December 2009

Andersons Policy Bulletin

Border Adjustments and US Climate Policy: Are they Legal?

Climate Policy and Trade

In the past decade, it has become increasingly obvious to many observers that even though negotiation of the Kyoto Protocol on Global Climate Change in 1997 was a useful first step, further efforts to develop a comprehensive multilateral agreement for reducing greenhouse gas (GHG) emissions will be necessary if global climate change is to be properly addressed. Discussion of what might constitute key dimensions of such an agreement has mostly focused on the need to include commitments by both developed and developing countries to reduce GHG emissions (*New York Times*, July 19, 2009).

Irrespective of the logic supporting a multilateral approach to climate policy, the United States has been and is actively pursuing a national effort to reduce GHGs. During the 110th US Congress, at least half of the twelve climate change bills introduced by legislators called for some type of border measure to be targeted at energy-intensive imports, based upon the GHG emissions embodied in those imports. More specifically, at the beginning of 2008, separate bills sponsored by Senators Bingaman and Specter, and Senators Liebermann and Warner respectively, were being discussed in the US Congress, both of which called for a domestic cap-and-trade system targeted at GHG emissions, along with a requirement that importers acquire emissions allowances based on the embedded carbon in their goods.

While neither of these latter bills became law, in the current session of Congress, a bill sponsored by Representatives Waxman and Markey was passed by the US House of Representatives in June 2009, and currently a companion bill sponsored by Senators Kerry and Boxer is under consideration by the US Senate as a whole. Like the earlier Bingaman-Specter and Lieberman-Warner bills, the Waxman-Markey bill contains provisions relating to border adjustments for US domestic climate policy. Under Title IX of the bill, "Promoting International Reductions in Industrial Emissions", the following statement is made as regards the objectives of any multilateral environmental negotiations,

"…(to) include in such international agreement provisions by which countries signatory to the agreement agree to apply, with respect to imports from countries not signatory to the agreement, border measures designed to minimize any carbon leakage from the signatory to the non-signatory countries, including border measures…"

In the absence of any multilateral agreement, on GHG emissions, the bill contains very clear language about unilateral implementation of border adjustments for US domestic climate policy. Specifically, if no multilateral agreement exists by 2018, the President is mandated to implement an international emissions allowance program, requirements being imposed on importers no earlier than January 2020.

Importers in eligible industries will be exempt from having to purchase emissions allowances if it is established that 85 percent or more of US imports of covered goods are produced in countries that meet at least one of two criteria: (i) the country, along with the United States, is party to an international agreement to reduce GHG emissions, where the GHG reduction requirement is at least as stringent as that applied in the United States; (ii) the country has implemented domestic climate policies that increase production costs in the eligible industry by at least 80 percent of the cost of complying with US legislation. Otherwise importers in eligible industries will have to purchase an appropriate amount of emission allowances as a condition of entry into the United States, the border price of allowances being based on the mean of the daily US market price for emission allowances.

Additional exemptions from the purchase of emissions allowances are specified for imported products coming from: (i) countries that are achieving reductions in GHGs equal to or better than US reductions; (ii) countries that are identified as being the least developed; and (iii) countries deemed to be producing less than 0.5 percent of total global GHG emissions and accounting for less than 5 percent of US imports of the eligible product.

The key political reason for inclusion of border adjustments in the Waxman-Markey bill was the need to "…secure the votes of Rust Belt lawmakers who were wavering on the bill because of fears of job losses in heavy industry…" (*New York Times*, June 29, 2009). Specifically, the provisions are designed to provide some protection to those parts of the US manufacturing sector that would face competition from countries with less stringent GHG emissions regulation.

