



Climate Protection and Border Tax Adjustment: Economic Rationale and Political Pitfalls of Current U.S. Cap-and-Trade Proposals

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While the Bush Administration has shown little willingness to reduce greenhouse gas (GHG) emissions before 2025, the energy and climate change debate in Congress has picked up considerable speed in recent months. After the enactment of the Energy Independence and Security Act in December 2007, the Senate is now discussing several comprehensive legislative proposals that would, for the first time, create mandatory limits for GHG emissions nationwide. Although not quite as ambitious as European GHG reduction targets, a US climate change bill could end the deadlock in international climate talks. It remains problematic, however, that current legislative proposals combine a national emission trading system with import restrictions, so called border tax adjustments (BTAs). While such measures increase the political feasibility of national climate change legislation, they pose a serious threat to the international trading system and potentially violate international trade law under the WTO.

Good chances for a cap-and-trade system under a new White House

The most prominent legislative energy proposal under discussion was the America's Climate Security Act introduced by Senators Joe Lieberman and John Warner. The bill exemplifies the intention of U.S. Congress to start fighting climate change while at the same time protecting U.S. industry from any competitive disadvantage through border tax adjustments. The bipartisan initiative proposed a national cap-and-trade system with mandatory limits for GHG emissions from 2012 onwards. The bill aimed at reducing carbon emissions by 10% until 2020 and by 70% until 2050, compared to 2005 levels. Emission caps would have applied to electric generation, industrial, transportation, and natural gas sectors. Most emission allowances would have been issued free of charge in the first years, but the contingent of auctioned emission rights were planned to be gradually increased over time. On December 5, 2007 the Environmental and Public Works Committee of the Senate voted 11-8 in favor of the Lieberman-Warner proposal. On June 6, 2008,

however, only 48 senators voted for the bill, staying short of the 60 votes needed to move forward with the legislation. The bill is thus unlikely to come up on the floor again this Congress.

The timing for the bill was not the best: The Lieberman-Warner bill would have, like any other cap-and-trade proposal currently discussed in Congress, increased the cost of energy derived from fossil fuels. Given the already steep hike in oil prices in recent months – a barrel oil now costs about \$140; a gallon gasoline has reached an all time high of \$4 – the threat of a recession looming and the upcoming elections, it is not surprising that the bill failed last week in the Senate. Nonetheless, climate legislation is not beyond reach. Since both presidential candidates, Barack Obama and John McCain, have already indicated their support for a domestic cap-and-trade program, chances are good that a revised version of the proposal will be passed into law during the 111th Congress. In any case, the America's Climate Security Act serves as a template for the numerous climate change proposals still pending in the Senate and the House of Representatives as well as for any future climate change legislation.

Competitiveness at the center of the debate

At the forefront of the present energy and climate debate in the Senate is the issue of competitiveness. The concern is that strong national measures to reduce carbon emissions would put domestic producers at a disadvantage if major economies such as China and India do not commit to GHG emission targets as well. This, of course, is not a new argument. Already in 1997, the Senate unanimously passed the Byrd-Hagel Resolution which stipulated that the US should not sign any international treaty that would result in serious harm to the US economy and did not include binding targets and timelines for developing countries. Consequently, President Bill Clinton signed the Kyoto Protocol, but never submitted it to the Senate for ratification. In 2001, President Bush officially withdrew from the Kyoto Protocol.

The debate on the America's Climate Security Act showed the necessity to include measures to prevent a loss of competitiveness and create a level playing field for US producers in any climate change legislation. The bill provided for border adjustment measures for GHG-intense products from countries which have no or only insufficient climate protection commitments. This idea has received strong political support: Among others, American Electric Power and the trade union International Brotherhood of Electrical Workers were actively involved in drafting the legislation. In order to

increase the political feasibility of any climate change legislation it will be indispensable to include the concerns of industry. The U.S. industry is only now starting to realize the vast business potentials of new energy technologies. It is – so far – not profiting from these opportunities to the same extent as its European and Japanese competitors. Besides the fear of a loss of competitiveness, this also explains the reluctance of powerful US business interests to support ambitious climate and energy legislation.

New provisions protecting U.S. industry

Rather than imposing “border climate taxes,” the Liebermann-Warner bill would have obliged importers of GHG-intensive products from countries without comparable GHG reduction schemes to either purchase international reserve allowances from the federal government or obtain other certified emission credits from a US GHG regulatory program. Before the measures are imposed, the US would have to conduct bilateral negotiations aiming at eliminating competition distortions. The trade partner’s failure to comply would eventually bar the goods from entering the US market. The provision primarily targets the big emerging economies, while exempting the least developed countries (LDCs) as well as countries that generate less than 5% of global GHGs. Revenues derived from BTAs would be used to offset negative effects of climate change in developing countries (e.g., through technology transfer).

