The race towards net zero

Indirect Tax | Large Corporate | Environmental



01 December 2020

With the UK committed to a 100% net reduction in greenhouse emissions by 2050, *Jason Collins* and *Lauren Redhead* consider the future of environmental taxation

Key Points

What is the issue?

The UK is legally obligated to achieve a 100% net reduction in its carbon account by 2050. To do this, it needs to reduce greenhouse gas emissions, or increase the capture of greenhouse gases, by an average of 15.5 million tonnes a year over the next 30 years.

What does it mean for me?

It means very little right now from a tax perspective. The UK is considering a carbon tax as a fallback on leaving the EU Emissions Trading Scheme. But can the tax system be better deployed to help meet the 2050 target?

What can I take away?

This is a fast moving area, with tackling Climate Change being at the top of the agenda for government and many businesses. The CIOT has recently established a Climate Change Working Group dedicated to pushing the agenda on the role of taxation in reducing emissions.

Wherever you might sit in the spectrum of views on climate change, the UK has legally committed itself to reaching a 100% reduction in net greenhouse gas emissions by 2050, using 1990 as the baseline. This article looks at the role the tax system may have to play in meeting that target. The government has committed to a ‘clean, green recovery’ from the coronavirus pandemic in terms of government stimulus. For many, it is clear that taxes are also going to have to rise to pay for the sums expended on supporting people during the pandemic. Should the government ensure that such rises have a twin aim of meeting the 2050 target?

Net zero by 2050

The Climate Change Act 2008 was passed with overwhelming support from politicians, environmental groups and businesses. The Act required the UK to reduce its net ‘carbon account’ by 80% by 2050 from 1990 levels. It also established an independent advisory body, the Committee on Climate Change, which is responsible for implementing the appropriate framework to ensure that the target is met.

Against the backdrop of the Extinction Rebellion protests and other climate strikes, in 2019 the Act was amended to increase the reduction target to 100%, making the UK the first major economy to commit to a ‘net zero’ target by 2050, measured

relative to a 1990 baseline. The UK is also seeking to take a leading position, leveraging its turn to host the next United Nations Climate Change Conference (COP26), postponed to November 2021, which is predicted to be the most important climate summit since the landmark Paris Agreement was agreed at COP21 in 2015.

To achieve a 100% reduction in its carbon account, the UK needs to reduce greenhouse gas emissions, or increase the capture of greenhouse gases, to the tune of on average 15.5 million tonnes per annum over the next 30 years. So although 2050 sounds like an unimaginably long way away, the size of the annual steps we need to take is very real.

Tackling current emissions

According to the ‘Commission on Climate Change – reducing UK emissions: progress report to Parliament’ (June 2020), emissions by sector last year in the UK were split as follows:

Sector	%
Transport	24
Industry	21
Buildings	18
Energy supply	12
Agriculture (Land)	9 (2)*
Aviation	8
Shipping	3
Waste	4
Fluorinated gases (F-gases)	3

* The land sector within agriculture naturally captured 2% of the UK's 2019 GHG emissions, making the sector's net contribution 7%.

Emissions will only reduce if we choose, as a society and economy, to do fewer things that involve emissions, or if technology and innovation ('cleantech') finds new ways of doing the same things but at a lower carbon cost. In both cases, the government – and tax policy – have a large part to play in promoting a reduction and alternatives strategy.

The largest emitting sector in the UK at present is transport, being responsible for around a quarter of total greenhouse gas emissions (road transport is responsible for 91% of domestic transport emissions). Transport contributes heavily to greenhouse gas emissions as many vehicles still run on petrol and diesel. The main challenges for this sector are to transition from fossil fuels to low-carbon energy sources, to support electric vehicle infrastructure and to reduce transport demand.

