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## CARBON PRICING AND THE PRICE OF FOSSIL FUELS

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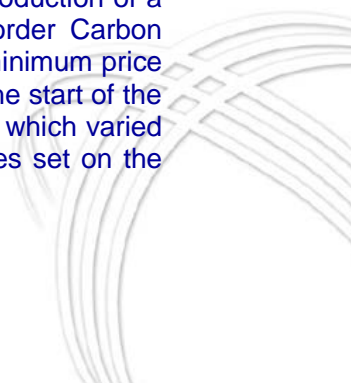
“The policy that will move us closest to achieving global environmental targets (...) is to raise the price of emitting carbon dioxide and other greenhouse gases”. But this achievement is not sufficient since “it would be great if policymakers could commit to a century long rising path for the carbon price”. This statement by [Jeffrey Frankel](#) seems justified in the light of the fact that investment decisions, which are necessary to progress along a path towards carbon neutrality, require that there is certainty about future costs linked to the use of fossil fuels, which will have to be high enough to ensure the profitability of resource allocation that aims to promote energy saving and to expand renewable energy production.

[Stephan Schulmeister](#) has made it clear that “the crucial point is anchoring the expectations of all actors that the price of CO<sub>2</sub> emissions will never again become cheaper. However, as long as there is uncertainty about the future price development of oil, coal and natural gas (or of CO<sub>2</sub> emission permits), even a permanently rising CO<sub>2</sub> tax (or rising floors of permit prices) cannot make sure that emission costs for the individual polluter will also steadily increase. This would, e.g., not be the case if fossil energy prices decline stronger than the CO<sub>2</sub> tax rises (or if emission permit prices fall strongly). As actors know from decades of experience that fossil energy prices fluctuate widely, even a stepwise rising carbon tax cannot anchor the expectation that the costs of emitting CO<sub>2</sub> will permanently increase”.

It is clear that the choice of an optimal price to be imposed on GHG emissions, deriving from the combustion of fossil fuels, with the introduction of a carbon tax or a floor price for emission allowances, cannot guarantee that the final price of traditional energy sources for consumers and/or producers is high enough to make the use of renewable energy sources affordable. In reality, in the event of a significant fall in fossil fuel prices, this incentive may be lost because, even with a carbon tax or a floor price for emission allowances increasing over time, the final cost may be lower than the price of renewable energy.

Such a fall in prices, which has manifested itself several times in the past, can indeed be governed by the introduction of a carbon price, which in fact has reduced the demand for traditional fuels, making the price decrease. And this reduction in turn can have a negative effect by increasing CO<sub>2</sub> emissions again. The setting of a carbon price is therefore a necessary, but not in itself a sufficient condition, to launch the European economy, and potentially the world economy, towards carbon neutrality.

The introduction of a carbon price must therefore be accompanied by the fixing of a minimum price for the use of traditional fuels, which must gradually increase over time, and must be guaranteed even in the presence of a fall in the price of fossil fuels on the world market. In the European Union this can be achieved by imposing a steadily increasing price of fossil fuels on the internal market – with the setting of a floor price for emission allowances or the introduction of a carbon tax – and by varying the compensatory duty levied at the border (a Border Carbon Adjustment), calculated on the difference between the world market price and the minimum price set on the European market. This rule has been used in the past in the EEC when the start of the common agricultural policy was marked by the introduction of compensatory duties, which varied as prices on the world market changed and which ensured that the minimum prices set on the European market were maintained.



A first, embryonic, step in this direction is represented in the decision agreed by the German Parliament for an extension of the ETS to transport and domestic heating sectors, that use fuels such as petrol, diesel, natural gas and coal. This would not be paid directly by the carbon dioxide emitters, but by the companies that distribute the fuels or by the fuel producers themselves (*upstream approach*). In this proposal it is suggested that from 2026 the price of emission allowances will be set by the market in a band between €55 and €65. This provision implicitly assumes that if the market pushes the price below the floor of the corridor, this floor price will be enforced through an intervention of the ETS authorities.

If a border carbon adjustment were introduced in the EU, the level of the border duty would vary according to the price of fossil fuels on the world market; this would ensure that the carbon price charged on CO<sub>2</sub> emissions from imported fuels or goods produced using these fuels would not be lower than the minimum price set by the European Union. And this measure will not be in breach of WTO rules as the minimum price on CO<sub>2</sub> emissions will also apply to goods produced in the European internal market.

Taking into account the difficulties that arise in getting public opinion to accept the introduction of a carbon price, the path that appears to be the easiest to pursue politically is to propose an extension of the – already existing – Emission Trading System to transport and domestic heating, as established in the agreement reached in the two branches of the German Parliament. In this way, on the one hand, the scope of application of the ETS is broadened, with only the agricultural sector remaining substantially excluded (which will probably be regulated with ad hoc rules as part of a revision of the common agricultural policy); and, on the other hand, if an upstream approach similar to the German one is adopted, there are no administrative difficulties in its application. This proposed mechanism is substantially equivalent to the excise duty regime given that permits will not be paid directly by the carbon emitters, but rather by the fuel distribution companies that sell to end users, or by fuel producers or refiners.

Finally, to promote the investment needed to support an appropriate ecological transition, strengthening renewable energy production, expanding required infrastructure and creating alternatives for goods that today require the use of fossil fuels (e.g. electric cars), a minimum price for carbon dioxide emitting fuels needs to be set that increases over time, to guarantee the profitability of the investments that will have to be made. Given the persistence of fossil fuel price variations on the world market, the achievement of this objective can only be guaranteed by varying the Border Carbon Adjustment to reflect the difference between the world price and the minimum price imposed in the internal market of the European Union.

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(The opinions expressed here do not necessarily represent the CSF)

