The Forgotten Fossil Fuel Subsidy

How the UK government forgoes nearly half a billion pounds per year through subsidizing fossil fuel investments in ISAs and pension products

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2i investing initiative

1 IN 1000

Summary

This note quantifies the foregone tax revenue associated with subsidizing fossil fuel investments in ISAs, pensions, and savings products for UK taxpayers. Based on the exposures analyzed in this note, we estimate that the UK government provides a fossil fuel investment subsidy through its savings and pensions products of GBP 356 – 517 million per annum. In the context of the growing urgency of the climate crisis, the note suggests a review of the tax incentives related to savings and pensions and to explore whether finance sector tax reliefs can be aligned with broader climate goals of the UK government.

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ABOUT 1in1000

1in1000 is a new research program by 2° Investing Initiative that brings together new & existing research projects on long-termism, climate change, and (inter-)connected future risks for financial markets, the economy, and society. Its objective is to develop evidence, design tools, and build capacity to help financial institutions and supervisors to mitigate and adapt to future risks and challenges. The program focuses on climate change and the universe of risks and challenges linked to climate change, notably ecosystem service and biodiversity loss, as well as risks from a decline in social cohesion and resilience. To achieve this objective, 1in1000 focuses on three main areas: i) Long-term metrics; (ii) Risk (management) tools and frameworks; and (iii) Policies & incentives.

The name '1in1000' represents three ideas. First the challenge of dealing with high impact events that are perceived as having a low probability (e.g., financial markets might perceive those risks as one in one thousand type events). Second, the inevitability of these risks and challenges materializing over the long run. And third, the lack of capacity and resilience of financial markets currently to deliver an adequate response towards those risks.

ABOUT 2° INVESTING INITIATIVE

The 2° Investing Initiative (2DII) is an independent, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals.

Working globally with offices in Paris, New York, Berlin, Brussels, and London, we coordinate some of the world's largest research projects on sustainable finance. In order to ensure our independence and the intellectual integrity of our work, we have a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, regulators, policymakers, universities, and NGOs.

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Introduction

Fossil fuel subsidies have been identified as a key barrier to aligning policies with climate goals. The International Energy Agency (IEA) estimates that governments spent over $400 billion worldwide in fossil fuel subsidies in 2018 (Matsumura & Adam, 2019). Estimates put the UK government's fossil fuel subsidy at around GBP 10 billion (EC 2019). While the UK government has committed to ending fossil fuel subsidies abroad, domestic fossil fuel subsidies are still in place (GOV UK 2020a).

Finance sector tax relief on savings and pensions can represent a significant unmapped subsidy to fossil fuel financing and investment. Tax incentives for savings and pension allocations are not normally the first issue that comes to mind when thinking about fossil fuel subsidies. However generic tax incentives on savings and pensions provide a significant subsidy to capital allocation to fossil fuels, as this note will show. Even where they do not create 'sector-specific incentives', the nature of portfolio allocation de facto drives an outcome where governments forego significant taxes associated with fossil fuel investment and returns. In the United Kingdom, tax incentives, in form of tax reliefs, associated with personal savings (notably through ISAs – Individual Savings Accounts) and pension contributions, are equivalent to 6% of overall UK government revenue. The relief is roughly twice the budget deficit pre-pandemic crisis (GOV UK 2020b).

These tax incentives either provide a tax relief when considering capital allocation to fossil fuel companies (in the case of pensions tax incentives) or on the returns generated from investing in fossil fuel companies (in the case of ISAs)[1]. In the case of pensions, the UK government does not tax contributions to savings or pensions accounts. However, the return on the investment is taxed (i.e. the pensions pay-out upon retirement is subject to certain taxes). Here, the fossil fuel investment subsidy manifests itself when capital is allocated to fossil fuel-related financial assets. In the case of ISAs, the tax relief is on the return (dividends, etc.) of the investment. In this case, the fossil fuel investment subsidy is a function of tax relief on returns related to fossil fuel investments. While functionally different, both instruments have the practical effect of reducing tax revenue for the UK government on money allocated by households and employers to fossil fuel companies.

The 'neutral' nature of these UK tax incentives raises the question as to their compatibility with broader policy goals. As this note argues, the current tax relief benefits fossil fuel investments. In doing so, the UK government foregoes significant tax revenues related to investing in companies whose business model and capital expenditure plans violate the Paris Agreement and UK policy commitments. This note looks at tax reliefs on two different products: ISAs, and Pensions (both employee & employer contributions). It quantifies the foregone revenues for the UK government associated with fossil fuel investments and returns for each of these tax incentives.

