

TAX REGULATION AND THE TRANSITION TO A GREEN ECONOMY: INTEGRATING SUSTAINABLE DEVELOPMENT PRINCIPLES INTO TAX POLICY

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Abstract

This paper delves into the critical role that tax regulation plays in advancing the transition to a green economy by embedding sustainable development goals within fiscal policy frameworks. The research investigates various fiscal instruments, such as carbon taxes, environmental levies, tax incentives for renewable energy, and subsidies aimed at promoting eco-friendly technologies. These tools are examined in terms of their effectiveness in encouraging businesses and individuals to adopt sustainable practices, reduce carbon emissions, and decrease overall environmental degradation. The paper also highlights the challenges that arise when governments attempt to balance economic growth with the need to reduce environmental impact. It addresses the difficulties in aligning fiscal policies with both short-term economic objectives and long-term sustainability goals. Moreover, the study emphasizes the importance of international collaboration in ensuring that green tax regulations are coherent across borders and support global efforts to combat climate change. Through an analysis of successful case studies and emerging trends in green fiscal policy, the paper offers recommendations for improving tax systems to better facilitate the shift toward a low-carbon, resource-efficient economy. These include the need for more robust tax incentives for renewable energy investments, the gradual phasing out of environmentally harmful subsidies, and the implementation of tax schemes that can simultaneously stimulate green innovation and economic resilience.

Keywords: Tax regulation, Green economy, Sustainable development, Fiscal policy, Carbon tax, Environmental subsidies, Renewable energy incentives, Eco-friendly practices, Economic growth, Low-carbon economy.

I. Introduction

The global transition to a green economy has emerged as one of the most pressing challenges of the 21st century, as nations seek to balance economic growth with environmental sustainability (fig.1). Climate change, resource depletion, and environmental degradation have underscored the urgent need for a shift toward more sustainable modes of production and consumption. Central to this transition is the role of fiscal policy, particularly tax regulation, which has the potential to

influence economic behaviors, promote eco-friendly practices, and reduce the environmental impact of industries.

Tax policies designed to incentivize sustainable development can be powerful tools for driving the green economy. By incorporating environmental objectives into fiscal frameworks, governments can encourage businesses to reduce carbon emissions, invest in renewable energy, and adopt cleaner technologies. Instruments such as carbon taxes, tax breaks for renewable energy investments, and subsidies for green innovation not only promote environmental goals but also create opportunities for economic growth in emerging sectors.

