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Carbon pricing in Germany's road transport and housing sector: Options for reimbursing carbon revenues

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Stefanie Schubert

Carbon Pricing in Germany's Road Transport and Housing Sector: Options for Reimbursing Carbon Revenues

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Manuel Frondel and Stefanie Schubert¹

Carbon Pricing in Germany's Road Transport and Housing Sector: Options for Reimbursing Carbon Revenues

Abstract

In 2021, Germany will launch a national emissions trading system (ETS) in its road transport and housing sectors. This climate policy instrument aims at raising the energy cost burden of those households and firms that consume fossil fuels, the major source of carbon dioxide (CO2) emissions. A promising approach to secure public acceptance for such a carbon pricing would be to entirely reallocate the resulting "carbon" revenues to consumers. This article discusses three alternatives: a) a per-capita reallocation to private households, b) the reduction of electricity prices by, e.g., decreasing the electricity tax, as well as c) targeted financial aid for vulnerable consumers, such as increasing housing benefits. To estimate both the revenues originating from carbon pricing and the resulting emission savings, we use price elasticities on individual energy consumption in the road transport and housing sector from the empirical literature. Most effective with respect to alleviating the burden of poor households would be increasing housing benefits. While this measure would not require large monetary resources, we argue that the remaining revenues should be preferably employed to reduce Germany's electricity tax, given the steadily increasing amount of electricity generated by renewable energy technologies.

JEL-Code: D12, Q21

Keywords: Electricity tax; housing benefits; distributional effects

December 2020

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1. Introduction

Between 1990 and 2018, Germany's greenhouse gas (GHG) emissions shrank by 30.8% (UBA 2019a). Both the energy and the industry sector contributed to this reduction. Being integrated in the European Union's (EU) emissions trading system (ETS) since its launch in 2005, these sectors reduced their emissions by 33.3% and 31.0%, respectively. By contrast, the road transport sector's emissions stagnated since 1990: According to Germany's Environmental Protection Agency (UBA 2019a), this sector's GHG emissions amounted to 161.9 million tons in 1990, increased to 165.0 million tons in 2016, and reduced again to 162.0 million tons in 2018. In Germany's housing sector, notwithstanding stagnation in the period from 2011 to 2017, GHG emissions decreased by about 24% between 2005 and 2018, from 154 to 117 million tons.

Notably due to the poor emissions performance in the road transport sector, Germany may miss its mandatory target for 2020 for the Non-ETS sectors, that is, those sectors that are not integrated in the EU ETS. This target requires that the GHG emissions of Germany's Non-ETS sectors are reduced by 14% by 2020, relative to the base year 2005. There is a likewise legally binding goal for the year 2030 that is even much more ambitious than the 2020 target: Until 2030, the GHG emissions of Germany's Non-ETS sectors must be reduced by 38% relative to 2005.

This target would become obsolete, though, if the Non-ETS sectors would be integrated in the EU ETS (SVR 2019:63), as an overarching cap limits the maximum annual GHG emissions of all sectors that belong to the EU ETS. Despite the high intensity of the climate policy debate in the European Union of late, it is rather unlikely that the road transport and housing sectors of the Member States will be completely integrated in the EU ETS in the near future.¹

Pushed by the Fridays for Future movement and the Green Party's success in last year's elections for the European Parliament, Germany will introduce a national ETS in its road transport and housing sectors in 2021. Yet, contrary to the EU ETS, where prices for emission certificates can vary freely, in this separate ETS, the prices for carbon dioxide (CO₂) allowances will be fixed in the first five years, that is from 2021 to 2025, starting with a CO₂ price of 25 euros per ton that is stipulated to increase to 55 euros in 2025. For the years 2022 to 2024, CO₂ prices are fixed to amount to 30, 40 and 45 euros, respectively. Only as of 2026 will emission allowances be auctioned for the first time, but certificate prices will be restricted to vary within a tight corridor from 55 to 65 euros.

As becomes evident from the price path sketched above, the purpose of this climate policy instrument is to raise the cost burden of those households and firms that consume fossil fuels, such as natural gas and heating oil. Yet, increasing the cost burden of fossil

¹ Note that the air traffic sector is integrated in the EU ETS since 2012, implying that for all intra-EU flights, emissions certificates must be purchased.

fuel consumers bears the risk of inciting social unrest and protests. To instead sustain the currently high acceptance for Germany's so-called Climate Package 2030, which includes the establishment of the national ETS in the road transport and housing sectors, a promising approach would be to entirely reallocate the revenues resulting from carbon pricing to consumers.

This article discusses three strands of alternatives to reallocate the "carbon" revenues originating from carbon pricing (see e.g. Preuss, Reuter, Schmidt 2019): a) the lump-sum per-capita reallocation of the revenues to private households, b) the reduction of electricity prices by decreasing the electricity tax to the EU minimum tax rates and/or by financing the industry exemptions with respect to the surcharge for the promotion of green electricity by taxes, and c) targeted financial aid for strongly burdened consumers, for example by increasing the housing benefits of poor households.

Using price elasticities on individual energy consumption in the transport and housing sector from the empirical literature (see e.g. Frondel, Vance 2014, 2018), for both private households and the sector Commerce, Trade and Services (CTS), we first estimate both potential emission savings and the revenues originating from a carbon pricing of three price levels: 25, 45 and 65 euros per ton. 25 euros corresponds to the fixed CO₂ price that is stipulated for the starting year 2021 of the national ETS. 45 euros is the fixed carbon price that is stipulated for 2024 and the price of 65 euros per ton reflects the upper limit of the price corridor that is foreseen for 2026 when emission allowances are auctioned for the first time in this separate ETS for Germany's road transport and housing sectors.

While our approach conceives carbon pricing by raising the energy taxes on fossil fuels, the same effects in terms of emission mitigation and revenues would arise from an ETS if the prices for certificates were to be identical to the tax rates. This equivalence holds particularly true for the years 2021 to 2025, because certificate prices are fixed in these years and, in effect, Germany's separate ETS constitutes a carbon tax regime in this period.

