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# Can taxes save the planet?

2020

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**Bloomberg  
Tax**

# Foreword

In the midst of a global pandemic and worldwide recession, it is somehow ironic to state that the world is facing a more far-reaching challenge in the coming years and decades. It is nothing less than the future of mankind and maybe of the earth which is at stake. Global warming may literally change the face of the earth with poles melting and seas threatening to submerge small islands and cause flooding inland. Less dramatic maybe is the possible relocation of Champagne grapes into non-EU England, but it is a small example which shows that climate change will impact our economy in the long term, even before mankind disappears.

As the famous polymath Ben Franklin once said, nothing is certain in this world but death and taxes: as the world is moving rapidly towards its death, taxes should be an efficient tool to prevent (or at least slow down) the deadly outcome promised by the ever increasing CO2 emission.

CMS has done extensive research on what options are available for companies and governments in order to support this growing drive to protect the planet. We would like to share this research with you.

Since the beginning of the year, our tax lawyers have researched and prepared articles which were then published by Bloomberg Tax in the form of Insights. These articles were very well received by Bloomberg readers and now we are combining them here in one thought-leadership document in order to focus on what is available and what can be done on a tax level within organisations in order to support this global push for tackling climate change.

In addition to the obvious reputational aspects to establishing greener company policies, there are also financial incentives to encourage better behaviour when it comes to respecting the planet.

The problem of climate change is a long-term one which smaller businesses have not yet prioritised (although they should). In fact, we see more and more large groups putting forward their climate change initiatives for the long term by striving to be greener businesses and

integrating carbon offsetting into their business strategies even though it requires real “green” investments.

- The first article provides an overview of current tax reforms and incentives being introduced by governments around the world to support efforts to reduce climate change.
- The second article considers whether value-added tax can and should be used as a public policy tool in the EU in the fight to conserve the environment.
- The third article focuses on how governments are providing tax measures and incentives to support and promote renewable energy and takes a look at what steps are being taken, with particular focus on measures in Germany and Spain.
- The final article considers the role of taxation in encouraging green behaviour and suggests a way to re-engineer the tax system in order to reflect a company's environmental impact.

We hope that by addressing these issues in this publication, we can inspire and advise you on your next steps to be a business that is working towards an end to climate change.



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# Climate Change – Tax Reforms and Incentives

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*With thanks for the invaluable input of Marie Dedoubat and Luca Scibelli*

While the [Paris Agreement](#) sets out clear targets, namely, to keep the increase in global average temperature to well below 2°C above pre-industrial levels while pursuing efforts to limit the temperature increase to 1.5°C, the tools are in the hands of governments. Since there is strong evidence that the climate is warming, governments are expected to undertake significant tax reforms, and the use of taxes and sustainability incentives to tackle climate change has become increasingly apparent.

This Insight aims to provide a snapshot of current tax reforms and incentives connected to climate change around the world.

## Environmental Taxes

Broadly speaking, governments can choose to tax environmental “bad players” by introducing environmental taxes. The Organisation for Economic Co-Operation and Development (OECD) notes that these taxes have numerous advantages, including “environmental effectiveness, economic efficiency, the ability to raise revenue and transparency.”

Under Article 2 of [Regulation \(EU\) No 691/2011](#), an environmental tax is “a tax whose tax base is a physical unit (or a proxy of it) that has a proven, specific negative impact on the environment.” Four broad subcategories of environmental taxes are identified – energy taxes, transport taxes, pollution taxes and resources taxes (although in practice, they often overlap).

In a nutshell, here is a selection of environmental taxes that have been introduced in various countries around the world:

- in Spain, the Hydrocarbon Tax (*Impuesto especial sobre Hidrocarburos*) is the most important tax in terms of profits for the country. This is an indirect tax on the production of hydrocarbons used as fuel, additives or used to increase the volume of hydrocarbon;
- in Italy, the so-called Plastic Tax (enacted by Directive EU 2019/904) has recently been introduced to promote environmental sustainability as in other Member States. It was intended to come into effect from July 2020 but has been moved back to January 2021 because of the Covid-19 pandemic and aimed at reducing the production and consumption of plastic. It consists of a proportional tax on manufactured products in plastic for single use (MACSI) such as bottles, bags and food containers. The tax obligation arises with the production or the import of the taxable products and is due at the moment it coming into use. The tax rate is fixed at EUR 0.45 (USD 0.51) per kilo of plastic included in the single item;

