



**Call for Papers "The European Green Deal: moving to action  
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**ENERGY TAXATION AND THE NEED FOR REFORM**

The need for a standard EU energy taxation to mitigate against internal competition and the undermining of the policy objectives of the EU Green Deal

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## **EXECUTIVE SUMMARY**

In 2019, President of the European Commission Ursula von der Leyen announced that Europe would be the first climate-neutral continent by 2050. This was followed with the details of the European Green Deal. The ambitious plan outlines key areas the European Union must address in order to reach its climate-continent goals. A central element of this plan is reform in the area of Energy Taxation. With a focus on the Energy Taxation Directive of 2003. This paper examines three aspects of the Energy Taxation Directive. First, the problems with the Directive and its current implementation. Second, the obstacles faced in trying to amend the Directive and bring it in line with the European Green Deal goals. Third, six policy recommendations are made in which the paper argues are required in part or in whole to achieve the reform needed to align Energy Taxation with the European Green Deal.

### **Social Media summary**

The need to Reform of the Energy Taxation Directive for the success of the European Green Deal.

### **Keywords**

#InternalCompetition    #CarbonLeakage    #GreenTaxation    #MarketDistortion  
#MaximumOverMinuim #HarmoniseOurTaxes

### **Short bio**

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## Introduction

The European Union has committed to being the first climate-neutral continent by 2050.<sup>1</sup> The Commission has outlined an ambitious plan to achieve this in the European Green Deal.<sup>2</sup> The subject of energy taxation is a central element of this plan. In particular, reforming the Energy Taxation Directive of 2003.<sup>3</sup> However, as this paper will show there are obstacles in the way of reform and many paths to choose from. At the heart of this challenge is the distortion in the energy market caused by the competition between Member States. This distortion prevents the harmonisation in energy taxation required to reach the aims of the European Green Deal. This paper will examine this distortion and make policy recommendations to bring about the harmonisation required for an efficient energy taxation system in Europe.

## Background

The seeds of the European Union's framework for energy taxation are found in Directives 92/81/EEC and 92/82/EEC, however, their scope was restricted to mineral oils. In 2003, this legislative framework began to set down roots through the Energy Tax Directive<sup>4</sup> which widened the scope of the existing Directives and set minimum rates for energy products to prevent distortion in the single market between competing Member States.<sup>5</sup> These rates were to be applied through a system of indirect taxation.

The underlying rationale of the Directive was not a concern with climate change, though this was undoubtedly a peripheral reason, rather the issue it aimed to address was distortions within the single market that arose between Member States by reason of excessive competition in taxation.<sup>6</sup> This distortion prevented further liberalisation of the energy market,<sup>7</sup> and fragmented the choices consumers and firms had depending on the Member State they resided in.

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<sup>1</sup> Von Der Leyen, A Union that strives for more (2019), p. 5.

<sup>2</sup> Communication from the Commission: The European Green Deal, COM(2019) 640 final.

<sup>3</sup> Ibid paragraph 2.1.1.

<sup>4</sup> Council Directive 2003/96/EC.

<sup>5</sup> Deloitte, Directorate-General for Taxation and Customs Union (European Commission), "Technical and legal aspects of Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, 2019 at p. 31.

<sup>6</sup> Proposal for a Council Directive restructuring the community framework for the taxation of energy products, Com (97) 30 final at p. 2-4.

<sup>7</sup> Commission Staff Working Document Evaluation of Council Directive 2003/96/EC, SWD(2019) 332 final at p. 24.



The attempt to introduce a uniform tax policy across Member States brought to the fore the tensions its implementation would create. This tension is evident in the Energy Tax Directive 2003, on the one hand it created a framework for energy taxation by implementing minimum rate with the aim of creating some harmonisation within the single market, but on the other, it allowed environmentally conscious Member States to tax above that rate through a series of exemptions as well as reductions for Member States who were more concerned with employment.<sup>8</sup> Built within the framework, however, Article 29 of the Energy Tax Directive was the ability for the Commission to review the minimum tax rates with the aim of preventing the rates becoming outdated and redundant.