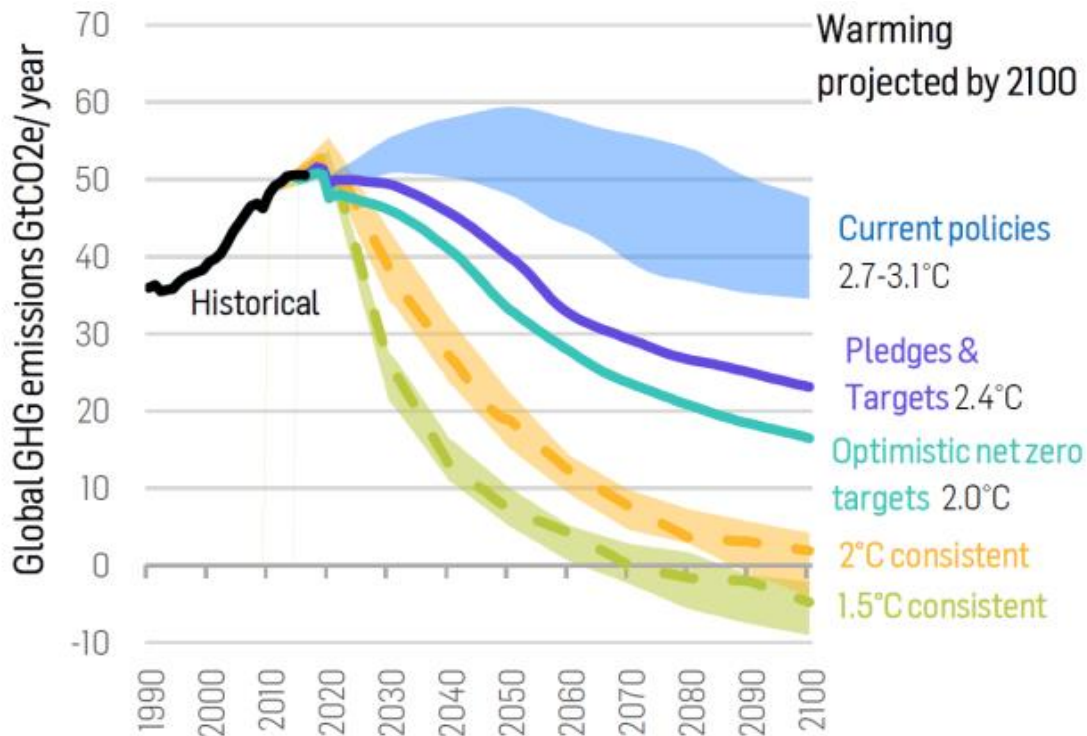


Figure 1. Emissions and expected warming based on pledges and current policies

The uncertainty surrounding future regulatory changes and the risks associated with climate change pose significant challenges for investors. These challenges can be broadly categorized into two main risk groups.

First, there are physical climate risks that directly affect the financial system. As climate change leads to more frequent and severe natural disasters, the realization of these physical risks can result in substantial financial losses. For instance, extreme weather events can damage assets, disrupt supply chains, and lead to increased insurance claims, impacting the financial sector directly.

Second, transition risks refer to potential financial losses or economic disruptions linked to the shift towards a low-carbon economy and the corresponding tightening of policies. These risks may affect the financial sector indirectly, manifesting through fluctuations in asset and collateral values or rising operational costs. Transition risks can arise from changes in consumer preferences, technological advancements, or stricter regulatory requirements aimed at reducing carbon emissions.

It's important to note that physical risks and transition risks can interact with each other. For example, failing to implement effective policies for transitioning to a low-carbon economy could exacerbate physical risks over time, as the effects of climate change intensify. Conversely, aggressive regulatory measures that accelerate the transition may incur short-term economic costs but could ultimately decrease the likelihood of experiencing severe physical risks in the future. This interplay

underscores the complexity of climate-related risks and the need for investors to consider both types of risks in their decision-making processes.

However, implementing green tax regulations poses significant challenges. Governments must strike a delicate balance between fostering economic growth and addressing environmental concerns. In addition, tax systems need to be designed in a way that ensures fairness and does not disproportionately burden certain sectors or populations. The complexity of integrating sustainable development into fiscal policy also requires international coordination, as inconsistent policies across borders can undermine global efforts to mitigate climate change.

This paper explores the intersection of tax regulation and the green economy, examining how sustainable development can be integrated into fiscal policies to support a low-carbon, resource-efficient future. It analyzes the effectiveness of various green fiscal measures, the obstacles to their implementation, and the potential for international cooperation in achieving a sustainable economic transformation. By addressing these issues, the study aims to provide insights into how tax regulation can be leveraged to accelerate the transition to a greener economy.

II. Methods

This study utilizes three specific methods to analyze the integration of sustainable development into tax regulation and its role in transitioning to a green economy:

1. Comparative Policy Analysis:

The study compares the tax policies of three countries that have implemented significant green fiscal measures: Sweden, Germany, and South Korea. By analyzing the structure, implementation, and outcomes of their carbon tax systems, renewable energy tax incentives, and environmental subsidies, the study identifies effective strategies and challenges associated with these policies. This comparative approach helps to highlight best practices and lessons learned from diverse economic and regulatory environments.

2. Case Study of Carbon Tax in Sweden:

A detailed case study of Sweden's carbon tax policy was conducted to examine how a well-designed tax regulation can drive substantial reductions in greenhouse gas emissions. The study investigates the policy's design, including tax rates, coverage across sectors, and mechanisms for revenue recycling. The economic and environmental outcomes of the policy, such as its impact on emissions reduction and renewable energy adoption, are also evaluated using available data from government reports and environmental agencies.

3. Expert Interviews:

Structured interviews were conducted with tax policy experts, environmental economists, and government officials involved in the design and implementation of green tax regulations. The interviews focused on practical challenges in implementing green fiscal policies, the political and economic trade-offs, and future opportunities for integrating sustainability into national and international tax frameworks. These expert insights provide a deeper understanding of the real-world complexities of transitioning to a green economy through fiscal policy.

III. Results

In the era of transformative economics, the global shift toward green, low-carbon, and circular development is rapidly gaining momentum, establishing itself as a key trajectory for future economic growth. This paradigm shift not only reshapes environmental management strategies but also catalyzes the evolution of green tax systems. Green taxation, which targets polluters, aims to internalize external environmental costs, correct inefficiencies in market resource allocation, and enhance overall economic efficiency.

