IoD POLICY PAPER

The Green Incentive: how to put net zero at the heart of business planning

May 2022

Executive summary

There is a gap in government policy to meet our national climate change target of net zero by 2050, namely a lack of effective incentives for smaller businesses to play their part to decarbonise our economy.

To date, the policy approach has been either sectoral or focused on larger companies. For small and medium sized enterprises (SMEs), the support that does exist relies on firms deciding to seek it out themselves. As a result, SMEs report that the main barriers to them taking action now to reduce their carbon emissions are uncertainty around the business case, and a lack of knowledge around what is required.

To remedy this, we make four specific medium-term recommendations to government.

First, define a clear goal that every business should achieve net zero in its operations. This is in line not only with the UK's national goal but also with a global United Nations initiative to encourage SMEs to make a 'climate pledge' to achieve net zero, which in turn is backed by the UK government. In this context, net zero is defined as a business putting no more carbon into the atmosphere than it is taking out of it.

Second, establish a clear business case for action by introducing, with several years notice, a lower corporation tax rate for organisations that have achieved net zero compared to those that have not. This recommendation does not necessarily require a greater use of taxpayer resources or, conversely, that taxes necessarily rise for other firms. What is important is that there is a wedge between the two to act as a clear financial incentive to achieve the desired change. This wedge could be adjusted over time to calibrate the necessary response, and in the light of the prevailing fiscal circumstances.

Third, a methodology for carbon footprint accounting should be developed that goes with the grain of the existing approach for the declaration of company profits. Limited companies should be required to keep records of, and report on, their carbon footprint and use the information to determine which corporation tax band they are eligible for. Those companies that currently require an external audit of their accounts would also have their carbon accounting audited; accountants of smaller companies would also include carbon accounting as standard. To achieve this would require a fully developed methodology for measuring carbon footprint, including guidance to the accountancy and audit professions, and the further development of tools and advice to support business to undertake the necessary calculations.

Finally, the government should undertake its own assessment of the suitability of support available for firms to become net zero. A number of initiatives already exist, across the public and private sectors, to provide knowledge and support to smaller firms seeking help to reduce their carbon footprint. There may be a need for additional measures, such as the development of a recognised kitemark scheme for companies to signal their progress on the path to net zero, strong professional pathways for zero carbon advisers, and action to fill reporting gaps such as a requirement for applicable commercial landlords to inform SME tenants of the carbon impact of their building use.

Introduction

There is a gap in the government's policy armoury to meet our national climate change target of net zero by 2050, namely the lack of effective incentives and support to ensure small and medium sized businesses can play their part to decarbonise our economy.

In some parts of the private sector, deliberate policy action by government is causing business leaders to change their behaviour. Asset managers and large listed businesses, for example, are now required to consider and report on the climate impact of their actions.[1,2] Commercial landlords and property developers face ever-increasing emissions targets for their buildings.[3] Large energy users have long been required to pay the climate change levy and work within the confines of the emissions trading scheme, as well as being encouraged to enter into climate change agreements to progressively reduce their emissions.[4, 5,6] And – separately – the government is investing heavily in technology demonstration projects for low carbon alternatives to traditional processes.[7]

There has been no structured policy initiative, however, designed to increase the number of smaller businesses taking their own action. Instead, support for SMEs to decarbonise – whether through the government-backed SME climate hub, private consultancy or local business support services – has fundamentally relied on firms making an active decision to seek it out. Unless required to by customers or clients attempting to monitor the carbon impact of their own supply chains, doing so may not be a top priority for some small businesses faced with competing short term priorities on their time and resources.

That is not to say that the SME sector does not want to play its part: our own research shows IoD members are keen to understand what they need to do. But for many there is also a fundamental uncertainty around the short-term business case for change, a lack of knowledge around what changes would be deemed as sufficient for the firm to have 'done its bit', as well as, in many cases, a basic lack of understanding simply around what needs to be done. We also found a paradox: business leaders accept government has a leadership role to ensure our national climate change targets are met but government is fearful of being accused of adding to business regulation.

There has been no structured policy initiative, however, designed to increase the number of smaller businesses taking their own action.