Since the implementation of the Directive there has, to date, been no successful increase in the minimum rates on a Union level.<sup>9</sup> However, the EU has introduced market-based solutions to environmental problems which operate parallel to the Energy Tax Directive 2003, such as the EU Energy Trading System,<sup>10</sup> implemented in 2005, with the specific aim of combating climate change. That system was the first international emissions trading system and it works by setting a cap on the total amount of greenhouse gas emissions that can be emitted by installations covered by the systems. Companies can buy (or otherwise receive) allowances which can then be traded with one another as required.<sup>11</sup> However, though this system aims to reduce emissions it does so in manner independent from the energy products covered within the 2003 Directive.

## **The Effectiveness of the Energy Tax Directive and its relevance today**

The Directive was initially effective. The minimum tax rate was successful in creating a safety net in the area of motor fuel tax and prevented a “race to the bottom” in the taxation rate.<sup>12</sup> This was of particular relevance to bordering Member States where transit across borders to gain better fuel prices would have acted as an incentive for a “race to the bottom” policy. However, outside of motor fuel it is hard to find an example where the Directive had a positive effect

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<sup>8</sup> See Articles 5, 8, 15 and 17 of Council Directive 2003/96/EC.

Ibid, SWD(2019) 332 final at p.14.

Proposal for a Council Directive amending Directive 2003/96/EC restructuring the Community framework for the taxation of energy products and electricity, SEC(2011) 409 final and SEC(2011) 410 final.

<sup>9</sup> Proposal for a Council Directive amending Directive 2003/96/EC restructuring the Community framework for the taxation of energy products and electricity, SEC(2011) 409 final and SEC(2011) 410 final.

Proposal for a Council Directive amending Directive 2003/96/EC as regards the adjustment of special tax arrangements for gas oil used as motor fuel for commercial purposes and the coordination of taxation of unleaded petrol and gas oil used as motor fuel, SEC(2007) 170 and SEC(2007) 171.

European Parliamentary Research Service Briefing Implementation Appraisal, “Review of the Energy Taxation Directive”, 2021.

<sup>10</sup> See EU ETS Handbook (ets\_handbook\_en.pdf (europa.eu)).

<sup>11</sup> EU ETS Handbook.

<sup>12</sup> Ibid. 24 .



overall. It must be noted that the divergence between Member States energy tax rates has created issues in singling out and quantifying some effects of the Directive.<sup>13</sup> However, this does not prevent an overall examination of the effectiveness of the Energy Tax.

The wide range of flexibility left to Member States to apply exemptions, reductions and refunds means that the Directive has no positive effect on the functioning of the energy market. The minimum tax rates have lost their converging effect on national tax rates. The lack of an update since 2003 of the minimum rates means that most national tax rates have exceeded the minimum rate making it irrelevant and ineffective. With the minimum rates outdated and having no relevant effect on energy taxation across the single market the Directive no longer prevents the “race to the bottom” taxation nor constituted a floor in taxation.<sup>14</sup> The dysfunction in taxation of the energy market prevents a unified response to climate change on a European Union level. In order for a reduction in carbon emissions the European Green Deal will have to address the disparity in energy tax rates.

This paper will highlight the divergence in minimum tax rates and national rates through three examples.<sup>15</sup> First, natural gas for propellant. Second, natural gas as implemented under the Article 8(2)(c)<sup>16</sup> exemptions. Third, electricity for business use.

### **Natural Gas for Propellant**

In the implementation of Natural Gas tax rates for propellant use, the divergence in national rates shows the shortcomings and effectiveness of the Directive. The average rate of taxation is €2.89 compared to the minimum of €2.60, this being 11% over the minimum rate. Moreover, 14 of the 28 Member States have a rate lower than the minimum rate, with 5 Member States having no tax at all. Further, fragmentation is found by 11 Member States having a rate set above the minimum tax rate with the highest being Denmark setting its rate at € 11.89 or 357% over the minimum rate.

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<sup>13</sup> SWD(2019) 332 final p. 11 and p. 24.

