Working Session 3 – Green Recovery: the future of environmental taxation in the EU

Background

Climate change is one of the greatest threats to the future of our Planet. The historical concentration of greenhouse gases (GHG), namely carbon dioxide (CO2), is intrinsically associated to fossil fuels consumption.

International cooperation is fundamental to mitigate the risks and impacts of climate change. To this aim, the Paris Agreement, adopted in 2015, establishes three global objectives:

- to limit the average increase in global temperature well below 2 ºC with additional efforts to limit the average increase in global temperature to 1.5 ºC, recognizing that this would significantly reduce the risks and impacts of climate change;
- increase the capacity to adapt to the adverse impacts of climate change and promote climate resilience and low carbon development;
- make financial flows consistent with resilient and low-carbon development trajectories.

The Paris Agreement further establishes that it will be necessary to achieve carbon neutrality in the second half of this century to achieve these goals. Furthermore, all Parties to the Agreement agreed to communicate their Nationally Determined Contributions in a successive and progressively more ambitious effort towards global greenhouse gas reduction.

EU is responsible for 9% of global CO2 emissions. Since 1990 (the reference period since Kyoto Protocol), EU has reduced its GHG emissions due to policies and measures that led to a strong increase in the use of renewables, a progressive shift from coal to gas for power generation, improvements in energy efficiency and structural changes across Member States' economies. These changes improved the carbon intensity of energy production and consumption with a lower energy intensity of the economy.

Nonetheless, further substantial reductions will be needed to achieve a climate neutral economy by 2050.

The European Green Deal has established a new European growth strategy that aims to transform the EU into a more just and prosperous society, with a modern, efficient and competitive economy. Accordingly, stepping up Europe's 2030 climate ambition corresponds to a renewed target of reducing emissions by 55% (from the current 40%) and, by 2050, to be the first continent to achieve carbon neutrality. However, achieving carbon neutrality is a global matter and requires cooperation and a coordinated effort. In the last few months there have been some positive developments in this regard: the USA has re-joined the Paris Agreement and committed to a 50% cut in emissions over 2005 levels by 2030; the UK has committed to reducing emissions by 68 percent by 2030 and 78 percent by 2035; and China has renewed its pledge to become carbon neutral by 2060.

The Role of Taxation in the Environmental change

In the November 2020 ECOFIN Council Conclusions, Member States agreed that fair and effective taxation systems in Member States are central to the sustainable recovery of the European Union as a whole and will contribute to the response to the economic and social impacts of the COVID-19 pandemic. This

requires tax policies that not only generate revenues for both national and EU budgets, but also allow for a smooth transition towards policy goals of sustainable competitiveness, the European Green Deal and a full use of the potential of digitalisation in a global economy[1].

As pointed about by the OECD[2], through a green recovery, governments have the opportunity to unleash innovation, undertake wider reaching and fundamental restructuring of critical sectors (not only on energy and transport sectors, but also on other sectors such as industry, agriculture, forestry and waste management), accelerate existing environmental plans, and make use of environmentally sustainable project pipelines.

In the context of green recovery, excise duties and carbon taxes can be very useful tools to decarbonize our economies. By giving the right price signals and incentives to producers and consumers, they can encourage less polluting consumption and contribute to sustainable growth, as well as other environmental goals of the European Green Deal[3]. Nearly 60% of CO2 emissions from energy use in OECD remained entirely unpriced in 2018 despite evidence that increased carbon pricing scores improve alignment of carbon prices with the costs of emissions to society and move towards a greener growth path[4]. Green taxation can also help reduce taxes in other areas, for example on labour.

This can be achieved, among others, by reforms that remove subsidies for fossil fuels and shift the tax burden to pollution.

Energy taxation will thus be increasingly called to contribute to the achievement of the climate change and environmental goals, and in this respect the European Green Deal includes the revision of the Energy Taxation Directive (ETD) among its implementing actions. The review process has started, and a proposal should be presented in July within the "Fit for 55" legislative package.

The carbon border adjustment mechanism can also play an important role, namely by mitigating carbon leakage, and incentivising third countries´ climate transition, while respecting WTO rules, it would be used to compensate differences in environmental policies ambitions among jurisdictions, which translate into different carbon prices. Currently, the carbon content of imported goods is not priced compared to EU production, with possible negative impacts on the fight against climate change. The Impact Assessment of this mechanism and the design of its features is ongoing, and the legislative proposal should be published by the Commission in July 2021.

Other taxes, such as VAT, could also play an important role supporting the EU transition towards a climate neutral and green economy. The Council Conclusions of November 2020 recognised the contribution of passenger transport to the objectives of the European Green Deal. It has acknowledged the necessity to review the VAT treatment of passenger transport taking into account its specificities and the impact of the COVID 19 pandemic. Furthermore, options to apply lower VAT rates to environmental-friendly supplies could be considered.

In sectors where electrification is difficult, the EU strategy will have to go through a clear commitment to encourage the production and consumption of “clean liquid fuels”, or “low carbon”, namely, biofuels, biogas and so-called green hydrogen, as a strategic and complementary solution to electrification.

[1] Doc. 13350/20 FISC 226 ECOFIN 1097.
[2] https://www.oecd.org/coronavirus/en/themes/green-recovery
[3] As it is shown in OECD (2008) Taxation and Economic Growth and OECD (2011) Towards Green Growth - Tracking Progress
[4] OECD (2021); Effective Carbon Rates 2021 – Pricing Carbon Emissions through Taxes and Emissions Trading)

To this end, it is crucial to set clearly defined and timed targets, which allow the industries, investors and consumers to have a predictable and reliable reference in the medium and long term. At the same time, it is also key to setup regulatory and tax frameworks that give equal recognition to all renewable and low-carbon technologies, to safeguard technology neutrality. All the while, Governments should carefully monitor and mitigate potential regressive effects and ensure social sustainability of tax measures related to green transition.

Questions for discussion

1. The recovery from the COVID-19 pandemic must be green, and in that context, the EU's flagship Recovery and Resilience Facility (RRF) provides an opportunity to extend the scope and use of environmental taxes. What should be the appropriate design for a green tax system?

2. Do you agree that energy taxes and CBAM should be used by Member States to support the transition towards carbon neutrality? How should environmental taxes, and particularly carbon pricing, enable climate transition?

3. Which other tax instruments (including other green taxes) could be used to achieve those goals?