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# The Climate Change Levy

The Climate Change Levy has been proposed as a measure to encourage business to become more energy efficient and thus reduce atmospheric carbon dioxide emissions. A tax on energy use, the Levy has attracted criticism from manufacturing industry and some environmentalists who would have preferred a carbon tax instead.

In the 1999 Pre-Budget Report the Chancellor announced modified proposals including lower levy rates, wider exemptions, and greater revenue recycling to business.

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## **Summary of main points**

- The UK has signed up to international agreements to reduce greenhouse gas emissions to 12.5% below 1990 emission levels during the period 2008-2012. The Government has a separate pledge to reduce carbon dioxide emissions to 20% below 1990 rates by the year 2010.
- The Climate Change Levy is one measure that has been proposed to achieve UK commitments. This measure is to address the business use of energy only and will come into effect in April 2001.
- The Levy is intended to be revenue neutral towards business as a whole. The revenue raised from the Levy will be recycled through reduced national insurance contributions and additional support for energy efficiency measures.
- Negotiations with business concerns along with Parliamentary scrutiny and debate have led to the Government: reducing the rates of the Levy overall; providing for a greater rebate for energy intensive industries; and, exempting electricity both from renewable sources and 'good quality' combined heat and power plants.



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## I Climate Change Levy: Genesis

In his March 1999 Budget the Chancellor (Gordon Brown) announced a new levy on the business use of energy to be introduced from April 2001.<sup>1</sup> There would be offsetting reductions in employers' National Insurance contributions (NICs) plus substantial rebates for energy intensive industries who could agree energy efficiency agreements with the Department for the Environment Transport and the Regions (DETR). Additional support would be provided for energy efficiency schemes and renewable sources of energy. This proposal follows closely the recommendations made in Lord Marshall's report on the role of economic instruments and the business use of energy, commissioned at the time of the March 1998 Budget and published in November 1998.<sup>2</sup> However, the genesis of the Levy can be traced back to work published by the Organisation for Economic Co-operation and Development (OECD) in the early 1970's which established the Polluter Pays Principle. This simply meant that the originator of pollution should be the one to pay for the environmental damage caused by that pollution.

The Polluter Pays Principle was initially adopted in the early 1970s when strict environmental regulations were first being introduced in OECD countries, and complaints about high costs and negative effects on competitiveness were beginning to emanate from industry. Governments were being pressured to help industry cover the costs of complying with these new regulations or to impose similar costs on imports through compensating import levies. The 1972 OECD Recommendation of the Council on Guiding Principles concerning International Economic Aspects of Environmental Policies<sup>3</sup> included recommendations not to subsidise the environmental costs of industry, except in limited cases, and not to use trade remedies or import duties to compensate for these costs. These recommendations, which were intended to guide government responses to the competitive effects of environmental regulations, have been largely maintained for the last twenty years. The Amsterdam Treaty, like the Treaties of Rome and Maastricht, provides that "the polluter should pay" principle forms a basis of Community policy on the environment.<sup>4</sup> Principle 16 of the Rio Declaration<sup>5</sup> relating to the internalisation of environmental costs also makes reference to this Principle.

### A. Climate change

The fundamentals of climate change, often referred to as global warming, have been detailed in many studies and papers. It is not envisaged that this paper will repeat this

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<sup>1</sup> HC Deb 9 March 1999 c 181

<sup>2</sup> HM Treasury, *Economic instruments and the business use of energy: a report by Lord Marshall*, November 1998 <http://www.hm-treasury.gov.uk/pub/html/prebudget99/marshall.pdf>

<sup>3</sup> OECD (1972), *Recommendation of the Council on Guiding Principles concerning International Economic Aspects of Environmental Policies* [C(72)128]

<sup>4</sup> Art. 130R(2), Treaty establishing the European Community, as amended by the Maastricht Treaty of 7 February 1992. Now Art. 174(2) in Treaty of Amsterdam 10 November 1997

<sup>5</sup> Earth Summit 1992, *The United Nations Conference on Environment and Development*, Rio de Janeiro

information beyond that necessary to understand the reasoning behind implementation of the Climate Change Levy. For further detail on climate change may be found in any number of Library research papers,<sup>6</sup> POST briefings<sup>7</sup> and select committee reports.<sup>8</sup>

In brief, the presence of certain gases within the global atmosphere provides a mechanism by which heat from the sun can be trapped and retained. Without this mechanism the average surface temperature would be much lower, and its variation between night and day so severe that advanced life could probably not have evolved. A major role is played by two gases: water vapour and carbon dioxide.

Carbon dioxide (CO<sub>2</sub>) is an essential component of the world's biosphere and is a major by-product of the biosphere and the consumption of fossil fuels such as coal, oil and gas. As industrialisation has progressed greater amounts of carbon dioxide have been released into the atmosphere every year. This has caused a rise in the concentration of carbon dioxide in the atmosphere. An observed rise in the global mean surface temperature over recent years has accompanied this.

The United Nations organised a body of scientists, the Intergovernmental Panel on Climate Change (IPCC), to study the problem. The IPCC believe that the industrial use of fossil fuels has increased the concentration of carbon dioxide in the atmosphere and caused the temperature of the world to increase. This conclusion resulted in an agreement at the Kyoto Summit 1997, between the developed nations to stabilise their carbon dioxide emissions at 1990 levels by the year 2000 and at 5% below 1990 levels over the period 2008-2012.

## **B. Carbon Dioxide Emissions**

The IPCC worked on several assumptions, a business as usual assumption and a series of others. Under the business as usual scenario the models predict a rise of between 1.5 and 3.5 degrees Celsius in global mean surface temperature over the next century.

Although cuts of 5% have been agreed, models predict that a cut in emissions of 60% would be required to stabilise the atmospheric concentration of CO<sub>2</sub> at current levels, and so avoid further warming.

There are three major sources of anthropogenic carbon dioxide emissions: transport, domestic energy use and industrial energy use. The most recent statistics available from the DETR show that carbon dioxide emissions for 1996<sup>9</sup> can be accounted for by power stations (43 million tonnes of carbon dioxide), road transport (31 million tonnes) and

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<sup>6</sup> For example, Library RP 97/141, *Climate Change After Kyoto*, 24 December 1997

<sup>7</sup> For example, POST Report 121, *Living in the Greenhouse*, December 1998

<sup>8</sup> For example, Environment Audit Select Committee Report, *Climate Change: Government Response and Follow-up*, 12 February 1999, HC 88 1998/99

<sup>9</sup> DETR, Digest of Environmental Statistics No. 20, September 1998

other sources (80 million tonnes). The Climate Change Levy has been introduced by the Government as a way of reducing the contribution of industrial energy use.

Even if emissions of carbon dioxide from power generation and transport were completely eliminated this would only represent approximately a 48% reduction in emissions. Not enough to reach the 60% necessary to stabilise the atmospheric concentrations of the gas. As carbon dioxide emissions represent 79% of the global warming potential of the gases emitted in the UK, the 48% reduction in CO<sub>2</sub> would actually only represent a 38% reduction in overall greenhouse gas emissions.

Obviously there must be a wider focus than purely on energy and transport. Commercial, public and agricultural combustion adds 9 million tonnes of carbon dioxide, and domestic combustion 25 million tonnes. Iron and steel combustion adds 7 million tonnes and the rest of industrial combustion 17 million tonnes. All of these sources must be addressed and some determination of how the associated emissions might be avoided or reduced. The Levy, however, was not conceived to address all industrial carbon emissions, only those related to the industrial use of energy.

### **C. Details of the Climate Change Levy**

It was originally expected that the Levy would raise around £1.75 billion in its first full year (2001-02) and save around 1.5 million tonnes of carbon a year by 2010. The recent pre-budget statement made by the Chancellor revised those figures. The Levy is now expected to raise only £1 billion in its first full year but save 2 million tonnes of carbon a year by 2010.

The Levy will apply to gas (natural gas and liquefied petroleum gas), coal and electricity used by business, agriculture and the public sector for energy uses. It will not apply to fuels used by the domestic or transport sector, or fuels used for generation or non-energy purposes.<sup>10</sup> The Levy will not apply to oils which are already subject to mineral oils duty.<sup>11</sup> HM Customs & Excise have issued a consultation paper on the details of how the Levy is to be administered, with a view to legislation being introduced in the Finance Bill in 2000 (see section III.1).<sup>12</sup>

### **D. Response to the Levy**

The response from industry, the intended target of the Levy, has been fairly strong. The Chancellor claimed the Levy would be revenue neutral as the money raised was to be returned through reduced NIC contributions and funds for energy efficiency measures.

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<sup>10</sup> For example, oil used to generate electricity or to make plastic.

<sup>11</sup> HM Treasury Budget press notice HMT6, 9 March 1999

<sup>12</sup> HM Customs & Excise, *Consultation on a Climate Change Levy*, March 1999  
<http://www.hm-treasury.gov.uk/budget/1999/index.html>

Industrial concerns were that the levying and recycling would not distribute money in an even fashion across the whole of business. Companies which used large amounts of energy and few staff would suffer financial loss whilst companies which employed large numbers of staff with relatively low energy expenditures would benefit financially from the Levy.

One of the main lobbying groups has been the Chemical Industries Association (CIA) whose 200 members tend to fall into the former category. The CIA claim that the chemical industry represents 10% of the UK's exports and 2.5% of the UK GDP. The CIA have stated that they recognise the industry's environmental responsibility and have contributed to the current climate change problem by 'improving energy efficiency by 60% between 1967 and 1990 and a further 15% in the time since 1990.

The CIA response to the Levy was to claim that, before rebates, the Levy would cost the UK chemical industry £130 million, threaten 6000 jobs over the long term and export pollution to countries with less rigid environmental regimes. They therefore proposed:

- that the Government extend the option of energy efficiency agreements to all sectors of industry rather than just a limited selection;
- that the levy should only apply to those companies with whom an efficiency agreement cannot be reached; and,
- that there be no link between the levy and the money needed to reduce employer NICs.<sup>13</sup>

Moreover, the CIA had been looking to secure a situation in which the sector itself would suffer no net costs as a result of the levy, assuming that all cost effective energy efficiency measures were taken.

Other heavy energy users, such as the steel industry,<sup>14</sup> were also concerned about the effect of the Levy. Metal industries have been the subject of questions to the Government:

**Mr. Gordon Prentice (Pendle):** What assessment he has made of the impact of the proposed climate change levy on (a) the aluminium industry and (b) other high-energy using manufacturing industries.

**The Economic Secretary to the Treasury (Ms Patricia Hewitt):** Following Lord Marshall's recommendation, the Government are not taking an across-the-board approach to the climate change levy. As my right hon. Friend the Chancellor announced on Budget day, we intend to set significantly lower rates of levy for those energy-intensive sectors that agree targets for improving their

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<sup>13</sup> Chemical Industries Association, *The Climate Change Levy and the Chemical Industry*, September 1999

<sup>14</sup> HC Deb 30 March 1999 c 665W

energy efficiency. My right hon. Friend the Deputy Prime Minister has had a useful initial meeting with the associations representing the energy-intensive sectors and detailed negotiations with those sectors, including the aluminium industry, are now under way.