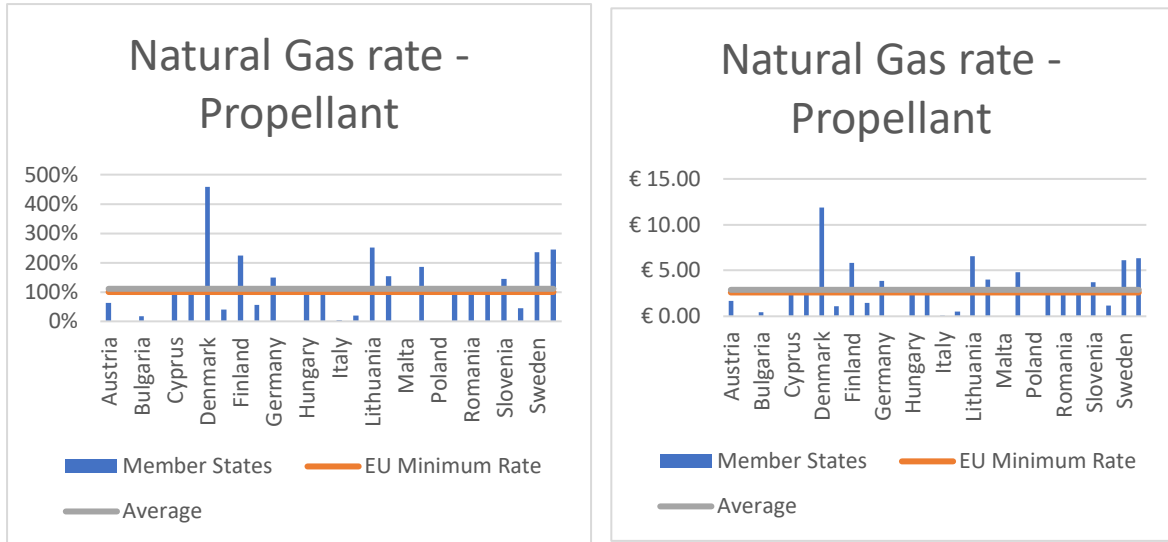
<sup>14</sup> Proposal for a Council Directive restructuring the Union framework for the taxation of energy products and electricity (recast) (Text with EEA relevance), SEC(2021) 663, p. 4.

<sup>15</sup> All figures compiled and analysed using the Taxes in Europe DataBase with figures last update on 2020/01/30.

<sup>16</sup> Article 8(2)(c): plant and machinery used in construction, civil engineering and public works.



Figure 1. National Gas tax rate for propellant as National percentage // National Gas tax rate for propellant as National price in Euro



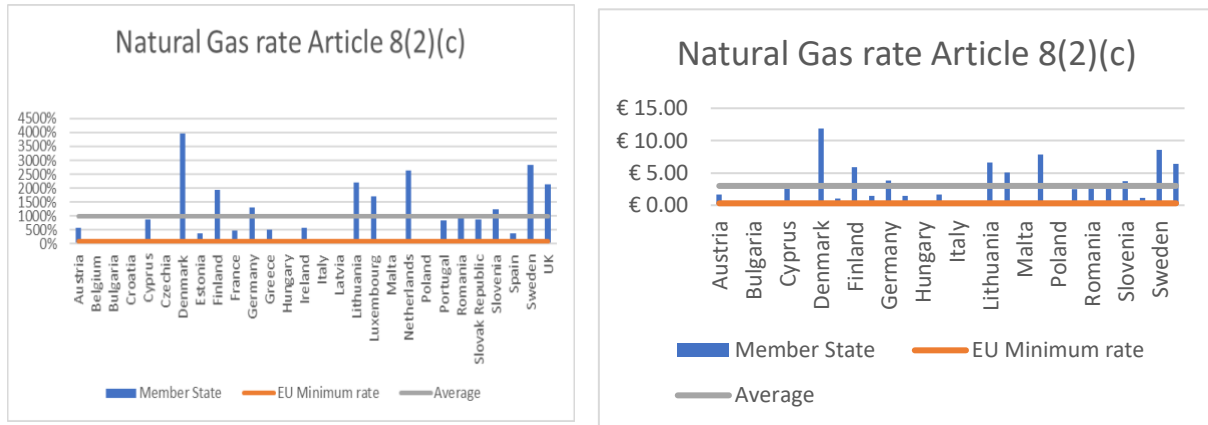
**Article 8(2)(c) exemption for Natural Gas for plant machinery used in construction, civil engineering and public works.**

Clear divergence exists between Member States through their utilisation of the Article 8(2)(c) exemption. The average rate of taxation is €2.99 compared to the minimum of €0.30, this being 898% over the minimum rate. Moreover, 24 of the 28 Member States have a rate higher than the minimum rate, with 4 Member States falling below the minimum rate. Further fragmentation is found by the wide divergence between Member States. With Denmark having the highest rate of €11.89 or 3864% over the minimum rate with 4 Member States having an effective rate of 0%.





