Aligning EU Investment and Climate Targets

How the EU Budget can help Member States in reducing emissions

November 2018

A Joint Position Paper By:

Summary

The Commission presented proposals relating to the post-2020 EU budget in May and June 2018. The next EU budget spans from 2021 to 2027 and the revenue streams, as well as where the money will be invested, are both topics of discussion for MEPs and Member States ahead of 2020.

The EU budget has the potential to be a positive driving force in reducing emissions across all sectors. It can also help Member States meet their climate targets and encourage smarter public investment. There are a number of fiscal measures relevant to the EU budget that can help the EU play an important role in mitigating climate change:

Connecting Europe Facility and the European Regional Development Fund - The EU budget should prioritise zero-emission investment post-2020 by giving such projects preferential treatment when considering applications. Such investments should help EU countries meet their national climate targets.

Emissions Trading System - If 20% of the ETS auctioning revenues are to become Own Resources for the EU budget then it's imperative that 100% of this revenue is invested in climate projects.

European Tax Directive - The ETD must be revised to redefine minimum tax levels for various transport fuels. As the Directive has not been revised since 2003, the current minimum rates do not adequately reflect the climate impact of such fuels. A portion of fuel tax revenues could become new own resources for the EU budget as recommended in the Monti report.

The infrastructure that the EU invests in between 2021-2027 will be maintained for decades once constructed. Therefore, it is vital for the EU to invest in infrastructure that helps the Member States meet the climate targets. Such investment would help improve energy sovereignty, improve EU competitiveness, and reduce emissions from all sectors. This is the kind of EU that the EU budget should be helping to build.

1.1. Setting the Scene

The European Commission published legislative proposals throughout May and June 2018 on the EU budget for the period 2021 to 2027[1]. The EU budget has several spending schemes relevant to transport

[1] https://ec.europa.eu/commission/future-europe/eu-budget-future_en

and energy infrastructure, which include the Connecting Europe Facility (CEF), the European Regional Development Fund (ERDF), the Cohesion Fund, Horizon 2020, and InvestEU.
The legislative proposals presented earlier this year also included new "own resources" for the European Union[2]. Own resources are the income streams for the EU budget. Any new own resource requires unanimous approval by all EU member states.

The current EU budget amounts to approximately €1 trillion over a seven year period. It is imperative that spending is aligned with the EU's climate targets. Projects selected for EU funding must play a role in helping EU Member States reach their climate targets.

The Climate Action Regulation ("CAR" - formerly the "Effort Sharing Regulation") defines a 2030 target to reduce emissions by -30% compared to 2005 levels. The CAR relates exclusively to sectors outside of the EU Emissions Trading System (meaning transport, buildings, agriculture, industry, and waste). Transport accounts for 35% of CAR greenhouse gas emissions. The -30% target is the EU-wide average, meaning member states have their own unique binding climate target (calculated based on GDP). The EU budget should invest in zero-emission transport in order to help Member States achieve the CAR targets.

As part of the new Own Resources provision of the EU budget, the Commission has suggested to divert revenues generated by the EU Emissions Trading System (ETS) away from Member States and towards the EU budget. Currently, the EU ETS revenues are allocated to domestic budgets, except for a share of allowances which feed into specific EU funds for innovation and the modernisation of the energy system in specific countries. The Commission's 'own resource' proposal suggests to divert 20% of Member State's revenues into the EU budget, but this wouldn't apply to the revenues already earmarked for the innovation and modernisation funds.

This proposal is therefore strictly limited to the use of EU ETS revenues, without impacting the design of the carbon market in any way. It therefore does not set any additional incentive for decarbonising the European power and industry sectors, and whether or not it will benefit the climate hinges largely on how the EU will spend the funds, compared to Member State spending.

2. EU Budget Revenue Streams

The EU is in the process of agreeing upon its post-2020 budget and determining spending priorities for the 2021-2027 period. The EU budget (or Multiannual Financial Framework - "MFF") defines the budget of the EU for a set period (usually 7 years). The EU budget mainly co-finances projects, which means that the amount that the EU provides is only a portion of the final amount of investment that is triggered. Examples of where the EU invests are the Erasmus programme, transport infrastructure, energy infrastructure, agricultural subsidies, and research. The EU budget primarily aims to support common EU policies and objectives in areas where the EU has added value.

