Why direct payments are necessary to make carbon pricing for households work in the EU

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1 EU governments should recycle revenues from carbon pricing in heating and transport fairly to citizens

In light of relatively weak regulatory instruments to decarbonise the heating and transport sectors, the carbon pricing scheme ETS2 will play an important role in the effort to achieve EU climate targets. To ensure that price rises are not accompanied by calls to loosen the emissions cap, it is vital to use revenues from ETS2 wisely.

A first and prominent use of revenues is to invest in non-fossil energy alternatives. ETS2 revenue can be used to reduce emissions by providing grants and affordable financing options for retrofitting and clean alternatives such as heat pumps, solar panels and zero-emission transport. This facilitates the transition by reducing the pressure on the ETS2 price as demand is lowered for pollution permits, especially if households only imperfectly foresee future ETS2 prices. By making these investments socially targeted, this can increase the fairness of ETS2.

A second, important use of carbon price revenues that is less prominent is also necessary in our view: to rebate part of revenues to all citizens in the form of direct payments. Most likely, citizens will be confronted with higher prices at the pump and higher heating bills at the end of the month. Policymakers and fossil fuel industries opposed to climate policies will start arguing against carbon pricing. Words alone are insufficient to counter this. A direct transfer to citizens' bank accounts (and in cash for those who have no bank account) is a visible, transparent, and credible argument that carbon pricing is not a tool to finance general government expenditure. In fact, direct payments can turn carbon pricing into a progressive tool benefiting households with middle and lower incomes. By contrast, in absence of direct income support for lower- and middle-income households, carbon pricing affects these households relatively more as they spend a higher proportion of their income on energy costs. Direct payments can increase and decrease in line with carbon prices, increasing public support for ambitious climate policy and protecting consumers' purchasing power, thereby strengthening the instrument of carbon pricing. Direct payments can have a positive environmental impact if they make higher prices and their associated emissions reductions viable.

Funding both investments and direct payments is not only advisable, it is also possible within the framework of EU law in multiple ways. The Social Climate Fund (SCF) is an important mechanism to address social difficulties arising from higher energy and transport prices – and it allows up to 37.5% of the fund to be spent on direct income support for those experiencing increases in energy and transport poverty. However, the size of the SCF is limited and it is capped such that its size does not increase when prices rise. Therefore, the ETS2 revenues that are not distributed via the SCF are an important source of funding for direct payments.

None of the arguments here remove the need for all EU countries to implement climate policies beyond ETS2 to reduce their emissions and thereby contain ETS2 prices. The effect on the price of policies by the large and relatively wealthy countries will be particularly important as Germany, France and Italy emit over 50% of the emissions under ETS2.

1. Direct payments create transparency

Trust in carbon pricing systems grows when citizens understand exactly what their payments are funding, so allocating ETS2 revenues to finance general state budgets must be avoided. With low trust in governments, climate policy instruments that raise revenues may be seen as tools to finance general state budgets. The greater the share of revenues that are spent on financing highly visible and socially targeted investments to lower emissions and on direct payments to redistribute revenue to all citizens,

the easier it is to explain that carbon pricing is not a way of raising taxes without benefit to people. Climate dividends are a tangible and very simple way to show citizens that while ETS2 is necessary, purchasing power can be protected for many: a transfer labelled "Climate Bonus" to your bank account every month is a very credible form of communication.

Using revenues for climate dividends can be much more transparent and therefore less susceptible to misuse than other uses of funds. As the Austrian experience with the Klimabonus has shown, administrative costs can be kept low and by including the entire population rather than offering funds only to specific individuals, the scope for special interests and favouritism is reduced.

2. Direct payments reach all those affected by carbon pricing

While the ETS2 is only levied on fossil fuels, prices may rise throughout the value chain of various products for which transport and heating is an input – this could include a broad range of goods and services. Using carbon pricing revenues only to help end users of fossil fuels misses these individuals who may rightly feel excluded.

Furthermore, even for individuals who use fossil fuel technologies, means-tested benefits may not be enough. Non-take-up of means-tested benefits is a real issue: it is not easy to reach the poorest who often face barriers to accessing the support.

3. Direct payments offer an insurance against high prices

Future carbon price levels are not easy to foresee. In light of potential price volatility, a climate dividend offers an automatic policy response: the value of direct payments increases when prices are high. If climate dividends are paid monthly, the feedback from higher prices to higher dividends can be very direct. Higher direct payments will create very visible benefits from higher prices that cannot be achieved by other funding programmes, helping to counterbalance the narrative that higher prices reduce purchasing power for all.

4. Direct payments are equitable

There is a common misconception that universal payments are unfair because they go to everyone. In reality, low-income households are the ones that benefit the most from this system. The revenue of carbon pricing comes overproportionately from rich households (in absolute terms, even if poor households pay relatively more of their income). Even if distributed uniformly, the overall effect of carbon pricing and direct payments is progressive. If the payment is taxable, this progressive nature becomes even more evident. Direct payments cannot substitute for targeted means-tested help for households strongly affected by carbon pricing, but can help the large majority cope. Focusing only on the poorest households risks overlooking middle-income households who feel their purchasing power is strongly affected by carbon pricing.

By contrast, revenues from carbon pricing that are not used for climate dividends are typically invested in programmes encouraging households and small businesses to transition away from fossil fuel technologies. While many of these programmes are sensible, they overproportionately reach wealthier households unless strict means-testing is included which is a cumbersome process with many pitfalls.