Figure 2. National Gas tax rate pursuant to Article 8(2)(c) as National percentage // National Gas tax rate pursuant to Article 8(2)(c) as National price in Euro



### Electricity for Business Use

There is clear competitiveness in the setting of energy taxation of electricity for business use. The average taxation rate was €8.56 compared to the minimum rate of €0.50, with the average accounting for an increase of 1611% above the minimum rate. However, no Member State falls below the minimum rate due to a lack of exemptions, with only Luxembourg setting its rate exactly at the minimum. Though, the divergence in national rates set is still high, with the highest, France, set at €22.50 accounting for an increase 4400% above the minimum rate.



Figure 3. Electricity for Business use tax rate as National percentage // Electricity for Business use tax rate as price in Euro



### What do these examples show?

The three areas examined show how the minimum rates prescribed by the Directive have become redundant. Though in all examples the average rate is far above the minimum this should be viewed in the context of how this average occurred. It is unrepresentative of a potentially new naturally occurring market minimum rate but rather represents the high divergence between Member States causing such a high average. This in turn indicates a complete lack of harmonisation and thus fragmentation in the tax rates in the Union, with a “race to the bottom” policy in effect within some Member States. This has the negative knock-on effect of maintaining carbon emissions due to market impetuous and incentive. The European Green Deal will have to remove this incentive in order for a real reduction to occur.

Further, the main issue with the energy taxation rate is the distinction it draws between the “high-taxing Member States” and the “low-taxing Member States”. The compromise reached by the Directive was to allow high taxes in some States to reduce emissions with the ability to stay competitive through exemptions, while providing for low taxes in other States concerned about employment.<sup>17</sup> However, the compromise between these two types of Member States has failed to crystallize sufficiently and has worsened the distortion in the market. This was highlighted in the Commission’s Staff Working Paper from 2011<sup>18</sup> in which the conflict between the two types of Member States was shown to have persisted.

<sup>17</sup> Impact assessment report, p.8.

<sup>18</sup> COM(2011) 169 final and SEC(2011) 410 final.



## **Failure to curb internal competitiveness and bring harmonisation into the area of energy taxation**

It is clear from the figures that the Directive has failed to harmonise energy taxation in the single market. Tax rates are either too low, and make no impact, or differ too much causing fragmentation in the internal market.<sup>19</sup> There are three issues which undermine the policy objective of the Directive. First, the exemptions: these are spread across the Directive with certain sectors subject to multiple exemptions and reduction provisions. This fragments the implementation of a harmonious taxation rate which in turn distorts the energy market. Second, the minimum and energy definitions are outdated or insufficiently clear following technological developments.<sup>20</sup> Third, the minimum rates are far too low to have any impact on the energy market and help create the large divergence in the rates set by Member States.

There are two consequences to these shortcomings in the Directive. First, it creates a “race to the bottom” scenario which undermines the principle of the single market by creating divergences based on internal competitiveness. Second, it fails to implement an effective emissions reduction policy that can be aligned with the European Green Deal objectives. Moreover, the Directive *de facto* favours fossil fuel use, as it indirectly incentivises its use caused by the wide range of exemptions and reductions leading to national divergence in rates.<sup>21</sup>

## **How to analyse the internal competitiveness in the energy market**

As stated, the divergence in taxation rates makes it difficult to quantify the extent to which differing rates lead to the flow of commerce between Member States. However, recent studies into the potential carbon leakage to third party states from the Union is comparable and indicative of the potential problems within the single market at present.<sup>22</sup> The logic behind the potential threat of carbon leakage is that the competitiveness of EU domestic industries is reduced by higher production costs compared to international producers due to the EU Energy Trading System. The potential consequences are the relocation of carbon heavy production to outside the EU. There is no conclusive data to show that this is, or will be the case when more taxation is introduced as part of the European Green Deal, however studies have shown that the potential carbon leakage lies anywhere between 5% to 30%.<sup>23</sup>

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<sup>19</sup> Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, “Energy prices and costs in Europe”, SWD(2019) 1 final p.28.

<sup>20</sup> Ibid, p.17.

<sup>21</sup> Ibid p. 3.

<sup>22</sup> Ramboll, DIW, Umweltbundesamt, FAU Erlangen-Nuremberg, Ecologic Institute, Study on the possibility to set up a carbon border adjustment mechanism on selected sectors Final report, 2021.