In the House of Representatives, the Committee on Energy and Commerce’s Subcommittee on Energy and Air Quality held a hearing on climate change and competitiveness concerns on March 5, 2008. The committee also published a White Paper on this topic which stressed again the need to encourage all major developing countries to curb their GHG emissions. After a hearing on the day before, an amendment of the Lieberman-Warner bill was issued on May 21, 2008. The amendment which was included after pressure from industry holds that entities covered by the bill can realize part of their annual reduction obligation with Certified Emissions Reductions (CERs) under the Clean Development Mechanism (CDM) of the Kyoto protocol. So far the possibility to achieve 15% of their obligations abroad, where reduction measures tend to be cheaper, did not apply to CERs. The new regulation would boost the CDM, one of the three main tools of the Kyoto protocol.

ECONOMIC RATIONALE AND PITFALLS

Climate change measures such as mandatory limits of GHG emissions, carbon taxes or tradable emission certificates put a price on the public good “climate”. The polluter pays the external costs of using this good. While this is certainly desirable from an environmental and fairness standpoint, resources will, nonetheless, not be allocated optimally if not all major economies participate in a global climate regime and undertake emission reductions at the same pace. Otherwise, the result would be unequal carbon prices across various countries.

There are several ways for a country to offset the production costs differentials: For one, imported energy sources containing CO₂ may be taxed at the same rates that apply to domestic energy sources. Another option would be to tax imported goods at the border at a rate which reflects the costs that the emission trading system puts on domestic producers. Finally, foreign exporters may be required to purchase emission rights for the carbon content of their goods in order to meet required offsets. The US focuses on this last alternative approach of BTAs.

BTAs as an instrument to address competitiveness and carbon leakage

The argument for BTAs revolves around two issues: competitive fairness and carbon leakage. Competitiveness is not a concern for all producers but for those in energy-intensive industries, which produce tradable goods for which cheap GHG reduction technologies are not yet available (e.g. cement, steel, bulk glass, pulp, and paper). For them, a cap-and-trade system would lead to rising export prices and falling export volumes, while at the same time increasing imports. Domestic consumption would shift from carbon-intensive domestic goods to cheaper import substitutes.

However, not only the competitiveness of domestic producers vis-à-vis competitors in countries without mandatory climate protection goals would be at risk. Ambitious reduction targets could also create the risk of relocation of energy-intensive industries to countries without comparable carbon pricing. This process can even lead to an increase of global GHG emissions if domestic emission reductions are more than offset by higher emissions of the imported goods resulting in carbon leakage. The consequence: The United States loses production and jobs, and little or no net reduction in global GHG emissions is achieved.

BTAs could prevent such damages to the domestic industry's competitiveness and the relocation of energy-intensive industries, hereby enhancing the political feasibility of national climate change policies. They are also expected to give more certainty to producers, especially for long-term investment. Finally, BTAs would hinder free riding of countries with no climate protection policies or the non-compliance with domestic climate change regulation, since they would prevent countries to profit from a safer and cleaner global climate without doing their fair share. Thus, they would also encourage other countries to strengthen their efforts to address climate change.

Serious downsides of a BTA approach

In a world of unequal cross-country carbon prices, BTAs could – at least in theory – be a useful instrument. In practice, however, they have serious downsides. First of all, border adjustment measures are anything but easy to administer: Should they apply to all products from singled-out countries, or only to specified ones? If they were to apply on a country basis, which criteria should be employed for the selection process? Membership of the Kyoto Protocol can certainly not be the only criteria. This becomes apparent by looking at the two biggest emitters of GHGs – the United States and China. While the United States has not ratified the Kyoto Protocol, China has – yet as a developing country has not been obliged to commit to binding reduction targets. So far, there is neither a consensus on how to evaluate different climate policies nor on how to calculate the costs of emission trading systems for domestic producers.

BTAs applied to individual producers prove equally daunting, requiring the correct calculation of carbon emissions during the production process – a task particularly difficult given today's long and complicated value chains. They would call for an enormous amount of data, time, and financial resources. Moreover, whether an adjustment measure really has an effect on trade flows, offers protection to domestic producers, and effectively addresses the carbon leakage issue is very uncertain. Hence, BTAs which apply to all products from a certain country could be offset by changes in exchange rates, different price levels across countries, or wage rates. In any case, the complexity of administrative procedures creates much room for the abuse of BTAs for political purposes.

WTO COMPATIBILITY

At the trade minister meeting in Bali in 2007, U.S. Trade Representative Susan Schwab emphasized that unilateral trade measures under the pretext of climate protection would create too much leeway for arbitrary protectionism. Also, in its 2007 report *WTO – Compatibility of Four Categories of US Climate Change Policy*, the National Foreign Trade Council rightly points out numerous conflicts with WTO law. Likewise, the World Bank warned in its *International Trade and Climate Change* report of 2007 that BTAs could violate trade rules.

In general, BTAs are taxes imposed on imports used to level the playing field between taxed domestic industries and untaxed foreign competitors. If used for goods that are subject to indirect taxes (e.g. sales taxes and value added taxes), they are permitted under the WTO. The extent to which they could also be applied to energy inputs of products, however, is unclear. As Pascal Lamy, director general of the WTO, argued: It is the design of a BTA system that matters. Ultimately, it would be the WTO Dispute Settlement Body, which determines whether a certain climate-motivated border adjustment measure is compatible with WTO regulation or not; WTO law does not offer specific provisions regarding this question.

