

section three  
connecting budget revenues to policy delivery

## connecting with carbon taxation

**Eulalia Rubio**  
**Notre Europe**

**The establishment of a common EU regime for carbon taxation would not only help the EU reduce carbon emissions but it would also provide the basis for the creation of a new EU own resource as a means of financing the EU budget.**



Researcher at Notre Europe (Paris), Eulalia Rubio holds a degree in Law from Pompeu Fabra University (Barcelona), a degree in Political Science from the Autonomous University of Barcelona and a PhD degree in Political Science from the

European University Institute (Florence). Before joining Notre Europe, she had been research assistant at the Department of Social and Political Science at Pompeu Fabra University.

An idea that pervades much of the discussion of EU budget reform is that the problems essentially fall on the expenditure side. The EU budget, it is argued, is a ‘relic of the past’. It is heavily tilted towards agriculture and cohesion and does not provide adequate finance to address today’s most acute EU challenges: global competitiveness, energy security or climate change. Budget reform is urgently needed, it is claimed, to “focus EU spending on the right areas”.

The European Commission itself has adopted this way of thinking all too quickly. One simply has to look at the way it organised the 2007-2008 budget review. While the mandate from the European Council was for a “comprehensive assessment of both expenditures and revenues”,<sup>1</sup> in Commissioner speeches and formal documents the review has been frequently portrayed as an historic opportunity “to discuss future EU priorities and spending needs”.<sup>2</sup>

No one can neglect the importance of revising the EU’s spending priorities. Yet a narrow focus on expenditures alone is a recipe for failure. History reminds us that previous attempts to undertake an ambitious reform of EU finances have only succeeded when tackling simultaneously all the elements of the budgetary system: expenditures, revenues and procedures.<sup>3</sup> We can endlessly debate EU spending priorities, but this will serve to no avail if we do not address simultaneously the structural factors explaining the path-dependency of EU budgetary negotiations.

One of these factors is the structure of the revenues. The EU is currently financed by three revenue sources: i) custom and agricultural levies (the so-called TOR, or ‘Traditional Own Resources’); ii) a levy on national Value Added Tax (VAT) receipts and iii) member states’ contributions paid according to levels of Gross National Income (GNI). While initially conceived to play a residual role, over the last decade this GNI resource has come to

represent three-quarters of total revenues, as detailed in Table 1.

**table 1 - structure of EU finances  
(in percentage share of revenues)**

	1992	1996	2000	2005
TOR	23.6	19.1	17.4	13.9
VAT	61.8	51.4	40	15.9
GNP/GNI	14.5	29.6	42.7	70.3

Source: European Commission

### three clear weaknesses

This system of financing has proved to be a stable basis for multi-year planning, and ensures that the EU does have sufficient resources to balance its budget. But there are three clear negative implications for the EU budget that flow from this revenue structure.

Firstly, the overwhelming dependency of the EU budget on national contributions has an influence on the way EU spending decisions are taken. The overt character of national contributions, which have a clear link to national treasuries, accentuates member states' tendency to calculate their net budgetary return (that is, the difference between what they pay and what they receive from the EU).<sup>4</sup> The result is a decision-making process conducive to the status quo, as member states tend to adopt a conservative stance and focus on defending a 'juste retour' from their budgetary positions.

Secondly, the strong EU dependency on national contributions has resulted in a growing reluctance to increase the size of the EU budget, despite increasing demands placed on it. The logic of net returns places particular pressure on those policy areas providing diffuse benefits for the whole of the EU. It is not entirely coincidental that calls from member states for a capping of the budget

started in the early 2000s, just at the time when national contributions had come to represent almost 50 per cent of total EU revenue.<sup>5</sup>

Thirdly, the current approach to financing the EU is one that neither contributes to nor supports the delivery of EU policy outcomes. In this respect, one should take into account that taxes or levies are not only means of yielding revenues, but are also direct policy instruments in their own right. They can serve to alter patterns of consumption (ie reducing consumption of tobacco or levels of CO<sub>2</sub> emissions) or induce other actors to adopt the right decisions (ie raising R&D investment).

All EU member states use tax policy as a matter of course in the pursuit of their policy outcomes, and a strong case can be made for the EU to do so too. Given that the EU has both a low budget and practically no direct implementation capacity, tax instruments could play an influential role in supporting the achievement of shared EU policy objectives. Besides, there is a strong economic logic in undertaking or aligning taxation at the supra-national level to address cross-border spillover effects.<sup>6</sup> Such an approach could help avoid a race to the bottom of member state tax competition as well as providing a visible means of reconnecting the EU to its citizens.