Carbon pricing burdens poor households more than wealthy households, as poor households generally spend a larger share of their income to cover their energy needs (Frondel et al. 2017, Heindl et al. 2014). To exemplify the distributional effects of carbon pricing, we present some extreme cases including three types of households that are threatened by poverty:

- Poor single-pensioner households that are not eligible for housing benefits, nor any other transfers,
- single-person households that are eligible for unemployment benefits and
- three-person households that are at risk of poverty.

Based on empirical data on the energy consumption of private households originating from the German Residential Energy Consumption Survey (GRECS, <http://www.rwi.de>)

<essen.de/GRECS/>), we gauge the fuel cost increases of these three types of households due to carbon pricing. Furthermore, assuming that only the revenues originating from the carbon pricing of the fossil fuel consumption of private households, not those from other sectors, such as CTS, will be reimbursed to private households, we estimate the levels of per-capita reimbursements for these household types for various CO₂ prices. On the basis of both estimates on the fuel cost increases and the per-capita reimbursements, we then calculate the net burden of these three household types due to Germany's carbon pricing.

In the subsequent section, we derive the surcharges on the prices of fossil fuels that result from establishing a national ETS in Germany's transport and housing sectors, as well as the revenues and emissions reductions that may be realized by this kind of carbon pricing. Section 3 exemplifies the distributional effects of carbon pricing on types of poor households. Section 4 discusses reimbursement mechanisms, while the last section summarizes and draws conclusions.

2. Revenues from Carbon Pricing and Emission Reductions

Based on emission factors published by Germany's Environmental Protection Agency (UBA 2019b) for natural gas, heating oil, diesel and petrol reported in Table 1, we now derive the surcharges on the energy taxes of these fossil fuels that are associated with carbon price levels of 25, 45, and 65 euros per ton of CO₂, thereby assuming that the prevailing energy taxes are raised for reasons other than carbon pricing. Neglecting the value added tax, which is raised on top of the net price of fuels, the increase in the tax on natural gas would amount to 1.3 cents per kilowatthour (kWh) if the CO₂ price were to equal 65 euros and 17.2 cents per liter for heating oil (Table 1), corresponding to about 1.7 cents per kWh.² Note that in the long run, tax rates that are higher for heating oil than for natural gas provide incentives for a fuel switch from heating oil to the less carbon-intensive natural gas. For a CO₂ price of 25 euros, as is stipulated for 2021 in Germany's separate ETS, the tax increases for road fuels amount to 5.9 cents per liter for petrol and 6.6 cents for diesel, with a value-added tax of 19% coming on top. For a CO₂ price of 65 euros, which is the upper limit of the price corridor for the national ETS in 2026, the tax increase for petrol amounts to 15.4 cents per liter and 17.2 cents for diesel.

These increases are lower than the daily volatility of gasoline prices, which may easily be larger than 20 cents per liter (RWI 2019). Hence, motorists should be familiar with such price changes, leading to the conclusion that, at least in the short run, substantial decreases in driving distances, fuel consumption and corresponding carbon emissions cannot be expected. In fact, estimates on the short-run fuel price elasticities taken from the literature indicate that responses in travel demand are rather moderate. Goodwin (1992),

² We ignore the value added tax in our calculations, as it seems unlikely that the additional revenues from this tax will be reimbursed to consumers given that the link between these additional tax revenues and carbon pricing remains obscure.

for instance, estimates the short-run fuel price elasticity of petrol consumption at -0.27, but finds a substantially higher long-run elasticity of -0.71 (Litman 2020: 8).

Table 1: Tax Increases (net of value-added tax) of Petrol, Diesel, Heating Oil and Natural Gas for various CO2 Prices (Sources: UBA 2019b, own calculations)

| | Emission factors | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|-------------|-------------------|---------------------|---------------------|---------------------|
| Petrol | 2.37 kg CO2/liter | 5.9 cents/liter | 10.7 cents/liter | 15.4 cents/liter |
| Diesel | 2.65 kg CO2/liter | 6.6 cents/liter | 11.9 cents/liter | 17.2 cents/liter |
| Heating oil | 2.65 kg CO2/liter | 6.6 cents/liter | 11.9 cents/liter | 17.2 cents/liter |
| Natural gas | 0.20 kg CO2/kWh | 0.5 cents/kWh | 0.9 cents/kWh | 1.3 cents/kWh |

In the long run, the permanent rise in fuel prices due to carbon pricing should substantially decrease the diesel and petrol consumption in Germany's transport sector. This conclusion is supported by econometric analysis of Germany's Mobility Panel (MOP), which suggests that the long-run price elasticities for gasoline lie within the range of -0,7 and - 0,4 (Frondel, Peters, Vance 2008; Frondel and Vance 2014, 2018). In other words, making gasoline more expensive through carbon pricing by, say, 10% reduces consumption by approximately 4 to 7%. These price responses are to be expected for both petrol and diesel demand alike, as Frondel and Vance (2014) found similar price elasticity estimates for both fuels. In the absence of fuel price elasticity estimates for the CTS sector, we assume that the long-run fuel price responses of commerce, trade and service companies are the same as those for private households when gauging the CO2 emission reductions due to carbon pricing for this sector.

As a benchmark, by presuming vanishing fuel price responses, that is, price elasticities of zero, in Table 2, we present upper-bound estimates of the revenues emerging from carbon pricing. Given the tax increases reported in Table 1 and consumption data for 2017, when Germany's petrol and diesel consumption amounted to 26.58 and 43.23 billion liters (BMVI 2019: 309), the German government can expect substantial "carbon" revenues from the carbon pricing of road fuels. In 2021, for instance, when the price of CO2 will be fixed at 25 euros per ton, these revenues may easily exceed 4 bn euros.

Employing long-run price elasticities of -0,4 for both petrol and diesel cars (Frondel, Vance 2014), rather than neglecting any price response, we find that revenues do not shrink dramatically relative to the benchmark of no behavioral response reported in Table 2. Presuming price levels of 1.3 and 1.5 euros per liter for diesel and petrol, respectively, which roughly reflect the average price levels in Germany in 2019, the tax increases reported in Table 1 and a price elasticity of -0,4 imply a reduction in Germany's diesel consumption by 2.0 to 5.3%, depending on the carbon price level (Table 3), and by 1.6 to

4.1% for petrol (Table 4). These ranges also reflect the relative emission reductions due to the carbon pricing of diesel and petrol.

