The EU Green Deal and the Proposed Carbon Adjustment Mechanism

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Tatiana Falcão

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Tatiana Falcão[1]

On 22 July 2020 the European Commission opened a public consultation on the Carbon Border Adjustment proposal put forward as part of the **EU Green Deal**. This is not the first document issued under that initiative. In March 2020 the European Commission published an **Inception Impact Assessment Report** to discuss policy options for a Carbon Border Adjustment Mechanism (CBAM). The CBAM is part of the European Commission's plan to modernize the **Energy Tax Directive**, in order to align it with environmental objectives. In this blog, I will discuss some of the legal issues the EU will face in introducing the CBAM, particularly concerning WTO rules.[2]

Carbon taxes are one of the main policies raised by the OECD in dealing with the restoration of the public finances post Covid-19 crisis.[3] it is therefore one of the main instruments for domestic resource mobilization by governments. The CBAM would come at a time when countries will need additional resources to recover from the economic downturn generated by Covid-19, and might be the decisive impulse needed for countries to further engage in the employment of carbon taxes.

The EU Green Deal was one of the main proposals flagged by Ursula von der Leyen, president in charge of the European Commission, while campaigning for her election. Currently, the CBAM proposal is the main policy instrument spearheading the Green Deal, with the aim of adopting a binding legal instrument to make Europe climate-neutral by 2050. This would entail a reduction in greenhouse gases emissions by 50-55% from 1990 levels by 2030, a very ambitious commitment. The purpose of the CBAM is to prevent 'carbon leakage' or, in other words, to prevent companies from simply moving carbon-intensive production offshore to avoid the EU's proposed stricter environmental standards. It follows from this that the CBAM would tax companies that heavily pollute outside of the EU single market at a level that is at least commensurate with the tax applied within the EU.

The Impact Assessment Report contemplates a few policy instruments to prevent carbon leakage, that is: (i) a carbon tax on selected products – both on imported and domestic products, which would probably entail a revision of the EU Energy Taxation Directive; (ii) an extension of the EU Emissions Trading Scheme (ETS) to imports, which would require a review of the regulations applicable to the ETS; or (iii) a new carbon customs duty or tax on imports applicable at the EU level. Furthermore, the Impact Assessment Report contends at first introducing the proposed instrument on select energy intensive sectors, where carbon leakage is the highest (with no specific guidance of which sectors would be envisaged at first).

The legal implications of introducing any of these instruments will clearly depend on the specific design of the tax. However, a few issues will need to be contended by the European Commission under each of these options, that is: (i) the validity of the measure under WTO rules; and (ii) a revision of the EU Energy Taxation Directive to admit the introduction of a carbon tax on selected products or a tax on imports. The European Commission will also need to assess how the proposed instrument will fit into the existing EU ETS Scheme. This blog will focus primarily on these two issues.

1. Border Carbon Taxes and Their Admissibility under WTO Rules

The European CBAM – which, in the literature, is also more commonly referred to as a Border Carbon Adjustments (BCA) or a border carbon tax – works by either taxing an import, so that it is taxed at the same level as the domestically produced product, or by providing a credit (or exemption) on export, 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 like tax.

The World Trade Organization (WTO) is responsible for determining whether a border adjustment is admissible under the General Agreement on Trade and Tariffs (GATT). According to the GATT rules, for the CBAM to be admissible, the tax that is either applied at the border on import, or credited back on export, must be levied and impose an equivalent burden both on the products that are produced domestically, and on those that are imported from abroad. The tax cannot impose an undue burden on the foreign-derived product, under the penalty of being classified as a discriminatory measure under the GATT. Furthermore, the number one rule for the CBAM to be admissible is that it is applied on a product, and not a process. Taxes applied on (production) processes are also known as hidden taxes, or '*taxes occultes,*' and are inadmissible under WTO rules.

The textbook example to distinguish a tax on a product from a production tax is a tax on fuel, as opposed to one on energy consumption or production. In this example, a domestic tax on fuel can be legitimately applied on similar imported fuel, following the same criteria for incidence of the domestic tax but a tax that is domestically applied on the energy consumed during an industrial process (for example, to produce electricity or aluminum) cannot be applied on similarly imported aluminum that has been subjected to an industrial process abroad.

As a result, the following concomitant requirements are necessary for the CBAM to be admissible:

- An equivalent tax ought to be applied on a like-domestic product (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 configure a hindrance to trade); and
- 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 (although a conclusion cannot be reached until the details of the policy are revealed);

Furthermore, although not currently contemplated by the Inception report, a CBAM-credit may also be employed on export. A credit on export would have the effect of nullifying the tax applied either domestically or on import, therefore the choice to employ a credit on export should be carefully considered and crafted in order not to defeat the purpose of the tax and demur from any consequent environmental gain. BCAs on export tend to be conceded by countries employing unilateral domestic carbon taxes, for example, in order to safeguard the national industry's competitive position in the global market when trading in products that are produced to be exported.

