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Environmental fiscal reform and transition to a green economy: A political economy analysis

Stefan Speck (European Environmental Agency)

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Environmental fiscal reform and transition to a green economy – a political economy analysis

Stefan Speck¹

Environmental fiscal reform is certainly not a new topic and has been implemented successfully in several countries during the last three decades. Essentially, environmental fiscal reform aims to change national tax systems by shifting the tax burden from economic functions, such as labour and capital, to activities that lead to environmental pressures and natural resource use. This process is of growing importance in the context of efforts to transition to a resource-efficient green economy in Europe and elsewhere.

In the past, governments have introduced environmental taxes as a way to achieve particular environmental objectives. Attitudes towards environmental fiscal reform have changed, however, as societies have become increasingly aware of the systemic links between environmental problems and the need to formulate coherent, integrated policy responses. This recognition is today reflected at all levels of EU policy. Environmental fiscal reform is recommended as a means to foster resource-efficiency and economic transition in EU fiscal and budgetary policies, in the European Semester process of the Europe 2020 strategy, and explicitly in the country-specific recommendations of the Annual Growth Survey.

One of the challenges for environment and climate policies is their long-term perspective as compared with the relatively short-term challenges and requirements of economic and social policies. Following the financial crisis, societies understandably regard job creation and social inequities as urgent issues, demanding swift action. Policymakers therefore face a significant challenge in reconciling slightly abstract, long-term goals with political realities. This is particularly visible in the academic and political discussion of carbon pricing as a prerequisite for the transition to a low-carbon economy.

The paper provides a political economy analysis of past environmental fiscal reforms, focusing on the interaction of economics and political realities. Energy taxes were implemented based on political reality meaning that they did not follow economic theory.

It then examines the future potential for environmental fiscal reform in view of the need to integrate the economic and environmental demands while taking into account social inclusiveness. This part of the paper is split into a short- to medium-term assessment, and a long-term perspective. The former is based on economic and fiscal outlooks of EU Member States, such as the UK economic and fiscal outlook published by the Office for Budget Responsibility for the period up to 2020. It studies whether and how policy recommendations of environmental fiscal reform are actually considered.

¹ European Environment Agency, Kongens Nytorv 6, 1050 Copenhagen, Denmark; email: stefan.speck@eea.europa.eu

The long-term perspective is a more qualitative assessment of policy drivers, such as the challenges European countries face due to population ageing and the EU's commitment to reducing GHG emissions by 80–95 % by 2050 compared to 1990. Demographic change will have significant budgetary implications for some EU Member States, creating pressures for increased expenditure (e.g. on pensions and health care) while undermining revenues due to a reduction in the labour force. Policymakers face a significant challenge in identifying new sources of fiscal revenues.

Environmental fiscal reform potentially offers a response to this challenge. However, there are uncertainties over whether environmental tax revenues, in particular those linked to carbon emissions, will be sufficient to meet the growing expenditures linked to population ageing. Successfully reducing GHG emissions by 80–95 % by 2050 would dramatically shrink the tax base for energy taxes and carbon pricing. It is therefore questionable whether increases in energy tax rates and a high carbon price would enable governments to sustain environmental tax revenues as a share of GDP, let alone increase them as proponents of environmental fiscal reform envisage.