The EU budget is financed mainly through contributions from Member States based on their gross national income (GNI). In addition there are the so-called own resources that provide direct revenue streams to the EU. These includes value added tax (VAT) receipts, and customs duties collected at the external borders of the European Union.

Changes to the Own Resources Decision (adding or amending existing own resources) requires unanimity in the Council and ratification by all member states. Such changes have been made before as part of the legislative package accompanying a new MFF. For example, the Council adopted a new own resource in 2013 based on VAT that intended to improve transparency and strengthen the link with EU VAT policy and actual VAT receipts[3].

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1527242435118&uri=CELEX%3A52018PC0325
[3] https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-eu-finances_en.pdf

The Commission's proposal for new post-2020 own resources was published in May 2018[4]. It included the following new own resources:

- A 20% share of the auctioning revenue of the **European Emissions Trading System**;
- A national contribution on the basis of the amount of **non-recycled plastic packaging waste** in each Member State.
- A 3% call rate applied to the new **Common Consolidated Corporate Tax Base**;

In 2016, the former prime minister of Italy, Mario Monti, wrote a report called "the Future Financing of the EU"[5]. This report proposed to introduce new own resources alongside traditional own resources and the GNI-based own resource. Monti's report suggests a motor fuel levy (or excise duties on fossil fuels in general) and a flight ticket tax as two such "new own resources". Monti continues by saying that the revenue from such taxation could then either fully or partially be own resources for the EU budget, which means that part of the tax revenue collected would directly contribute to the EU budget whereas the rest would contribute to national budgets.

Transport or fossil fuel taxes are not explicitly included in the Commission's proposal but there is still time before 2020 to assess other measures than those proposed by the Commission, in particular those included in the Monti-report.

2.1. Transport

Transport is Europe's biggest climate problem, representing 27% of the bloc's greenhouse gas emissions. Transport accounts for 35% of CAR greenhouse gas emissions. There is an opportunity to raise revenue from transport for both the EU and national budgets while helping to tackle rising emissions from the sector. Taxing climate-intensive transport would encourage smarter transport behaviour and accelerate the uptake of cleaner technologies. As was outlined in a T&E position paper on the topic[6], the potential revenue from only three of such taxes could be over €50 billion per year. A small part of this could be used as an own resources for the EU budget – where it should be earmarked for climate spending. The bulk of revenue would become available to member states to reduce labour taxes or other economically harmful taxes.

[4] https://ec.europa.eu/commission/sites/beta-political/files/budget-proposals-modernising-budget-revenue-side-may2018_en.pdf
[5] https://ec.europa.eu/commission/sites/beta-political/files/communication-new-modern-multiannual-financial-framework_en.pdf
[6] https://www.transportenvironment.org/sites/te/files/publications/2018_02_TE_Own_resources_position_paper_final.pdf

Whilst tax policy is predominantly a national prerogative, each of the three measures included in the adjacent image are agreed at EU level. Diesel and petrol taxes are set in the Energy Tax Directive (ETD)[7]; kerosene taxes too are regulated by the ETD. The ETD defines the minimum level of taxation legally permissible in Europe for certain fuels. The adopted text goes back to October 2003. One of the key reasons why minimum tax rates for fuels are adopted at EU level is to reduce opportunities for Member States to lower fuel taxes to promote fuel tourism. In a number of small and centrally located EU countries (ideal for tax tourism) the EU minima are the effective tax rates. The ETD has been a key tool in preventing a race to the bottom regarding fuel taxation.

The ETD has not been reviewed since 2003. Updating the ETD to shift towards greener taxation would help in the fight against climate change, the reduction of labour taxes, and strengthen the economy[8].

