

## Insight



# U.S. Carbon Border Adjustment Proposals and World Trade Organization Compliance

TORI SMITH | FEBRUARY 8, 2023

## Executive Summary

- The European Union’s new carbon border adjustment mechanism (CBAM), which will start taxing U.S. exports in carbon-intensive sectors in 2026, will likely bring U.S. proposals for a similar mechanism back to the forefront this year (members introduced legislation during the 117th Congress to tax carbon-intensive sectors, but the issue is still widely debated).
- A CBAM in any form would likely run the risk of violating international trade commitments under the World Trade Organization (WTO).
- Compliance with U.S. commitments under the WTO should be a top priority when considering any mechanism to tie trade and climate policy because disregarding WTO commitments could draw retaliation from trading partners.

## Introduction

On December 13, 2022, the European Union (EU) announced that it had finalized plans to institute the world’s first carbon border adjustment mechanism (CBAM). This announcement comes after years of debate in the EU member states on how to transition their carbon pricing system to a CBAM, which also led to a CBAM debate in the U.S. Congress.

Last session, members of Congress put forward several proposals to create a CBAM for the United States. Legislation ranged from a simple tariff on carbon-intensive products to establishing a carbon price and a CBAM. It is very likely that Europe’s new CBAM will reignite a debate over whether the United States should create its own CBAM.

As new legislation is developed and evaluated, it is essential that these proposals are compliant with the United States’ international trade commitments, namely rules under the World Trade Organization (WTO). The specifics of how or if a carbon price is set, how taxing carbon emissions is carried out, and how issues such as carbon leakage are addressed can run afoul of WTO commitments. If Congress fails to consider WTO commitments, the United States could be subject to retaliation from trading partners.

## What Is a Carbon Border Adjustment Mechanism?

A key component of policymakers’ efforts to mitigate climate change has been centered on reducing carbon emissions. It is [estimated](#) that “one-fifth of the world’s carbon emissions come from the manufacturing and production sectors.” Policymakers ostensibly see cutting carbon emissions in manufacturing sectors as an essential aspect of their carbon emission reduction objective. The Biden Administration has a goal of “50-52

percent reduction from 2005 levels in economy-wide net greenhouse gas pollution in 2030”[1] and the EU’s goal is to “reduce greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels.”[2]

Increasingly, policymakers have sought to use trade policy to decrease carbon emissions, especially in developing countries with fewer environmental regulations than developed countries. A carbon border adjustment mechanism is one of the most prevalent examples of those efforts. A CBAM taxes carbon-intensive goods produced domestically or abroad based on an established carbon price, which is determined by the government. The border adjustment aspect of this is that the tax is based on domestic consumption of the carbon-intensive good, so products that are exported are given a rebate of the tax. A CBAM includes the rebate for exports to disincentivize moving carbon-intensive production overseas, known as carbon leakage.

Proponents of a CBAM claim that assigning a cost to carbon emissions would ensure that both domestically produced goods and imports are subject to that cost, and that this would prevent carbon leakage. The ultimate goal of a CBAM is to decrease carbon emissions by creating a cost to those emissions and hopefully incentivizing innovation to create cleaner ways to produce the goods. The U.S. Chamber of Commerce, a skeptic of a CBAM in the United States, contested these claims:

“[W]hile tariffs on steel, aluminum and other industrial imports may prevent leakage and protect U.S. industry from economic disadvantages, the competitiveness of many clean energy industries is dependent on affordable steel and aluminum and fabricated products...raising the costs of such goods could negatively impact deployment of clean energy technologies such as electric vehicles or renewables.”[3]

The EU will implement [the first CBAM](#) in October 2023, when importers of iron and steel, aluminum, cement, fertilizer, electricity, and hydrogen will be required to report their carbon emissions to the EU. Starting in 2026, importers will need to purchase CBAM certificates, the price of which will be determined by the Emissions Trading System (ETS). The EU’s approach is not a traditional border adjustment, however, because it does not include rebates for exporters.[4]

## **Congressional CBAM Proposals**

During the 117th Congress, several pieces of legislation were introduced to use trade policy to impact carbon emissions. Some proposals sought to impose a tariff on carbon-intensive goods, while others would have set a carbon price and established a CBAM for the United States. The last Congress did not approve any legislation on this specific issue, but it is likely that some proposals will be reintroduced in the 118th Congress.

