Update: Is a carbon border tax inevitable?
By Angelo Katsoras

In a March 2021 report titled “Is a carbon border tax inevitable?”, we argued that growing support in the European Union and, to a lesser extent, in the United States for a carbon border adjustment mechanism—or what is more commonly referred to as a carbon border tax (CBT)—had the potential to reshape the global trade and geopolitical landscapes. We also argued that this tax would gain in popularity because political support for stricter climate regulations and avoiding political backlash over the long term depended on investment not migrating abroad to regions with weaker environmental regulations.

Moreover, we felt that it would be much easier for the EU and the United States to eventually arrive at a compromise on a CBT than it would be for either side to reach separate agreements with the major developing countries.

In this follow-up report, not only do we examine how recent developments bolster our original findings, but we also investigate how the notion of using the carbon footprint of certain imports to restrict their market access has quickly gained ground.

The EU is likely to be first major region to implement CBT on wide scale

The European Commission officially proposed a CBT on July 14. The measure would apply initially to four carbon-intensive sectors: steel, aluminum, cement, and fertilizers. Imports from these sectors would fall under the European Emissions Trading System and be subject to a carbon price equivalent to what would be paid in the EU by domestic companies.

While EU members are divided on many issues, there is strong support for a CBT. The European Commission Executive Vice-president Frans Timmermans reflected the views of many EU parliamentarians and countries when he stated: “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.”

The proposal would be implemented in two phases. First, from 2023 to 2025, the carbon footprint of imports from the targeted sectors would be measured. Then, starting in 2026, their footprints would be taxed. Over time, the aim is to apply the tax to other sectors.

Some business sectors are pushing to shorten this timeline. In this regard, the CEO of ArcelorMittal warned recently: “It is critical to ensure that there is a level playing field otherwise the steel industry will not survive in Europe.”

If the carbon footprint of an import cannot be agreed upon, it would automatically be considered to be as dirty as the worst 10% of the same European-produced goods. Some people contend that this penalty is a recipe for trade tensions.

Not surprisingly, China has publicly stated that the EU’s planned CBT violates global trade regulations.

Is America’s long-standing opposition to a CBT weakening?

While the United States is nowhere close to obtaining legislative approval for a CBT, it is an idea that is gaining acceptance among more and more politicians and businesses. The U.S. Special Presidential Envoy for Climate, John Kerry, recently stated that a CBT was one of several regulatory approaches under consideration to address the issue of imports from regions with lower environmental standards. Also, U.S. President Joe Biden supported this policy during his election campaign.

The Climate Leadership Council, a business-backed group that supports a CBT, said that U.S.-manufactured products in the metal, chemical, electronics and automobile sectors generate 40% less carbon dioxide than the global average.

The EU-U.S. steel agreement merges climate and trade policies

An example of growing American support for penalizing imports produced in regions with less stringent environment regulations is the ground-breaking agreement between the United States and the EU to link carbon emissions and the steel trade. It entails the two sides reducing tariffs reciprocally and eventually taking measures to exclude imports from other

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1 EU sees carbon border levy as ‘matter of survival’ for industry,” Reuters, January 18, 2021
2 “Carbon border taxes are defensible but bring great risks;” The Economist, July 17, 2021
3 “Tariffs to Tackle Climate Change Gain Momentum. The Idea Could Reshape Industries;” Wall Street Journal, November 2, 2021
countries that fail to hit the standards for low-carbon steel production. The objective is for this environmental measure to be implemented in two years’ time.

The agreement also requires that U.S.-bound products made from steel or aluminum be “melted and poured” inside the EU. The aim is to prevent metals from China and non-EU countries from being only minimally processed in Europe before being exported to the United States.

Biden did not mince words when explaining the deal’s objective to reporters: “The new agreement would help restrict access to our markets for dirty steel from countries like China, and counter countries that dump steel in our markets, hammering our workers.”

The following excerpt from a White House press brief further clarifies the aim of the deal: “The United States and European Union will work to restrict access to their markets for dirty steel and limit access to countries that dump steel in our markets, contributing to worldwide over-supply.” A growing number of countries will eventually conclude that they have little choice but to sign on to this agreement to avoid being hit with tariffs.

Not surprisingly, the deal has the full support of the American steel industry and its union. More than 70% of American steel is produced in electric-arc furnaces, which melt mostly scrap steel. This process emits far fewer greenhouse gases than does the smelting of iron ore in coal-powered blast furnaces, which is the most widely used method in China. The Climate Leadership Council estimated that a carbon tariff of $43 a ton could reduce steel imports to the United States by 50%.

China is widely considered a major reason for the overcapacity in the global steel sector, which reached 700 million tonnes in 2020. China alone accounts for over half of the world’s steel production.

The Chinese ambassador to the EU attacked this deal, saying it would “aggravate the tension” in industrial supplies and worsen “inflationary pressures”. Finally, there is a strong possibility that this green-oriented trade deal, which can probably be approved in the United States by way of executive order instead of going through Congress, will become the template for other sectors. The agreement also marks the beginning of a new era of cooperation between the EU and the United States, which appears to target China.

**Canada will follow in America’s footsteps**

Canada is likely to enter into this climate-steel deal soon. Not only would this level the playing field for Canadian companies against competitors in regions with laxer environmental standards, it would also reduce the risk of seeing Canada on the receiving end of U.S. or EU climate-related sanctions.