Table 2: Revenues from Carbon Pricing in Germany's Transport Sector if No Demand Response to Carbon Pricing is presumed

| | Fuel Consumption | € 25/ton of CO2 | € 45/ton of CO2 | € 65/ton of CO2 |
|------------------------|------------------|-----------------|-----------------|-----------------|
| Petrol | 26.58 bn liters | 1.575 bn euros | 2.835 bn euros | 4.095 bn euros |
| Diesel | 43.23 bn liters | 2.864 bn euros | 5.155 bn euros | 7.446 bn euros |
| CO2 savings | – | 0 tons | 0 tons | 0 tons |
| Carbon revenues | – | 4.439 bn euros | 7.990 bn euros | 11.541 bn euros |

Comparing Table 3 and 4 with Table 2 suggests that in the long term, the desired reduction in gasoline consumption does not dramatically erode the revenues originating from carbon pricing: Despite substantial long-run demand decreases, carbon revenues of billions of euros would still be available to be reimbursed to consumers. Given lower short-run demand responses, the revenues from carbon pricing would even be higher in the short term than those reported in Tables 3 and 4. In fact, short-term carbon revenues should be rather of the magnitudes displayed in Table 2.

Table 3: Long-run Reduction of Diesel Consumption in Germany's Road Transport Sector and the Revenues from the Carbon Pricing of Diesel if a long-run Price Elasticity of Diesel Demand of -0,4 is presumed

| Carbon prices: | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|---------------------------|---------------------|---------------------|---------------------|
| Diesel consumption | 42.35 bn liters | 41.64 bn liters | 40.94 bn liters |
| Consumption change | -2.0% | -3.7% | -5.3% |
| CO2 savings | 2.335 m tons | 4.203 m tons | 6.072 m tons |
| Carbon revenues | 2.806 bn euros | 4.966 bn euros | 7.052 bn euros |

Patterns similar to those for petrol and diesel can be expected for the consumption of natural gas and heating oil. With respect to the natural gas consumption of private households, for instance, the difference in the revenues from carbon pricing between the short and the long term amounts to just a few 100 million euros (see Table 5 and Table A1) if short- and long-run gas price elasticities of -0.1 and -0.4 are presumed (see e.g. Liu 2004). Based on an elasticity of -0.4, the long-run gas demand would shrink by 3.3 to 8.7% (Table 5) given the natural gas consumption of 266.3 bn kWh for private households in 2017 (AGEB 2018) and a price level of 6 Cents per kWh. This reduction in the natural

gas consumption of private households may lead to CO2 savings of several million tons per year. Similar calculations were undertaken for the heating oil consumption of private households, as well as the gas and oil demand of the CTS sector, the results of which are presented in the appendix.

Table 4: Long-run Reduction of Petrol Consumption in Germany's Road Transport Sector and the Revenues from the Carbon Pricing of Petrol if a long-run Price Elasticity of -0,4 is presumed.

| Carbon prices: | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|---------------------------|---------------------|---------------------|---------------------|
| Petrol consumption | 26.16 bn liters | 25.82 bn liters | 25.49 bn liters |
| Consumption change | -1.6% | -2.8% | -4.1% |
| CO2 savings | 0.995 m tons | 1.729 m tons | 2.588 m tons |
| Carbon revenues | 1,550 bn euros | 2.754 bn euros | 3.926 bn euros |

Taken together, the revenues resulting from the carbon pricing of Germany's road transport, household and CTS sectors are summarized in Table 6, with the corresponding CO2 savings reported in Table 7. In the long run, a carbon price of 25 euros would generate carbon revenues of about 7.7 bn euros (Table 6). These revenues would exceed the volume generated by Germany's electricity tax, which amounted to 6.86 bn euros in 2018 (BMF 2019). In the short run, revenues are even higher due to moderate demand responses.

Table 5: Long-run Reduction of the Natural Gas Consumption of German Households and the resulting CO2 Savings if a Long-Run Price Elasticity of -0,4 is presumed

| Carbon prices: | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|---------------------------|---------------------|---------------------|---------------------|
| Gas consumption | 257.5 bn kWh | 250.4 bn kWh | 243.2 bn kWh |
| Consumption change | -3.3% | -6.0% | -8.7% |
| CO2 savings | 1.775 m tons | 3.196 m tons | 4.616 m tons |
| Carbon revenues | 1.287 bn euros | 2.253 bn euros | 3.162 bn euros |

Revenues of about 7.7 bn euros would also suffice to finance the exemptions of the energy-intensive industry with respect to the support of renewable energy technologies. These technologies are currently financed by consumers via a surcharge on the electricity price, the so-called EEG levy, but firms in energy-intensive industries are allowed to pay just a small fraction of this levy, which in 2020 amounts to 6.76 cents per kWh. As a result of the industry exemptions, all other consumers have to pay a higher levy, frequently

leading to claims of unfairness in the distribution of the costs of Germany's energy transition (Andor, Frondel, Sommer 2018). In 2018, 2,156 German firms benefitted from these exemption rules, while the remaining consumers had to bear a higher burden of about 5.5 bn euros in total (BAFA, BMWi 2019: 15). Even for a low CO₂ price of 25 euros per ton, the revenues from carbon pricing would allow financing these industry exemptions out of the carbon revenues, which in turn would reduce the electricity prices for German consumers.

