A Green Tax Shift is often talked about as something government could perhaps attempt in the future. Yet, a number of green tax shifts have already been implemented in the UK and beyond. This briefing describes and draws lessons from two green tax shifts that have already taken place in the UK in the 1990s, one by a Conservative government and the other by a Labour government. Both shifts were based on a fuel duty escalator increasing the price of road fuels and income tax cuts reducing the cost of labour.

These shifts resulted in benefits that are often overlooked. These include the environmental benefits of reduced fuel use, emissions and travel demand. In economic terms a reduction in taxes on employment, is to be expected to have increased both UK employment and economic output. Yet these broader benefits of the tax shift were rarely highlighted and the public unpopularity of the fuel tax escalator eventually resulted in its being abandoned.
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About the Green Fiscal Commission

The Green Fiscal Commission is an independent body and is not affiliated to any political party or government. Its membership includes experts from business, leading academics, senior MPs from all three main UK political parties, three members of the House of Lords, and representatives from consumer and environmental organisations.

The Commission’s aim is to assess the social, environmental and economic implications of a substantial green tax shift, such that 15-20 per cent of tax revenues come from environmental taxes. The Commission is reviewing and collating the existing evidence on the implications of a green tax shift as well as conducting new research. The results from this work will be placed in the public domain to stimulate debate and we hope action on this agenda.

This briefing is the first in a series which will summarise the main messages from the work of the Commission. Future briefings will cover a wide range of issues associated with the implementation of a major green tax shift, problems that may arise and how these can be overcome. The series will, for example, cover the impact of green fiscal reform on economic competitiveness, the effectiveness of green taxes, and associated distributional issues. These briefings will be available on the Green Fiscal Commission website where it is also possible to sign up to receive email updates on the work of the Commission.

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Lessons from Two Green Tax Shifts in the UK

Summary

A green tax shift, that is a systematic shift of taxation from ‘goods’ like labour, to ‘bads’ like pollution, is often talked about as something government could attempt in the future, perhaps when the time is right or when perceived issues associated with it are overcome. Yet, a number of green tax shifts have already been implemented in the UK and beyond. This briefing describes and draws lessons from two unannounced green tax shifts that took place in the UK in the 1990s, one by a Conservative government and the other by a Labour government. In both shifts, a fuel duty escalator increased the price of road fuels, whilst simultaneous cuts in income tax reduced the cost of labour.

These shifts resulted in benefits that are often overlooked. Environmental benefits included reductions in fuel use, emissions and vehicle mileage below what they would otherwise have been. In economic terms a reduction in taxes on labour will have made employment more attractive, and may have increased both UK employment and economic output. Yet these broader benefits of the tax shift went almost entirely unnoticed and uncelebrated, and the public unpopularity of the fuel tax escalator eventually resulted in its being abandoned.

What is a green tax shift?

The concept of a green tax shift is simple: taxes on the things that are valued by society, like jobs, incomes and profits, are reduced and the lost revenue is replaced by taxes on things society does not like, such as pollution and environmental degradation. ‘Pay as you burn, not pay as you earn’ as Shadow Chancellor George Osborne has put it. This shift not only reduces pollution, but is a more economically efficient way of raising necessary, but as ever, unpopular tax revenues. Taxes on labour at their current level, for example, distort the economy and reduce its efficiency and output. A green tax shift does not mean a change in the overall level of tax, just a different basis for raising the public revenues that are required by Government to operate.

While a green tax shift does not mean the overall rate of tax will change at the national level, it does mean people and business will see the amount of tax they pay change: the polluter will pay. Highly polluting households and businesses should see their tax bill increase where as low pollution households and businesses should see their tax bill cut.

Why do we need a green tax shift?

If the UK is to meet its climate change and other environmental targets it will need to apply a wider range of policy measures, and apply them more stringently.

The blunt fact is that current policies are not sufficient to drive reduction of carbon emissions to a level that will avoid a dangerous level of climate change.