- in Austria, every aircraft owner must pay a flight fee to the tax office for every passenger departing from Austria. The flight tax is EUR 3.50 per passenger for short-haul flights, EUR 7.50 for medium-haul flights and EUR 17.50 for long-haul flights;
- in China, the Environment Protection Tax (EPT) targets organisations and other business operators who release taxable pollutants directly in to the environment. “Taxable pollutants” include air pollutants, water pollutants, solid pollutants and noise, covered by the lists attached to the EPT law;
- Peru has a contribution called “*Aporte por Regulación*” to tax mining, hydrocarbon and electricity companies at a rate of 1% on the sales invoiced (although different rates may apply on each sector);
- Switzerland introduced a CO<sub>2</sub> tax in 2008, with the goal of reducing the use of fossil thermal fuels. As of 2018, the rate of the levy is 96 Swiss francs (USD 103) per ton of CO<sub>2</sub>.

## Sustainability Incentives

Another option available to governments to tackle climate change is providing relief for environmental “good players.” Governments may decide to offer tax credits, subsidies or other incentives to encourage individuals and companies to engage in behaviours and develop technologies that can impact positively on the environment.

Interestingly, such tools are less popular than environmental taxes. This could be explained simply by the fact that tax expenditures are a cost for governments. The OECD also points out that, by reducing costs, tax subsidies may indirectly increase pollution and inevitably involve “picking winners,” which may prejudice other good alternatives.

Examples of sustainability incentives can be found in France, where the most recent French finance bill enlarged the mechanism of accelerated depreciation for energy-efficient and renewable energy property (so-called *suramortissement*). Regarding individuals, the energy transition tax credit (CITE) was revoked and replaced by a premium granted under restricted income conditions. In the end, this premium is likely to concern only low-income individuals who may not have the resources to invest in energy-efficient and renewable energy.

Italy grants several investment reliefs related to environmental sustainability, such as the “*Ecobonus*” tax credit which allows a deduction from the taxable income for expenses incurred in maintaining, restoring and improving the energy efficiency of Italian properties. Entrepreneurs and companies can obtain significant incentives by means of “white certificates”, i.e. energy efficiency bonds, that are granted for new equipment which achieves energy savings in manufacturing processes. Regarding individual taxpayers, the so called “green-bonus” provides for an income tax credit on allowable costs incurred in the creation and maintenance of green and uncovered areas to housing units, such as terraces, gardens and balconies.

Another example is Hungary, which provides tax credits for environmental reasons. For example, a tax allowance is granted for independent environmental projects with an investment value of at least 100 million forints (USD 337m): taxpayers may reduce their corporate income tax liability by 80% with such tax credit.

In Russia, partial reimbursement of the interest on loans issued by Russian banks to finance investments in energy conservation and energy efficiency projects is provided by a federal law on energy conservation and on improving energy efficiency.

## What Does the Future Hold?

Even though no country has shown a strong will to use taxation as a tool to achieve the Paris Agreement's goals, a few have made an effort to implement tax reforms connected to climate change.

For instance, Germany announced the introduction of a carbon dioxide price and an increase of the air traffic tax at the end of 2019. The carbon price will come into effect in 2021 and the air traffic tax was introduced in April 2020. In addition, the value-added tax (VAT) charged on train tickets was reduced by 12%.

In Austria, the new government program for 2020–2024 announced an eco-social tax reform. Among other things, the levy on short-haul and medium-haul flights is to be increased significantly. Also, the engine-related insurance tax is to be increased, without cap.

The Spanish government is hoping to introduce a new carbon border tax as proposed by the European Commission. Peru introduced a tax on consumption of plastic bags from 2019 onward.

The introduction of a carbon tax in Russia is under discussion, although its adoption remains unclear. Government initiatives to introduce a new tax may face resistance from the business community and/or taxpayers. France finds itself in a similar position, where the carbon tax on fuels was repealed after weeks of "*gilets jaunes*" protests in Paris and major cities across the country, suggesting that the politics of carbon pricing can be very challenging.

Finally, despite not having environmental taxes *per se*, it should be noted that the primary legislation for environmental protection in the United Arab Emirates is Federal Law No. 24 of 1999 for the protection and development of the environment. Dubai, in particular, aims to have 75% clean energy by 2050, pursuant to the [Dubai Clean Energy Strategy](#).

## Conclusion

Article 4 of the Paris Agreement stipulates that developed countries shall take the lead by undertaking economy-wide absolute emission reduction targets. However, it seems that there is still a lot to do to achieve the Paris Agreement's goals.

