



SCHOOL OF
TRANSNATIONAL
GOVERNANCE

CHOOSING THE RIGHT CLIMATE POLICIES: LOOK BEFORE LEAPING

CHAIRMAN'S EXECUTIVE SUMMARY:

Participants at the High-Level Policy Dialogue debated 3 topical hypotheses that would probably be addressed as part of the forthcoming Communication by the European Commission on a “European Green Deal”. These hypotheses were: (1) the use of carbon offset credits to fulfil a higher greenhouse gas reduction in 2030 than previously envisaged; (2) introduction of a carbon border tax as a measure to protect EU competitiveness; (3) the possible inclusion of transport and housing in the EU’s Emissions Trading System. Dialogue participants made arguments for and against each hypothesis. Possible ways of taking each issue forward were also identified.

While there were certain advantages of each hypothesis, overall the feeling of participants was that the drawbacks of each were considerable, and that there were risks of adverse consequences. While the issues underlying each of these hypotheses were acknowledged, the existing approaches in EU policy were on balance thought to be basically sound. It emerged clearly from the dialogue that policy strengthening would be required at all levels of governance in the case that the EU decides to increase its climate ambition in 2030, and reach the objective of carbon neutrality by 2050.

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The topics discussed at the Dialogue have been summarised for the purpose of this paper. The dialogue took place under the Chatham House rule, whereby no attribution of opinions expressed can be made.

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Issue 2019/08
December 2019

**POLICY
BRIEF**

The climate crisis is ever more serious.

There is urgent need for policies to be implemented to deliver the Nationally Determined Contributions made under the Paris Agreement. Europe has made a useful start in curbing its emissions since 1990 (minus 23.2% to 2018), but is not on track to meet its existing target of reducing emission by at least 40% by 2030, and even less a reduction target of 50%, or even 55%, by 2030 (yet to be decided)¹.

Several Parties to the Paris Agreement, including the European Union, have decided or are considering setting a goal of carbon neutrality, or “net-zero emissions”, around the mid-century. The ambition of such an objective is easily underestimated, and will require most of the economy to be completely decarbonised. Furthermore, a certain extent of carbon dioxide removals will be required to cover unavoidable emissions from certain industrial processes, some sectors of agriculture or international aviation.

Long-term targets are useful as clear indicators of the direction of travel, so as to frame policy development and steer new investment. However, it is obviously easier to sign-up to ambitious targets in the longer-term than to implement ambitious policies in the near-term. There is a mismatch in timing between the political cycle and the climate crisis. Even if we act now, results in terms of emissions reduction are only achieved in the medium- and long-term.

Fortunately, there are potential short-term benefits from carefully designed policies, in terms of jobs created by investments in the transition to a low-emissions economy, such as in renovating homes, in future-orientated industries embracing the circular economy, in new infrastructure deployment and in terms of air quality.

The political capital needed to steer such a transition must not be underestimated. Cost-efficiency and fairness are both crucial requirements of the policy-mix.

PART 1: TOWARDS A NEW APPROACH ON OFFSETS, IN THE WORLD AND IN EUROPE?

Carbon neutrality will require the decarbonisation not just of the electricity-generation sector, which itself will need to produce more electricity, but also industry, buildings and most transport modes.

Europe’s existing 40% reduction target for 2030 is a domestic target, excluding the possibility of using offset credits from outside Europe. If Europe’s climate ambition is to be further increased, it is likely that consideration of offset credits will be re-opened. The arguments in favour of using offsets will centre around cost-efficiency being an enabler of higher ambition and greater public acceptability. Those against will argue in terms of the weak environmental integrity of many offset credits, of investment flows leaving Europe, and also about the inequity of “low-hanging” abatement possibilities flowing to richer countries, leaving more costly abatement options to fulfil commitments made by project host countries under the Paris Agreement.

In the context of the Paris Agreement, under which practically all countries have made commitments, the exporting of offset credits must mean that the reductions cannot also count towards the emissions performance of the project’s host country. That would amount to double-counting. A credit exported must be matched by a debit somewhere else in a host country’s inventory.

The “reduction” achieved in the host country will usually be one made in comparison with a business-as-usual scenario in the host country, and the credit generated will be used to cover higher emissions in the purchasing country. While this might be described as a “zero-sum game”, where reductions in one country merely compensate for extra emissions in another, the reductions do lead to lower-emission investments in the host country than would have occurred in the absence of the project.