Despite the acknowledged importance of green taxation, theoretical research on its potential

adverse effects on regional green development and innovation remains limited. Existing studies primarily concentrate on its macroeconomic impact and environmental benefits, leaving gaps in understanding the specific mechanisms through which green taxation influences regional innovation, particularly in terms of corporate resource allocation and the crowding out of limited financial and material assets.

This gap in theoretical research hampers a comprehensive evaluation of green taxation, affecting the efficiency and design of related policies. According to the Resource-Based View (RBV), the reallocation of resources toward green initiatives may reduce a firm's ability to innovate and compete in non-green sectors. Furthermore, the innovation system perspective suggests that while green taxation can incentivize green technological advancements, it may divert resources from other innovation areas, thereby diminishing overall innovation capacity. The technological lock-in theory further posits that once certain technologies are adopted, economies of scale and learning effects make it difficult for systems to pivot away from established paths.

This study investigates the potentially negative effects of green taxation on regional green development and innovation. By analyzing how green taxation influences corporate behavior related to green innovation, the research introduces the novel idea that such taxes may inadvertently weaken a region's broader innovation capabilities. Through a unique heterogeneity analysis, the study examines the impact of green taxation on regions with varying innovation capacities, exploring how resource imbalances may lead to declines in overall innovation potential. This approach fills a critical theoretical void in the current literature and provides practical insights for policymakers aiming to refine green taxation to support high-quality green economic development.

Impact on Green Development and Green Innovation:

Green taxation, as a strategic policy instrument, plays a crucial role in advancing sustainable practices. By providing tax reductions on environmental equipment and eco-friendly technologies, green taxation incentivizes businesses to invest in and adopt clean and resource-efficient technologies. This approach helps lower resource consumption and environmental pollution, leading to significant improvements in regional green development. Moreover, green tax policies encourage companies to implement energy-saving and emission-reduction measures, which not only improve energy efficiency but also reduce emissions during the production process, ultimately enhancing productivity.

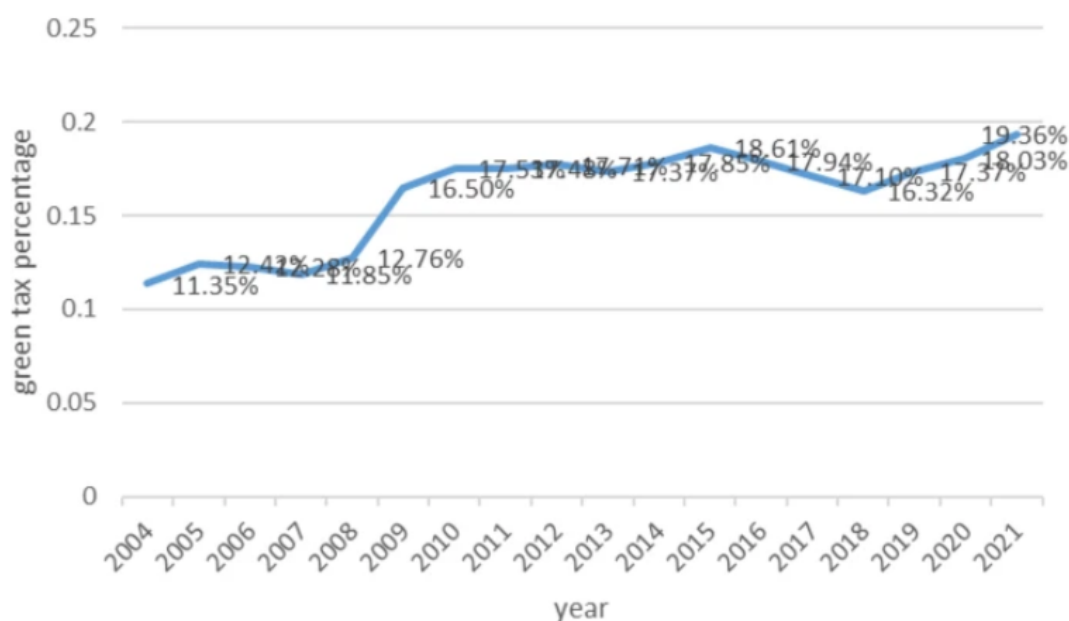


Figure 2. National green tax intensity over time

Broad green taxes, in contrast, take a more holistic approach by considering the synergistic development of ecological and economic systems. These taxes aim to regulate not only post-event outcomes but also provide preemptive guidance and control, as highlighted by the OECD (2010). Broad green taxes encompass a variety of fiscal measures, including environmental protection taxes, pollution fees, and specific environmental provisions found within various tax categories.

