

**“Climate Policy and Border Tax Adjustments:
Some New Wine Mixed with
Old Wine in New Green Bottles?”**

**Ian Sheldon
(Ohio State University)**

**CAES-CATPRN Workshop, “Beyond the Three Pillars:
The New Agenda in Agri-Food Trade”**

Québec, Canada, October 23, 2009



Climate Policy and Trade Policy

- **Clear connection being made between climate policy and trade policy, e.g., US Congress - Waxman-Markey Bill (2009); Kerry and Graham (*NY Times*, Oct.10, 2009)**
- **Domestic climate policies should be accompanied by appropriate border measures applied to carbon-intensive imports**
- **Krugman claims “...there’s perfectly sound economics behind border adjustments...” (*NY Times*, Jun.29, 2009)**
- **Is this just “old wine in new green bottles”? (Lockwood and Whalley, 2008, NBER)**

Trade and the Environment

- **Absent an international carbon price, implementation of any domestic climate policy may negatively affect competitiveness of domestic firms, i.e., lost profits and market share (UN/WTO, 2009)**
- **Non-universal application of climate policies will also create potential for carbon leakage, and hence carbon-havens, i.e., environmental inefficiency**
- **Language relating to carbon is new – but economic issue already embodied in literature on “pollution havens” (Copeland and Taylor, 2004), and “regulatory chill” (Bagwell and Staiger, 2001)**

WTO Law and Border Tax Adjustments

- **Old principle – goes back to Ricardo (Sraffa,1953)**
- **Issue arose in 1960s, when EEC adopted destination-basis, harmonized VAT system with taxes on imports and tax rebates on exports**
- **Debate as to whether in violation of GATT Articles III and XVI - no negotiation occurred during Tokyo Round**
- **Lockwood and Whalley (2008) claim analysis of Shibata (1967) and others showed when all consumption goods are taxed at same rate, no real effects on trade, production and consumption**

WTO Law and Border Tax Adjustments

- 1970 GATT Working Party defined BTAs:

“...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)

- Objective of BTAs is:

“...to ensure *trade neutrality* of domestic taxation...and thus to preserve the competitive equality between domestic and imported products.” (WTO, 1997, para: 24)

- Taxes subject to BTAs include VAT and excise duties

WTO Law and Border Tax Adjustments

- In principle, nothing to prevent country from applying BTA for taxes on inputs (energy) used in production of final good (aluminum)
- Raises issue of BTAs on *like* products vs. BTAs applied on basis of *processes and production methods* (PPMs)
- Embodied taxes on carbon/energy likely to be contentious – despite WTO Appellate Body's findings in *shrimp-turtle* case (Charnowitz, 2002)
- Potential challenges will come under GATT Article III, but legal issues are less than clear-cut

WTO Law and Border Tax Adjustments

- **GATT Articles III:1 and III:2 (National Treatment) obliges WTO members not to discriminate against imports in application of internal laws and regulations**
- **Key language in Article III:2 states 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”.
- **20% BTA applied on imported diesel fuel to adjust for a 20% domestic excise tax on diesel fuel would be consistent with Article III**
- **Less clear if BTAs applied to inputs are permitted**

WTO Law and Border Tax Adjustments

- **GATT *Superfund Case* (1987) – challenge to US taxes on imported substances that were end-products of chemicals taxed in the US**
- **Given tax on imported substances was equivalent to tax borne by domestic substances, Panel deemed measure consistent with Article III:2 - ruling focused on fiscal burden not product “likeness” (Goh, 2004)**
- **Key issues: (i) what products are being compared for “likeness”? (ii) can imported and domestic products be compared given differences in amount of energy embodied in final product?**

WTO Law and Border Tax Adjustments

- **If energy BTAs found inconsistent with GATT Article III:2, possible to justify under GATT Article XX (General Exceptions)**
- **Justification for measure has to satisfy 2-tier test:**
 - necessary “to protect human, animal or plant life or health...” or relating to “conservation of exhaustible natural resources...”
 - 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...” (Article XX Chapeau)
- **Significant debate about legal outcome (Goh, 2004; Biermann and Brohm, 2005; Pauwelyn, 2007; Bordoff, 2008) – will only be settled via an actual ruling**

