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A tax whose time has come?

Blog post by Practice Lead Ermenegilda Boccabella, 6 July 2020

Carbon border adjustment taxes are not a new concept. The idea applies carbon pricing to goods that enter the single market where products are manufactured offshore have avoided carbon pricing. In theory, this prevents 'carbon leakage'. Europe's energy-intensive industries, especially cement and steel, have long argued they need a level playing field against imports with lower energy and decarbonisation costs.

To date, the lobbying has been dismissed by many as unacceptably protectionist. There are also many questions about how, this sort of duty can be legal. And the supportive industries, while vocal, have generally lacked the political clout to get their way. Before covid-19, CBA was the EU's metaphorical equivalent of speaking softly and carrying a big stick. In February 2020, during a fireside chat, Ditte Juul Jørgensen, Director General for Energy at the European Commission, spoke of the measure as an 'item in the EU's tool box'. In simple terms, the CBA is a punishment to the US for backing out of the Paris Agreement and a warning to China, to stay in.

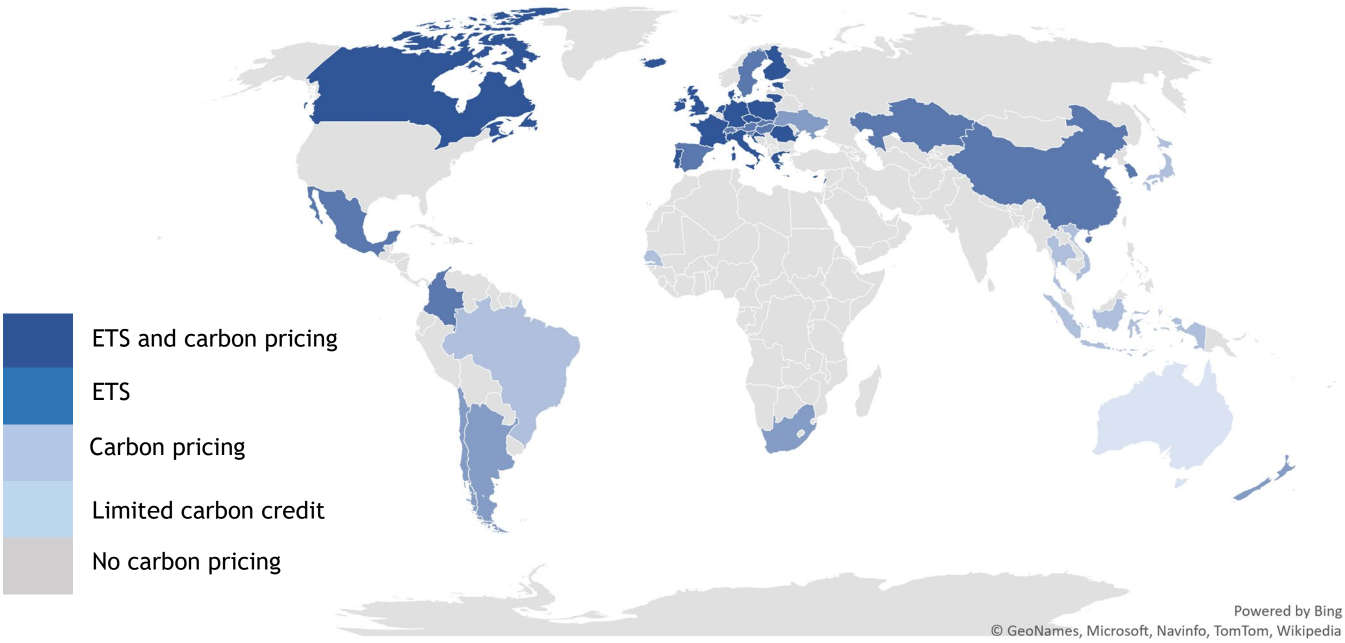
However, it seems the European Union is becoming more serious about implementing carbon pricing on all goods. Commission executive vice president, Valdis Dombrovskis, has defended a possible measure by saying "If we set stricter targets for European companies, we can't allow goods in that are based on looser targets." Two things are driving this change in the policy. First, the EU is ratcheting up the pace of its plans to decarbonise the economy. This makes the leakage issue more salient. Second, policymakers are searching for new sources of revenue as EU member states seek to pay for post-covid recovery plans. There are growing calls to move the CBA out of its toolbox and put it to work to provide an initial cushion, as a windfall revenue stream.

For some, a CBA has the added benefit in theory of incentivising industrial emissions reductions in EU trading partners that are otherwise reluctant. However, question of WTO legality is extremely complex and has always been a hurdle for a CBA. Even if a CBA can be justified as an exception from general WTO national treatment principles, it will still have to meet non-discrimination and non-arbitrariness obligations that will mean trying to reflect different approaches to carbon across trading partners. The EU will be hoping that the threat is enough to encourage partners to move to some form of carbon pricing – although that will reduce the revenue of the tax in turn. Countries who have carbon pricing of some sort, would mitigate against a CBA. As for the United Kingdom, a post-Brexit UK ETS may be wider in scope than its European counterpart, meaning British manufacturing would not need to pay.

If there is a change in administration in the White House, then a CBA would also become an incentive for the US to re-join the Paris Agreement and agree to an international carbon trading mechanism - all in time for COP26. If there is not, WTO legality might be beside the point compared with the colossal trade war that could be triggered. It is worth remembering the way the US and China responded in 2010 to the EU's attempts to implicate them in its aviation emissions regime.

Policymakers in the EU argue that they need to generate revenue for its recovery plan, and to protect its climate ambitions. The green recovery focus is integral to the Next Generation EU programme, which will fund the enormous scale-up in emissions reductions projects, will eventually need to be paid for. Generating revenue, through carbon border adjustment taxation, in order to service the debt, starts to make sense for the EU, as it moves towards a legally binding, net-zero 2050 target. Germany, who has traditionally opposed carbon border adjustment taxes, will find it hard to dismiss the 'Klimazoll'. As Germany sets up a domestic carbon market (with a broader scope than the EU ETS) and introduces carbon taxes, the arguments both for reducing emissions, and protecting German industries and revenue will rise in Germany. If Paris and Berlin both push the idea, then its time probably has come.

Countries that have or are considering introduction of carbon pricing



Global Counsel can provide bespoke insight and advice into all aspects of carbon pricing and emissions policy.