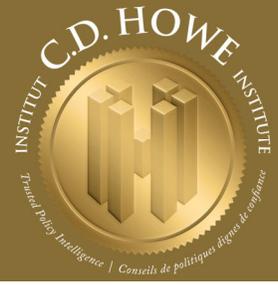


Intelligence MEMOS



From: Jon Johnson

To: Global Affairs Canada

Date: June 21, 2021

Re: **CARBON BORDER TAXES: LESSONS TO COME AS THE EU PLUNGES IN**

The European Union is set to announce its plans for a Carbon Border Adjustment Mechanism on July 14. European importers would be required to buy certificates covering carbon (i.e. greenhouse gases such as carbon dioxide, methane, etc.) content in their imports of steel, aluminum, cement and fertilizer, with other industries being included later. A transition period could start as early as 2023, with the scheme being fully implemented in 2025, according to the current draft proposal.

The purpose of a border carbon adjustment is to level the playing field between trading partners that regulate carbon emissions and those that do not. Carbon emissions can be regulated in many ways, including: by imposing regulatory charges on carbon emissions; through output based allocation systems (cap and trade) requiring carbon emitters to pay for emissions over imposed levels and rewarding emitters whose emissions fall below the levels; and by prohibiting or severely limiting production methods that result in high emissions. These methods all result in additional producer costs.

Canada already regulates carbon emissions. Canada's *Greenhouse Gas Pollution Act*, which recently survived a Supreme Court challenge, uses a combination of charges on specified fuels and an output based allocation system. Provinces whose regimes for regulating carbon emissions are considered adequate by the federal government maintain their own regimes, with some based on cap and trade and others on carbon pricing.

As announced in Budget 2021, the government intends to "launch a consultation process on border carbon adjustments in the coming weeks." International reaction to the proposed EU scheme will be highly instructive to the government in determining whether Canada should consider adopting border carbon adjustments of its own.

Of critical importance is the US reaction. While the Biden administration accepts that carbon emissions contribute to global warming, the US federal government currently does not maintain measures that regulate carbon emissions. There are efforts by state governments to control carbon emissions, notably California which is party to a cap and trade scheme that also includes Quebec. However, comprehensive measures at the federal level can only occur with congressional approval which may be difficult to secure. As a further complication, US businesses adversely affected may file petitions under Section 301 of the US Trade Act of 1974.

Developing countries may strongly oppose the EU scheme, maintaining (consistent with the Paris Agreement and the WTO principle of special and differential treatment of developing countries) that wealthy countries should bear a heavier burden of combatting climate change than developing countries.

The EU maintains that its proposal would comply with WTO requirements because the carbon price (based on the EU's emissions allowance market) would be the same for emitters within the EU as those outside the EU. However, the fact that importers from countries that set a price on carbon emissions will be able to deduct those costs from the proposed adjustment could create difficulties because products from those countries would be treated differently from products from other countries. There are numerous ways of pricing carbon emissions and the EU would have to choose which ones entitle an importer to a deduction and which do not.

If a WTO panel found that imports from different WTO member countries were being treated differently, the EU scheme would have to fall within one of the GATT 1994 Article XX exceptions (e.g. necessary to protect human, animal or plant life or health or relating to the conservation of exhaustible natural resources, namely air without carbon pollution) to be WTO-consistent.

A WTO challenge to the EU scheme is possible and, while the Appellate Body currently cannot function for lack of a quorum, WTO dispute panels continue to take cases and render decisions.

A panel decision upholding the EU plan would be positive for the development of border carbon adjustments. However, a panel decision deciding that it was inconsistent with WTO rules would be a real setback.

The EU initiative provides Canada an excellent opportunity to monitor how a border carbon adjustment mechanism plays out before adopting any such mechanism of its own.

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