**Mr. Prentice:** That is a very reassuring answer, but even with the 50 per cent. reduction for energy-intensive industries such as aluminium there are fears that production costs will rise dramatically. I have been told that the aluminium industry anticipates a rise of perhaps 12 per cent. per tonne, which would drive it offshore. I was reassured by what I heard about discussions and negotiations taking place, with a concluding date of 28 May, and I very much hope that my hon. Friend will take into account and give full weight to the concerns expressed by the industries.

**Ms Hewitt:** I am grateful to my hon. Friend for that question. The points that he makes are precisely those that we are taking into account in our discussions with the energy-intensive sectors. I stress that the 50 per cent. lower rate in the Customs and Excise consultation document is purely an illustrative assumption. It is not a statement about what the lower rate might be for any energy-intensive sector. That lower rate will depend on the stringency of the targets to which the sectors agree. In line with our published statement of intent on the principles of environmental taxation, international competitiveness is one of the key issues that we consider for any environmental tax, including the climate change levy.

**Mr. John Bercow (Buckingham):** Given that British Steel estimates that the climate change levy will add £200 million to its annual tax bill, whereas the offsetting reduction in national insurance is worth only £5 million a year to it, does the Economic Secretary acknowledge that the levy is yet another clear example of the Government's policy of taxation by stealth, which has served to throttle manufacturing industry in this country and plunge it into recession while she has been a Minister?

**Ms Hewitt:** The hon. Gentleman does not seem to appreciate that, as my right hon. Friend the Chancellor made clear, the new levy will entail no increase in the overall burden of tax on business: it will be revenue-neutral. As I have already said on a similar point, we are now looking in detail at the different energy-intensive sectors, what each of them is willing to do to improve energy efficiency and how we should respond by introducing a significantly lower rate of climate change levy. I am interested in the fact that the hon. Gentleman, judging from his remarks, seems to have abandoned the commitment that the Conservative Government made to meeting the Kyoto target. The climate change levy is an essential part of meeting those targets. We estimate that it will save about 1.5 million tonnes of carbon a year by 2010.<sup>15</sup>

The Government stated that small to medium sized enterprises are an important facet of the climate change strategy and they should benefit from the energy efficiency measures financed by the Levy:

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<sup>15</sup> HC Deb 13 May 1999 cc 410-412

**Mr. Meale:** In his Budget Statement on 9 March 1999, Official Report, columns 173-190, the Chancellor announced as part of the climate change levy £50 million per annum package to fund schemes aimed at promoting energy efficiency directly including energy efficiency audits/advice, mechanisms to promote low carbon technologies, and additional support for renewable sources of energy. Further details will be set out in the draft UK climate change programme later this year. The Government recognise that SMEs [small to medium sized enterprises] are a key part of the economy with special needs. They have already therefore designed specific schemes and programmes to help them save energy and money and, importantly from our point of view, do their bit to reduce greenhouse gas emissions.

My Department's Energy Efficiency Best Practice programme provides independent advice and information on energy efficiency and support for RD&D projects. Non-domestic energy users including SMEs are an important target audience for the programme. The Department also funds grant schemes specifically for SMEs delivered through the Energy Saving Trust. The experience gained from the Energy Efficiency Best practice programme will provide a good basis for developing further energy efficiency schemes as part of the £50 million per annum package.....<sup>16</sup>

A study<sup>17</sup> commissioned by the UK Worldwide Fund for Nature (WWF-UK) examined the effects of the Levy on business. This provided a different perspective on the impact that the Levy might have on various industries. The key findings of the study are reproduced below:

- In itself the cut in employers' NIC is unlikely to be of benefit to the whole of industry
- Overall the economic size of the industries that are benefiting from the policy, measured either in number of employees or in contribution to GDP, is double that of sectors losing from the policy;
- Industries employing 93% of the UK workforce and earning 90% of GDP are either beneficiaries of the policy or have very small net costs (defined as less than 0.1% of the value of their output);
- Energy prices have fallen over the past five years due to liberalisation of the energy markets and low international oil prices. The climate change levy will have the effect of increasing energy prices to levels that have been experienced in the past five years.
- The two greatest beneficiaries of the policy are education (£77 million) and health service industry (£66 million).
- The extra money available to the education and health sectors is sufficient to fund an extra 7,000 employees in the health industry and 3,500 more teachers.

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<sup>16</sup> HC Deb 12 May 1999 cc 153-154W

<sup>17</sup> ECOTEC, *Who gains from the climate change levy?*, WWF-UK, 29 September 1999, <http://www.wwf-uk.org>

- By 2002 the climate change levy might reduce emissions of carbon by around 0.9 million tonnes of carbon. The Government believes that these could rise to 1.5 million tonnes by 2010.
- No industry is likely to lose out from the combined effect of the climate change levy and the cut in NIC by more than 4% of the value of its sales even if the levy is applied at its full rate.
- The industry that loses out most from the package is Food Production (£87 million). However this loss is a small fraction, about 0.15%, of the industry's total turnover.
- There is the possibility to offset the extra cost of energy by improvements in energy efficiency.
- The climate change levy and NIC cut will hurt the competitiveness of a small minority of British industry. Energy intensive industries that are losers from the levy will be under pressure to reduce emissions in other countries also.<sup>18</sup>

This study, having been published in October was carried out utilising the initial figures supplied by the Government and not the revised lesser figures provided by the Chancellor in his 1999 Pre-Budget Report (see Section IV).

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<sup>18</sup> <http://www.wwf-uk.org/news/ecotec.pdf>

## II Environmental taxation

The terms 'environmental taxation' and 'ecotaxes' are not defined in legislation. The European Commission considers that they can be used whether the revenue accrues to the Government or is earmarked for a particular purpose, if either the taxable base has a clear negative effect on the environment or if the tax itself has a less clear but discernable positive effect on the environment (this might be achieved through setting a tax differential between two products according to environmental friendliness).

### A. General Principles

There are two basic types of ecotaxes:

- **Emission taxes** [sometimes called '**pollution taxes**']; payments directly related to the real or estimated pollution caused to land, air or water by pollutant emissions from, for instance, power stations, or water outfalls from sewage plants. Noise pollution might also be taxed (in the aviation industry, for instance).
- **Product taxes**; on raw materials and intermediate inputs such as fertilisers, pesticides, minerals or water [**'input taxes**'] or on final consumer products such as packaging, car tyres or batteries [**'consumption taxes**']. Product taxes in the field of **energy** (taxes on oil, diesel and electricity) which have been imposed for some time for revenue raising rather than green motives, are increasingly being seen as having an environmental role to play.<sup>19</sup>

Pollution taxes have several advantages over a conventional enforcement system where a pollution limit is set and fines imposed for any breaches in this limit. For a firm producing a polluting output, it may be cheaper to pay a fine rather than reduce output to meet an emission standard. Also, once the firm has met the standard there is no incentive for it to clean up its act any further. On the other hand, taxes can continue to provide an added incentive to invest in clean technology and to innovate; this is known as 'dynamic efficiency'. It can however be argued that the tax burden drains firms of the resources to invest in technology and that regulation can achieve the same result, particularly if it requires the use of Best Available Technology (BAT).<sup>20</sup>

Pollution taxes administered by central government allow less scope for evasion than potentially irregular, on-site inspections by the responsible regulatory agency, and taxes on one pollutant will often cause a reduction in emissions of associated pollutants.<sup>21</sup> It is

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<sup>19</sup> European Commission, *Environmental taxes and charges in the Single Market*, COM(97)9, January 1997 para 10 and OECD, *Implementation strategies for environmental taxes*, 1996 p10

<sup>20</sup> OECD, *Implementation strategies for environmental taxes*, 1996 p15

<sup>21</sup> "Chapter 12: Green taxes" in Turner, Pearce and Bateman, *Environmental economics: an elementary introduction*, Centre for Social and Economic Research on the Global Environment (CSERGE) 1994

also said that regulators can sometimes get too close to the industry they are regulating, and market instruments are less susceptible to such 'regulatory capture'.<sup>22</sup>

However, because of the difficulty of putting a cost on environmental damage, it is difficult to determine the rate at which environmental taxes should be set. It is said that another reason for the reluctance of policy makers to set pollution taxes has been that once a firm has reduced its pollutant output to an acceptable level, it is still paying a tax on the pollution which it is producing, which seems unfair. Taxes levied on the pollution or products of one country's industry may also damage that country competitively by making foreign imports more economically attractive if competitor countries have no similar charges.

Most of the concern regarding pollution taxes, however, focuses on the effects on the consumer. Very simplistically, once the firm is paying a tax on each unit of pollutant or item it produces, it will probably try to pass this cost on to the consumer. The proportion met by the consumer will probably vary according to whether alternatives are available. With a tax on petrol for instance, even a steep rise in price is likely to reduce consumption by only a little, and consumers will be willing to meet most of the cost of the tax (there is an 'inelastic' demand curve). A tax on a washing powder containing phosphorus on the other hand, or on a domestic cleaning fluid containing zinc, allows consumers the choice of switching to alternative brands without these ingredients. In this case the producers have little chance of pushing the cost of the tax onto the consumer (the demand for the product is highly 'elastic' and price sensitive).<sup>23</sup>

Pollution taxes, then, send signals to both consumers (raising prices) and producers (lowering profit margins). The signals indicate the pollution cost of products and encourage a switch to lower pollution cost products. One problem is that of 'linkage': the link between the tax and the environmental problem needs to be as explicit as possible. A loose link gives poor economic signals regarding the appropriate environmental choice.<sup>24</sup> Of course, environmental taxes have an added advantage over regulations in that they raise revenue, although some or all of this may be needed to administer the tax, and the OECD considers that only taxes on fossil fuels are likely to raise the significant amounts of revenue capable of having macro-economic impacts.<sup>25</sup> It has also been pointed out that the poor might be disproportionately affected because, for instance, a larger proportion of their income goes on items being taxed, such as petrol, or heating fuel. But since profits go to central government, corrections could be made for this by altering tax free income allowances, perhaps increasing targeted social security benefits, or removing tax from other basic commodities.<sup>26</sup>

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<sup>22</sup> OECD, *Implementation strategies for Environmental Taxes*, 1996 p12

<sup>23</sup> *Environmental economics: an elementary introduction*, CSERGE 1994 p178

<sup>24</sup> OECD, *Implementation strategies for Environmental Taxes*, 1996 p74

<sup>25</sup> *ibid* p.65

<sup>26</sup> *Environmental economics: an elementary introduction*, CSERGE 1994 p177

So the possibility of a 'double dividend' from environmental taxes exists. Taxing environmentally unsound practices or 'dirty' goods improves the environment thus effecting welfare benefits which outstrip the increased prices. Secondly, the revenue may be used to lower an existing distortionary tax. Whether this works in practice can be debated. The whole point of environmental taxes is that they themselves will produce distortions, in that they seek to alter behaviour. They are imposed to more accurately reflect the externalities and true costs of environmentally unsound practices or goods in their price, and so distort consumer/product choice, not necessarily creating a more efficient tax system. However, by shifting taxes from labour (particularly in countries where wages are 'too high') to pollution, there may be an employment double dividend.<sup>27</sup>

A paper produced by Cambridge University<sup>28</sup> investigated equity and ecotax reform. The study was to determine the effects of utilising excise duties to achieve a 10% reduction in CO<sub>2</sub> emissions. They utilised a model being developed EU-wide and co-ordinated within the Department of Applied Economics at Cambridge. The main findings of the study are:

- In all countries the tax changes lead to a change in personal disposable income from the baseline case for all socio-economic groups; there is also an increase in employment in all countries.
- The eventual effects on the distribution of incomes associated with carbon taxation in the EU are not nearly so regressive as the initial impact on expenditure suggests.
- The most regressive impact is on West Germany, the UK and Ireland, although the impact is weak.
- The regressive effect comes from the impact of taxation on domestic energy consumption.
- If revenues are recycled through reductions in employer taxes, all Member States and all socio-economic groups in the study experienced an increase in real disposable income; the UK, Italy, Belgium, Ireland and West Germany stand to gain the most, but the largest gain is only an increase in the growth rate of 3.0 per cent a year for Belgium over 1999-2010.
- The scale of the revenues is such that the changes can easily have a progressive effect, but this is not likely to be via the market responses and is only likely to take place by deliberate policy – for example, (a) targeting reductions in employer taxes on employment of the lower paid, (b) using some of the revenues to improve the energy efficiency of domestic fuel use by lower income groups or (c) using the revenues to raise incomes of vulnerable groups directly via social security payments.

