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Editorial

Energy Taxes and Emissions Trading on the Bumpy Road to a Climate Neutral EU

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In her 'Agenda for Europe' (her electoral manifesto as candidate for the presidency of the European Commission) Ursula von der Leyen announced the proposal of an ambitious European Green Deal, including among others a review of the EU Energy Tax Directive and the introduction of a 'Carbon Borden Tax' (meanwhile re-titled into Carbon Border Adjustment Mechanism).[1] In this editorial I will go into the development of these proposals in the Green Deal that was published on 11 December 2019, shortly after Von der Leyen took office. Before doing so, I will summarize the history of a long road that started around thirty years ago in the UN and eventually should lead to a climate-neutral EU in 2015.

1. The long road from Kyoto to Paris

In its report 'Climate Change: The IPCC 1990 and 1992 Assessments'[2] the Intergovernmental Panel on Climate Change IPCC (established in 1988 by the UN Environmental Programme and the World Meteorological Organization) stated that the increase of human-caused emissions of greenhouse gases (mainly carbon dioxide, CO2) affect the energy balance of the global atmosphere (more CO2 emitted than absorbed by 'sinks', such as forests and oceans) leading to global warming (the 'greenhouse effect'). In the long term the greenhouse effect would lead extreme climate events (floods and drought) and a general rise in sea level around the world, increasing the risk of disappearance of island states. One of the working groups of the IPCC, the Response Strategies Working Group III (RSWG III), formulated technical options for responding to the threats of global warming. It was clear that all technical options would bring substantial costs related to both energy transition from fossil to sustainable energy and investments to adapt to the ecological effects of global warming, such as the rising of sea levels. Although RSWG III did not have the task to identify political options for responding to the threats of global warming, it stated that long term strategies for all individual nations include policy instruments (such as standards, taxes and incentives, and tradeable permits) which will induce sustainable energy choices by producers and consumers without jeopardizing energy security and economic growth.[3]

Around the same time (mid 1992) the United Nations, in its Conference on Environment and Development (the 'Earth Summit' in Rio de Janeiro), adopted the 'polluters pay' principle, meaning that environmental costs should be internalized in the price of polluting products, without distorting international trade and investment.[4]

In 1997 the United Nations Framework Convention on Climate Change (UNFCCC)[5] adopted the so-called Kyoto Protocol as the first multilateral instrument to reduce carbon emissions.[6] In Article 3 of that protocol,

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1 Ursula von der Leyen, *A Union That Strives for More – My Agenda for Europe: Political Guidelines for the Next European Commission 2019–2024*, https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf. *See also* Roland Ismer, *A Union That Strives for More Also in the Area of Taxation: Tax Measures in the Incoming Commission's Political Guidelines*, 29(1) EC Tax Rev. 1 (2020).

2 IPCC, *Climate Change: The IPCC 1990 and 1992 Assessments*, https://www.ipcc.ch/report/climate-change-the-ipcc-1990-and-1992-assessments/.

3 *See*, https://www.ipcc.ch/site/assets/uploads/2018/05/ipcc_90_92_assessments_far_wg_III_spm.pdf, para. 4.1.16, at 131.

4 United Nations, Rio de Janeiro 'Earth Summit', *Report of the United Nations Conference on Environment and Development, Volume 1, Resolutions Adopted by the Conference* 16 (June 1992), Principle 16: 'National authorities should endeavour to promote the internalization of environmental costs and the use of economic instruments, taking into account the approach that the polluter should, in principle, bear the cost of pollution, with due regard to the public interest and without distorting international trade and investment'., https://www.un.org/esa/dsd/agenda21/Agenda%2021.pdf.

5 The UNFCCC is an international environmental treaty, adopted on 9 May 1992 (at the United Nations Conference on Environment and Developed (UNCED, also referred to as the 'Earth Summit' in Rio de Janeiro) entered into force on 21 Mar. 1994, https://unfccc.int/process-and-meetings/the-convention/what-is-the-united-nations-framework-convention-on-climate-change. Its membership counts 197 countries. The ultimate objective of the treaty is to achieve 'stabilization of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system', https://unfccc.int/resource/docs/convkp/conveng.pdf.