The objective of the note is to highlight a potential inconsistency in the policy framework between UK climate goals, budget targets, and the fossil fuel investment subsidies associated with tax relief on pensions and savings.

[1] Note, while ISAs are of course also a type of savings instrument, they represent a distinct regulatory category in the savings landscape with differential tax treatment to the savings related tax incentives in the UK tax code and are thus separated here.

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Methodology & Results

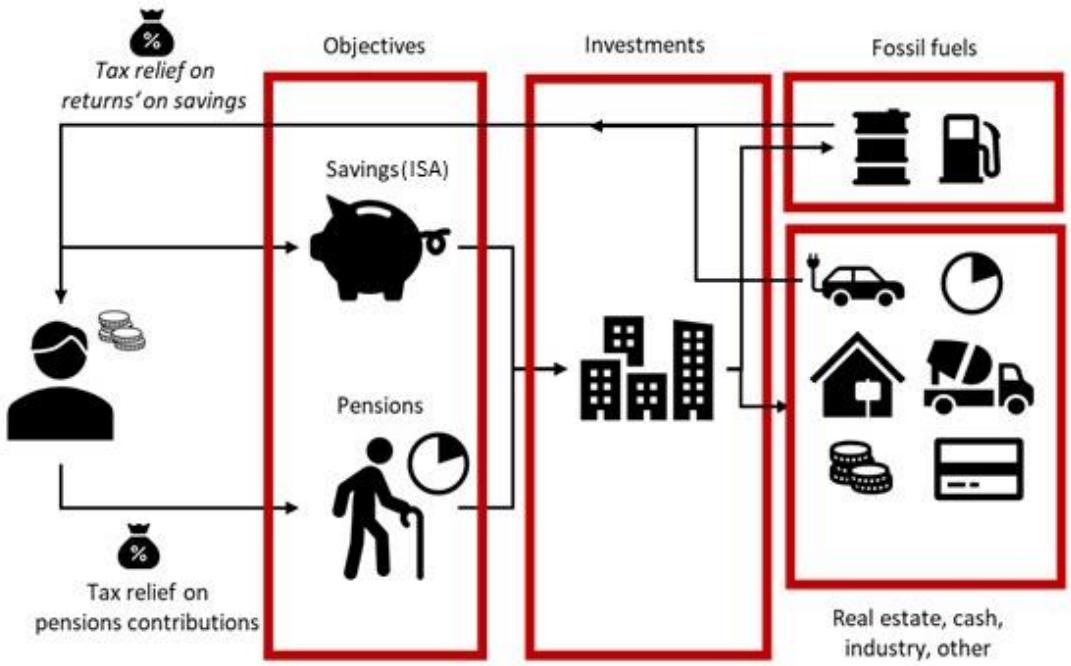
This note seeks to estimate the scale of the fossil fuel investment subsidy in the United Kingdom related to tax relief on pensions and ISAs allocation. In order to estimate the scale, our analysis builds on the following steps:

1. **Calculating the tax relief:** We use UK Treasury data (HM Revenue & Customs, 2019a) that provides information on the tax relief related to savings contributions (ISAs), and pension contributions (employers and employees) in general, i.e. without focusing on specific sectors or asset classes.

2. **Allocating the tax relief according to assets and returns:** We then estimate the distribution of this tax relief to asset allocation classes as a way to understand how this tax relief can be mapped to different types of investments. This exercise will build on a combination of UK government data on the asset allocation of ISA (HM Revenue & Customs, 2020b), and OECD data on the asset allocation of UK pension funds (OECD, 2019). As outlined above, in the case of UK pension contributions, the tax relief is on the contribution itself, not the "return" on the investment. In the case of ISAs, the tax relief is on the return, which requires information on return by asset class (and ideally by sector, if available) in order to understand the relative contribution of each asset class (and sector) to the tax incentive. Figure 3 below illustrates that distinction.

3. **Calculating the fossil fuel investment subsidy:** Finally, we estimate the percent of fossil fuels investments in each asset class and their returns in order to understand the fossil fuel investment subsidy associated with these tax incentives.

