The UK Tax System and the Environment

Despite the stark findings of the Stern Report, published this week, the Government now receives a smaller share of both national income and total tax receipts from environmental taxes than when it was elected in 1997, research published today by the IFS shows. Meanwhile total carbon dioxide emissions have risen.

The report, *The UK Tax System and the Environment*, funded by the Esmée Fairbairn Foundation, examines in depth the current system of green taxes in place in the UK, their design and effectiveness, and looks at the recent history of green tax revenues and greenhouse gas emissions.

Under the Kyoto Protocol, the UK is required to reduce emissions of a basket of greenhouse gases by 12.5% compared to 1990 levels by 2008 – 2012. The UK met this target as early as 1999 but since then total emissions have stabilised at just below the target level. Looking at CO$_2$ alone the story is worse. In 2000, the Government set itself a domestic target to reduce CO$_2$ emissions by 20% from their 1990 levels in 2010. By 2005, emissions had fallen by only around 5% from 1990 levels, but had risen by 4% compared to their lowest level in 1999 and by 2% since 1997 when Labour came to power. In 1990, CO$_2$ emissions would have had to fall by an average of 1.1% per year to hit the target in 2010. From 2005 levels, emissions will have to fall by 3.3% per year, three times as quickly, for the target to be met.

In terms of revenues from green taxes, the report looks at trends between 1993 and 2004 from the Office for National Statistics. Unavailable at the time of writing, more recent data to 2005 reveals that:

- In cash terms, total revenues from green taxes rose from £27.3bn in 1997 to £35.0bn in 2005, the highest value on record. Adjusting for inflation, however, real revenues expressed in 2005 values have increased only by £2bn, from £33.0bn to £35.0bn over the same period. Real revenues peaked at £37.7bn in 1999.

- Receipts from green taxes have fallen from 3.4% of national income in 1997 to 2.9% in 2005 having peaked at 3.6% in 1999, and from 9.4% of total receipts to 7.7% over the same period. They now make up a smaller share of total revenue and national income than at any time since 1993, from when figures are available.

- These trends have been almost entirely driven by the decision to abandon the annual fuel duty escalator in 1999. Since abandoning the escalator, real fuel duty per litre has fallen by 16.9% and real fuel duty revenue has fallen by almost £3bn, from £30.4bn in 1999 to £27.4bn in 2005.

- However the UK is not alone in these trends – latest data from the OECD shows that in 2003 environmental tax revenues made up a smaller share of GDP across developed countries than in 1994. Further, the UK takes a larger share of revenues and GDP in green taxes than the OECD average, largely due to the relatively high fuel tax rate.
Since 1997, a number of new green taxes have been introduced and other taxes have been adjusted to give them a greener hue: the Climate Change Levy and Aggregates Levy have been introduced, the rate of Landfill Tax has been tripled, incentives to install energy saving materials have been incorporated into the VAT system, and Vehicle Excise Duty and the company car tax have been adjusted so that the amount payable depends on the emissions rating of the vehicle. In addition, 2002 saw the launch of the UK Emissions Trading Scheme (ETS) and 2005 the EU ETS. There has therefore been considerable activity in environmental taxes in recent years even as total real-terms revenues have fallen. Some reforms have gone the other way: for most passengers, the rate of Air Passenger Duty was halved in 2001 and whilst the cut in the rate of VAT on domestic fuel from 8% to 5% in 1997 will have had positive distributional impacts for the poorest, the environmental effects of the move are likely to have been negative.

The report’s author, Andrew Leicester, said: “Green tax revenues are now at their lowest in real terms for almost a decade and have not represented a smaller share of total revenues in 15 years, yet we now have a greater number of green taxes than ever. This apparent paradox can be explained by two factors. First, the decision to abandon the fuel price escalator – the new measures simply don’t bring in enough revenue to cover the revenue cost of a fall in real duties of almost 20% since 1999. Second, the growing importance of emissions trading schemes, which haven’t brought in revenues but still provide environmental incentives to businesses to reduce emissions. In the wake of the Stern Report, there will doubtless be strong pressure on the Chancellor to push up green tax revenues and/or extend emissions trading schemes.”

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Notes to editors


2. Revenue data is taken from the Spring 2006 Environmental Accounts, available at http://www.statistics.gov.uk/downloads/theme_environment/EAMay06.pdf. In 2006, the ONS published a review of the classification of environmental taxes which will affect future data – see page 15 of Economic Trends October 2006, available at http://www.statistics.gov.uk/downloads/theme_economy/ET635.pdf. The most notable change was the decision to exclude the VAT charged on fuel duty from the definition, which removes about £4bn from environmental tax revenues in 2005. However as it affects data going back as well, the trends discussed in this release will remain largely unchanged. Figures for fuel duty revenues in this release include the VAT on the duty.

3. The fuel duty escalator was introduced by the Conservative Government in 1993, at a rate of 3% above inflation each year. This was raised to 5% in 1995 and 6% in 1997. The escalator was abandoned in the Pre-Budget Report of November 1999. The 16.9% real decline in duties represents the fall for premium unleaded and diesel between November 1999 and September 2006. In September 2006 prices, fuel duty was 56.66p / litre in November 1999 and 47.10p / litre in September 2006.

4. Andrew Leicester is a Senior Research Economist in the Consumption and Savings sector at the IFS.