It would seem, the current framework of taxes and sustainability incentives might not be enough to motivate taxpayers to take decisive actions aimed at environmental protection. This is why most companies may opt to pay taxes, rather than adopt behaviours that could positively impact the environment.



# Using VAT as a Tool to Fight Climate Change

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Value-added Tax (VAT) has been a harmonised tax in the EU since 1967 ([Directive 67/228/EEC](#)) and the current rules were established in the Sixth Council Directive of 17 May 1977 ([Directive 77/388/EEC](#)) consolidated in the Directive of 28 November 2006 ([2006/112/EC](#), the VAT Directive).

Many alterations have been made to those rules, particularly taking into account economic changes, but none is directly related to the issue of climate change, which was of course not a concern of the EU when the Sixth Directive was adopted.

Unlike other collective concerns, such as serving the public interest or social policy, environmental policy is currently not included in the articles or in the provisions of the VAT Directive (see, however, Articles 102 and 122 of the VAT Directive). Studies have been carried out on this matter, in particular on the extension of reduced VAT rates for the supply of goods and services in connection with renewable energy and environmentally friendly products (Reduced VAT for Environmentally Friendly Products, Final Report, (see below) December 19, 2008), the conclusions of which are mostly sceptical about the efficiency of such subsidy schemes.

Under current EU legislation, only a few national initiatives with an environmental objective can be taken in relation to consumption by final consumers, and the European Commission has not taken any legislative initiative in this field so far.

However, VAT has no influence on the consumption behaviour of businesses, since in principle they do not bear its cost. There are some exceptions to this such, as in France, where companies have long been prohibited

from deducting the VAT on their motor fuel costs, except for diesel. When France decided for environmental reasons to penalise the use of diesel fuel by removing its VAT deduction, the government finally renounced the measure because (in addition to budgetary obstacles) the “standstill” clause of the VAT Directive provides that member states are not allowed to introduce (or “re” introduce as was the case) in their legislation a limitation of the right to deduct input tax ([ECJ case C-40/00, June 14, 2001](#)).

## Limited Leeway for Member States

According to Articles 96 *et seq.* of the VAT Directive, member states apply a standard rate of VAT on the supply of goods and services that may not be less than 15%, and one or two reduced rates which may not be less than 5% (Article 99 of the Directive), provided that those operations are included in the categories exhaustively listed in Annex III to the Directive.

Member states may, however, still apply “super-reduced” rates on the dual condition that such rates were applicable prior to 1 January 1991, and that they were introduced for “social reasons and for the benefit of the final consumer” (Article 110 of the VAT Directive).



A [draft directive](#) (Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax, January 18, 2018) currently being discussed among EU member states, proposes an amendment to this regulation, allowing members to freely choose, with a few exceptions, goods and services subject to a reduced VAT rate.

According to the Commission, this amendment would be implemented “so that Member States can make a more targeted use of VAT rates to reflect increased environmental ambitions” ([Communication](#) from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal.)

However, the probability of seeing this project adopted in the short term or even in the longer term seems very low at present.

In current legislation, member states’ initiatives motivated by environmental objectives are based solely on a targeted application of a reduced rate on certain products or services falling within one of the categories listed in Annex III to the VAT Directive, none of which refers to a climate change policy.

## National Initiatives

As discussed above, the possibility for member states to promote the consumption of environmentally friendly goods and services is quite limited under current EU legislation. For instance, in France and the Netherlands the only examples of the application of a reduced VAT rate in this respect are:

- works carried out in order to improve the energy efficiency of housing stock over two years old in France, and in the Netherlands this only applies to the application of energy-saving insulation material to floors, walls and roofs of houses over two years old;
- public transport (only in the Netherlands);
- the supply of heat when at least 50% is produced from certain renewable energies and/or waste (only in France).

In France, members of parliament make numerous proposals regarding this matter each year during the preparation of the Finance Bill. Because of the limited list of goods and services eligible for a reduced rate provided by the VAT Directive, most of those proposals are rejected simply because of their non-compliance with the EU VAT legislation, when instead the discussion should be based on their effectiveness in reducing environmental impact.

Other European countries apply reduced VAT rates on green electricity (Italy) and energy efficient materials and products (UK). Norway even applies a 0% rate on zero-emission vehicles. Germany has recently proposed an increase of the VAT rate on meat. As in France and many other countries, the Netherlands have several other, non-VAT, initiatives developed in relation to climate change (such as waste tax, energy tax and several subsidies to encourage the use of energy-saving initiatives). The Dutch government, however, does not focus on the possibilities for promoting energy efficient alternatives within the VAT framework.