6 The Kyoto Protocol, https://unfccc.int/resource/docs/convkp/kpeng.pdf entered into force in 2005.

forty-one countries plus the EU were called-on to achieve between 2008 and 2020 a reduction of greenhouse gases of 5% below 1990 levels.

These UN actions created awareness of the risk of climate change and led in various EU Member States to the initiatives for 'greening' the tax system through the introduction of 'green taxes' (such as carbon taxes and tax incentives to stimulate the use of sustainable energy sources, hybrid and electric cars), as well as subsidies for energy saving (such as isolation). In 2005 the EU Emissions Trading Scheme (EU ETS), a 'cap and trade' system resulting in carbon prices for emission allowances, was introduced for energy-intensive sectors.[7] And not without success: it is expected that in 2020, CO2 emissions from sectors covered by the EU ETS will be 21% lower than in 2005.[8]

Since 1997, however, advancing scientific knowledge on climate change has learned that the effects of 'Kyoto' were not satisfactory. The UNFCCC, recognizing 'the need for an effective and progressive response to the urgent threat of climate change' adopted in 2015 its 'Paris Agreement', meanwhile ratified by 189 countries (Parties)[9] including the three largest emitters of CO2.[10] The objectives include holding the increase in the global average temperature in the second half of this century well below 2 degrees Celsius above pre-industrial (pre-1990) level and pursuing efforts to limit the temperature increase to 1.5 degrees Celsius. In order to achieve this long-term temperature target, Parties shall aim to reach global peaking of CO2 emissions as soon as possible, so as to achieve a net-zero balance between human-caused CO2 emissions and removals of CO2 by 'sinks'. In line with the Paris Agreement, the EU quickly responded by setting the emission reduction targets on at least 40% in 2030 and 80% in 2050 compared to 1990 levels.[11]

2 The EU Green Deal

In October 2019, the European Environment Agency (EEA) concluded that, without additional policies and measures, the existing EU target for 2030, i.e. at least 40% reduction of greenhouse gas emissions below 1990 levels, will not be met.[12]

These findings led to the EU Green Deal of the European Commission (hereinafter: 'Commission'), published on 11 December 2019. [13] In order to put more pressure on the process, the Commission has set even more ambitious emission reduction targets: the 2030 target is at least 50% (and towards 55%) reduction below 1990 levels and in 2050 the EU should be 'the first climate-neutral continent on earth' with net-zero CO2 emissions.

Also, the timetable of the Commission for legislative actions required to deliver these new emissions targets is ambitious.[14] On 4 March 2020 the Commission published Inception Impact Assessments on two proposals announced in its Green Deal, the revision of the EU Energy Directive and the introduction of a Carbon Border Adjustment Mechanism, to be followed by an impact assessed plan by summer 2020[15] and by June 2021 the Commission will review and propose to review where necessary, all relevant climate-related policy instruments, including the European Emissions Trading Scheme.

3 Revision of the Energy Tax Directive

According to Directive 2008/11/EC, energy products and electricity (as well as alcohol and alcoholic beverages, and manufactured tobacco) are excise goods.[16] For each category of excise goods, separate directives provide rules for the harmonization of the structure of excises and the approximation of the rates of excise duties in the form of minimum rates.[17] The current Council Directive 2003/96/EC, Energy Tax Directive (ETD), includes EU rules for the taxation of energy products (mineral oils and gases) used as motor fuel or heating fuel, and electricity.[18]

[7] Directive 2003/87/EC, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003L0087&from=EN. Free allowances will be received up to a benchmark set at the average emission level of the 10% most efficient emitting installations in a specific sector. The EU ETS is applied in the European Economic Area (EU Member States and Iceland, Liechtenstein and Norway) and covers power and heat generation, energy-intensive industries and commercial aviation (until 1 Dec. 2023 only for flights between airports located in the European Economic Area). The UK will leave the EU ETS on 31 Dec. 2020 and starts a UK ETS on 1 Jan. 2021.