As for a broader CBT, indications are that the Canadian government supports such a policy initiative, as evidenced by this excerpt from a recent speech by Prime Minister Justin Trudeau:

“We know that Canada produces some of the cleanest aluminum in the world. But we are competing with aluminum around that world that can be sold at even cheaper prices because it is done in dirtier ways with significantly lower labour standards. I don’t think that’s the kind of world we want, where people who do the right things, the right way, are penalized and people who do the wrong things, the wrong way, get advantages.”

However, Canada will likely have to wait for the United States to do more on this front before it can move ahead with a CBT on a wide scale.

**CBT: a tension point between developed and developing countries**

First and foremost, poorer countries argue that, as they contribute a far smaller volume of greenhouse gas emissions per capita than richer industrialized countries do, they should not be penalized.

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4 “Biden hails EU-US steel deal as chance to curb ‘dirty’ Chinese imports,” Financial Times, October 31, 2021
5 “The United States and European Union to Negotiate World’s First Carbon-Based Sectoral Arrangement on Steel and Aluminum Trade,” White House, October 31, 2021
6 “U.S. steel executives favor carbon border adjustment to combat ‘dirty’ imports,” Reuters, November 2, 2021
7 “Tariffs to Tackle Climate Change Gain Momentum. The Idea Could Reshape Industries,” Wall Street Journal, November 2, 2021
8 “A global climate trade war is looming. Here’s how to avert it,” South China Morning Post, November 15, 2021, and OECD
9 “China accuses EU of threatening global trade,” Financial Times, November 14, 2021
10 “For once I agree. Trudeau is right about the need to make carbon pricing global,” National Post, November 2, 2021
Another challenge is how to reconcile the Paris Climate Accord with a CBT. The Paris agreement allows for less stringent targets to apply for developing countries, whereas a CBT in theory would punish these very same countries for having weaker standards. To make matters worse, rich countries have not fulfilled their promise to provide $100 billion in loans and grants annually by 2020 to help poorer countries make the green transition. Current figures indicate that this target will not be reached before 2023.

What’s more, many major developing countries, including China, India and Indonesia, view this amount as insufficient and have recently asked for $1.3 trillion in annual financial transfers starting in 2030.

Not surprisingly, many major developing countries, including Brazil, South Africa, India and China, say that EU plans for a carbon levy on imported products would unfairly penalize their economies.11

It was reported in the Chinese state media that President Xi Jinping told German Chancellor Angela Merkel and French President Emmanuel Macron that “tackling climate change should...not become an excuse for geopolitics, attacking other countries or trade barriers.”12

**Technical challenges: The devil is in the details**

Figuring out how much carbon is in each product is a massive undertaking. The lack of international agreement on how to measure carbon only adds to the complications.

To illustrate the practical difficulties, the Brookings Institution cited the following example: “When a Ford is made in the United States, only 40% of its parts are produced in the USA or Canada. The rest comes from different countries around the world.”13

Trying to figure out the combined carbon content of all these parts will not be easy.

A recent investigation by Washington Post claiming that many countries are significantly underreporting their level of greenhouse gas emissions to the United Nations further underlines the difficulty of arriving at a consensus on how to measure greenhouse gas emissions. (Refer to the footnote for a link to the study).14

All of this raises the risk of countries contesting the carbon footprint ascribed to products produced by their companies and retaliating with counter tariffs.

**Gaming the system**

Yet another risk is that, once the CBT or climate–steel deal is implemented, countries will seek to redirect their low-carbon production to Europe and the United States and sell their other more carbon-intensive goods elsewhere without actually changing their carbon footprint.

Indeed, Rusal, the Russian aluminum producer, has already announced plans to split its assets into a low-carbon company aimed at the European market and a new entity focused on the domestic Russian market.15

Implementing regulations to counter such moves would likely lead to a spike in trade tensions.

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11 “Carbon border tax discriminatory,” The Hindu, November 12, 2021
13 “Carbon border taxes: What are their implications for developing countries?” Brookings, October 2021
14 “Countries’ climate pledges built on flawed data, Post investigation finds,” Washington Post, November 7, 2021
15 EU aluminum groups seek exclusion from carbon border tax,” Financial Times, July 11, 2021
Conclusion

Despite the logistical difficulties involved, we feel that many developed countries will eventually implement a CBT and/or other forms of carbon tariffs in order to lower the risk of political backlash associated with fears that climate regulations are rendering domestic industries uncompetitive.

However, some of the challenges of going down this route include the following:

- A generalized CBT or environmental tariffs aimed for a specific sector, such as steel, would likely target developing countries primarily and lead to a spike in trade tensions. The question whether certain developing countries should be partially exempt from this tax would likely arise.

- Even if countries choose to develop their own carbon trading systems, there would likely be disputes over how various countries measure pollution. China, in particular, might be reluctant to align itself with Western standards and would likely not be open to having Western experts audit the carbon footprint of its products.

- A combination of growing geopolitical tensions with the West and the fact that its exports carry a relatively heavier carbon footprint owing to greater use of coal-generated electricity places China at high risk of being targeted by carbon-related tariffs.

- In contrast, India’s growing importance as geopolitical counterweight to China in Asia makes it more likely that it will ultimately be granted certain exemptions.

- While a carbon border levy would level the playing field for domestic industries vis-imports from regions with weaker climate regulations, it would raise operating costs in certain sectors. Many of these higher costs would subsequently be passed on to consumers. This comes on top of the higher costs associated with the green energy transition, supply chain bottlenecks the and the rejigging of supply chains in strategic sectors, such as semiconductors and electric vehicle batteries, to ensure security of supply.

**Bottomline:** The growing momentum towards carbon border levies is yet onemore indication that the early stages of the transition to a lower carbon world will likely mark a break with the low inflation environment of the past decade.
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