The issue of energy/carbon taxation and its effect on the economy has of course become a highly cerebral debate amongst economists and there have been many attempts to model

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<sup>27</sup> "Environmental taxes" in IFS, *Options for 1997: the Green Budget*, October 1996 pp 128-133

<sup>28</sup> T Barker and J Kohler, "Equity and Ecotax reform in the EU: Achieving a 10 per cent Reduction in CO<sub>2</sub> Emissions using excise duties", *Fiscal Studies*, Vol 19 No 4, 1998, pp 375-402

the damages and benefits of applying varying rates of tax. A recent paper<sup>29</sup> published in the *Energy Policy* journal highlighted the huge uncertainties involved in such models, but argued the prototype discussed appropriately included low probability but policy relevant outcomes.

## **B. The Government's Approach**

In its 1997 election manifesto, the Labour party referred to the potential of the tax system to tackle pollution:

Taxation is not neutral in the way it raises revenue. How and what governments tax sends clear signals about the economic activities they believe should be encouraged or discouraged, and the values they wish to entrench in society. Just as, for example, work should be encouraged through the tax system, environmental pollution should be discouraged.<sup>30</sup>

In his first Budget in July 1997, the Chancellor set out the Government's priorities in environmental taxation: a review of the possibilities of charging taxes on quarrying and water pollution, as well as a review of the landfill tax introduced in October 1996; a revision of the system of Vehicle Excise Duty (VED); and, the introduction of a higher 'escalator' for excise duties on oil & petrol (the target minimum annual increase in duties, first established by the previous Government).<sup>31</sup> In addition, the Government published a statement of 'environmental principles' - a wider statement of intent on the use of 'green taxes':

The Government's central economic objectives are the promotion of high and sustainable levels of growth and high levels of employment. By that we mean that growth must be both stable and environmentally sustainable. Quality of growth matters; not just quantity. Delivering sustainable growth is a task that falls across government. It will be a core feature of economic policy under this administration. The Treasury is committed to that goal.

How and what governments tax sends clear signals about the economic activities they believe should be encouraged or discouraged, and the values they wish to entrench in society. Just as work should be encouraged through the tax system, environmental pollution should be discouraged.

To that end, the Government will explore the scope for using the tax system to deliver environmental objectives - as one instrument, in combination with others like regulation and voluntary action. Over time, the Government will aim to reform the tax system to increase incentives to reduce environmental damage.

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<sup>29</sup> Tim Roughgarden and Stephen H. Schneider, "Climate change policy: quantifying uncertainties for damages and optimal carbon taxes" *Energy Policy*, vol 27 pp 415-429, 1999

<sup>30</sup> *New Labour: because Britain deserves better*, April 1997 p 12

<sup>31</sup> HC Deb 2 July 1997 c 311

That will shift the burden of tax from "goods" to "bads"; encourage innovation in meeting higher environmental standards; and deliver a more dynamic economy and a cleaner environment, to the benefit of everyone. But environmental taxation must meet the general tests of good taxation. It must be well designed, to meet objectives without undesirable side-effects; it must keep deadweight compliance costs to a minimum; distributional impact must be acceptable; and care must be had to implications for international competitiveness. Where environmental taxes meet these tests, the Government will use them.<sup>32</sup>

### **C. The Marshall Report on the business use of energy**

In his March 1998 Budget the Chancellor announced a new review into the possibility of a tax on the industrial and commercial use of energy:

I now turn to the environment. The Kyoto summit was a landmark for international agreements on the environment, and the work of my right hon. Friend the Deputy Prime Minister in securing agreement has been widely applauded. Having signed up to an 8 per cent. reduction in European Union carbon emissions, we are determined to play our part--nationally and internationally--in meeting those targets. In those important policy decisions, which affect generations ahead, there will be proper information, proper consultation and full openness in government ...

There has been increasing pressure, not least from businesses, for measures that encourage greater energy efficiency in industry. I am grateful to Sir Colin Marshall, the chairman of British Airways and, until July, president of the CBI, for agreeing to head a Government review into economic instruments to improve the industrial and commercial use of energy. It will include a study of whether new economic instruments, such as an industrial energy tax and/or other market mechanisms, should be introduced to help to curb industrial emissions, and, if so, how that will be done.<sup>33</sup>

Following consultations with industry, environmental organisations, academics and others, Lord Marshall published his report in November 1998.<sup>34</sup> His first conclusion was that economic instruments did have a role in helping reduce greenhouse gas emissions:

In my view, a mixed approach will be necessary. Within that context, I believe that there is a role for economic instruments in helping improve business use of energy and reducing greenhouse gas emissions as part of a package of measures, alongside existing regulations, voluntary and negotiated agreements, and other measures, and appropriate action on the part of other sectors. However, any measures must be subject to careful design in order to protect the competitiveness of British industry and maximise their environmental benefit.<sup>35</sup>

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<sup>32</sup> HM Treasury press notice, *Tax measures to help the environment*, 2 July 1997

<sup>33</sup> HC Deb 17 March 1998 cc 1108-1109

<sup>34</sup> HM Treasury, *Economic instruments and the business use of energy*, November 1998

<sup>35</sup> HM Trasury, *Economic instruments and the business use of energy*, November 1998 p 1

The main options were a system of tradeable emissions permits and a new tax. In the former case, firms buy and sell permits to pollute – a system which has been used in the USA to control sulphur emissions. An international system of tradeable permits is expected to be in place by 2008, and care would have to be taken to ensure any UK system was compatible with this. Since participants in such a scheme would have to monitor their emissions, and verify them to an auditable standard, Lord Marshall judged it unlikely that small firms could practicably be involved.

That permit systems can be time-consuming to design and develop was one of the lessons I drew from US experience of sulphur trading. In particular I suspect it may require extensive consultation to arrive at an arrangement for allocating permits which commands consensus among participants. In the light of responses to the consultation paper I believe it may not be realistic to expect a statutory UK scheme to be operating much before international trading begins with the Protocol commitment period in 2008.

**This leads me to the conclusion that it may not be sensible for Government to introduce a statutory scheme in the UK at this stage.<sup>36</sup>**

Justifying the introduction of a tax, Lord Marshall concluded:

Even when the international trading scheme is fully developed, it is unlikely that all businesses will be involved. Indeed, I doubt whether it will ever be practical for the majority of small and medium sized enterprises (SMEs) and less intensive users in industrial and commercial sectors to participate in the international trading scheme. Taken together, these firms account for around 60 per cent of total carbon dioxide emissions from business, and may offer scope for significant improvements in energy efficiency and reductions in emissions.

Hence, my conclusion is that there probably is a role for a tax if businesses of all sizes and from all sectors are to contribute to improved energy efficiency and help meet the UK's emissions targets.<sup>37</sup>

In order to tax business, and avoid imposing burdens on domestic consumers, Lord Marshall came to the conclusion that it would be necessary to apply a “downstream” tax, rather than an “upstream” tax on the use of primary fuels such as those used in electricity generation.

**Given current policy objectives for the domestic sector, the leading option would therefore appear to be a ‘downstream’ tax on supplies of energy products and electricity for final use by industrial and commercial consumers.**

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<sup>36</sup> Ibid, p 16

<sup>37</sup> Ibid, p 2

A 'downstream' tax could be *collected from* the suppliers of energy products to final industrial and commercial users. It would be *paid for* by the final users, and it may be sensible to include an explicit reference to the tax on energy bills to increase its visibility. Preliminary estimates suggest that the distribution sector for all energy products involves no more than about 3,000 businesses. The vast majority of these will already be registered for VAT. This would facilitate the administration of the tax since the distinction between supplies to business and domestic customers is already made for VAT purposes.<sup>38</sup>

The rate of taxation would be determined either by reference to the carbon content of the fuel consumed or the energy used. Fuels like coal emit more carbon dioxide per unit of energy extracted than natural gas. The "vast majority" of respondents to the consultation judged that the tax should reflect the carbon content of the fuels used though this would introduce complications in assessing the equivalent carbon content of electricity generated from several different primary fuels.

Further work would be needed to refine these options before any decisions could be reached. In particular, it would be necessary to investigate in more detail the extent of fuel switching that might occur, and the resulting impact on emissions, under different tax structures. **But, in my view, there is a good case for trying to reflect, at least in broad terms, the carbon content of different fuels in the rates set in order to maximise the emissions savings resulting from the tax.**<sup>39</sup>

A carbon-based tax would benefit renewable energy sources and nuclear power, gas to a lesser extent, and coal least of all. Even a tax based on energy content could take into account government policy to promote renewable energy, though such an approach is not without complications:

There are good arguments on environmental grounds for offering tax relief to electricity generated from renewable sources. This would be relatively simple to administer in cases where the renewable electricity is supplied direct to the final customer. However, for electricity not supplied directly, it is not possible to identify at the point of supply to the final customer whether the electricity came from a renewable source. (In effect, a 'downstream' tax would treat electricity generated from renewable sources in the same way as electricity generated from other sources.)

At present, therefore, it may not be possible to exempt directly from tax all electricity generated from renewable sources. Possible changes in the electricity market and, in particular, the establishment of auditable "green business electricity contracts" may make this more practicable in the future. Alternatively, it may be possible to devise a scheme which provides direct incentives to renewables generators on the basis of the approximate percentage of electricity coming from renewable sources. **The Government should explore the feasibility and compliance costs involved with these options.**<sup>40</sup>

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<sup>38</sup> HM Treasury, *Economic instruments and the business use of energy* November 1998 p 20

<sup>39</sup> *Ibid*, p 21

<sup>40</sup> HM Treasury, *Economic instruments and the business use of energy*, November 1998, p 22

Lord Marshall's task force adopted a working assumption that the revenues from a carbon/energy tax would be recycled in full to business.