[8] European Commission, *EU Emission Trading System (EU ETS)*, https://ec.europa.eu/clima/policies/ets_en.

[9] *See*, https://unfccc.int/files/essential_background/convention/application/pdf/english_paris_agreement.pdf and, https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XXVII-7-d&chapter=27&clang=_en.

[10] In 2018 (most recent available figures) global CO2 emissions amount 36 Megatons CO2. About 53% is emitted in Asia (including China); the three largest emitters are China (28%), USA (15%) and EU-28 (10%). *See*, http://www.globalcarbonatlas.org/en/CO2-emissions. On 4 Nov. the Government of the USA (the #2 emitter) notified the UN of its decision to withdraw from the Paris Agreement; the withdrawal shall take effect on 4 Nov. 2020.

[11] European Commission, *The Roadmap for Transforming the EU into a Competitive, Low-Carbon Economy by 2050*, https://ec.europa.eu/clima/sites/clima/files/2050_roadmap_en.pdf.

[12] EEA Report No 15/2019 (31 Oct. 2019), https://www.eea.europa.eu/publications/trends-and-projections-in-europe-1. These targets were based on the Paris Agreement.

[13] European Commission, *A European Green Deal*, https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en; and COM(2019) 640 final, The European Green Deal (11 Dec. 2019), https://eur-lex.europa.eu/resource.html?uri=cellar:b828d165-1c22-11ea-8c1f-01aa75ed71a1.0005.02/DOC_1&format=PDF.

[14] *See* COM(2019) 640 final, at 4 and 5.

[15] At the time of completion of the editorial (28 July 2020) this plan was not yet published.

[16] Council Directive 2008/118/EC of 16 Dec. 2008, concerning the general arrangements for excise duty, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32008L0118&from=EN.

[17] Council Directive 92/81/EEC resp. Council Directive 92/82/EEC. Harmonization of consumption tax rates (VAT and excise rates) is a very sensitive policy area in the EU; therefore 'harmonization' is mostly restricted to setting minimum rates.

[18] Council Directive 2003/96/EC of 27 Oct. 2003 on restructuring the Community framework for the taxation of energy products an

Traditionally, excise on mineral oils and gas are a stable source of income for the government, but since the last decade of the twentieth century, energy taxes are more and more seen as a possible way to internalize external costs (notably the environmental cost of CO2 emissions) in the final energy prices, based on the 'polluter-pays' principle.[19] As it seemed to be a bridge too far to transforming the ETD into a harmonized 'carbon tax', in 2003 the Council introduced the ETS (see footnote 8). [20]

Yet, in 2011, the Commission proposed to revise the ETD and bring it more in line with the energy market and climate challenge. However, in 2015, after four years of discussions in which it became clear that the revision would not be unanimously adopted by the Council, the proposal was withdrawn.

It took again four years until the Commission, in its 2019 evaluation of the ETD,[21] concluded that the current rules in the ETD do no longer contribute to the new EU regulatory framework and policy objectives in the area of climate and energy. Sectoral exemptions (notably for the maritime and aviation sectors), optional exemptions and tax rate reductions granted by Member States contradict other EU policies, there are no links between the minimum tax rates for fuels and their energy content and CO2 emissions, and the relation between the ETD and the EU ETS should be improved.

Upon an invitation by the EU Finance Ministers,[22] the Commission announced in its EU Green Deal a proposal to revise the ETD 'focusing on environmental issues'.[23]

In the Inception Impact Assessment on this proposal (a preliminary assessment required for proposals with a potentially great impact on the economy, such as this one) the Commission summarizes various options for new policy measures, though without further elaboration.[24] Feedback was received from 180 stakeholders. Most of them found the outline of the proposals too vague for assessing the impact. But energy intensive sectors expressed their worries about a combination of increasing energy taxes and revising the EU ETS leading to an increase of the carbon price. Several respondents urged for more incentives to facilitate emission-reducing investments.