Another heavy emission sector is industry, which includes manufacturing and construction. Fossil fuels provided around 69% of industrial energy use in 2018. There is a drive to transition to low-carbon energy production, such as electricity from renewable energy sources, and hydrogen. The increased deployment of 'carbon capture and storage' – technology which captures carbon dioxide before it is released into the atmosphere, which is then transported and stored in a secure site – is prominent in this sector. However, the current scale of this innovation is nowhere near enough to hit net zero through carbon capture alone.
The remaining sectors have their challenges too and there is clearly a need for significant changes. Incentivising the development and procurement of greener alternatives, as well as reducing overall consumption, will be critical over the next 30 years.

Green priorities in Budget 2020

The chancellor announced some policies in the 2020 Budget to shift the UK towards a low-carbon economy. This included a £640 million contribution to the Nature for Climate Fund to plant more than 40 million trees and restore 35,000 hectares of peatland (both forms of natural 'carbon capture') and £500 million to support the rollout of the super-fast electric vehicle charging network. The government also announced Green Homes Grants, which provide homeowners in England with up to

£5,000 for energy efficient home improvements, such as low-carbon heating systems and insulation.

However, it was also clear that the chancellor did not see Budget 2020 as being the time to raise taxes so there were no climate change focused initiatives at all (the closest being the plastic packaging tax to reduce single use plastic announced in Budget 2018). Let's look at some of the 'green' options at the chancellor's disposal when the time for raising taxes does come.

Carbon tax

The United Nations has for some time promoted carbon taxation, which has been introduced in various guises by a number of countries. Sweden, for example, implemented a carbon tax from 1991, which taxes polluters by reference to the level of carbon content in fossil fuels. Ireland has introduced a number of forms of carbon taxation, including the natural gas carbon tax (levied by reference to the amount of heat energy produced when fuel is completely burnt); and the solid fuel carbon tax (set at different rates based on energy source).
The UK has to date chosen not to implement a carbon tax, opting instead for a carbon price floor made up of a carbon price support tax (imposed only on the UK power sector) and participation in the EU's Emissions Trading Scheme (ETS). The UK will be leaving the EU ETS at the end of the year and the current proposal is that the UK will enact its own ETS. The 2020 Budget did, however, announce a consultation to start later this year on the design of a 'carbon tax' as an 'alternative' to introducing the UK's own ETS – and as a 'fallback' given the 'inherent uncertainty' in whether it would be possible, even if desirable, to agree to link the UK and EU schemes.

The clear benefit of a carbon tax is that it is levied at source (either on extraction or importation of fossil fuels). It is therefore easier to impose because it is levied before the carbon is burned and the emissions become fragmented into industrial and other supply chains, where taxation of carbon or emissions becomes more difficult to measure and administer. However, the principal downside of a carbon tax (and an ETS) is that the cost becomes lost very quickly within those supply chains. It can lack transparency for the end user in terms of how tax is being levied on their individual carbon footprint and how they can make greener choices moving forward.

Principles of environmental tax reform

Environmental taxation has for many years sat on the fringes of domestic tax policy and targets particular issues, such as the climate change levy and air passenger duty. As an indirect form of taxation, environmental taxes are payable on the basis of consumption. Increases in environmental taxes may be viewed as regressive, especially where alternatives to avoid or reduce the tax burden are unavailable or expensive. Tax policy has had a stronger focus on social and economic impact than on climate change. The VAT code, for example, treats food, energy and transport as ‘essential items’ which are not to be burdened by excessive taxation.

In many cases, these tax breaks fail to distinguish in any way between goods and services based on their environmental impact. Even where tax breaks are apparently green in nature, their application can be haphazard with arbitrary cut off points. This can be seen in the recent case of Greenspace (UK) Ltd [2020] UKFTT 349 (TC) concerning the VAT treatment of insulated roofing panels supplied to domestic customers, which the taxpayer argued fell within the reduced rating provisions for installation of energy-saving materials.

