Harmonizing Green Incentives

Thomas Pogge

As has been much remarked in the media, the world's large banks have, even after the 2015 Paris Agreement, continued to finance fossil fuel projects. Massively: the 60 largest banks provided some $3.8 trillion. Many of these banks are our banks here in Europe and, if we don't approve of what they are doing, then it is our task as citizens to enact appropriate regulations and/or incentives.

An efficient way to do this is to put a price on emissions. This can be done through a tax, or else by imposing an overall emissions ceiling and then letting some auction process determine the price of emissions permits.[1] The EU's Emissions Trading Scheme (ETS) exemplifies the latter option. Once such a scheme is in place, then the harmful effects of emissions are "priced in" and only the more valuable fossil-fuel projects remain financially viable and competitive. Assuming the emissions tax or ceiling was set at an appropriate level, banks need not feel bad about financing any of those remaining high-value fossil-fuel projects.

This position leaves one large issue unaddressed: what about financing by EU banks of fossil-fuel projects outside the EU? Insofar as these projects are located in countries that have put a roughly equivalent price on emissions, the preceding resolution can be extended to them. But what about countries that have put a much lower price on emissions or none at all, like most low- and middle-income countries? With projects in those countries, the harmful effects of emissions are not priced in, and those deciding about these projects therefore do not have, and do not transmit to our banks, the right incentives. Our banks thus often end up supporting decisions that, from the standpoint of the EU, are wrong decisions: decisions that do not take proper account of the disvalue that we in the EU have politically decided to attach to harmful emissions.

One response to this problem is to tax or otherwise penalize banks in proportion to the emissions that will be produced by the projects they finance. This penalty could be based on the EU's ETS rate, doubly discounted. One 50% discount arises from the penalty being split between the banks that (co-)finance the project and the firms that help construct it. The other discount reduces a bank's share of the penalty according to the percentage of the project cost

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[1] Either way, emissions could be quantified in metric tons of CO_2e or CO_2equivalent, a scale that weights all greenhouse gases relative to CO_2 according to their global warming potential over some specific time frame.

it finances. Thus, if some bank finances 15% of a fossil-fuel project in Africa that, over its lifetime, is expected to cause emissions of 2 million metric tons of CO_2e, and if the average CO_2e price in the EU ETS for the preceding year was €60 per metric ton, then the bank would owe a penalty of €9 million (= €60 * 2,000,000 * 50% * 15%).

An obvious problem with this response is that it would put our banks at an unfair disadvantage vis-à-vis other banks that, headquartered in China, say, or in Japan or the United States, escape this penalty. This problem would be avoided if the proposed penalty were globalized. But our climate emergency is too urgent for us to wait for that happy day. Is there an alternative solution that can be implemented right away?

An immediate solution of this kind is a Painless Penalty Pact (PPP), which would fully rebate the penalty to the banks that are subject to it. Here is how it would work. First, we delineate all the countries that do not impose emissions penalties that are comparable to, or higher than, those prevailing in the EU. This part of the world is the *penalty zone*. Second, we collect appropriate penalties from EU banks that provide financing for fossil-fuel projects in the penalty zone as detailed above. Third, we distribute all the collected penalties back to EU banks in proportion to their shares in aggregate EU bank financing provided into the penalty zone. The result is that the EU banks as a group get back all of what they pay in. Yet, EU banks whose financing into the penalty zone is associated with above-average emissions per € provided will be net losers, and EU banks whose financing into the penalty zone is associated with below-average emissions per € provided will be net winners.[2]

The PPP would leave basically unchanged the overall position of European banks in the international competition. And, assuming that competing European banks will pass on much or all of the PPP's impact to their customers in the penalty zone, the PPP would give such customers some opportunities to get cheaper financing by turning to European banks for greener projects. In this way, the incentives given to EU banks transmit to those who make decisions about projects in the penalty zone: they will be able to obtain cheaper financing than would be available to them without the PPP for greener projects, that is, for projects that will generate low emissions per € invested. This may often affect their decisions about, for example, what kind of power plant to build, which is exactly the impact sought for the PPP.

[2] Revenue-neutral schemes of this sort have been proposed at the national level, for example as a gasoline surcharge that is fully rebated, with each citizen receiving an equal share. Here those who consume more gasoline than the per-capita average are net losers and those who consume less are net winners – and everyone wins by consumption becoming less fossil-fuel intensive. The scheme worked for a while in Australia (2011 Clean Energy Act) under Prime Minister Julia Gillard but was then abandoned in 2014 by the succeeding Liberal Party government under Tony Abbot. The EU ETS is not revenue-neutral but rather generates considerable revenues for EU member states (p. 14).

While the scheme is in principle revenue-neutral, it does bring some administrative costs to ensure that all assessed payments are, and can be seen to be, based on accurate data. This administrative burden might be borne by the EU as a substantial and highly cost-effective contribution to global emissions reduction. But it is also possible for the banks to make this important contribution by shouldering the administrative burden themselves by setting up an impartial monitoring and accounting body. What is probably unrealistic is to make the scheme one that banks voluntarily sign up to. For one thing, this would bring on an adverse selection problem where the banks that care least about the environment and the future of humanity refuse to sign up. So, the scheme should be compelling for all EU banks that do any financing in the penalty zone – either legally mandatory or practically unavoidable.

The PPP can be analogously extended to EU firms involved in construction of fossil-fuel projects in the penalty zone. The calculation of the penalty would be the same as for the banks, except that the fourth factor would now be the percentage of the overall project cost that is received by a particular EU-based construction or supplier firm.

The PPP is a partial solution to the problems that arise when we try to avert a global climate catastrophe in a divided world. At substantial cost, high-income countries (HICs) have been making various efforts to reduce greenhouse gas emissions within their respective jurisdictions. Poorer countries are doing much less. This disparity seems appropriate in light of the fact that the HICs tend to have much higher *per capita* emissions, have historically contributed much more to the accumulation of greenhouse gases in the atmosphere and can much more easily afford costly efforts without sacrificing essentials such as basic health care, education, social security and infrastructure for their populations.

Morally plausible as it may be, the disparity is inefficient by prioritizing less cost-effective emissions reduction efforts in HICs over more cost-effective such efforts in poorer countries. With the money HICs are spending on reducing emissions in HICs, they could achieve much greater emissions reductions in middle- or lower- income countries. Moreover, the disparity provides perverse incentives, such as the incentive to “export pollution” by shifting high-emission production of goods consumed within the EU to a non-EU country. Specific solutions to these inefficiencies have been found and are already partially implemented through emissions offset credits and through environmental tariffs like the EU carbon border levy. The PPP proposal is offered in this same spirit.