[1] https://www.fca.org.uk/publications/policy-statements/ps-21-24-climate-related-disclosures-asset-managers-life-insurers-regulated-pension
[2] https://www.fca.org.uk/publications/policy-statements/ps-21-23-enhancing-climate-related-disclosures-standard-listed-companies
[3] https://www.gov.uk/government/consultations/non-domestic-private-rented-sector-minimum-energy-efficiency-standards-epc-b-implementation
[4] https://www.gov.uk/guidance/register-for-climate-change-levy#main-rates
[5] https://www.gov.uk/government/publications/participating-in-the-uk-ets/participating-in-the-uk-ets
[6] https://www.gov.uk/guidance/climate-change-agreements--2
[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1033990/net-zero-strategy-beis.pdf analysed, for example, here: https://sustainablefutures.linklaters.com/post/102ha2c/uk-net-zero-strategy-a-tech-centric-approach

The problem

The main barrier to SMEs taking action now to reduce their carbon emissions is uncertainty around the business case.

This expresses itself in a number of ways, for example via concerns around the up-front cost to the business, either in terms of cash outlay or management time, requests for direct government financial support and uncertainty about the direct business benefits when compared to other calls on a management team's capacity. With the UK's national target of reaching net zero by 2050 feeling some way off, firms may also feel that there's a penalty for being a first mover: the policy incentives for change may be greater as that target gets closer.

This is not to say that most business leaders do not understand that in the longer-term the negative impacts of climate change could affect the wider business environment (not to mention society) in a profound way, but more that in the here-and-now there are also other pressing calls on their organisation's available resources.

Our own data shows:

One in five

of our members cite the 'lack of a clear business case to invest in net zero measures' for their individual business as one of the biggest obstacles in reducing their carbon footprint.

61%

of our members cited upfront or ongoing costs, or lack of access to external finance/ grants as one of the biggest obstacles they face in reducing their carbon footprint.

66%

said financial support or incentives from Government would be most useful in helping them to address climate change.[8]

In addition:

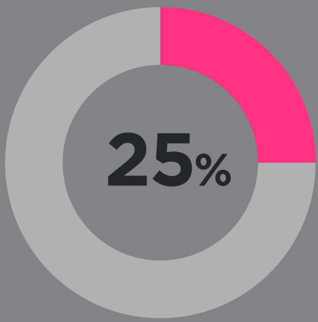
Lack of funding was reported as the barrier to taking climate action by 48% of SMEs surveyed by the UN-backed SME Climate Hub; 'lack of (non-financial) resources' such as personnel, knowledge or time was the barrier for 68% surveyed.[9]

McKinsey estimates that the annual global increase in capital spending required for net zero transition between now and 2050 was roughly equivalent to half of global corporate profits.[10]

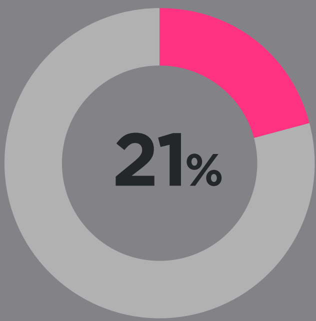
Linked to this is the second main barrier to taking action: a lack of knowledge and understanding around the practicalities of what is involved. This expresses itself in a desire for government to lead, uncertainty and anxiety on the part of business leaders as to where they are on their 'journey', how their own policies compare to others and, specifically, how much more action their own organisation should take. Alongside these concerns is a straightforward lack of knowledge around how to make the change. Even if the expertise and information is, in fact, available at zero or reasonable cost, if the business has not sought it out then it will still report that a lack of knowledge is a barrier.

[8] IoD Policy Voice survey Nov 2021
[9] Survey: small businesses face recurring barriers to carbon reduction - SME Climate hub
[10] The net-zero transition: Its cost and benefits | Sustainability | McKinsey & Company

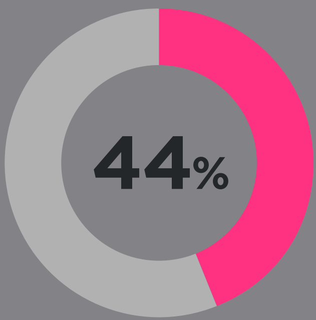
In our Policy Voice survey of members undertaken in November 2021:



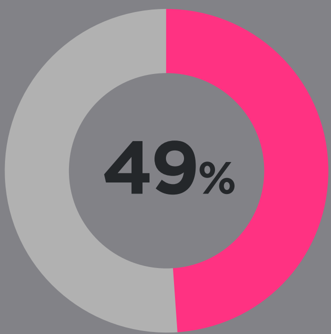
reported 'lack of knowledge' is one of the biggest obstacles to reducing their carbon footprint.



