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Environmental and environmentally-related taxation

Note by the Secretariat

Summary

This paper provides background information on environmental and environmentally-related taxation issues, for consideration by the Committee in developing their work programme. A decision is sought by the Committee, on the establishment of a Subcommittee on Environmental Taxation Issues.

The Committee started substantive work on environmental taxation issues in 2016. It established a multi-stakeholder, multi-disciplinary Subcommittee in 2017, with the mandate to develop policy and administrative guidance on carbon taxation. The decision to focus on carbon taxation was due to its suitability as an instrument for all countries including developing countries (simple to design and administer, uses existing fiscal infrastructure) and its efficacy in reducing carbon emissions, therefore supporting countries in meeting their targets under the Paris Agreement on Climate Change. At the international level, besides the Handbook, there is currently a lack of comprehensive guidance on carbon taxation that is specifically targeted to the needs and situations of developing countries.

The paper proposes the creation of a Subcommittee on Environmental Taxation Issues, with a mandate centred on the following issues: producing practical guidelines on targeted, additional and emerging issues in the area of carbon taxation; and, in collaboration with any Extractive Industries Taxation Subcommittee created and authorized to do so, working on practical tax policies/measures assisting country efforts in transitioning from fossil fuel energy to renewable sources.

Background

Environmental and environmentally-related taxes

1. Currently there is no universal, generally accepted definition of *environmental taxes*; the OECD and the International Energy Agency (IEA) define an environmental tax as: "a tax whose tax base is a physical unit (or proxy of it) that has a proven, specific negative impact on the environment. Four subsets of environmental taxes are distinguished: energy taxes, transport taxes, pollution taxes and resource taxes". In this note, we refer to "climate taxation" to indicate taxes that have a direct impact on the reduction of carbon emissions (which are responsible for climate change).

2. On the other hand, *environmentally-related taxes* (also referred to in this agenda item) are defined by the OECD as "compulsory, unrequited payment to general government levied on tax-bases deemed to be of particular environmental relevance". In this sense, while environmental and environmentally-related taxes can have the same effect on the environment, the reason why they are introduced is different: environmental taxes have an environmental purpose (and effect), while environmentally-related taxes can be introduced with any purpose, although their effect can have environmental significance as well.

3. Environmental taxes are usually indirect taxes, most commonly employed in the form of excise taxes, which are either imposed on a product or on a production process and can be levied on extraction, import, during a production process or at consumption level. Environmentally-related taxes, on the other hand, can be both direct and indirect taxes. In the note below, the discussion is focused on environmental taxes, although it is recommended that other environmentally-related taxes be also covered in the work of the Subcommittee, when considering instruments that can achieve a certain environmental goal.

4. A carbon tax is a specific type of environmental tax, levied on carbon emissions or its proxy. Carbon taxes also belong to the broader category of carbon pricing instruments, i.e. measures intended to put a price on carbon emissions and thereby encourage consumers and producers to reduce them. Other carbon pricing instruments include emission trading systems (ETS, or cap-and-trade) and carbon offsets; unlike a carbon tax, these require the creation of a carbon market where each industrial installation is granted a maximum level of carbon emission beyond which it is required to pay for the excess. Industrial units may sell or buy their carbon "allowance" on the open market.

5. Carbon taxes put a price on carbon emissions, thereby motivating companies to invest in cleaner technology or switch to more efficient practices. Likewise, consumers may be incentivized to invest in energy efficiency, change their lifestyle habits or, where options are available, switch to cleaner forms of energy. Moreover, additional revenues could be used to invest in sustainable development. From a practical point of view, carbon taxes are an instrument that is relatively simple to administer, and it can take advantage of existing fiscal infrastructure present in most

countries. For example, one way to introduce carbon taxes is to apply a tax on fossil fuels (e.g. gasoline, diesel etc.), that is proportionate to the carbon content of those fuels. Since most countries in the world apply some type of tax or levy to fuels, they most likely already have in place at least some of the necessary administration to also introduce a carbon tax.