Interestingly, the European Economic and Social Committee (EESC), in its report 'Taxation mechanisms for reducing CO2 emissions' (June 2020), points at the fact that, even with new taxes and additional measures, global warming is likely to continue unless already-emitted CO2 can be removed from the atmosphere. Therefore, the EESC believes that Member States should follow a symmetrical approach: measures in the form of taxes (or ETS) aiming at reducing CO2 emissions and 'negative taxes' (or subsidies) incentivizing investments in carbon removal.[25]

Bearing in mind what happened with the 2011 proposal, we may wonder whether this time the Commission will be more successful. The legal basis of the ETD is Article 113 of the Treaty on the functioning of the European Union (TFEU), ruling that adoption of provisions on tax harmonization (such as energy taxes) necessary for the functioning of the internal market, requires unanimity of the Council. However, the Commission states that, because the proposed review of the ETD should focus on environmental issues, ' … .it is possible to use Article 192 TFEU (environmental measures including measures of fiscal nature) that allows the European Parliament and the Council to adopt proposals in this area through the ordinary legislative procedure by Qualified Majority Voting rather than by unanimity in the Council'.[26] Herewith the Commission refers to the so-called '*passerelle clause*' in this Article.

According to the first paragraph of Article 192, the European Parliament and the Council shall by ordinary legislative procedure (qualified majority voting) decide on environmental measures (mentioned in Article 191), including particular measures combating climate change. Article 192 (2) TFEU rules that, by way of derogation from the first paragraph, adoption of (a.o.) 'environmental provisions primarily of a fiscal nature' requires *unanimity* in the Council. However, according to the last sentence of this paragraph (the *passerelle clause*), qualified majority voting on 'environmental provisions primarily of a fiscal nature' is possible only if the Council first *unanimously* (!) decide to apply qualified majority voting instead of unanimity voting.

In its Communication of 15 January 2019, 'Towards a more efficient and democratic decision making in EU tax policy', the Commission presented a roadmap to move away from unanimity voting in taxation and said ' … to be ready to activate this *passerelle clause*, should the necessity arise'.[27] In the Economic and Financial Affairs Council (ECOFIN) meeting of 5 February 2019, the Commission's

electricity, https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32003L0096&rid=6.

[19] First mentioned at the UN 'Earth Summit' in 1992, *See supra* n. 5.

[20] Directive 2003/87/EC of 13 Oct. 2003, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32003L0087.

[21] Commission Staff Working Document, *Evaluation of the Council Directive 2003/96/EC of 27 October 2003*, SDW(2019) 329 final (11 Sept. 2019), https://ec.europa.eu/taxation_customs/sites/taxation/files/energy-tax-report-2019.pdf; and its executive summary, https://ec.europa.eu/taxation_customs/sites/taxation/files/energy-tax-summary-report-2019.pdf.

[22] Council conclusions on the EU energy taxation framework, Outcome of the proceedings of 5 Dec. 2019, 14861/19, https://data.consilium.europa.eu/doc/document/ST-14861-2019-INIT/en/pdf.

[23] EU Green Deal, *see supra* n. 13, at 5.

[24] Inception Impact Assessment (IIA), Ares(2020)1350088 – (04 Mar.2020), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12227-Revision-of-the-Energy-Tax-Directive.

[25] EESC, *Taxation Mechanisms for Reducing CO2 Emissions* (2 June 2020), ECO/512-EESC-2020, points 3.9 and 6.10.

[26] Inception Impact Assessment, *supra* 24, at 2.

[27] Communication from the Commission 'Towards a more efficient and democratic decision making in EU tax policy', COM(2019) 8 final, at 12 (15 Jan. 2019), , https://ec.europa.eu/taxation_customs/sites/taxation/files/15_01_2019_communication_towards_a_more_efficient_democratic_decision_making_eu_tax_policy_en.pdf.

Communication was not embraced. According to the outcome of the meeting, '… a considerable number of Ministers called for the current balance of voting rules to be kept, while others showed openness towards examining whether there is room for improvement'.[28] Moreover, the ECOFIN made clear that the Commission does not have the right of initiative to propose activating the *passerelle clause*.

