The Tax Treatment of Tradable Permits for Greenhouse Gas Emissions

Climate change is a global challenge which requires global leadership. This means not only setting ambitious goals for the reduction of greenhouse gas emissions, but also developing effective policy instruments to achieve them. Moreover, the lower the economic cost, the more politically acceptable policies are likely to be.

In the context of the global Climate Change negotiations, tradable emission permits have emerged as an essential policy tool. The European Emission Trading System (EU ETS) established in 2005 already covers about half of total greenhouse gas emissions coming from Europe.

With similar schemes under active consideration by a number of other countries, the share of total emissions from rich countries covered by "cap and trade" or other tradable permit regimes could triple in a few years. Addressing the treatment of emission permits and offsets in both direct and indirect taxation is therefore vital.

Failure to deal with potential tax obstacles could make the desired reductions in greenhouse gas emissions excessively costly and impede the global integration of carbon markets.

The use of "cap-and-trade" regimes to achieve emission targets

A key attraction of "cap and trade" is that it would set a ceiling for emissions. A government would then allocate emission permits consistent with this ceiling, for example via auction. Businesses would be able to trade permits among each other and a market price would be determined by supply and demand.

This price on greenhouse gas emissions would be taken into account by businesses and consumers in decisions about what to buy, what to produce and how to produce it. A business holding permits could decide whether to emit the corresponding volume of greenhouse gases and surrender the permits, or to spend more on abating emissions and sell its surplus permits.

Additional abatement will be worthwhile if it costs less per ton of emissions reduced than the market value of permits. Thus firms that could reduce their emissions at low cost would be encouraged to undertake abatement activity, until the point where marginal abatement costs are equal across all emitters linked via emissions trading. In this way, the overall reduction in emissions would be achieved at least resource cost. The wider the coverage of the tradable permits market, the better.

There is considerable uncertainty about how much it will cost to reduce greenhouse gas emissions, and one reason for opting for cap and trade schemes is that they should provide greater certainty about levels of emissions. Such schemes would also establish a visible market price for carbon emissions, and they should be able to achieve a targeted reduction in the level of emissions over time, whatever happens to the prices of fossil fuels.

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Tax issues

To date, most analyses of tradable permit regimes have ignored the role of corporate and personal income tax and VAT, implicitly assuming that tradable permits would be outside these taxes or that the impact of the taxes would be neutral.

In practice, however, keeping tradable permits outside the tax system could give rise to distortions through the costs of acquiring permits, and proceeds from selling them, being treated differently from other business decisions.

A more realistic assumption is that tradable permits would be accommodated within existing tax regimes. The question is how best to do this, given the environmental objectives outline above and considerations about good tax policy design.

Tax administration and compliance regimes can "piggy-back" on the administration of the tradable permits markets, but the risk of fraud and other abuses may require particular attention to avoid giving emission trading a bad image and to protect the revenue base.

For its part, business will be looking for tax rules that are stable and predictable, as many investments to abate emissions are capital-intensive or have long pay-back periods.

Some of these investments to abate emissions could take place in developing countries (e.g. through the Clean Development Mechanism) and this raises further risks of tax obstacles distorting decisions. Similar considerations apply in relation to the tax treatment of domestic offset projects compared with other investments to abate emissions.

How permits are originally allocated – for free or via auction – has important implications for government revenue. For example, permits issued under the European Emission Trading System cover nearly 2 billion tonnes of carbon emissions annually.

At a carbon price of EUR 13-15 per tonne, the fiscal revenue from auctioning one year's emission permits would exceed EUR 25 billion or 0.2% of GDP.

The amounts of tax relief given and tax charged on trading in these permits could also be substantial although, to some extent, these money flows would offset each other with limited net effects on fiscal revenues.

Getting the tax treatment of tradable permits "right" is important not only for achieving environmental objectives, but also for the integrity of tax systems.

The proposed policy process

The challenge of integrating carbon markets globally makes it all the more pertinent to have an international dialogue about the tax treatment of tradable emission permits. Against this background, the OECD's Committee on Fiscal Affairs has initiated a project to examine the issues and consider whether it would be appropriate to develop a statement of best practices for the tax treatment of tradable emission permits. Given the inter-disciplinary character of the issue, the OECD's Joint Meetings of Tax and Environment Experts have a key role to play along with other working parties with competence in areas such as international tax treaties and the economics of climate change.

An initial meeting held on 16-17 September brought together tax and environment experts, including representatives from business, to identify the key issues. The experts concluded, in line with the considerations outlined above, that this was indeed an important issue that needs to be discussed further to minimize tax distortions. The project is now taken forward with a view to reporting to member countries and other interested parties in early 2011. The OECD wants to engage in a discussion with all interested countries, to build viable global solutions.

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