Is a carbon border tax inevitable?
By Angelo Katsoras

Introduction
Growing support for a carbon border adjustment mechanism (more commonly known as a carbon border tax) in the European Union and to a lesser extent the United States has the potential to reshape the global economy and the geopolitical landscape.

The argument for this carbon border tax (CBT) is that countries with stringent climate regulations have long faced the risk of seeing investments migrate to regions with fewer restrictions (a process referred to as carbon leakage). Taxing imports from countries with laxer environmental standards would protect domestic companies from the cost of complying with ever more stringent climate regulations at home.

Trudeau’s recent comments suggesting that Canada and the United States could jointly take “into account the emissions profiles of industrial competitors around the world” suggests that Canada feels a continental CBT is needed.

Such a tax would, however, present its share of complications. For starters, developing countries would argue that they are being unfairly penalized. Second, figuring out how much carbon is in each product and which country’s imports to target would be very challenging from both a technical and political perspective.

Despite these challenges, it is argued that industrialized countries must implement a CBT in order to lower the risk of a political backlash associated with concerns that climate regulations are rendering domestic industries uncompetitive vis-à-vis many foreign competitors.

This report analyzes:
- The steps being taken by the EU to adopt a CBT
- The odds of such a tax being implemented in the United States
- Under what circumstance Canada would adopt such a measure
- The complexities of managing a CBT regime
- The risk for increased trade tensions with the developing world and China

The EU will likely be the first major region to implement a CBT

The European Commission is planning to unveil its CBT proposal in June. If approved, it would go into effect by 2023 and initially target imports from carbon-intensive sectors, such as cement, aluminum, steel and chemicals.

These imports would likely be required to participate in the European Emissions Trading System, which allows companies that exceed their limit for greenhouse gas emissions to buy emission permits from other companies. The price charged would be set by the EU carbon market.

There appears to be growing support for the CBT among European politicians and businesses.
- The European Commission Executive Vice-president Frans Timmermans reflected the views of many EU parliamentarians when he stated the following: “It’s a matter of survival of our industry. So, if others will not move in the same direction, we will have to protect the European Union against distortion of competition and against the risk of carbon leakage.”
- UK Prime Minister Boris Johnson has expressed public support for taxing goods from countries with weaker climate laws. Despite Brexit, the UK would likely align itself closely with any CBT adopted by the EU.
- Patrick Pouyanné, CEO of the French oil and gas major Total, stated that putting a carbon price on imported goods was “a very logical extension of the EU’s carbon price policy” and a necessary step to ensure a level playing field between EU industries and foreign competitors.

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1 “Biden-Trudeau climate plan may target polluting trade rivals,” Bloomberg, February 24, 2021
2 “EU sees carbon border levy as ‘matter of survival’ for industry,” Reuters, January 18, 2021
3 EU carbon border levy shaping up as ‘notional ETS’,” EURACTIV.com, January 25, 2021
Europe-based steel manufacturer ArcelorMittal, too, has come out in favour of a CBT. Its support no doubt stems from estimates that have shown that reaching the EU’s goal of eliminating net greenhouse gas emissions by 2050 would cost the company between 15 billion and 40 billion euros.4

For the environmental tax to become law it must be brought forward by the European Commission, which has the sole authority to propose EU laws, and then be approved by both the European Parliament and the European Council (which represents the heads of states of the 27 EU members).

On March 9, the European Parliament passed a symbolic resolution supporting a carbon border tax on imports. The statement noted that while the EU has significantly reduced its domestic greenhouse gas emissions, the emissions content of its imports continues to rise.5 The vote tally was 444 votes in support of the resolution, 70 against and 181 abstentions.6

The United States is inching towards CBT

While the United States is much less advanced in its deliberations than the EU, Biden’s election campaign literature laid out the following: “The Biden Administration will impose carbon adjustment fees or quotas on carbon-intensive goods from countries that are failing to meet their climate and environmental obligations. This will ensure that American workers and their employers are not at a competitive disadvantage and simultaneously encourage other nations to raise their climate ambitions.”7

Biden has two options at his disposal for passing this measure:

- Congressional approval: While the partisan divide has never been wider in Washington, a CBT might enjoy some degree of bipartisan support given that it shifts some of the cost of decarbonization from domestic companies to foreign ones.
- Executive order: Trump’s use of national security laws (i.e., Section 232 of the Trade Expansion Act) to impose tariffs via executive order has, some analysts argue, set a precedent for Biden to do the same regarding a CBT.

There is at least some support for this tax in more carbon-intensive sectors

- “We definitely think that it is worth looking at the question [of a U.S. CBT],” recently stated American Iron and Steel Institute President Kevin Dempsey.8
- The American Petroleum Institute, the oil and gas industry’s main lobbying body, is reportedly close to coming out in favour of a carbon tax. While reports do not go into specifics, it is fair to assume that this likely includes support for a CBT that also covers imports of oil and gas from countries with laxer climate regulations.

