US Cos. Must Prepare For EU Carbon Tax On Imports

By **David Lakhdhir and Mark Bergman** (February 18, 2021)

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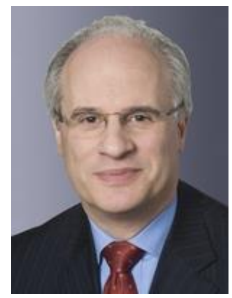

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As a facet of the so-called European Green Deal,[1] the European Union is currently contemplating instituting a carbon border adjustment mechanism, or CBAM. A formal proposal from the European Commission is expected as early as the end of this year, with the objective of implementing a CBAM by the end of 2022.

The mechanism would impose a tax, or duty, on goods imported into the 27 member states of the EU, which would reflect the amount of carbon emissions attributed to their manufacture and inputs.

Companies that export U.S.-manufactured goods to EU countries are likely to be significantly affected by the CBAM, particularly if their products are associated with high levels of carbon emissions. They should monitor this impending development closely, both to anticipate the risk it presents and also to take advantage of any opportunities it presents to mitigate its costs.

In addition, given the high priority that the new Biden administration has placed on combatting climate change, as well as the CBAM's likely impact on U.S. manufacturers, the Biden administration would be well advised to engage with the EU on an urgent basis, regarding its structure and scope.

The impetus behind the CBAM, both economic and political, is clear. In order to meet the ambitious carbon reduction targets envisioned by the European Green Deal, the EU will need to significantly raise the cost of its primary carbon pricing mechanism, the EU's cap-and-trade emissions trading system, or ETS, and to phase out the free allocation of emission permits.

The EU's desire to take bold action to combat climate change through the European Green Deal is critical to avoiding environmental disaster, and has broad public support in Europe. Many member states have expressed concern, however, that the imposition of increased ETS costs on European manufacturers — while those in non-EU countries are free to export to countries in the EU without the burden of those costs — will be damaging to European companies.

They claim that an offsetting charge on imported goods is needed to maintain the level playing field that that should exist between EU and non-EU suppliers of goods. They also argue that a CBAM is necessary to eliminate the incentive that would otherwise exist for European companies to transfer carbon-intensive production outside the EU, often referred to as carbon leakage.

There are several ways to structure a CBAM, and these are being actively debated.[2] The CBAM was initially proposed as part of an overhaul of the ETS, but it might be addressed separately. If implemented through the ETS, the CBAM could take the form of an extension of the ETS's cap and trade mechanism to EU importers or non-EU exporters to the EU.

Alternatively, the CBAM could take the form of a separate import tax, calibrated — to the extent practicable — to the amount of carbon that would have been emitted in products' manufacture, or to the cost of carbon imposed by the ETS in respect of comparable EU-manufactured products. As a third alternative, the ETS itself could be replaced by an EU-wide carbon tax, which would be applied to both EU-based manufacturers and non-EU exporters to the EU.

The scope of a CBAM is also unclear. The tax on goods imported into the EU might only apply to goods imported from countries that do not have a carbon pricing mechanism deemed to be equivalent to the EU's — or the tax might apply to all imports, but be offset by equivalent carbon taxes imposed by the government in their country of origin.

It might apply to all products — or only those in sectors that are particularly carbon intensive in the manufacturing process. And it may create incentives for non-EU manufacturers to reduce their carbon emissions in order to reduce the CBAM's cost — or be insufficiently nuanced to facilitate that level of fine-tuning.

Several things are clear, however. As the U.S. does not currently have any carbon tax or cap and trade system, U.S. exports to the EU are likely to be significantly affected by the CBAM. And several sectors — those that are carbon-intensive and export in significant quantities to the EU — are more likely to be materially affected than others.