At the time of the bill's passage through the House of Representatives, President Obama, while recognizing that parts of the US manufacturing sector have legitimate reasons to be concerned about competition from producers in developing countries, did express concern about the border adjustment provisions of the bill, noting that, "…At a time when the economy worldwide is still deep in recession and we've seen a significant drop in global trade…I think we have to be very careful about sending any protectionist signals out there…" (*New York Times*, June 29, 2009). In addition, Senators Kerry and Boxer, sponsors of the Senate Bill on climate change indicated that they had problems with the inclusion of border adjustments in the House bill, Senator Kerry expressing his concerns during hearings of the Senate Finance Committee.

However, with pressure coming from several senators in states with manufacturing sectors likely to be negatively affected by a cap-and-trade system, a recent editorial by Senators Kerry and Graham suggests that bi-partisan agreement may eventually result in the inclusion of border provisions in the Senate bill, "…we cannot sacrifice another job to competitors overseas…For this reason, we should consider a border tax on items produced in countries that avoid these standards…" (*New York Times*, October 11, 2009).

WTO Rules and Border Adjustments

The idea of making adjustments at the border in the presence of domestic taxes is not new. Such taxes have been applied at borders since the late-18th century, and the underlying principle for such adjustments has long been recognized. Ricardo observed, "…In the degree then in which (domestic) taxes raise the price of corn, a duty should be imposed on its importation…By means of this duty…trade would be placed on the same footing as if it had never been taxed…" The key phrase here is that any border adjustment should result in imports remaining at the same level as before implementation of the domestic tax.

Even though border adjustments have a long history, it was the formation of the European Economic Community (EEC) in the mid-1950s and its subsequent implementation of a harmonized system of value added tax (VAT), that resulted in economic and legal discussion of adjustment at the border for such an internal tax system. The central issue that arose was whether VAT should be applied on an origin or a destination basis. If the EEC had adopted the former, VAT would have applied to production, the tax would also have applied to exports, with no tax rebate at the border, and imports entering the EEC would have done so tax free. The original members of the EEC did in fact adopt the latter principle for taxation, VAT being applied to both domestic consumption and imports as they entered the EEC, and with VAT rebates on exports.

As a result of implementation of the harmonized VAT tax system, concerns arose in the United States that its exports to the EEC were subject to a trade barrier when entering the EEC, while at the same time VAT-free exports from the EEC were receiving an export subsidy. After completion of the Kennedy Round of GATT in 1967, and prior to the launch of the Tokyo Round in 1973, there was considerable discussion in the United States as to whether the destination basis of VAT as applied in the EEC was a violation of GATT Article III. In the event, no dispute settlement case was initiated through GATT by the United States, and there was no negotiation over the issue in the Tokyo Round.

Economic analysis at the time suggested that border tax adjustments for VAT would be neutral in their effects on trade, and this lies at the heart of the legal discussion of such taxes. In a 1970 report, a GATT Working Party defined border tax adjustments as:

"…any fiscal measure which put into effect, in whole or part, the destination principle (i.e., which enable…imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)…" [WTO, 1997, para: 28]

The objectives of such taxes are:

"…to ensure trade neutrality of domestic taxation…and thus to preserve the competitive equality between domestic and imported products…" [WTO, 1997, para: 24]

The key language in these two paragraphs concerns whether border tax adjustments are imposed on imported products that are *similar* to the domestic product, and that they are *neutral* in terms of their impact on trade.

Border tax adjustments are normally implemented with respect to taxes on final goods, e.g., domestic excise taxes are levied on goods such as alcohol and cigarettes, and equivalent taxes are then levied at the border on imports of such goods. In principle, however, there is nothing to prevent a country from also applying a border tax adjustment for taxes on inputs such as energy used in production of a final good such as aluminum.

The implementation of border tax adjustments for domestic climate policies raises the important distinction between, application to final goods, versus their application to final goods produced that use energy-intensive inputs. This relates to the issue of trade measures applied on the basis of process and production methods (PPMs). Border tax adjustments on final goods that embody carbon emissions are likely to be highly contentious.