2.2. ETS

The Commission's budget proposal for the 2021-2027 period would see 20% of the revenues generated by the sale of each EU ETS allowance directed into the EU budget, instead of going to national budgets of Member States. After 2020, at least 450 million allowances will be auctioned under the EU ETS to support innovation (the Innovation Fund) and 2% of the overall allowances will be auctioned to modernise existing power infrastructure (the Modernisation Fund). The 20% share diversion to the EU budget will not apply to these two funds.

This new use of ETS revenues will also not apply to allowances distributed for the purposes of "solidarity and interconnection". These allowances represent 10% of the overall quantity of allowances marked for auctioning. They are distributed to the 10 Member States with the lowest Gross Domestic Product (GDP), contrary to the other 90% of allowances which are distributed to Member States based on their historical emissions level.

Finally, allowances auctioned or allocated to airlines will also not be covered by the new proposal.

The 20% share of revenues going to the EU budget will apply to so-called "article 10c" allowances, which some Member States can decide to freely allocate to their power sector instead of auctioning them, as is the norm for the power sector. Should Member States decide to proceed with such free allocation, they will still be required to pay an amount equivalent to 20% of the value of those allowances, to ensure that the decision of freely allocating those allowances is not done to avoid paying into the EU budget.

[7] https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0096:en:HTML
[8] https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-4224148/feedback/F6931_en

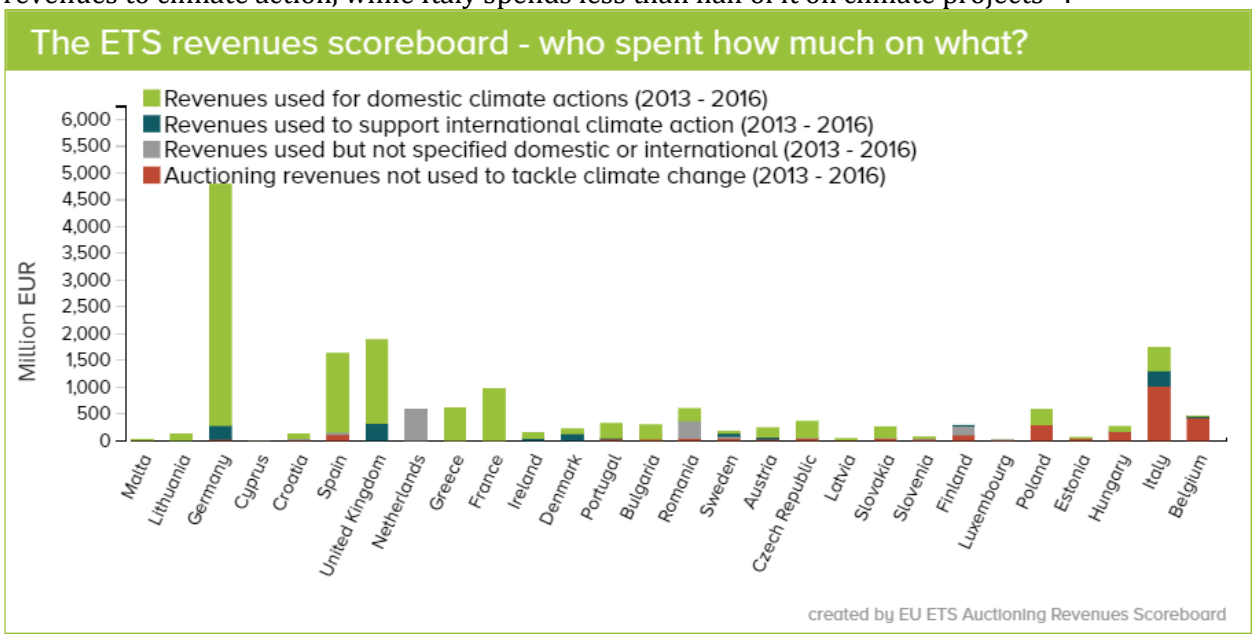
Overall, the proposal would therefore see around 90% of auctioned ETS allowances covered by this requirement having to transfer part of their auctioning revenues to the EU budget. However, not all allowances in the EU ETS are auctioned. In fact, nearly half of the allowances released each year are allocated for free to companies. Therefore, it is difficult to estimate the absolute number of allowances which will be covered by this new provision, given that it will only cover auctioned allowances, and that the exact number of allowances to be auctioned is not known precisely. In addition, the introduction of the newly established Market Stability Reserve which is likely to reduce the number of allowances auctioned from 2019 onwards, further complicates the calculation. In relative terms, it is likely that allowances for which part of the revenues will go into the EU budget will represent between 48.6% and 50.9% of the overall volume of ETS allowances over the 2021-2027 period[9].