Table 6: Long-run "Carbon" Revenues from Carbon Pricing

| Carbon prices: | € 25 per ton of CO ₂ | € 45 per ton of CO ₂ | € 65 per ton of CO ₂ |
|------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Transport | 4.356 bn euros | 7.720 bn euros | 10.978 bn euros |
| Households (oil, gas) | 2.166 bn euros | 3.798 bn euros | 5.340 bn euros |
| CTS sector (oil, gas) | 1.174 bn euros | 2.059 bn euros | 2.897 bn euros |
| Total carbon revenues | 7.696 bn euros | 13.577 bn euros | 19.215 bn euros |

With respect to emissions savings, the effects of carbon pricing are not as promising as those for the federal budget. At a carbon price of 65 euros, the long-term CO₂ emissions savings that can be realized in Germany's road transport and housing sectors would be lower than 20 million tons (Table 7). This outcome means that only about a fifth of the emission reductions required for fulfilling Germany's mandatory climate target related to the Non-ETS sectors would be achieved. The target for 2030 demands that their emissions are reduced by -38% relative to 2005, when these sectors' GHG emissions amounted to 405.0 million tons (UBA 2019b). In absolute terms, the target necessitates that the GHG emissions of the Non-ETS sectors shrink to 251.1 million tons in 2030. That is, until 2030, these sectors' GHG emissions must be reduced by 107.9 million tons relative to 2018. Apparently, this ambitious target can hardly be reached by carbon pricing alone. According to a recent study by Bach et al. (2019: 2), even a carbon price of 180 euros per ton would not suffice to reach Germany's climate targets for 2030.

Hence, in addition to any carbon pricing beyond the price levels that are fixed until 2025, Germany must establish further emission abatement measures to ultimately fulfill its climate targets for 2030 (Edenhofer et al. 2019). However, the government should abstain from employing the revenues accruing from carbon pricing to continue to finance a variety of measures that would not be undertaken under an ideal carbon pricing regime, such as market premia for the support of renewable energy technologies in the heating sector. Instead, to foster the acceptance of the carbon pricing regime, it is critical that the

revenues originating from carbon pricing are entirely reallocated to the consumers in a highly transparent way.

Table 7: Long-run Greenhouse Gas Emissions Savings due to Carbon Pricing

| Carbon Prices | € 25 per ton of CO ₂ | € 45 per ton of CO ₂ | € 65 per ton of CO ₂ |
|--------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Road Transport | 3.330 m tons | 5.995 m tons | 8.660 m tons |
| Households (Oil, Gas) | 2.803 m tons | 5.045 m tons | 7.287 m tons |
| CTS sector (Oil, Gas) | 1.503 m tons | 2.705 m tons | 3.907 m tons |
| Total emissions savings | 7.636 m tons | 13.745 m tons | 19.854 m tons |

3. Impact of Carbon Pricing on Poor Households

Carbon pricing aims at raising the cost burden of those households and firms that consume fossil fuels, such as natural gas and heating oil. This pricing policy particularly affects those consumers who are either unwilling or unable to lower their fossil fuel consumption, for example by substituting fossil fuels through renewable energy sources. Most important from a social policy perspective is that carbon pricing burdens poor households more than wealthy households, as poor households generally spend a larger share of their income to cover their energy needs (e. g. Frondel et al. 2017, Heindl, Schüßler, Löschel 2014). Conversely, if the revenues originating from carbon pricing would be reallocated to consumers, this would particularly help to alleviate the cost burden of poor households. Reimbursing these revenues would thus be a promising approach to reduce the threat of social distortions and protest waves against this climate policy instrument.

To exemplify the distributional effects of carbon pricing, as well as the reallocation of the revenues by per-capita transfers, this section presents potential extreme cases, including three household types that are at risk of poverty: Poor single-pensioner households that are not eligible for housing benefits, nor any other transfers, single-person households that are eligible for unemployment benefits, and three-person households threatened by poverty.³ Of course, these three types of households are not representative for the population of German households, but nonetheless there are several millions of such households in Germany (BMAS 2017).

Based on the GRECS data on the energy consumption of private households, we now estimate the fuel cost increases of these three types of households due to carbon pricing. Furthermore, assuming that the revenues originating from the carbon pricing of

³ By definition, households are at risk of poverty if their net income equals or falls below the threshold of 60% of the median income of households of the same size (BMAS 2017).

private households will be entirely reallocated, we estimate the levels of per-capita reimbursements. On the basis of estimates on both the fuel cost increases and the per-capita reimbursements, we then calculate the net burden of these three household types due to Germany's carbon pricing.

To present conservative estimates that are not too optimistic with respect to the households' behavioral response to carbon pricing, we assume that households that are threatened by poverty do not reduce their fossil fuel consumption. This assumption seems plausible given that poor households lack financial opportunities to invest in more energy-efficient and less emissions-intensive technologies and is corroborated by recent research that is also based on GRECS data, concluding that the electricity price elasticities of poor households are not significantly different from zero in statistical terms (Frondel, Kussel Sommer 2019).

According to the GRECS data, the average living space of a typical poor single-pensioner household amounts to 55 square meters. The annual heating demand for this area averages about 8,000 kWh if this household heats with natural gas and about 800 liters of heating oil if the heating demand is satisfied with oil. The additional burden of this household type due to the carbon pricing of heating would be as high as 137 euros per year, that is, almost 12 euros per month (Table 8).

If the revenues from the carbon pricing of the private households' consumption of heating oil, natural gas and gasoline would be entirely reallocated to Germany's 83 million inhabitants via per-capita premia, each citizen may expect a reimbursement of around 54 to 134 euros per year, depending on the carbon price level (see last row of Table 8).⁴ Based on these reimbursement levels, if a poor single-pensioner household does not own a car and heats with gas, this household type may expect a net gain of around 14 to 30 euros per annum. If the household heats with oil, its burden due to carbon pricing would roughly be equalized by the per-capita reimbursement of carbon revenues.

According to the GRECS data, about 40% of the poor single-pensioner households own a car and would experience a further burden due to carbon-price-induced higher gasoline costs. If the car is a diesel, this pensioner would have to bear additional costs between almost 21 to around 54 euros per annum, while owning a petrol car would bring about higher cost between almost 21 to around 49 euros (Table 8). These cost estimates are based on annual average travel distances of this type of household of about 4,500 km,

⁴ The per-capita premia reported in Table 8 are calculated on the basis of, first, the revenues from the carbon pricing of the diesel and petrol consumption of private households, which amounted to 14.64 and 23.19 bn liters, respectively, in 2017 (Destatis 2019). For carbon prices of 25, 45, and 65 euros, these revenues amount to 2.303, 4.085, and 5.814 bn euros and must be added to, second, the revenues reported in Table 6 for the private households, the sum of which must be divided by the number of 83 million German citizens.

mean specific consumption values of 7.8 liters per 100 kilometers for petrol cars and 7.0 liters for diesel cars, as well as the respective carbon price burden reported in Table 1 for both kinds of gasoline.

