



CENTRO STUDI SUL FEDERALISMO

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## **AFTER THE DROP IN OIL PRICES NOW IS THE TIME FOR A CARBON TAX**

*Alberto Majocchi \**

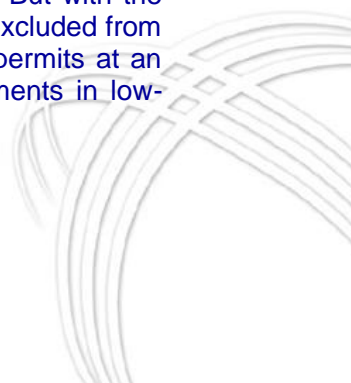
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In just over a year, since 2 January 2014 until 12 January 2015, the price of Brent crude has plummeted from \$107.78 to \$47.44, a fall of over 55%. In a time when the European economy is suffering from a severe recession and looming deflation has yet to be dealt with by courageous decisions from the European Central Bank, the reduction in the cost of energy should be a positive shock from the supply side and provide a boost in production. The problem is that Europe is primarily suffering from a lack of effective demand, so that measures which only act on the supply side are not sufficient. But the reduction in oil prices should also be a good opportunity for Europe to adopt important decisions to put in place the appropriate tools for combating climate change and to start the transition to a sustainable economy.

The European Union has already been leading in this area for some time. The European Council meeting of 23-24 October 2014 defined an ambitious strategy regarding climate and energy. Maintaining the same target set in 2007 for an 80% reduction in CO<sub>2</sub> emissions by 2050, the Council decided on: a) a 40% decrease in emissions of greenhouse gases in 2030 compared to 1990. The annual reduction in the cap on emissions under the Emission Trading System (ETS) will be taken from 1.74% to 2.2% in 2020. The emissions from the ETS sectors must reduce by 43% compared to 2005, while the reduction required will be 30% for sectors outside the ETS; b) the proportion of renewable energy in total energy consumption must reach 27% by 2030; c) there must be a 27% increase in energy efficiency, to be reviewed upwards to 30% in 2020.

However, the main problem is with the effectiveness of the tools used for achieving these targets. The ETS has been in operation in the EU since 2005, and this covers about 45% of the emissions and is applied to some 11,000 energy-intensive plants in electricity generation and in the manufacturing industry. This is a cap-and-trade mechanism which “caps” the emissions of some greenhouse gases, particularly CO<sub>2</sub>, and is progressively made more stringent. The companies forming part of the system receive a certain number of emission permits which they can sell or purchase (trade) depending on their needs. Limiting the number of permits allocated creates a market price for them. However, following the decline in production levels owing to the recession, there is now an excess number of permits, amounting in 2013 to over 2.1 billion, whose price has dropped to €6.70 and thus significantly curtailed the effectiveness of this tool to discourage the use of fossil fuels.

As regards the sectors not covered by the ETS – the domestic sector, agriculture, transport (except for the airline industry) and the construction industry – which together account for around 55% of total emissions, the European Council of 23-24 October 2014 decided to set national reduction objectives to ensure a 30% global reduction for these sectors by 2030. But with the recent fall in oil prices, it becomes possible to introduce a carbon tax in the sectors excluded from the cap-and-trade system and, at the same time, to set a minimum price for the permits at an equivalent measure to the carbon tax rate, at a level able to support the investments in low-carbon energy.



The carbon tax should be levied on fossil fuels taken from coal, gas and oil based on their carbon content, essentially a proxy for a tax on carbon consumption. Introducing this domestic tax should be accompanied by imposing a countervailing duty at the frontier (border tax adjustment – BTA) on imports of energy-intensive goods coming from countries that do not impose a price for using high carbon content fossil fuels. As noted recently by Lawrence Summers in the Financial Times, the BTA is essential to avoid that the risk of loss of competitiveness of domestic companies can reinforce their objections to introducing the tax, and it could also encourage countries not yet doing so to start using tools – of price or quantity – to limit emissions of greenhouse gases.

Two final considerations. The carbon tax would provide substantial revenues that could be at least partly used for the European budget, so as to guarantee the issue of the Eurobonds necessary for funding a sustainable development plan aimed at a “green” re-launching of the European economy. In practice, using the assumption based on the Commission’s proposal for a rate of carbon tax amounting to €20 per tonne of CO<sub>2</sub>, given that a barrel of oil emits about 0.3 tonnes of CO<sub>2</sub> and is equivalent to around 159 litres of petrol, the levy would amount to €6 per barrel or €0.0377 per litre. With a litre of petrol costing about €1.50, the increase due to the tax would be 2.5% and would mean an additional burden to households and businesses of only one-tenth of the reduction in the price of oil.

Based on the most recent data published by the European Environmental Agency, the total emissions of CO<sub>2</sub> in 2012 amounted to 4,522 million tonnes. If a carbon tax were introduced in the sectors outside the ETS, there would be revenues of about €50 billion (emissions in these areas amounted to about 55% of the total). Despite the necessary approximations in these estimates, it seems clear that the returns would be substantial.

The second consideration concerns whether Europe should proceed to unilaterally introduce its own carbon tax, while awaiting a decision on the introduction of a worldwide carbon tax, recently suggested by Jeffrey Sachs, to be used to finance the Green Climate Fund managed by a World Environment Organisation within the United Nations. If the tax is structured to impose countervailing duties on imports and if there is a significant fall in oil prices, the carbon tax can be introduced without negatively affecting the competitiveness of European industry while still allowing households and businesses to largely gain from increases in real income arising from the reduction of energy costs.

*\* Professor of Public Finance at the University of Pavia; Board Member of the CSF (Centre for Studies on Federalism)*

(The opinions expressed here do not necessarily reflect those of the CSF)

