intention should be to change behaviour and deliver environmental benefits. A tax which continued to raise significant amounts of revenue over a prolonged period of time would have failed. Initially there could be high yields as those affected adapt to the new regime but if the environmental tax is well-designed receipts should subsequently decline, along with the targeted environmentally damaging behaviour.

The long-term consequence of successful environmental taxes will often be a reduction in government revenues which is likely to present problems. For example, fuel duty currently produces significant revenues – but these will reduce as people switch to electric cars. If more incentives are provided to encourage the switch to electric cars, the decline in revenues will gain momentum. At some point in the future it may no longer be possible to raise enough revenue from taxing environmental 'sins' or to continue to incentivise 'virtuous' green behaviour through tax breaks.

The Government will have to identify alternative ways of raising revenues – and persuade the public to accept that other taxes may have to increase to fill the gap. The Government's 2021 Transport Decarbonisation plan 'Decarbonising Transport A Better Greener Britain' comments that the Government will need to ensure that "the tax system encourages the uptake of EVs and that revenue from motoring taxes keeps pace with this change, to ensure we can continue to fund the first-class public services and infrastructure that people and families across the UK expect".

The House of Commons Transport Committee recently suggested that the Government should urgently look at options for replacing fuel duty and vehicle excise duty with some form of road pricing – before the growing patchwork of local schemes make it impossible to deliver a national road pricing scheme.

## Reports and recommendations

Whilst the Government has not had much to say on the role of tax in getting to net zero, other bodies have been reporting on the issue, including:

### National Audit Office

In February 2021 the National Audit Office (NAO) published a report on Environmental Tax Measures which examined how HM Treasury and HMRC manage tax measures with environmental objectives, including the work undertaken to design, monitor and evaluate them. The report also considered how the exchequer departments use their resources to manage the relationship between the wider tax system and the Government's environmental goals. The report noted that there were currently four taxes with explicit environmental objectives (Climate Change Levy, Carbon Price Support, Landfill tax and Aggregates Levy) but also considered other taxes and tax reliefs it identified as having an environmental impact.

The NAO concluded that there was some evidence of the positive impact that taxes can have on the environment but that not enough is known about their effect – and that the exchequer departments tended to focus on the revenue raised rather than environmental impact. It also noted that there are other taxes and tax reliefs which affect the Government's wider environmental objectives, but which are not recognised as environmental in nature. As a result little is done to identify these measures or assess their relevance to environmental goals.

### House of Commons Public Accounts Committee

The Public Accounts Committee (PAC) produced a report on Environmental Tax Measures in April 2021. It concluded that the Treasury had yet to set out how the tax system can help the Government achieve the UK's net zero target – but that the Treasury did recognise that households and businesses needed to understand the overall policy direction and where costs are likely to fall, so that they can plan. The PAC noted that the Institute for Government had called for a tax roadmap to net zero in 2020 and that the Treasury Select Committee had recommended a wider tax strategy including principles for meeting environmental objectives. The PAC added its voice by recommending that HM Treasury should consider the pros and cons of publishing a roadmap that signals a clear trajectory to taxpayers for how tax measures will be deployed to contribute net zero.

### Institute for Government

The Institute for Government published two reports on tax and net zero in 2020 and 2021. Its most recent one, published in October 2021 made a number of recommendations, including that the Chancellor should make a coherent net zero tax strategy a key element in his October budget, covering the roles both tax and spending will play in climate change mitigation and adaptation. It also suggested that the Treasury should commit to a net zero tax audit to ensure that the current tax system supports the transition. This should cover all taxes, not simply those the Treasury defines as environmental taxes.

## Will there be a UK tax roadmap to net zero?

In spite of the various recommendations for the publication of some form of environmental tax roadmap or strategy, the Government's response to the PAC report suggests that nothing is likely to appear in the near future. Whilst noting that such roadmaps offer certainty to business and individuals to support future planning, the response went on to say that it is not always appropriate for the Government to pre-announce tax reforms given the issues caused by forestalling activity and wider market uncertainty. It also noted that there is a great deal of uncertainty inherent in any modelling as far into the future as 2050, which is highly sensitive to economic, societal, and technological developments. In this context the Government's view is that a tax roadmap could ultimately give a false sense of certainty.

