EU CARBON BORDER ADJUSTMENT AND ITS POTENTIAL IMPACTS ON DEVELOPING COUNTRIES

Discussion paper - March 2020

Introduction

This discussion paper seeks to **analyse the possible consequences or benefits for developing countries of a carbon border adjustment** (CBA) that would be levied on goods imported from outside the EU, equivalent with the carbon tax (or price) being applied in the EU. The scope of the analysis is limited, and does not include a systemic critique of our globalised economic model.

Globalisation driven by trade and investment liberalisation over the last 30 years has deeply transformed our economies. The trade liberalisation regime has reached what UNCTAD calls hyperglobalisation[1], leading to the integration of Global South countries into global economic systems, including through financialisation. More often than not, this integration has led to lowering of trade tariffs, de-industrialisation, and a push for an export-driven growth model. This model is largely based on the extraction of natural resources and labour from countries in the Global South, with limited benefits and numerous adverse impacts for local communities and the majority of the population in those countries. We believe it would be important, but beyond the scope of this briefing, to examine into more depth crucial questions that in fact should be the starting point of a deep rethink of hyperglobalisation: What would be a just, green and equitable development pathway for commodity dependent countries? How to reduce Europe's footprint on global natural resources such as water (encompassed in imported products), land and minerals?

As initially suggested by the European Commission[2], one of the main objectives of the EU with the CBA is to ensure European companies do not have competitive disadvantages compared to companies from countries with lax climate regulations, and to reduce the risk of carbon leakage. The objective of the CBA is to allow the EU to pursue ambitious climate objectives to reduce greenhouse gases (GHGs) released into the Earth's atmosphere, whilst ensuring that domestic efforts do not simply serve to drive production and GHGs emissions elsewhere.

The risk of carbon leakage is still being debated in research[3], i.e. the risk that without the CBA, EU climate regulations might create perverse incentives for more imports from countries outside the EU which might be harming the environment, climate and rights. While we recognise the possible rationale of the CBA from a climate objective perspective, in this paper we do not undertake to assess climate impacts of this tool, which environmental organisations and academia may be best placed to do. Instead, this paper should be seen as a complementary analysis of socio-economic impacts to accompany analysis from a climate perspective. **We are particularly focusing on social justice questions that may arise from a CBA, especially in relation to potential impacts on developing countries.** Overall, we believe that the EU should seek to reduce carbon emissions associated with EU imports but other, potentially more effective tools than a CBA, such as import standards regulations, should also be considered alongside or even instead of a CBA.

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[1] UNCTAD, 2019, Trade and Development Report: Financing a Global Green New Deal, available at: https://unctad.org/en/PublicationsLibrary/tdr2019_en.pdf

[2] Mission Letter of Paolo Gentiloni, Commissioner for Economy, 1 December 2019, available at: https://ec.europa.eu/commission/commissioners/sites/comm-cwt2019/files/commissioner_mission_letters/mission-letter-paolo-gentiloni_en.pdf

[3] Bruegel, 2020, A European carbon border tax: much pain, little gain, available at: https://www.bruegel.org/2020/03/a-european-carbon-border-tax-much-pain-little-gain/

That being said, if and when considering and designing the CBA, **the EU should be guided by the following principles:**

1. **Global environmental benefit:** a CBA should be designed with global climate, environment and social objectives at its core, and should be flexible and nuanced enough to avoid causing perverse incentives in other countries that ultimately lead to more harm.
2. **Policy Coherence for Development**: a CBA should be coherent with development policy objectives and avoid any negative impact on the economies of developing countries, including via flanking measures.
3. **Equity**: acknowledging the EU's climate debt towards developing countries, as early-Industrialised countries have already consumed most of the global carbon budget and must undertake steeper emission reductions to keep the planet under 1.5°C of average global warming.
4. **Existing commitments under the Everything But Arms initiative:** special approach towards the Least Developed Countries (LDCs), in order to encourage their social, environmental and economic development, and consider impact on tariff-free access to the EU market where it exists.
5. **Fairness and progressivity**: considerations of progressivity must be applied to both the exporting developing countries as well as importing EU countries, to ensure the CBA does not create an additional, disproportionate burden on low-income households in Europe nor negative impacts on jobs and inequality in developing countries.