The National Treatment obligation

BTAs potentially conflict with the core WTO principle of non-discrimination, reflected in the GATT Articles I and III. First, as for GATT Article III, the National Treatment obligation requires imported products to be treated no less favorably than “like” domestic products. While there is no legal definition for “likeness”, criteria applied include the product’s end-use in a given market, consumers’ tastes and habits, as well as the product’s properties, nature, and quality. Import restrictions on the basis of non-product-related process and production methods are generally not permitted. Consequently, since the amount of GHG emissions in the production process does not alter the nature of the product itself, that product may not be treated differently from products with a better emission record. But this is precisely what is done with regard to climate-motivated BTAs: The method of production *is* considered when declining equal treatment to an imported good. From our point of view, BTAs for GHG emission schemes thus would conflict with the like product rule of Article III.

However, Article XX of the GATT may be applicable: Certain measures are exempted from WTO obligations if under Article XX (b) they are “necessary to protect human,

animal, or plant life and health”, or under Article XX (g) they relate “to the conservation of exhaustible natural resources” – even if these resources are located outside the sovereign territory of the respective country. In 1998, this provision was confirmed by the WTO Appellate Body in a landmark ruling on US import barriers on shrimp from Thailand. The US import ban aimed at protecting sea turtles endangered by certain fishing techniques. Noteworthy about the Shrimp-Turtle case is that the ruling gave a very wide interpretation of what constitutes an ‘exhaustible natural resource.’ Following this line of reasoning, one could also conclude that the Earth’s climate constitutes a natural resource. However, Article XX also requires that such measures must not be applied in an arbitrary or unjustifiably discriminatory manner, or act as a disguised restriction on trade. Furthermore, the provision is only applicable if a trade barrier contributed directly to the conservation of the exhaustible natural resource. Finally, the stipulation only applies in the absence of alternative, less-distorting instruments of trade regulation.

The Most Favored Nation clause

Second, there is a general divergence between GATT Article I, the Most Favored Nation clause (MFN) of the WTO, which requires equal treatment among WTO signatories, and the Kyoto Protocol. Article 3 of the United Nations Framework Convention on Climate Change clearly acknowledges the different responsibilities of developed and developing countries. This principle of “common but differentiated responsibilities” ascribes the main responsibility for solving the climate problems to the industrialized countries. It does not entirely exonerate the developing and emerging countries from their share of responsibility, yet also acknowledges their right to develop. This might lead to some legal contentions. The same holds true for BTAs applied on a country basis: More restrictive trade rules would apply to countries with less ambitious climate policies. This is not compatible with MFN.

The incompatibility with the MFN clause was reinforced by a recent decision by the WTO Appellate Body, which ruled on a case put forward by the EU targeting Brazilian restrictions on imports of used, reprocessed tires. Brazil had restricted the import due to disposal-related health and environmental risks. When reprocessed tires catch fire, toxic gases are set free, and the flames are difficult to extinguish. Furthermore, the reprocessed tires are a popular hatchery for mosquitoes, thus contributing to the

epidemic spreading of malaria. The WTO Appellate Body ruled in favor of Brazil, thereby confirming the Shrimp-Turtle decision: Import barriers aiming at the protection of human, animal, and plant health are legal under Article XX, albeit conflicting with the like-product rule. Importantly, however, there was one aspect in which the WTO Appellate Body ruled in favor of the EU: By accepting imports of reprocessed tires from other Mercosur countries, Brazil discriminated arbitrarily and unfairly against European tires. This constitutes a clear breach of the MFN rule. Against this background, it seems possible that the exceptions for LDCs written into the current US legislative proposals on border adjustment measures may likewise conflict with WTO law. In sum, due to a variety of stipulations in international law which are partially at odds with one another, the question of BTA compatibility with WTO law remains unclear.

NEW MOMENTUM FOR INTERNATIONAL CLIMATE CHANGE TALKS

International trade and climate protection would be promoted most efficiently through a global climate regime based on the principle of common but differentiated responsibilities including all major polluters. A new U.S. climate change bill with mandatory caps for GHG emissions would be one important step in this direction. Moreover, such action would significantly increase pressure on other major polluters such as China and India. According to a study by the International Energy Agency, China and India alone account for 56% of the increase in GHG emissions between 2005 and 2020. As long as these two countries as well as other major developing countries do not reduce their GHG emissions, the problem of competitiveness and leakage cannot be solved satisfactorily.

Therefore, linking domestic GHG reduction programs with BTAs, as currently discussed, could be a useful tool to offset competitive disadvantages and thereby increase the political feasibility of a comprehensive climate change policy in the United States. However, the political and economic downsides of BTAs need to be sufficiently addressed. Since compatibility of BTAs with WTO law remains unclear, border adjustments need to be carefully designed with a watchful eye on multilateral trade law. Moreover, linking BTAs with climate change policies could create serious trade

conflicts, especially with emerging and developing countries. Thus, BTAs cannot substitute for positive incentives, dialogue, and cooperation to create a common feeling of responsibility for the mitigation of climate change.

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