## Should EU VAT Legislation Be Amended?

The advantages of applying a VAT-reduced rate are not clear.

First, it is not (or at least hardly) sufficient by itself to influence consumption for many reasons, including the fact that:

- it is not possible to obligate stakeholders to pass on any price reduction to the consumer;
- the rate difference must be significant to have an actual effect on consumption.

Second, many recent studies show that reduced VAT rates are not necessarily the most effective way to combat climate change:

- OECD (2018), [Consumption Tax Trends 2018: VAT/GST and Excise Rates, Trends and Policy Issues](#), Consumption Tax Trends, OECD Publishing, Paris;
- European Commission (DG Environment, 2018), [Final Report](#), The use of differential VAT rates to promote changes in consumption and innovation, Institute for Environmental Studies, Amsterdam;
- Copenhagen Economics (2008), [Final Report](#), Reduced VAT for Environmentally Friendly Products, Copenhagen;
- Copenhagen Economics (2007), [Final Report](#), Study on reduced VAT applied to goods and services in the Member States of the European Union, Copenhagen.

A reduced VAT rate may bring significant environmental benefits for some product categories (such as central heating boilers, refrigerators, freezers, and washing machines) but may also involve higher administrative and compliance costs, lower tax revenues, and higher costs of checks and inspections. VAT differentiation could be an incentive for tax evasion and could also lead to economic imbalances, because both low- and higher-income households profit equally from the VAT reduction.

Further, lower VAT rates can have two opposing effects: while reduced VAT rates are applied on energy-efficient products to encourage consumers to prefer these products over energy-intensive products, this may result in the use of more energy-consuming products in general. Fixed subsidies are considered to be a better alternative, since these can be allocated more efficiently and have no influence on the internal market. Other alternatives are rebates on energy-efficient products and/or targeted energy taxes.

In addition, and as the European Commission has pointed out in its work, the application of a reduced rate can have perverse or contradictory effects. The application of a reduced rate to drinking water is fully warranted, for example, as it facilitates access by all consumers to a necessity, but it does not encourage the moderate consumption of this commodity, which needs to be preserved due to the effects on climate change (The use of differential VAT rates to promote changes in consumption and innovation, Final Report, p.15.)

However, most of the restraints mentioned above apply to any type of goods or services on which member states are free to apply reduced rates ... and do.

It therefore cannot now be politically justified that the EU-harmonised VAT system might still be an obstacle for a member state in using VAT rates for the purpose of fighting climate change policies.

The VAT Directive should, at least, be amended to provide member states with the possibility of introducing reduced rates on goods or services on the condition that this subsidy applies as part of a green policy.



# Renewable Energy – Market and Tax Focus

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Governments around the world are striving to advance the transformation of the existing fossil-nuclear energy system towards a sustainable energy system. Renewable energies are a fundamental part of this process and are expected to take over the major share of energy supply in the future. To achieve this ambitious target, many governments are looking to provide a good framework for investment in this area. This includes tax incentives for investment as well as tax measures to encourage eco-friendly consumer behaviour.

This Insight is intended to provide a snapshot of the tax framework of governments world wide, with a focus on the tax measures and incentives in Germany and Spain.

## Gigantic Market, but Declining Trend— Need for Action

For a long time, the market for renewable energies was characterised by exponentially increasing investments. Between 2004 and 2011, according to United Nations Environment Programme (UNEP) [surveys](#), global investment increased by around 600% (from USD 45bn to USD 286bn). This investment enthusiasm has so far inspired and supported the ambitious environmental targets of governments.

Since 2012, however, global investments in renewable energies have been stagnating, and in 2018 were at the same level as in 2011. One of the main reasons given for this stagnation was the considerable fall in prices for solar panels (around 80%) and wind turbines (around 50%) on the world market, and it was initially assumed that the stagnation in investment would not have any direct impact on global transformation targets.

However, since the stagnation has continued for almost a decade now, other reasons are likely to play a major role, such as the uncertainties that investors have regarding the regulation of renewable energy sources.

At the same time, political pressure at international level to achieve the environmental targets agreed in the Kyoto Protocol and the Paris Agreement has increased. The EU member states therefore, bindingly agreed at the end of 2018 that the share of energy from renewable sources in the EU's gross energy consumption will be at least 32% by 2030 (Article 3 of [Directive \(EU\) 2018/2001](#)).