<sup>23</sup> Ibid and see also Böhringer, C., Carbone, J. C., & Rutherford, T. F. (2018). Embodied Carbon Tariffs. The Scandinavian Journal of Economics, 120(1), 183–210.



There are however mitigating factors which may prevent carbon leakage, such as tariffs and other import related taxes that if higher than the costs of the energy tax would reduce the incentive for relocation to a third-party country outside the Union.

In relation to internal competitiveness within the single market, or internal carbon leakage, there are several reasons why the underlying logic of external carbon leakage is applicable to the current implementation of the Directive. This is because the reduced rate of energy taxation in certain Member States compared to the high rate in others creates a competitiveness that acts as an incentive for relocation of chains of production. Moreover, the geographical advantage of the mainland continental Member States for transport in chains of production acts as a greater incentive for relocation than it would to external relocation. The lack of any tariffs or excise duty when trading and transporting chains of production between Member States is another incentive that is not present in external carbon leakage.

Therefore, though it is difficult to quantify the exact impact the Directive has had on internal competitiveness, the applicability of the rationale behind the analysis of external carbon leakage is mirrored in acting as a similar or higher incentive for relocation within the Union due to distorted energy taxation caused by the Directive. This could have the direct effect not only maintaining carbon emissions but also increasing them in certain Member States, with the incentivised relocation of industry to low carbon taxing countries.

## **Obstacles to Change and Reform**

### **Legal challenges**

The Treaty on the Functioning of the EU Article 113 states:

“The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.”<sup>24</sup>

This is the procedure for the Council adopting provisions for the harmonisation of the Member States rules in the area of indirect taxation. This ability to harmonise through a legislative process enables the prevention of indirect taxes distorting competition within the Single Market. Therefore, the procedure for proposing new energy taxation is under Article 113. However, built into this procedure is an obstacle to the harmonisation of any indirect energy tax. In order for any new measure to be implemented it must first be agreed by all Member States acting in the Council by unanimously voting in its favour. Therefore, a situation could

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<sup>24</sup> TFEU ([LexUriServ.do \(europa.eu\)](http://LexUriServ.do.europa.eu))



arise whereby certain Member States could veto key taxation reform needed for the implementation of the European Green Deal.

This paper argues that this procedure creates an obstacle to the formation of far-reaching new proposals to the Directive as it allows Member States to veto any changes due to national economic concerns.

### **Economic and Political Challenges**

As already explained, at the heart of the Directive was a compromise between the competing interests of the low-taxing Member States to maintain an advantage to attract industry for employment and the high-taxing Member States to implement environmental policies. This paper argues that this conflict has worsened in the current climate for three reasons. First, time has demonstrated the advantage for low-taxing Member States to come to fruition, and there is no clear incentive for a Member State to give up an advantage they have benefited from since the implementation of the Directive. Second, in the current economic climate the effects of Covid-19 are still felt, particularly in the area of unemployment with an increase to 7.5% Europe wide as of August 2021.<sup>25</sup>

Though, it is expected that the EU economy will rebound the effects of this rebound have yet to be felt. It would be counterintuitive for low-taxing Member States to risk losing an advantage in the midst of an uncertain economic future. Third, the EU finds itself in the midst of an energy crisis with price increases and availability becoming a major issue.<sup>26</sup> Again it would be counterintuitive for both low-taxing and high-taxing Member States to increase the taxation on energy during a time when its pre-taxation costs are increasing, particularly when these cost increases will be felt by the electorate directly and indirectly through an increase in industrial production costs. These challenges are no doubt going to be felt in other areas the European Green Deal aims to address, however with energy taxation they are more prevalent due to the lack of reform of the system to date.

Therefore, it appears unlikely in the present economic environment for there to be any political will on a national level to agree to any energy taxations on a Union level. When one considers

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<sup>25</sup> Unemployment statistics - Statistics Explained (europa.eu), available at [https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Unemployment\\_statistics](https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Unemployment_statistics)

<sup>26</sup> Sandbu, Energy Crisis is moment of truth for Europe's green ambition, Financial Times 2021 (<https://www.ft.com/content/ab284905-8f54-4200-ab12-783d4580ad03>)

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that previous proposals for change, during more favourable economic times failed<sup>27</sup> the potential for unanimity for a new energy Directive that deals with all the issues outlined seems improbable.

