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Is a Border Carbon Adjustment on the Horizon? Five Things You Should Know

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It's a new policy intended to level the playing field for domestic companies that have adopted less carbon-intensive manufacturing processes. But can a tax on foreign imports based on their carbon intensity serve as key tool to combat climate change?

We will soon find out.

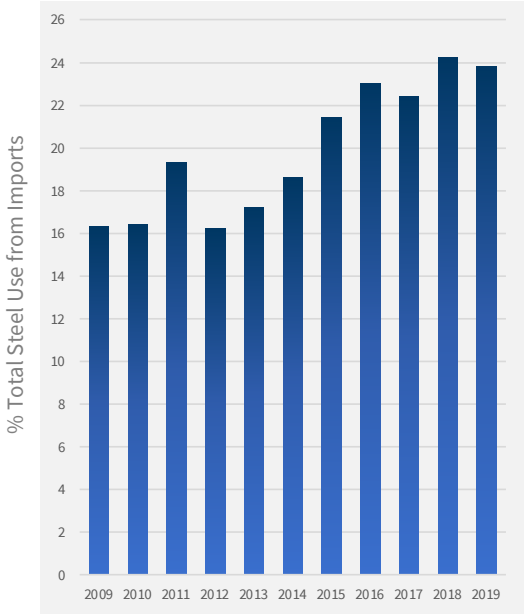
The European Union released its 291-page draft in June to introduce the world's first tax on carbon-intensive imported goods, including those from the United States. The success of the initiative – known as a Border Carbon Adjustment (BCA) – depends on whether other countries decide to adopt similar policies. The EU is hoping most will. Lawmakers in the United States introduced their own BCA after weeks of public discussion about the EU's plan.

Here are five things to keep in mind about a BCA and what it could mean for the United States, international trade, and the climate.

1. The EU has the first-mover advantage

No jurisdiction has a tax on imported goods solely based on their carbon intensity. As a result, the EU is effectively establishing how aggressive or lenient a border carbon adjustment should be. Setting the terms of a new global trading framework could benefit the EU since domestic industries would presumably be slightly better equipped to deal with a policy developed locally. However, this also means the EU is the guinea pig for such an ambitious policy, and if the

EU Increasingly Reliant on Imported Steel



SOURCE: U.S. Department of Commerce

economic consequences are larger than expected, the EU will have disadvantaged itself. Moreover, a failed BCA means other countries could reconsider how they structure trading relationships with the EU to hedge against similar policies in the future.

2. Major companies are already taking action on GHGs

It is important to note that many of the world's largest companies are not waiting for new policies like a BCA. Over the past few years, major employers have been proactively announcing plans to dramatically reduce their greenhouse gas emissions, from altering their fuel mix to investing in technologies in carbon capture. Companies in every industry are signaling to their suppliers – many of which are the raw materials producers most impacted by a BCA – that they will not be doing business with heavy emitters whose operations are inconsistent with their own targets and public pledges. That in and of itself could be a stronger motivation for change than a BCA. More recently, John Kerry, the U.S. Special Presidential Envoy for Climate, announced the formation of a global coalition of major companies in shipping and manufacturing that are pledging to buy lower-carbon products like sustainable jet fuel and steel made from hydrogen. The goal is to send a strong demand signal and spur increased development of cleaner technologies, which will ultimately make "greener" options more affordable.

3. WTO and implications for international trade

Any new trading policy must also be compliant with the trading rules established by the World Trade Organization, and trade experts are already calling out potential legal issues with the EU's BCA. As it stands, a BCA cannot treat domestic producers more favorably than imports, discriminate against one individual trading partner, impose unjust compliance costs on producers, or prevent exporters from calculating their own carbon intensities.

These stipulations appear to leave limited room for the EU and other nations to stay within the bounds of WTO rules—however, there are policy options the EU can implement. A consultation paper from July 2020 outlines four different approaches the EU can take to remain compliant with the WTO.

