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Green Taxation and Sustainable Fiscal Reform

Stephen Smith

University College London

Introduction

- My story today is about tax reform.
  - *What are the prospects for achieving rational and durable reforms to the tax system?*

- Some reflections based on two major reviews of the UK tax system, both chaired by UK Nobel prize-winners in economics
  - *James Meade, "The Structure and Reform of Direct Taxation", 1978*
  - *James Mirrlees, "Tax by Design: The Mirrlees Review", 2011.*

- Some observations about the role of green taxation in sustainable tax reform
  - *What should be the priorities?*

Fiscal policy and the economic crisis

- Urgent need for additional tax revenues in many countries to eliminate the structural deficit in public finances
  - *and, in some, to reduce short-term deficit financing needs*
- These extra revenues need to be raised in a way which minimises long-term damage to the efficient functioning of our economies
  - *Tax-induced inefficiency and waste in production and consumption activities*
  - *Failure to set appropriate prices for the consumption of natural and environmental resources.*
- In addition, the additional revenues need to be derived in a manner consistent with social solidarity
  - *questions of short-term political feasibility and long-term durability*

Green taxation and fiscal consolidation

- There is obvious scope for new green taxes on energy and road transport to contribute substantial revenues
  – *though not enough to close the revenue gap entirely.*

- Carbon tax at € 30 / tonne CO2 could raise £15 billion if applied to all UK energy consumption (approx 2% of total revenues)

  …but lower if domestic energy and road transport fuels excluded, and if existing Climate Change Levy replaced

  …and even lower if some trade-exposed sectors exempted

- Efficient externality taxes on road transport could raise more than £25 billion (5% of revenues), mainly by charging for congestion

  …but existing motor fuel taxes are at a similar level

  …so better incentives, but little extra revenue

The Meade Committee (1978)
The Structure and Reform of Direct Taxation

- Origins amongst tax practitioners in the City who were dismayed by many years of poorly thought-out and unprincipled tax legislation
  - *Initiated by the Institute for Fiscal Studies (ie at arm's length from government), with tax practitioner and academic members*
- Emphasised "neutrality" as simple guiding principle for tax structure
  - *as far as practicable, taxes should raise required revenues without "distorting" taxpayer behaviour*
  - *tax similar activities in the same way – eg income and capital gains*
- Most radical recommendation was a "direct expenditure tax"
  - *Replace income tax with a tax on income minus net savings*
  - *To eliminate "double taxation" of income from savings*

The Mirrlees Review: “Tax by Design” (2011)

- Like the Meade Committee, initiated by IFS, with funding from major research charities and ESRC (academic research funder).
- 5 year exercise, with intermediate conferences to discuss and test ideas
- 63 contributors to background papers on each major area of taxation, published in 2010 as “Dimensions of Tax Design”; each paper had UK and international co-authors
- 10-member review team, chaired by Mirrlees, wrote report, informed by, but independent of, the background papers
- Aimed to identify the requirements for a good tax system in an open economy in the 21st century, and to suggest how the UK tax system should be reformed.
- Considered the whole of the tax system (Meade review was confined to the direct tax system)

Meade and Mirrlees: some differences

- Major changes in the policy context in 30 years since Meade
  - *Globalisation of the economy*
  - *The growing importance of the EU for UK policy*
  - *Major changes in information technology have implications for tax collection and enforcement, and for economic activity*
  - *Greater awareness of environmental issues*
- Significant advances in economic analysis
  - *No radical changes in economic theory of taxation, though refinement in some areas*
  - *Much more scope to quantify effects of taxes and to simulate possible tax reforms. This is a distinctive feature of the Mirrlees Review – the use of state-of-the-art estimates of the impact of its proposals.*

Mirrlees Review: Three principles to underpin good tax policy

- **Consider the tax system as a whole**
- Many mistakes are made by looking at one tax in isolation, without considering how it fits into the system as a whole

- **Seek neutrality**
- Generally avoids distortions and implies cost-reducing simplicity.
- Non-neutrality is justified only where there are strong reasons to change behaviour – carbon, tobacco, etc

- **Achieve progressivity (“re-distribute”) as efficiently as possible**
- Poorly-designed redistribution can impose significant costs on the economy.

Mirrlees review recommendations include

- Integration of income tax and social security payroll taxes into a single tax with a coherent structure
- Extend VAT to tax most goods and services at a single rate, and impose equivalent taxes on financial services and the consumption of housing.
- Maintain higher taxes on alcohol and tobacco.
- Use taxes to ensure a consistent carbon price on all emissions sources.
- A well-targeted road congestion tax to replace poorly-targeted motor fuel taxes.
- Other major changes to the taxation of savings and investment, and to corporate taxation.
- A land value tax for business and agricultural land

How did the Mirrlees Review expect to influence tax policy?