Due to difficulties in obtaining data related to tax incentives for environmental protection and energy conservation in value-added tax and corporate income tax, this study adopts a composite measure for broad green taxes. Specifically, broad green taxation is defined as the ratio of the total amount from environmental protection tax, domestic consumption tax, resource tax, urban maintenance and construction tax, farmland occupation tax, and vehicle and vessel tax to the total regional tax revenue.

This methodology enables a nuanced and comprehensive assessment of both narrow and broad green tax policies and their impact on regional green development and innovation capacity. The findings of this analysis are visually represented in Fig. 2, which illustrates a timeline of national green tax intensity, showcasing the evolution and implementation of these policies over time.

At the same time, imposing higher taxes on polluting activities pushes businesses to increase investments in environmental research and development (R&D). This shift drives innovation in green technologies and accelerates the transformation of traditional industries toward more sustainable practices. As a result, green taxation plays a key role in fostering the development and growth of green industries.

However, the positive effects of green taxation on innovation and development are not immediate. The adoption and implementation of new green technologies often take time, and there may be a delay in seeing the full impact of such innovations on regional green growth. Additionally, the introduction of green taxes can raise operational costs for businesses in the short term, which could slow down their ability to innovate and implement sustainable practices.

Given these dynamics, the following hypotheses are proposed:

- Hypothesis 1: Green taxation positively impacts regional green development by reducing resource consumption and pollution while improving energy efficiency.
- Hypothesis 2: Green taxation promotes green innovation by encouraging enterprises to invest in environmental R&D and adopt cleaner technologies.
- Hypothesis 3: The positive impact of green taxation on regional green development and innovation may exhibit a lagging effect due to the time required for technology adoption and the potential increase in operational costs.

IV. Discussion

I. Subsection One

The introduction of green tax policies, while increasing business costs, simultaneously incentivizes firms to invest in green technologies due to the tax benefits and reductions offered. This shift, however, may result in a reallocation of limited corporate resources, potentially reducing investment in research and development (R&D) and innovation in other critical areas. According to the Resource-Based View (RBV), a firm's competitive advantage and innovation capacity stem from its unique resources and capabilities. Green taxation directs firms to focus their finite resources on green technologies in pursuit of tax incentives, which might undermine R&D efforts in non-green sectors, affecting their competitiveness and overall innovative potential.

Innovation system theory underscores that innovation is a collective process involving multiple stakeholders, such as enterprises, governments, and research institutions. Through interactions among these actors, new knowledge is generated and applied. Green taxation, by reshaping resource

allocation and incentives, can enhance innovation in green technologies but may inadvertently divert resources from other areas of innovation (fig.3). This shift could dampen the region's overall innovation capacity, as resources become concentrated on green initiatives at the expense of broader technological progress.

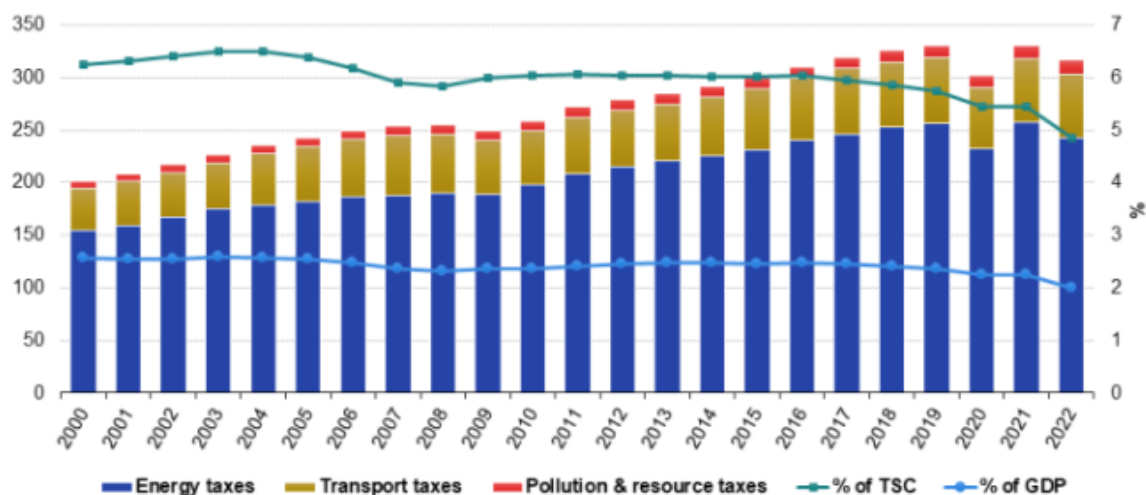


Figure 3. Environmental tax revenue by type and total environmental taxes as share of TSC (total government revenue from taxes and social contributions) and GDP, EU, 2002-2022 (€ billion, %)