Associated revenues are uncertain because of the variations in auctioning volumes and allowance prices, but the Commission estimates put them between €1.2 and €3 billion annually, on average over the 7 year period, or between €16.1 and €21 billion in total.

2.2.1. Use of EU ETS revenues under the current system

While the new proposal was carefully drafted to avoid modifying the incentives associated to the EU ETS, it could still have an impact on climate policies through its effect on the allocation of ETS revenues.

Currently, the EU decision sets out that Member States should spend at least 50% of EU ETS revenues on climate action. In effect, it is estimated that over 85% of such revenues, which amounted to around €16 billion over the 2013-2016 period, have been spent on climate and energy projects. As shown on the graph below, there are still significant differences between Member States in the allocation of ETS revenues to various types of investments, with Germany leading the way in affecting nearly all its revenues to climate action, while Italy spends less than half of it on climate projects[10].



The climate impact of the proposed change in revenues therefore depends on how the EU will spend such revenues compared to the current practice at Member State level. The earmarking of EU ETS revenues to specific types of expenditures, such as climate action, has not been indicated in the Commission's budget proposal, and it can therefore be assumed that the funds will go into the overall budget without specific earmarking. The proposed target for climate spending in the 2021-2027 EU budget has been set at 25% of the overall budget.

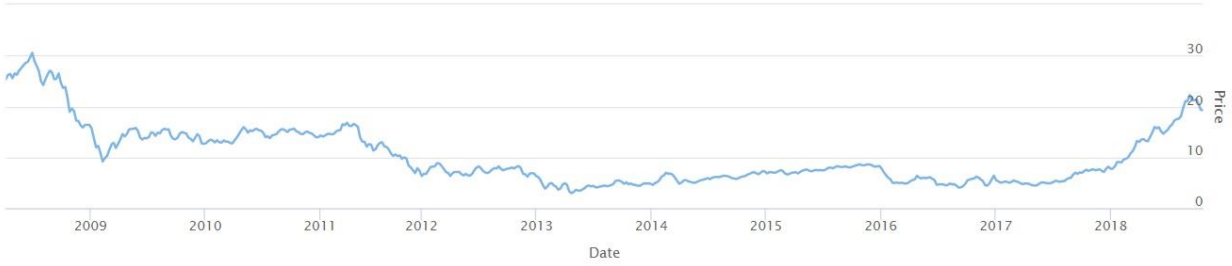
[9] This takes into account the fact that free allocation under phase 4 of the ETS could vary between 43-46%, as well as the interaction of this variation with the Modernisation Fund. This does not take into account the interaction of this variation with the Innovation Fund, but the impact of this is likely to be minimal.

[10] WWF Maximiser project, www.maximiser.eu

Therefore, redirecting 20% of ETS revenues to the EU budget, in the way outlined by the Commission proposal, would redirect around 11% of total EU ETS revenues away from climate action and towards other purposes[11]. This would leave the climate worse off. Not only is the EU's overall climate spending target lower than the current climate spending of ETS revenues at Member State level, but this EU target is also at serious risk of not being met[12].

