Council on Geostrategy

Primer
Environmental Security Programme
No. ESPP01
May 2021

When climate and trade combine: British policy options

By William Young

Whilst most climate policy discussion is distracted by the return of the United States (US) to the Paris Agreement and the People's Republic of China's (PRC) surprise commitment of 2060 carbon neutrality, a rather boringly named policy innovation has the potential to radically transform international climate diplomacy and trade negotiations – 2021 is the year in which carbon border adjustment mechanisms (CBAMs) are hitting political agendas. If handled well, this innovation could help resolve one of the longstanding barriers to climate action – the 'free rider' problem – and support an acceleration of decarbonisation in every country. If handled badly over the coming months and years, it could foster renewed trading tensions[1] and further weaken free and open nations, making them less united, less strong, and less green.

This paper summarises the argument for CBAMs, its relation to carbon leakage and the motivation and approach of the main powers. It then outlines the complications resulting from: firstly, the challenge of evaluating country and industry level carbon intensity for this purpose and, secondly, the likely response of international trading partners and middle- and low-income countries. Next, it outlines four policy options for the United Kingdom (UK) before identifying a

[1] Leigh Collins, 'IEA: Carbon border taxes would need careful international negotiations to avoid trade wars', *ReCharge News*, 24/11/2020, https://bit.ly/3ugZksc (found: 26/05/2021).

recommended option by which the undoubted enthusiasm for CBAMs in the developed world is channelled, managed and handled properly to address the real challenge of carbon leakage.

What are carbon borders?

One of the primary challenges holding back climate action for the last forty years has been the fact that greenhouse gas (or 'carbon') emissions, even when emitted in one country, affect the whole world and there is no direct economic incentive for any one country to reduce their emissions. In fact sometimes the opposite - countries with lower environmental standards can sometimes produce goods at a lower cost, increasing their export competitiveness with those with higher standards. These countries are sometimes referred to as 'free-riders'. Carbon borders – also known as 'carbon border adjustment mechanisms (CBAMs)' or 'border tax adjustments (BTAs)' – are one of a variety of potential policy mechanisms to address this imbalance. Put simply, a tariff is placed on imports of goods from jurisdictions where the regulation of carbon emissions is weak, reducing the economic advantage enjoyed by that country.

Why CBAMs, why now, and the global response so far

Decarbonisation efforts in Europe (and globally) have so far focused on electric power and the automotive sector. One of the sectors in the next stage will be industry including cement, chemicals, steel and aluminium. The European Union (EU), which prides itself on its climate leadership, is grappling with how to do this without placing it's trade exposed heavy industry (steel, aluminium, and to a lesser extent cement),[2] in an uneconomic position in relation to countries that do not take action. The strong fear is that action by the EU will lead to closure of industrial facilities and the import of goods from countries with lower environmental standards – a process known as 'carbon leakage'. The European Commission sees this as a 'matter of survival' of industry and by extension the success and failure of its climate plans.[3]

[2] Sarah Ladislaw and Stephen J. Naimoli, 'Climate Solutions Series: Decarbonizing Heavy Industry', Centre for Strategic and International Studies, 05/10/2020, https://bit.ly/3hQ3TXX (found: 26/05/2020).
[3] Frans Timmermans quoted in: 'EU sees carbon border levy as "matter of survival" for industry', *Euractiv*, 19/01/2021, https://bit.ly/3oPhHDz (found: 26/05/2021).

To counter this risk, the EU is examining proposals for a CBAM. France has long advocated for some form of border adjustment and experimented itself with solar power; however, it is only since the UK left the EU and Ursula von der Leyen succeeded to the presidency that CBAMs have moved from France's preferred position to the EU's stated plan as part of the much-feted 'Green Deal'.[4]

The proposals, initially due in June 2021 have been delayed to July, are expected to focus on a narrow subset of industries – steel, cement, aluminium and power – and will aim, by 2023, to bring in an adjustment for imported goods that are higher in carbon intensity than those produced in the EU. Various designs are being examined with, in addition to a strong focus on compliance with World Trade Organisation (WTO) rules, potentially including the option for individual firms to prove their carbon intensity credentials and thus qualify for a reduced tariff.[5] However, although the EU's unilateral approach has its advocates, it has put the wind up international trading partners who are concerned that this will be detrimental to their trading interests and/or potentially derail diplomatic efforts around the United Nations Climate Change Conference (COP26) in November.

