Hertie School
Jacques Delors Centre

Policy Position

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#GreenTransition
#EconomicInequality
#IndustrialPolicy

Avoiding the Road Bumps of the Green Transition

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Green growth requires strategy and coordination. The green transition entails important costs and will fail politically if we do not address socio-economic inequalities. In this Policy Position, Cornelia Woll proposes three pathways to a net-zero economy by 2050 that ideally should be combined: (i) correcting market signals through taxonomies and taxation; (ii) developing a European industrial policy that supports green innovation but also rewards successful transition plans; (iii) facilitating the funding for companies and financial institutions lending to those invested in green technology.

This policy position is based on remarks delivered at the 31st Franco-German Meeting in Evian from 7 - 9 September 2023.[1]

Is green growth possible? Can we succeed in a green transition without slowing down the economy?

The transition to a net-zero economy by 2050 entails important distributional challenges between firms and countries, but we also know that the green transition will fail politically if we do not address socio-economic inequalities stemming from green adjustment. The French have learned this the hard way when a rise in fuel taxes led to the Yellow Vest movement in 2018. The Germans are reminded of it in the current push back against the proposed heating law that is feared by many less well-off households.

At the bottom of all of this is one simple fact: achieving a green economy is very costly. Jeremy Rifkin famously referred to the current period as the

[1] For the same meeting, the Jacques Delors Centre Berlin prepared a discussion input, which can be found here. Nicole Gnesotto, Vice President of the Jacques Delors Institute Paris, and Pascal Lamy, Coordinator of the Jacques Delors think tanks network, prepared a paper on European defense (forthcoming).

"Third Industrial Revolution" and it has only just started. After the steam-power-driven first industrial revolution of the late 18th century and the second industrial revolution at the turn of the 20th century powered by oil and combustion engines, the current break must embrace the promise of digital communication and low-carbon energy sources. This is not a marginal adjustment that the market can solve by itself with some light regulatory support, even if one is a technological optimist (and I am).

A just green transition requires political strategy and coordination, but also solutions to funding that can leverage public and private finances. However, we must also be clear that adjustment entails slowing down and bearing the cost of transition that we would not otherwise have. Despite these obstacles, it is urgent to shoulder this task now, as costs will only rise if we try to catch up later, when others have already advanced on green technologies and the transformation of their economies.

I would like to develop three pathways towards green growth that I believe should all be on the table and ideally combined to allow us to achieve net-zero by 2050. (1) The first is getting market signals right by shaping prices and profits through taxonomies and taxation. (2) Second, we need to support green tech directly through a new kind of European industrial policy, but also by rewarding transition plans not just for sectors but at the level of individual companies. (3) Third, it is important to facilitate access to funding for companies and for financial institutions lending to those invested in green tech. Let me develop each of these in turn.

First, shifting investment incentives requires the market to price the cost of carbon emissions and their negative externalities correctly. Since this is not the case, central banks and supervisors created the Network for the Greening of the Financial System in 2017, which seeks to integrate climate-related risks into financial stability monitoring and encourages sustainability portfolio management. To create similar incentives and transparency at the company level, a new standard-setting body was created at the 2021 climate summit in Glasgow: the International Sustainability Standard Board headed by Emmanuel Faber. Its task is to develop sustainability-related financial reporting to guide investors. In parallel, carbon pricing through the expansion of emission quota trading and carbon taxes is already used to reduce the profitability of pollution. All these measures are necessary but not sufficient. Research has shown that capital investment and skill accumulation create path-dependencies: companies will continue to seek innovation in those sectors where they have traditionally excelled, even if profits are continuously squeezed.

This is why we also need a second approach: direct support for green technologies. Investment in innovation will only happen if we address both externalities: the cost of pollution and the costs of knowledge transfer. Industrial policy has made such a fulminating come back because the US and China have shown us how it is done. Setting clear strategic priorities, the US Inflation Reduction Act is simple and makes investment benefits predictable, as it is based on tax breaks. It does not include carbon pricing and does not cap subsidies. The EU's Net Zero Industrial Act is unlikely to be a sufficient reply, because it relies essentially on the acceleration of the permitting procedure and traditional state aid, which can further fragment the European market which already includes high coordination costs. What is needed from a common European industrial policy is an EU-wide funding strategy to support green investment in a way that is technology neutral, if innovation addresses the net-zero challenge. This means tackling the coordination issue between member states and accepting that a common industrial policy may imply the relocation of industries within the European market. After all, the European project arose in the form of an industrial production alliance when the Coal and Steel Community was founded in 1951. It should not be an insurmountable challenge to achieve a cohesive vision on energy and industrial

strategy over seventy years later.

In addition to supporting innovative technologies, we must also think about all the assets tied to carbon-intensive production that will significantly drop in value over time. Supporting and rewarding transition plans for companies that redesign their industrial production should be a political priority to encourage the commitment of firms and gain the support of employees, which is in many cases central to the industrial transformation of entire regions. This can be done in a perfectly pro-competitive manner. Why not create green growth units in national competition authorities that review transition plans and give a green light to public funding in support of those that have made the most credible headway? The funding could be managed at the supranational level to ensure Europe-wide support.

The third approach centers on the availability of funding beyond direct subsidies. Innovation is risky, and the cost of private equity rises with interest rates. Markets are conservative, even if the taxonomies I have just cited aim to reshape investment behavior. In addition to private equity, public authorities can support banks who lend to support green innovation. One such proposal was recently made by Isabel Schnabel of the European Central Bank: a green lending facility. While the proposal concludes that the need for such a facility is currently low, it should be made available if credit tightens. And let me add for the central bank conservatives that you sometimes hear in the German debate: supporting a green transition is perfectly compatible with the mandate of central banks, which are responsible for financial stability. This also means mitigating climate risk, which can have a massively destabilizing effect on the economy. The same is true for price stability. Energy markets are sources of massive inflationary shocks which we import in regular cycles. We do not need to change central banks mandates to include more decisive action on the green transition.

Finally, direct public funding for research and innovation needs to be increase in the EU-27, as the Jacques Delors Brief by Findeisen, Jäger and Linder persuasively argued. Public money will need to be raised and should be spent through an EU-wide mechanism to avoid a beggar-thy-neighbor spiral of protectionism. The green transition is costly, and this will impact all citizens. One way to respond to this challenge and consider socio-economic inequalities is a green wealth tax, proposed by Jean-Pisani Ferry. The proposal is worth considering. We know that we will need the support of all citizens to succeed with the industrial transformation and provide for a *just* green transition.

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