The desirability of using offset credits in the purchasing jurisdiction is to lower the compliance costs of meeting a given emissions target, although the investments are located outside the jurisdiction. While cheaper compliance enables greater ambition for the same investment cost on a global level, the downside is an outflow of funds that could potentially go towards financing the low-carbon transition in the country buying credits. This is not necessarily the best way to create jobs and cleaner investments in the local economy.

In the discussion of this session a recurring theme was the importance of strong governance to ensure environmental integrity. Ensuring the absence of double-counting, the additionality of the projects, the robustness of methodologies to quantify emissions reductions, the traceability of credits and their irrevocable cancellation when used for compliance are all fundamentally important criteria. The effective application of these criteria both in the host country and the country where the credit is used for compliance purposes pre-supposes a robust and transnational governance mechanism. Equally important is for there to be an approximate balance between the supply and demand for credits. If credits are abundant and there is substantial over-supply, the scarcity (and hence value) of offset credits will be low. As such, the purchaser will have little incentive to change behaviour and reduce emissions. In the contrary case, if credits are very scarce, then the economic advantage of lower cost abatement in host countries would be lost. A balance therefore needs to be struck between supply and demand.

The experience of the EU’s Emission Trading System (EU ETS) was first to be open towards offset credits. There were so many of them available that the price fell, and European emitters acted rationally in trying to maximise the use of credits up to the

¹All reductions mentioned in this Policy Brief are compared to the level of greenhouse gas emissions in 1990.

maximum levels allowed (fortunately there were maximum limits set). However, due to serious doubts about the robustness of governance of the Clean Development Mechanism (CDM), the EU has gradually closed down the scope for using offset credits and from 2021 no credits at all can be used for compliance within the EU ETS. The EU ETS was undoubtedly put in grave danger by the abundance of offset credits that were not always of high environmental quality.

There was considerable discussion on the offsetting system to be partially introduced in 2021 by the International Civil Aviation Organisation (referred to by its acronym “CORSIA”)². Views within the group varied, from CORSIA being considered as a “very poor agreement” to “an agreement with real potential to make a difference”. The majority of participants were of the view that CORSIA was not robust enough and suffered from weak governance. There was particular concern that double-counting was not addressed sufficiently. Compliance and control would be ensured by the administering country of each airline, potentially giving rise to different treatment of operators on the same route.

There was also a high probability that the potential supply of offset credits would far exceed demand generated by CORSIA, and that the result would be a very low, almost negligible carbon price. If this were to prove true, CORSIA would be seen as a very weak instrument of questionable environmental added value. In these circumstances it could be expected that Governments would be pressured to apply more stringent measures to address the rapidly growing emissions from international aviation.

Finally, it was discussed how using old offset credits, relating to projects established before the Nationally Determined Contributions were made, could not be additional reductions instigated as a result of the Paris Agreement. Investment in projects that pre-date the Paris Agreement could not have been motivated by any agreement that had not yet been reached. The same argument can be used in the context of CORSIA, which was not envisaged before 2013.

CONCLUSIONS PART 1:

1. We need market-based solutions to reduce the cost of fulfilling commitments made under the Paris Agreement. Offset credits can only be a transitional solution, as ultimately all countries will need an absolute cap on emissions, and to achieve substantial reductions of domestic emissions in absolute terms.
2. Good governance is at the heart of implementing the Paris Agreement. The Paris Agreement is a “bottom-up” agreement, which makes the question of robust governance more complex. Governance is linked to credibility when it comes to the rules governing offsets. If the EU were to pursue offsets in the future, it would have to guarantee strong environmental credibility, if necessary by setting up its own governance system. The EU has the hard capacity to regulate governance, and perhaps it could do that with like-minded States. The EU is already de facto a robust carbon grouping of countries, and maybe that could be extended to wider group of countries. The existing “Florence Process on Carbon Markets” is already a precursor network of countries or regions that have established carbon markets within their jurisdictions, and could extend its reflections to cover offsets and high standard-setting.
3. Companies are global and will be regulated in different ways in different jurisdictions. They might unilaterally choose to be covered by a strong governance system that would facilitate credible offsetting that optimises cost-efficiency across their worldwide operations. This may be especially true of companies that commit to carbon neutrality.
4. Offsets are a lower-cost solution, and there is nothing wrong with cost-effectiveness if it ensures environmental integrity. It also means that ambition can be raised. Equity and social fairness must be taken into account or grand climate ambitions may backfire.
5. The idea of developing possible sectoral orientations for offsets may be an idea worthy of further research and reflection.