Carbon border adjustments – in theory

Carbon border adjustments (CBAs) work by either taxing an import so that it is taxed at the same level as the domestically produced product, or by crediting taxes on exports, in order not to impose an undue burden on the nationally produced product when it is known that the foreign product is not burdened by a similar tax, a carbon tax in this case.

The WTO is responsible for regulating when a border adjustment is admissible and when it is not through the General Agreement on Tariffs and Trade (GATT). For carbon border adjustments to be admissible, the tax applied (or credited) must be applied on both foreign and domestically produced products. The tax cannot unduly burden a foreign derived product. Moreover, the tax can only be applied on a product, not a process (also referred to as '*taxes occultes*' or hidden taxes under WTO rules).[4] *Taxes occultes* are not admissible under WTO regulations.

For example, a domestic tax on fuel can be legitimately applied on similar imported fuel, but a tax that is domestically applied on the energy consumed during an industrial process cannot be applied on similarly imported steel. This is because it is not straightforward to what extent the tax burdens the product – other factors could come into play, such as the technology employed, or the type of fuel burned to produce energy.

It follows from the above that, under WTO regulations, the following requirements are necessary for a carbon border adjustment to be admissible:

[4] T. Falcão, *A Proposition for a Multilateral Carbon Tax Treaty*, (2019), IBFD Online Books

(i) An equivalent tax ought to be applied on a like-domestic product[5]. The concept of equivalence requires the tax rate of the national product and the imported product to be similar, so that no undue burden is applied on the foreign derived product in such a way that it might constitute a hindrance to trade.

(ii) The tax must be levied on a product and not a process. Carbon taxes would therefore be admissible if employed both domestically and at the border, but the same might not hold true for energy taxes (if they apply in the production process, not to the finished product, see above) – although a conclusion cannot be reached until the details of the policy are revealed.

A key challenge for the carbon border adjustment intended by the EU is whether it will be a mechanism able to differentiate between the environmental impact of products produced in different ways, or whether it will only be able to recognise whether the import is burdened by a domestic carbon tax in the exporting country.

The EU carbon border adjustment proposal

The European Commission's flagship initiative or framework for its 2019-2024 mandate is the European Green Deal. Among various climate measures, the Green Deal foresees the introduction of a carbon border adjustment in selected sectors to protect European industry from loss in international competition and ensure that the price of imports reflect more accurately their carbon content.[6]

The proposal, as initially announced by the European Commission,[7] is envisaged as a tool to ensure European companies do not have competitive disadvantages compared to companies from countries with lax climate regulations, and to prevent companies from simply moving carbon-intensive production to third countries to avoid the EU's strict environmental standards (also known as carbon leakage).[8] Absent a revenue redistribution policy, the adjustment cost will ultimately be borne by the final consumer (in the EU) according to their consumption habits. Measures must be put in place to ensure that the tax is socially just and does not disproportionately impact low-income households.

According to EU Tax Commissioner Paolo Gentiloni, the carbon border adjustment "*will have to be carefully crafted to exert political pressure on climate laggards to take action, to ensure that EU companies can compete on a level playing field, and to be fully compatible with rules of the World Trade Organization*."[9] Along with the carbon border adjustment, the Commission has also announced its intention to revise the existing Energy Taxation Directive, focusing on environmental issues.

As previously noted however, energy taxes tend to be production taxes and therefore a carbon border adjustment in respect of (or corresponding to) a domestic energy tax might not be admissible under

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[5] Like-product is the WTO terminology to designate a similar product

[6] European Commission Communication, The European Green Deal, 2019, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1576150542719&uri=COM%3A2019%3A640%3AFIN

[7] Mission Letter of Paolo Gentiloni, Commissioner for Economy, 1 December 2019, available at: https://ec.europa.eu/commission/commissioners/sites/comm-cwt2019/files/commissioner_mission_letters/mission-letter-paolo-gentiloni_en.pdf

[8] New EU Tax Commissioner Pledges Carbon Border Tax Law 360, 3 October 2019

[9] Answers to the European Parliament questionnaire to the Commissioner-designate Paolo Gentiloni, September 2019, available at: https://www.europarl.europa.eu/resources/library/media/20190927RES62447/20190927RES62447.pdf

WTO rules. European Member States already applying domestic carbon taxes would be legally allowed, under WTO rules, to apply carbon border adjustments. However, for an EU-wide approach, there might be issues related to the disparity in tax rates administered by different European countries, which could lead to intra-EU competition.