## Policy Recommendations

It is clear that energy taxation in Europe fails to uphold the principle of market harmonisation and to reduce carbon emissions on a coherent Union basis. It is out of step with the ambitions of the European Green Deal. There are six policy recommendations that this paper posits would solve the issues with the 2003 Directive whilst bringing energy taxation more in line with ambitions of the European Green Deal. The following six recommendations are considered separately as each could be effective if implemented solely or as part of the entirety.

- The first policy recommendation is to alter and expand the taxable base of the types of energy that come within the remit of the new Energy taxation system. This would take into account technological advancements in cleaner energy sources whilst disincentivizing the use of fossil fuels. In essence, this recommendation would just update the outdated tax base already in place by the 2003 Directive. This policy recommendation is perhaps the least contentious as it does not remove any of the preferred exemptions under the current directive. Rather it just updates the Directive to accurately reflect the energy market as it is today.
- The second policy recommendation would be to fully remove any exemptions and reductions for the use of fossil fuels. At present these exemptions and reductions act as incentive in the use of fossil fuels as they are still comparatively cheaper than alternative energy sources, which often require initial investment to create the structure by which they can operate. This policy would be the most important change and most in line with the aims of the European Green Deal in that would move the EU away from fossil fuels. However, given the current energy crisis as outlined, a full removal of these exemptions seems unlikely.
- The third policy recommendation is to remove all exemptions and reductions within a new Directive. These are at the heart of the distortions in the Single Market and any attempt to maintain them runs counter to all the issues created by their existence in the 2003 Directive to date. An alternative to these exemptions and reductions would be an implementation period by which the minimum tax rates are introduced. In practice this would initially maintain the distortions caused by the exemptions and reductions but gradually reduce the distortions over time. This policy recommendation is perhaps the most radical but equally the most effective in ending distortions and reducing emissions. The low-taxing Member States would have to increase their national taxation rates with the high-taxing Member States reducing theirs. What is lost in the

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<sup>27</sup> 2011 (<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011PC0169&from=EN>) 2007 (<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52007PC0052&qid=1554283587067&from=EN>)



higher tax rate in one is gained by lower emissions in the other. Importantly this would decrease the taxation gap and help reduce distortion. However, both low-taxing and high-taxing Member States would be incentivised to veto this. The former gains the ability to have effectively 0% tax rates under some categories of fuel. The latter can maintain high tax rates while mitigating loss to industry through certain reductions and exemptions.

- The fourth policy recommendation would be the implementation of a maximum energy tax rate. This would prevent distortions forming from the high-taxing Member States through capping the nominal tax rate they could implement. Therefore, helping to maintain a uniform tax rate across the Union. This policy recommendation would be aimed primarily at the high-taxing Member States who are to an extent the biggest contributors of the energy market distortion through the creation of a large gap in tax rates. This recommendation could only occur with the sixth policy recommendation as both would help narrow the gap in tax rates and reduce distortion.
- The fifth policy recommendation would be neither a minimum or maximum, rather one fixed rate. This would be the most radical choice but would guarantee no distortions in the energy market. Again, the implementation period could be spread over a number of years to allow for a gradual reduction in the distortions as they exist currently. This policy recommendation would be the most effective in reducing distortion in the energy market. It could be set high with an implementation period allowed. This would lead to harmony in energy pricing as well as allowing the Union to analyse and increase the rates in line with the European Green Deal objectives. If this was implemented with the third policy recommendation then all market distortion would be removed. However, for the reasons already outlined the support from Member States for these options is unlikely.
- The sixth policy recommendation is to increase the minimum tax rates to bring them in line with current ambitions under the European Green Deal. This policy recommendation is the bare minimum that needs to occur. The current minima are ineffective at acting as a floor in taxation as the majority of Member States have surpassed them. In practice making the Directive almost completely defunct. If there are to be reductions in emissions then an increase in the minimum tax rate is required.

For the European Green Deal to be effective energy taxation has to be reformed. Harmonisation has to be brought to the energy market to achieve a Union wide approach and reduction to carbon emissions. The six policy recommendations would help shift the energy market in the right direction through a more harmonised energy tax regime with the overall effect of carbon emissions reduction. The European Green Deal is the best chance the Union has at achieving this.



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