The taxpayer lost. Despite offering a solution for roof installation that would reduce household fuel consumption and thus benefit the environment, the narrow wording of the provisions meant that the panels fell outside the preferential VAT treatment. If a true climate change tax policy mindset was present across government, a response to the case could have been to change the law, perhaps even retrospectively. As Judge Rachel Short commented: ‘The answer to any perversity in a case like this is to argue for a change in the legislation to include the type of insulated conservatory roof panels which have been supplied by Greenspace, rather than use perversity as the basis for interpreting legislation to override its clear wording.’

Perhaps the need to meet the 2050 target should be given a legislative basis such that tax provisions can be construed or enabled to allow for developments in carbon efficiency without the need to return to Parliament on each occasion of change At the very least, new tax legislation needs to have an overarching policy test to ensure that it has the net zero target in mind.

Post-Brexit VAT policy

There are many areas of VAT policy where the climate is simply not a consideration; for example, the use of the reduced VAT rate for domestic fuel or power, even where it comes from fossil fuel sources, and the zero rating of ‘non-luxury’ food, regardless

of whether it has been sourced locally or flown around the world.
The end of the Brexit transition period on 31 December 2020 will mean the UK has autonomy over VAT and an opportunity to incorporate green initiatives in the future structure of our VAT system. For example, the UK could only allow reduced rated VAT to apply where domestic fuel is derived from renewable sources or to take away the zero-rating on transportation which does not involve a green method.

In addition, the tax system could seek to change consumer tastes to make them greener. The VAT rate could be flexed according to a regulatory traffic light system showing the environmental impact of a product (such as energy efficiency in white consumer goods). A similar approach could be taken in other consumer areas, such as in food. There is a risk that imposing higher taxes based on food ‘air miles’ might be viewed as anti-competitive under trade agreements. At the moment, however, it is not clear that climate is even considered to be a factor in trade negotiations.

Perhaps the biggest challenge against reform is that the most climate friendly option in VAT and consumption taxes may come at heavy social and economic impact on poorer households. Changes in consumption tax may need to be balanced by adequate compensatory spend in other government policy areas, such as through benefits, grants or other tax reliefs.

Cleantech and innovation

The other side of the coin to reducing emissions-heavy activities is the promotion of new lower-carbon ways of doing things, supporting innovation through R&D credits on creation of new cleaner technologies. However, this has limited effect if businesses are not then encouraged to purchase them. Enhanced capital allowances for energy efficient or environmentally beneficial technologies and products have been abolished since April 2020, meaning businesses have fewer incentives to choose eco-friendly plant and machinery options.
The government has said that the ‘savings’ from abolishing these reliefs will be used to fund the Industrial Energy Transformation Fund – to support the development of technologies that enable businesses with high energy use to transition to a low carbon future. This highlights a critical question: is a system of grants better at promoting innovation than a system of tax reliefs or payable tax credits? Or do we need a combination of both?

The way forward

The CIOT has recently established a Climate Change Working Group – a cross-cutting committee dedicated to pushing the agenda on the role of taxation in reducing emissions. Some key ideas coming out of its first meeting in September 2020 are:

- the need to ensure there is a proper climate change focused mindset at government level; for example, by introducing the requirement to consider the impact on the net zero target when designing all new tax legislation (just as it currently has to go through a social and economic assessment as part of the tax information and impact notes);
- a full review of the effectiveness of past environmental taxes to identify lessons to be learned (the National Audit Office is working with academics and stakeholders to review management of the lifecycle of a number of environmental taxes, aiming to identify good practices and changes for the future, but we also need to examine whether they have achieved their policy aims); and
- the need for a climate change tax policy road map – similar to the corporate tax road map published by the Coalition government in 2010 – setting out the key aims of future tax policy in tackling climate change and how to achieve those aims.

Clearly, action needs to be taken now if the country is going to achieve its legal obligations. We need to create a framework that ranks the importance of tackling climate change alongside that of other key priorities in our already complex tax system.