This opposition ranges from individual higher-income countries expressing concern regarding WTO compliance (Australia[6]) to those concerned for international climate diplomacy (US). It has also come from groupings of lower and middle-income countries whose concerns are both that their exports would be disadvantaged and that this is a departure from the Paris Agreement's underpinning principles of equity and common but differentiated responsibility (CBDR) (the so-called 'BASIC' group of Brazil, South Africa, India and the PRC).[7] Canada and the UK have been quietly supportive of the discussion of carbon leakage, considering it a potential agenda item for the G7, though not yet taking a formal policy position.[8]

[4] The EU's Green Deal is a 'plan to make the EU's economy sustainable.' It wraps together Covid-19 recovery funding with EU level debt issuance, and cross border fiscal transfers under the pretext of funding the shift to a green economy. For some the programme is a vehicle for the EU to become more geopolitically relevant. See: Mark Leonard et. al., 'The geopolitics of the European Green Deal', European Council on Foreign Relations, 03/02/2021, https://bit.ly/3unHdkc (found: 26/05/2021). For the Green Deal itself, see: 'A European Green Deal', European Commission, 2021, https://bit.ly/3fMgsRp (found: 26/05/2021).
[5] Michael Mehling and Robert Ritz, 'Going beyond default intensities in an EU carbon border adjustment mechanism', *Cambridge Working Papers in Economics* (No. 2087), 16/09/2020, https://bit.ly/3oUgNps (found: 26/05/2021).
[6] Jason Scott, 'Australia Needs More Climate Action for EU Deal, ABC Says', *Bloomberg News*, 11/03/2021, https://bloom.bg/3hQ4hWp (found: 26/05/2021).
[7] Vishwa Mohan, 'BASIC nations oppose EU's plan to impose a "carbon border tax"', *Times of India*, 20/04/2021, https://bit.ly/3uoyApA (found: 26/05/2021).
[8] Jessica Shankelman, 'UK's Boris Johnson Considers G-7 Bid on Green Border Levies', *Bloomberg News*, 04/02/2021, https://bloom.bg/2QUDjBW (found: 26/05/2021).

Despite the opposition the EU has stated that it will not be dissuaded from pursuing CBAMs, rebuffing concerns from other countries.[9] The main option for de-escalation that the EU has so far nodded to is that countries instituting their own domestic carbon prices would be exempt. Other options put forward by different think tanks include a reduction in tariff for companies based on their individual carbon intensity or that lower-income countries would be exempt.[10] While arguing that a CBAM should be a last resort, John Kerry, the US Special Presidential Envoy for Climate, has stated that the US was 'particularly interested in evaluating a levy', though a widespread or comparable system to that which the EU envisages would likely require a domestic carbon price which has proved challenging in the past.[11]

Further complications: international trading partners and generally accepted methodologies

The handling of two major and interrelated complications will determine whether the EU's preferred policy is effective or counterproductive.

The first is that of alignment to the principles of equity and CBDR. CBDR is founded on the deeply rooted belief that economic development cannot happen without increased emissions and that lower-income countries should not be prevented by climate policies from achieving higher income status. A CBAM, by placing external constraints on trade in carbon-intensive goods, would undermine growth and place yet another burden on developing countries, undermining the principles of equity and CBDR. As revealed by the BASIC ministerial meetings in April 2021 this argument is already being made and it's quite possible that this position will harden.

As a result, and depending on implementation, a CBAM could be a significant source of tension between the developed and the developing world,

[9] Camilla Hodgson, 'EU rebuffs US concerns over carbon border tax threat', *Financial Times*, 31/03/2021, https://on.ft.com/3flk6Ti (found: 26/05/2021).
[10] See: Michael Mehling and Robert Ritz, 'Going beyond default intensities in an EU carbon border adjustment mechanism', *Cambridge Working Papers in Economics* (No. 2087), 16/09/2020, https://bit.ly/3oUgNps (found: 26/05/2021) and Sam Lowe, 'The EU's Carbon Border Adjustment Mechanism: How to Make it Work for Developing Countries', Centre for European Reform, 22/04/2021, https://bit.ly/3ujOH7X (found: 26/05/2021).
[11] See: Leslie Hook, 'John Kerry warns EU against carbon border tax', *Financial Times*, 12/03/2021, https://on.ft.com/3fOngOf (found: 26/05/2021) and Ari Natter, Jennifer Dlouhy, and David Westin, 'Biden Exploring Border Adjustment Tax to Fight Climate Change', *Bloomberg News*, 23/04/2021, https://bloom.bg/3bQy51e (found: 26/05/2021).

undermining efforts to secure enhanced Nationally Determined Contributions (NDCs) and increasing the conditions which countries like Brazil and India place on them.

The second complication is that of calculation and assessment. While everyone – broadly – understands the principle of a CBAM, and the EU and its advisors are reasonably confident that a WTO compliant plan can be developed, there is no agreement, and in fact no accepted framework, for actually calculating carbon intensity, or the embedded emissions in different industries.

