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Climate mitigation that pays for itself?

A proposal for a new tax coalition and reward fund by the EU and China to unlock billions in climate finance, lower fuel prices and cut emissions.

Prof. Dr. Ottmar Edenhofer, Prof. Dr. Matthias Kalkuhl and Dr. Lennart Stern from the Potsdam Institute for Climate Impact Research (PIK) have published a new paper: *"How to Scale Up Effective Climate Finance by the EU? Tax Coalitions and Jurisdictional Reward Funds for the Case of Fossil Fuel"*. The paper is part of a project led by the Kiel Institute for the World Economy and Global Nation to increase the evidence on where "mutual benefit" can be delivered from concessional international financing flows, and Official Development Assistance (ODA) in particular.

It proposes a bold new idea for mobilizing additional financing for climate mitigation in low- and middle-income countries (LMICs) that also serves the political, economic and environmental interests of wealthier nations.

This briefing note sets out a summary of the proposal, with a particular focus on the benefits to the EU.

An innovative proposal that addresses current challenges

The proposal focuses on the urgent need to close the growing gap between climate finance pledges and real contributions, particularly to low- and middle-income countries (LMICs). If successful, it would deliver much needed climate finance while helping prevent a shrinking pot of global ODA from being diverted away from other important priorities.

Crucially, it goes beyond the framing of a moral responsibility by wealthy nations by demonstrating how the EU can serve its own economic and strategic interests while scaling up climate finance for LMICs, and how a partnership with China could unlock major progress. With this "mutual interest" frame, it offers a

credible pathway out of the political deadlock that has plagued climate finance since the Copenhagen and Paris Accords.

Key factors setting this proposal apart are:

- **No need for global consensus** or new binding treaties
- Contributions based on **self-interest**, not moral appeals
- This is a system that **works for both high- and low-income countries** and turns narrow national interests into a force for the common good.

The proposal: A new fossil fuel tax coalition and jurisdictional reward fund

The paper proposes a new mechanism combining small levies on fossil fuel imports with a system of performance-based financial rewards. The levies would be created via a "fossil fuel importers' coalition"—a group of countries that place modest taxes on their fuel imports. The revenues would then be used to fund a "jurisdictional reward fund" that pays LMIC governments for proven emission reductions at the national or regional level. This mechanism would also cut fuel prices and reduce climate damages, yielding significant direct benefits for high-income countries. The exact rate of this levy is calculated so that, together, the coalition raises precisely the amount of money to fund global demand reductions that are collectively optimal for the entire coalition.

This offers a pragmatic, incentive-based architecture that:

- Aligns **EU self-interest** with global development goals, thus achieving benefits that are in countries' **mutual interest.**
- Is **self-enforcing** and can be launched unilaterally and then expanded, **adapting as members join or leave** (e.g., with only the EU participating, the tax rate would be ~ 0.9 percent of import value. If China also joined, it would rise to ~ 3.1 percent, allowing EU contributions to also increase.)
- Allocates funds raised **according to measurable outcomes**, avoiding many of the pitfalls that have plagued earlier climate finance schemes and traditional project-based funding, which suffer from inefficiency, crowding out, and even fraud.

- Provides a **long-term vision** for EU leadership in global public goods financing, consistent with strategic autonomy and soft power goals as it **can be scaled** to cover areas beyond fossil fuel reductions, such as pandemic preparedness and biodiversity.

The returns and benefits for the EU and its partners

The modelling set out in the proposal quantifies the benefits to the EU in the case of a partnership with China to show that it would, in a baseline scenario:

- **Mobilize US$66 billion annually** to support climate mitigation in LMICs.
- **Cut emissions by 1060 Mt CO_2 per year** (~half the EU's current emissions from fossil fuels), reducing climate damages at home and abroad.
- **Reduce the cost of climate damages to the EU and China**, by US$35 billion and US$37 billion respectively as a result of the reductions in emissions.
- **Lower fuel prices for the EU and China** by reducing demand for fossil fuels (energy companies will reduce prices to avoid excess supply). This would more than offset the tax added to fossil fuels and would save the EU US$18.9 billion (enough to cover the EU's Just Transition Fund for fossil fuel regions) and save China US$18.3 billion (enough to pay for most of the Three Gorges Dam) in fossil fuel costs.
- **Deliver US$33 billion in transfers per year to LMICs** in rewards for reducing their emissions, supporting development outcomes that also benefit wealthier nations (see "Identifying Mutual Interests: How Donor Countries Benefit from Foreign Aid", Kiel Working Paper 2291, June 2025).
- **Reduce climate damages and fuel prices to LMICs**, saving US$78 billion in reduced climate damages and US$19 billion from lower fuel prices.
- **Improve geopolitical positioning and global security** (e.g., reducing fossil fuel revenues to Russia).

Why the EU should be the first adopter

The paper identifies the EU as the natural starter for this approach due to its unique strengths and capabilities:

- It faces high climate risks and energy import costs, making the economic case particularly compelling.
- It has a strong administrative capacity to implement fuel import levies.
- It has diplomatic reach to negotiate with China and LMICs.

For the EU, the proposal:

- Fits with ambitions to reduce Russia's leverage and improve global security.
- Strengthens Europe's role as a global climate leader.
- Offers a performance-based model that aligns with domestic budget scrutiny.
- Aligns smoothly with the EU's existing carbon pricing system (ETS) and Carbon Border Adjustment Mechanism (CBAM).

Implementing this proposal would strengthen the EU's role as a global climate leader, while securing tangible benefits for European citizens by decreasing risks due to instability and reducing geopolitical dependencies.

About the research

This paper and briefing note is part of a project to build the evidence on ODA in the Mutual Interest of Donors and Recipients, led by the Kiel Institute for the World Economy and Global Nation, with support from the Gates Foundation. Learn more about the project.