- Two of the authors of the report, Paul Johnson and Gareth Myles, write…

- "In the real world… proposals for tax reform are constrained by politics – not least the unfortunate observation that those who lose from tax reforms then to be vengeful while those who gain from them tend to be ungrateful. This can lead to … the *tyranny of the status quo*.

- The review was not written with any expectation that all its recommendations could confidently expect immediate and enthusiastic support across the political spectrum. That would have left us with a very short report indeed."

Independence

- Clear independence from government was crucial to the Mirrlees Review (and to the Meade Committee)
  - *This is crucial to long-term influence, extending beyond the tenure of the current government.*
- The review could (and did) draw conclusions without regard to short-term political feasibility.
- The aim is a long-term blueprint
  - *a "policy compass" to influence future policy development*
  - *and to discourage unjustified policy change.*
- There is considerable evidence that the earlier Meade Committee report played this role for many years, influencing an entire generation of tax policy-makers.

Durability/sustainability in tax policy

- A clearly-articulated, non-partisan underlying logic is the best defence against opportunistic change
- This requires simplicity and transparency wherever practicable (though some areas of taxation are unavoidably complex)
  - *Uniformity ("equal treatment") is more defensible against special-interest lobbying than more sophisticated rate structures.*
- Policy stability is desirable in many areas of tax policy, especially where taxation is liable to affect long-term business investment decisions.
  - *External policy audit or review institutions which slow the pace of policy change can play a useful role in limiting instability*
- The tax system also needs to offer scope for the political process to effect change (eg a shift in the distribution of the tax burden) without costly disruption.

Sustainable green taxation – some implications - 1

- Green taxes will play a crucial role in delivering environmental sustainability, fiscal sustainability and economic sustainability.

- *I hardly need to say this here, but….*

- Broad changes in behaviour are needed across many firms and individuals
  - *millions of individual decisions by businesses and individuals*
  - *Direct regulation on the scale needed would be impracticable, and risks making the market sclerotic and inflexible.*
  - *It would have to focus on large-scale projects, but many smaller decisions need to change too.*

- Green taxes can guide every individual decision by changing the “grain” of the economy.
  - *A crucial linkage between the case for green taxation, and the promotion of economic recovery*

Sustainable green taxation – some implications - 2

- Bear in mind the limitations of targeting
  - *Effective targeting is crucial if environmental effectiveness*
  - *Poorly-targeted incentives can cause wasteful actions*
  - *But complexity and over-sophistication can be costly to run*
  - *and are exposed to erosion through lobbying*
- Large incentives may be needed to change business behaviour
  - *Internal organisation of firms may inhibit response to taxes*
  - *Firms may simply pay small environmental taxes without taking any action to cut emissions*
  - *Green taxes should be large, or they are not worth having*
  - *(but of course any green taxes should be set at a level reflecting marginal environmental damage)*
- Both imply focus on a limited number of major potential taxes
  - *Carbon tax, congestion tax.*

Sustainable green taxation – some implications - 3

- Both fiscal and environmental policies are subject to continual evolution and adjustment, in response to experience, political and lobbying pressures, etc.
- Where stability is crucial to effectiveness, this creates real problems:
- In the energy sector, some of the crucial decisions affecting emissions performance are based on incentives over a long time horizon
  - *Investing in renewables, nuclear or CCS requires long-term premium for non-carbon energy – ie a positive carbon price, sustained over 20+ years*
  - *Requires a degree of political commitment that few democratic systems can deliver*
- Does this have implications for the policy instruments we employ?
  - *Is a $30/tonne carbon tax more likely to survive for 20 years than an ET system with the same carbon price?*

In conclusion….

- Both environmental and fiscal policies face issues of long-term sustainability, in the face of political developments and lobbying pressures.

- Thinking about how to promote long-term policy durability should be a key question for advocates of green taxation

- There are no simple answers, and experience of tax policy-making provides many cautionary tales
  - *Persistence of tax privileges for groups with lobbying power*
  - *Costly complexity and lack of transparency*
  - *Destructive political initiatives*

- What can be learned from tax policy-making, that will help promote a long-term and sustained transformation in environmental incentives?

- I have described some of the ways in which I believe periodic independent review can make a useful contribution to promoting long-term policy rationality and stability.