### taxation is needed to combat climate change

During recent years, the EU has shown strong commitment to the fight against climate change. The EU's effort to curb greenhouse gas (GHG) emissions has principally consisted in the establishment of a carbon emissions trading scheme (ETS). The ETS is the largest such scheme in the world, covering more than 10,000 energy generation and industrial sites across the 27 member states, and the EU should be praised for establishing it. Yet, it still presents some weaknesses, particularly in

respect to emissions caps and the auctioning of allowances, which have not been fully resolved by recent reforms.

More worryingly, the ETS is only a partial answer to the problem. The system covers less than half of the greenhouse emissions in Europe. In particular, it does not include direct emissions from households; the service sector; transport (the second largest source of emissions in Europe); nor emissions from waste and agriculture. All together, the non-traded sectors represent about 60 per cent of total GHG emissions in Europe.

The non-inclusion of transport in the ETS is particularly worrying. Transport sector greenhouse gas emissions – of which more than 90 per cent are due to road transport – increased by 26 per cent from 1990 to 2007. This compares with a reduction of emissions in all other main sectors. In fact, among the main polluting sectors, transport is the only one that has increased in volume of emissions over the past twenty years.

So far, the EU strategy to address transport emissions has consisted of the promotion of biofuels and increased fuel-efficiency for vehicles. However, as pointed out by the European Environment Agency, an exclusive focus on transport supply-side measures will not suffice to reverse the trend.<sup>7</sup> The increase in transport GHG emissions has occurred even though vehicles have generally improved their energy efficiency. Thus, whereas average emissions from new cars have decreased by 12.4 per cent from 1996 to 2006, over the same period car ownership has increased by 26 per cent and passenger car use – calculated in terms of km per passenger – has increased by 18 per cent. Similarly for freight transport, road- and air-freight volumes have grown considerably (45 per cent and 43 per cent respectively), reflecting a shift away from more environmentally efficient rail and maritime transport.

To reduce transport emissions, existing policies will need to be complemented with pricing measures able to influence consumer behaviour and therefore demand. The same is true for other non-ETS sectors. In the field of housing, for instance, the EU regulation on energy labelling has shifted consumer buying behaviour towards the purchase of more energy and water-efficient home appliances. Yet, energy consumption has grown by an average of one per cent a year between 1990 and 2005.<sup>8</sup>

It is therefore time to recognise that taxation is essential to curb carbon emissions in non-ETS sectors. But in order to move in this direction, a coordinated EU approach will be needed. The recent French debate on national carbon taxation shows it is difficult to convince national public opinions to accept higher taxes if the rest of the EU does not follow the same direction. This is not least because the maintenance of different levels of taxation on energy sources creates distortions in the EU internal market, a problem that is particularly acute in the field of transport.

Most importantly, an EU approach will be required because there is little interest or political will to introduce carbon taxation at national level. Over the past decade, only a few member states have introduced national carbon taxes (Denmark, Sweden and the UK), while the levels of energy taxation in the EU25 have decreased, passing from 2.1 per cent in 1993 to 1.8 per cent in 2007. Hence, if carbon tax policy is left to national governments to decide on their own, the most likely scenario will be a continuous downgrading of energy or carbon taxation in national fiscal regimes, undercutting attempts to reduce carbon emissions.

### **designing an EU regime of carbon taxation: different options**

There are a number of alternatives to establishing an EU regime of carbon taxation.

In a recent study for Notre Europe,<sup>9</sup> Eloi Laurent and Jacques Le Cacheux sketch out three possible scenarios.

The first is the climatic conversion of existing energy taxes through a reform of the EU Directive on Energy Taxation.<sup>10</sup> Adopted in 1997 and modified in 2003, this Directive sets the minimum rates for the taxation of all sources of energy (mineral oils, coal, gas and electricity). However, at present these minimum levels do not reflect the environmental impacts of different fuels and, in most cases, they are too low to have an impact on consumer demand.

A way to resolve this problem would be to divide the current minimum level of taxation into two components that refer respectively to the energy content and environmental impact of each energy source. In this way, member states would then introduce a tax on all fuel sources according to their energy content, but also by reference to the carbon emissions attributable to them.

This option, which is built on a proposal by the European Commission in 2007,<sup>11</sup> would be relatively easy to implement. Yet, as noted by Laurent and Le Cacheux, it would still consist in the establishment of minimum rates alone, and would therefore not resolve the problem of distortions within the single market due to different national tax rates.