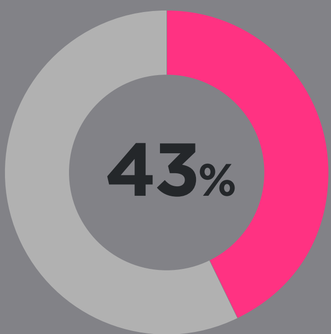
agreed that they fully understand how their organisation can lower its carbon footprint and meet net zero carbon goals.



said they need education and training programmes to achieve net zero.



want more guidance and advice from government around the changes their business should make.



felt it is role of government to decide the best way for firms to measure their carbon impact.

The solution

The most pressing solution is to provide stronger incentives for management to decide to address the issue. Once that decision is made, there may then be other changes that are required to support them to do so.

We see the role of policy as:

1. Defining the end goal
2. Incentivising business to achieve the goal
3. Establishing the monitoring system
4. Ramping up help and support

1 Defining the end goal

At a national level, the government has a target of achieving net zero by 2050. The latest Carbon Budget also commits the UK to a 78% emissions reduction target by 2035 compared to 1990 levels.[11]

In addition, the government has backed the UN-led SME Climate Change Hub which encourages individual SMEs to take the pledge to achieve net zero in their own operations "before 2050", where net zero is defined as a business putting no more carbon into the atmosphere than it is taking out of it.

This SME pledge also includes an intermediate target of halving greenhouse gas emissions by 2030 and a commitment to report on progress annually. So far over 3,000 companies have signed the pledge in the UK.[12]

Given the high-level alignment between the government's national goal and the SME pledge, we suggest that this should be the explicit end goal of policies aimed at smaller businesses.

Recommendation 1:
Government should be explicit that it wants every business to achieve net zero in its operations in line with the national goal and the UN-backed SME climate pledge.

2 Incentivising business to achieve the goal

It then follows that if the aim of government is for SMEs to become net zero then the incentive structures should be designed to achieve this specific outcome. We therefore propose a high profile, simple, and easy-to-understand policy intervention designed to provide a strong incentive for all firms to achieve net zero, as follows:

Recommendation 2:
Government should introduce, with several years' notice, a lower corporation tax rate for organisations that have achieved net zero compared to those that have not.

Note this recommendation does not necessarily require a greater use of taxpayer resources or, conversely, that taxes necessarily rise for other firms. The important outcome is that there is a wedge between the two to act as a clear financial incentive to achieve the desired outcome. This wedge could be adjusted over time to calibrate the necessary response, and in the light of the fiscal circumstances of the time.

If announced with a long lead time, it would guide the market to achieve the desired change as part of its routine planning process. Given the commitment to achieve net zero across the economy from 2050, it may be that the corporation tax system could be progressively adjusted to sharpen the incentives as this date becomes nearer.

Consideration would need to be given to corresponding measures for the self-employed, sole traders, partnerships and other forms of economic activity. In the public sector, a straight decision can be made to achieve net zero at an organisational level rather than using the tax system to achieve change.

Although this recommendation is designed with the aim of providing sufficient incentive to smaller businesses, we see no downside to having it operate across the economy to sharpen incentives for all organisations.

[11] https://www.gov.uk/government/news/uk-enshrines-new-target-in-law-to-slash-emissions-by-78-by-2035
[12] https://smeclimatehub.org/uk/

3 Establishing the monitoring system

At present, for limited companies, corporation tax is applied to profits, which are declared via the submission of annual accounts to Companies House and tax returns to HMRC. All limited companies are required to keep records to back up these declarations that can be subject to HMRC investigation. All but the smallest firms are also required to employ an auditor to assure that the accounts are true and fair. Most companies employ an accountant to compile the accounts, although this is not a legal requirement.

We recommend that, with several years' notice, the same approach be replicated for net zero accounting. Just as at present, it would be a criminal offence to falsify the information, and all but the smallest firms would be required to have their net zero calculations audited.