2.2.2. Are EU ETS revenues a good source of financing for the EU budget?

In addition to the potential change in climate spending, the impact and possible benefits of the proposal also depend on whether it would bring a stable and sufficient stream of revenues into the EU budget. From 2019 onwards, the Market Stability Reserve will start operating within the EU ETS, absorbing surplus emissions in the market, thus lowering auctioning volumes but increasing prices. The anticipation of this can already be seen with EU ETS allowance prices reaching around €20 in October 2018, compared to €7 at the start of the year. This is a welcome development to improve the functioning of the market, and it should bring some stability in the long term, but the high volatility in prices which has characterised the EU ETS since its inception is unlikely to be solved. As can be seen from the graph below, EU ETS prices have always fluctuated significantly, and this has increased over the past months following the latest market reform and the uncertainty around its impact on the supply of allowances.



Source: Sandbag.org.uk

As highlighted in a report produced by the European Court of Auditors[13], this means that the EU ETS own resource for the EU budget would be highly unstable and subject to strong, sudden changes, which is problematic for long-term investments.

One way of reducing this uncertainty is by introducing a price floor in the EU ETS. This can be done by introducing a top-up levy applied to the auction of every allowance and which corresponds to the difference between the market price of an allowance and the politically-determined minimum price level, as is currently done in the UK. This would ensure that prices never drop below a certain threshold and therefore set a minimum boundary to ETS revenues. If the revenues from the top-up fee are distributed in the same way as the auction revenues (i.e. with 20% of the revenues going to the EU budget), then this would allow to set an estimated lower bound prediction on expected revenues for the EU budget. Exact revenues would still depend on the auctioning volume, but it is likely to have much smaller ranges of variation than the allowance prices do.