PART 2: CARBON PRICING AND COMPETITIVENESS: A CASE FOR BORDER MEASURES?

Climate policies have cost implications, and as climate ambition increases, the risk of adversely impacting the competitiveness of European industries increases. Conscious of this fact, the European Union has taken specific measures to address the issue. However, if the EU is about to increase its ambition to achieve a 50%, or even 55%, reduction of its emissions by 2030, and assuming that industry will play a role in achieving this goal, then there is clearly a risk to EU competitiveness. One possible way to address this risk, as mentioned on several occasions by European Commission President von der Leyen, is a carbon border tax. Furthermore, the winner of the Noble Prize for Economics in 2019, William Nordhaus, has advocated the formation of carbon “clubs” as a means to protect competitiveness.

So far, the EU has addressed the competitiveness of the industries covered by the EU ETS by the maintenance of free allocation to exporting industry sectors. This is the compromise reached by all the European institutions in the context of the target to reduce the EU’s emissions by 40% by 2030. In 2018 the equivalent of approximately EUR 11.6 billion was allocated to European industry for free, which has been criticised by some as a “fossil fuel subsidy”. Generally speaking, economists prefer allocation to be by auctioning as opposed to free allocation, but EU legislation foresees partial free allocation to continue through to 2030.

If going beyond a 40% reduction by 2030 requires an increased effort from industry sectors covered by the EU ETS, then this will re-open the question of preserving competitiveness. Industry is rightly concerned about maintaining its competitiveness, but exporting industries are equally concerned about an escalation of protectionism, and possible retaliatory action. The European Commission has framed such a carbon border tax as needing to be compatible with World Trade Organisation rules.

The design of measures to protect competitiveness is not simple. It cannot be automatically assumed that the EU has a carbon regulatory burden and that the rest of the world is doing nothing. The extent of climate regulation varies across the world. However, there is a striking lack of comparable emissions data relating to traded products upon which to base any possible carbon border tax.

Given that free allocation and a carbon border tax are both intended to protect competitiveness, there would be a real risk of over-compensation of EU producers if both instruments were to be used simultaneously. To prevent undue advantage being gained by EU producers, which would more likely be found incompatible with WTO rules, it was widely felt that free allocation should be discontinued in the case of a carbon border tax.

Whether exports from the EU should be relieved of any domestic carbon charge was also debated. Such an exemption would be complex to administer and would also reduce the scope and environmental effectiveness of the EU ETS. Exporters would no longer be incentivised to reduce their emissions within Europe, which is a fundamental objective of the system. Furthermore, the accounting rules under the UN Framework Convention on Cli-

mate Change and the Paris Agreement would still attribute emissions from production on EU territory to the EU.

In the absence of detailed data on the carbon content of imported products, WTO compatibility could still be possible if imports were subject to a carbon charge equal to the EU average for the same product, and allowing the importer to claim lower liability if lower carbon content could be established under equivalent Monitoring, Reporting and Verification rules as applied within the EU. Lower liability to the carbon border tax could be won at the expense of greater administrative complexity (but not more than EU entities are subject to).

However, there is a general presumption in this debate that imported products are “dirtier” in terms of emissions than equivalent EU production. Such a presumption may be false. European production facilities are ageing while installations in emerging economies tend to be more recent, so that the carbon intensity per unit of production of non-EU sources products may in some cases be lower than equivalent EU production. In the case where there is no equivalent EU production, the benchmark for application of the carbon border tax might be a world average, against which lower emissions intensity might be demonstrated.

Rather than apply a carbon boarder tax to all imported products, the tax might apply rather to limited types of energy or energy-intensive products such as: coal, oil, gas, electricity, iron and steel, lime, clinker and cement. Electricity and gas imports to the EU were seen as feasible starting points for testing a carbon border tax.