Fossil fuel subsidies are a persistent problem in all EU member states. Since wealthier households use more fossil fuels than poor households, the households that receive the majority of the subsidies do not need them. Thus, direct payments reduce a large injustice and should be accompanied by investments with effective social targeting.

The legal basis for refunding ETS revenues back to households via direct payments

There are three types of ETS revenues, all with specific rules for their usage under EU law — and all of which may be relevant to fund direct payments to rebate households for higher living costs as a result of carbon pricing.

First, a maximum of one quarter of ETS2 revenues are distributed to EU countries via the Social Climate Fund (SCF) after approval by the European Commission of National Social Climate Plans (NSCPs).

Specific rules govern the types of expenditure that may figure in these NSCPs, and one type of expenditure concerns "temporary direct income support". The fraction of expenditure in any one NSCP that may go toward this kind of scheme is capped at 37.5%, should decrease over time, should be temporary and must benefit vulnerable households and transport users (SCF Directive Art. 8(2)). This constitutes a first clear option to fund schemes that directly compensate households for higher living costs.

Second, a potential source could also be revenues from ETS1. Until the changes introduced in the Fit-for-55 package, the conditions on the use of revenues that were raised by EU countries through the sale of emissions certificates in this system were fairly weak. The relevant ETS Directive stipulated[1] that EU governments "should" spend at least 50% of the revenues on a set of defined uses, such as "to develop renewable energies and grids for electricity transmission to meet the commitment of the Union to renewable energies". Following recommendations by many stakeholders, including EU civil society organisations (here and here), the rules have changed: now, 100% of revenues "shall" be spent on an expanded set of revenue uses[2]. As the arguments made above for the potentially crucial role of direct payments for the politics of carbon pricing were well known, a specific amendment was formulated to include such schemes as a permitted use of ETS revenues. Revenues may be used "to finance national climate dividend schemes with a proven positive environmental impact" (ETS Directive Art. 10(3hb)).

The formulation is not immediately clear. Does the addition "with a proven positive environmental impact" represent a restriction on the set of possibly fundable schemes, or is it a positive statement of fact that climate dividend schemes do in fact have positive environmental impact? In either case, it is hard to see how the statement could apply merely to the revenue use and not also include the carbon pricing element. Rebating funds to households can be interpreted as having positive climate impact by creating the political conditions for continued support of carbon pricing, as explained above.

There are several indications that this was indeed the intended meaning[3]:

(i) the ECON committee's definition of "climate dividend schemes" is "a direct per capita refund of any additional revenues generated through carbon pricing", confirming that climate dividend schemes cannot be separated from carbon pricing.

(ii) to the extent that requiring a "positive environmental impact" on the side of revenue use is taken as a reference to climate effects, this would appear to ignore the caps on yearly emissions in the ETS2 architecture. However, it is important to note that the cap on yearly emissions may also be breached by efforts to limit future price increases, as allowances released from the Market Stability Reserve (MSR2) are in excess of the ETS2 cap.

(iii) it is not obvious how a climate dividend scheme could condition payments on specific spending uses by households. The solution of vouchers for specific expenditure uses was considered by parliament and rejected[4].

(iv) there has been speculation[5] that there could be a link with a preceding allowed revenue use (ETS Directive Art. 10(10ha)) concerning providing "financial support to address social aspects in lower- and middle-income households". This would then raise the question of whether direct payments would need to exclude higher-income households. But given that the amendment was proposed independently, there is no link between these two revenue uses.

Third, as the price of ETS2 directly affects households, it appears particularly intuitive to present direct payments as 'rebating' ETS2 revenues. Those ETS2 revenues that do not finance the SCF are directly allocated to EU governments with a broader set of permitted uses. The set of permitted uses refers back to the uses permitted under the already existing emissions trading scheme ETS1 (mainly covering emissions-intensive industries), but with two differences. First, EU countries are asked to give "priority to activities that can contribute to addressing social aspects of the emissions trading under this Chapter" (ETS Directive Art. 30d(6)). Second, there is an additional list of four revenue uses proposed for ETS2, one of which may be relevant to direct payments: "to provide financial support in order to address social aspects concerning low- and middle-income transport users" (ETS Directive Art. 30d(6b)).

In conclusion, there are multiple paths to redistributing revenues from carbon pricing in both ETS1 and ETS2 back to all households who will ultimately pay higher prices for a number of goods even where carbon prices are nominally only levied on fossil fuels (as in ETS2) and specific actors (as in ETS1). Financing is already available if ETS1 funds are used, can be extended from the start of 2026 with the payments from the SCF and could be further bolstered in 2027 with the introduction of ETS2 and the associated revenues that EU countries will receive.

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Contact

Luke Haywood, Policy Manager for Climate & Energy (European Environmental Bureau)
luke.haywood@eeb.org

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The opinions expressed in this policy briefing are solely those of the author of this research.

Contributors: James Collis, James Denman (Citizens Climate Europe), Hannah O'Sullivan (European Environmental Bureau), Caroline Whyte (Feasta), András Lukács (Levegő Munkacsoport), Marin Chaveyriat (Lobby Climatique Citoyen), Marie Zeller (Zukunft KlimaSozial). Additional thanks go to the consortium of LIFE Effect & the EEB's Climate & Energy Working Group members for their contributions.

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