Price is a fundamental factor which affects the type of products and services individuals and businesses buy and the level of demand for them. Changing the price of polluting activities relative to clean ones is a vital element in any serious package of measures intended to reduce climate change emissions.

A green tax shift is one way of achieving this shift in prices. As with any major policy initiative a green tax shift is not without challenges to be overcome. Not least, changing prices is politically controversial, although the reality is that any measure that is likely to be effective in changing behaviour will be controversial. The objective of the Green Fiscal Commission is to explore the economic, social and environmental implications of a major green tax shift for the UK, address the challenges it poses and develop a framework for a green tax shift that is economically sensible and environmentally effective, and can become socially acceptable as people realise the imperative of reducing carbon emissions and climate change.

This briefing examines the UK’s experience of implementing the Fuel Duty Escalator over the period 1993-1999. Based on detailed research conducted by the Green Fiscal Commission it explores the broader fiscal context surrounding the escalator and draws lessons for government to consider in implementing any further green tax shifts.
The Fuel Duty Escalator – recognising its benefits

The Fuel Duty Escalator (FDE) was introduced by the Conservative government in 1993, and was maintained by Labour until 1999. It entailed an annual increase in fuel duty above the rate of inflation, of 3 per cent in 1993-94, 5 per cent from 1994-95 to 1997-98, and 6 per cent from 1998-99 to 1999-2000.

No measure like the Fuel Duty Escalator that aims to increase annually the duty on a product at a rate significantly above the rate of inflation is ever going to be popular. Public attention focused almost exclusively on the impact of the escalator on the price of fuel, the consequent impact on the consumer and business finances, and the fuel protests of 2000 that followed albeit the year after the escalator was abandoned.

Yet behind the headlines and the spectacle of fuel protests there is a more positive story to tell. With a broader perspective the fuel-duty escalator can be presented as an eminently desirable public policy measure. For example, it raised significant revenues, allowed other distorting taxes to be reduced, penalised pollution and rewarded labour: all of which are desirable policy outcomes. This more positive view of the benefits of the FDE hardly emerged in the public debate to balance the unpopularity of the measure itself. Yet in the context of these broader benefits and the imperative of addressing climate change it shifts the focus to how to introduce measures that are necessary but politically difficult.

Fuel Duty Escalator revenues were balanced by cuts in income tax

Introduced in 1993, as the revenues from the FDE increased the Conservative government simultaneously cut income tax from 25 per cent to 24 per cent in 1995 and to 23 per cent in 1996. The loss in revenue from these cuts in income tax totalled about £4.7 billion in 1997, which was more or less the same as the revenues generated over 1993-97 by the FDE as calculated by the Green Fiscal Commission. Without drawing attention to it, the Conservative government had in fact implemented an environmental tax reform, or green tax shift.

In its first term from 2001, the Labour government also made a number of changes to income tax, including a cut in the standard rate to 22 per cent, which altogether cost about £2.3 billion. This was more than offset by revenues from the FDE in 1998 and 1999 of at least £2.8 billion. Labour had also introduced an unannounced green tax shift.

Environmental taxes do not need to be spent on environmental measures

It is important to note that the revenues from the FDE were not allocated to environmentally-related spending. It is a widespread view that revenues from environmental taxes should be directly allocated – or hypothecated – to environmentally-related spending and this view is used to define green taxes. Of course, if they are so allocated, then increases in green taxation amount to an increase in public taxation.

The Green Fiscal Commission does not accept an automatic link between the revenues from green taxes and how they are spent. Instead it regards the benefit of green taxes - taxes that are levied on non-renewable resources or pollutants or on activities that use or produce them - as encouraging the more efficient use of resources, and reduced pollution. Revenues may be used to reinforce this effect, but can also be used to reduce other taxes.

This difference is important as the Commission is investigating the impacts of a major green tax shift, such that 15-20 per cent of tax revenues are from green taxes (instead of the current 7 per cent). It is clear that it would be excessive to allocate 20 per cent of tax revenues to environmentally-related spending. The Commission does of course acknowledge that it may be appropriate to allocate a proportion of green tax revenues to spending on environmentally-related expenditure and one aspect of its work is examining the impact this might have.