Although Article 194 of the Treaty on the Functioning of the European Union formulates the promotion of renewable energy sources as one of the objectives of European energy policy, this agreement is particularly noteworthy because the starting points within the EU are heterogeneous. While the share of renewable energies in gross energy consumption in 2018 was about 7% in the Netherlands, about 12% in Poland, Slovakia and Hungary, and about 16–18% in the large economies of France, Germany, Spain, Italy and Greece, Sweden, at about 55% as well as Finland and Latvia at about 40%, can generate a much higher share of their gross energy consumption from renewable energy sources.

In addition, investment in renewable energy in the EU is not only stagnating in line with global developments but is also showing a sharp downward trend. Investments in renewable energies in the EU have more than halved between 2011 and 2018 (from USD 130bn to USD 62bn). Even if part of the decline in investment is due to the fall in price of solar panels and wind turbines, this poses challenges for EU member states.

### Tension between Additional Tax Burden and Tax Incentives

A best practice for governments to boost investment in certain sectors is to grant tax incentives because they ultimately increase the profitability of the investment. However, this tool is typically used very cautiously by governments to prevent the loss of tax base. In the EU, this restraint can be partially reinforced by the strict requirements of state aid law.

Another preferred method is the additional tax burden on fossil-nuclear energy sources to facilitate market access for renewable energy sources. However, many countries are pursuing a multi-pronged approach by combining the effects of the additional tax burden on fossil-nuclear energy sources and the simultaneous tax incentives for renewable energy sources. This is intended to create a profitability advantage in favour of renewable energy sources.

In the field of energy and electricity, there is a comprehensive minimum harmonisation of the tax structure in the EU through [Directive 2003/96/EC](#). This Directive determines which products are to be subject to harmonised energy or electricity taxation and the possibilities for member states to exempt energy products and electricity from taxation or to apply reduced rates of taxation. Article 15 of the Directive provides for the optional possibility of granting favourable tax treatment to electricity produced from renewable energy sources. Several EU member states have made use of this option by exempting electricity from renewable energy sources from taxation under certain conditions. However, also with regard to state aid law, a full exemption was generally not implemented.

In Spain, the implementation of Directive 2003/96/EC has been carried out mainly through Law 38/1992, of December 28, on Special Taxes, which establishes a burden on hydrocarbons, on certain means of transport, and on electricity and coal. By means of this Law, the Spanish government has regulated the taxation of energy and electricity in Spain, incorporating the regulation and levying of these taxes. In Germany, the Directive has also been implemented in various laws, including the Energy Tax Act and the Electricity Tax Act.

With regard to the optional incentives for electricity from renewable energy sources, Germany and Spain follow a similar path. They have established an exemption for electrical energy consumed by the owners of renewable technology electricity production facilities whose installed capacity does not exceed a defined threshold of megawatts (self-consumption scenarios).

## The Importance of Intelligent Use of Taxes

In addition to increasing the tax burden on fossil-nuclear energy sources and providing tax incentives for renewable energy sources, the way governments use the taxes levied is invaluable. Used smartly, the tax burden on fossil-nuclear energy sources can be turned into a financing instrument for focusing the expansion of renewable energy sources.

In Germany, for example, investors are granted a fixed feed-in tariff for feeding electricity generated from renewable energies into the public grid in order to minimise investment risks. Possible differences between electricity production costs and the market price are financed by a levy, which all electricity consumers pay through a share of their electricity bill. Following the global approach, these feed-in tariffs are increasingly determined by tenders, which are intended to strengthen competition. From 2021, the carbon dioxide (CO<sub>2</sub>) pricing system already in place for the energy sector and energy-intensive industry under the [European Emissions Trading Scheme](#) is also to be extended to the transport and building sectors. The German government also wants to reinvest these revenues in climate protection measures.

The measures being adopted by the Spanish government are following this same path. The government is currently considering the introduction of certain taxes aimed at protecting the environment in order to comply with European standards. In particular, one of the measures would be to establish a state tax directly levied on CO<sub>2</sub> emissions. In addition, in order to expand renewable energy sources, the Institute for the Diversification and Saving of Energy (IDAE), which is a public business entity affiliated to the Spanish Ministry for Ecological Transition, has been developing a series of specific aid programs in the renewable energy sector for energy producers and traders.