6. Carbon pricing can be used by countries to lower their carbon emissions and meet their Nationally Determined Contributions (NDCs) pledges under the Paris Agreement. In fact, two-thirds of all submitted NDCs (around 100 countries) consider the use of carbon pricing to achieving their emission reduction targets. It is estimated that it could alone reduce the cost of climate change mitigation by 32% by 2030 and achieve full potential when coupled with coherent energy and environmental policies.

7. As of May 2021, 64 carbon pricing instruments had been implemented, and three more scheduled for implementation; of these, 33 are carbon taxes, primarily applied on a national level. Although these instruments represent around 21.5% of global Greenhouse Gas (GHG) emissions, less than 3.8% of emissions are priced at levels consistent with the Paris Agreement goals.

8. Within the broader context of environmental issues, carbon taxation remains a key pillar for long term solution for environmental rehabilitation for sustainable development. It should be noted that the annual ECOSOC Special Meeting on international cooperation in tax matters (most recent meeting on 29 April 2021) has included a panel on environmental taxation, aimed at advancing intergovernmental discussion on tax matters in context of efforts to implement the 2030 Agenda, Addis Agenda, Paris Agreement and Sendai Framework. These discussions engage UN Member States and members of UN Tax Committee and other top tier experts in the field. At the 2021 meeting focused on carbon taxation as an instrument to support countries in changing behaviours towards more sustainable consumption and production patterns, and on strategies to balance the potential negative effects of the tax on households and firms.

9. Moreover, at the recently concluded Global Roundtable on Extractive Industries by the Secretary-General in June 2021, the importance of exploitation of resources in a sustainable way that preserve the environment and keep in check the carbon emission was highlighted. The energy transition -from fossil fuel to renewable energy- is the way of the future, as it has become imperative to “decarbonize” the economy.

Previous Work by the Tax Committee

10. The Committee of Experts on International Cooperation in Tax Matters first considered the topic of environmental taxation in a comprehensive fashion at its twelfth session, in October 2016. The Committee noted that developing countries, though most affected by environmental changes, were the least likely to apply environmental taxes because of the lack of capacity and resources and the limited knowledge in the application of indirect tax systems[1]. Additionally, demand for clearer guidance on environmental taxation was repeatedly expressed at capacity development events held by the Financing for Sustainable Development Office (FSDO), with the request to gear this guidance specifically to the needs and realities of developing countries.

11. At its 15th session, the Committee decided to establish a multi-stakeholder Subcommittee on Environmental Taxation with the mandate to "consider, report on and propose guidance on environmental tax issues and opportunities for developing countries in particular". The Subcommittee was also mandated to provide an initial report on what were the most pressing issues to start work. Based on this recommendation, the Committee requested to prioritize work on carbon taxation for the 2017-2021 mandate, given the global and urgent nature of the climate crisis and the potential for carbon taxation to reduce greenhouse gas emissions that cause climate change, in line with the commitments of the Paris Agreement.

12. During the 2017-2021 period, the Committee, through the Subcommittee on Environmental Taxation Issues, produced the forthcoming new UN Handbook on Carbon Taxation for Developing Countries. The Handbook aims to assist countries in various phases of the decision-making process that might lead to the introduction of a carbon tax, starting with the assessment of whether this instrument would be suitable given their specific priorities, and how to increase public acceptance of such a tax. It contains extensive discussion of the options available to design and administer a carbon tax, to use the resulting revenues, and to assess potential interactions with laws and other policies already in force in a country.

13. The forthcoming UN Handbook on Carbon Taxation, will help to address the need for a comprehensive guidance on carbon taxation that is specifically targeted to the situations of developing countries. However, a range of issues remain pending and the following are possible areas where the Committee may wish to focus its work on environmental taxation for the next four years.

