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Avoiding 'Tax' Label May Ease Path For EU Carbon Measure

By **Natalie Olivo**

Law360 (March 19, 2021, 6:16 PM EDT) -- The European Union's planned carbon border adjustment mechanism could attach import costs to emissions-heavy items brought into the bloc from places with looser environmental standards — and the measure may have an easier way forward if it's not technically a tax.

The European Commission, the EU's executive branch, is aiming to propose a carbon border measure that would make it more expensive to import items from parts of the world with weaker environmental regulations. While the formal proposal won't be released until June, EU officials have signaled that the mechanism could take the form of an import tax that adjusts based on carbon content, or alternatively, a mechanism that's linked to the bloc's current Emissions Trading System, or ETS.

Specialists have said a carbon measure may be more feasible as an extension of the ETS that would require companies to buy emission allowances to import from outside the bloc — similar to the existing allowance system within the EU. At the same time, a measure that's connected with the ETS, rather than a separate border tax, could run a greater risk of violating rules under the World Trade Organization if the mechanism is seen as favoring EU companies.

If the carbon measure is proposed as part of the ETS, the commission could argue that it's not actually a tax, according to Matthew Porterfield, deputy director and adjunct professor at the Harrison Institute for Public Law at Georgetown University Law Center. A tax would need unanimous agreement among member countries to get enacted, but it also wouldn't face the same potential trade constraints as a measure connected to the ETS, he said.

"The problem is they're in a bit of a Catch-22," Porterfield said of a border tax. "That would help in terms of WTO compliance, but it would also mean that it would be subject to the unanimity requirement within the EU's internal legislative process."

Free Allowances and a "European Green Deal"

Under the current ETS, which has been in place since 2005, there's a cap on emissions for heavy energy-using installations — power stations and industrial plants — and airlines operating in the bloc, according to the EU. Within this cap, companies can receive or buy emission allowances that they can trade with each other.

The EU has also provided free allowances to protect competitiveness and to address risks of carbon leakage, where companies move their operations to places with looser restrictions on carbon emissions. But the muted risk of carbon leakage is coming to an end in part due to reduced amounts of free allocation, according to a report published in September from the European Roundtable on Climate Change and Sustainable Transition.

Prices that companies are paying within the ETS also have gone up, according to Elke Asen, a policy analyst at the Tax Foundation, a conservative-leaning economic think tank in Washington, D.C. There are questions about how to expand the EU's cap-and-trade system while reducing the disadvantage that EU companies are facing, she said.

"One of the solutions to that would be a carbon border adjustment," Asen said. "It can be seen as a part of the cap-and-trade system that the EU currently has."

The carbon border adjustment mechanism was proposed as part of the "European Green Deal" in December 2019. The proposal said the measure, known as CBAM, would be designed to comply with WTO rules and function as "an alternative to the measures that address the risk of carbon leakage in the EU's Emissions Trading System."

Shortly after the outbreak of the coronavirus pandemic, Paolo Gentiloni, the EU's tax commissioner, rejected the idea that environmental concerns should be moved aside in favor of helping the economy rebuild. As for a CBAM, he said, "It's time to accelerate and not to slow down."

Option One: A Border Tax

As for the form a CBAM could take, the European Parliament's resolution for the measure, adopted March 10, noted the commission is assessing the different options "ranging from tax instruments to mechanisms using the EU ETS."

Earlier in March, Gentiloni had said the commission was looking into "an import tax, a mechanism … similar to the EU Emissions Trading System allowances, or a new excise duty on carbon intensive materials covering consumption of both domestic and imported products."

If the CBAM were an import tax, it likely wouldn't face the same WTO issues as a tariff, according to Moutaz Altaghlibi, an assistant professor of law, economics and governance at the Utrecht University School of Economics in the Netherlands. A tax would be adjusted based on the carbon content of imports and could incentivize companies to reduce emissions, while a tariff would be levied on the value of imports and would distort competitiveness, he said.

"If you are producing in a clean way, you can get rid of the carbon border tax," Altaghlibi said. "But the tariff, since it's on the value of imports, whether you are being cleaner in your production or not, you will always need to pay it."

In a similar vein, Porterfield at Georgetown said a carbon border adjustment would take a domestic carbon tax and simply apply it to imports of energy intensive products at the same rate. In theory, this approach wouldn't distort trade and would address carbon leakage — but tax measures also have an elaborate legislative process, he said.

