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## **Committee of Experts on International Cooperation in Tax Matters Twenty-fourth session**

4-7 April and 11-12 April 2022

Item 3(g) of the provisional agenda

### **Environmental Taxation**

#### **Co-ordinators' Report**

##### ***Summary***

At its 23rd Session, the Tax Committee decided to consider emerging issues in environmental taxation and address critical topics that were either not covered in the UN Handbook on Carbon Taxation (2021) or were covered there but not sufficiently and to this end established the Subcommittee on Environmental Taxation and its specific mandate.

The Subcommittee met for the first time on 28 January 2022 to consider the topics of immediate relevance for developing countries that could be included in its proposed 2022-2025 work plan.

The Subcommittee now presents this document to the Committee and seeks its **approval** of the proposed work plan (as set out in **paragraphs 6 to 9** of this CRP and described further in the **Annex**). The Subcommittee proposes to produce short papers on the critical aspects during the mandate, with the possibility of the short papers being compiled and published as one volume at the end of the mandate (as set out in **paragraph 12** of this CRP). The proposed areas are as follows:

- (a) the interaction of carbon taxation with other national measures, including (but not limited to) in the context of broader tax reform and particular attention to fossil subsidies;*
- (b) the role of carbon taxes and other measures to support energy transition;*
- (c) the interaction between carbon taxes and carbon offsetting programs; and*
- (d) Carbon Border Adjustment Mechanisms and how developing countries can avoid undesired spillover effects from other countries applying those measures.*

The Subcommittee also seeks the Committee's **guidance** regarding additional work as set out in **paragraph 10** of this CRP, which is to be determined substantively after consultation with developing countries, namely: *analyze environmental taxes other than carbon taxes such as deforestation and the management of water, waste disposal, wastewater, waste gas, plastics, etc.*

## Background and mandate

1. At its 23rd Session, the Committee considered note E/C.18/2021/CRP.26, which, among other things, proposed possible topics for consideration for future work of the Committee regarding environmental taxation and climate change issues. Such future work could cover topics that were either not addressed in the Handbook or were only partially discussed and could be further expanded. In addition, the paper proposed the establishment of a multi-stakeholder, multidisciplinary subcommittee.
2. Following discussion on the paper, the Committee decided to establish a Subcommittee on Environmental Taxation, with Dr. Muhammad Ashfaq Ahmed as the Coordinator. Subsequently, and to assure continuity in the work undertaken in the previous Committee and resulting in the Handbook, Ms. Susanne Åkerfeldt has taken on the role as Co-Coordinator, on an ad hoc basis, of the now established Subcommittee. Susanne served in the Subcommittee during the previous Committee's membership.
3. As decided by the Committee at its 23<sup>rd</sup> Session, 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, including the consideration of distributional effects; and (iii) in collaboration with the Extractive Taxation Subcommittee (if one is created), work on practical tax policies/measures/incentives with the potential to accompany countries' efforts in transitioning from fossil fuel energy to renewable sources.
  - Pay particular attention to the needs and priorities of, and the barriers faced by, 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 may wish to consult broadly and engage with others active in the field. The Subcommittee shall report on its work at each session.

4. The Co-Coordinators invited experts in carbon taxation, environmental taxation, and climate change issues from the public sector, the private sector, international organizations, regional organizations, business, and academia to participate in

discussions on an ad hoc basis in preparation for the 24th Session. The experts exchanged ideas on the most pressing issues for developing countries to consider regarding the Subcommittee mandate. The discussions considered issues also within the context of broader global discussions calling for just transitioning from fossil fuels to sustainable renewable energy sources, among other key topics. The Co-Coordinator convened the **first meeting with the experts on 28 January 2022**.