Extensive progress has been made on establishing greenhouse gas emissions from point sources, needed to support policy mechanisms such as emissions trading schemes, and from countries needed to support the Nationally Determined Contribution process. However, the methodology for doing this at a country-industry-individual business level, sufficient to support customs declarations and levies, does not yet exist. It is not insurmountable; in fact various workable proposals have been made, even if they are complex.[12]

That it is complicated and that there is no generally accepted methodology means that even if the underlying fairness of a CBAM were to be accepted, there is likely to be significant dispute of any unilateral calculation and assessment. As we have seen with digital taxes and agriculture before it, if there is no agreement on underlying methodologies and economic interests are sufficiently misaligned then trade disputes are likely and there can be retaliatory tariffs in unrelated sectors.

What this all indicates is that whilst much thought has been put into how CBAMs could address carbon leakage and gain support in the countries that would institute them it is an untested assumption that a virtuous circle of increasing carbon adjustments would take place internationally.[13] Little thought has been put into how this virtuous circle can actually be made a reality and the high likelihood of increased trade tensions managed down.

Should the EU proceed unilaterally it is possible that the UK's leadership on decarbonisation will position it well for equivalence with the EU. However, as we've seen with financial services when significant interests are at stake, as they would be again in this context, this is not a given and when coupled with the fact that other countries will be less well placed, increased tensions are likely.[14] As

[12] Michael Mehling and Robert Ritz, 'Going beyond default intensities in an EU carbon border adjustment mechanism', *Cambridge Working Papers in Economics* (No. 2087), 16/09/2020, https://bit.ly/3oUgNps (found: 26/05/2021).
[13] Ted Halstead, 'A climate solution where all sides can win', BloombergNEF Summit, 26/03/2019, https://bit.ly/3hQlvmB (found: 06/05/2021).
[14] Josh Burke et. al., 'What does an EU Carbon Border Adjustment Mechanism mean for the UK?', LSE and Grantham School of Research on Climate Change and the Environment, 01/03/2021, https://bit.ly/3wvpvwT (found: 09/05/2021).

such the UK's choices may wish to be informed by this and guided by pre-emptive action to manage these tensions.

Policy options

There are a number of options the British Government could take on CBAMs, of which four stand out:

1. **Do nothing:** The arguments in favour of this approach are firstly: trade barriers are bad and the EU is shooting itself in the foot by both reducing competition and antagonising international partners with the CBAM proposal. Secondly, given the EU's behaviour towards the UK since 2016, not standing in the way of this mistake might be sensible. The primary argument against this approach is that given EU institutions capabilities on trade and climate, it is possible that it could actually develop a credible and norm-setting position which would further concentrate power in EU institutions.

2. **Form a blocking coalition:** Side with and mobilise an international coalition founded in BASIC countries and Australia to exert pressure on the EU to drop or severely dilute its proposals. The model for this could be the effort that prevented international air travel from being included in the EU Emissions Trading Scheme (ETS). The primary argument against this approach is that: firstly, there is appetite in the UK itself to potentially implement measures to deal with carbon leakage, potentially a CBAM; secondly, the US and Canada are unlikely to join an outright blocking coalition, severely undermining its likelihood of success; and, thirdly, because one of the powerful aspects of a CBAM is its unilateral nature will make the EU likely resist all but a very concerted effort.

3. **Copycat:** Wait for the EU's proposals to be released and then support and mirror their implementation plans. The primary argument against this approach is that it would reinforce the EU as a norm-setting institution and centre of gravity at the nexus of trade and climate, areas in which the EU already has significant reach and authority. Further concentrating power in EU institutions in this way would run counter to the British Government's attempt to uphold national sovereignty, as specified in the

Integrated Review.[15] Secondly, this would only increase the likelihood of tensions with the developing world undermining not only COP26 diplomacy but also evolving bilateral relationships such as those between the UK and India.

4. **Multilateral channelling:** Channel the widespread developed world interest in pre-empting carbon leakage and enthusiasm for the CBAM concept into a multilateral process and institutions tasked with defining (a) the methodology underpinning the calculation of embedded emissions in a limited number of trade exposed primary industries such as steel manufacturing and principles by which countries would (b) place tariffs on imports from carbon intensive production and (c) direct foreign aid to support the conversion of developing country facilities to lower carbon methods. The arguments for this approach are that it would (a) address the real fears around carbon leakage in developed countries (b) provide a process for input from countries which fear they will be disadvantaged (c) reduce the potential concentration of power in EU institutions (d) likely receive active support from countries such as the US.[16] The primary arguments against this approach are firstly, that by moving this to multilateral fora, the time frame for implementation would likely be extended and secondly that it would undermine the raison d'etre of a CBAM which is to unilaterally address environmental risks to a country or trade bloc's citizens.