In the absence of a roadmap, individuals and businesses are likely to find it difficult to plan ahead for the tax changes and costs which will arise as part of the implementation of the Net Zero Strategy. It may also be difficult for the Government to ensure that tax policy is closely aligned with the development of new green technologies and supporting infrastructure.

ICAS would like to see a tax roadmap or strategy from the Government – even if the uncertainty the Government refers to means that it is subject to change in the longer term.

## The Scottish Government

The Scottish Government has its own Climate Change Plan and has put into legislation an even more ambitious target of reaching net zero by 2045. The Framework for Tax 2021, in the chapter on strategic objectives, refers to tax policy as having a crucial role in tackling climate change. However, the Scottish Government's approach to using tax to reach net zero is constrained because only certain taxing powers have been devolved.

One of the UK taxes which has been completely devolved is an environmental tax – Scottish Landfill Tax. The Scotland Act 2016 paved the way for Air Passenger Duty and Aggregates Levy to be devolved. The introduction of the Scottish Air Departure Tax (to replace APD) was expected to happen in 2018 but has been deferred due to issues with the Highlands and Islands exemption. A timeline for the devolved aggregates levy has not yet been agreed; work is ongoing, but the UK levy continues to apply in the interim.

The Scottish Climate Change plan, in its section on buildings, states that the Scottish Government will consider how to use its local tax powers, such as council tax and non-domestic rates, to incentivise or encourage the retrofit of buildings. Part of the remit of the Scottish Land Commission is to give advice on how land and property taxes could be used to help achieve various long-term outcomes for land reform, including "a just transition to net zero". The Commission's recent report to Scottish Ministers, Land Reform and Taxation, notes that the current mix of reserved and devolved taxation powers limits the ability of the Scottish Government to use tax in support of land policy, particularly as significant taxes including capital gains and inheritance taxes are not devolved. However, it does consider the extent to which taxation reforms within devolved powers can support land reform priorities, including the transition to net zero.

The Scottish Parliament does have the power to introduce new local taxes that can be collected by local authorities. For example, the Workplace Parking Levy (WPL) came into force in 2022 allowing Scotland's councils to charge businesses for providing workplace parking, if they choose to do so. The WPL is intended to cut the number of car journeys and protect the environment.

Fuel duty is a wholly reserved matter; the Scottish Government welcomed a recommendation made in the Infrastructure Commission for Scotland's 2020 report that "To enable a managed transition to an inclusive net zero carbon economy road infrastructure, the Scottish and UK Governments should immediately commit to work together to establish a charging/payment regime alternative to the existing fuel and road taxation based structure" – and made representations to the UK Government to seek progress on it. The Climate Change Plan notes that to enable reduced private car use, it continues to press the UK Government 'to review options on Fuel Duty and Vehicle Excise Duty, in the context of the need to end unsustainable travel and potential revenue generation therefrom'.

ICAS supports cooperation and joint work between Westminster and the devolved administrations on net zero policy and implementation, wherever possible.

## ICAS and sustainability

Beyond the tax arena, ICAS is one of thirteen accountancy bodies from around the world which have committed to reaching net zero emissions as soon as possible. It also joined other leading accountancy institutes in supporting a new call for action which sets out six key actions accountants can take to reverse the process of nature loss.

Stakeholders, including investors, are increasingly looking for reliable information about what entities are doing to mitigate climate change risks to which they may be exposed, and to consider opportunities arising from the transition to a greener economy. ICAS recently published a report setting out the necessary conditions for the reporting of high quality sustainability information.

## The ICAS role

ICAS (The Institute of Chartered Accountants of Scotland) is the oldest professional body of accountants. We represent over 23,000 Members who advise and lead businesses. Around half our Members are based in Scotland, the other half work in the rest of the UK or in almost 100 countries around the world.

ICAS has a public interest remit – a duty to act not only for its Members but for the wider public good. Our technical experts work in a positive and constructive manner to advise policy makers on legislation and to raise issues of importance to our Members, individual taxpayers and businesses.

Taxation is one such area of importance and ICAS has contributed, and will continue to contribute, to tax policy in Scotland, the UK and beyond.

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