Table 8: Annual Burden of a typical Poor Single-Pensioner Household due to Carbon Pricing and potential Per-capita Reimbursement of Revenues

| | Consumption | € 25/ton of CO2 | € 45/ton of CO2 | € 65/ton of CO2 |
|---------------------------------|-------------|-----------------|-----------------|-----------------|
| Natural gas | 8 030 kWh | 40.2 euros | 72.3 euros | 104.4 euros |
| Heating oil | 792 liters | 52.5 euros | 94.5 euros | 136.5 euros |
| Diesel | 315 liters | 20.9 euros | 37.6 euros | 54.3 euros |
| Petrol | 351 liters | 20.8 euros | 33.6 euros | 48.5 euros |
| Per-capita reimbursement | -- | 53.9 euros | 95.0 euros | 134.3 euros |

For a carbon price of 25 euros, for example, the higher heating and gasoline costs of this household type cannot be outweighed by the per-capita reimbursement of 53.9 euros. This also holds true for higher carbon prices of 45 and 65 euros. Therefore, a higher per-capita reimbursement would be required to ensure a positive net balance for this household type. Yet, higher per-capita reimbursements require revenues from areas other than the private household sector, for example from the CTS sector. This, however, would imply that there are no financial resources to alleviate the burden of the firms of the CTS sector.

The second type of household that is scrutinized here refers to single-person households that are eligible for unemployment benefits. Carbon pricing would imply additional costs for heating of about 37 to 95 euros per annum if the household heats with natural gas and almost 48 to 124 euros if heating oil is employed (Table 9). Ultimately, though, this type of households does not have to bear this burden, as the transfers for these households would be increased accordingly.

Like poor single-pensioner households, a large share of about 60% of this second household type does not possess a car. Such households would not have to bear any burden from carbon pricing. Moreover, if carbon revenues would be reimbursed via per-capita transfers, these households would be even better off than without carbon pricing. However, if these single-person households own a car, they would incur carbon costs of 56 to 145 euros for gasoline purchases (Table 9). These figures are based on GRECS data indicating an annual driving distance of this household type of about 12.000 kilometers, on average. Given average consumption values of 7.8 liters per 100 kilometers for petrol cars and

7.0 liters for diesel cars, the annual driving distance of 12,000 kilometers implies a consumption of 936 liters of petrol per year and 840 liters of diesel. The resulting gasoline cost burden of about 54 to 134 euros exceeds the per-capita reimbursements reported in the last row of Table 9. In other words, if households of this second type own a car, carbon pricing would burden their budget even if the resulting revenues are reimbursed by lump-sum per-capita transfers.

Table 9: Annual Burden due to Carbon Pricing of a typical Single-Person Household that obtains Unemployment Benefits and potential Per-capita Reimbursement of Revenues

| | Consumption | € 25/ton of CO2 | € 45/ton of CO2 | € 65/ton of CO2 |
|---------------------------------|-------------|-----------------|-----------------|-----------------|
| Natural gas | 7.300 kWh | 36.5 euros | 65.7 euros | 94.9 euros |
| Heating oil | 720 liters | 47.7 euros | 85.9 euros | 124.0 euros |
| Diesel | 840 liters | 55.7 euros | 100.2 euros | 144.7 euros |
| Petrol | 936 liters | 55.5 euros | 99.8 euros | 144.2 euros |
| Per-capita reimbursement | -- | 53.9 euros | 95.0 euros | 134.3 euros |

A third household type that is scrutinized here refers to three-person households at risk of poverty. The heating costs of this household type may increase substantially due to carbon pricing, by up to about 200 euros if heating oil is employed for this purpose (Table 10). If this household type does not own a car and would benefit from per-capita reimbursements, its net balance may nevertheless turn out to be positive, most notably due to the fact that with three household members, this household type enjoys three times the reimbursements of single-person households.

Yet, according to the GRECS data, some 85% of three-person households threatened by poverty own a car and, thus, in addition to heating costs, these households have to bear higher mobility costs: Given average driving distances of around 17,000 and 20,000 kilometers per year for petrol and diesel car drivers, respectively, the additional mobility costs of this household type due to carbon pricing amount to about 80 to 240 euros per annum (Table 10). If the revenues originating from carbon pricing would be reimbursed via per-capita transfers, this household type's burden could be outweighed. The net balance would turn out to be positive if such households were to heat with the less carbon-intensive natural gas and drive with a petrol car. In contrast, the net balance would be negative for those households that are heating with oil and driving a diesel car.

Table 10: Annual Burden of a typical Three-Person Household Threatened by Poverty due to Carbon Pricing and potential Per-capita Reimbursement of Revenues

| | Consumption | € 25/ton of CO2 | € 45/ton of CO2 | € 65/ton of CO2 |
|---------------------------------------|--------------|-----------------|-----------------|-----------------|
| Natural gas | 11.826 kWh | 58.3 euros | 105.0 euros | 151.6 euros |
| Heating oil | 1.166 liters | 77.3 euros | 139.1 euros | 200.9 euros |
| Diesel | 1.400 liters | 92.8 euros | 167.0 euros | 241.2 euros |
| Petrol | 1.326 liters | 78.6 euros | 141.4 euros | 204.3 euros |
| Total per-capita reimbursement | | 161.5 euros | 285.0 euros | 403.1 euros |

In sum, these examples indicate that, first, households that employ heating oil for heating purposes tend to suffer from a higher burden due to carbon pricing than households that use natural gas. It therefore bears noting that, according to the GRECS data, oil heating is more common among pensioner and poor households than for other household types. Second, larger households tend to benefit more from a per-capita reimbursement than households with less members, given that energy consumption and costs generally do not grow proportionately with the number of household members (Frondel, Kussel, Sommer 2019). Hence, the larger the number of household members, the lower is the net burden under a per-capita reimbursement scheme. In short, this scheme would turn out to be particularly beneficial for families with many children, which are likely to be better off from a carbon pricing with a per-capita reimbursement of the resulting revenues.