But any tax must be designed in a way that protects the competitive position of British industry. To this end, **I recommend that:**

- **the revenues are recycled in full to business;**
- **consideration be given to special treatment of energy intensive industries;**
- **any measures are subject to detailed consultation about their design.**<sup>41</sup>

Recycling of revenues could take place via general business taxation, such as corporation tax or employers' National Insurance Contributions. This would shift the burden of taxation away from jobs and on to pollution. Inevitably, some would say desirably, this would impact most heavily on energy inefficient manufacturing processes. However, some industries by their very nature are energy intensive and, for this reason, Lord Marshall judged that special arrangements should apply. These could, for example, take the form of exemptions or lower tax rates for selected industries, and credits for energy saving investments. There was a general case for recycling some revenue into energy efficiency schemes.

The Government's initial response to Lord Marshall's report was set out in the 1998 *Pre-Budget Report*:

The Government will be considering Lord Marshall's recommendations very carefully in developing its strategy on climate change, and will continue work and consultation on the further design issues identified in his report. The Government will take into account any potential impacts on competitiveness in seeking to find the most cost-effective means of meeting its targets for reductions in emissions of greenhouse gases.<sup>42</sup>

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<sup>41</sup> Ibid, p 2

<sup>42</sup> Cm 4076 November 1998 p 76

## D. The potential for carbon taxation

In October 1998 the Government published a consultation document which set out a range of possible options for meeting the UK's legally binding target of a 12.5 per cent reduction in greenhouse gas emissions, and for moving towards the Government's domestic goal of a 20 per cent reduction in carbon dioxide emissions.<sup>43</sup> In this it was argued that all sectors of the economy would need to play a part in tackling the problem of climate change, and that a mix of policy instruments would also be needed.<sup>44</sup>

This Climate Change Programme recognised business had made significant reductions in energy use and carbon dioxide emissions but there was a slowing trend. Despite a projected continuation in emissions reduction, it was felt this was more due to effort from generators than from industry as a whole. The Government indicated that it would lay down a policy framework within which business would be encouraged to take action but given the freedom to determine what that action would be. The following March the Levy was proposed.

This preference was supported by a report made by the Advisory Committee on Business and the Environment (ACBE),<sup>45</sup> *Climate Change: A Strategic Issue for Business*.<sup>46</sup> The report accepted the need for action and outlined the elements of a long term policy framework within which business could operate and deliver carbon savings cost-effectively. ACBE was confident that if business responds to the climate change challenge now it can manage and control the process in a cost-effective way, put in place long-term solutions, and maximise the gains in terms of new markets and increased competitiveness.

There was also some acceptance of the fact that, whilst a small number of intensive energy users accounted for approximately 40% of carbon dioxide emissions, these users were 'generally efficient' in their use of energy. There was a perception however that further savings could be made even where a high level of efficiency already existed.

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<sup>43</sup> The consultation period closed on 12 February. Over 700 responses were received. The Government has been assessing these responses, with a view to producing a draft programme later in 1999. HM Treasury Budget press notice HMT6, 9 March 1999

<sup>44</sup> Department of the Environment, Transport and the Regions, *UK Climate Change Programme - a consultation paper*, October 1998

<sup>45</sup> ACBE was established in 1991 to engage in a strategic dialogue with business on environmental issues. Members are jointly appointed by the Secretary of State for Trade and Industry and the Deputy Prime Minister and serve in a personal capacity. Membership consists of senior business leaders, drawn from a range of sectors.

<sup>46</sup> DETR, *Advisory Committee on Business and the Environment: eighth progress report to and response from the Deputy Prime Minister and the Secretary of State for Trade and Industry*, October 1998, pp 11-14

The remaining 60% or so of carbon dioxide emissions from business is attributable to the less energy intensive industries, to commercial sectors such as retail, banking and other services, and to small businesses.<sup>47</sup>

The ACBE made some definite statements on how they would like to see a tax implemented:

**Economic Instruments – Carbon Tax:**

ACBE believes that in order to help secure a change in the approach to energy and to meet the Government's targets, an economic instrument in the form of a tax may be necessary. However if adopted, such a tax must be part of a comprehensive programme of measures and introduced on the basis that it does not lessen UK business competitiveness, that its revenues are fully recycled by encouraging low carbon technology and by being otherwise revenue neutral, that it is targeted to achieve changed behaviour and should not fall exclusively on business. This should be supported by clear Parliamentary undertakings with regard to fiscal neutrality and the recycling of revenues in particular.<sup>48</sup>

The Government reported back on the Climate Change Programme consultation in August 1999.<sup>49</sup> Responses on a carbon/energy tax varied between environmental and business groups. There was agreement, however, that a range of policies, using a variety of measures, were needed to ensure that energy efficiency was improved across all sectors. There was also a measure of concord concerning the need for business to have a definite indication of future taxation plans to allow for sound future financial management.

There were also ideas presented to encourage energy efficiency within small businesses:

- Many thought that the Government should make free, or low cost, energy audits available accompanied by free or low cost consultancy advice.
- Some respondents said that information and advice which gave a clear, consistent message was needed.
- Some suggested that existing networks, for example, local chambers of commerce, should be used to give out information and advice.
- Some people stressed that using larger companies could influence smaller ones through the supply chain.<sup>50</sup>

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<sup>47</sup> DETR, *Advisory Committee on Business and the Environment: eighth progress report to and response from the Deputy Prime Minister and the Secretary of State for Trade and Industry*, October 1998, pp 11-14

<sup>48</sup> DETR, *Advisory Committee on Business and the Environment: eighth progress report to and response from the Deputy Prime Minister and the Secretary of State for Trade and Industry*, October 1998, pp 11-14

<sup>49</sup> DETR, *Climate Change Consultation Report*, August 1999  
<http://www.environment.detr.gov.uk/consult/climatechange/response/index.htm>

<sup>50</sup> DETR, *Climate Change Consultation Report*, August 1999 p 14

In February 1999 the Environmental Audit Committee published its response to the *Pre-Budget Report*, including its views on the Marshall proposal for a tax on the business use of energy:

36. We consider the time is now ripe for confirming the Government's intentions regarding a tax on business use of energy: the groundwork has been done and opportunities for consultation have been exploited to the full. One of the most important aspects, when considering taxes affecting the business sector, is that there should be clarity over the Government's long-term strategy to aid in business planning. **We look forward to the announcement of a decision, to give a clear signal on the long-term direction of policy, in line with Lord Marshall's conclusions.**<sup>51</sup>

A communication from the EU Commission to the Council and Parliament in May 1999 made comment on '*Preparing for Implementation of the Kyoto Protocol*'.<sup>52</sup> The accompanying press release<sup>53</sup> stressed the need for '*All sectors [...] to make a contribution to the reduction of emissions*'. There was also an identification that '*The most important sectors where action needs to be taken or further pursued are transport, energy, industry and agriculture, but also private individuals and households will have to make an effort*'.

With respect to energy and industry the communication states:

**Energy:** The Community's commitment to limit greenhouse gas emissions cannot be achieved by continuing "business as usual" without making changes in energy policy and taking measures for internalising the external costs of energy production and consumption.<sup>54</sup>

The Commission proposed a range of complementary actions focussing at Community level such as

- promoting energy efficiency and saving- increasing the share of production and use of cleaner energy sources: the Commission has advocated to double the share of renewables up to 12% of the EU energy mix by 2010;<sup>55</sup>
- reducing the environmental impact of the production and use of energy sources.

**Industry:** There is potential within Industry to reduce greenhouse gas emissions. Progress in increasing energy efficiency has already been made for example

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<sup>51</sup> 16 February 1999 HC 93 1998-99 p xviii

<sup>52</sup> Commission Communication, *Preparing for Implementation of the Kyoto Protocol*, COM(1999)230final [http://europa.eu.int/comm/dg11/docum/99230\\_en.htm](http://europa.eu.int/comm/dg11/docum/99230_en.htm)

<sup>53</sup> Commission Press Release IP/99/333, *Preparing for implementation of the Kyoto Protocol*, 19 May 1999

<sup>54</sup> As indicated in the Commission Communication on "*Strengthening environmental integration within Community energy policy*", COM(98)571final

<sup>55</sup> Commission Communication "*Energy for the future: renewable sources of energy - White Paper for a Community strategy and action plan*" COM(97)599

through voluntary initiatives. Other interesting tools providing incentives for businesses towards the achievement of the Kyoto target are the further promotion of EMAS<sup>56</sup> and the use of energy labelling schemes. The integration of environmental aspects into European and international standardisation and the implementation by industry of eco-efficiency strategies should provide additional incentives.

There is some comment on the potential for fiscal incentives such as energy taxation:

Energy taxation is one of the most important of all common and co-ordinated policies and measures. The Commission has done its work. During the 1990s, 3 distinct proposals have been made to the Council. The Commission has moved from a Proposal for a CO<sub>2</sub>/energy tax with high rates of taxation and a high degree of harmonisation, to a more pragmatic approach for an energy products tax that foresees the extension of the existing system of excise duties and a gradual increase in levels of taxation. This Proposal is even more important given current and forecast low energy prices.

The Proposal for an energy products tax would allow Member States to tax aircraft fuel for domestic flights and for intra-Community flights by bilateral agreement of the Member States concerned. In an international context, the Commission is committed to the taxation of aircraft fuel “as soon as the international legal situation allows the Community to levy such a tax on all carriers including those from third countries”.<sup>57</sup> However, the potential for using other economic instruments, such as differentiated on-route charging, should also be carefully considered.

The issue of negotiated efficiency agreements with industry was also mentioned as a possibility to ease the impact of any such tax:

The Proposal for an energy products tax provides for Member States to allow partial exemptions for companies that make investments in improving energy efficiency. They can bring forward in time investment in equipment that will save energy over an extended period. Similar tax breaks could also be applied for direct taxes. However, tax breaks are primarily for the Member States to determine, within the margins defined by the guidelines for the use of state aid for environmental purposes.

The report also provides figures for EU Member States’ emissions and the relative importance of the various greenhouse gases which have been reproduced in Appendix B of this paper (p 48).

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<sup>56</sup> Eco-Management and Audit Scheme

<sup>57</sup> Report from the Commission to the Council and the European Parliament on excise duty reductions and exemptions COM(96)549 final of 14 November 1996, p 11

## **E. The March 1999 Budget**

In his March 1999 Budget speech the Chancellor announced that the Government had decided to introduce a Climate Change Levy, on the lines proposed by Lord Marshall, from April 2001:

As Britain works to lead in the new economy, we must resolve to lead also in respecting the environment. Our Government's target is to reduce greenhouse emissions by 12½ per cent. by 2010. So today, I am announcing a programme of measures that will cut carbon pollution by 3 million tonnes.

My first proposal alone will reduce carbon pollution by 1.5 million tonnes. The Government have received Lord Marshall's report, for which I thank him, on the role of economic instruments and the business use of energy. We will now implement Lord Marshall's recommendations and we will introduce a levy on business use of energy from April 2001. And it will be brought in, after further consultation with the industry, on a revenue-neutral basis, with no overall increase in the burden of taxation on business. Because we intend at the same time to cut the main rate of employers' national insurance contributions from 12.2 per cent. to 11.7 per cent.