Finally, fixed feed-in tariff systems are currently being replaced in Spain by “Power Purchase Agreements” (PPAs) for renewable energy. A PPA is a long-term contract between a consumer and a producer of renewable energy or between a producer and a trader, to buy electricity from renewable sources at a fixed price, on agreed conditions and for a pre-established period of time. There are several reasons why PPAs are being widely introduced, such as the ability to establish better control over costs and final sales prices, and, above all, to comply with the European guidelines on policy goals and objectives for the whole of the EU in regard to energy produced from renewable sources.

## Tax Implications in the Structuring of Acquisitions

The tax incentives for renewable energy investments relate to the target and thus affect the profitability of the investment as such. In principle, they do not influence the tax structure of the investment. Rather, the tax structuring of the investment in renewable energies depends on factors that are typical for tax structuring, e.g. how the target is financed, whether it is to be held for the long term or sold in the short term. The different taxation systems (transparent and non-transparent taxation) at local, national and international level must be reconciled for a tax-optimised structure.

In the case of an inbound investment in Germany, transparent taxation at local and national level—traditionally through the involvement of partnerships—can prove advantageous in order to be able to take account of the initial losses in a tax-reducing manner. At the international level, this could be combined with a non-transparent unit usually located in Luxembourg or the Netherlands. However, a non-transparent structure at all levels is also conceivable. In this respect, the usual tax considerations for structuring should be taken into account.

In Spain, inbound investments related to renewable energy projects are usually constituted by means of the incorporation of new Spanish non-transparent entities. These special purpose vehicles (SPVs) are specifically created to undertake the individual projects, their only purpose being to generate energy from renewable sources. The SPV, which usually adopts the legal form of a Sociedad Limitada (limited liability company) might be directly or indirectly held by the foreign investors.

This structure allows more transparent and separate management from the other activities or investments that the investors may have, and, of course, limits the eventual losses that might be incurred in the development of the project. Likewise, the Spanish SPV, as the owner of the project, will carry out all the procedures to obtain permits, raise the necessary funds and agree on all necessary contracts with the public institutions and private entities. In addition, the SPV, as a newly constituted company, might, during the first two years from the commencement of its activity (subject to certain requirements benefit from certain tax reliefs established on local taxes, such as business activity tax.

## Special Tax Rules

In some cases, national regulations provide for certain privileges that consider the specifics of structuring a transaction in the renewable energy sector. This concerns, for example, the mandatory unbundling of energy producers and network operators under energy law. In this regard, German law provides for special rules on unbundling which are intended to ensure the fiscal neutrality of the unbundling. They contain exemptions from tax liability for unbundling based on energy law under certain circumstances and, in the case of transformations relevant to tax law (spin-offs, splits, spin-offs or partial transfers), they simulate the fiction of a required partial operation with the possibility of carrying forward the book value.

## Further Steps Might be Necessary

In recent years, important foundations have been laid for energy transformation. In view of the trend towards declining investment, it is safe to say that governments should show courage and take further steps in the right direction to achieve set environmental goals. Tax measures can also make a significant contribution to this: the use of intelligent tax systems and the correct use of tax revenue are invaluable. Equally important, however, is addressing the existing uncertainties in the area of regulation through clearer and more investment-friendly regulations.

# Taxing the Environmental Footprint

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If there is one thing that the world should have learned from what's happened in the last few months, it is that certain matters should not, and perhaps cannot, be handled on a country-by-country basis. Environmental matters are a decisive factor in shaping the future of life on this planet so there should be no doubt that they belong in this category.

The importance of the issue and the urgency that comes with it, require all options to be put on the table in an attempt to find a solution. Just as every individual and every business has a role to play, the part that tax systems can play in bringing about change should not be overlooked.

Prior Insights in this series have put together a summary of the main measures introduced in the recent past by a number of countries. The myriad measures introduced by different countries have created a jungle of incentives and punitive charges that is difficult to navigate and the actual impact of which is difficult to assess, especially if looked at on a global basis.

The idea of this Insight is to imagine a way for tax to help, assuming there is the will and the freedom (there should be no doubt that there is the need) to reimagine and simplify tax systems, making the impact on the environment an organic part of the way taxes are calculated.

So far, the two main types of taxes that countries have had at their disposal are value-added/consumption taxes and income taxes. Both types of taxes have been struggling to keep pace with a fast-changing economy and evolving business models. The seemingly endless discussion about the taxation of the digital economy is just one example of how tax systems that have been developed for an economy that was completely different to today's are showing signs of distress.