These sectors include metals, refined petroleum products, mining and quarrying, textiles and apparel, and pharmaceutical products — although it should be noted that in some cases U.S. manufacturers are less carbon-intensive than their non-EU competitors. And in those cases, the imposition of a well-designed CBAM would bring U.S. producers into cost parity with EU producers, but give them a competitive advantage compared to more carbon-intensive producers in other non-EU countries.[3]

In order not to violate the principles of nondiscrimination embedded in the General Agreement on Tariffs and Trade, or GATT, and the rules of the World Trade Organization, the CBAM will need to comply with the WTO's most-favored-nation and national treatment rules. The European Commission has stated its intention to propose a measure designed to comply with the WTO rules. This may not be easy.

The GATT permits a contracting party to impose "a charge equivalent to an internal tax imposed … in respect of a like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part." But formulating a CBAM that fits squarely within this exception may be difficult.

The GATT also includes general exceptions for measures "necessary to protect human, animal or plant life or health" and/or "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption." If appropriately targeted at reducing carbon emissions — as opposed to serving as a discriminatory duty to protect EU manufacturers — it may be possible to structure the CBAM to fall within one of these exceptions.

The U.S. does not at present have a carbon tax. Despite strong support for this from Janet Yellen,[4] recently confirmed as secretary of the Treasury, a wide range of U.S. economists and even the Republican-led Climate Leadership Council,[5] it would face significant political hurdles.

U.S. manufacturers that export to countries within the EU may, however, be facing an indirect carbon tax on those exports in a few years' time. Assuming that the EU legislation does provide an exemption or offset for products already subject to an equivalent carbon tax, the U.S. may be losing tax revenue in respect of those exported products.

Companies that have significant exports to the EU, and whose products are manufactured in processes that have a high carbon content, should analyze, in line with requirements currently applicable to EU producers, the carbon content of their products, so as to assess the possible adverse economic impact of a CBAM — and the steps that might be taken to reduce emissions, and thus mitigate the associated cost.

For U.S. companies that export to the EU, preparing to deal with the impact of a CBAM, and finding ways to reduce its impact, will be critical. The fact that the structure and scope of the CBAM is not yet set in stone may offer an opportunity for the new Biden administration to engage with the European Commission on these matters — but there is not much time.

The European Commission undertook a public consultation process on the CBAM, with feedback received from July through October 2020,[6] including from the U.S. Chamber of Commerce.[7] It has stated its intention to table a formal proposal by summer 2021,[8] with the objective of adopting the CBAM by the end of 2022.

The Biden administration should engage, as soon as possible, with the EU on this issue. The administration should encourage the European Commission to fashion a mechanism that is consistent with WTO rules; is clear and not administratively burdensome; provides incentives to non-EU exporters to reduce their carbon emissions; and — if possible — fits together well with tax or other incentives that are implemented in the U.S. to encourage companies to cut their greenhouse gas emissions.

Indeed, if the choice is for U.S. exporters to pay taxes to the EU under a CBAM, or to pay the U.S. the same amount under a U.S. carbon tax, the EU's initiative might well be another strong argument in favor of the U.S. adopting some form of carbon tax itself.

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[1] See Communication from the Commission, The European New Deal (Dec. 2019).

[2] See, e.g., Andrei Marcu, Michael Mehling and Aaron Cosbey, Border Carbon Adjustments in the EU: Issues and Options, published by the European Roundtable on Climate Change and Sustainable Transition (Sept. 30, 2020).

[3] See B. Aylor, M. Gilbert, N. Lang, M. McAdoo, J. Oberg, C. Pieper, B. Sudmeijer and N. Voight, How an EU Carbon Tax Could Jolt World Trade (June 30, 2020) (Boston Consulting Group study).

[4] Matthew Green, "U.S. could adopt carbon tax under a Biden presidency, ex-Fed Chair Yellen says," Reuters (Oct. 8, 2020).

[5] See Climate Leadership Council, The Four Pillars of our Carbon Dividends Plan.

[6] See European Commission consultation.

[7] U.S. Chamber of Commerce, Comments in Response to the European Commission Consultation on a Carbon Border Adjustment Mechanism (Oct. 28, 2020).

[8] European Parliament Legislative Train (Dec. 2020).