It sounds as a warning signal. Although climate change is a hotter topic than in 2015, tax sovereignty is still a sensitive topic for the individual Member States of the EU. We will learn whether the twenty-seven members of the Council, either or not via the *passerelle clause* in, will be willing to adopt the (not yet known) concrete Commission proposals for a substantial revision of the ETD.

4 Introduction of a Carbon Border Adjustment Mechanism

Internalization of the social costs of CO2 emissions (the carbon price per ton of CO2) leads to higher prices for energy-intensive products. As long as the levels of internalizing the carbon price differ worldwide, there is a risk of cross-border 'carbon leakage'.

Carbon leakage may occur when producers in the EU move their activities to countries outside the EU with a lower climate ambition in order to stay competitive, or when EU traders decide to import goods from non-EU countries with a lower climate ambition that the EU. Increasing energy taxes in the EU and increasing prices of allowances in the EU ETS may lead to carbon leakage as the Commission states in its EU Green Deal. [29]

Therefore, the Commission wants to introduce a Carbon Border Adjustment Measure (hereinafter 'CBAM') in 2021.[30]

In its Inception Impact Assessment for this proposal, the Commission stayed rather vague on the type of a CBAM. [31] It could include a carbon tax on selected products (both on imported and domestic products), a new carbon customs duty or tax on imports, or the extension of the EU ETS to imports. Moreover, any option shall be assessed in relation to the WTO agreement (notably GATT Article XX, paragraph b[32]), EU's trade agreements and the complementarity with the EU ETS. Furthermore, any CBAM should be commensurate with the internal EU carbon price.

The feedback from 224 respondents on this Incept Impact Assessment reflects the vagueness of the Commission's proposal. Most respondents adhere to the idea that carbon leakage has to be avoided (be it for the sake of EU business and industry's competitiveness or to avoid shifting of CO2 emissions to elsewhere in the world) but show preference for adapting the EU ETS to make that system more carbon leakage proof than it is, instead of introducing new duties or taxes on import, the impact of which cannot be assessed at this moment. One of the respondents, BusinessEurope (whose membership includes national business federations in various sectors covering all-sized enterprises in thirty-five European countries), observes that Carbon Border Adjustments are a sensitive measure for business and industry.[33] Without taking a position neither for nor against a CBAM at this point of time, they expect that the EU ETS, including the system of free allowances reducing the risk of carbon leakage, is and should remain the key market-based instrument for Europe's industries and power sector to cost-effectively reduce CO2 emissions. As they expect that replacing the existing carbon leakage measures by untested mechanisms could create considerable uncertainties and risks for European industry, they call on the Commission to include at least one scenario in its impact assessment where a CBAM co-exist with the existing carbon leakage measures.

Three publications on the CBAM proposal (all in June 2020) provide, in my view, useful comment and analysis for further discussion on the options for a CBAM.

BusinessEurope published a more elaborated comment on carbon border adjustments in their report 'What can trade do for the climate'. They point at the need to explore more bilateral talks with regions and countries on linking the EU ETS with their carbon markets, and elaborate on six guiding principles which, in their view, should be followed for assessing the impact of any CBAM option.[34]

In a policy paper of the think tank Europe Jacques Delors, 'Greening EU trade 3', the authors go into the history of previous proposals for carbon border adjustment mechanisms, the legal and political obstacles, the criteria for success and the fundamental characteristics of the CBAM and modalities of implementation. They

[28] Outcome of the Council Meeting of 12 Feb. 2019, 6301/19, at 5, https://www.consilium.europa.eu/media/38505/st06301-en19.pdf.

[29] COM(2019) 640 final, para. 2.1.1., at 4.