Likewise, there is a potential for double (or triple) taxation if the carbon tax, energy tax and the EU Emissions Trading Scheme (ETS) are applied over the same tax base. As it is now, most EU Member States applying unilateral carbon taxes do so on products not covered by the EU ETS (i.e. excluding the energy intensive sector covered by the EU ETS).

Therefore, the introduction of a carbon border adjustment might also require the introduction of an EU-wide carbon tax, complementary and coherent with the EU Energy Taxation Directive and the EU ETS – a task that could prove difficult, considering the introduction of a carbon tax would require unanimous support and approval from all EU Member States.

An EU-wide carbon tax, applied at the upstream level (extraction or import of the carbon intensive product), and with a uniform carbon tax rate across the EU, would imply an increase in carbon tax rate for most EU countries. An extensive carbon tax could cover currently untaxed areas of the economy, such as maritime transport and international aviation (through the taxation of kerosene). However, social considerations will need to be taken into account to ensure that the cost of the carbon tax does not disproportionately fall on lower-income households, especially for products and services for which there are no sustainable alternatives currently available and accessible to them.

Considering the political difficulty in implementing proposals through unanimity, the Centre for European Reform[10] has noted that internal discussions within the EU have so far focused on the idea of levying a tax on imports equivalent to the costs borne by domestic industries as a result of needing to buy carbon permits under the European Emissions Trading Scheme. However such a measure may annihilate the (already low) positive impact of ETS on actual greenhouse gas emissions, since the disincentive of the cost to buy ETS would be reduced.

This is untested ground under the WTO, and therefore it is unclear whether applying a carbon border adjustment equivalent to the costs of acquiring carbon permits under the ETS would be (i) considered a product-based carbon border adjustment; and (ii) admissible under the GATT. The framework might have to be adjusted for the different targets conferred to different EU Member States under the EU ETS, thus significantly increasing the complexity of the regime. It might, as a result, be challenging to have a single carbon border adjustment price administered towards the whole EU common market, leading to an environment of internal competition.

In addition, the EU ETS scheme only applies to energy intensive industries, which means that the scope of reach of the carbon border adjustment would be limited only to those industries already subject to the ETS, thus leaving a significant portion of the economy out of the regime (i.e., small/medium enterprises and the transport sector).

A final question would be whether those countries already administering domestic carbon taxes in addition to the ETS would be allowed to adjust the carbon border adjustment upwards, to consider both the domestic carbon tax and the EU-wide ETS. This is a further issue that might build complexity in the internal market and create an unequal stand between EU member states.

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[10] Centre for European Reform, Should the EU Tax Imported CO2? (by Sam Lowe), 24 September 2019

Potential impacts on developing countries

A carbon border adjustment, as explained above, would be a tax levied at the border at a price that is commensurate with the carbon tax (or price) being applied domestically. An EU-wide carbon border adjustment would either (i) be commensurate with the cost borne by companies under the ETS (though challenges around this are raised above); (ii) correspond to the carbon tax applied by each EU Member State (if the policy allows for different States to employ different tax rates); or (iii) be commensurate with a potential EU-wide carbon tax, introduced into the common area. The objective of such a policy is to provide cost parity between the domestically produced and the imported product, so that they are both negotiated at equivalent prices within the EU common market, and so that domestically produced products are not disproportionately affected by the domestic tax.

The EU might consider granting a carbon border adjustment exemption to countries administering equivalent carbon taxes. Should the EU tax rate be higher than in partner countries, a partial exemption from the tax could be administered in the EU, corresponding to the rate employed in the third country of origin. Under a partial exemption system, the carbon border adjustment rate would correspond to the EU tax rate minus the rate already employed by the third state. The overall result would be to assess the carbon border adjustment at the full EU rate, while avoiding double taxation.