Beyond these conclusions, several stylized facts are important to note: First, the energy consumption of wealthy households is generally higher than that of other households, not least due to, on average, a larger number of vehicles and longer driving distances per year. Thus, in perfect accord with the aims of climate policy, under a carbon pricing scheme, wealthy households tend to bear a net burden even if the carbon revenues would be reallocated via per-capita transfers.

Second, while about a quarter of the German households heat with oil and around half with natural gas, a per-capita reimbursement would turn out to be positive for all those households that do not use fossil fuels for heating purposes, but instead employ renewable energy technologies, such as solar thermal collectors. Such households would not suffer from carbon pricing at all if, in addition to regenerative heating technologies, they satisfy their mobility demand by alternative motor technologies, such as electric vehicles.

While such households tend to belong to the higher end of the income distribution, they would be among the winners of any carbon pricing that is accompanied by a per-

capita reimbursement. From a social policy perspective, though, such distributional impacts of carbon pricing must not be ignored (see Heindl and Kanschik (2016) for a discussion on environmental policy and distributive justice). This is all the more relevant as poor households, nor any other less carbon-intensive technologies, such as heat pumps, given their low budget for investments, generally cannot afford more efficient energy technologies. With the ever-increasing cost of Germany's energy transition, the government would be well-advised to pay close attention to the distributional impacts on poor households to avoid jeopardizing the wide acceptance among the German population for this huge societal challenge.

Beyond such adverse distributional effects, another disadvantage of reimbursing carbon revenues via per-capita transfers is that the transaction costs of these transfers are non-negligible: Bureaucracy costs may absorb large shares of the carbon revenues so that per-capita transfers may turn out to be substantially lower than those reported in Table 8. By contrast, employing carbon revenues to compensate the tax deficits due to the reduction of the electricity tax would not imply any transaction costs. These considerations indicate that it is worthwhile to discuss alternative mechanisms of reallocating the revenues accruing from carbon pricing.

4. Alternative Mechanisms for Reallocating the Revenues from Carbon Pricing

Reducing consumers' electricity costs, for instance by lowering Germany's electricity tax of 2.05 cents per kWh to the EU minimum rates for private households and firms, is among three alternative mechanisms that are discussed in this section. Abolishing the electricity tax would be warranted for several reasons. First, given that electricity is burdened by the electricity tax irrespective of whether it is produced by fossil-based plants or on the basis of renewable technologies, this tax implies lower incentives for an environmentally benign behavior than a tax with differentiated rates. Moreover, the justification for this tax steadily shrinks with the strongly increasing shares of green electricity in consumption. In 2018, the share of green electricity in consumption amounted to 37.8% (BMWi 2019), whereas this share was lower than 7% in 2000, when the feed-in tariff system for the support of renewable electricity generation technologies was introduced in Germany.

Second, the electricity tax became largely redundant when the EU ETS was introduced in 2005 with the aim to mitigate the environmental impact of both industrial and electricity production. This argument holds particularly true since prices for emissions certificates have increased substantially, from below 10 euros before 2018 to the current level of about 25 euros. The costs for purchasing emission certificates, which are required for the electricity production based on fossil fuels, increase production costs and, hence, tend to increase the electricity prices for consumers. Thus, the EU ETS provides incentives for a

less carbon-intensive behavior for both electricity producers and consumers, rendering the electricity tax largely obsolete.

Third, with a share of slightly more than 50% in the end-use price of electricity for private households in 2019 (BDEW 2020), levies and taxes play a much larger role for this type of energy than for other energy carriers, such as natural gas and heating oil. This fact hampers the switch from fossil fuels to green electricity in sectors other than the electricity sector, a switch that is denoted by the notion of sector coupling and regarded as highly relevant for achieving Germany's ultimate climate goal of a carbon-neutral economy in 2050.

All in all, it hardly seems warranted for EU Member countries to still tax electricity beyond the minimum rates that are demanded by the European Commission. These minimum rates amount to 0.1 cents per kWh for private households and 0.05 cents for firms. Given that the revenues generated by carbon pricing can be employed to replace those originating from the electricity tax, this argument particularly holds true in the context of Germany's ecotax on electricity of 2.05 cents per kWh. The ecotax was introduced in 1999 to also stabilize the monthly contribution rates to pension systems, in addition to the aim of dampening the electricity consumption for environmental reasons ("double dividend").

Indeed, the estimates reported in Table 6 indicate that, at a carbon price of 25 euros, the revenues originating from carbon pricing would suffice to replace the annual revenues accruing from the ecotax. In 2018, the ecotax revenues amounted to 6.86 bn euros (BMF 2019). Were the ecotax to be reduced to the minimum rates, consumers would benefit from electricity cost savings. For instance, for our first type of households, the poor single-pensioner household, whose annual electricity consumption amounts to some 1,860 kWh (Frondel, Sommer 2018), costs savings of around 36 euros (see Table 11) would result from reducing the ecotax to the minimum rate of 0.1 cents per kWh, that is, by 1.95 cents. These cost savings, however, cannot outweigh this pensioner's higher heating costs due to carbon pricing (Table 8).

For single-person households that receive unemployment benefits, whose annual electricity consumption amounts to 1,680 kWh according to the GRECS data (Frondel, Sommer 2018), reducing the ecotax would result in annual cost savings of about 33 euros (Table 11). By comparison, the standard rate of unemployment benefits to cover the needs of everyday life such as food, cloths, and electricity consumption, was raised in 2019 for single-person households by 8 euros, from 416 to 424 euros per month, that is, by around 2%. Annual savings in electricity costs of around 33 euros are thus equivalent to a monthly increase of the standard rate of unemployment benefits of almost 0.7%.

Due to an ecotax cut, a typical three-person household threatened by poverty would save about 72 euros per year (Table 11), given that its annual electricity consumption

amounts to around 3,700 kWh according to the GRECS data. These savings would more than outweigh the higher burden from heating at a carbon price of 25 euros if this household employs natural gas for this task (Table 10). If heating oil is employed, though, this household type would have to bear a net burden, which would be more pronounced if the household owns a car. It deserves noting in this context that, in addition to private households, firms would also benefit from reducing the ecotax, while they may have the opportunity to shift the costs of carbon pricing to the consumers, at least partly.

