



## Research

# Design Principles for a WTO-Compliant Carbon Border Adjustment

CATRINA RORKE | JULY 31, 2013

Any domestic carbon policy will necessarily carry costs for consumers of fossil fuels. These costs require honest consideration of measures to reduce risks to American competitiveness and the likelihood of emissions migrating to countries without a similar policy. A border adjustment can address these concerns and improve the integrity of a carbon policy by equalizing costs for all goods exchanged domestically.

As discussed in this memo, a border adjustment must comply with the constraints imposed by our membership to the World Trade Organization. Such a policy is attainable with careful policy design to avoid demonstrating favoritism to domestic production. For a more in-depth discussion, please refer to the report “Changing Climate for Carbon Taxes: Who’s Afraid of the WTO?” authored by Jennifer Hillman of the German Marshall Fund.

*What are our international trade obligations?*

The U.S. is a member of the World Trade Organization (WTO), which supervises international trade, provides a mechanism for establishing trade agreements, and resolves disputes arising from non-compliance with those agreements among its 159 member countries.

A domestic carbon policy with a border measure is most likely to invite challenge under the General Agreement on Tariffs and Trade (GATT), which prohibits policies that discriminate between goods based on their country of origin. This requires any carbon border adjustment to evaluate imports in the same way the domestic policy evaluates domestically produced goods.

*What domestic policy is most likely to comply?*

If the U.S. chooses to pursue a carbon-limiting policy, it may do so without regard to WTO requirements. The likely addition of a border measure, however, requires some design parameters that will help simplify international compliance.

First, the policy should resemble a product-based (or “indirect”) charge as much as possible. Second, the cost of the policy should be established through a transparent and replicable method. The simplest path to compliance is through a carbon tax applied to products in an amount that reflects the carbon dioxide emitted during its production or consumption.

*What would a border adjustment for imports look like?*

A WTO-compliant adjustment would apply to products that are “like” their domestic counterparts and would not exceed the tax applied to domestic products. “Likeness” is typically framed in terms of the end use and

physical characteristics of a product, and how it competes with other goods. If a domestic tax is calculated based on the amount of carbon dioxide emitted in the production of a good, the import duty should be calculated similarly.

The border adjustment can be determined in one of two ways to avoid discrimination. First, importers can provide emissions information on a product- or plant-specific basis to calculate the adjustment in the same method as the domestic tax. This would obviously be administratively daunting. Second, the adjustment can be set to equal the tax applied to “like” domestic products produced by the “predominant method of production” or with the “best available technology” in the United States. Such a policy would ensure that an import adjustment would not discriminate against imports, but may also allow many imports to underpay for their carbon output.

*What would a border adjustment for exports look like?*

Matching an import adjustment with a rebate for domestically produced exports would reasonably restrict the carbon policy to goods consumed in the United States. A straightforward product-based carbon tax could be rebated, so long as the amount of the rebate is no higher than the carbon tax due for “like” products. If the domestic tax is constructed appropriately, this rebate is fairly simple in terms of international compliance.

*If these measures aren’t accepted, is there an alternate route?*

The GATT permits border adjustments that do not comply with its rules in limited circumstances necessary to protect human, animal, or plant health, or to conserve an exhaustible natural resource. In order to justify a border adjustment under these exemptions, the U.S. must prove that (1) the policy is not an arbitrary or unjustifiable discrimination between countries, and (2) does not function as a disguised restriction on trade. Very few measures have satisfied these requirements, but if a policy is clearly designed and implemented for environmental goals (and not competitiveness concerns), it may qualify for exemption. This is not the preferred route to compliance.

*Other considerations*

Any differentiation between countries of origin in assessing the adjustment will likely result in a violation of the GATT’s strict “most favored nation” principle, which requires duties or fees to be equal across all import partners. This prohibits any differentiation among imports according to carbon policies enacted by trading partners.

The border adjustment will generate new federal revenues, which can be dedicated to a host of policy priorities. Dedicating a significant portion of that funding stream to help developing countries lower emissions and adapt to climate change could clarify the environmental intent of the policy. This would help the policy survive a WTO challenge.

The simplest method of building a domestic carbon policy, even a carbon tax, may not be the simplest route to satisfying international compliance obligations. This memo is not intended to endorse a carbon limit of any form, but to address the pressing challenge of building a policy that tackles competitiveness and emissions leakage issues.