Tax policy options: achieving net zero commitments

OMB | Large Corporate | International Tax | Indirect Tax | Environmental

Tax policy options: achieving net zero commitments
20 February 2023

As countries seek to decarbonise their economies to transition to a net zero future, we consider the options for the UK within an international context.

Key Points

What is the issue?

Countries are looking at solutions to accelerate the decarbonisation of their economies to transition to a net zero future. The tax system is a lever available to achieve these objectives.

What does it mean for me?

Tax policy is expected to be used more extensively and more creatively by governments to achieve their net zero ambitions. Both taxes and incentives are likely to be used to influence behaviours.

What can I take away?

Looking at international trends and potential choices available for the UK government can be useful to ensure businesses influence and advocate for change in the tax policy area. With a diversity of legislation and regulation around the world, tracking the compliance requirements and incentives opportunities will become critical.

The UK was the first major economy to enshrine its 2050 net zero commitment into law. Days before the UK's presidency of the UN Climate Change Conference (COP) 26 in 2021, it published its Net Zero Strategy titled 'Build Back Greener' to lay out steps to achieve the transition. This strategy was found unlawful by the High Court in July 2022 for not providing a detailed implementation plan; a new net zero strategy is expected by the end of March 2023.

In January 2023, former Energy Minister Chris Skidmore MP published his Net Zero Review 'Mission Zero', which described the historic opportunity offered by net zero and made 129 specific recommendations that the UK government should adopt to create a green economy.

The UK may have been at the start of the movement, but since COP26, it is reported that commitments to the net zero target cover over 90% of the world's global gross domestic product (GDP). Governments around the world are now actively seeking ways to achieve those commitments through legislative and regulatory changes, including utilising their tax system more efficiently.

Governments are grappling with a list of challenges, including managing post Covid debt levels, energy security, rising inflation and trade protectionism. However, Deloitte's Global Turning Point Report last year revealed that unchecked climate change could cost the global economy $178 trillion over the next 50 years, unless global leaders unite in a systemic net-zero transition. The cost of inaction is becoming more significant than action itself, and tax policy should play an important role. This article examines global trends in the transport sector, green technologies, circularity and plastic packaging tax and carbon leakage.

Accelerating the electrification of the transport sector

One of the key targets to reduce emissions is the transport sector and reducing the number of petrol and diesel vehicles. While incentivising electrification started over a decade ago, more recently countries have announced phase-out dates for the sale of new petrol and diesel cars: these include the EU by 2035, the UK by 2030 and Norway by 2025.

Tax policy tools accelerating the electric vehicles roll out include:

VAT reduction: Norway, a leader in the electric car revolution with a population of only 5.4 million, has seen a large uptake in consumers purchasing electric vehicles due to the decision in the early 2000s to reduce the VAT rate on such purchases from 25% to 0%. This created a real difference, so much so that the Norwegian government decided last year to change its electric vehicle subsidy system so that from 1 January 2023 the new scheme becomes dynamic, with fewer advantages for more expensive models.

Government subsidies: France has introduced both an ecological bonus and a scrappage scheme for older diesel-powered cars to incentivise the purchases of electric vehicles. The French Bonus-Malus system consists of offering a financial incentive (bonus) for low carbon emissions vehicles compared to a fee (malus) for high-emission cars. It was implemented in 2008 and has fluctuated in value since. France also provides additional grants where an individual lives or works in a low emission zone and for the installation of charging points. Electric vehicles are also exempt from company car tax, which is another incentive to shift company fleets to electric vehicles or hybrid vehicles.

Provincial rebates: In Canada, provinces have different rebates available on top of a maximum federal government rebate of C$5,000 on the purchase of new electric vehicles. The two rebates are 'stackable'; for example, the purchase of an electric vehicle in the province of Quebec could currently include a saving of up to C$12,000 directly from the car dealership.

Income tax credit: Since August 2022, the US offers a federal income tax credit of up to $7,500 for eligible vehicles subject to specific assembly requirements.

Employee benefits: In the UK, businesses can offer electric vehicles to their employees through company car schemes at a lower cost than petrol and diesel equivalent (see 'Electric vehicle company car schemes' (Dec 2022), *Tax Adviser*).

While the UK may not use its VAT rate, likely due to scale and cost issues, the numerous policies to render electric vehicles more affordable are starting to impact the overall uptake. Other benefits such as no or reduced congestion charges, grants for home chargers, and enhanced capital allowances to write off purchases may also be available locally. The combination of these policy choices creates strong incentivisation to make the move to electric vehicles, with the main challenge being the visibility and ease of such incentives for buyers.

