

Climate change

Mitigation and adaptation



Designing a WTO Compliant Border Carbon Adjustment for the European Union

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The EU Commission recently announced plans to propose a Border Carbon Adjustment (BCA). In its recent Communication, the Commission noted that if differences in levels of ambition worldwide persist as the EU increases its climate ambition, it will propose a BCA for selected sectors to reduce the risk of carbon leakage. The details of the potential BCA designs are currently under review and a Commission proposal is expected before the summer of 2021.

This combination of import tariffs and export rebates is known as full Border Carbon Adjustment. A BCA levels the playing field between domestic products subject to carbon prices and imports by ensuring that importers also internalise the cost of emitted greenhouse gases. It could also, depending on its design, incentivise or pressure trading partners into climate action. This is even more likely if the country imposing a BCA has a high share in global trade or where it is implemented by a number of countries.

Main findings

- A BCA for the EU ETS is likely to take the form of either including importers in the EU ETS by requiring them to purchase emissions allowances OR a border carbon tax on imports equivalent to the cost of obtaining emission allowances by a domestic company for producing the same product.
- For compliance with WTO law, the EU needs to do away with free allowances and have all allowances auctioned.
- BCA designs should ensure similar treatment not only between imported and 'like', i.e. similar domestic products but also between imports from different third countries. Imports from developing/least developed countries may be granted preferential treatment or exemption.
- A BCA could be based on an EU best technology benchmark, i.e. imports are assumed to have been produced with the same carbon intensity as their EU equivalents.

What might a BCA in the EU look like?

To implement a BCA within the EU's current legal framework, there are 3 main options: i) including importers in the EU ETS by requiring them to purchase emission allowances; ii) a border carbon tax on imports of ETS-covered sectors; and iii) introducing an EU-wide carbon tax and then tax imports the same as domestic products. The third option particularly poses a challenge since passing an EU-wide carbon tax requires unanimous backing by all EU members. Considering the previous unsuccessful attempts to introduce EU-wide carbon taxes, this may be a long shot for the European Commission. Consequently, a potential BCA in the EU is likely to take the form of either of the first two options. Both options however raise compatibility issues with WTO law and compliance will mainly depend on their design.

What is BCA and what is the rationale?

To address climate change, some countries have introduced carbon pricing mechanisms in the form of a carbon tax or an emission trading scheme. However, not all countries are equally tackling climate change, let alone pricing carbon at all or at roughly comparable levels. With the difference in the stringency of climate policies, production may shift to countries with weaker policies or to sectors not covered by climate policies leading to emissions reduction in one country being replaced with increased emissions in another, otherwise known as carbon leakage. A country with a carbon pricing scheme may apply a tariff to imports from countries without comparable climate policies. Additionally, to maintain the competitiveness of domestic products in the global market, exporters may be eligible for export rebates i.e. a refund of taxes paid or of the cost of emission allowances.

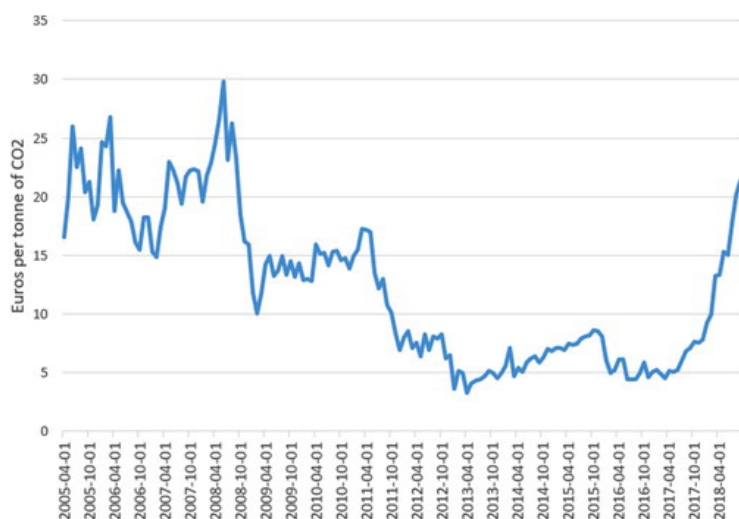
What are the WTO compatibility issues?