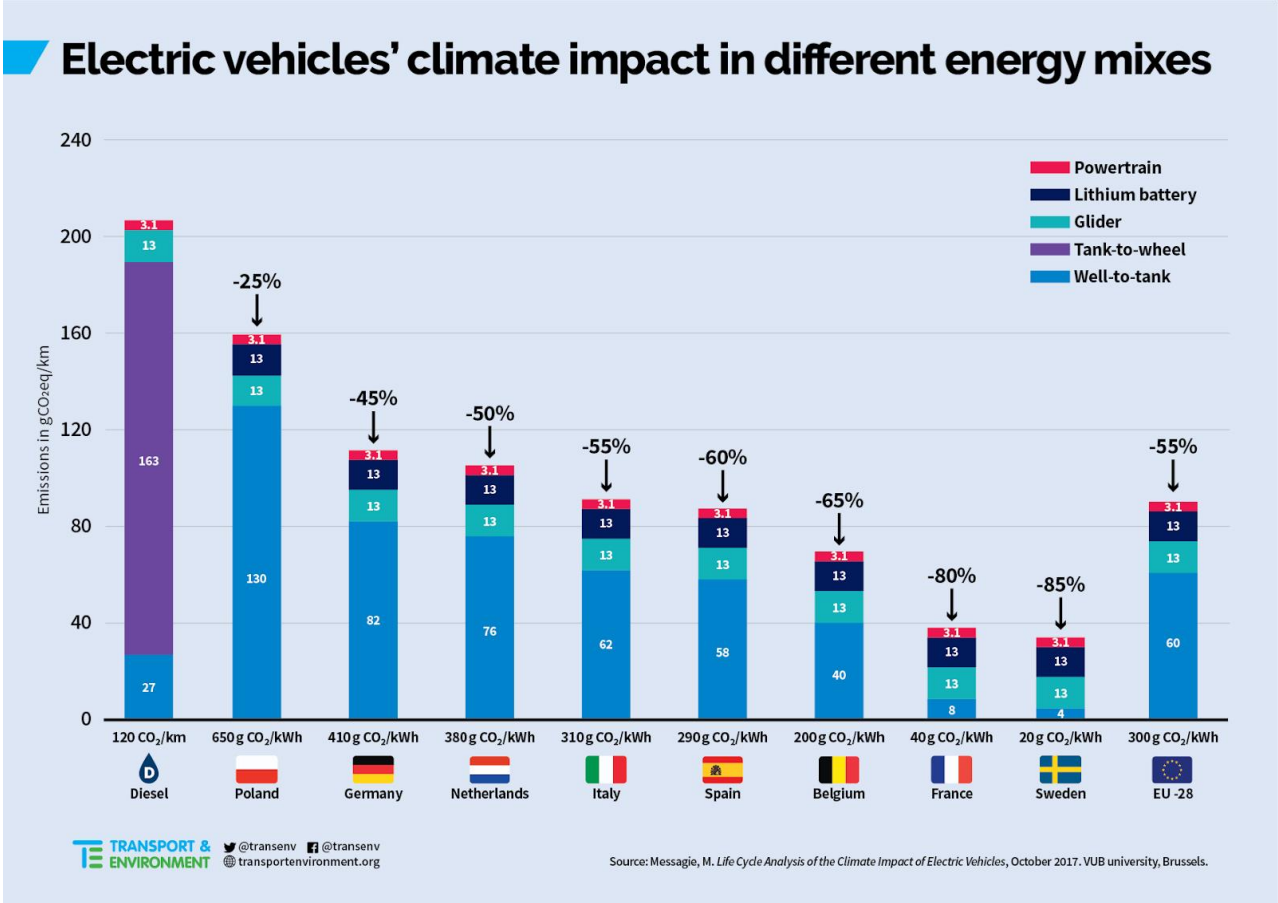
3. How to Best Spend the EU Budget

With the MFF, the EU will spend billions of Euro on transport and energy infrastructure between 2021 and 2027. As infrastructure is normally maintained for decades once it is constructed, it is imperative that the EU is investing in the right kind of infrastructure. The "right kind" of infrastructure is that which helps the EU comply with climate targets and helps guarantee EU leadership in the fields of zero-emission transport, renewable energy, and smart grids.

[11] Assuming 90% of ETS revenues are subject to the 20% diversion into the EU budget, and the EU spending only 25% of these revenues on climate action versus 85% for Member States.
[12] See here a report by the European Court of Auditors.
[13] https://www.eca.europa.eu/Lists/ECADocuments/OP18_05/OP18_05_EN.pdf

3.1. E-Mobility

Electric transport is the greenest form of transport. This is due to zero tailpipe emissions during the operation of the vehicle. Furthermore, even when considering a well-to-wheel analysis, electric vehicles (EVs) are on average 55% cleaner than traditional internal combustion engine vehicles if the current EU electricity grid is considered. As the EU grid becomes cleaner (as mandated by the EU Renewable Energy Directive and, ideally, with the help of CEF Energy investments), the climate benefit of EVs will further improve.



There are other ways to have truly zero-emission energy sources (like PtX and Hydrogen) but the energy required to produce them makes electric transport (i.e. charging a battery) far more efficient. If we are to source the electricity from renewables then the path to fully zero-emission transport is most achievable if we are to invest in electric infrastructure. In order to actualise this, there will need to be investment in improving battery storage, cleaning/improving the grid (see the section below), and deploying infrastructure to charge EVs. As electric transport is the greenest form of transport, it should take priority when assessing projects applying for EU funds. Furthermore, electric projects should receive a higher level of co-financing to promote investment in such technology. Although the example of road transport is used above, this prioritisation of zero-emission projects applies to all modes of transport.

Investment in electric transport infrastructure aligns well with existing EU transport policy. For example, the EU is in the process of defining 2025 and 2030 CO2 standards for cars[14] and trucks[15]. Both proposals include an incentive to sell zero and low emission vehicles. An often echoed argument of the automotive industry for the lack of EVs sold is an insufficiency of infrastructure. Investing in infrastructure necessary for electric transport would further encourage manufacturers to sell electric models. A recent analysis performed by T&E[16] found that by 2030 €12 billion is needed cumulatively for the rollout of publicly accessible charging infrastructure. This figure is the financial investment

[14] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017PC0676R%2801%29
[15] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2018:284:FIN
[16] https://www.transportenvironment.org/publications/roll-out-public-ev-charging-infrastructure-eu

needed for light-duty EVs only. Naturally, the more electric vehicles are on the road then the higher the business case is for private investment in such infrastructure - thus, a reduction in CEF spending.