Recommendation 3:
A methodology for carbon footprint accounting should be developed that goes with the grain of the existing approach for the declaration of company profits. Limited companies should be required to keep records of, and report on, their carbon footprint and use the information to determine which corporation tax band they are eligible for.

4 Ramping up help and support

The road map to implementing this decision would require a fully developed methodology for measuring carbon footprint, including guidance to the accountancy and audit professions, and the further development of tools and advice to support business to undertake the necessary calculations. There would be significant implications for the audit and accountancy professions, where investment in the necessary knowledge and skills will be needed to undertake their assurance role on carbon accounting alongside financial accounting. This may of itself require a long lead-in time to ensure that the profession is ready.

The government should work with the British Standards Agency to establish a kitemark scheme to enable firms easily to signal that they have met the net zero goal, in addition to existing schemes that allow firms to signal that they are monitoring and improving their environmental impact.[13]

The SME Climate Change Hub has recently made available free tools to support individual companies in calculating their carbon footprint.[14] These would need to be sufficiently robust to apply to all limited companies and in time should be replaced by more formal government advice around the type of records that firms are required to maintain.

Place-based business support services that currently offer help to firms to decarbonise, such as those offered through devolved administrations, local authorities, LEPs and their Growth Hubs, may need additional resources as demand for services ramps up. The development of thriving private sector green advisory services will help spur the necessary change, but strong signposting will also be necessary to ensure that eligible firms do not incur unnecessary costs from private sector environmental consultancy providers if free support is available.

There may be blockages to firms obtaining the necessary information to determine their carbon footprint that need to be identified and fixed. When we asked our members about the barriers to reducing their carbon footprint, 42% cited 'a lack of practical feasibility, such as existing tenancy agreements or technology systems'.[15] For example, at present commercial landlords who include energy bills in the rent they charge to tenants, such as in shared spaces, have no requirement in law to inform those tenants as to the climate impact of their own part of the building's use. Without this, smaller firms are not able to monitor their own carbon impact. Similarly, an established methodology would have to be developed to account for people working from home.

Having sufficient 'green skills' in the economy may also be a blockage to firms being able to hire staff that can support them in their transition to net zero. As a minimum we suggest a greater focus on the necessary skills to help firms achieve net zero in the ongoing reform to the National Skills Fund, including the free training included in the Skills Bootcamps and Level 3 Lifelong Learning guarantee, all of which would help create strong professional pathways for carbon advisers. Net zero accounting should also be added to the curriculum for chartered accountancy qualifications.

There may also be corresponding corporate governance changes that are required. The IoD has previously argued that the Corporate Governance Code should be amended to require listed firms to have a sustainability committee. Section 172 of the 2006 Companies Act should also be amended in order to require directors to define a purpose for their company, the pursuit of which not only benefits its shareholders but also benefits the environment, and eliminates environmental harm or costs in line with the Better Business Act campaign.

Recommendation 4:
The government should undertake its own assessment of the suitability of support available for firms to become net zero.

[13] For example, the international Eco-Management and Audit Scheme (EMAS) originally designed by the European Commission allows firms to signify they monitor and improve their environmental impact, underpinned by the environmental management requirements of ISO 14001.
[14] https://smeclimatehub.org/tools/
[15] IoD Policy Voice survey Nov 2021

Conclusion

Radical change requires clear incentives.

At present the policy focus for achieving change in the private sector has been based on sector and size of firm. This leaves a policy gap for achieving change in the wider SME sector where, despite understanding the need for change at a societal level, business leaders would welcome a clearer path to enable them to plan.

We argue that the easiest and most impactful way for government to do this would be for lower corporation tax rates to be payable by companies that are demonstrably net zero in their own operations, to be operationalised in a similar way to how profits and corporation tax are currently determined.

[16] https://betterbusinessact.org/wp-content/uploads/2021/04/The-Better-Business-Act-2021.pdf

Appendix: the data

All the data in this section comes from the IoD's internal Policy Voice surveys of its members.

November 2021
What would you say are the biggest obstacles faced by your organisation in reducing its carbon footprint? Please select all that apply.