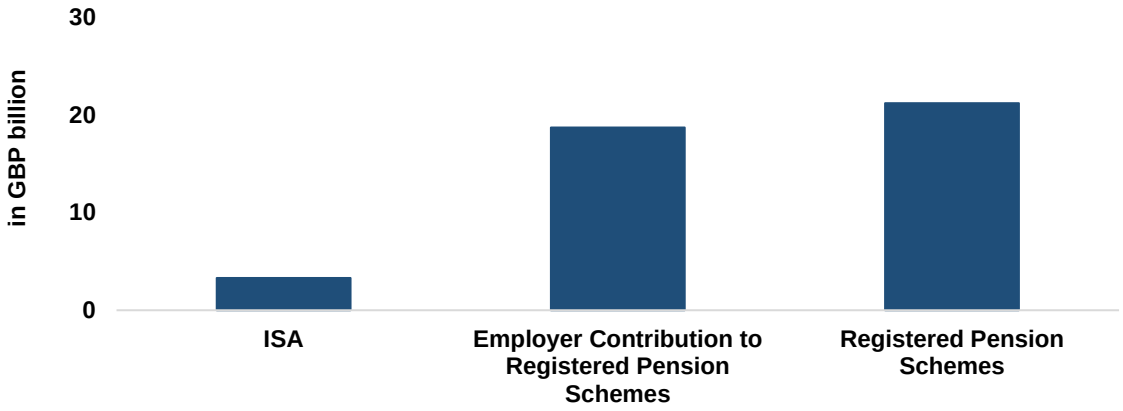
Figure 1: Tax reliefs on savings (ISA) and pension products (Source: Own).



a. Calculating the tax relief

According to estimates by the UK Treasury for 2019, the total tax relief related to savings (ISAs) and pensions products amounted to over GBP 40 billion, equivalent to roughly 6% of the UK government's total revenues – a significant amount and displayed in the figure below (HM Revenue & Customs (2019a)). This tax relief represents roughly half of the UK's education budget or four times the foreign aid budget (GOV UK, 2020e).

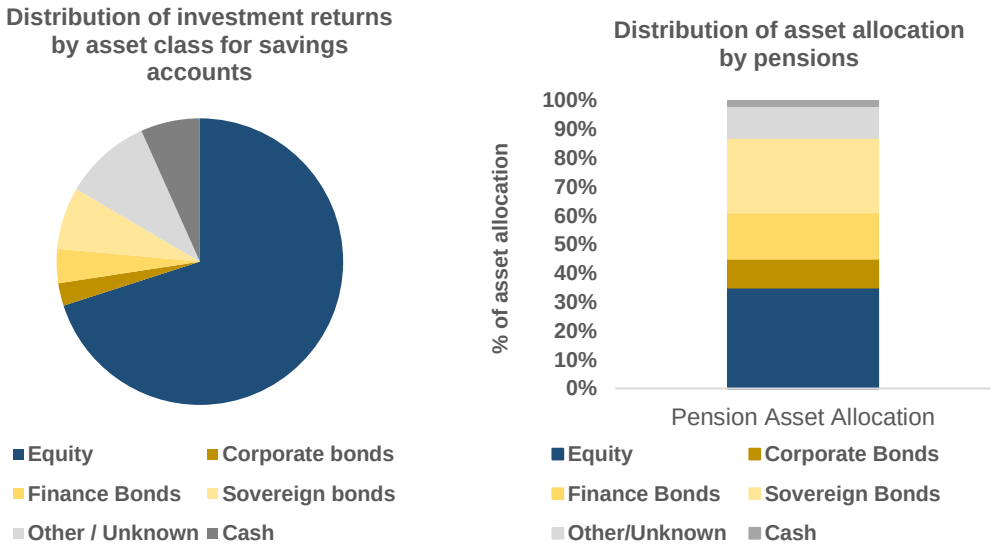
Figure 2: Tax Reliefs for Savings (ISAs) and Pension Products in the UK in 2019 (Source: HM Revenue & Customs (2019a).



b. Allocating the tax relief according to assets and returns

These tax reliefs are linked to specific investments and the returns on these investments. As outlined above, in the case of pensions, the tax relief is linked to the money invested, in the case of ISAs it is linked to the return. The Figure below provides estimates for both the asset allocation of pensions, as well as the estimated distribution of returns on savings by asset class.

Figure 3: Estimated Distribution of Returns on Savings by Asset Class and Estimated Asset Allocation for Pensions (Source: Authors, based on Willis Tower Watson 2020, HRMC 2020b, Statista 2020, and 2DII 2018).



The analysis above obviously has a meaningful amount of uncertainty. Asset allocation statistics normally do not explicitly distinguish between corporate, finance-sector issued, and sovereign bonds, rather only providing aggregate statistics on asset allocation to bonds or fixed income. Nor – when providing funds allocation information - is there hard information on the breakdown of funds by asset class. The actual asset allocation may thus differ somewhat from the estimates provided in this note. However, while the actual asset allocation and choice of funds of an individual pension fund or saver may differ dramatically, there are meaningful and useful meta statistics as to the average asset allocation across different types of fund instruments, and the relative size of different bond instruments.