Going forward, governments may reduce the stable revenue stream from the transition to electric vehicles, notably in relation to UK fuel duty which in January 2023 represented £25.9 billion out of a total tax take of

£715.5 billion in 2021/22, slightly above 3.6%. The chancellor Jeremy Hunt signalled in November 2022 that electric cars, vans and motorcycles will begin to be subject to vehicle excise duty from 1 April 2025 in the same way as petrol and diesel vehicles. We expect other countries will start to acknowledge the loss in revenue and explore other avenues such as through road tax.

Turbocharging investment

Last summer, the US legislated the Inflation Reduction Act, which provides a broad state support in the form of subsidies, grants and tax incentives amounting to $369 billion to support green industries in the US, such as the production of electric vehicles, batteries and renewable technologies like hydrogen or carbon capture projects. With the Inflation Reduction Act, the US acted unilaterally, marking a positive step to achieving net zero targets; however, this impacted relations between the US and its trading partners. It is widely acknowledged that new technologies could be a turning point in the net zero strategy and so incentivising the right technologies will be critical.

The trade controversy around the Inflation Reduction Act is notably in respect of the personal tax credit of up to $7,500 given to individuals buying American made electric vehicles. Currently, half of the electric vehicle tax credit is available if a certain percentage of the value of the battery components are manufactured or assembled in North America. The other half is available if a certain percentage of the value of battery minerals are extracted, processed or recycled in the US, or extracted or processed in a country which has a Free Trade Agreement with the US.

Additional restrictions will apply for battery components and critical minerals from foreign entities of concern. This has caused complaints of anti-trade policies, including from the EU and South Korea, for making electric vehicles made outside the US far less financially attractive to consumers. This measure has been seen by some as discriminatory in favour of US produced goods (and as such against those with non-US components), which some have said is a prima facie breach of the World Trade Organisation’s fundamental principle of national treatment.

While the official aim of this incentive is to accelerate the electrification of the transport sector, it also promotes and ties in the return of supply chain elements to the US which will bring growth and green jobs. Compared to its neighbouring trading block (the EU), the UK government was not outspoken on this issue.

The UK government is seeking to move towards a net zero carbon economy, through a range of grants and incentives to encourage changes in economic activity. The range of initiatives is very broad, from R&D and grants for green technologies to the installation of capital equipment to improve energy efficiency and reduce greenhouse gas emissions.

The UK government has already mobilised funds to support the creation of thousands of green jobs. It has allocated £180 million for achieving 10% sustainable aviation fuel by 2030; more than £300 million for the net zero hydrogen fund and accelerator; and £1 billion to fund the industrialisation of a high value electrified automotive supply chain at scale. This is on top of the £20 billion in R&D investment which the UK government is supplying in 2024 to 2025.

However, the UK government may have been restrained so far by the requirement, as part of the Brexit agreement, to maintain a level playing field with the EU bloc. As the EU develops proposals to compete with the US Inflation Reduction Act, notably by loosening their own state aid rules, the UK will be able to follow suit without the risk of breaking the terms of the withdrawal agreement.

Plastic packaging tax

The UK introduced its plastic packaging tax with effect from 1 April 2022. It aims to encourage the use of recycled plastic instead of new plastic within packaging. The plastic packaging tax applies to plastic packaging manufactured in or imported into the UK which does not contain at least 30% recycled plastic by weight and is charged at a rate of £200 per tonne (above a de minimis threshold of 10 tonnes of in-scope packaging per year). There are some limited exemptions and exclusions.

Spain introduced a similar tax with effect from 1 January 2023, with the new tax applying at a rate of €450 per tonne of non-recycled plastic packaging. Imports and intra-EU acquisitions of goods subject to the tax are exempt if they do not exceed 5kg of non-recycled plastic packaging per month. Unlike in the UK, plastic packaging tax on imports is payable at the same time that customs duties are due. Italy has been looking into introducing a similar tax at a rate of €450 per tonnes of virgin plastic but the entry into force was suspended until 1 January 2024 (with further delays possible).

Other regulatory changes are being implemented, such as bans on single-use plastics in various jurisdictions like Canada (from December 2022), France (from 1 January 2023) and from October 2023 in the UK. A deposit return scheme is also under review in the UK with a potential introduction from October 2025. Sweden is the leader in such schemes, with one of the highest return rates with around 85% of target materials returned.

