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Energy taxation – way forward

Presidency Issues Note for informal ECOFIN working session IIb

- The first aim of this session is to discuss the present and possible future role of energy taxation in mitigating climate change, based on experiences at national and EU level. The second aim is to identify the main elements that should be taken into account in the possible revision of the Energy Taxation Directive, covering not only environmental aspects but also the Directive more generally.

Motivation

- The economic consequences of climate change are increasingly visible. Many countries have recently set ambitious strategies and targets at national level. However, climate change is a challenge that requires coordinated action both across the EU and globally.
- The Energy Taxation Directive (2003/96/EC) provides a common framework for taxing energy products. It defines the fiscal structures and the minimum levels of taxation to be imposed on energy products used as motor or heating fuel and on electricity. In 2011, the Commission proposed changing the scope and structure of the Directive to introduce taxation based on the CO2 emissions and energy content of the different fuels covered. The Directive was meant to widen the scope of taxable products so as to treat competing products in the same way, to establish minimum rates while enabling Member States that wished to do so to make greater use of taxation of energy products for environmental purposes. However, political agreement was not reached and the Commission decided to withdraw the proposal in 2015. Therefore, the current European framework for energy taxation has remained unchanged since 2003.
- The Commission is currently evaluating the Energy Taxation Directive, with a view to its potential revision. This evaluation is taking into account the proper functioning of the internal market, the real value of the minimum levels of taxation and the wider objectives of the Treaty and other EU policies. After the evaluation has been published, consideration should be given to whether any subsequent policy action is needed, especially by means of new legislative proposals to amend the Directive.

- The current Directive leaves considerable flexibility for Member States to tailor energy taxation to their national circumstances. This may not be conducive to the smooth functioning of the internal market, nor that of wider environmental policy objectives. Overall, given the political and technological progress made since 2003, the Directive now seems outdated.
- In particular, energy and climate policies have advanced significantly since the adoption of the current Directive. Member States have committed to fully implementing the 2015 Paris Agreement, contributing to the fulfilment of the climate finance goals and continuing to lead the fight against climate change.
- During its Presidency, Finland aims to strengthen the EU's profile as a global leader in climate action. It will continue to work on defining the key elements of the EU's long-term climate strategy for 2050 in the European Council by the end of 2019 at the latest. Furthermore, the Presidency encourages the implementation of the Energy Union and promotes emissions reductions. Energy taxation alone will not solve the climate challenge, but it can be an important part of the economic incentives that will steer our economies towards environmentally sustainable structures.
- In some Member States, in addition to fulfilling its fiscal purpose, energy taxation already has a role in addressing environmental challenges. Some Member States have designed their energy taxation systems to take into account the energy or carbon content of different energy products. Some Member States also use other relevant tools to mitigate climate change.

The role of energy taxation

Addressing environmental challenges

- From an environmental policy viewpoint, the Directive seems outdated and poorly adapted to climate change challenges and developments in energy policy at EU level.
- The Directive does not factor in the environmental performance of different energy products. Energy sources are not treated consistently because taxation does not take into account their polluting capacity; taxes are not based on products' energy or carbon content, but on volume alone. Furthermore, the Directive does not differentiate between renewable and carbon-intensive sources of electricity. The environmental differences between biofuels and fossil fuels are not recognised. This contradicts an energy policy that promotes fuel switching and the use of renewable and other clean energy sources.
- The Directive does not cover new technologies and products (such as biomethane and power-to-gas products) and is poorly aligned with newer energy legislation, such as the Renewable Energy Directive, which seeks

to encourage the use of advanced biofuels and other products that are more environmentally friendly than traditional fossil fuels.

- The different minimum rates for different energy products do not reflect any specific logic. Furthermore, the Directive does not require any consistency in how Member States set their national levels of taxation on these different products above the minimum rates. They do not have to base them on, for example, energy efficiency, or any other environmental performance indicator.
- The minimum rates have remained unchanged since 2003 and their relative value has decreased over time. The minimum rates for electricity and heating fuels, for example, are too low to give an adequate price signal to energy users. This discourages investment in energy-efficient technology and behaviour. Furthermore, there are a number of optional exemptions and reductions leading to even more ineffective tax rates.
- The presence of sector-specific energy tax exemptions – and indeed reductions in general – substantially weakens incentives for investing in more energy-efficient production technologies in these sectors. The mandatory tax exemption for international aviation and maritime transport is not in line with the decarbonisation objectives of the Union’s transport policies, nor does it allow for a level playing field for all modes of transport. There are other tools for tackling emissions in the aviation sector – such as the emission trading system (ETS) – that could be as effective as the taxation of fuels. However, the ETS allocates substantial free allowances to airlines, and also does not apply to flights outside the EU.

Functioning of the internal market

- The Directive also has shortcomings with regard to the proper functioning of the internal market.
- Divergent national tax rates above the EU’s rather low minimum rates increase the fragmentation of the internal market. There is a risk of growing distortion of competition in the internal market and an erosion of the tax base in high-taxing countries.
- Since the Directive fails to differentiate between biofuels and fossil fuels, Member States apply their own classifications in their taxation systems, which could lead to the fragmentation of the internal market. The same applies to new energy products not covered by the Directive.
- Furthermore, some of the Directive’s technical provisions are outdated and cause uncertainty among tax authorities and economic operators.

Issues for discussion

- Do Ministers consider energy taxation to have a role in delivering the EU’s climate goals?

- What main elements (political, technical, etc.) should be taken into account when considering the potential revision of the Energy Taxation Directive?
- Ministers are also invited to share best practices for amending energy taxation to address environmental challenges.