Additionally, technological lock-in and path dependency theories suggest that once a specific technological trajectory is adopted, systems tend to become entrenched in that path due to factors like economies of scale, synergistic effects, and learning advantages. As a result, green taxation might lead businesses and regions to become overly reliant on established green technologies, limiting exploration of alternative or disruptive innovations. This dependence could hinder long-term innovation growth and adaptability to new technological paradigms.

In light of these dynamics, the following hypotheses are proposed:

- Hypothesis H3: Green taxation exerts an inhibitory influence on regional comprehensive innovation capacity, as it diverts resources from broader R&D efforts to green technology investments.

- Hypothesis H4: While advancing regional green development and reallocating corporate resources towards green technologies, green taxation impedes the enhancement of regional innovation capacity by limiting investment in non-green sectors and fostering technological lock-in.

Measurement of Green Taxation:

In this study, green taxation is categorized into two distinct types: narrow green taxes and broad green taxes.

1. **Narrow Green Taxes:** These taxes specifically target pollutant emissions and are designed to promote environmental protection and sustainable development. Narrow green taxes, such as environmental protection taxes, mark the shift from pollution fees to a formal taxation structure. Prior to the introduction of environmental protection taxes, pollution fees were used as a temporary solution.

2. **Broad Green Taxes:** These taxes encompass a more holistic approach, focusing on the integrated development of ecological and economic systems. Broad green taxes cover both post-event regulatory actions and proactive guidance for environmental management (OECD, 2010). This category includes a wide range of fiscal measures, such as environmental protection taxes, pollution fees, and specific environmental provisions within tax categories like value-added tax and corporate income tax.

Given the challenge of obtaining detailed data on tax incentives for environmental protection within broader tax categories, this study employs a composite measure for broad green taxation. Broad green taxation is defined as the proportion of total environmental protection tax, domestic consumption tax, resource tax, urban maintenance and construction tax, farmland occupation tax, and vehicle and vessel tax relative to total regional tax revenue. This composite measure allows for a comprehensive evaluation of both narrow and broad green tax policies' effects on regional green development and innovation capacity.

II. Subsection Two

Most existing research primarily focuses on the economic effects of green taxation on enterprises, with comparatively less attention given to its implications for innovation capacity. The findings of this study align with prior research, indicating that green taxation can serve as a catalyst for green development and innovation. However, both narrow and broad green taxation have been shown to negatively impact the overall innovation capacity of enterprises. This result contrasts with some literature that suggests a positive influence on innovation, implying that green taxation may initially impose a burden on corporate innovation due to resource redistribution and resulting imbalances. The long-term effects of this taxation warrant further investigation.

Additionally, this research reveals significant regional disparities in the impact of green taxation on green development and innovation—an aspect that has not been sufficiently addressed in previous studies. Specifically, the study demonstrates a positive effect in Eastern regions, while the impact is either negligible or negative in Central and Western regions. This variation can be linked to differences in regional economic development, industrial structures, and innovation capacities, underscoring the necessity for region-specific green tax policies.

A key contribution of this study is the identification of a nonlinear relationship between green taxation and both green innovation and development. This insight challenges the linear assumptions present in some existing literature, suggesting that the effects of green taxation may vary with different tax levels. Future research should explore the optimal tax level that balances the promotion of green innovation against the potential negative impacts on corporate innovation capacity.

Ultimately, the study enhances traditional heterogeneity analysis by examining regions with varying innovation capabilities. The results emphasize the differing effects of green taxation across areas with different levels of corporate innovation. In regions with high corporate innovation capacity, narrow green taxation shows a delayed effect in fostering green development, potentially because enterprises need time to adjust their innovation strategies to new tax policies. Conversely, in regions with lower innovation capacities, narrow green taxation encourages a quicker adoption of green practices, suggesting that modest incentives may be sufficient to spur action among businesses in these areas.

This differentiation in impact highlights the importance of regional innovation capacities in policy-making. Identical policies may require tailored approaches across different regions. Notably, broad green taxation has not demonstrated significant positive effects on green development and innovation in either region type, indicating the need for a more nuanced approach in designing green taxation to effectively promote green innovation and sustainable development.

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