We also intend to set significantly lower rates of tax for energy-intensive sectors that improve their energy efficiency. Today, we are inviting these companies to submit their proposals. In pursuit of our policies for sustainable development, we will allocate an extra £50 million to encourage business to invest in the new environmental technologies and in renewable fuels.<sup>58</sup>

Further details were given in a Budget press notice:

The climate change levy will play a major role in helping meet the UK's targets for reducing greenhouse gas emissions. It will entail no increase in the tax burden on business as the revenues will be recycled in full to business. These reforms will promote energy efficiency, encourage employment opportunities, and stimulate investment in new technologies ...

The Government agrees with Lord Marshall's recommendation that the levy must be designed in a way that protects the competitiveness of UK firms. The Government therefore intends to recycle the revenues to business, and intends to cut the main rate of employer NICs by 0.5 percentage points. Businesses will also benefit from schemes aimed at promoting energy efficiency directly and stimulating the take-up of renewables sources of energy, like solar and wind power. The introduction of the climate change levy will therefore entail no increase in the burden of taxation on business.

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<sup>58</sup> HC Deb 9 March 1999 c 181

The Government also recognises the need for special consideration to be given to the position of energy intensive industries given their energy usage, the separate Integrated Pollution Prevention and Control regulation and their exposure to international competition. In line with the recommendations made by the CBI, the Government will not be taking a blanket 'across the board' approach to setting the appropriate level of the new levy. Subject to any legal and practical constraints, the Government intends to set significantly lower rates for those energy intensive sites that agree targets for improving their energy efficiency which meet the Government's criteria. The Deputy Prime Minister has written to the trade associations of the main energy intensive sectors on Budget day, and will begin negotiations with energy intensive sectors shortly.<sup>59</sup>

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<sup>59</sup> HM Treasury Budget press notice HMT6, 9 March 1999

### III Climate Change Levy and Energy Policy

The 1997 Kyoto Protocol established legally binding targets for the reduction of emissions of greenhouse gases: carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide (N<sub>2</sub>O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), and sulphur hexafluoride (SF<sub>6</sub>). Compared with 1990 levels, the UK will have to reduce its overall emissions of these gases by 12.5%, a target to be achieved during the period 2008-2012. As mentioned earlier, the Government also has a manifesto commitment to reduce emissions of the most important (after water vapour) greenhouse gas, carbon dioxide, by 20% by 2010. A variety of measures could be put in place to meet these targets, including the promotion of energy efficiency schemes and switching from fossil fuels (coal, oil, gas) to nuclear or renewable energy (wind, solar, biomass etc).

#### A. Customs & Excise consultation

On the day of the 1999 Budget, HM Customs and Excise published a consultation document setting out detailed options for the design and administration of the Climate Change Levy.<sup>60</sup> Then designed to raise £1.75 billion (before revenue recycling) in its first full year (2001-2) and save 1.5 million tonnes of carbon<sup>61</sup> a year by 2010, the Levy would have had the following scope:

4.1 In order to ensure that domestic consumption of energy is not caught by the levy, and to keep compliance costs to a minimum, the levy will be imposed on energy supplied to industrial and commercial consumers rather than directly on the use of energy by industrial and commercial consumers. This means that suppliers of energy products will be required to register and to pay to Customs the levy that will be due.

4.2 The levy will apply to:

- electricity ;
- coal;
- coal and hydrocarbon derivatives such as orimulsion and petcoke; and
- natural gas and liquid petroleum gas (LPG)

when supplied to commerce and industry or heating and motor purposes (ie lighting, heating, motive power and power for appliances).

4.3 The levy will not apply to:

- mineral oils, renewable sources of energy or waste materials, and by-products used for heating purposes such as coke oven and blast furnace gases, but because of the structure of the electricity industry, it will apply to electricity generated from such sources unless used exclusively by an autogenerator for the purposes of their own business; or

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<sup>60</sup> HM Customs & Excise, *A Climate Change Levy – A Consultation Document*, March 1999

<sup>61</sup> 1.5 million tonnes of carbon is equivalent to 5.5 million tonnes of carbon dioxide

- road fuels (petrol, diesel, CNG, LPG) or aviation kerosene (AVTUR) and AVGAS.

#### 4.4 The levy will not be charged on:

- domestic use of energy. We propose that the existing rules used to establish which supplies of fuel and power are charged at the lower rate of 5 per cent VAT should be used to determine domestic consumption. Therefore, non-business use of energy by charities will not be subject to the levy (see **paras 7.1 to 7.5** for more details);
- energy used by public transport. We propose that the definition of public transport also follows the one used for VAT (see **para 8.1** for more details);
- fuels used as an input to the production of another fuel (see **section 9**, and **section 16** regarding CHP);
- non-energy use of fuels, for example fuels used for chemical processes (see **section 10** for more details).

Though the Marshall report had lent towards basing the Climate Change Levy on the carbon content of the fuels, the Customs and Excise consultation document found in favour of using the administratively simpler energy content. One consequence of this would be to avoid disadvantaging coal still further than current market arrangements are considered to do.

5.2 The Government is aware of the attractions, in principle, for structuring the levy so that it reflects the *carbon content* of different fuels. However, as recognised in Lord Marshall's report, given the current structure of the electricity and distribution industries, it is only possible to determine the carbon content of electricity as a broad average. On that basis, the additional fuel switching that would be induced by such an approach is likely to be limited.

5.3 Structuring the levy with regard to the *energy content* of different fuels has the advantage of simplicity. It would also be consistent with the 1998 Review of Energy Sources for Power Generation. This identified distortions in the generation market as a potential threat to the security and diversity of energy supplies and announced a programme of reform to ensure fair competition between fuels. In light of these considerations, the Government therefore intends to use the *energy content* of fuels as the basis of the levy.

The consultation document published the following, purely illustrative, rates for the Climate Change Levy: coal and gas (0.21 p/kWh); electricity (0.60 p/kWh). The higher rate for electricity reflects the fact that much of the energy in power station fuels is lost as waste heat. Options for providing relief for special cases were presented for consultation, these being energy used to produce other energy products; non-energy use of fuel products (e.g. as chemical feed stocks); energy intensive industries; energy use by public transport.

Renewable sources used for heat (such as landfill gas) would not be subject to the Levy, but exempting renewable electricity generation (e.g. wind farms) would be problematical, at least under current electricity trading arrangements. It remains to be seen to what

extent the forthcoming (in Autumn 2000) New Electricity Trading Arrangements, replacing the Pool, will make it easier to distinguish renewable and non-renewable electricity.<sup>62</sup> For example, electricity supplied direct by small-scale renewable generators might feasibly be exempted.

Other issues addressed by the consultation document were the position of autogenerators (businesses which generate electricity for their own use) and combined heat and power plants (which generate electricity and make use of the waste heat produced as a by-product). In both cases, Customs & Excise suggested that these businesses be treated as final consumers, the Levy being applied to the input fuels. Refund arrangements may have to be put in place, for example where a CHP plant exports some heat to domestic consumers.

So far as administration of the Levy is concerned, the arrangements would follow as closely as possible those in place for VAT. The types of businesses expected to register and account for the Levy are generally those already registered for VAT:

- electricity supply companies (including licensed suppliers);
- gas supply companies (including licensed suppliers);
- other energy suppliers, although suppliers who make only supplies not subject to the levy such as supplies to domestic consumers may be entitled to simplified treatment (see paragraph 7.6);
- importers of energy for their own commercial/industrial consumption;
- energy producers using own produced energy; and
- community heating schemes supplying surplus heat to industrial and commercial customers.

Certain consumers may also be required to register to claim refunds of levy charged on supplies of energy used for particular purposes

The consultation period for the Customs & Excise paper ended on 28 May 1999.

## **B. Parliamentary questions**

While the Climate Change Levy may be fiscally neutral at a macroscopic level, clearly some areas of business and industry will be affected more than others. There are bound to be winners and losers. A number of parliamentary questions have been tabled with a view to assessing the impact on business, including the following:

**Mr. Syms:** To ask the Secretary of State for Trade and Industry if he will make a statement about the cost to business of the proposals for new energy taxes.

**Mr. Gray:** To ask the Secretary of State for Trade and Industry if he will make a statement about the impact of the climate change levy on business.

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<sup>62</sup> Ofgem/DTI Conclusions Document, *The New Electricity Trading Arrangements*, October 1999

**Mr. Battle:** I welcome the representations from so many quarters of industry and business that something must be done to tackle climate change and to reduce emissions of greenhouse gases. The new climate change levy is intended to encourage energy efficiency in business and to contribute towards our commitments to reduce greenhouse emissions. Any assessment of the impact of the levy will depend on the final rates of tax which are set by my right hon. Friend the Chancellor of the Exchequer. HM Customs and Excise has previously published a consultation document on the design of the levy, which included some rates, but for illustrative purposes only. The Government has promised that there will be significantly lower rates of levy for those energy intensive sectors, covered by the EU Integrated Pollution Prevention and Control Directive, which are prepared to enter negotiated agreements with the Government to deliver energy efficiency improvements and/or emissions reduction targets. Discussions with a number of energy intensive sectors are under way to develop outline negotiated agreements for their sectors. The Government is determined to work closely with business on the detailed design and implementation of the climate change levy, and will take final decisions in the light of the responses to the Customs and Excise consultation as well as representations received from business and others.<sup>63</sup>

### C. Trade and Industry Committee

On 19 July 1999, the House of Commons Trade and Industry Committee published its Ninth Report, *Impact on Industry of the Climate Change Levy*.<sup>64</sup> This provided John Battle with an opportunity to reiterate his points concerning the needs of energy intensive users:

26. Mr. Battle told us that Government officials were examining the estimates made by industry of the losses they might suffer as a result of the Levy. While emphasising that he did not regard the industry estimates as necessarily exaggerated, he commented that "it is amazing how many people suddenly claim they are energy intensive users". Ministers assured us that the Levy was "not going to disadvantage UK industry". **We have been disturbed by the unprecedented scale of the reaction to the Government's proposal. We share the view expressed by several witnesses that, without appropriate modifications and exemptions, the Levy could prove a blunt instrument which does considerable damage to sectors of the British economy already struggling to maintain their profitability. It is imperative that the Levy makes special provisions for energy intensive industries, such as to minimise any damage to their international competitiveness.**

The construction industry and the public sector stood to gain most from the proposed arrangements since they were more labour-intensive (hence benefiting from the reduced

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<sup>63</sup> HC Deb 15 July 1999 cc 270-1W

<sup>64</sup> Trade and Industry Committee Ninth Report, *Impact on Industry of the Climate Change Levy*, HC 678-I, 1998-99

NICs) than energy-intensive. The Committee agreed that energy intensive industries required special treatment under the Levy, and that agreements to pursue energy efficiency measures were an important component.

**We are concerned, however, that the Government is considering negotiating 25 or more agreements, some with sectors which are not intensive users of energy, when the efficacy of such agreements is untested, and the experience reported by the chemical industry less than persuasive.<sup>65</sup>**

Another concern of the Committee was the way in which energy intensive firms were to be identified. To qualify for concessions, businesses would have to be subject to coverage by the EU Integrated Pollution Prevention and Control Directive.