Table 11: Annual Cost Savings from a Reduction of the Electricity Tax of 2.05 Cents per kWh to the Minimum Rate of 0.1 Cents per kWh for Private Households.

| | Consumption | Cost Savings |
|--------------------------------------------------|-------------|--------------|
| Poor Single-Pensioner Household | 1.860 kWh | 36.27 euros |
| Unemployed Single-Person Household | 1.80 kWh | 32.76 euros |
| Three-Person Household at Risk of Poverty | 3.700 kWh | 72.15 euros |

Another alternative to alleviate the burden of consumers would be to finance the industry exemptions in the promotion of renewable energy technologies by using the revenues from carbon pricing. These industry exemptions imply a higher surcharge on the electricity price for consumers with which green electricity is promoted since the introduction of the Renewable Energy Act (EEG) in 2000. From a fairness perspective, reducing this surcharge would be highly desirable (Andor, Frondel, Sommer 2019), as financing the industry exemptions via the so-called EEG levy on the electricity price results in a higher burden of poor households, relative to their income, than for wealthy households (Frondel et al. 2017).

To finance the industry exemptions by revenues from carbon pricing, around 5.5 bn euros would be required (BAFA, BMWi 2019: 15). At a carbon price of 25 euros, the carbon revenues should easily exceed the amount of 5.5 bn euros (Table 6). With this amount of money, the level of the EEG levy could be reduced by about 1.64 cents per kWh (BAFA, BMWi 2019: 15): Rather than 6.756 cents as in 2019, this surcharge would have only amounted to 5.116 cents per kWh. With this reimbursement alternative, though, the net electricity cost savings per kWh would be lower than with a reduction of the ecotax by 1.95 cents per kWh, suggesting that an ecotax reduction should be preferred over the financing of the industry exemptions via carbon revenues. At a carbon price of 45 euros, however, both alternatives could be financed simultaneously by the revenues from carbon pricing: According to Table 6, revenues of around 13.5 bn euros would be available in case of a carbon price of 45 euros.

Although there are numerous reasons that would justify electricity price reductions by lowering the ecotax or by financing the industry exemptions or by both, from a social policy perspective, there is one disadvantage of this reimbursement mechanism: In absolute terms, poor households would benefit less from reducing electricity prices than wealthy households, given that the electricity consumption of wealthy households is typically higher than that of poor households of the same size (Frondel, Kussel, Sommer 2019).

This disadvantage does not apply to the reimbursement mechanism that is based on lump-sum per-capita transfers, the second alternative that is discussed here. Yet, given that these transfers would be paid to all 83 million citizens of Germany, both children and adults, the per-capita transfers may turn out to be rather low if only those carbon revenues are employed for reimbursement that arise from the fossil fuel consumption of private households, but not those from other sectors. For instance, at a carbon price of 25 euros, this per-capita transfer amounts to about 54 euros (Table 8). However, employing the carbon revenues raised from the fossil fuel consumption of firms in the CTS sector to reimburse households would be ill-advised if the government wants to alleviate the burden of these firms from carbon pricing as well, which might be warranted for competitive reasons.⁵

Arguably, the most effective alternative with respect to mitigating the burden of poor households originating from carbon pricing would be the third alternative that is considered here: targeted measures, such as housing benefits, for strongly affected households. This alternative is in accord with the recommendation of Germany's Council of Economic Experts, who suggest increasing housing benefits as an appropriate instrument against the rising burden of poor households due to growing housing rents (SVR 2018:356).

Housing benefits are exclusively paid to people who do not obtain other transfers, such as unemployment benefits and social assistance, as the latter transfers also cover housing costs. The most recent increase in the housing benefits came into force on January 1, 2020 (Federal Government 2019), with the previous increase dating back to 2016. In 2020, around 660,000 households receive housing benefits, that is, about 1.5% of all households. In 2019, the total amount of housing benefits accounted for around 1.2 bn euros. That is, monthly housing benefits amounted to some 150 euros per household, on average. As of January 2022, housing benefits will be regularly increased every two years. If we assume that these benefits were to be increased by 10%, that is, by 15 euros on

⁵ In alleviating the net burden of firms accruing from carbon pricing, Germany could adopt the approach of Switzerland, where except for transport fuels, the carbon pricing of fossil fuels was introduced already in 2008. In Switzerland, the reimbursement of the revenues from carbon pricing to firms is proportional to the sum of wages that is paid by a firm. The net burden of labor-intensive firms is therefore lower than that of energy-intensive companies. Energy-intensive companies, though, can be exempted from paying a carbon price if they commit to voluntary carbon mitigation measures (BAFU 2019). In any case, those firms that participate in the Swiss ETS are not additionally burdened by the carbon pricing of fossil fuels.

average, additional costs of about 120 million euros per annum would have to be borne for the roughly 660,000 recipients of housing benefits.

This amount could be easily covered by the revenues originating from carbon pricing. In addition, the carbon-price-induced growth of the housing costs of transfer recipients should be financed through carbon revenues. If we assume that the average housing costs of transfer recipients were to increase by 50 euros per year due to carbon pricing, another 306 million euros per annum would have to be covered by the revenues from carbon pricing, given that at the end of 2018 there were roughly 7.2 million transfer recipients in Germany (Destatis 2019), among which were 5.6 million beneficiaries of unemployment benefits. Note that 50 euros per year equals roughly the burden due to a carbon price of 25 euros that would have to be paid by our second household type, single-person households that receive unemployment benefits, if these households heat with oil (see Table 9).

With this third alternative, the revenues from carbon pricing have to be distributed to only around 7.9 million recipients of transfers and housing benefits, rather than 83 million German citizens, as with the alternative of a per-capita reimbursement. Thus, a large fraction of the carbon revenues would be left for further targeted social policy measures. Most notably, the government could raise the standard rate of unemployment benefits with which the needs of every-day-life, such as electricity consumption, is covered. During many years, this standard rate was not increased as much as the consumer price index rose (HartzIV.org 2019). An important reason for the temporarily increasing gap between this standard rate and the consumer price index has been the growth in electricity prices since the beginning of the millennium, which is primarily due to increasing taxes and levies (Frondel, Sommer 2018).