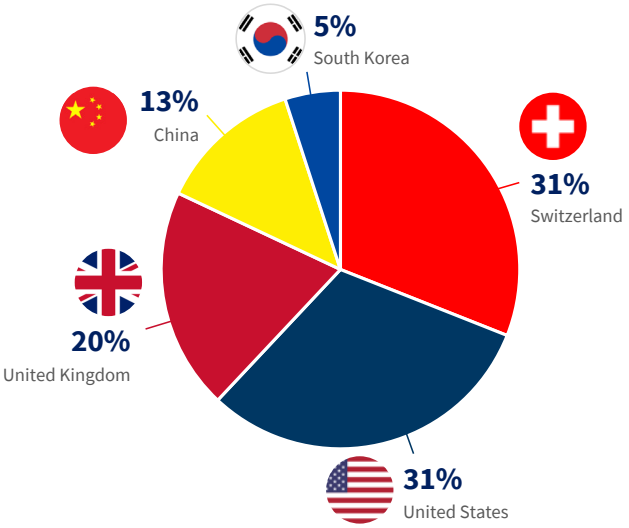
- A tariff on select products in industries that are at risk of carbon leakeage, which is when strong climate policies of one region result in increased greenhouse gas emissions in another region.
- Require exporters to the EU to purchase emission permits from a separate pool that mirrors the price of the EU Emissions Trading System (ETS).
- A carbon tax on consuming products that were produced in sectors that are at risk of carbon leakage.
- An extension of the EU ETS to imports—essentially the EU would require foreign importers and producers to purchase EU ETS emission permits.

While all of these options are presumably available, the implementation would be challenging at best. Despite the best of intentions, it's unlikely a BCA – particularly the first one ever adopted – will insulate it from WTO challenges.

4. Heavy metals, cement, and electric power industries will be hit the hardest

Border carbon adjustments will not affect every industry equally. With the EU's policy, the world will get a first look at how and which industries are affected—and ultimately, whether producers adopt greener processes and how international trade flows are changed as a result.

Top 5 Sources of EU Chemical Imports, 2020



SOURCE: Eurostat

As it stands right now, the EU BCA targets industries such as cement, steel, aluminum, paper, glass, and some basic chemicals. The EU would need to apply a comparable carbon tax on domestic producers of these goods in order to comply with the rules of the WTO. The European Steel Association, or Eurofer, sent a letter to EU Commissioners in May asking them

to reconsider withdrawing the industry's free allowances under the EU's cap-and-trade Emissions Trading System, which are set to be gradually phased out in the coming years. Eurofer says an abrupt phase-in of a BCA policy and phase-out of free carbon allowances would have a dramatic impact on operating costs for the EU's steel industry and EU-based manufacturers more broadly:

"Our industry would have 10 to 100 times more carbon costs than global competitors, because of costs on every single tonne of EU steel, while competitors will have costs only on the share of their production they export to the EU (0% – 10%). This would create a damaging and significant mismatch especially when combined with the steadily increasing carbon related costs in the EU."

Meanwhile, Asian steel and petrochemical companies are coordinating with government agencies on how to adjust their own policies to remain competitive given the EU's new BCA. In June, South Korea's Minister of Trade, Industry and Energy announced it will begin a study looking at how border carbon adjustments will impact the country's steel industry and then devise strategies to enhance its competitiveness:

"The carbon border adjustment measures will establish new trade barriers, which will have a drastic effect on our overall industry, as the country is heavily reliant on exports. If we do not prepare in advance, our competitiveness in steel exports will experience a significant decline due to its nature as a high emitter of carbon."

Oil and natural gas have received a temporary reprieve from being subject to a BCA in the EU, although those products will face separate rules targeting methane.

5. Nothing is set in stone, and probably won't be for a while

In April, ministers from emerging economies like Brazil, South Africa, India, and China issued a joint statement calling the proposed BCA a "grave concern because such a tax undermines a key tenet of the Paris Agreement that developed countries should bear the brunt of the costs associated with addressing climate change. Recently, a spokesperson at China's Ministry of Ecology and Environment signaled China's opposition to the EU's BCA, calling it a "unilateral measure to extend the climate change issue to the trade sector," which "violates WTO principles.

In the United States, the Biden administration has been less clear on a BCA. For example, President Biden's climate envoy and former Secretary of State John Kerry acknowledged the EU is ahead of the United States in deploying a BCA but also pushed back on the idea, stating the tax should act as a "last resort" because it has serious implications for economies, trade, and relationships. Earlier this year, President Biden floated the idea of adding a BCA to this year's trade policy agenda, but no tangible progress on the matter has been seen to date. The White House has indicated that a BCA is "not off the table," although President Biden's climate czar Gina McCarthy expressed concerns that a "carbon price could end up landing on consumers, and we simply don't want that".

Conclusion

Without a firm commitment from the United States and stiff opposition from other major markets like India and China, the success of a border carbon adjustment faces long odds. A global economy depends on the free flow of goods and services, and a BCA by design would alter that dynamic in ways that could ultimately raise drive inflation, impacting both consumers and businesses. However, even with these institutional challenges, a BCA is likely to remain an option as countries explore ways not only to address climate change, but also ensure that their well intentioned climate policies and the investments they have made to reduce emissions are not putting their domestic industries at a disadvantage.

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