	Total %
Total	**580**
Upfront or ongoing costs	**37**
Lack of practical feasibility e.g. due to existing tenancy agreements or technology systems	**42**
Lack of access to external finance or grants to support net zero actions	**24**
Unwillingness to prioritise decarbonisation	**7**
Lack of a clear business case	**20**
Lack of knowledge around how to make progress	**25**
N/A	**14**
Other (please specifiy)	**11**

November 2021
What measures do you feel would be most useful in assisting SMEs to address climate change? Please select all that apply.

	Total %
Total	**580**
Education and training programmes	**44**
More guidance and advice from government	**49**
More guidance and advice from the IoD	**35**
Endorsement by government of sustainability certification schemes/kitemarks	**36**
Specific SME reporting requirements relating to carbon footprint	**28**
Embedding of sustainability requirements into government and large company procurement contracts	**39**
Financial support or incentives from government	**66**
N/A	**4**
Other (please specify)	**9**

October 2021
To what extent do you agree or disagree with the following statements?

	Agree strongly	Agree	Neither agree nor disagree	Disagree	Disagree strongly	Don't know
My organisation measures its carbon impact.	**8%**	**20%**	**24%**	**30%**	**16%**	**2%**
My organisation has a well worked out plan to reduce its carbon impact.	**7%**	**20%**	**26%**	**31%**	**14%**	**2%**
My organisation has decided to become a zero carbon organisation by a specific date.	**6%**	**10%**	**25%**	**36%**	**20%**	**3%**
It is the role of government to advise business on how to reduce its carbon impact.	**12%**	**39%**	**28%**	**11%**	**9%**	**1%**
It is the role of government to decide the best way for firms to measure their carbon impact.	**11%**	**32%**	**27%**	**18%**	**11%**	**1%**
Government should regulate to require firms to become net zero by a specified date.	**10%**	**26%**	**19%**	**21%**	**23%**	**1%**
The cost of transitioning to a zero carbon economy should mainly be met by government through general taxation.	**5%**	**19%**	**28%**	**29%**	**17%**	**2%**
The price of carbon should be raised to incentivise firms and individuals to switch to other energy sources.	**12%**	**35%**	**24%**	**15%**	**12%**	**1%**

March 2021
How much do you understand about the way in which your organisation can lower its carbon footprint and meet net zero carbon goals?

		Number of employees		
	Total	**Small**	**Medium**	**Large**
Total	**703**	**485**	**144**	**74**
Fully understand	**24%**	**21%**	**26%**	**42%**
Somewhat understand	**52%**	**52%**	**53%**	**46%**
Don’t understand very well	**14%**	**15%**	**15%**	**5%**
Don’t understand at all	**4%**	**4%**	**3%**	**1%**
Not applicable	**6%**	**7%**	**3%**	**5%**

March 2021
How important is it for your primary organisation to operate in an environmentally friendly and sustainable way?

		Number of employees		
	Total	**Small**	**Medium**	**Large**
Total	**703**	**485**	**144**	**74**
Very Important	**46%**	**41%**	**52%**	**62%**
Somewhat Important	**37%**	**39%**	**34%**	**28%**
Not Very Important	**12%**	**13%**	**9%**	**7%**
Not At All Important	**6%**	**7%**	**5%**	**3%**
Don’t know	**0%**	**0%**	**0%**	**0%**
Total important	**83%**	**80%**	**86%**	**90%**

March 2021
To what extent do you agree or disagree with the following statement? "The costs associated with moving towards net-zero goals in my organisation are prohibitive"

		Number of employees		
	Total	**Small**	**Medium**	**Large**
Total	**703**	**485**	**144**	**74**
Strongly agree	**7%**	**6%**	**8%**	**7%**
Agree	**23%**	**20%**	**37%**	**19%**
Disagree	**40%**	**41%**	**33%**	**46%**
Strongly disagree	**13%**	**13%**	**12%**	**18%**
Don't know	**17%**	**20%**	**10%**	**11%**

December 2021
Should the government require landlords to provide organisations with information about the carbon footprint of the premises they lease?
*those who lease only

	Total
Total	**315***
Yes	**61%**
No	**29%**
Don't know	**10%**

The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum – from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies.

The IoD was granted a Royal Charter in 1906, instructing it to “represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation.”

The Charter also tasks the Institute with promoting “for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors”, which the IoD seeks to achieve through its training courses and publications on corporate governance.

iod.com

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