Climate taxes need a step change in thinking

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Sir Nicholas Stern's admirable - if lengthy - report on the science and economics of climate change is not for the faint-hearted. From a public policy perspective, it reveals all sorts of difficulties. In the UK, the most alarming conclusion is our position of impotence: whatever we do to reduce emissions, our efforts will make no real difference to the impact on the UK's environment of a looming global catastrophe. Whether or not London is flooded in 100 years' time as a result of persistent increases in global temperatures will be determined by events beyond our borders. The UK contributes a tiny percentage to carbon emissions. The countries to worry about are the US and many of the fast-growing emerging markets. Stern estimates the cost of inaction - based on a series of possibly-questionable assumptions - could be between 5 and 20 per cent of global GDP per year, "now and forever". The costs of action, though, amount to only 1 per cent of global GDP per year.

Climate change is a classic economic externality. Those who pollute (either through emissions or cutting down trees) cause others - now and in the future - to suffer. Those who pollute, though, do not have to pay for others' suffering. Within countries, it's sometimes possible to control the externality. Ken Livingstone's congestion charge is a case in point: it places more of the costs of traffic congestion on those directly responsible for causing it. Climate change is, though, a much bigger challenge because of its cross-border nature. The depressing feature of international externalities is our seeming inability to come up with structures that protect the "common good".

This is not really surprising. Those most affected by climate change are those least represented - either because they come from poor countries who unfortunately happen to be the most directly threatened by rising sea levels (Bangladesh is a good example) or because they are either too young to vote or no more than a twinkle in their parents' eyes. There are also coordination problems. Most of the global warming seen so far has reflected the economic success of the Western nations. Much of the warming to come will be the result of industrial development in the emerging nations. We can complain as much as we like about the impact of China or India on global warming but they will reasonably point out we started it: and, because of this, it is unreasonable to expect them to bear all the costs of dealing with the problem, a point repeatedly emphasised in Stern's report.

How realistic, though, is a globally acceptable outcome? I am not hopeful. If the European Union is incapable of dealing with minor externalities - the disappearance of cod from our waters is a classic externality which public policy-makers have singularly failed to resolve - I suspect the chances of success at the global level are rather low, particularly given that many people, politically, have a distaste for non-market solutions which, even if deemed to be in society's best interests, come with more than a whiff of paternalism. Nevertheless, I wish Sir Nicholas and his supporters - notably Gordon Brown - success in their global quest. As part of this quest, Britain will presumably be setting a few examples in the coming years. After all, the Stern report was commissioned by the current Labour Government while the Conservatives under David Cameron are also offering increasingly "green" policies. Stern believes we have to take carbon pricing a lot more seriously. Public policy can encourage this through a mixture of tax, carbon trading or regulation. Many will see the tax option as simply a way for the Government to raise additional revenues through the back door. After all, Gordon Brown's fiscal arithmetic has been creaking for some time, and a new source of additional tax revenue would help him - or his successor - balance the books in the coming years, whether or not climate change really is a serious threat. So the case for green taxes has to be made very carefully: people have to understand what the externalities are, and to what degree changes in tax will help to alleviate those externalities. Above all, green taxes have to be seen as somehow "fair". If they're not, they'll eventually go the same way as the poll tax.

The current tax system already contains components designed to change our behaviour in line with the ambitions of a green tax system. So-called "sin taxes" (reflecting duties on tobacco, alcohol, betting and gaming) are acceptable because, although many of us might like the odd tipple or puff of tobacco, we know that too much in the way of beer and cigarettes will kill us. We also know - although perhaps don't think about it quite so much - that those who indulge too heavily impose an unfair burden on other taxpayers reflecting the additional costs to the National Health Service. Sin taxes, therefore, can be justified through the externalities placed on society as a whole. Sin taxes also appear to have worked. The first chart, from Cancer Research UK, shows the decline in the percentage of adults smoking over the past fifty-odd years. This is not just the result of sin taxes alone but, to the extent that sin taxes have helped fund a public campaign against smoking, these taxes could be deemed a success. The state took a paternalistic interest in our health and most of us, today, would argue that this was a good thing.

But you need steely determination to rig a tax system to deal with climate change. Despite rising fuel duties, UK annual petroleum consumption has been steadily rising over the past 20 years, helped along by the worldwide collapse in oil prices that occurred in the mid-1980s. And when Gordon Brown attempted to raise more revenue through fuel duties, road hauliers brought the country almost to a standstill. The Stern review argues climate stabilisation "requires that annual emissions [of greenhouse gases] be brought down to more than 80 per cent below current levels". In more than 50 years, the numbers of adult men who smoke has come down by a little more than 50 per cent so an 80 per cent emissions reduction is quite some ambition.

It points to a tax system radically different to the one we see today. The second chart shows the main sources of revenue in 2005/06. The dominant sources, not surprisingly, are income tax, national insurance contributions, VAT and corporation tax. None of these is likely to change our behaviour in an environmentally-friendly way. Maybe, then, it's time for a change. In the 1700s, the main source of government revenue was tariffs. Income tax was introduced in 1799, reflecting Pitt the Younger's need to raise funds to deal with Napoleon. Shortly after the Battle of Waterloo, income tax was abandoned, only to be reintroduced by Sir Robert Peel in 1842. We've had it ever since. If, though, the public can be persuaded climate change is the big challenge of our times - like Napoleon was at the end of the 18th century - maybe we're about to see another, dramatic, change in the sources of government revenue. More money left in our pockets through income tax cuts, perhaps, but much higher duties on all those nasty things that pollute our planet.