Politically speaking, we feel that the U.S. (like the EU) will find it increasingly difficult to implement climate regulations that raise costs for domestic companies without imposing countervailing taxes on certain imports to level the economic playing field.

The U.S. could either do this via setting a national price on carbon emissions or through the more complicated process of trying to ascertain how much importers should have to pay to comply with numerous U.S. environmental regulations.

Will there be an EU-U.S. CBT alliance?

John Kerry, Biden’s climate envoy, has for the time being not expressed support for following the EU’s lead and developing a carbon price mechanism. Instead, suggesting the US would forge its own path. “It would be a shame if at the end of the day we had two sets of rules in Europe and the US,” said French Finance Minister Bruno Le Maire.9

Despite these differences, we maintain that it will be much easier for the EU and the United States to eventually arrive at a compromise than it would be for either side to reach an agreement with major developing countries.

Canada will follow U.S. lead

Should the United States adopt a CBT, the most likely scenario is that Canada would immediately follow suit. This would not only level the playing field for Canadian companies with competitors in regions with laxer environmental standards, it would reduce the risk of Canada being on the receiving end of U.S. climate-related sanctions.

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4 “Green steel: the race to clean up one of the world’s dirtiest industries,” Financial Times, February 15, 2021
5 “European parliament backs a carbon border adjustment mechanism,” Pinsent Masons, March 15, 2021
6 “MEPs: Put a carbon price on certain EU imports to raise global climate ambition,” European Parliament, March 10, 2021
7 “The Biden plan for a clean energy revolution and environmental justice,” 2020 (Campaign Platform)
8 “Biden could seek carbon taxes with same strategy Trump used for steel, aluminum,” S&P, December 11, 2020
9 “John Kerry warns EU against carbon border tax,” Financial Times, March 12, 2021
A recent press release from the Canadian government suggested that a carbon levy was imminent: “Canada is committed to ensuring that Canada’s transition to a low-carbon economy is achieved in a way that is fair and predictable for businesses and supports Canada’s international competitiveness. To this end, the Government is exploring the potential of border carbon adjustments and will be discussing this issue with its international partners.”

Another sign that Canada intends to implement a CBT is the recent release of draft regulations for creating a countrywide domestic market for trading carbon credits. Companies from regions with insufficient climate standards exporting to Canada could one day be required to participate in this market.

**How would Canada’s trading partners react?**

A major challenge that would arise from Canada adopting a CBT would be the potential reaction of some of its trading partners. For instance, Canada recently signed onto the Trans-Pacific Partnership. How would certain developing countries in this trade agreement react to Canada imposing a carbon tax on their exports?

**The devil in the details: implementing a CBT would not be easy**

The biggest challenge relates to the difficult task of trying to calculate the greenhouse gas emissions of various imports, including their supply chains. A recent Forbes article highlighted the complexity of this exercise: “Imagine the difficulty in calculating the carbon content of a car produced overseas. That car will have components produced by a number of suppliers, through a variety of methods and from a potentially dizzying array of source countries.” This underscores the risk many companies would claim that the carbon footprints ascribed to their products are inaccurate.

Further, if not carefully designed, the world’s trading system would be burdened by a significant amount of additional paperwork. For all these reasons, we feel that it would be best to start with carbon-intensive industries that have less complex supply chains, such as energy, steel and chemicals, and then gradually extend the system to more complex sectors once experience has been acquired.

**How to share burden of decarbonization will be a source of growing tension between developed and developing countries**

A carbon border tax implemented by the EU and/or the United States would likely target developing countries mostly and could be met with counter-tariffs.

Poorer countries will argue that they contribute a far smaller volume of greenhouse gas emissions per capita than richer industrialized countries do (see chart below) and that, consequently, they should have to achieve much less stringent targets and should be granted financial assistance for their efforts. It has been pointed out, also, that much of the reduction in emissions by the developed countries has been because many of them have outsourced their emissions (i.e., factory production) to emerging countries.

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11 “Carbon Tax Border Adjustments: Good Politics, Bad for Consumers,” Forbes, July 26, 2020
Is China the principal target of a CBT?