### **Proposed work streams**

5. Based on the Subcommittee's mandate and the input received from the invited participants, the Subcommittee has identified priority areas on which the Subcommittee can start working and seek the Committee's approval to commence work based on those identified priority areas. The proposed topics reflect the current issues for developing countries and align well with the current areas of expertise of the Committee members engaged in the Subcommittee work and the other ad-hoc participants invited to the first Subcommittee meeting mentioned in paragraph 4 above.
6. As a carbon tax is introduced in the context of other national measures, and not in a policy vacuum, its interactions with existing national measures should be carefully assessed especially in the context of a broader tax reform. Therein comes the relevance of the first proposed workstream on ***the interaction of carbon taxation with other national measures, including (but not limited to) in the context of broader tax reform and particular attention to fossil subsidies***. This topic is crucial for developing countries with lower administrative resources, which derive most of their revenues from indirect and corporate taxes. Another aspect to take into account is the extent emission reductions can derive from other measures, such as special environmental programs and how such reductions could affect the design of carbon tax schemes. Attention should also be paid to the effect that the tax can have on the full value chain and aspects such as the fair allocation of the tax cost and tax revenue. The Subcommittee would collaborate with the Subcommittee on Extractives Taxation in this regard.
7. There can be diverse paths towards energy transition, with different roles played by taxes and prices in each framework. Carbon taxes can facilitate the transition. However, developing countries may face a significant challenge when implementing a carbon tax if the costs of fossil fuels increase without cheaper renewable energy alternatives in place. Therefore, the Subcommittee proposes to pursue work on ***the role of carbon taxes and other measures to support energy transition*** to provide guidance on the diverse aspects that developing countries may face in the context of transitioning to renewable energy sources. The issue is particularly relevant for resource-rich developing countries with sizable extraction industries. The Subcommittee would collaborate with the Subcommittee on Extractives Taxation in this regard.
8. Nearly all developing countries have signed up to the Paris Agreement on Climate Change. The Glasgow Climate Change Pact approved actions to operationalize Art. 6 of the Agreement, which deals with carbon credits or offsets. Developing countries will need to consider how offsets (and the system replacing clean development mechanisms (CDMs)) contribute to lowering their carbon emissions and meeting their

Nationally Determined Contributions (NDCs) pledges under the Agreement. Furthermore, developing countries need to assess the appropriate tax treatment and cross-border treatment of tradeable emission rights, offset rights, and credits for nature-based solutions. Offsets may be attractive in developing countries looking for ways to encourage investments that preserve the services of nature or reduce greenhouse gas emissions. To address these aspects, the Subcommittee proposes pursuing work on and developing guidance on ***the interaction between carbon taxes and carbon offsetting programs***. In executing this workstream, the Subcommittee would work closely with the Transfer Pricing Subcommittee to avoid duplication of work and draw synergies from each other's expertise.

9. The EU Carbon Border Adjustment Mechanism (CBAM) is still currently being negotiated in the Council and the European Parliament but is due to enter into effect in 2023. The United States has discussed a proposal, and Canada is holding a public consultation on aspects relating to the topic. Developing countries are concerned about the potential effects of these measures on their exports' competitiveness and tax revenue leakages. The issue is crucial for developing countries, especially if carbon pricing mechanisms continue expanding worldwide. These developments make the Committee's role integral in providing guidance to help developing countries prepare for and understand the impact of CBAM on their economies. Accordingly, the Subcommittee proposes to start work on ***Carbon Border Adjustment Mechanisms and how developing countries can avoid undesired spillover effects from other countries applying those measures***. For this priority area, the Subcommittee proposes to begin with an overview of the developments in different fora and the impact for developing countries. After 2023, the Subcommittee can undertake a more extensive analysis when further details are available on the subject.
10. Discussions in the Subcommittee are ongoing on how best to engage developing countries in a broader consultation on additional topics of particular relevance for those countries. For example, there is a specific interest in learning about developing countries' needs to ***analyze environmental taxes other than carbon taxes such as deforestation and the management of water, waste disposal, wastewater, waste gas, plastics, etc.*** Some of the possible outreach options in this regard include obtaining feedback during DESA's capacity development workshops on environmental taxation planned for 2022 and 2023, and direct interaction with developing countries through a survey. If such an interest is identified based on such consultation, the Subcommittee will expand its workstream to include those topics since they also fall within the Subcommittee's mandate.
11. Further details on the above workstreams are set out in the Annex to this CRP below.