One of the fundamental concepts of WTO law is non-discrimination, which is especially contained in Article I (most-favoured nation principle) and Article III (national treatment principle) of the GATT. The national treatment principle requires that imports from other WTO members should not be treated less favourably than domestic products. If the EU introduces a border carbon tax on imported steel, then the tax on imported steel should be commensurate to the permit price under the EU ETS for domestic steel. Alternatively, if the EU requires importers to buy emission allowances, it should be at the same price and conditions faced by domestic producers including the available amounts of allowances and their accessibility. Whichever form the BCA takes, in order to be 'WTO-compatible', ETS allowances need to be fully auctioned rather than being allocated for free.

¹ General Agreement on Tariffs and Trade.

Maintaining free allowances would grant domestic products a favourable treatment as they would not be subject to a carbon price while imports would be.

In the case of an EU border carbon tax, there is a potential issue regarding the fluctuating carbon price in the EU ETS. This could lead to imports being treated less favourably particularly where the permit price falls below the tax burden on imports. To ensure compliance, a price floor could be implemented which can then be used as a tax rate for imports. The most-favoured nation principle requires that any advantage granted to imports of one WTO member should be unconditionally granted to 'like' products of all the other members. In this sense, a country should not discriminate between imported products of third countries. While exemption or preferential treatment of products from developing countries is allowed, exemption (or favourable treatment) of products from other developed countries would contravene this principle.



The price of one European Union Allowance (EUA) over time. The figure depicts the price of the right to emit one CO₂ tonne per year. Source: Krokida S.I., Lambertides N., Savva C. and Tsouknidis, 2020.

One of the problematic issues is the estimation of the carbon content of imports so as to determine the adjustment level in a way that would ensure similar treatment. To avoid discrimination and limit administrative burden, the adjustment could be based on an EU best technology benchmark. In this way, the emissions assigned to imports correspond to emissions that would have been emitted if all components had been manufactured with the best technology in the EU. It however remains an open question if and to what extent the use of EU best-technology benchmarks would solve the issue of carbon leakage. The Commission is also probing if importers could be granted an opportunity to demonstrate that the carbon intensity of their products is lower than the EU benchmark, in which case a BCA can be based on the 'true' carbon content.

Justification under GATT Exceptions

If a BCA is found to violate the non-discrimination principle or any other provision of the GATT, it may still be justified under the exceptions of Article XX of the GATT. A GATT-inconsistent BCA may be allowed if it is necessary to protect human, animal or plant life or health or if it relates to the conservation of exhaustible natural resources.

² Article XX (b)(g) of the GATT

³ Report of the Appellate Body in United States – Import Prohibition of Certain Shrimp and Shrimp Products WT/DS58/AB/R

The environmental effectiveness of a BCA would be relevant in demonstrating that it is designed to achieve these objectives and that it actually makes a material contribution. It therefore needs to be demonstrated that the main goal is emission reduction. For instance, if it can be shown that a full BCA actually decreases emissions, then the likelihood of compliance with Article XX increases. However, if the effect of a refund is that reductions in certain sectors are replaced with increased emissions in export sectors, then it may be difficult to justify a full BCA under Article XX of the GATT.

Secondly, according to the introductory paragraph of Article XX of GATT, the BCA should “not be applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade”. Thus, the method of carbon accounting used to determine the carbon content embedded in imports will have to be such that it cannot be interpreted as a means of arbitrary discrimination. Furthermore, a potential EU BCA design will have to demonstrate that it only adjusts for the internal level of carbon pricing and is not in fact an instrument designed to increase EU industries’ relative competitiveness. Finally, since discrimination could also occur where a measure fails to take into account the different conditions in different countries, the potential BCA could be designed in a way that there is sufficient flexibility to take into account the conditions prevailing in any exporting country.

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This work is funded by the Austrian Science Fund (FWF) under Research Grant W1256 (Doctoral Programme Climate Change – Uncertainties, Thresholds and Coping Strategies)



Der Wissenschaftsfonds.



Impressum CCCA

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Stand: Juni 2020
ISSN 2410-096X