[1] A full report on how the Committee considered environmental taxation up to the start of the 2017-2021 mandate can be found at: https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-08/N1724857.pdf

Issues

14. The forthcoming Handbook primarily addresses the core design and administration aspects of a carbon tax. A non-comprehensive list of topics that were not addressed in the Handbook, but are significant for developing countries include:

- *Carbon taxes within a broader tax reform (including the interaction with other environmental taxes).* Many countries are undertaking, or considering, either a general tax reform or a specific environmental tax reform; there is currently no comprehensive international guidance on how to establish overall goals, how to generate public support, etc. Guidance could also include:
  - *The interaction between a carbon tax and income tax, corporate tax and consumption-based taxes;*
  - *The relationship between a carbon tax and other environmental taxes;*
  - *The relationship between a carbon tax and environmentally-related taxation, e.g. vehicle taxes.*
- *Co-benefits of a carbon tax on non-climate environmental protection and health, and on the economy as a whole (e.g. macroeconomic effects).* A carbon tax has the potential to generate significant macroeconomic effects (on labour, production etc.), as well as environmental effects beyond decarbonization (i.e. reduction of pollution, improvement of water quality, etc.). Specific design features, taking also into account the interactions of the tax with standards and regulations in place, can maximize those effects.
- *Carbon Border Adjustment Mechanism (CBAM) and their implications for trade.* The European Commission released a CBAM proposal in July 2021, where products imported to the European Union would be subject to a levy that, in essence, would equalize the carbon price paid by importers to that imposed on domestic producers through the EU ETS.

15. The following (non-comprehensive) list of topics have partly already been addressed in the Handbook, but might require more detailed guidance in a further expansion, also in light of emerging feedback from countries beginning to use the Handbook. Each topic includes a brief explanation as well as a brief description of some of the work that has been carried out at the international level, as a way to identify potential gaps in guidance:

- *How to deal with the interactions between a carbon tax and other energy taxes, and how to maximise these interactions to boost the environmental benefits.* The Handbook currently includes a brief section (in Chapter 10) about the interaction of the carbon tax with energy taxes; however, further and more detailed guidance would help countries ensure there are no unintended effects, either environmental or economic, deriving from the interaction, and that vulnerable citizens are protected from the increase in energy prices, while providing the economy with an adequate price signal for decarbonization.

- *How to introduce a carbon tax in countries where fossil fuel subsidies are present, and how to deal with the dynamic interaction between the tax and the subsidies, while reforming the latter.* The removal of harmful fossil fuel subsidies is a very current topic for many developing countries, and a commitment under SDG 12 (Responsible Consumption and Production). The Handbook includes a section on fossil fuel subsidies (Chapter 10), upholding the view that a carbon tax can be introduced even before a comprehensive fossil fuel subsidy reform has been implemented. However, detailed policy and administrative guidance would be very relevant for developing countries that are considering the introduction of a carbon tax in the presence of subsidies. There is currently no international guidance on how to deal with the interactions, however the Subcommittee could benefit from the work of UN Environment (together with the OECD and International Institute for Sustainable Development's, IISD), which developed a conceptual framework to monitor fossil fuel subsidies, highlighting the importance of measuring as a first step to reform inefficient subsidies.
- *Potential interactions generated from the introduction of a carbon tax for countries that already have an Emission Trading System (ETS) in place, and the potential creation of hybrid instruments*. Several countries already have in place, or are considering the introduction of, a carbon tax in conjunction with an ETS, as a way to cover additional economic sectors or to stabilize carbon prices; other countries are considering the introduction of a carbon tax with hybrid ETS features. The interaction of these two market-based instruments is particularly delicate, as in the design or administration phases there can be features that duplicate or counter the intended decarbonization effects. In conducting this work, the Subcommittee could expand the current guidance in Chapter 10 of the Handbook, and draw upon practical tools such as the World Bank Carbon Pricing Assessment Tool (CPAT), which is a spreadsheet-based model allowing for country-specific analyses to assess the potential of carbon on four macroeconomic metrics.