Since this note provides a meta-analysis, it is reasonable to assume that such statistics serve as useful proxies for the breakdown of the asset allocation of pensions. That being said, the note sought to take somewhat “conservative” assumptions as to the asset allocation and allocated to “unknown” where no meaningful split could be derived. This uncertainty will be considered later when providing the results and suggests that the results may even understate the overall subsidy.

c. Calculating the fossil fuel investment subsidy

The next step of the exercise is then to estimate the fossil fuel share of different asset classes.

There is a range of different metrics around defining the boundaries of fossil fuel exposure and of course, many climate frameworks classify companies as “high-carbon” beyond fossil fuels. For simplicity, the focus here is on fossil fuels in the energy, power, and automobile sector. Even here, measurement uncertainties persist. To reflect these uncertainties, the note provides ranges, sourced and outlined in the table on the next page.

Table 1: Estimated Fossil Fuel Share by Asset Classes (Source: Own Calculations and Others (see in Table)).

Asset class	Fossil fuel share	Explanation
Equity	4.5%-6.5%	The fossil fuel share is based on MSCI World (MSCI, 2021), FTSE 100, and FTSE250 index factsheets on energy/oil & gas exposure (FTSE, 2021), combined with PACTA analysis of cross-sector fossil fuel exposure (utilities) (PACTA, 2021). The analysis takes into account the home bias of UK pension funds and assumes this is mirrored in private investments (36% of investments in UK domestic equity according to an analysis by FTSE Russell). The estimates thus take a combination of an estimated lower bound fossil fuel exposure of 7.5% (based on all UK equity) and 9% (rounded down from the FTSE 100 exposure and taking into account PACTA analytics) and a 2%-5% exposure range for non-UK equity (based on the MSCI World and PACTA statistics).
Corporate bonds	5%-8%	The fossil fuel share is estimated based on a global corporate bonds ETF factsheet on energy exposure, combined with PACTA analysis of cross-sector fossil fuel exposure (utilities). Given the factsheet chosen (iShares Global Corp Bond UCITS ETF) (iShares, 2021) has higher exposure than the equity index factsheet, the overall exposure estimate is higher. However, as with equity, the lower bound is lower than the index factsheet reference to reflect the allocation uncertainty both of UK investors to indexes and the uncertainty as to the underlying asset class exposure.
Finance bonds	0-1%	While financial institutions invest in fossil fuels and asset-backed securities issued by financial institutions may be linked to financial institutions, this note will only consider direct fossil fuel investments and not “indirect” investments through financial institutions. At the upper end, however, up to 1% of finance-sector issued bonds may be considered to be linked to fossil fuels (e.g. asset-backed securities linked to coal-fired power plants).
Sovereign bonds	0%	The linkages between governments and fossil fuels are varied and often indirect. As outlined above, the UK government provides for fossil fuel subsidies, some of which may be paid for through debt issued through sovereign bonds. However, the relationship is very complex to map. As a result, for simplicities sake, we assume here that the fossil fuel subsidy share is 0% (arguably a conservative assumption given the fossil fuel share in many government budgets).
Other / Unknown	Unknown	Since the allocation here is unknown, a conservative assumption was applied, assuming no exposure to fossil fuels.
Cash	0%	There is no exposure to fossil fuel investments when money is held in cash accounts.