With or without these exemptions, **an EU carbon border tax may have an impact on developing countries in many ways**:

Firstly, a number of developing nations are among important energy and mineral exporters to Europe, for example when it comes to crude oil. Many developing countries are also source countries of EU imports that are manufactured with the use of fossil fuels. As products imported from developing countries might become less competitive than they are at the moment for the EU market if a carbon border adjustment is introduced, this **could result in lower exports to the EU, with potential negative impacts on jobs** in those countries if flanking measures as part of a just transition are not in place. That being said, there can be of course social, climate and environmental benefits from moving away (or not expanding/incentivising) carbon-intensive industries. The CBA may however not be the most effective or fair tool to encourage this transition.

Secondly, **the carbon border adjustment would apply to goods from all countries, even the least developed countries** that currently benefit from duty free entry in Europe under the Everything But Arms initiative. This does not take into account the Paris Agreement recognition that developing countries have differentiated responsibilities, as they have historically contributed far less to global emissions than early industrialised countries. That being said, we also acknowledge that developing countries that depend on exports of carbon intensive products (such as the extractives industry, with its load of adverse social and environmental impacts) may have to envision an alternative development pathway in the mid to long term. While the EU should support this transition, the EU should also **respect the policy space of the countries in question, as well as international commitments in the area of climate action, finance and development**. The EU could consider exempting least developed countries from a CBA or returning all proceeds from the CBA applying on imports from developing countries to those countries for their own budgetary needs.

An additional concern is that the CBA, if it can only be adjusted down if exporting countries already implement a carbon tax or price, **could in fact act as a penalty on developing countries for not having**

their own carbon tax. This ignores the fact that there are various legitimate reasons why some developing countries may have decided not to implement a national carbon tax, including fairness and equality concerns at domestic level - and that they might have more suitable policy options for supporting a just transition (for example, better royalties regimes on extractives). **Carbon taxes, when poorly designed, can be regressive and have disproportionate impacts on people living in poverty**, who are struggling to lead dignified lives.[11]

Several recent examples show that an increase in the price of fuel without social considerations can lead to massive protests and unrest, whether in France, Iran or Chile. There can also be disproportionate gendered impacts - for example, taxes on energy products for domestic use (e.g. gas and oil products used for heating and cooking) can impact women more as they tend to spend a higher proportion of their disposable income on household items and expenses. **Developing countries should not be penalised by the EU for the choices made with regards to their tax systems alone**, but should be evaluated according to their broader environmental and social policy frameworks. It would also be much fairer and more effective for the EU to instead support, through its development cooperation, the countries that are interested in implementing this kind of taxes to ensure that such policies will not further increase economic and gender inequalities.

Conclusion

If the EU does decide to go ahead with a CBA, it must thoroughly consider and take into consideration in the Impact Assessment the following challenges:

- Is the CBA an **effective tool** to discourage carbon leakage or high GHGs in countries exporting to the EU? Are there other measures that could be more effective, e.g. import standards regulations?
- Is the CBA **able to recognise and adjust when other national policies, practices or regulations** beyond domestic carbon prices and taxes have led to reduced GHG emissions and benefits to the environment?
- Finding **the right balance** between respecting developing countries' policy space, export needs and the EU's policy coherence for development principle, and addressing the climate emergency by discouraging fossil fuel extraction and other carbon intensive economic activities in the EU and beyond.
- How to **ensure that low-income households in Europe are not unfairly and disproportionately penalised** by higher prices on essential products? Ways of addressing this can include the provision of affordable alternatives and systems such as public transport as well as considering providing direct transfers to low-income households to mitigate the impact on their income.[12]
- **Can the revenues from the CBA be used in a fair way**?
    - The revenues accumulated in Europe via the CBA when imposed on products imported from developing countries could be transferred back to the countries concerned for their own budgetary goals, in order to strengthen their domestic

[11] See also ActionAid, 2020, Progressive Taxation Briefings: Carbon Taxes: https://actionaid.org/sites/default/files/publications/Carbon%20taxes_1.pdf

[12] See also ActionAid, 2020, Progressive Taxation Briefings: Carbon Taxes: https://actionaid.org/sites/default/files/publications/Carbon%20taxes_1.pdf

resource mobilisation for financing of public services such as housing, education, health, environmental protection, or a just transition.

- When a CBA applies to countries that are neither least developed countries nor developing countries, such as non-EU OECD countries, the proceeds could be used for redistribution within Europe to mitigate impacts on low-income households, or alternatively they could be directed to the UN’s Green Climate Fund as additional contributions.

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