Centrality of carbon taxation as a policy priority and relevance of the Committee in providing guidance

16. Carbon taxation is crucial in promoting decarbonization efforts of countries, in line with National Determined Contributions (NDC) pledges within the framework of the Paris Agreement and to achieve a wide range of SDGs, including with respect to the promotion of renewable energy, reduction of pollution and promotion of healthier societies. In fact, two-thirds of all submitted NDCs (around 100 countries) consider the use of carbon pricing (i.e. carbon taxation and emission trading systems) to achieving their emission reduction targets. It is estimated that carbon pricing could alone reduce the cost of climate change mitigation by 32 percent by 2030 and achieve full potential when coupled with coherent energy and environmental policies. However, although these instruments represent around 21.5 percent of global GHG emissions, less than 3.8 percent of emissions are priced at levels consistent with the Paris Agreement goals.

17. In light of their potential for decarbonization (as well as a range of additional macroeconomic and environmental benefits), several countries have chosen to introduce a carbon tax (as of October 2021, 33 carbon taxes have been implemented globally, primarily applied on a national level), and many more countries are considering introducing this instrument, either as stand-alone or as part of a broader fiscal reform.

18. However, as mentioned above, there is a current lack of guidance (besides the Handbook) specifically tailored to developing countries, despite their high vulnerability to environmental degradation and social inequality. The Committee is well placed to continue providing guidance in this area in collaboration with other centres of expertise and liaising with developing countries about their needs and priorities.

19. The Committee's distinctive value added in providing guidance on carbon taxation is due to several factors. The Committee has a unique placement as a United Nations body, which allows it to capitalize on experience related to the Paris Agreement and held within the system (for example by the UN Environmental Programme, UNEP); it is specialized in providing guidance with particular attention to the needs of developing countries, which are disproportionately impacted by climate change and environmental degradation; and it is backed by a Secretariat with experience in providing demand-driven capacity development, allowing for dissemination of its products to all UN Member States. Furthermore, intergovernmental platforms, such as the the Financing for Development Forum and Development Cooperation Forum, as well as the ECOSOC Special Meeting on Tax, allow the Committee to directly interact with the broader development community, providing important opportunities for multi-disciplinary and multi-stakeholder dialogue and feedback into this work.

Recommendation

20. It is recommended that the Committee should form a multistakeholder and multidisciplinary Subcommittee on Environmental Taxation Issues. The Subcommittee could include representatives of developing and developed countries with experience in environmental taxes, as well as representatives of international and regional organizations (including, but not limited to, partners of the Platform for Collaboration on Tax - IMF, OECD, World Bank – and long-standing partners in capacity development, such as the regional tax organizations). It is also advised to involve representatives of civil society, academia and private sector organizations.

21. It is proposed that the Subcommittee should be given a mandate along the following lines:

"The Subcommittee is mandated to consider, report on and propose guidance on environmental and environmentally-related tax issues and opportunities. In particular, the Subcommittee shall:

- Produce practical guidelines on targeted, additional and emerging issues in the area of carbon taxation, which are not covered or fully developed in the Handbook on Carbon Taxation for Developing Countries. These guidelines could initially be released as stand-alone materials, and later be assembled in a publishable format. Relevant issues might include: (i) the interactions of a carbon tax with other environmental and environmentally-related taxes, (ii) the role of a carbon tax in a broader fiscal reform; and (iii) in collaboration with the Extractive Taxation Subcommittee (if one is created), work on practical tax policies/measure susceptible to accompany countries' efforts in transitioning from fossil fuel energy to renewable sources.

- Pay particular attention to the needs and priorities of developing countries, and report on relevant cases of current country practices, policy considerations and administrative issues;
- Work on any additional relevant environmental taxation issues as requested by the Committee.

In undertaking its work, the Subcommittee shall consult broadly and engage with others active in the field. The Subcommittee shall report on its work at each session."