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Border Carbon Adjustments and the Potential for Protectionism

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Introduction

Border carbon adjustments (BCAs) were the source of irreconcilable positions in the run up to the Copenhagen climate conference in late 2009 and may well be so at in the next conference in Cancun. BCAs would be targeted at goods crossing borders between countries not making equivalent climate change efforts, but what 'equivalent' means, and who has the right to define it, is the subject of heated debate. Though none appear to be even pencilled in for implementation before 2020, there is already talk of retaliation: India has let its objections to them be known, and China threatens retaliatory BCAs based on emissions-per-head. Talk of trade war is in the air.

Key messages

- Unilateral Border Carbon Adjustments (BCAs) are disruptive to global trade rules and to an effective global climate agreement after 2012
- BCAs are not necessarily in violation of the General Agreement on Tariffs and Trade (GATT) but would seem to require case by case legal analysis under the GATT's General Exceptions provisions
- The room for dispute over the correct level of carbon charge is substantial
- Destination based BCAs levied at the same rate as on home goods are likely to be environmentally inefficient even if least trade distorting
- A firm Multilateral Environmental Agreement (with explicit reference to trade measures) forming the basis for origin based charges on traded goods is the optimal way forward – but requires strong carbon monitoring, reporting and verification (MRV) which in the absence of a global agreement may develop on a bilateral or regional basis.

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The case for BCAs has been made on both *environmental* and *competitiveness* grounds. The former seeks to prevent production moving elsewhere to ensure no adverse environmental impact. The latter argument is essentially designed to avoid loss of activity, profit and employment. Our research suggests that the competitiveness argument is weak, but may hide behind environmental arguments.

This raises the questions of what:

- is the World Trade Organisation's (WTO's) current scope for dealing with such matters?
- might lie immediately ahead for the WTO in particular and the 'trade and climate change' regimes in general?

Our view on the legal context

There is dispute about the WTO status of BCAs. Our reading of the legal literature is that charges levied on imports at the same rates as on domestic products could claim to satisfy the non discrimination provision of Article III of the General Agreement on Tariffs and Trade (GATT). But if imported products were produced in more carbon intensive ways than home products then destination based charges would not be environmentally efficient. Charges which discriminated arbitrarily against imports might be justified under GATT Article XX if it could be shown that there was no arbitrary discrimination.

Evidence on carbon foot printing suggests that the scope for manipulation is great.

In the *Shrimp-Turtle* case the WTO Appellate Body established that non product related process and production methods affecting trade may be authorised if they can be shown to be an appropriate instrument of environmental policy. Thus, we appear destined to see BCAs being evaluated case by case by the WTO Dispute Settlement Body under GATT's Article XX. The "WTO-compatibility of such measures is complex and cannot be answered in general terms. [L]awyers having a look at this would answer: 'It depends'" (Lamy, 2008).

Our own analysis of the evidence on carbon foot printing suggests that the scope for manipulation is great and the WTO Dispute Settlement Body would be faced with major problems in assessing what was a justifiable rate of charge on imports.

Illustratively, our research indicates that BCAs on cement would range from 21% to 36% of a European producer's marginal cost at a carbon price of €10/tCO2. Estimates by car manufacturers show even more variation ranging from 150kg to 6 tonnes of carbon emissions per car. Resulting maximum BCAs based on a €10 carbon price are low at below 1% of final retail prices, but the room for legitimate uncertainty over the carbon footprint is itself a potential barrier to trade.

To avoid such delicate and complicated judgements and in the absence of an monitoring, reporting and verification (MRV) system, uniform charges on imports would have to be made based on best available technology or domestic average emissions. While these approaches satisfy the competitiveness criterion they reduce the incentive to adapt to low carbon technology in exporting and importing countries.

Assuming best available technology for all imports it would imply that imports as a whole are under taxed from an environmental perspective.

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Possible Ways Forward

BCAs could potentially take many forms, eg environmental taxes levied on all products sold in a country, anti-dumping duties, countervailing duties, or requiring imports to buy Emissions Trading Certificates.

For some commentators the only viable system is that importers charge non-discriminatory VAT style taxes on all products sold in their territory. Alternatively ETS certificates could be demanded from importers. This would be based on an assessment of the carbon content of each product based on importer coefficients (perhaps average actual or on best available technology) and would offer reassurance on competitiveness grounds since domestic and imported products would attract the same tax rate. However basing BCA on domestic coefficients would only coincidentally remove the threat of carbon leakage. Assuming best available technology for all imports it would imply that imports as a whole are under taxed from an environmental perspective.

Such a destination or consumption based tax would involve every traded good undergoing two border adjustments. If importers tax goods sold in their territory it would be normal for any charges paid by exporters at home (eg embodied in electricity prices) to be rebated. The world would face an explosion of import taxes and export subsidies. Free allocations of ETS certificates and the exemptions in proposed non ETS carbon tax regimes already lead to accusations of unfair subsidies.

This solution may seem somewhat idealistic but our message is that given the room for disagreement over carbon footprints and unless progress can be made in this direction there will be a proliferation of BCAs. These BCAs will be arbitrary, disrupt the world trade system, delay a multilateral climate agreement and potentially create problems for countries with carbon abatement policy regimes as well as for those with none.

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