A second possible scenario is the creation of a new EU harmonised energy or carbon tax on the use of fuels in the main non-ETS sectors (transport and housing). This approach could take inspiration from a proposal for an EU carbon tax presented by the European Commission in 1992<sup>12</sup> in the context of the preparations for the Rio Earth Summit. This consisted in the establishment of a harmonised tax of hybrid type, taxing fossil fuels according to both their energy content and the carbon emissions emitted in their use. The proposed tax was intended to cover all sectors but it envisaged the possibility of

exempting the most energy-intensive sectors (such as the steel and cement industries), which are now covered by the ETS. It was intended to be introduced in stages, starting at a level equivalent to \$3 per barrel of oil in 1993 until reaching a level of \$10 per barrel in the year 2000.

There is no doubt that such a proposal would encounter strong political resistance. The reluctance of certain EU member states to any type of fiscal harmonisation is well known. Besides, fiscal matters are subjected to unanimity vote by the EU treaty, meaning that the opposition of any single member state would suffice to block an initiative of this type for the introduction of a new EU tax. On the positive side, this proposal would be superior to the first in that it would establish a common carbon price in Europe for non-ETS sectors.

Finally, the third scenario would be the creation of an EU carbon added tax. Based on the same principles as the existing VAT, this tax would be levied on all goods according to their carbon footprint. Such a tax would provide financial incentives to both producers and consumers, as those goods with lower carbon footprints would be financially advantaged. Besides, unlike other options, it would also tax imports, hence eliminating the problems of carbon leakage and loss of competitiveness. On the other side, it would be very difficult to put into action, not only due to political resistance but also because of technical obstacles in assessment and implementation. In particular, the creation of such a tax would require all EU firms to be able to calculate their carbon footprint, something that is difficult to envisage in the short term.

### **the double dividend of an EU carbon tax**

The establishment of a common EU regime for carbon taxation would have an additional advantage: it would not only help the EU

reduce carbon emissions but it would also provide the basis for the creation of a new EU own resource as a means of financing the EU budget.

There are various reasons why an energy or carbon tax can be a good EU tax candidate as a source of EU revenue. At present, national energy taxes raise an amount equivalent to about twice the level of EU expenditure, which converts them into a potentially buoyant source of revenue for the EU.<sup>13</sup> Although the levels of energy taxation are rather diverse across Europe – and therefore any attempt to introduce an EU energy or carbon tax would require a previous effort of harmonisation – the differences in tax rates have diminished over the last decade. Last but not least, an EU carbon tax would offer an important advantage with respect to other options: it would be popular, and clearly linked to EU policy priorities.<sup>14</sup>

The easiest means of implementation would be the establishment of an EU surcharge on existing energy taxes, or on a specific national tax (ie the excise duty on motor fuels). This could be combined with a reform of the EU energy tax directive as proposed above, so that the EU surcharge could consist in the revenues yielded by the environmental component of the tax. Another, more ambitious option would be the establishment of an EU harmonised tax (scenarios 2 and 3 above) and the use of the revenues yielded by this tax (or part of them) to finance the EU budget.<sup>15</sup>

Finally, it should be taken into account that the introduction of an EU carbon tax would lead to a heavily unbalanced distribution of financial burdens among member states. In particular, the poorest countries would be the major losers of its introduction, as the ratio of fuel consumption relative to GNI decreases with increasing national wealth. Yet this should not be a categorical impediment to the creation of the tax. As noted in the 2008 budget review study for the European Commission by Begg et al,<sup>16</sup> one might

imagine different alternatives to offset the distributional consequences of the carbon tax, such as the creation of another EU tax or the establishment of an automatic equalisation scheme. Besides, if the revenues provided by this tax are earmarked for action on climate change – ie support for low-carbon energy systems and climate adaptation measures – poorer member states countries would be particularly advantaged.

## conclusions

The introduction of an EU carbon tax would have direct benefits for both the achievement of EU policy outcomes and the political standing of the budget as a whole.

On policy delivery, a carbon tax could help drive emissions reductions from the sectors not covered by the ETS, particularly in the transport sector. By being introduced at EU level it would avoid many of the economic pitfalls that make national introduction of carbon taxation so difficult.

For the EU budget itself, the introduction of a carbon tax as a new own resource could help break the dominance of the GNI resource, creating a new political dynamic in favour of the delivery of European public goods and away from the current logic of net balances.

On both topics, ambitious action is required to breakthrough on delivering EU added value. Without attention to the revenues side of the EU budget, any efforts at reform in the coming years are liable to fail.