### Next steps

12. The Subcommittee proposes to commence work on the streams identified above. As set out in the mandate, the selected topics will culminate in *standalone documents to be presented to the Committee in the short term and made public (upon approval by the Committee) throughout the mandate period*. The output documents could eventually be *compiled and published in one volume*. The proposed workstreams would be undertaken in parallel by different drafting groups within the Subcommittee.
13. The Subcommittee would be delighted to learn the Tax Committee's views and receive suggestions on the proposed work. Based on the Committee's guidance at this 24th Session the Subcommittee will commence the substantive work under the mandate. In the meantime, the Subcommittee envisages holding its next meeting towards the end of April.

### Issues for decision

14. The Subcommittee seeks the Committee's **approval of the proposed work plan** (as set out in **paragraphs 6 to 9** of this CRP and described further in the Annex) and the **next steps** set out in **paragraph 12** above. The proposed areas are as follows:
  - (a) *the interaction of carbon taxation with other national measures, including (but not limited to) in the context of broader tax reform and particular attention to fossil subsidies;*
  - (b) *the role of carbon taxes and other measures to support energy transition;*
  - (c) *the interaction between carbon taxes and carbon offsetting programs; and*
  - (d) *Carbon Border Adjustment Mechanisms and how developing countries can avoid undesired spillover effects from other countries applying those measures.*
15. The Subcommittee also seeks the Committee's **guidance regarding additional work** as set out in **paragraph 10** of this CRP, which is to be determined substantively after consultation with developing countries, namely: analyze environmental taxes other than carbon taxes such as deforestation and the management of water, waste disposal, wastewater, waste gas, plastics, etc.

***Annex: Extended description of (initial) work streams***

***1. Interaction of carbon taxation with other national measures including (but not limited to) in the context of a broader tax reform and particular attention to fossil subsidies.***

As highlighted in point 8 above, carbon tax is not introduced in a policy vacuum, and interactions with existing national measures should be carefully assessed especially in the context of a broader tax reform.

As mitigation ambitions rise and are translated into policy action, differences in approaches become stronger; this leads to concerns over leakage, competitiveness, and equity for low-income segments of the population. This topic is very important for environmental, trade, inequality-reduction and fiscal purposes. The interaction between the carbon tax implementation and other economic policy instruments will lead to changes in its actual effects, as well as on the impact of the carbon tax on technological progress.

This issue is very relevant for emerging and low-income countries that are often facing inequality and want to protect competitiveness of local industries.

The interaction of a carbon tax with some national policy measures was already explored in the Handbook, but further guidance on how to avoid these undesired effects could help countries put in place solid and easily administrable carbon taxes. The interaction of a carbon tax with fossil subsidies is particularly relevant for low-income countries, that want to move away from subsidizing energy and start collecting revenue from energy use - but need to make sure they do so soundly.

Practical guidance for developing countries could include:

- How to assess and correct interactions between a carbon tax and other taxes, including the following:
  - o Value-added tax (VAT).
  - o Corporate income tax.
  - o Excise duties/taxes.
  - o Personal income tax.
- How to assess and correct interaction between a carbon tax and other environmental-related measures:
  - o Emissions trading schemes.
  - o Climate policy.
- Step-by-step guide on how to remove fossil fuel subsidies and introduce a carbon tax: Which types of fossil subsidies could be removed, at what cost to whom, and how might governments use the recaptured revenue.

- How to evaluate potential synergies and improve the environmental effects of the carbon tax.
- How to address potential regressivity issues through the interaction with other taxes and measures, and potential effects on inflation.
- How to introduce a carbon tax in the context of a broader tax reform.
- How to tax emissions along the full value chain (national aspects).
- Measures to avoid or relieve tax burden from affected households/sectors.
- Pros and cons of using tax revenues to provide corporate incentives, support other environmental measures or development/equity purposes such as to alleviate poverty, pay down pandemic debt or incentivise job-creating investment.