In July 2021, Senator Chris Coons (D-DE) introduced the [Fair, Affordable, Innovative, and Resilient \(FAIR\) Transition and Competition Act](#). A companion bill was also introduced in the House of Representatives. The FAIR Transition and Competition Act would have instructed the Treasury Department to determine the “domestic environmental costs incurred” by domestic businesses producing a variety of products including aluminum, cement, iron, steel, oil, and natural gas, or the cost of the environmental regulatory burden in the United States. Treasury would have also been tasked with the “production greenhouse gas emissions” for the covered products and use the two numbers to calculate the border carbon adjustment fee for imports of that product.[5]

The [Clean Competition Act](#), introduced Senator Sheldon Whitehouse (D-NH) in June 2022, would have set a carbon tax of \$55 per ton starting in 2024 on industries in the Environmental Protection Agency’s Greenhouse

Gas Reporting Program. Covered companies would have to pay for their emissions that exceed their industry's average. Most importers would pay the tax according to how their home country's industry emissions compare to the domestic industry. Domestic companies covered by this law would receive a rebate for the carbon tax for exported products.[6] Senator Whitehouse said his proposal would "give American companies a step up in the global marketplace while lowering carbon emissions at home and abroad and steering the planet toward climate safety."

## **CBAM and WTO Compliance**

The EU's impending CBAM is likely to inspire similar legislation in Congress this session. When considering any new mechanism that would impact trade, it is essential that policymakers do not neglect the United States' commitments under the WTO. International trade law and WTO experts such as Joel Trachtman of Tufts University and Jennifer Hillman of the Council on Foreign Relations have examined at length the areas where a CBAM might trigger a WTO violation,[7] but the general conclusion is that CBAMs are uncharted territory.

The WTO agreements that a CBAM could violate are clearer, however. The WTO agreement most important for the structure of a tax on carbon-intensive products is the General Agreement on Tariffs and Trade (GATT), which details the core tenets of the WTO, such as the most-favored nation (MFN) and non-discrimination principles. Commitments under the Agreement on Subsidies and Countervailing Measures (SCM) are also important when it comes to making a measure border-adjusting by issuing rebates for exports. CBAMs have not been tested by a WTO dispute settlement panel, so it is difficult to know exactly how a panel would rule on questions under these agreements.

Uncertainty about the permissibility of CBAMs should give U.S. policymakers considering such a policy pause, because neglecting WTO rules could leave the United States open to retaliation by its trading partners. In recent years, U.S. trade policy and legislation, most recently with the Inflation Reduction Act (IRA), has disregarded WTO rules. The Biden Administration is currently engaged in yet another trade dispute with allies over its neglect of WTO rules in implementing the IRA. While debate among scholars remains, there do seem to be three principles to follow to have a "reduced risk of violating WTO law"[8] when considering a CBAM: (1) the carbon tax must apply to domestic goods and imports; (2) imports from all WTO members must be treated the same; and (3) rebates for exports cannot exceed the carbon tax.

### *Application to Domestic Goods and Imports*

There are several provisions in the GATT that matter for a CBAM – or indeed any kind of tax on carbon. [Article II of the GATT](#) states that imports from WTO members must be "exempt from ordinary customs duties" and "exempt from all other duties or charges of any kind imposed on or in connection with the importation" in excess of the MFN tariff rate. [Article III of the GATT](#) states that imports "shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products." In short, if a CBAM is applied as a condition of importation and causes the tariff rate to go above the MFN rate, it could violate Article II. If, however, the tax is applied after importation due to "an internal factor," it must apply to imports and domestic goods equally, otherwise it could violate Article III.[9]

In the case of the European Union’s CBAM, that its ETS and the carbon tariff are tied to the average ETS price could represent equal application of the measure on imports and domestic goods. The EU, however, offers free allowances to some of the covered products domestically, and while those will be phased out over time, their existence could potentially constitute a GATT violation.<sup>[10]</sup>

### *Treat Imports from all Members the Same*

Article I of the GATT details the parameters for most-favored nation treatment. At its core, this principle means that a WTO member must give the same “advantage, favor, privilege, or immunity”<sup>[11]</sup> to all WTO members. In the context of a CBAM, an MFN principle violation could be triggered if the carbon tax set is contingent on the policies of other countries. Trachtman explains the example of steel in the context of a CBAM:

“[A]ll steel of a certain type would be treated as like products and required to be treated the same, regardless of its origin. If an import BTA were structured simply to apply to that type of steel, regardless of its origin, there would be no violation of Article I. If, on the other hand, steel from different origins were treated differently based on (i) the amount of carbon used in production or (ii) the carbon tax or carbon limit regime of its origin country, countries whose steel is treated worse might claim a violation of Article I MFN.”<sup>[12]</sup>