Impact of fuel duty escalator on tax revenues

Following its implementation in 1993, there was an increased and continued upward trend in revenues from fuel duty as Figure 1 shows. In 1987 receipts from fuel duty were £7.6 billion. In 1993 receipts totalled £12.5 billion, but had almost doubled in value by 2000 when receipts peaked at £23 billion. The effect of abandoning the FDE in 1999 cannot be clearly seen in Figure 1, as the upward trend was not only halted, but receipts fell, taking around four years for...
Furthermore, due to the relative size of fuel duty revenues, the abandonment of the FDE has had a wider impact on receipts from all environmental taxes in the UK. Receipts from all green taxes have fallen from 3.4 per cent of national income in 1997 to 2.7 per cent in 2006, having peaked at 3.6 per cent in 1999, and from 9.4 per cent of total government receipts to 7.3 per cent over the same period. In real terms, they now make up a smaller share of total revenue and national income than at any time since 1987.

However, the post-2000 plateau in receipts only tells part of the FDE story, since the data in Figure 1 do not take inflation into account. There was, in real terms, a reduction in the per litre level of fuel duty taxation following the abandonment of the FDE. Between 1999 and 2006 there were only three rises in fuel duty, each time only in line with inflation (IFS 2007:192). IFS (2006) calculates that after the abandonment of the FDE, real fuel duty per litre fell by 16.9 per cent and real fuel duty revenue fell by almost £3 billion between 1999 and 2005, from £30.4 billion in 1999 to £27.4 billion in 2005 (index year 2005).
The two unannounced green tax shifts highlighted above were in fact in addition to two explicit green tax shifts that were implemented over this period by successive Conservative and Labour governments: the Tories’ introduction of landfill tax in 1996, accompanied by a cut in the rate of employers’ National Insurance contributions (NICs); and Labour’s introduction of the Climate Change Levy in 2001, also accompanied by a cut in employers’ NICs.

It is not clear why the two governments did not make an explicit connection between the FDE and the cuts in income tax which it enabled. Whether an explicit environmental and economic justification from government for the FDE would have prevented its being publicly discredited is debatable. What is clear is that failing to defend it as a desirable public policy measure has caused problems for the subsequent debate on environmental tax reform. In reality, both these tax shifts clearly illustrate the benefit of a green tax shift as a policy: environmental improvement (acknowledged and quantified in the Government’s Climate Change programme in 2006), and a reduction in taxes on ‘goods’ (in this case employment), which may be expected to have a positive effect on the labour market. What is more, the revenues from the FDE proved to be stable so that the green tax shift they made possible was also sustainable in public finance terms.

There seems little reason why a green tax shift of this kind should not be made explicit and celebrated as a policy that makes both economic and environmental sense.

Key messages

• Price is a powerful policy tool but this also makes it controversial. Therefore the wider benefits of shifting prices through tax must be highlighted.

• There is an explicit need for a green tax shift – to reduce carbon emissions – and a need to be explicit about implementing green tax shifts and their broader benefits if they are to be publicly acceptable.

• Any green tax shift therefore needs to be clearly articulated by government, highlighting both the taxes that will be increased and, more importantly, the ones that will be cut. The broader environmental and economic benefits of the shift also need to be clearly communicated to make it clear that people and businesses that pollute will pay more taxes and those who don’t will pay less.

• Green taxes can be simultaneously used to raise revenue, change behaviour, reduce resource use and pollution (through behavioural change and stimulation of new technologies) and shift the basis on which tax revenues are raised.

• The revenues from green taxes do not need to be spent on environmental measures – if they are it is no longer a green tax shift but an increase in government spending which implies either higher taxes or making cuts in other services.

• Green taxes can generate significant revenues, particularly if escalators are used, allowing other taxes on households and business to be cut.

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