**The IPPC regime is designed to deal with industrial pollution and is only indirectly related to the energy intensity of industry. Administrative convenience would seem to be the only reason why the Government has chosen to use IPPC coverage to define energy intensive industries. We understand that DTI is updating its ten year old figures on energy use by UK industry. These figures should be used to specify which firms and plant are energy intensive and therefore deserve special treatment under the Levy. The use of other, less accurate, measures of energy intensity is likely to create anomalies and inequities which will serve only to discredit the Levy.<sup>66</sup>**

Aspects of Government energy policy were, the Committee noted, contradictory: a Climate Change Levy aimed at reducing energy use sat uncomfortably alongside ongoing market liberalisation which was driving down prices.<sup>67</sup> Furthermore, "There is a tension between the Government's desire to protect the coal industry and the need to cut back carbon dioxide emissions which, at least partly, explains the reluctance to link the taxation of energy use to the carbon content of fuels."<sup>68</sup>

The Committee concluded:

51. The Government is inching towards a coherent strategy aimed at ensuring that the industrial and commercial sectors play their full part in the achievement of the UK's Kyoto target for reductions in greenhouse gas emissions. That strategy would seem to involve a range of instruments being used, including taxation, regulation, negotiated agreements, and emissions trading, with a range of concessions for industries which use energy intensively and already seek to use energy efficiently and for particular types of fuels. We do not think that the Climate Change Levy, as presently designed, sits easily with that strategy. It treats all fuel types equally, regardless of their carbon content. A crude method of

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<sup>65</sup> HC 678-I, 1998-99 para 38

<sup>66</sup> HC 678-I, 1998-99 para 41

<sup>67</sup> HC 678-I, 1998-99 para 21

<sup>68</sup> *ibid*, para 34

recycling revenues has been chosen, which essentially effects a transfer of resources from manufacturing industry to the service and public sectors. It places undue reliance on untested, unproven energy efficiency agreements between Government and industry. A more subtle approach is required from Government, for instance making use of more imaginative means of recycling the revenues raised by the Levy, including tax incentives for energy efficient investments, and drawing on the experiences of other countries which have established energy or carbon taxes. The Government is right to make a bold commitment to meeting its Kyoto target, but that target must not be met at the expense of British manufacturing industry. **We anticipate that the Chancellor will be moving the debate on the Climate Change Levy forward when he releases his pre-Budget report in the autumn. We intend to keep the announcements he makes on the Levy under close scrutiny.**

In its response to the select committee,<sup>69</sup> the Government stated that it recognised industry's concerns, and noted the Committee's view that the (indicative) proposals for the Levy should be modified. The Government did not see the Climate Change Levy as the only tool for reducing greenhouse gas emissions:

It will sit alongside other approaches, including emissions trading, regulation, voluntary action and negotiated agreements, within the eventual policy framework for tackling climate change.<sup>70</sup>

The IPPC regulatory regime was seen by the Government as a "reasonable proxy" for the most energy intensive sectors of business. Their negotiated agreements on energy efficiency will be convertible to carbon emissions targets. This might compensate, to some degree, for the Government's continued intention to keep the Climate Change Levy an energy rather than carbon tax. Under current proposals, if participants failed to meet agreed energy efficiency targets, the benefit of the reduced rate of levy would cease.<sup>71</sup>

Responding to the suggestions by the select committee that a tension existed between a desire to support coal and the need to reduce carbon dioxide emissions, the Government summarised its energy policy:

The Government's energy policy, including the Review of Energy Sources for Power Generation, is focussed on ensuring a level playing field between fuels for generation. This against the background of the Government's central energy policy objective of ensuring secure, diverse and sustainable supplies at competitive prices. Competitive markets are key to achieving this objective; and much of what the Government has been doing in this context has been aimed at making energy markets work properly and fairly.

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<sup>69</sup> Trade and Industry Committee, *Government observations on the ninth report from the Trade and Industry Committee (Session 1998-99) on the impact on industry of the proposed Climate Change Levy*, 20 October 1999, HC 834 1998-99

<sup>70</sup> *ibid*, p iv

<sup>71</sup> *ibid*, p x

The climate change levy, as proposed in the March 1999 Budget, is consistent with this policy in proposing a single rate of taxation for all electricity generation. With a downstream tax, the additional environmental gain from linking tax rates to carbon is likely to be fairly small.<sup>72</sup>

#### **D. Environmental Audit Committee**

Shortly after the Trade and Industry published its report, the Environment Audit Committee released a wide-ranging study of *Energy Efficiency*.<sup>73</sup> Though only one paragraph was given over to a discussion of the Climate Change Levy, the following recommendations emerged:

**We recommend that the Climate Change Levy be identified clearly on consumers' bills.**

**The Government should address the impact that the Levy will have on the competitiveness of heavy users of energy in a proportionate way.**

**We recommend that electricity bought under verified green tariffs be exempted from the Climate Change Levy.**

**We recommend that the amount of direct funding for energy efficiency under the Climate Change Levy be doubled and reviewed over time as to cost-effectiveness in securing savings.**

**We believe the Government should assess the effects of using a proportion of the Climate Change Levy revenue to provide continuing incentives and assistance for investments in energy efficiency in the form of tax breaks or rebates. For the Government and interested parties not to consider options for emissions trading schemes alongside the development of the details of the Levy may prove a lost opportunity.**

The committee's intentions were to ensure that appropriate signals to improve energy efficiency were sent, read and acted upon. The Energy Saving Trust's "Future Energy" accreditation scheme could provide one way of identifying electricity from renewable sources.<sup>74</sup> Finally, the committee felt that a higher proportion of the revenues could be recycled into energy-efficiency related measures, with less focus on National Insurance Contributions. The Chancellor's recent pre-budget report (see section IV) announced an increase (from £50 million to £150 million) in support for energy efficiency, in the first year.

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<sup>72</sup> *ibid*, p xii

<sup>73</sup> Environment Audit Committee, *Energy Efficiency*, HC 159-I, 1998-99 22 July 1999

<sup>74</sup> Energy Saving Trust press release, *The Energy Future's Bright*, 13 July 1999

So far as emissions trading is concerned, the government view was put by Patricia Hewitt during the energy tax debate, described in more detail in the following section:

The development of trading schemes for emissions permits offers us a new competitive opportunity. We see emissions trading as part of the long-term solution to reducing emissions in the United Kingdom. That is why we are working closely with representatives from the Confederation of British Industry and from many companies on the design of a domestic emissions trading scheme. By developing such a scheme now, we can learn valuable lessons ahead of the international trading scheme envisaged under the Kyoto protocol, which we expect to be in place by 2008.<sup>75</sup>

### **E. The Energy Tax Debate**

On 20 July 1999, the House of Commons debated the following Opposition motion:

That this House notes that the proposed energy tax represents a huge transfer of cash from manufacturing and energy intensive industries to the public and service sectors; threatens to drive large energy users out of the United Kingdom altogether and is a badly targeted and inefficient way of reducing CO<sub>2</sub> emissions; believes this is another stealth tax on industry and notes the Government has increased the Landfill Tax without applying the revenue to offsetting cuts in National Insurance Contributions as was done by the last Conservative Government; and calls on the Government to consult on alternative ways of meeting Britain's international commitments to counter global warming and to withdraw this damaging threat to industry.<sup>76</sup>

Opening for the Opposition, David Heathcoat-Amory talked of "Labour's addiction to new taxes", adding that the proposals would represent "a massive transfer of cash from the manufacturing and energy-using sectors of the economy to the service sector, and to the public sector in particular."

An additional muddle is that the proposals do not even try to tax carbon. The Government want to reduce carbon dioxide emissions, but electricity from sources that produce no carbon dioxide, such as nuclear plants, will be taxed at the same rate as electricity derived from coal or oil. There is no incentive to switch from a source of energy that produces CO<sub>2</sub> to one that does not. That runs contrary to Lord Marshall's report, and to the recommendations of the Select Committee.<sup>77</sup>

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<sup>75</sup> HC Deb 20 July 1999 c 1047

<sup>76</sup> HC Deb 20 July 1999 c 1033-1082

<sup>77</sup> HC Deb 20 July 1999 c 1037

He concluded:

What we know after we have been through all the fog of uncertainty around the Government's policy is that they have come up with a tax-driven solution. That tax is badly thought out, badly targeted, damaging, anti-competitive, wrong and we will oppose it.

The then Economic Secretary to the Treasury (Patricia Hewitt) focused on climate change and carbon dioxide emissions, advancing the following argument for an energy, rather than carbon, tax:

The climate change levy--as spelled out in the consultation document--needs to be primarily based on energy because, for the reasons that I have given, this is a downstream, not an upstream, tax. Given the electricity pool arrangements, it is not possible for any business user to tell how much of his electricity comes from a particular source--whether it be coal, gas or a renewable source.<sup>78</sup>

However, she added that the Government was considering the establishments of contracts for "green trading arrangements" within the context of replacing the current electricity pool.

As we said at the time of the Budget, the levy will be designed in a way that protects the competitiveness of United Kingdom firms. The scale and rates of the climate change levy will, of course, be a matter for my right hon. Friend's Budget next year, but, as my right hon. Friend the Member for Alyn and Deeside (Mr. Jones) indicated, we continue to consult with business and industry on the design of the levy--for example, on the treatment of renewables and combined heat and power, the appropriate treatment of electricity used in electrolysis, the best way of recycling the revenues and how to deliver extra help to small firms to become more energy efficient.<sup>79</sup>

As already noted, the Climate Change Levy will not be revenue neutral at the level of individual firms. Accordingly, maintaining competitiveness at this level could involve a combination of NIC reductions and further energy efficiency improvements. Dominic Grieve commented:

At least the Government are consulting on their proposals for the climate change levy. It would be remiss of me not to point out that there are, to say the least, misgivings about the likely proposals among industrialists in the west midlands, part of which I represent. I shall come to the detail of those misgivings in a moment, but first I must say to my hon. Friend the Financial Secretary that she will have to tell us exactly what is a revenue-neutral tax. I have been in the House for a long time--too long, perhaps, in the opinion of some--but that is a creature

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<sup>78</sup> HC Deb 20 July 1999 c 1044

<sup>79</sup> HC Deb 20 July 1999 c 1045

that I have never yet come across in my 25 years here. It is a one-legged fish, a Loch Ness monster or a mythical figure... there is in fact no such thing as revenue-neutral taxation. As with any other tax, the money will be taken from some people for the benefit of others. Some businesses will suffer and other businesses will get the benefit.<sup>80</sup>

Peter Snape's doubts over nomenclature even extended to the Levy's name:

It is all very well calling this measure a climate change levy, but it is a little like the poll tax being called the community charge. A climate change levy will be seen and described as an energy tax and there will be no point in Ministers sending out directives instructing people to call it by its proper name.<sup>81</sup>

Andrew Stunell said the Liberal Democrats broadly welcomed the levy because it would reduce carbon emissions to some extent:

It will help to slow down the rate of climate degradation and will perhaps direct investment into green technologies. However, we have some major reservations. Perhaps the most important of those is the one to which the hon. Gentleman referred: the levy does not discriminate between carbon-based and non-carbon-based fuels. That means that the environment for renewables will become increasingly difficult.<sup>82</sup>

Tim Loughton echoed these concerns:

The climate change levy is nothing more than an energy tax, and that is rightly the title of the debate. It is a tax by stealth, another red herring of a green tax, and a masterful piece of political presentation by the Government.