## Re-Engineering the Tax System

So why not make an effort to re-engineer tax systems, "thinking out of the box" and question, for example, if companies (and perhaps individuals) should continue to be predominantly taxed on the amount of income that they generate?

Among many reasons to support this idea, there is the fact that across populations there seems to be an increasing demand to understand the correlation between taxes paid and the reason they are paid, as well as what use governments make of the money that they collect. The latter issue, in particular, should not be underestimated, because one of the main ways to achieve spontaneous compliance is the understanding of this relationship.

A clear link between taxes and why they are paid helps understanding and acceptance of the tax, and creates more collective participation in pursuing a goal.

## Assessing the Environmental Footprint

The "clean-up" of the environment, or the treatment of diseases that come with such massive change to the environment (of which climate change is only one example), are items that will be growing exponentially in the budget of any country; the point could therefore be made that these should become some of the drivers in deciding how much each taxpayer should contribute to the related costs.

In other words, if two taxpayers make exactly the same amount of money before taxes but one has very little impact upon it while the other has a huge (negative) impact on the environment, the expense that the government will incur with respect to the impact on the environment of the latter is much greater. Is it fair that the two people end up paying the same amount of taxes?

If the answer to this question is no, an assessment of the “environmental footprint” of taxpayers and the formulation of a tax system that, in calculating how much money each should contribute to the overall budget of the country, needs to take into account the “environmental cost” associated with their activities. This could be the answer (at least partially) to the amount of taxes paid relative to the “cost” that derives from business activities.

The assessment of the environmental footprint could be based on the type of products manufactured or services rendered as well as the way the products are manufactured, and the services are rendered.

In fact, it should not be just a matter of what product or service the taxpayer manufactures or renders and the specific impact of such product or service on the environment, but also what kind of decisions the company takes when it comes to how to carry out its activities. Considerations such as whether a business uses electric vehicles over petrol ones, recyclable packaging instead of plastic, or whether it allows employees to work from home, are just a few examples of what this assessment could be based on.

The type of products manufactured or services rendered would likely relate better to the field of indirect taxation, whilst the way products are manufactured and services rendered, being more influenced by decisions taken by the taxpayer about how to manufacture or deliver the services, would probably apply to direct taxation.

Reformulating the fundamentals of corporate income taxes to transform them into “corporate income and environmental impact taxes” would mean that they could play an amplified role in this process. There are many different ways of doing this, but, hypothetically, let’s think of a traffic-light assessment of businesses as one of the possible solutions. Taxpayers would be awarded a red, yellow or green status with respect to their impact on the environment, and their tax would accordingly be determined through a system of different rates, so that companies which do less harm to the environment (and have a lower social impact and, therefore, use less public money) would be rewarded by paying lower tax.

## Role of Taxes in Encouraging Greener Behaviour

How to do so in a transparent and reliable way? Companies currently spend a significant amount of money to have external parties verify their financial credentials, the quality of their internal processes, and other matters. Their green credentials should be just as important and measurable. Needless to say, to avoid confusion and opportunistic behaviour, it would be

necessary to develop generally accepted criteria to assess the environmental footprint of taxpayers and to identify the parties who should perform the valuation.

Indirect taxation could also play a major role. The need to replace highly polluting plastic products with more eco-friendly products is widely recognised. However, what often happens is that the more eco-friendly a product is, the more expensive it is to produce, especially in the short term due to the necessary initial investment in research and development (R&D). Inevitably, the cost is passed on to the consumer and these products are therefore less affordable.

If revised corporate income taxes could partially help, indirect taxes could also have an immediate impact on consumers. A differentiation could be introduced that would see high-polluting and low-polluting products become subject to different rates.