In addition, next year will see changes to the Extended Producer Responsibility programme in the UK. This will lead to companies paying the cost of collection and recycling for all plastic packaging they put on the market, paying more for ‘less sustainable packaging’.

The new, more proactive approach to tackling plastic waste is also playing out at a global level. The UN Environment Programme convened UN member states to agree to a global treaty for plastics, and after two years of negotiation this will be put forward for ratification in a similar fashion to the Paris Agreement. With new initiatives being introduced in the EU – including mandatory recycled content targets – the legislative and public interest in plastics is forcing consumer businesses to take positive action demonstrating that tax and regulatory changes can be effective levers for change.

The European Carbon Border Adjustment Mechanism (CBAM)

Any country trying to measure and reduce greenhouse gasses would typically only cover their domestic emissions. However, much of what is utilised domestically is manufactured elsewhere and such imported emissions would not be counted. By placing a levy on certain carbon-intensive goods, a CBAM can prevent ‘carbon leakage’ where high emitting business choose to import products from jurisdictions with less stringent climate regulations and a lower carbon price.

The European Commission published its CBAM proposal on 14 July 2021 as part of its ‘Fit for 55’ package of climate measures and is moving this proposal through its approvals process. Currently, the European Parliament and Council of the European Union have reached a provisional agreement to implement the CBAM from 1 October 2023, with only a formal approval needed now.

Under this proposal, companies importing certain products to the EU would need to buy digital certificates for each tonne of carbon emissions embedded in their goods. Initially, the EU CBAM would cover aluminium, iron, steel, electricity, cement, hydrogen, some fertilisers and some downstream products like screws and bolts, so the greatest impact would be felt within those carbon-intensive sectors. The list looks set to grow, with a transitional and gradual phase in between 2023 and 2026 seen as a ‘review and revise’ period. Ultimately, the goal will be to match the broader coverage of the EU Emissions Trading System. It is noted that the EU Emissions Trading System is evolving, and reform is underway to ensure it is fit for purpose.

The UK, like the EU, already has an Emissions Trading System in place, which should provide some broad consistency to the carbon price of goods produced in the UK. Under the EU CBAM, carbon taxes paid in the country of origin should be deductible from the CBAM cost – this will notably be the case for UK exports to the EU. The main compliance with the EU CBAM is likely to be proving that this is the case in practice and any deviation could result in higher adjustments for UK exporters to the EU. To date, there have been calls through the Climate Change Committee, the House of Commons Environmental Audit Committee, and more recently in the Net Zero Review, to investigate urgently the potential of a UK CBAM through a consultation.

A multilateral approach would be an attractive solution, which we believe many businesses would appreciate. However, time is of the essence and with a lack of political agreement on this topic, it remains difficult to imagine a clear consensus. It is noted that the OECD has set up a new Inclusive Forum on Carbon Mitigation Approaches with the aim of obtaining better data and information sharing about the comparative effectiveness of a full range of policy approaches beyond carbon pricing. A first inaugural meeting on 9-10 February gathered 607 individuals to discuss ways to boost global emissions reductions through improved collaboration.

Policy principles at stake and looking ahead in the UK

In recent years, governments are designing new policies and adjusting existing ones to match their net zero ambitions. Holistic designs rely on several principles for adequate trade and tax policies, such as: certainty, recognising that businesses need medium and long-term predictability to support their investment decisions; collaborative design, including comprehensive consultation processes with a wide range of stakeholders; carrots and sticks; and a multilateral approach where appropriate.

The UK has been leading on setting emission reductions targets and with regards to the plastic packaging tax. The Net Zero Review recommends in-depth assessments of various parts of the UK tax system to ensure existing measures are fit for purpose and efficiently incentivise good behaviours, including on the long-term tax treatment of the North Sea, green capital investments and R&D, and VAT rates on public and private electric vehicle charging. It also identifies areas where it recommends that the UK government endorses and implements international standards such as the International Sustainability Standards Board (ISSB) standards in relation to financial disclosures and international voluntary carbon markets standards for carbon credits and offsets. The Spring Budget mid-March will provide the government with an opportunity to introduce such measures or open new consultations.

In summary

There are no miracle policies or ‘one size fits all’ legislative and regulatory change to tackling climate change, but tax and trade policies will be key to helping governments to accelerate the decarbonisation of their economies while ensuring a just transition. Multinational businesses with operations and supply chains spanning across the globe will need to dedicate time and resource to this challenge and the tax function will have a decisive role on their decarbonisation journey.