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A UNIFORM CARBON PRICE FOR EUROPE

Joint Statement of the Council of Economic Analysis (CAE) and the German Council of Economic Experts (GCEE)

Climate policy is at the top of the agenda in many European countries. Its urgency is documented by the projected non-compliance with the national carbon reduction goals stipulated in the European effort sharing agreement. The French Council of Economic Analysis⁽¹⁾ and the German Council of Economic Experts⁽²⁾ have independently published reports on the economic policies needed to address climate change, stressing that ultimately a uniform price for CO₂ is a must to reduce emissions at palatable cost.

We publish this joint statement to emphasize the potential for a Franco-German initiative in climate policy and the need for European cooperation in this area. The councils endorse implementing a uniform price on CO₂ emissions. In our view, officials need to increase their efforts to explain to the public the circumstances and options for a reduction of CO₂ and, particularly, how the strategy of carbon pricing can be augmented with an effective mechanism for returning the revenue to the private sector. Both councils will also intensify their efforts in this respect.

The question of political acceptability is crucial for the design of a successful carbon pricing scheme, as illustrated by the yellow vest movement in France. While an economically efficient carbon pricing scheme requires a uniform CO₂ price encompassing all sectors and countries, the precise form of distribution of the corresponding revenues (to households and firms) remains a national affair.

A uniform carbon price across all EU member states and sectors

A uniform price on CO₂ allows for achieving the emission reduction objective at the lowest cost and leaves the choice of implementation and the area of emission reduction to economic actors. Ideally, the price signal implies a uniform price across all sectors and industries, which pertains in as many countries as possible. Due to the inherently global nature of climate policy, actions are best taken at the global level.

Yet, even if it only held across EU member states, a uniform carbon price across member states would allow achieving the goals set in the Paris agreement more efficiently than an array of national approaches. As goods and services can flow freely within the EU, a uniform carbon price would also avoid carbon leakage and distortions of competition within the EU. If necessary to achieve commitment, a redistribution of funds across countries could be part of the efforts to extend the carbon price to all member states.

(1) "A Proposal for the Climate: Taxing Carbon not People", Dominique Bureau, Fanny Henriët and Katheline Schubert, *CAE Note*, no 50, March 2019.

2 *Setting Out for a New Climate Policy*, Special Report by the German Council of Economic Experts, July 2019.

The natural choice to implement this uniform price for CO₂ would be an expansion of the European system for trading emission certificates (EU-ETS) to other sectors. We encourage the European Commission and the member states to take this step, not least because a homogenous treatment of CO₂ emissions would be an important element of the completion of the EU Single Market. If such an agreement comprising all member states cannot be forged in the short term, a group of countries led by France and Germany should move forward as a first step by introducing their non-ETS sectors into the EU-ETS to pave the way for eventually implementing an encompassing approach.

Such an extension of the EU-ETS might not be possible immediately, however, because it requires legal changes and political agreement. In that case, the group of member states should transitionally implement a separate CO₂ pricing scheme for the non-ETS sectors. This could either be achieved by establishing a separate trading system for the current non-ETS sectors, or by implementing a carbon tax. Irrespective of the concrete design of the pricing scheme, the price formed in an ETS or set by a tax should adequately reflect the intended reduction in emissions and provide a reliable signal for private investment decisions.

The implementation of such a uniform carbon price will necessarily have distributional consequences across and within member states. The distributional consequences across member states need to be addressed at the European level. Specifically, the initial allocation of certificates could favor poorer and historically more carbon-intensive countries to facilitate their transition. Furthermore, the EU regional and structural funds could provide further support for low-emission investments.

Distributional consequences within countries are best tackled at national level. We suggest returning a significant part of the national revenues collected through carbon pricing to households and companies in order to increase public acceptance and cushion the income effect, while preserving the incentives for behavioral adjustments. Regarding the distribution scheme to households, geographic location as well as the income level are two parameters that member states could take into account.

Pooling resources for research and development

Carbon pricing is a necessary component of any strategy to reduce emissions. Other strategies, such as regulations and public investment into environmental transition, can be important measures complementing the price signal. The incentives generated by the CO₂ price will be amplified, for instance, by public investments and regulations aiming to alleviate financial constraints or cognitive biases of economic actors, which might prevent them from adjusting their behavior even in presence of severe carbon pricing. In some cases, like for electric charging stations for electric vehicles, public investment might be needed to provide infrastructure and realize economies of scale.

Moreover, a considerable expansion of innovation activities and an accelerated pace of technological change will be necessary to achieve significant reductions in the cost of low-emission equipment and investment. Carbon pricing already stimulates green investment and innovation. However, in addition, research and innovation should be stimulated by various means to lower the cost of low-carbon technologies, since the investment decisions of private actors are at the heart of the national but also the global switch to these technologies.

Funding for basic technological research with large spillovers is best placed at supranational level, since private efforts tend to generate large social returns and would, thus, be undersupplied in the absence of sufficient public funding. France and Germany (potentially together with other EU member states) could pool their resources in this area to achieve economies of scale.

The funding of applied research is a more intricate issue, since the private entrepreneurial investment into the discovery process also tends to yield high private returns. Thus, any targeted funding of applied research should be disbursed on a temporary basis and in a transparent competitive process and should be open regarding specific technologies. It should also be subject to thorough ex-post economic evaluation that compares their cost with the CO₂ reduction they help to avoid.

Spearheading efforts towards a global carbon price

France and Germany together are responsible for only 3.2% of worldwide CO₂ emissions in 2016, and even the EU accounts for only 10.5%. Thus, even a complete decarbonization of the European economy would not be sufficient to significantly slow down climate change. The national contribution commitments submitted so far by its signatories are also insufficient to achieve the climate goals agreed upon in the Paris agreement. France and Germany should therefore spearhead increased international efforts to introduce carbon pricing –ideally a uniform CO₂ price– that is applied globally, or at least within an extended international coalition of countries that is to be as large as possible.

The strategy for implementing this price (e.g. through a carbon tax or an emission trading scheme) could be chosen by each region individually. In a future step, the different national pricing schemes could then be linked with the EU-ETS. A range of proposals suggests that the coalition of countries could employ trade measures at its border to avoid carbon leakage and incentivize other countries to join. They include import taxes on the CO₂ content of all goods imported from countries that do not engage in carbon pricing (border adjustment tax), a uniform customs duty against countries that do not share ambitious emission-reduction objectives adopted by a group of countries (climate clubs), and environmental commitments in trade agreements. They could also take place within the EU-ETS framework, by obliging member states to buy carbon quotas for imported goods. These proposals need to be analyzed and discussed in detail. It will be particularly important to avoid that such measures are utilized as protectionist measures.

Due to its emphasis on cost efficiency, a uniform carbon price might first lead to a reduction of CO₂ emissions mainly in poorer countries, which tend to have the lowest abatement costs. Contrary to often voiced political concerns, this does not mean that these countries would have to bear the bulk of the costs. By choosing a suitable initial allocation of certificates in a trading scheme or by implementing transfers through the introduction of various support schemes, developed countries could support the transition of poorer countries.

This support could especially help those countries that currently rely heavily on fossil fuels. More specifically, an enhanced international climate fund could foster investment in low-emission equipment and technology. Access to this fund should be made contingent on the country having implemented a carbon pricing scheme comparable to that within the coalition of countries. Furthermore, a comparable pricing of carbon should be an important part in the negotiations of future trade agreements. Hence, there is a wide range of approaches centered on carbon pricing that allow France and Germany to together pave the way for a more efficient international climate policy.