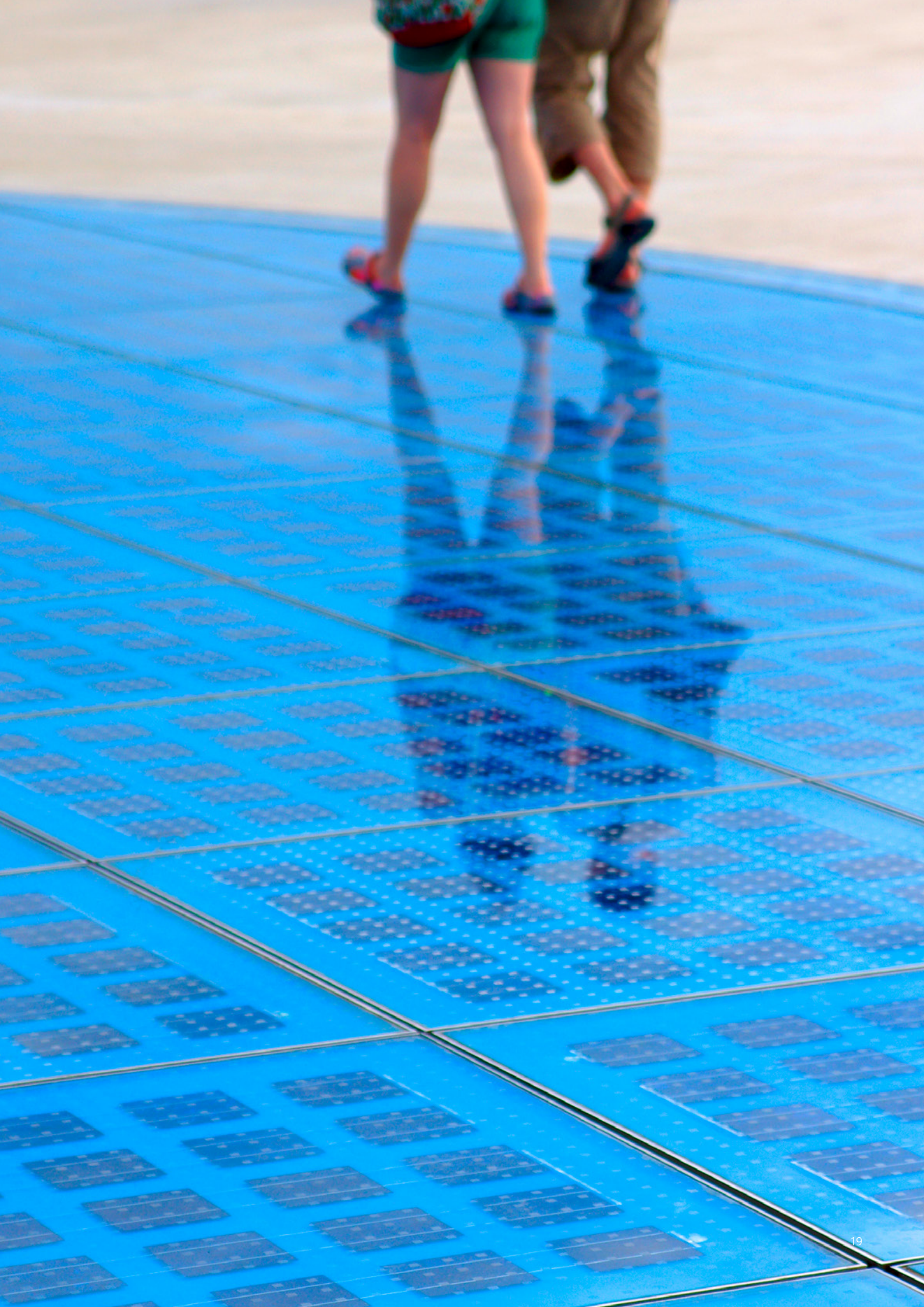
The most common indirect tax is value-added tax (VAT), but because of the way VAT generally works, the impact of different rates would likely be diluted down the chain and, consequently, the desired outcome of making low-impact products more competitive would be diluted as well. Excise taxes could arguably be much more effective for this purpose.

In addition, if we consider that many eco-friendly products are designed and manufactured by start-ups, the need to “help” them is even stronger, given the fact that start-ups already face the challenge of finding investment and entering new markets. Allowing them a more favourable tax profile (in the form of reduced income tax rates and/or lower excise taxes on the low-polluting products) could therefore be an effective way not only to encourage companies to invest more in R&D in order to make more of these products, but also to lower the cost of the products for consumers (making them more competitive).

The results could be twofold: initiating a race between companies to invent and manufacture new environmentally-friendly products and services as well as new manufacturing techniques, and a cost reduction for consumers who are charged a lower price on such items.

In this imaginative exercise, what we have attempted to sketch is an idealistic tax system where income taxes are a function of a combination between income and environmental footprint, and products are subject to indirect taxes based on how eco-friendly they are. To bring a healthy touch of realism into this discussion, it must be said that any serious discussion on this theme could only be started if there was unanimous consent.

The recent discussions on the taxation of the digital economy have taught us how difficult it is to reach consensus when dealing with tax questions; however, in a different context, what is at stake here is not the redistribution of taxing rights among different countries but the survival of our planet. Is this serious enough to make us consider it?



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