WTO compatibility is nevertheless a high bar to meet for a carbon border tax. The minimum needed is for a debate in the WTO context to begin in earnest. WTO processes are slow, so if EU action is conditioned as it has been, there is a need to start the process soon. A long discussion in the WTO context should be expected.

The Nordhaus model of carbon clubs is to have political alliances: countries would either be “in” or “out”. Such a construction is less likely to be compatible with WTO rules. If a club were to take into account different degrees of carbon content of imported goods, this would de facto create a halfway status that would undermine the political nature of the alliance. It must also be borne in mind that there are many other factors that impact on competitiveness beside carbon regulation, such as the financing of State Owned Enterprises.

The value of a carbon border tax is as much in the threat as in the implementation. However, the threat must be credible, and the EU would ultimately have to be ready to act. Some questioned the political resolve of the EU, which did not prove to be sufficiently strong when retaliatory action was threatened in response to the inclusion of international aviation (flights to and from third countries) into the EU ETS. That carbon border taxes should be discussed again has some logic to exert pressure on other countries, and corresponds with the self-declared “geopolitical” European Commission that has recently been established. It was gen-

erally welcomed that the new Commission shows a willingness to defend European interests.

A final phase of discussion returned to the current practices of the Commission with regard to trade agreements agreed with environmental chapters, introducing conditionality with Paris Agreement implementation. This is clearly another way of incentivising third country partners to introduce carbon constraints (that may be implemented differently, but which would feed through into an economic cost on competitiveness of production by that country).

In the context of enhancing competitiveness, the Innovation Fund of the EU ETS was widely welcomed, in addition to research funding under the EU's research programmes. Suggestions were made

to expand the Innovation Fund's resources. Innovation, and its deployment at scale, by European industry was seen as essential to economic growth. An Industrial Strategy was suggested that would look at what was strategically important for Europe, be focused and not constrained by technological neutrality. Europe should not become a gated economy that was not competitive, unattractive to new investment. It would be in Europe's interest to create a "safe-space" for innovation. Europe already has the disadvantage of low economic growth and an ageing population. In this context, it was doubtful that a carbon border tax would turn this situation around. There was concern that it might, like Brexit, rather suck up resources.

CONCLUSIONS PART 2:

1. The discussion was beneficial in having explored the complexities of competitiveness and climate policy, and the carbon border tax instrument in particular.
2. The international debate on competitiveness impacts and a carbon border tax will take time and effort. There are different options, and choices will have to be made. WTO endorsement would be a long-haul exercise. This may be more feasible in a limited number of sectors (e.g. electricity imports).
3. We must avoid unnecessary complexity. A carbon border tax is an instrument and not a goal. Carbon competitiveness impacts could also be addressed in other ways (as has been done to present).
4. A quid pro quo of a carbon border tax will be the ending of free allocation. Industry will have to decide which of these two means of addressing competitiveness impacts they prefer. To have both would amount to a subsidy for EU industry that would never be WTO compatible.
5. The creation of a climate club, as advocated by William Nordhaus, would be a blunt, political instrument. The EU would have to be ready for a fight. More realistic would be to strengthen instruments to push innovation by industry, harnessing budgetary resources and focusing on technologies critical for the climate-transition. This would amount to an enlightened industrial policy.

PART 3: HOW TO ADDRESS EMISSIONS FROM TRANSPORT/HOUSING

Housing and transport are sectors covered by the Effort Sharing Decision and Regulation of the European Union. They are difficult to decarbonise sectors for all economies, not least due to the number of individual, small emitters and rising standards of living that tend to increase energy consumption.

Germany has recently been going through a robust political debate on carbon pricing and how to address the emissions from these two sectors. A national upstream emissions trading system has been developed for these sectors. The approach taken builds upon existing tax practices and anomalies. The German regulations have been adopted very quickly. Germany would like its national approach to become the core of cross-border cooperation. Revenues raised would go, in part, to fund public transport.

One main topic of debate was whether road transport should be brought into the EU ETS. Views varied: on the one hand, it was

strongly felt that transport should not be brought into the EU ETS. CO2 standards for vehicles have worked, and these standards need to be further strengthened over time. Taxes on fossil fuels also need to be increased through revision of the EU's energy taxation Directive. The fear was expressed that including road transport and buildings in the EU ETS would weaken the responsibility of Member States for reducing emissions in these sectors, although this argument was contested. Furthermore, it was felt that it was better not to risk adding difficult new sectors to the EU ETS, which was possibly too fragile to integrate road transport, only recently exiting from a decade of weak carbon prices.