## ***2. Role of carbon taxes and other measures to support energy transition***

As mentioned in note 9 above, the issue on the role of carbon taxes and other measures in supporting emerging transition is particularly relevant for resource-rich developing countries.

Potential issues include the increase in productions costs and tax burdens, opposition for the public, and loss of revenues from extractive industries taxation. The challenge might be so significant that developing countries will have to abolish the tax or convert carbon tax revenues into subsidies, ultimately nullifying the emission reduction effects of carbon tools.

Practical guidance for developing countries could include:

- High-level framework of the different pathways to the energy transition. The role played by carbon taxes, complementarities and overlaps between tax and non-tax instruments, pricing paths compatible with net zero, internalization of different externalities, and structural policy.
- International aspects of carbon tax along the value chain,
- An examination of the fiscal measures that could better support the transition to renewable energy (including by incentivizing investment) with a perspective on the renewable energy supply.
- Examination of different allocation mechanisms for natural resources, with a focus on auctions as they are often used for wind farms.
- Environmentally-related tax incentives that countries have introduced or are considering, and what options remain available in view of the OECD/Inclusive Framework proposal under Pillar 2 (which generally counteracts tax incentives).

## ***3. Interaction between carbon taxes and carbon offsetting programs***

In addition to the observations set out in note 10 above, developing countries can set up a carbon tax while allowing to compensate part of the obligation with carbon offsets. This solution (briefly explored in the Handbook) allows countries to take advantage of revenue generation from the tax, while also creating a carbon market without the administrative

complications (as even local projects can be traded on international markets, with the added benefit of supporting local sinks).

Practical guidance for developing countries could include:

- Overview of the role of carbon offsetting in national carbon pricing.
- Carbon certificates and their role in future climate policy, including developments regarding Article 6 of the Rulebook methodology and their use as offset mechanisms in carbon taxation.
- How and to what extent offsets should play a role in a carbon tax regime:
  - o Whether taxpayers who pay a carbon tax should be eligible for reductions in their tax burden if they engage in other activities that offset taxed greenhouse gas emissions.
  - o Practical country experiences to date.
  - o Importance of quality/certification of offsets to ensure the right incentive is provided.
  - o Current status of the rules governing offset programs under the Paris Agreement.
  - o How to design linkages between offset programs and carbon taxes if linkage is appropriate.
- In recognition of developed countries commitment under the Paris Agreement to facilitate climate financing to developing countries, determine how those developed countries can so contribute by allowing part of their tax/Emissions Trading Systems (ETS) obligations to be met with carbon offsets, helping to reach decarbonization goals while providing much-needed funds to low-income countries where projects are usually generated.
- Potential VAT implications.

#### ***4. Carbon Border Adjustment Mechanisms: how developing countries can avoid undesired impacts***

Based on the discussion in note 11 above, practical guidance for developing countries could include:

- Overview of existing mechanisms, future trends and interaction with WTO rules.
- Effectiveness and fairness of CBAM in allocating tax costs and revenues while achieving emissions reductions.
- How carbon taxes (and carbon pricing) can influence developing countries' trade and development positions, and how they could respond.



- Practical guidance on how to assess the impact of a CBAM on the national economy, for different economic sectors and industries.
- Policy measures for developing countries to avoid revenue leakage and protect trade-exposed local industries, for example:
  - o Introduction of a carbon tax to capture revenue and avoid the CBAM.
  - o Design considerations for these taxes, including for WTO purposes.
  - o Potential links with carbon taxes of neighbouring countries.
- Practical guidance on administrative requirements for exports towards countries with a CBAM, for example accounting of emissions along the value chain.
- Comparison with alternative measures that could be implemented to reduce carbon leakage, such as free distribution of permits under ETSs; reduced carbon tax rates; Output-Based Pricing System (OBPS) in the Canadian Federal Backstop.