Potential legal challenges to countries seeking to implement border tax adjustments for their climate policies will come under GATT Article III, and if found inconsistent with WTO obligations, may be still justifiable under GATT Article XX. GATT Article III.1 and III.2 (National Treatment) are the rules that oblige WTO members not to discriminate against imports from other members when applying internal laws and regulations. The key language in Article III.2 states that imported products,

"…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…"

Consequently, a 20 percent border tax adjustment on imported diesel fuel to adjust for a 20 percent domestic excise tax on diesel fuel would clearly be consistent with Article III.2. The 1970 GATT Working Party on Border Tax Adjustments also made it clear that indirect taxes levied on products such as diesel fuel were eligible for border tax adjustment, while direct taxes such as payroll taxes were not.

While the WTO position on border tax adjustments on final goods seems quite clear, it is much less clear that Article III.2 will allow border tax adjustments on final goods that embody energy inputs, given imposition of domestic taxes on GHG emissions. The GATT Working Party was actually unable to agree on the legality of such measures, and it was not until the 1987 *Superfund* case that this issue was re-examined by the GATT.

This case was a challenge by Canada, the EEC and Mexico against US taxes being levied on certain imported chemicals as well as substances that were end-products of chemicals being taxed in the United States under the US Superfund Act.[1] Essentially, the GATT Panel ruled that the rate of tax on the imported substances was equivalent to the tax borne by the like domestic substances, given the tax on chemicals, and, therefore was consistent with Article III.2.

Irrespective of the GATT ruling in the Superfund case, it is likely that the key issue still remains as to whether a border tax adjustment for domestic climate policy will fall under Article III.2, i.e., what goods are being compared for "likeness", and can imported and domestic goods be compared given differences in the amount of energy embodied in the final product?

Even if a border tax adjustment for domestic climate policy is deemed inconsistent with GATT Article III: 2, it may still be possible to justify it under GATT Article XX (General Exceptions). Both GATT/WTO panels and the Appellate Body have adopted a two-tier test to determine whether any border measure is justified under Article XX: (i) does the measure fall within the scope of Article XX – specifically is such a measure, "…necessary to protect human, animal or plant life or health…", or "…relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption…"; and (ii) that the measure is "…not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade…"

Whether or not border tax adjustments for domestic climate policies are covered by Article XX will depend on their being shown to be a reasonable means of achieving the ends, i.e., conservation of exhaustible natural resources. In addition, interpretation of how Article XX might be applied to such border adjustments will depend on: (i) the requirement, as indicated by the WTO Appellate Body in the *Shrimp-Turtle* case, that members of the WTO pursue multilateral agreements on environmental issues; (ii) whether, special and differential treatment can be expected in the application of border adjustments, based on whether the imported good comes from a developed or developing country; and (iii) when application of the border measure fails to take proper account of the comparative effectiveness of measures and policies applied in the exporting country.

The conclusion to be drawn is that there is uncertainty about the outcome of any WTO Dispute Settlement Panel on the issue of border tax adjustments for domestic climate policies, and that this will only be settled via an actual ruling.

[1] The purpose of the Superfund tax was to help underwrite the cost of cleaning up hazardous waste sites.

Bibliography

New York Times. "Obama Opposes Trade Sanctions in Climate Bill," *New York Times* June 29 (2009).

New York Times. "Trade and Climate," *New York Times* July 19 (2009).

New York Times. "Yes We Can (Pass Climate Change Legislation)," *New York Times*, October 11 (2009).

WTO. "Taxes and Charges for Environmental Purposes-Border Tax Adjustments, Committee on Trade and the Environment," WT/CTE/W/47, Geneva: World Trade Organization (1997).

Andersons Policy Bulletins are discussions of key trade and policy issues. The author of this bulletin, Ian M. Sheldon, is Andersons Professor of International Trade in the Department of Agricultural, Environmental, and Development Economics within the College of Food, Agricultural, and Environmental Sciences at The Ohio State University.

Questions or comments?
e-mail: sheldon.1@osu.edu

Columbus, OH USA 43210-1067
12/2009

http://aede.osu.edu/programs/Anderson/trade