Worse still, the proposals are indiscriminate and unfocused. As Labour Members have said, no allowance is made for businesses that have already heavily invested in energy efficiency, or for more environmentally friendly energy such as combined heat and power and liquid petroleum gas. This is a downstream tax with no regard to the carbon content of the production method used. It begs the question whether a genuine carbon tax was ruled out because of the powerful vested interests in the coal industry.<sup>83</sup>

Tony Baldry also criticised the Levy for failing to discriminate between fuels on the basis of their carbon content. He was also concerned, like many Members, about the impact on industry:

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<sup>80</sup> HC Deb 20 July 1999 c 1051-2

<sup>81</sup> HC Deb 20 July 1999 c 1052-3

<sup>82</sup> HC Deb 20 July 1999 c 1050

<sup>83</sup> HC Deb 20 July 1999 c 1059

This is a levy on manufacturing industry that can only damage UK industrial competitiveness. A crude method of recycling revenues has been chosen that has nothing to do with energy efficiency. It simply transfers resources from manufacturing industry to the service and public sectors...

... Moreover, most of the industries that stand to be hardest hit because they are substantial users of electricity have over recent years, for sound commercial reasons, tried to ensure that they are as energy efficient as possible. An energy levy will not make them more energy efficient; it will simply be a tax on manufacturing industry.<sup>84</sup>

Denis MacShane put a similar point more forcibly:

...manufacturing is sick and tired of being patronised by Liberal Democrats, Greens and the City boys from the Conservative party. Manufacturing is sick of being told that it represents the past; it is in fact the internationally traded competitive sector of our economy, and the men who work in manufacturing, from top management to new recruits, deserve much more time and attention than the Conservative party has given them over the past 20 years.

I find some of the language used in the debate disagreeable. There is an idea that we tax "bads" and give tax relief to "goods". We cannot moralise about taxation in that way. Manufacturing, particularly the steel sector, is full of good men who make good products.<sup>85</sup>

Alan W. Williams was more positive about the impact the Levy would have:

The clear intention is that the levy should be revenue neutral, which means that there will be both those who gain and those who lose in the national insurance contribution cuts. Not surprisingly, in tonight's debate, attention has focused on the losers, but in the economy as a whole the result will be a gain of 14,000 jobs and there will be some protection for energy-intensive industries.<sup>86</sup>

Winding up for the Government, the then Financial Secretary to the Treasury (Barbara Roche) reminded the House that it had always been made clear that the Levy would not entail an increased burden on industry taken as a whole. The use of national insurance reductions to counter the introduction of a new tax had a precedent with the landfill tax brought in by the Conservatives. She did not rule out further support or exemptions for renewable energy.

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<sup>84</sup> HC Deb 20 July 1999 c 1055

<sup>85</sup> HC Deb 20 July 1999 c 1066

<sup>86</sup> HC Deb 20 July 1999 c 1070

By 311 votes to 162 the House resolved:

That this House notes that there is now compelling evidence that climate change needs to be tackled, that there is therefore a need for action to reduce greenhouse gas emissions, and that the United Kingdom has a legally-binding target for reducing greenhouse gas emissions set under the Kyoto Protocol; welcomes the recommendations of Lord Marshall on the case for a climate change levy; further welcomes the measures taken by the Government to help British business, including cutting corporation tax rates to their lowest ever level; welcomes the Government's decision to pre-announce the introduction of the climate change levy by two years to give time for further consultation on its design; and supports the Government's determination to work with industry and other parties to ensure that it meets its environmental objectives whilst safeguarding Britain's international competitiveness.

## **F. Negotiations with industry**

Following the 1999 Budget the Deputy Prime Minister met industry leaders on 29 March to discuss the reduced rate levy for energy intensive sectors:

Mr Prescott, with Environment Minister Michael Meacher and Treasury Minister Patricia Hewitt, was joined by representatives of nine key trade organisations and the CBI. Significantly lower rates of levy are on offer for those covered by agreements which improve energy efficiency and meeting the Government's criteria. This arrangement will extend the effect of the tax by leveraging additional carbon savings.

The Deputy Prime Minister said: "Climate change is undoubtedly one of our greatest environmental threats. We are determined to respond, but in ways which emphasise gain, not pain. That is why we are offering a lower rate of levy for energy intensive energy users who sign up to energy efficiency gains. Industry has benefited from substantial reductions in energy prices. We anticipate that they will continue to fall as the Government reforms the electricity trading arrangements in the medium term. The Government wants to work closely with industry to ensure that we meet our climate change objectives and improve energy efficiency in a way which helps rather than hinders our overall competitiveness.

"The energy intensive sectors are major emitters of greenhouse gases and I acknowledge that they have already done a great deal to reduce emissions. But there are still many more opportunities in all sectors to make further cost-effective energy efficiency improvements. Independent case studies from leading companies show that a substantial level of savings can be achieved." (Examples of these savings can be found later in the press notice). In line with recommendations made by the CBI, there will not be a blanket approach to setting the appropriate level of the new levy. The Government's proposal for energy efficiency agreements with the energy intensive sectors is a ground-breaking approach. Companies will be able to exchange part of their liability for the climate change levy in return for commitments to environmental gain. This

will give industry maximum flexibility on how it is implemented and before the levy comes into force in April 2001."

Mr Prescott told the meeting that the proposal will form only a part of our climate change strategy. "Our full package of proposals, which will involve all sectors of the economy, will be published later this year," he said

Speaking earlier today, John Battle Minister for Energy and Industry said: "These agreements offer business the opportunity to work with Government in developing a strategic approach to climate change. Properly constructed, they will produce a framework which also encourages business participation in domestic and international emissions trading. Emissions trading could prove to be a key environmental tool of the 21st century, tackling pollution and sustaining business simultaneously. Out of that will come many opportunities for new business and for exports, including renewable energy and other power projects." ...<sup>87</sup>

Nonetheless there has been considerable concern on the part of business that the levy will have a substantial impact on competitiveness; in March the UK Steel Association argued:

UK Steel Association is concerned that its members should be able to maintain their world competitive position, despite the introduction of the climate change levy says UK Steel Association President Peter Siddall. Speaking following a meeting with the Deputy Prime Minister on the Government's proposed climate change levy, he said that the UK steel industry supported Government's objective of reducing CO2 emissions. However, while the industry claims that it is already one of the world's most energy efficient and most productive in man-hours per tonne, these advantages could all too easily be undermined because the levy's effect will be far from tax neutral.

"We applaud the Government's recognition that energy intensive sectors like steel have special needs as well as a special role to play in achieving the UK's Kyoto commitments. But the fact is that this levy could still penalise the steel industry for its recent investments in more efficient plant and processes." UK Steel Association estimates, with the sector employing about 60,000, that the industry's cut in National Insurance will be under £5 million pa, while the levy it faces could take a total of over £120 million out of the industry in its first two years. "This is hardly the way to further competitiveness in manufacturing. Nor will it help maintain full-time manufacturing jobs."

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<sup>87</sup> DETR press notice 316, *Climate Change Levy Deal Offered For New Energy Users*, 29 March 1999

Last year UK Steel Association tabled proposals for a scheme that would commit the industry to make further energy savings under penalties for non-compliance, monitored by an independent agency such as the Environment Agency. "We believe that a negotiated agreement, backed by penalties for non-compliance, is the best way to deliver the required cut in emissions and maintain industrial competitiveness. We will be working with DETR officials to deliver this."<sup>88</sup>

In April the CBI raised this issue in relation to manufacturers:

Adair Turner, Director-General of the Confederation of British Industry, tonight (Thursday) told the Government to recognise the problems facing manufacturing and to avoid piling on unnecessary burdens through an energy tax. Speaking at the CBI East Midlands Manufacturing Dinner in Nottingham, Mr Turner said ... "There is little the Government can do about the strong pound but they must refrain from piling any unnecessary burdens onto manufacturers. The details of the climate change levy must be designed to ensure that manufacturing competitiveness is not harmed. The proposed 50 per cent reduction for energy intensive users will be too small to achieve this. Any levy will inevitably create winners and losers. But our concern is that the majority of the losers will be manufacturing companies since the rebate is going to be paid via NICs - not helpful for a cement plant that uses a lot of energy but doesn't have that many staff. In these energy intensive sectors we need to find ways of achieving environmental objectives which are consistent with competitive success. Maximum use needs to be made of voluntary agreements, rebates should be available also for companies participating in effective emissions trading schemes."<sup>89</sup>

The Government currently intends to apply a lower rate of energy tax in return for agreements by certain industries to improve energy efficiency. The present state of play has been given in a written answer:<sup>90</sup>

**Mr. Bill Michie:** To ask the Secretary of State for Trade and Industry what progress there has been in discussions with industry regarding the impact of the Climate Change Levy. [95953]

**Mrs. Liddell:** The Government have had extensive discussions with industry about the impact of climate change levy, which was announced by my right hon. Friend the Chancellor of the Exchequer in his Budget Statement on 9 March 1999, *Official Report*, columns 173-90. The Government have made clear that they wish to design the levy in a way which maximises its environmental benefit while seeking to protect competitiveness. They have been concerned to develop

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<sup>88</sup> UK Steel Association press notice, *Concern that tax remains major drain on manufacturing's ability to invest*, 29 March 1999

<sup>89</sup> CBI press notice, *Energy tax details must reflect dangers to manufacturing - CBI Chief*, 22 April 1999

<sup>90</sup> HC Deb 27 October 1999 c 908W

the best possible understanding of business's perspective in discussions over recent months, in order to inform their decision on the levy for the Finance Bill 2000. The Government have said that they recognise the special circumstances of energy intensive sectors of business in this context including their energy usage and exposure to international competition. The Department of the Environment, Transport and the Regions (DETR) has been leading the discussions with a number of key trade associations representing energy intensive sectors to develop negotiated agreement. Under these agreements, sectors which are to be subject to Integrated Pollution Prevention and Control regulation would earn significantly reduced rates of the climate change levy in return for commitments to targets for energy efficiency and/or emissions reduction. The DETR has been conducting detailed negotiations with an initial ten trade associations. Some initial offers of targets have now been made. The period for these discussions has been extended from mid-October to 20 December in order to give the trade associations more opportunity to consult their members.

## IV November 1999 Pre-Budget Report

On 9 November 1999, the Chancellor announced further details on the design of the Climate Change Levy:<sup>91</sup>

As we pursue our ambitions for growth and jobs, we can and must keep our environmental commitments. Under my right hon. Friend the Deputy Prime Minister, Britain took the lead in successfully negotiating the Kyoto agreement, and I am today announcing the results of our consultation with business on the climate change levy. Our original proposal was to cut environmental pollution by 1.5 million tonnes a year by 2010. Our consultation has shown that we can cut environmental pollution even further by 2010--by more than 2 million tonnes a year--and at the same time cut the levy from £1.75 billion to £1 billion.

I have decided that renewable energy sources and combined heat and power will be exempt from the levy. The main rate per kW hour will be cut from 0.21p to 0.15p, and there will be an 80 per cent. discount to energy-intensive sectors signing energy efficiency agreements. Taken together, those changes approach a 90 per cent. discount on the levy published at Budget time in return for agreed industry action to cut emissions.