[30] More recently, the European Economic and Social Committee has stated that, since the impact of CO2 emission is global in scope, its price (in the form of a Carbon tax) should be the same everywhere and as long as that cannot be realized, the need of a border tax adjustment mechanism arises. *See* EESC, *Opinion on Taxation Mechanisms for Reducing CO2 Emissions*, ECO/512 (29 June 2020), para. 3.3 with fn. 8, https://www.eesc.europa.eu/en/our-work/opinions-information-reports/opinions/taxation-mechanisms-reducing-CO2-emissions.

[31] *See* Inception Impact Assessment (IIA), Ares(2020)1350037–04 Mar. 2020, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism.

[32] *See* P. Lamy, G. Pons & P. Leturcq, *Greening EU Trade 3 – A European Border Carbon Adjustment Proposal*, Eruope Jacques Delors 7 (June 2020), https://institutdelors.eu/wp-content/uploads/2020/06/A-European-Border-Carbon-Adjustment-proposal_EN.pdf.

[33] *See*, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism/F525247.

[34] BusinessEurope, position paper *What Can Trade Do for the Climate* (June 2020), https://www.businesseurope.eu/sites/buseur/files/media/position_papers/rex/2020-06-22_what_can_trade_can_do_for_climate_0.pdf.

conclude that a CBAM should be designed as an external transposition of the EU ETS, which as such will also need internal reformation in order to provide an appropriate and stable CO2 price floor.[35]

The Institute for European Environmental Policy IEEP published its report 'Making trade work for EU climate policy' in which they go into the various critical comments on the introduction of a CBAM and wonder whether a CBAM is what de EU really wants to double-down on. Pointing at the post-COVID-19 economy, carbon prices may prove to be too instable to support effective industrial decarbonization, they suggest and explain a two-track policy: pushing forward new standards on low-carbon, resource efficient products (which is non-discriminatory, comprehensive and compatible with wider EU environmental policy) as well as a CBAM. [36]

5 Last but not least: The impact of COVID-19

In March 2020, three months after the launch of the EU Green Deal, Europe was hit by the COVID-19 pandemic, leading to far-reaching health measures and measures to prevent a deep and long economic crisis.

As regards the crisis, in a special (marathon)meeting of the European Council (17, 18, 19 20 and 21 July 2020),[37] an ambitious and comprehensive package has been adopted, combining the classical Multiannual Financial Framework (MMF) with an extraordinary Recovery effort (under Next Generation EU, NGEU) destined to tackle the disastrous socio-economic effects of the COVID-19 crisis. As regards climate policy for the period 2021–2007, 30% of the total amount of the EU budget and NGEU expenditures shall support climate objectives. At the income side, new own resources will be generated by an EU tax on non-recycled plastic packaging (as from 2021), the proposed CBAM (as from 2023), and a revised EU ETS.

No one can predict how long it will take before the threat of COVID-19 becomes manageable and no one can make a reliable estimate of the size and duration of the economic contraction during and after this pandemic, both in developed and developing countries. [38] Anyhow, a deep economic crisis that could develop into a financial crisis, followed by a slow recovery, can be a setback for clean energy innovation and thus for the transition from fossil to sustainable energy, required to achieve the net-zero CO2 emissions targets in 2050.[39] As a result of COVID-19, the bumpy road to climate neutrality may become even more bumpy.

[35] Lamy, Pons & Leturcq, *supra* n. 32.

[36] Institute for European Environmental Policy IEEP), *Making Trade Work for EU Climate Policy: Carbon Border Adjustment or Product Standards* May 2020, https://ieep.eu/publications/making-trade-work-for-eu-climate-policy-carbon-border-adjustment-or-product-standards .

[37] Conclusions adopted by the European Council, EUCO 10/20, 21 July 2020, https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf.

[38] In its *World Economic Situation and Prospects Mid-2020 Report*, the UN estimates that the global economy is expected to lose nearly USD 8.5 trillion in output over the next two years., https://www.un.org/development/desa/en/news/policy/wesp-mid-2020-report.html.

[39] International Energy Agency, Clean Energy Innovation, Flagship report, July 2020, https://www.iea.org/reports/clean-energy-innovation?utm_campaign=IEA%20newsletters&utm_source=SendGrid.