

# Resource productivity, environmental tax reform and sustainable growth in Europe



## Differences in ETR between CEEC and Germany / UK

(abstract)

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## PRODUCTIVITY AND ENVIRONMENTAL TAX REFORM IN EUROPE

Differences in ETR between CEEC and Germany/UK

by Stefan Speck

Since the beginning of the 1990s the intention behind implementing environmental taxes has slightly changed as they are now regularly introduced as part of a tax shifting programme, in particular in EU Member States. The principle behind this strategy is to address multiple interests and objectives simultaneously.

This concept is referred to as environmental tax reform (ETR)<sup>1</sup> describing basically a reform of the national tax system where there is a shift of the burden of taxes from conventional taxes, such as labour, to environmentally damaging activities, such as resource use or pollution (EEA 2005). The rationale is to guarantee a fairer distribution of the tax burden from a sustainable development perspective as the burden should fall more on environmentally damaging activities and therefore should provide consumers and producers with the appropriate price signal to change their behaviour. Revenue neutrality is an important characteristic of ETRs in Europe meaning that the overall tax burden of the individual state remains the same: the government budgetary position is unchanged in the sense that revenues generated from environmental taxes are recycled back to the economy by reducing other taxes, such the ones levied on labour, ie either in form of reducing income taxes or social security contributions paid by employers or employees.

The idea and concept behind an ETR is promoted by the European Commission throughout the last 15 years in different publications. Already in 1993 the EC White Paper on Growth, Competitiveness and Employment discussed this concept as a means to achieve sustainable development and as an opportunity to increase employment: ... *if the double challenge of unemployment and pollution is to be addressed, a swap can be envisaged between reducing labour costs through increased pollution charges* (EC 1993)<sup>2</sup>.



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The adoption of the 'Taxation of Energy Products Directive' (Directive 2003/96, EC 2003) must be seen as an important milestone for the introduction of an ETR in new EU Member States as the Directive also promoted the ETR principle: *Fiscal arrangements made in connection with the implementation of this Community framework for the taxation of energy products and electricity are a matter for each Member State to decide. In this regard, Member States might decide not to increase the overall tax burden if they consider that the implementation of such a principle of tax neutrality could contribute to the restructuring and the modernisation of their tax systems by encouraging behaviour conducive to greater*

Several old EU Member States including Germany and the UK implemented ETRs during the last two decades. However, the scope and the design of ETRs are rather different between the EU Member States and are based on the national policy objectives which are attempted to be achieved (Speck 2006). The national approaches differ widely in terms of:

- which environmental taxes have been implemented: all ETR countries implemented energy taxes but the taxes are levied on different energy products;
- which recycling mechanism has been adopted: the majority of ETR countries reduced labour taxes. However, there are some clear differences between the effects of reducing income taxes and employees' social security contribution and of the reduction of employers' social security contribution. The former approach increases employee's net income and the latter reduces total labour costs. Other recycling measures adopted was to reduce capital taxes and also to provide financial incentives for investment in environmental infrastructure including renewables; and
- the scope of revenues shifted: in the case of Germany the ETR shifted almost 1 percent of GDP as compared to the UK where the shift was around 0.1 percent of GDP.

Based on the detailed analysis of ETRs in the old EU Member States the question arises how the concept of an ETR is also to be launched in the new EU Member States. During the last years ETR proposals have been launched in several of the new EU Member States. In the meantime, Estonia already launched an ETR and the Czech Republic will implement an ETR in 2008. Both countries are in the same position in terms of the need to extend the scope of taxes levied on energy products as laid down in the 2003 Directive on taxation of energy products. This directive sets minimum rates for almost all energy products which are in particular demanding for some of the new EU Member States as compared to the situation in some of the new EU Member States which do not require any increase in existing excise tax rates or implement new taxes on energy products.

The need for transposing this directive into national law can be used as the starting point for the launch of an ETR as it is done in these two countries. However, the adopted recycling mechanism differs slightly as Estonia uses the revenues generated by environmental taxes to further reduce the marginal income tax rate following the concept Sweden applied in the mid 1990s and the Czech Republic will pursue the German approach by reducing social security contributions. It must clearly be stated that the blueprint of an ETR must be different between countries as the fiscal system between countries can differ largely and this has to be respected when designing an ETR and in particular the recycling mechanism. For example, the share of revenues generated by personal income tax to GDP is low in the Czech Republic and Estonia when compared to some of the old EU Member States, in particular Denmark and the UK. On the contrary the share of the social contributions paid by employers is high in the two new EU Member States when measured in terms of GDP (Eurostat 2007).

Noteworthy to report is that the Czech Republic is already planning the second stage of the ETR by implementing a CO<sub>2</sub> tax in due course. This tax should replace the current system of air pollution charges. In particular interesting with regard to this proposal is the fact that it would have some serious consequences for the State Environmental Fund as air pollution charge revenues are significant for the budget of the Fund and these revenues would no longer be available as the revenues of the CO<sub>2</sub> tax would be part of the state budget. The relevance must be seen in the context of the Fund's disbursement policy as

the co-financing of EU funds (structural fund, etc.) is one of the important tasks of the Fund which would be impaired.

This most recent development shows that there are no differences between the old and new EU Member States in terms of using ETRs as a policy means to address the sustainable development agenda and as an opportunity to tackle environment and employment policies simultaneously. The policy of implementing ETRs is regularly linked to the promotion of growth and employment at the EU level as the EC discusses in recent publications (EC 2005a and EC 2005b). However, the economic success of ETRs in promoting employment relies on the accruing of a sustainable source of revenues via environmental taxes in form of energy taxes to reduce other taxes mainly those levied on labour. During the most recent years energy taxes slightly lost their attractiveness as a source of stable revenues. The reasons were manifold: the international oil price increased during this time period dramatically which was probably one of the causes why many governments did not increase energy tax rates. Furthermore, the consumption of transport fuels, in particular petrol, dropped in many EU Member States but was regularly offset in an increase in diesel consumption. For example, the revenues of transport fuel taxes (petrol and diesel) increased by a meagre 1 percent between 2000 and 2005 in Germany and the UK. At the same time petrol consumption dropped by 21 percent in Germany and 9 percent in the UK and diesel consumption increased by 24 percent in the UK but also dropped by around 6 percent in Germany. This development is in particular of great significance as transport is often seen as one of the sectors which will be heavily targeted with new reduction policies under the climate policy strategy. To save tax revenues from transport fuels - which are currently contributing by far the biggest share to total environmental tax revenues<sup>3</sup> - would therefore require a continuous increase in the tax rates levied on petrol and diesel so that the anticipated reduction in transport fuel consumption could be offset and the amount of revenues collected would be stable. It is rather questionable whether such a policy of a continuous increase in energy tax rates would be implemented by countries unilaterally and so far no movement at the EU level is recognisable.

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