All the revenues raised will be recycled to business. I can confirm that every business will receive a tax cut of 0.3 percentage points in employer national insurance contributions. I have ensured not only that that package is revenue neutral for business and revenue neutral between manufacturing and services, but that even after the national insurance change there will be no gain to the public purse.

In the run-up to the Budget, we will consult on a new 100 per cent. first-year investment allowance for companies moving from environmentally unfriendly to environmentally friendly technologies and processes. I propose to make available not, as originally announced, £50 million, but in the first year a total of £150 million to support energy efficiency in British industry. With all those measures taken together, Britain is on track to meet our country's Kyoto target.

From the standpoint of industry, the proposed reduction in the levy rate and the increase in the discount in return for energy efficiency agreements will both be seen as significant concessions. Indeed, the Chemical Industries Association commented:<sup>92</sup>

Although there are still some detailed issues to be resolved, the big threat to the competitiveness of our wealth-creating industry seems to have been removed.

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<sup>91</sup> HC Deb 9 November 1999 c 889

<sup>92</sup> Chemical Industries Association News Release, *CIA welcomes chancellor's pre-budget energy tax statement*, 9 November 1999

Even before the pre-budget announcement, the CIA already had grounds for some relief in a government decision<sup>93</sup> to exempt from the tax electricity used in electrolytic processes<sup>94</sup> such as chlor-alkali production (from brine) and aluminium extraction.<sup>95</sup> Increased support for energy efficiency measures, and plans to exempt some forms of renewable energy (such as solar and wind) together with “good quality” (presumably involving the combustion of gas or renewable fuels) combined heat and power schemes will provide some discrimination in favour of low carbon fuels.<sup>96</sup> However, the same levy rate is still expected to apply to both gas and coal, despite the environmental advantages of the former as a fuel source.

Responding to steel industry concerns raised by Barry Jones, the Chancellor underlined the 80 per cent discount, and reduced levy rates together amounting to a 90 per cent reduction. He added that the steel sector could also claim from the £150m energy efficiency fund and benefit from 100 per cent capital allowances for moving to more energy efficient products and processes.

Martin O’Neill (chairman of the Trade and Industry Committee) welcomed the changes to the Levy:<sup>97</sup>

May I congratulate my right hon. Friend on his statement? I was one of those who had misgivings about the climate change levy, and in large measure my right hon. Friend seems to have listened to what we were saying. Given the opportunities that are now available to companies and trade associations to enter into negotiations with our right hon. Friend the Deputy Prime Minister, there is no reason why most of them should not be able to arrive at reasonable settlements, in view of the reduction offered by the discount and the lower rate, the opportunities for combined heat and power, and the £150 million for energy efficiency investment, as well as the capital allowances. We must congratulate my right hon. Friend because, although many of us criticised him, he listened; and I believe that most of us are relieved and almost happy.

Denis MacShane also welcomed the announcement, particularly in the context of its lessened impact on the steel industry. However, Francis Maude cited CBI concerns that the Climate Change Levy (and the windfall tax and the removal of the dividend tax credit) remained a significant burden on business. The CBI reaction to the pre-budget report noted that the Chancellor had gone a significant way towards meeting business concerns. However, some sectors remained likely to face significant net costs. Further

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<sup>93</sup> HC Deb 27 July 1999 c 390W

<sup>94</sup> Electrolysis involves passing an electric current through a molten substance or a solution to separate out some of the constituents

<sup>95</sup> “The climate change levy debate rolls on”, *ENDS Report*, July 1999

<sup>96</sup> HM Treasury Press Release 7, *Further details announced on the climate change levy*, 9 November 1999

<sup>97</sup> HC Deb 9 November 1999 c 899-900

negotiations, involving more sectors, were needed.<sup>98</sup> The CIA, while still cautious about certain aspects of the Levy, were also upbeat in their assessment:

Overall, the chemical industry is greatly relieved that the Government has listened to our representations. If we gain acceptance of our proposed energy efficiency agreement and if we succeed in our continuing efforts to get non-IPPC but energy-intensive sites eligible for the rebate, then the overall net cost to CIA members will be less than £10 million - around 1% of the chemical industry's total energy bill. This will be further lessened by any grants and tax breaks which members can obtain from the £150 million fund which will be available for energy efficiency improvements. This should be compared to the initial threat which, with the 50% illustrative rebate, was a net cost of over £60 million.

“Our main goal now is to negotiate, by 20 December 1999, an energy efficiency agreement to attract the rebate of 80%. We know that this will require a very demanding target. The second issue is to persuade Government that the criteria for entering such energy efficiency agreements should be changed to allow involvement of all CIA members.<sup>99</sup>”

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<sup>98</sup> CBI News Release, *CBI reaction to the pre-budget report*, 9 November 1999

<sup>99</sup> Chemical Industries Association media briefing, *Climate change levy - energy taxation*, 12 November 1999

## Appendix A: The Marshall Report : Energy taxes in other EU countries<sup>100</sup>

### Energy taxes in other European countries

**B.19** Since 1990, six European countries have introduced explicit taxes on the carbon or energy content of fuels. These are Norway, Sweden, Finland, Denmark, Austria and the Netherlands. In addition, Italy has recently announced powers to enable it to phase in taxes on energy over a period of years. The new coalition Government in Germany have proposed increases in the excise duties on gas, oil, road fuels and electricity.

**B.20** At present, only taxation of mineral oils is covered by European legislation. In March 1997, the European Commission published a proposal for a Council Directive which would restructure the Community framework for the taxation of energy products. The proposed Directive is subject to unanimity. In broad terms, the proposal would extend the scope of EU minimum duty rates and structure provisions to apply to all energy products – including coal, gas and electricity – and not just mineral oils, which are currently covered. It would also increase the existing minimum duty rates on mineral oils. However, the Task Force has noted the Government's views on the draft Energy Products Directive, as set out in the explanatory memoranda of May and December 1997.

**B.21** The Task Force has considered the experience of the six European countries who operate taxes on energy. International comparisons, however, are not generally straightforward. Energy taxes must be seen in the wider context of other environmental policy measures, which will vary between countries. More importantly, the pattern of business energy use and electricity generation varies considerably between countries. In summary:

- of the six countries that tax energy, three countries operate carbon taxes, two reflect both carbon and energy, and one country charges an energy tax;
- all six countries tax electricity downstream, at the point of consumption;
- all countries now grant special treatment to some parts of industry. These have been justified by concerns over sectoral competitiveness. The special treatment has usually taken one of the following forms:
  - reduced rates of tax;
  - tax exemptions for certain sectors or industries;
  - caps on the total amount of tax paid, usually in proportion to total sales or costs.
- CHP and renewable sources of electricity receive special treatment in some Scandinavian countries;

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<sup>100</sup> This summary of the incidence of energy taxes in European countries is taken from, HM Treasury, *Economic instruments and the business use of energy: a report by Lord Marshall*, November 1998, pp 40-41

- the Netherlands and Denmark reduced other taxes alongside the introduction of energy taxes to ensure that the average tax burden on business remained broadly unchanged. Austria earmarks around 20 per cent of revenues for energy saving measures and public transport, but the bulk goes to the general budget. Finland and Norway use the revenues as part of the general budget;
- few studies have looked at the historical effectiveness of the taxes at reducing greenhouse gas emissions. A study by the Swedish Environmental Protection Agency estimated that the introduction of a carbon tax reduced emissions by 2 per cent, but suggested that the lower rates and exemptions for parts of industry meant that reductions were not being achieved in the most cost-effective way. A more recent study by the Swedish Green Tax Commission estimated that doubling the current tax rates would reduce emissions by between 0.2 per cent to 1.6 per cent;
- a study of Norwegian carbon dioxide emissions concluded that the carbon dioxide tax had brought about shifts in the carbon-intensity of energy use. Shifts in the direct business use of energy (largely from electricity to oil) were estimated to have reduced carbon emissions by 0.1–0.3 per cent of the Norwegian total, before the effects on overall energy consumption were considered. The carbon intensity of transport use of energy declined by 3 per cent over a similar time period;
- in Denmark, certain businesses (mostly those in energy intensive sectors) can negotiate a reduced carbon tax rate if they undertake to implement energy saving measures. In the Netherlands, tax credits and free depreciation are available to companies investing in energy saving or innovative environmental technologies.

## Appendix B: Commission Communication: Climate Change Data<sup>101</sup>

The following table provides data for each member of the EU. There is an emphasis on the year 1990 which has been adopted as the baseline against which emission changes will be measured. The share of emissions as at 1990 is presented in terms of percentage of the total EU emissions, in million tonnes of carbon dioxide equivalents, and in tonnes of carbon dioxide equivalents per capita. There is then some indication of the change in emissions between 1990 and 1994/5 followed by the agreed changes to emissions within the EU bubble both in percentage terms and million tonnes of carbon dioxide equivalents.

### Greenhouse gas\* emissions in the EU (\*CO<sub>2</sub> + CH<sub>4</sub> + N<sub>2</sub>O)

	Share of EU emissions in 1990	Emissions in 1990 in Mt eq CO <sub>2</sub>	Emissions in 1990 in t eq CO <sub>2</sub> per capita	Evolution from 1990 to 1994 (%change)	Evolution from 1990 to 1995 (%change)	Burden sharing	Burden sharing in Mt eq CO <sub>2</sub>
Austria	1.7	74	9.2	-1.3	0.6	-13%	64
Belgium	3.2	139	13.7	4.1	4.4	-7.5%	129
Denmark	1.7	72	13.7	15.2	10.0	-21%	57
Finland	1.7	73	14.2	-3.6	-0.5	0%	73
France	14.7	637	11.0	-2.9	-1.1	0%	637
Germany	27.7	1201	14.7	-12.1	-12.3	-21%	949
Greece	2.4	104	9.9	3.2	4.6	25%	130
Ireland	1.3	57	16.0	2.6	4.3	13%	64
Italy	12.5	542	9.5	-2.9	1.7	-6.5%	506
Luxembourg	0.3	14	34.7	-10.2	-45.0	-28%	10
Netherlands	4.8	208	13.5	3.4	7.5	-6%	196
Portugal	1.6	69	7.0	6.0	-	27%	87
Spain	7.0	301	7.6	4.0	8.0	15%	347
Sweden	1.6	69	7.9	-2.6	-3.3	4%	72
UK	17.9	775	13.3	-6.9	-8.4	-12.5%	678
<b>Total EU</b>	<b>100</b>	<b>4334</b>	<b>13.1</b>				<b>3998</b>

Source: "Annual European Community Greenhouse Gas Inventory 1990-1996, submission to UNFCCC", prepared by the European Environment Agency for the European Commission (DGXI), April 1999

The figures above are presented in terms of carbon dioxide equivalents. This is because carbon dioxide is held to be the most important greenhouse gas (see below). Each of the gases has been analysed as to its effect on the climate and then reported in terms of how much carbon dioxide would produce a similar effect, thus the carbon dioxide equivalent.

<sup>101</sup> Commission Communication, *Preparing for Implementation of the Kyoto Protocol*, COM(1999)230final [http://europa.eu.int/comm/dg11/docum/99230\\_en.htm](http://europa.eu.int/comm/dg11/docum/99230_en.htm)

**The relative importance of the 6 greenhouse gases within the EU  
year 1990 - in CO2 equivalent**