The EU’s CBAM could run afoul of these commitments because it gives special treatment to countries that already have a carbon price. This is estimated to benefit South Korea and Singapore by allowing them to lessen their price when sending products to the EU. It is also likely that some countries, such as Switzerland, Norway, Iceland, and Liechtenstein, could be fully exempt from the CBAM because they all have an ETS that is tied to the EU’s.<sup>[13]</sup>

### *Rebates Cannot Exceed the Carbon Tax*

Export subsidies are generally prohibited under SCM because they create an unfair price advantage for exports by reducing costs for the domestic producer. Advocates of CBAMs claim that “without such an exemption, if few countries impose their own carbon taxes or carbon reduction schemes, then U.S. exporters would be at a competitive disadvantage.” This is the crux of the debate over carbon leakage, so proponents see rebates for exports as an essential component of a tax on carbon-intensive goods. Moreover, in order for such a tax to be truly considered a border adjustment, it must include a rebate. Under the SCM, any rebates for exports to compensate for carbon leakage cannot exceed the cost of the CBAM, otherwise the rebate could be considered an export subsidy.

An export rebate was not included in the European Union CBAM, though it was discussed as an alternative to the free allowances that are offered to some industries under the ETS. European businesses that currently receive free allowances asked the government to include an export rebate in the CBAM, but it was left out. According to the Peterson Institute for International Economics, “export rebates are a key point of friction between Parliament and the Commission, as they are not accepted by the Commission and were omitted from its proposal due to concerns about WTO compatibility.”<sup>[14]</sup>

## **Conclusion**

The EU’s new CBAM is likely to reignite debate in Congress over whether to create a similar mechanism in the United States. Europe’s CBAM could run afoul of WTO rules in several areas, which should give pause to U.S.

policymakers. Compliance with WTO commitments should be a top priority when considering any new tariff or tax, Therefore, any proposal for a U.S. CBAM should be met with increased scrutiny, particularly considering that such measures are untested at the WTO.

[1] <https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/22/fact-sheet-president-biden-sets-2030-greenhouse-gas-pollution-reduction-target-aimed-at-creating-good-paying-union-jobs-and-securing-u-s-leadership-on-clean-energy-technologies/>

[2] [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_21\\_3541](https://ec.europa.eu/commission/presscorner/detail/en/IP_21_3541)

[3] <https://www.globalenergyinstitute.org/sites/default/files/2021-09/CBAM-principles.pdf>

[4] <https://www.niskanencenter.org/whats-in-the-latest-eu-carbon-border-adjustment-provisional-agreement/>

[5] <https://www.whitecase.com/insight-alert/legislation-impose-border-carbon-adjustment-fee-imported-steel-and-other-carbon>

[6] <https://www.niskanencenter.org/whats-in-the-carbon-border-adjustment-bill-introduced-by-senator-whitehouse/>

[7] <https://media.rff.org/documents/RFF-DP-16-03.pdf>; and [http://americanactionforum.aaf.rededge.com/uploads/files/research/1374767060Hillman\\_CarbonTaxes\\_Jun13\\_web.pdf](http://americanactionforum.aaf.rededge.com/uploads/files/research/1374767060Hillman_CarbonTaxes_Jun13_web.pdf)

[8] <https://media.rff.org/documents/RFF-DP-16-03.pdf>

[9] [http://americanactionforum.aaf.rededge.com/uploads/files/research/1374767060Hillman\\_CarbonTaxes\\_Jun13\\_web.pdf](http://americanactionforum.aaf.rededge.com/uploads/files/research/1374767060Hillman_CarbonTaxes_Jun13_web.pdf)

[10] <https://www.niskanencenter.org/whats-in-the-latest-eu-carbon-border-adjustment-provisional-agreement/>

[11] [https://www.wto.org/english/docs\\_e/legal\\_e/gatt47\\_01\\_e.htm](https://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm)

[12] <https://media.rff.org/documents/RFF-DP-16-03.pdf>

[13] [https://www.akingump.com/en/news-insights/eu-reaches-provisional-agreement-on-carbon-import-charge.html#\\_ftn3](https://www.akingump.com/en/news-insights/eu-reaches-provisional-agreement-on-carbon-import-charge.html#_ftn3); and <https://www.whitecase.com/insight-alert/european-parliament-and-council-reach-agreement-carbon-border-adjustment-mechanism-0>

[14] <https://www.piie.com/sites/default/files/2022-10/pb22-14.pdf>