Another kind of a targeted financial aid is the increase of the commuting allowance per kilometer for employees with which the government wants to outweigh the higher costs of driving to the workplace due to carbon pricing. As of 2021, the level of the commuting allowance will be increased from 30 to 35 eurocents per kilometer, but only for travel distances to the workplace that are larger than 21 kilometers, whereas for distances below 21 kilometers, the currently uniform level of 30 eurocents per kilometer remains unchanged.⁶ Yet, this measure cannot be embraced from an ecological perspective: In fact, increasing this allowance equals a per-liter compensation for higher fuel costs. It would thus undermine the incentives set by carbon pricing and is counterproductive with respect to reducing annual driving distances and related GHG emissions. This adverse impact would even be at work if the commuting allowance would only partly outweigh the higher driving costs due to carbon pricing.

⁶ For the period 2024 to 2026, the commuting allowance will be increased from 35 to 38 eurocents per kilometer, but after 2026, the temporary increase in this allowance will be abolished.

5. Conclusion and Policy Implications

In 2021, Germany will launch a national emissions trading system (ETS) on carbon dioxide (CO₂) allowances in its road transport and housing sectors, two sectors that are not integrated in the ETS of the European Union (EU) so far. Irrespective of its concrete implementation, any carbon pricing regime brings about higher costs for the consumers of fossil fuels – otherwise, this climate policy instrument would not be effective. A promising approach to sustain the currently high acceptance for a national carbon pricing in Germany would be to entirely reallocate the resulting revenues to consumers.

This article has discussed three alternative mechanisms to reallocate the revenues originating from carbon pricing: a) a lump-sum per-capita reimbursement to private households, b) the reduction of electricity prices by reducing the electricity tax to EU minimum tax rates and/or by refinancing the industry exemptions with respect to the promotion of green electricity, as well as c) financial aid for strongly burdened consumers, for example by increasing the housing benefits of poor households.

Most effective with respect to alleviating the burden of poor households would be the third alternative. While raising housing benefits would not require large amounts of financial resources, the remaining “carbon” revenues should preferably be employed to reduce Germany’s electricity tax, as this tax is increasingly losing justification from an ecological perspective (Edenhofer, Flachsland, 2018). Although there are good reasons for both a per-capita reimbursement of carbon revenues and a reduction of electricity prices, diminishing the electricity tax has several advantages over a per-capita reimbursement, particularly with respect to transaction costs, which would be negligible in case of tax cuts.

Alas, reimbursing “carbon” revenues to consumers in the form of an electricity tax cut or by per-capita transfers is not foreseen by the German government. Rather, carbon revenues are scheduled to support a large spectrum of policy measures, such as increasing the subsidies for the purchase of electric vehicles from 4,000 to 6,000 euros and increasing the commuting allowance of a driving distance to work as of 20 kilometers to outweigh the higher costs of driving due to carbon pricing. Such measures hardly yield any environmental benefits and may even foster counterproductive behavior. Moreover, they tend to favor wealthy, rather than poor, households and are thus questionable from both an ecological and a social policy perspective. Instead, to sustain the wide acceptance of carbon pricing in Germany, it is critical that the government establishes measures to primarily favor poor households and alleviate their burden originating from carbon pricing.

Appendix

Table A1: Revenues from the Carbon Pricing of the Heating Oil and Natural Gas Consumption of Private Households if No Demand Response is presumed, that is, price elasticities are assumed to be zero.

| | Consumption | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|------------------------|--------------|---------------------|---------------------|---------------------|
| Natural gas | 266.3.bn kWh | 1.332 bn euros | 2.397 bn euros | 3.462 bn euros |
| Heating oil | 136.5 bn kWh | 0.904 bn euros | 1.628 bn euros | 2.351 bn euros |
| Carbon revenues | | 2.236 bn euros | 4.025 bn euros | 5.813 bn euros |

Table A2: Long-run Reduction of the Heating Oil Consumption of Private Households in Germany and the resulting CO2 Savings if a Long-Run Price Elasticity of -0,3 is presumed

| Carbon prices: | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|------------------------------|---------------------|---------------------|---------------------|
| Consumption | 13.2 bn liters | 12.9 bn kWh | 12.6 bn kWh |
| Demand reduction | -2.8% | -5.1% | -7.4% |
| CO2 emissions savings | 1.027 m tons | 1.849 m tons | 2.670 m tons |
| Carbon revenues | 0.879 bn euros | 1.545 bn euros | 2.178 bn euros |

Table A3: Long-run Reduction of the Natural Gas Consumption of the CTS Sector in Germany and the resulting CO2 Savings if a Long-Run Price Elasticity of -0,4 is presumed

| Carbon prices: | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|------------------------------|---------------------|---------------------|---------------------|
| Consumption | 123.9 bn kWh | 120.5 bn kWh | 117.1 bn kWh |
| Demand reduction | -3.3% | -6.0% | -8.7% |
| CO2 emissions savings | 0.854 m tons | 1.538 m tons | 2.221 m tons |
| Carbon revenues | 0.619 bn euros | 1.084 bn euros | 1.522 bn euros |

Table A4: Long-run Reduction of the Heating Oil onsumption of the CTS Sector in Germany and the resulting CO2 Savings if a Long-Run Price Elasticity of -0,3 is presumed

| Carbon prices: | € 25 per ton of CO2 | € 45 per ton of CO2 | € 65 per ton of CO2 |
|------------------------------|----------------------------|----------------------------|----------------------------|
| Consumption | 8.37 bn liters | 8.18 bn liters | 7.98 bn liters |
| Demand reduction | -2.8% | -5.1% | -7.4% |
| CO2 emissions savings | 0.648 m tons | 1.167 m tons | 1.686 m tons |
| Carbon revenues | 0.555 bn euros | 0,975 bn euros | 1,375 bn euros |

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