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Border Carbon Adjustments: The Canadian Context

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Issue

Border carbon adjustments (BCAs), also known as carbon tariffs, are being proposed in the EU and US. The rationale is that such tariffs will level the playing field for industries facing a domestic carbon pricing mechanism – carbon tax or cap and trade system – and eliminate unfair competition from countries with less stringent environmental regulation. Analysis suggests that imposition of BCAs would not prove punitive to most Canadian industry. However, it remains unclear whether carbon tariffs are desirable for trade and economic policy or whether they are legal under World Trade Organization (WTO) rules.

Assuming that both the EU and US pass some form of BCA, it is important to understand:

1. The impact an EU or US BCA could have on Canadian industry;
2. The advantages and disadvantages of Canada implementing its own BCA;
and,
3. The impact a Canadian carbon tariff could have on the BC economy

Background

In the aftermath of the 2009 UN Climate Conference in Copenhagen, EU ministers, led by France and Germany, started to push for a carbon tariff in an attempt to curb unfair competition from countries like China, which have weaker climate protection lawsⁱ. According to some analysts in the USⁱⁱ, the inclusion of border carbon adjustment measures seem essential to secure the passage of any US climate legislationⁱⁱⁱ and to reduce the competitive advantage of less environmentally stringent countries. When a country or region attempts to cap emissions by implementing a cap-and-trade system or carbon tax, emissions, jobs and money may migrate out of that jurisdiction to countries or regions with less stringent environmental standards (e.g. China and India)^{iv}; an effect known as “carbon leakage.”

In essence a cap and trade scheme or carbon tax has the general effect of increasing the relative price of domestically produced goods, although this is not true uniformly, because in many cases domestically produced goods are primarily manufactured using foreign labour and inputs. A carbon tariff is an attempt to correct for this imbalance by taxing carbon-intensive imports^v.

Critics of carbon tariffs point to a number of contentious issues that make the use of BCA less straight-forward. These include:

1. **Carbon leakage:** It is not clear that a BCA is the most effective tool to address the problem of carbon leakage, nor is it clear that carbon leakage will even be a problem. In 2008, a revised EU ETS granted exemptions to vulnerable carbon intensive industries that are subject to competition from countries with less stringent CO₂ emission-reduction regimes^{vi}. It is likely that US legislation would include similar measures.

Recent economic analysis^{vii} argues that carbon tariffs may actually worsen global welfare effects in return for an almost negligible reduction in global emissions. In addition, carbon tariffs may trigger a trade war with damaging consequences for domestic industry and target emerging economies whose cooperation is vital for global climate policy.

2. **WTO compatibility:** The argument about the legality of BCA has been promoted by the Chinese, who are adamant that such policy is protectionist. However, if the political will exists, there are at least two ways a BCA could pass WTO rules:
 - a. Countries could impose a GATT border tax adjustment (BTA) on imports as long as the equivalent tax is imposed on domestic carbon emissions. If they can argue that the carbon border tax on imports is the “same treatment” as an “internal measure” it may not contravene Article II obligations^{viii}
 - b. The EU and US can admit that BTA’s are incompatible with the GATT and appeal to Article XX which allows countries “to protect the global environment”. Under WTO rules, Article XX allows for exemptions for the protection of global natural resources and one could argue that a low-carbon atmosphere is an ‘exhaustible natural resource’

Implications

Despite the uncertainty as to the effectiveness of carbon tariffs and questions about their WTO compatibility, it appears that both the EU and the US will pursue some form of carbon tariffs in upcoming climate legislation.

What does this mean for Canada?

Assuming that Canada harmonizes its carbon policy with the US, carbon tariffs imposed by the EU and US will have very little impact on our overall economy. The American Clean Energy and Security Act (ACES) states that it would not impose a US border measure if “imports in the trading partner’s sector have GHG intensities that are equivalent or below the US sector’s GHG intensities.”^{ix} Based on current GHG-intensities and 2007 export levels, this criteria would exempt 89 percent of Canadian trade from US border adjustments.^x The obvious exception is oil produced from the oil sands, which currently has higher production-related emissions than

conventional sources.

Should Canada impose a carbon tariff?

According to the National Roundtable on the Environment and the Economy, Canada should not impose a carbon tariff because:

- The net impacts on the Canadian economy as a result of carbon pricing policy will likely be small.
- Modeling suggests some sectors will likely be better off (e.g., electricity generation, office machinery and equipment) and some likely worse off (e.g., natural gas, refined petroleum, and crude sectors), compared to a business as usual scenario.
- In the short to medium term, domestic climate policies and carbon emissions pricing policies are likely to be implemented by many of Canada's trading partners, moderating the impact on competitiveness.^{xi}

Furthermore, a rebate of all Canadian emissions-permit costs on exports, similar to those proposed by ACES, would return more money to Canadian exporters than would be collected on imports. This would result in a windfall for many domestic producers, but at the expense of domestic consumers, taxpayers and importing firms^{xii}.

Implications for BC

Preliminary research suggests that British Columbia is not particularly vulnerable to carbon leakage as a result of carbon pricing from either the existing carbon tax, or the pending cap and trade scheme devised under the WCI. Some of BC's carbon intensive industries are vulnerable to leakage to other jurisdictions that do not participate in programmes like the Western Climate Initiative (WCI). BC's carbon intensive industries, including cement, steel, and oil and gas, are relatively less mobile than non-carbon intensive sectors. These deposits cannot be moved, only the willingness to invest in their exploitation. Unless the cost of compliance with the cap and trade system exceeds the net rents to the industry, they will not move^{xiii}. In addition, some large sectors will be exempt from the WCI cap and trade scheme (e.g. forestry) and may be net beneficiaries.

Finally, electricity generation in BC is predominately hydroelectric, and BC's Energy Policy has set electricity self-sufficiency as a goal with incremental generation coming from clean (non-carbon or fully carbon sequestering) sources. Thus industries using electricity (e.g. pulp and paper, aluminum, computer-intensive sectors) will be much less affected in BC than in jurisdictions dependent on thermally generated electricity. As a result, a carbon tariff would not significantly help the BC economy as only a few of the very energy intensive industries would face challenges to their competitiveness.

Recommendations

The current language, structure, and intent of the Bill indicate that it would not be punitive to most Canadian Industry, however, the nature of US policy making could allow some influence by special interests. BC and Canada should ensure that they will not be unnecessarily punished by a US BCA enacted by the ACES.

Further Reading

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Sources

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^x Dachis, B. (2009). Ibid.

^{xi} National Roundtable on the Environment and the Economy, ‘8.3 Competitiveness Risks and Macroeconomic Impacts Resulting From Broad, Unified Carbon Pricing Policy’: <http://nrtee-trnee.ca/eng/publications/carbon-pricing/carbon-pricing-tech/chapter8-3-carbon-pricing-tech-eng.php>

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