3.2. Renewable Energy and Smart Grids

As mentioned in the section above, the climate benefit of EVs in a well-to-wheel analysis are already 55% better than a conventional diesel vehicle. The climate benefits of electric transport will continue to improve as the EU sources more energy from renewable electricity. Furthermore, the efficiency of using electricity for transport can be improved by investing in so-called "smart grids" that can better manage EV charging so that it takes place at off peak times. Smart grids can also include technologies like "Vehicle to Grid" (or V2G) infrastructure that allow for cars to store electricity at times of high supply and then redistribute it to the grid when needed. V2G is at the preliminary stages of development and innovative projects that pursue such infrastructure should be part of the EU's spending priorities.

The Commission proposal to revise the CEF Regulation[17] includes provisions that better enable synergies between the transport, energy and digital sectors. For example, a project that is relevant mostly to the transport sector but also to the energy sector can source co-financing from the amount of the EU budget earmarked for transport as well as "ancillary" money from the energy budget (provided this energy part doesn't exceed 20% of the total eligible costs). The Commission note that this was included with the intent to "significantly improve the socio-economic, climate or environmental benefits of [projects]". If the Commission's proposal is supported by the other EU institutions, co-financing rates under CEF Energy could be as high as 75% for infrastructure that is deemed "highly innovative". The Commission's proposal to modernise CEF could help co-finance innovative grid solutions, including the smart integration of EVs (smart charging and V2G) and domestic energy generation with the grid.

The money that will be earmarked for energy investment in the next MFF should be used to accelerate the share of renewable energy in the EU's electricity grid. Furthermore, interconnectors between countries should be built to ensure efficient flows of electricity when one country is producing excess energy. Finally, the EU (in line with the priority to invest more in synergy projects) should spend on innovative infrastructure that allows for EVs to better integrate into the energy systems of the EU.

4. Policy Recommendations

4.1. EU ETS

As outlined in Section 2.2 above, the proposal to raise own resources through ETS revenues could be an interesting new source of financing for the EU budget, but several issues must be resolved:

First, it must be ensured that this does not result in a net decrease in climate expenditure, which means the EU should earmark these new revenues for climate action, in addition to its existing 25% climate expenditure target foreseen in the MFF.

Second, Member States and the EU should adopt a price floor in the EU ETS and thereby secure multiple benefits. This would reduce price volatility, and hence increase the stability of revenues both for Member States and the EU budget. It would further increase the incentive for emissions reductions by ensuring that prices do not drop below a reasonable level, which means revenues of allowances would also be guaranteed at a certain level, except for variations in auctioning volumes. Currently, the higher bound estimates of the EU Commission assessment put the ETS own resource revenues at €3 billion annually, using a 25€/tCO2e price level. With a price floor in line with Paris agreement targets, this could rise to up to €10 billion[18].

[17] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2018%3A438%3AFIN

[18] Assuming an auctioning volume of 120 million allowances annually being subject to the own resources provision, and a carbon price of 80 euros per tonne of CO2e, in line with recommendations of the High-Level expert group on carbon pricing.

Third, to increase revenues and strengthen the environmental integrity of the scheme, the EU should phase out free allocation within the ETS, which would ensure that the polluter pays principle is finally implemented consistently throughout the Union, and could double the revenues.

Finally, as pointed out in the Monti report on own resources for the EU budget, it must be noted that an own resource from the EU ETS is inevitably time bound. Good climate spending using ETS revenues would itself reduce the amount of revenues collected if it helped ETS-covered installations to reduce their emissions. It must therefore be clear that using EU ETS revenues as an own resource in the EU budget should under no circumstances serve as a reason for failing to increase the environmental stringency of the mechanism over time, including by accelerating the pace by which the overall cap is reduced.

4.2. ETD

The ETD defines the minimum level of taxation legally permissible in Europe for certain fuels. The adopted text goes back to October 2003 and it hasn't been reviewed since then. The ETD has been a key tool in preventing a race to the bottom regarding fuel taxation. This has benefited the climate but also serves to protect the single market and protect government tax revenues.