Many developed countries argue that China should do much more to control greenhouse gas emissions. They point out that China has overtaken the United States as the world’s top carbon emitter since the mid-2000s. It now accounts for 28% of global emissions, compared with 15% for the United States, about 10% for the EU, and 7% for India.\(^{12}\) China even emits more greenhouse gases than certain European countries do on a per capita basis.\(^{13}\) About 69% of the world’s increase in carbon emissions over the last decade comes from China; with India a distant second at 20%.\(^{14}\)

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\(^{12}\) Union of Concerned Scientists, 2020

\(^{13}\) “China, not America, will decide the fate of the planet,” Financial Times, January 27, 2020

\(^{14}\) “This Week May Turn the Tide on Two Centuries of Emissions.” March 15, 2021 & Carbon Border Project
The EU has already warned China that it could be subjected to a carbon border adjustment mechanism, while the U.S. Trade Representative’s Office recently stated in its annual policy report that it would consider some form of CBT to reduce greenhouse gas emissions and ensure that China meets its trade obligations.¹⁵

China has responded by voicing concerns that a CBT would damage the global fight against climate change.¹⁶ Indeed, China’s recent pledge to be carbon neutral by 2060 is seen by some analysts as an attempt to avoid being hit by these tariffs. Moreover, if this tax were adopted, China would likely emphasize that its emissions per capita are still much lower than those of several countries, including the United States.

**China: short-term opportunities and long-term challenges**

In the short term, the more the EU and the United States move into green energy, the more they will need to increase imports from China. China produces more than 70% of the world’s solar photovoltaic panels, half of the electric vehicles, and a third of wind power. It is also the world’s largest battery producer and controls many of the raw materials crucial to green energy supply chains, such as cobalt and rare earth minerals.¹⁷

However, the longer-term goal of the CBT for the United States and the EU is to bring this some of this production home. The fact that China’s exports are relatively more carbon-intensive makes them vulnerable to being targeted by an environmental tax. Part of the reason for this difference in carbon intensity is coal consumption. In 2019, coal accounted for 65% of China’s power generation, versus only 25% in the United States¹⁸ and 14.6% in the EU.

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¹⁵ “Biden administration to consider carbon border tax as part of trade agenda: USTR,” Reuters, March 1, 2021
¹⁶ “China says CO2 border tax will damage global climate change fight,” Reuters, November 26, 2019
¹⁷ “How the race for renewable energy is reshaping global politics,” Financial Times, February 4, 2021
¹⁸ Source: Wood Mackenzie

The increasingly negative perception that the citizens of many developed countries have of China further raises the odds of it eventually being hit by CBTs.
Case study: aluminum and steel sectors

In some sectors, the CBT has the potential to change the competitive positions of certain countries. For example, in 2019, Morgan Stanley estimated that a hypothetical tax of $40 per ton of emissions would make it cheaper to buy aluminum from Britain than from China.19

The introduction of a carbon tax on steel could have a similar effect. China generates about two tonnes of CO2 for each tonne of steel it produces, versus close to one tonne for Europe and the United States.20

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19 “From China to India, exporters brace for Biden carbon policy,” Nikkei Asia Review, November 1, 2020
Conclusion

Despite the significant technical and political challenges involved, we feel that many developed countries will conclude that it is necessary to implement a CBT for the following reasons:

- Maintaining political support for stricter climate regulation over the long term depends on investment not migrating abroad to regions with weaker environmental regulations. The more this migration occurs, the greater the odds of a political backlash and of environmental regulations being diluted or even reversed.
- Implementing environmental programs that require significant financial investments at a time when many governments and people are already grappling with high debt levels requires a new source of revenue. Under these circumstances, a new carbon tax that targets foreign companies would be politically easier to implement than an increase in domestic taxes.
- Given Europe’s ambitious climate plan, and generally higher cost structure particularly regarding taxes and energy, it will be the first region to adopt a carbon border tax in order to help preserve the competitiveness of its companies.
- The EU and eventually the U.S. will each establish their own separate CBT policies and after a subsequent rise in tensions between them efforts will be made to gradually align the two programs.
- Other major developed economies like Canada will eventually have to harmonize their environmental policies with both the United States and the EU to avoid being hit with tariffs and to ensure that their governments are the ones collecting the carbon tax revenues.
- Requiring certain companies to buy carbon credits will be the preferred solution for most countries that decide to impose a tax on imports from regions deemed to have weak climate regulations.

The geopolitical fault lines of a CBT

A carbon border adjustment tax implemented by the EU and/or the United States would ultimately mostly target developing countries. These countries could respond by either imposing counter-tariffs or developing their own carbon trading systems. Even if most countries chose the latter option, there would likely be disputes over how various countries measure pollution. The question of whether certain developing countries should be exempt from this tax would likely be raised as well.

China, in particular, could be reluctant to align itself with Western standards when it comes to its measuring its carbon footprint, arguing that its own model is superior. Similar to what has occurred with 5G, internet and GPS standards, different environmental regulations could emerge in certain regions of the world.

Finally, we believe that a carbon border levy will impact the global supply chain in the not too distant future by, among other things, raising production costs.