

## THE UNITED KINGDOM CLIMATE CHANGE LEVY: A STUDY IN POLITICAL ECONOMY

### EXECUTIVE SUMMARY

*The United Kingdom has an elaborate array of policy measures to tackle its emissions of greenhouse gases.*

Apart from more conventional measures relating to energy efficiency standards, policies include a number of market-based instruments. Economic theory suggests that the adoption of such instruments should (a) minimise compliance costs relative to conventional regulation, and (b) provide a stimulus to the development of new technology to reduce emissions, a stimulus that is absent with normal means of regulation. Notable among the market-based approaches is a combined energy tax – the ‘climate change levy’ – and a set of negotiated agreements with industry whereby the levy is reduced in return for an agreed package of measures to reduce emissions. The current report addresses a ‘political economy’ issue, namely why this combination of measures does not approximate the kind of market based approach that would be recommended if we lived in a textbook world in which policy was designed efficiently. Political economy looks at the factors that influence the design of policy measures, factors which will include the relative influence of different pressure groups, political sensitivities of governments to concerns such as the effect of policy on the poor, and the existence of a past history of policy measures which cannot easily be swept aside to make way for the new policy measure. Moreover, the presence of regulatory agencies which may not have a strong incentive to adopt market-based approaches can further inhibit the optimal design of policy measures.

The United Kingdom has had a strong tradition of action on climate change, dating mainly from the early acceptance of the problem by Prime Minister Thatcher in 1988. While there is some evidence to suggest that early support for action was based on a view that UK science would be a beneficiary from understanding climate change better, it soon became apparent that policy measures would be needed. Early discussion of carbon taxes was inhibited by concerns for the effect of such taxes on industry in general, and the sensitive issue of electricity privatisation. Carbon taxes might appear to reduce the attractiveness of investment in the sector. Nonetheless, clear indications were given that energy prices would have to rise to help combat the increase in greenhouse gas emissions.

*The advent of a Labour government in 1997 reaffirmed the commitment to act on climate change and to use market-based instruments where possible.*

However, the new government had added concerns that made the design of such measures more complex. First, the previous government had faced difficulties in extending value added tax to the household sector, and the new government also did not wish to introduce measures that might have a disproportionate effect on the poor. Second, Labour owed an allegiance to the coalmining communities, in stark contrast to the previous government which had successfully made overt attempts to curtail the power of the mineworkers. Third, Labour had to escape a past image of ‘high tax and high public spending’, so that whatever measures were introduced had to be as friendly to industry as possible and had to avoid the impression that any new tax was simply for revenue-raising. The ‘Marshall Report’ of 1998 attempted to resolve the problems by proposing (a) an energy tax and (b) a permit trading scheme. The end result was the climate change levy and the UK (carbon) emissions trading scheme.

*The UK has several greenhouse gas targets.*

The first, under the EU-wide burden sharing agreement linked to the Kyoto Protocol sets a 12.5 per cent reduction in all gases relative to 1990 by 2008-12. The second is a domestic 20 per cent reduction in carbon emissions by 2010, subsequently effectively abandoned in 2004. The third is a longer run ‘aspirational’ and conditional target of 60 per

## THE OECD ENVIRONMENT PROGRAMME

cent reduction on 1990 emissions by 2050. The two domestic targets, which are not linked to international agreements, indicate the strength of government commitment to climate change control.

The levy itself has features that are readily explained by the need, as government saw it, to avoid taxing households, keep industrial cost burdens to a minimum, and bring industry on board with the UK climate change programme. The levy is 'downstream', i.e. is paid by energy users not extractors or generators, is levied on industry only, with households and transport being exempt, and is structured so as to encourage renewable energy but not nuclear power (users of nuclear electricity pay the tax). An 80 per cent discount could be secured if the industry in question negotiated a 'climate change agreement' –i.e. an industry package of measures to reduce emissions relative to some baseline. Anyone over-complying with their agreement could, in principle, trade the resulting credits into the UK emissions trading scheme, along with permits allocated under that scheme and renewable energy certificates under a separate renewable energy constraint on generators. In this way the levy is linked to the other measures in the climate change programme.

### *How far is the climate change levy effective?*

The issue really reduces to asking how effective it is relative to what the alternative measure might have been. Different commentators use different counterfactuals, with most believing that a 'pure' carbon tax would have been better. In contrast, the levy is perversely related to the carbon content of fuels – gas being taxed more heavily in terms of carbon content, than coal. The electricity generators have no incentive to switch between fuels by carbon content because the tax is levied downstream rather than upstream. Coverage is limited because of the exemption of households, who must nonetheless bear some incidence of the tax, and transport which is subject to other tax measures. The climate change agreements appear to have been very successful with over-compliance with targets even in the first year or so of operation. Others believe this reflects the 'soft' nature of the targets from the outset, with the system being largely 'captured' by industry. What is clear is that the levy's design very much reflects the political economy considerations of government. A pure tax would have come into conflict with government goals concerning household vulnerability, competitiveness concerns and the sensitivity of some sectoral interests.

### *Is it a good tax?*

It has made a contribution to the UK climate change targets, but this measure of effectiveness assumes that the alternative was doing nothing. It may well have fared better than some outright regulation measures, but whether it has done better than a pure carbon tax is very much open to debate. The problem, then, is one of the counterfactual against which the levy is compared. The political economy literature argues that there is little point in comparing actual measures against ideal measures if the ideal measures could never be implemented. Equally, there is a risk in the political economy approach that explaining why policy measures look as they do will amount to justifying those measures. This paper attempts to chart a course between the ideal and the realised measures.

For more information about **THE UNITED KINGDOM CLIMATE CHANGE LEVY: A STUDY IN POLITICAL ECONOMY**, contact: Nils Axel Braathen, National Policies Division, Environment Directorate, OECD.  
Email: [Nils-Axel.Braathen@oecd.org](mailto:Nils-Axel.Braathen@oecd.org); Fax : +33 1 44 30 63 99.

To download this report for free, visit our website at [www.oecd.org/env/taxes](http://www.oecd.org/env/taxes). To purchase other OECD publications, visit the OECD Online Bookshop at [www.oecd.org/bookshop](http://www.oecd.org/bookshop) or send an email to [sales@oecd.org](mailto:sales@oecd.org).

For more general information about the **OECD Environment Programme**, visit our website at [www.oecd.org/env/](http://www.oecd.org/env/) or send an email to [env.contact@oecd.org](mailto:env.contact@oecd.org)