If well crafted, a potential CBAM could actually be a useful instrument to stimulate third countries to employ like carbon or environmental taxes, as further discussed below.

2. Interaction with the EU ETS

The Centre for European Reform 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 a need to buy carbon permits under the European ETS. However, this option might also fall through if it is found that carbon permits refer to a production charge.

This is untested grounds under WTO law and therefore it is unclear whether applying a CBAM equivalent to the costs of acquiring carbon permits under the ETS would be (i) considered a product-based BCA; and (ii) admissible under the GATT. The framework so developed would have to take into account (and provide a corresponding price discount) the price impact of permits that are distributed to energy intensive companies for free. According to the Inception report, free allowances based on the emissions performance of the best installations under the system have been conferred in order to address the risk of carbon leakage for the sectors covered by the EU ETS. Under this proposal (if admissible), a free permit would correspond to zero-rating the CBAM, which would reduce the effectiveness of the regime.

Furthermore, the EU ETS might also have to be adjusted for the different targets conferred to different EU Member States, thus significantly increasing the complexity of the regime. It might, as a result, be challenging to have a single CBAM price administered towards the whole EU common market, leading to an environment of internal competition.

Notably, the EU ETS scheme only applies towards energy intensive industries, which means that the scope of reach of the BCA might be limited only to those industries already subject to the ETS, thus leaving a significant portion of the economy out of the regime.

A final question would be whether those countries already administering domestic carbon taxes in addition to the ETS would be allowed to adjust the CBAM upwards, to consider both the domestic carbon tax and the EU-wide ETS.

Data from the 2018 World Bank State on trends in carbon pricing demonstrates that the range of carbon tax rates in the EU may go from less than USD 1 per ton of CO_2e ($t/CO_{2e}e$) in Poland to USD 139 t/Co_2e on the other side of the Baltic Sea in Sweden.

Amongst the highest chargers (qualified as those countries applying taxes higher than USD 30 t/CO_2e), are Switzerland and Lichtenstein USD 101 tCO_2e, Finland USD 77, Norway USD 64 tCO_2e, and France USD 55 tCO_2e. Within the mid-range of USD 20-30 are Denmark, the UK Carbon Tax Floor, Spain, Ireland,[4] and Slovenia. Lower than USD 10 are: Portugal, Latvia, Estonia, and Poland.[5]

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

Under an EU wide approach, the EU Commission would have to define a single price for carbon within the common market, under the penalty of having to employ multiple tax rates at the border depending on the country of destination of the good.

The Carbon Pricing Leadership Coalition has predicted that a carbon price of USD 40-80/tCO_2e by 2020, and USD 50-100/ tCO_2e by 2030, would be necessary to achieve the Paris Agreement targets. That is an incredibly high price for some EU Member States, and a low price for others. Bridging the gap in too much or too little environmental taxation would have to be a topic for discussion under the proposed CBAM.

Likewise, there is a potential for double (or even triple) taxation if the carbon tax, energy tax and the EU ETS are applied over the same tax base. As it is now, most EU Member States applying unilateral carbon taxes do so over products not covered by the EU ETS (i.e., hence excluding the energy intensive sector covered by the EU ETS). The Green Deal for Europe proposed revision of the EU Energy Directive and proposed CBAM will have to account for these policy considerations.

Provided a target carbon price is defined in legislation, there would be no need to determine the greenhouse gas emissions associated with the production of an imported product (the so-called 'carbon footprint'), which would greatly simplify the administration of the tax at the border, particularly when the product is imported from a developing economy where it is difficult to obtain data capable of monitoring, reporting and verifying (MRV) the carbon footprint of a product.

3. **Conclusion**

The objective of this blog was to discuss the two most immediate issues resulting from the introduction of a proposed CBAM, namely, compatibility with the existing EU community wide legal framework and with the WTO rules. Other questions exist, such as the impact on third countries and compatibility with third countries' environmental approaches, as well as the key issue of passing the legislation and overcoming the unanimity requirement. These issues will be discussed, respectively, in two upcoming blogs.

[1] Tatiana Falcão, LL.M (Cantab), LLM (NYU), PhD (WU), is a senior policy expert in international tax and environmental taxation and is a member of the United Nations Subcommittee on Environmental Taxation.

[2] T. Falcão, *Toward Carbon Tax Internationalism: The EU Border Carbon Adjustment Proposal*, Tax Notes International, June 1, 2020, p. 1047

[3] *See* OECD Tax Talks #15, May 2020, https://www.oecd.org/tax/oecd-tax-talks-webcast-may-2020.htm.

[4] The Irish 2020 budget foresees a significant increase in tax rate for the next year, that would elevate the price applied in Ireland to EUR 70.

[5] Please note that this is not an exhaustive list.