Updating the ETD to shift towards greener taxation would help in the fight against climate change, the reduction of labour taxes, and strengthen the economy. This revision should include a minimum €30 per ton carbon tax on diesel and petrol (equivalent of 7.5 cents per litre) and a minimum 33 cents per litre tax on kerosene used in aviation. These two taxes alone could generate minimum €35.5 billion in additional tax revenue per year (with revenue decreasing from a switch to cleaner technologies).

4.3. EU Budget (MFF)

The 2021-2027 EU budget should play a bigger role in helping EU Member States reach their CAR targets. As transport accounts for 35% of CAR greenhouse gas emissions, the EU should prioritise e-mobility investment when spending the transport budget. Although there are several legislative proposals relevant to transport spending, there are some common requirements that apply to all if the EU is to invest the budget wisely in future-proof infrastructure:

- The EU should prioritise zero-emission transport projects when assessing which applications are granted financing. This should be made explicit in the legislative proposals accompanying the EU budget.
- Zero-emission projects should receive up to 50% co-financing rates under CEF (85% for Cohesion Funds) and be considered 100% climate spending when accounting for whether the overarching 25% climate target (of the EU budget) has been met.
- The EU should also spend more on electric transport synergy projects that better connect transport with the electricity grid (and vice-versa).

Furthermore, investment in renewable energy and smart grids must be prioritised in CEF Energy. The cleaner and more efficient the electricity grids are in the EU, the greater the climate and environmental benefits are from a shift to e-mobility. The EU must build upon the Commission's proposal to invest more in synergy projects that allow for greater interrelationships between transport and energy investment.

5. Conclusion

The EU budget has the potential to be a positive driving force in reducing emissions across all sectors. It can also help Member States meet the CAR targets and encourage smarter public investment. There are

a number of fiscal measures relevant to the EU budget that can help the EU play an important role in mitigating climate change:

1. **EU Budget** - The EU budget should prioritise zero-emission investment post-2020 by giving such projects preferential treatment when considering applications. Such projects should help EU countries meet their national climate targets.
2. **Emissions Trading System** - If 20% of the ETS auctioning revenues are to become Own Resources for the EU budget then it's imperative that 100% of such revenue is invested in climate projects.
3. **European Tax Directive** - The ETD must be revised to redefine minimum tax levels for various transport fuels. As the Directive has not been revised since 2003, the current minimum rates do not adequately reflect the climate impact of such fuels. A portion of fuel tax revenues could become new own resources for the EU budget as recommended in the Monti report.

The infrastructure that the EU invests in between 2021-2027 will be maintained for decades once constructed. Therefore, it is vital for the EU to invest in infrastructure that helps the Member States meet the climate targets. Such investment would help improve energy sovereignty, improve EU competitiveness, and reduce emissions from all sectors. This is the kind of EU that the EU budget should be helping to build.

Further information

Samuel Kenny
Freight Policy Officer
samuel.kenny@transportenvironment.org
Tel: +32 487 57 14 69

Gilles Dufrasne
Policy Officer – Carbon Pricing
gilles.dufrasne@carbonmarketwatch.org
Tel: +32 2 335 3668

Cristina Mestre
Climate and Biofuels Officer
cristina.mestre@transportenvironment.org
Tel: +32 488 797 439

Acknowledgement
T&E acknowledges the generous funding of this project from the German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety.

Supported by:
Federal Ministry for the Environment, Nature Conservation and Nuclear Safety
based on a decision of the German Bundestag

European Climate Initiative EUKI

Legal notice
The project Emission Reduction Strategies for the Transport Sector in Hungary is financed by the European Climate Initiative (EUKI). EUKI is a project financing instrument by the Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU). Its implementation is supported by Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).

It is the overarching goal of the EUKI to foster climate cooperation within the European Union in order to mitigate greenhouse gas emissions. It does so through strengthening cross-border dialogue and cooperation as well as exchange of knowledge and experience.
The information and views set out in this report are those of the author(s) and do not necessarily reflect the official opinion of the Federal Ministry for the Environment, Nature Conservation and Nuclear Safety
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