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FOR AN EFFECTIVE EUROPEAN STRATEGY FOR COP26

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On 14 July, the Commission will present its *Fit for 55* package of proposals to extend the scope of carbon pricing to sectors that are currently excluded, notably transport and domestic heating. A revision of the Emissions Trading System (ETS) will be part of a package of energy and climate laws, but the ETS will continue to be the main tool to achieve the goal of at least 55% emission reduction by 2030.This goal has been confirmed by the Climate Law, approved by the Council on 28 June, following a large majority in the European Parliament taking a favourable position on it on 24 June. As a result of this decision, the political commitment of the European Green Deal for climate neutrality by 2050 has been transformed into a binding obligation.

This transformation will allow Europe to go to COP26 – which opens in Glasgow on 31 October 2021 and will be co-chaired by the UK and Italy – with an extension of the carbon pricing system to all sectors. In the Climate Law, the Commission proposes to extend the ETS to transport and heating, presumably with a model similar to that of Germany, with an upstream approach that places the obligation to buy emission permits on the importer or producer of the fossil fuel that will then be sold to households and businesses in the domestic market. This approach is equivalent to a carbon tax, even if the imposition of a price on carbon does not take place with the collection mechanism of excise duties, but with the purchase of emission permits. In any case, irrespective of the instrument adopted, the important thing is to charge a price in these sectors too. Moreover, a Commission proposal on the LULUCF (Land Use, Land-Use Change and Forestry) regulation to curb greenhouse gas emissions and removals from land use, land use change and forestry is imminent, whereby all emissions would pay a price for carbon use. According to the Commission's proposal, at least 50% of the revenues generated by extending the ETS to transport and energy efficiency in buildings will have to be redistributed to households with lower incomes, bearing in mind that, alongside ecological transition, social equity also appears to be one of the priority objectives of the Green Deal.

The ETS reform also foresees the phasing out of free allocations of emission permits in sectors such as steel and power generation, which should be protected from future carbon duty levied at the EU border. The adoption of a border tax adjustment, which will also be presented on 14 July, is designed to put EU companies on an equal footing with their competitors, through preventing carbon leakage, as EU industries covered by the ETS risk becoming less competitive, thus incentivising the shift of part of European production abroad where it would cheaper in the absence of a carbon price.

Europe should thus arrive at COP26 having adopted, in parallel to the application of a generalised carbon pricing, a border tax adjustment mechanism. With this mechanism, goods imported from countries that do not impose a price on fossil fuels commensurate with their carbon content would be charged a tax equivalent to the price paid by producers and consumers within the EU. The European policy proposal would have to be clear and explicit, but it may not be easy to implement. To combat climate change, economists agree that the most effective instrument is generalised carbon pricing. But this objective is difficult from several points of view, as the conditions of the countries participating in the COP are different both in terms of income levels and the energy mix adopted. Europe will therefore have to put in place a strategy based on reaching a multilateral agreement at the COP to introduce a minimum carbon price in all countries of the world (along the lines of the global minimum corporate tax proposed by Biden to reduce downward tax competition, the substance of which has been accepted by 130 countries within the OECD).

Indeed, as a recent IMF paper suggests, achieving sufficient progress to stabilise the climate requires accelerated mitigation action in the short term, but doing so among 195 parties at once proves to be a difficult challenge. Accordingly, strengthening the Paris Agreement by establishing an International Carbon Price Floor (ICPF) could accelerate emission reductions through effective policy action, whilst curbing the growing pressure to introduce border tax adjustments. The ICPF should be based on two elements: (1) it should be negotiated among a small number of key countries with high emission levels, and (2) the agreement should include the minimum carbon price that each of these countries commits to implement.

This proposal is realistic and could be based on an initiative of the European Union, which, as mentioned above, will be in a good position in Glasgow to demand similar carbon pricing behaviour from other high-emitting countries. On the other hand, if any country does not accept the proposal for an ICPF, it will be forced to pay a compensatory duty at the EU border, with a double disadvantage: it will not be able to use the lower production costs guaranteed by the non-payment of a carbon price on the domestic market to achieve an increase in the export of its products to the European market and, moreover, it will provide an additional revenue linked to the imposition of a carbon price not to its own treasury, but to the EU budget through the proceeds of the Border Carbon Adjustment.

Finally, this global package of proposals from the European side will have to be completed with the activation of the 100-billion-fund for fair burden sharing in favour of the weakest countries, already promised by COP15 in 2009. This fund could be financed by adopting the Global Carbon Incentive proposed by Raghuram Rajan, which envisages a contribution to be imposed on countries that emit more than the world average (more than 5 tonnes per capita, in Rajan's proposal) and, with this revenue, to finance countries with below-average emissions. The poorest countries could then be helped to ensure a green transition that is not only effective, but also equitable from a distributional point of view, through incentives to invest in energy transition and support measures for the weakest classes.

With these proposals – generalised carbon pricing for all sectors, border tax adjustment for countries that do not adhere to a multilateral proposal for a minimum carbon price and, finally, the fund envisaged by Rajan for fair burden sharing – the EU will be able to come to COP26 with strong and realistic ideas. This position together with the new climate created by the Biden administration could favour an agreement, at least at the transatlantic level.

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