On the other hand it was also argued that road transport should be bought within the EU ETS – so as to be brought under a cap. California had done this. This would add additional inelastic demand within the EU ETS. It was pointed out that as road transport electrifies, it comes under the EU ETS. It would even be possible

to develop a “downstream” ETS for road transport, where those registered as the vehicle user, would have a liability to pay based on annual distances driven multiplied by the CO2 emissions of the vehicle. The liability could be settled by payment of a charge linked to the price of allowances in a given period, and, so as to have a cap on emissions, an equivalent number of ETS allowances would be subsequently cancelled. De facto this would have much the same effect as an increase in fuel taxes.

Some favoured the market-based based emissions trading approach and some were strongly in favour of fuel taxation, also for housing. It was widely agreed that the energy taxation rules needed to be updated. It was understood by all that taxes on fuels could be increased in a fiscally neutral way. Care was needed in designing the “European Green Deal” to avoid the trap of triggering a “gilets jaunes” reaction. Taxes provided revenues that could be recycled for social reasons. Caution was voiced in exacerbating inequalities of certain groups, such as those living in rural areas that were more dependent on private transport and less likely to be connected to gas grids. The higher taxation of fossil fuels

could possibly slow fuel switching, and the air quality benefits that could be gained, by encouraging the continued use of locally supplied wood for burning. Local air quality benefits were both tangible and immediate. A strong case was made for deployment of a whole range of policies to address transport emissions, and not just pricing, such as investments in public transport, cycling infrastructure, parking policies, congestion charging, and road pricing for freight transport. It was widely supported that aviation and maritime transport should pay taxes on fuel used, like other transport modes.

Due to the inelasticity of transport demand, scepticism was expressed that pricing mechanisms would suffice. A high level of investment in new transport infrastructure was needed, from electric vehicle (EV) charging points, new clean synthetic fuels, rail and public transport investment, cycling lanes and pedestrianized town centres. High investment costs will be needed to prepare for the energy transition, and have to be paid for somehow.

1. Transport and housing are very sensitive sectors. Everyone has a view on them. These are also socially sensitive sectors, impacting people’s lives more directly. The EU ETS is likely to play only a minor part in the transport and housing sectors. The EU ETS works through costs and efficiency, whereas the transport sector is more complex. However, there was wide agreement that the aviation and maritime sectors could be integrated into the EU ETS.
2. Sub-European levels of governance are more important for the transport and housing sectors. A mixture of many instruments is needed, and the effort-sharing targets for 2030 will not be met without meaningful new measures. The EU should not hinder such measures. Step-by-step approaches are more judicious.
3. Energy taxation urgently needs careful review and reform, removing inconsistencies, such as the exemptions of important modes of transport, such as aviation and maritime. This could potentially be done through qualified majority voting³. Revenues generated can be recycled towards innovation and social cohesion.
4. We need multiple short-term measures, which also improve air quality, such as parking and congestion charges. National Energy and Climate Plans need to be comprehensively scrutinised at EU level so as to ensure the adequacy of measures in the transport and housing sectors.
5. We need a quantum leap in terms of investment. Capital is available, but we should look at the Stability and Growth Pact rules to make investment easier in the necessary low-carbon infrastructure.

The meeting was closed with the conclusion that while the set of climate policies deployed in Europe was more complete, and generally functioning better than ever (with a carbon price under the ETS of EUR 25 a tonne, and revenues accruing as a result generally being used for good purpose), there was absolutely no room for complacency in view of attaining climate-neutrality in Europe by 2050. More and strengthened policy initiatives at all levels of governance would urgently have to be developed in the coming months and years. The forthcoming “European Green Deal” was an opportunity to be seized.

³ Subject to agreement by the European Council.

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Co-funded by the
Erasmus+ Programme
of the European Union



The European Commission supports the EUI through the European Union budget. This publication reflects the views only of the author(s), and the Commission cannot be held responsible for any use which may be made of the information contained therein.

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