"It'd be very difficult for them to at least quickly move from their ETS to a carbon tax," Porterfield said. "I don't think that's going to happen, at least in the near term."

According to the European Parliament, the CBAM should cover the power sector and energy-intensive industrial sectors — including cement, steel, aluminum and oil refinery — by 2023. But this timeline may be unlikely if the measure takes the form of a border tax, according to Asen at the Tax Foundation.

Even if the EU gets agreement from all of the member states, each country would still have to put that legislation into its domestic law, she said.

"It is probably quite optimistic to have it implemented by 2023," Asen said. "That would definitely put a lot of pressure on all the member states to implement that law by then."

Option Two: An Expansion of the ETS

According to the resolution recently adopted by the European Parliament, carbon pricing under the CBAM "should mirror the dynamic evolution of the price of EU allowances" and the mechanism could require importers to buy allowances from a separate pool.

A measure that's part of the ETS, rather than a border tax, might be implemented more easily, according to Asen. Member states already agreed to the trading system 15 years ago and they may see a border adjustment measure as "just an additional element of the cap-and-trade system" that also puts domestic businesses in a better spot, she said.

On the other hand, Porterfield noted that a system of buying allowances could create issues under WTO rules, which were drafted to accommodate border adjustments of internal consumption taxes, which is known as indirect taxes.

"They weren't drafted to permit border adjustments of emissions trading schemes that require you to purchase and surrender allowances, which sounds more like a regulatory requirement," he said.

However, the central WTO agreement — the General Agreement on Tariffs and Trade, or GATT — has environmental exceptions under Article XX, according to Porterfield. One of the exceptions, Article XX(g), covers measures related to the conservation of exhaustible natural resources, he said.

"In theory, even if a border adjustment ETS violated GATT, it might still be permissible under the environmental exception," Porterfield said.

He added that different legal standards make it so "you have to run the gantlet to qualify as an environmental exception. In practice, it's difficult to do, but not impossible."

As Altaghlibi at Utrecht saw it, trade compliance could depend on how the allowance system is structured. If foreign producers had to buy allowances from the market, where domestic producers currently have free allowances, the domestic companies could be seen as having preferential treatment, he said.

But if the free allowances were phased out before implementing the CBAM, then there could be an auction market where both domestic and foreign producers bid for these allowances, according to Altaghlibi.

"If this was the case, then as far as I am concerned, I don't think there will be a problem from the WTO side," he said.

"These Measures are Coming"

Although the CBAM's final form isn't yet known, companies can make some inferences to prepare for the upcoming measure, including by looking at trade compliance requirements.

The exceptions under Article XX only would apply if the CBAM is designed to clearly target carbon reduction without indirectly imposing an unnecessary burden on international trade, according to David Lakhdhir, a partner at Paul Weiss Rifkind Wharton & Garrison LLP's London office. The measure would also have to be designed in a way that treats EU and non-EU producers equally, he said.

There is a practical corollary to this requirement, according to Lakhdhir. Although it's impossible to know what form of the CBAM will be adopted, it's possible for U.S. producers to assess what the cost impact on them would be if their production facilities were in the EU, he said.

In addition, U.S. producers could assess what they might be able to do to reduce that cost if they were in the EU, according to Lakhdhir.

"If the system is then constructed in a nondiscriminatory way — as it must be to comply with WTO rules — that should give U.S. producers a decent window into the probable cost impact of the CBAM," he said.

According to Jeff Weiss, a partner in Steptoe & Johnson LLP's Washington, D.C., office, companies should prepare for climate measures — not just in the EU, but in the U.S. and elsewhere as well.

"These measures are coming," he said.

As Weiss saw it, companies and members of industry associations should figure out how they can demonstrate their ability to meet low carbon thresholds, rather than having a government give them a number.

"Go out and actually map your supply chain," he said. "Figure out how to lower the number of what you can meet [and] how that's a comparative advantage for your industry versus an industry in another country or another industry that competes with yours."

Weiss added: "I wouldn't be waiting for governments to come to me and say, 'This is how much you're going to pay.' I would want to get out ahead of it."

--Additional reporting by Matt Thompson and Todd Buell. Editing by Tim Ruel and Vincent Sherry.