To implement the fourth option, the UK would need to utilise its diplomatic network and the G7, COP26 and other platforms to establish support from Japan, the US, Canada, Australia, the wider Commonwealth, BASIC countries, the EU, New Zealand, Costa Rica and others. It would do this to build support for a process by which appropriate multilateral organisations would develop and promulgate methodologies, data and benchmarks for the carbon intensity of a small number of trade-exposed carbon intensive industries or goods by jurisdiction, ultimately translating these into product standards. Potential candidate organisations for this include the Taskforce on National Greenhouse Gas Inventories (TFI) in Japan or the Organisation for Economic Cooperation and Development (OECD) in Paris. These would be supported by the International

[15] 'Global Britain in a Competitive Age: the Integrated Review of Security, Defence, Development and Foreign Policy', Cabinet Office, 16/03/2021, https://bit.ly/3vX8RGY (found: 26/05/2021).
[16] The US has a track record of narrowly applied border tax adjustments linked to product standards. For a good overview, see: Robert Ireland, 'Implications for Customs of climate change mitigation and adaptation policy options: a preliminary examination', *World Customs Journal*, 4:2, 09/2010, https://bit.ly/3umT56e (found: 26/05/2021).

Energy Agency (IEA), the International Standardisation Organisation (ISO), the International Institute for Sustainable Development (IISD), and the World Customs Organisation (WCO) and others. Input would be sought from the key industrial sectors in line with the wider 'Race to Zero' effort.[17] With political backing these organisations together have the credibility, network and knowledge to develop a widely accepted methodology and framework for these policy mechanisms and with the various trade ministries establish how this approach would link into WTO dispute resolution mechanisms.

A high level agreement between said countries establishing the principles by which, firstly, they would place tariffs or other trade barriers on carbon intensive goods; secondly, commit to limiting reprisals to other carbon intensive goods, and explicitly excluding those with environmental benefits; and, thirdly, use foreign aid budgets to support industry in low income countries affected by barriers on carbon intensive goods to develop domestic carbon prices, or convert specific industries to low carbon production.

Conclusion

Inside and outside the EU framework, the UK has a track record of shaping unilateral and somewhat clumsy proposals from continental Europe into something that works for itself and the wider international community. Practitioners should take heart from Margaret Thatcher's response to the face off in 1987-1990 which transformed the unworkable proposals of the 1989 Hague Declaration on the Environment into the United Nations Framework Convention on Climate Change (UNFCCC) process and the creation of the Intergovernmental Panel on Climate Change (IPCC) working groups.[18] These initiatives received widespread international backing and although not perfect laid the foundations for the acceptance of climate science, nationally determined contributions and the progress we see today.[19] Furthermore these initiatives protected the UK's sovereignty and freedom to act as it saw fit with regard to its domestic and

[17] The Race to Zero is a UN role tasked with engaging non state actors in making progress on emissions reduction. Part of this engagement is with specific industrial groups. See: 'Industry', Race to Zero, 2021, https://bit.ly/2TaGhms (found: 26/05/2021).
[18] 'Hague Declaration on the Environment', *International Legal Materials*, 28:5 (1989), pp. 1308-1310.
[19] William Young, 'Why do high income states show international climate leadership? A neoclassical realist study of the UK in the periods 1987-1990 and 2016-2019', London School of Economics, 27/08/2020, unpublished dissertation.

international commitments. Walking this tight rope and giving itself the tools to do so in the next stage of decarbonisation and geopolitical rivalry is critical.

Through its diplomatic leadership, environmental knowledge and capability, the UK can again shape the international environment agenda towards a more united, stronger and greener world for free and open nations.

Acknowledgments

The author would like to thank the following for their feedback on drafts of this paper: Sam Hall, Eamonn Ives, Antoine Vagneur-Jones and Kristyna Young. He would also like to thank the following for valuable conversations related but not directly linked to this paper: Ben Caldecott, Ted Halstead (†), Michael Liebreich, Alexandra Toft and Adam Tooze. Of course all responsibility for the contents of this paper including omissions and inaccuracies lie with the author.

About the author

William Young is Director at BloombergNEF, Bloomberg's strategic research business and climate lead on the East-West focused New Economy Forum. He was formerly Chief of Staff to the Chief Executive Officer and Chief Operations Officer and prior to that was instrumental in launching NEF's research capabilities and advising clients on technology, finance, economics, politics and business opportunities in the transition to a low carbon economy. He holds an MSc in International Strategy and Diplomacy from the London School of Economics and an MA (Hons) in Modern History from the University of Oxford.

> **Dedicated to making Britain, as well as other free and open nations, more united, stronger and greener.**

ISBN: 978-1-914441-07-3

Address: 14 Old Queen Street, Westminster, London, SW1H 9HP
Phone: 020 3915 5625
Email: info@geostrategy.org.uk