d. Results

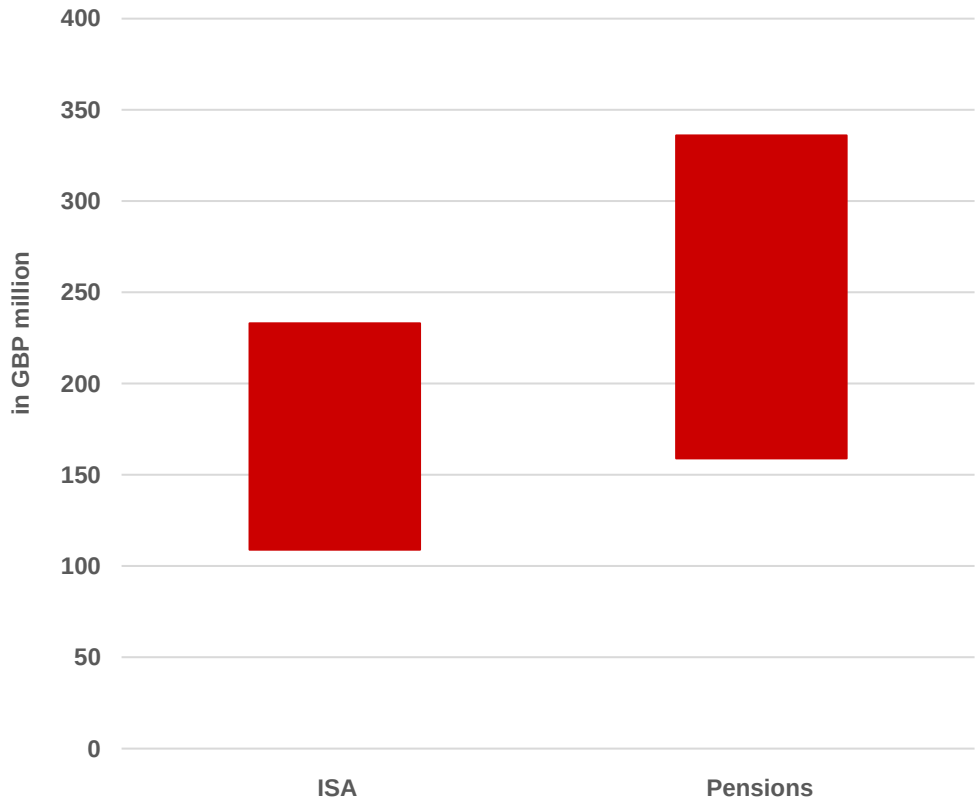
Based on the exposures described above, we estimate that the UK government provides a fossil fuel investment subsidy through its pension's products and savings (ISA) of GBP 342 – 496 million per annum.

This subsidy represents the effective tax break on citizens and employers related to their fossil fuel investments. The chart below shows the estimates for the tax reliefs by pension products based on the above-described estimates for fossil fuel exposure, asset allocation strategies, and UK government statistics on aggregate tax relief cost to UK taxpayers.

Given the approach to take very conservative assumptions in this note, we assume that the actual subsidy is likely to be on the upper bound of this range. The results are summarized in the Figure below.

These numbers represent 2x-3x the stimulus spending on clean energy in 2020 (Forbes 2020). If accounted in fossil fuel subsidy statistics, they would increase the subsidy figures by 5-10%, massive when considering that they are effectively ignored in today's statistics (Forbes 2020).

Figure 4: Estimated range of tax relief by saving and pension products (lower and upper bound) (Source: Own Calculation).



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Conclusion

This note quantifies the financial loss to the UK government associated with subsidizing fossil fuel investments as part of pensions and household savings (ISAs) of potentially upwards of nearly half a billion pounds per year.

In the context of a clear commitment to net zero by the UK government, the findings raise questions as to whether a more targeted tax regime can contribute to reducing the deficit and/or ensuring more coherence between finance sector taxes and climate goals.

Addressing this issue raises a number of questions.

- *Policy neutrality vs. coherence.* Campaigners and other interest groups are pushing for a simplification of the current tax regime on ISAs in particular (Nixon, 2021). More generally, policy actors in finance tend to argue in favor of 'neutrality' over supporting specific policy goals, although there is also a growing push to address the neutrality issue in the context of climate change. However, such simplification and 'neutrality' (a neutrality contested in the literature (CEP 2020)) comes at the expense of policy coherence. Right now, the UK government has decided to eliminate taxes on fossil fuel investment through ISAs and pensions. This seems on its face incoherent with the broader policy agenda.

- *Fossil fuels vs. Paris Agreement.* The second key question is how a policy intervention could be effectively targeted. This note takes a broad brush to climate issues by focusing on the issue of 'fossil fuel' investment – a key touchpoint for retail investors and climate campaigners. However, high-carbon companies are broadly dispersed throughout portfolios. The 2DII PACTA tool (PACTA, 2021) identifies seven key climate-relevant sectors for analysis. The CA100+ initiative (Climate Action 100+, 2021) – the largest global initiative on investor engagement targeting around 167 companies – 'only' has about one-third of their engagement targets in the fossil fuel sector. On the other hand, even within the fossil fuel sector, there is a small (but potentially growing) number of companies that are seeking to align their business model with the Paris Agreement.

- *Impact vs. tax relief.* Finally, a policy intervention may consider the broader question of the 'impact' of the policy instrument. As outlined by some academics (see e.g., Kölbel et a. (2020)) divestment may not be the most impactful measure to achieve climate goals. Some pension funds explicitly maintain fossil fuel exposure for the purpose of climate engagement. On the other hand, independent of corporate stewardship, the underlying fact of a fossil fuel subsidy remains. Policy interventions may thus have to trade off their desired 'climate impact' versus the purity of avoiding tax relief on certain types of investment.

Despite these open questions, the note concludes that reviewing this issue is important in light of the urgency of the climate crisis.

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