Neutrality and Border Tax Adjustments

- **Poterba and Rotemberg (1995) examine perfect competition at intermediate and final goods stages**
- **Import tax on final good equal to environmental tax times extent to which intermediate good enters final good cost function is neutral**
- **McCorrison and Sheldon (2005) used model of successive oligopoly to explore two rules concerning neutrality:**
 - (i) Import-volume neutrality (Figure 1)**
 - (ii) Import-share neutrality (Figure 2)**

Figure 1: Import Volume Neutrality

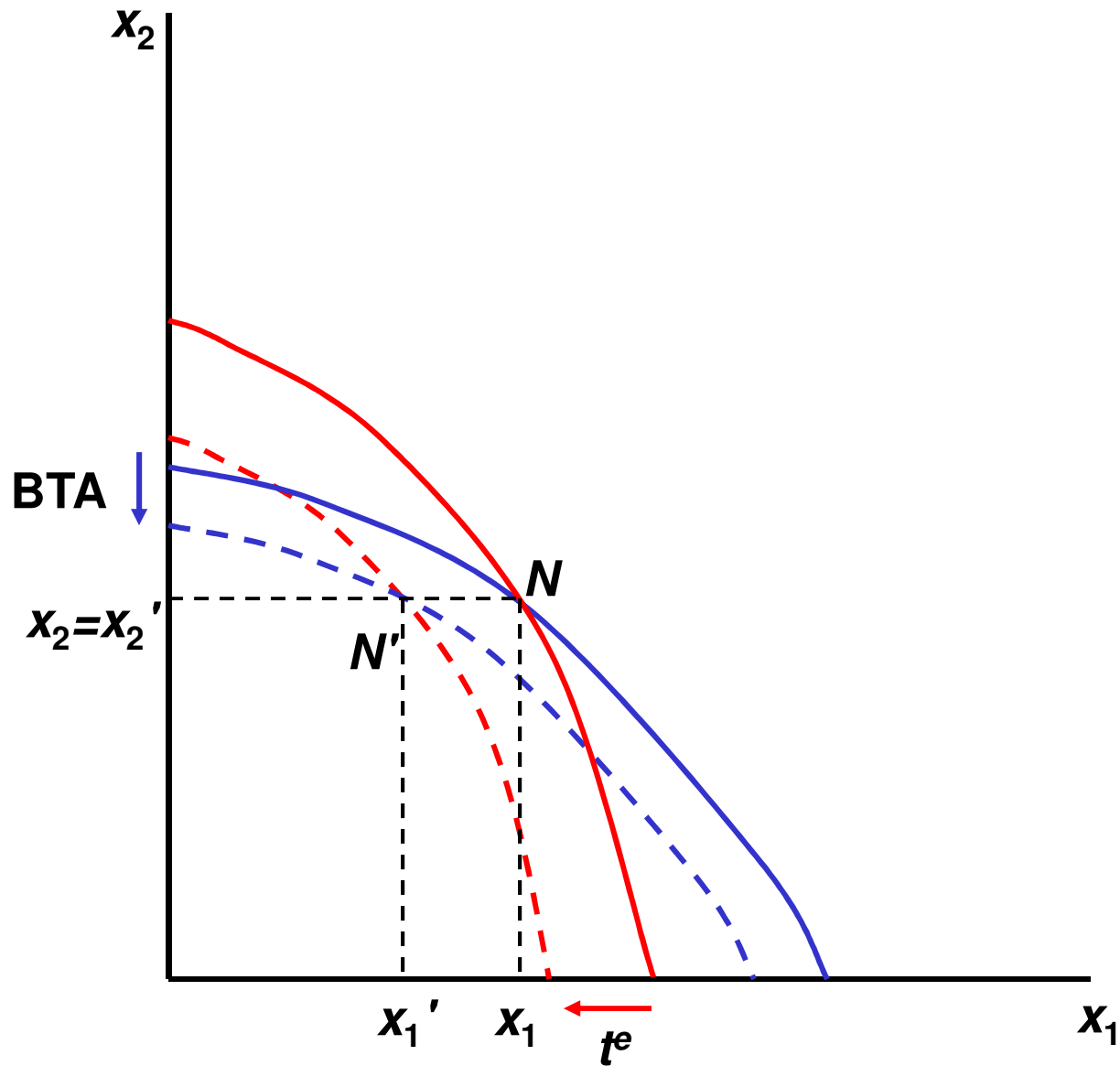
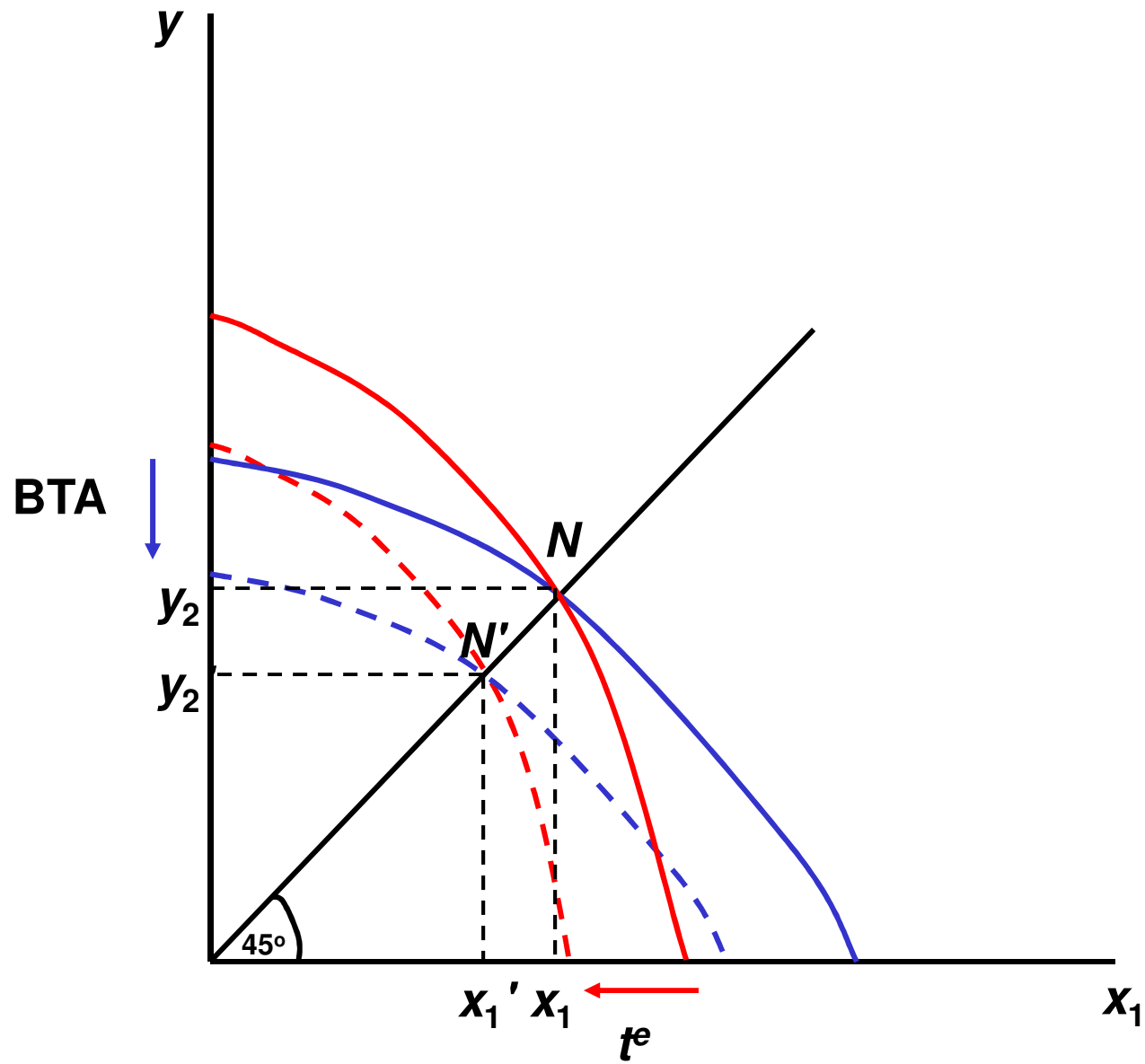
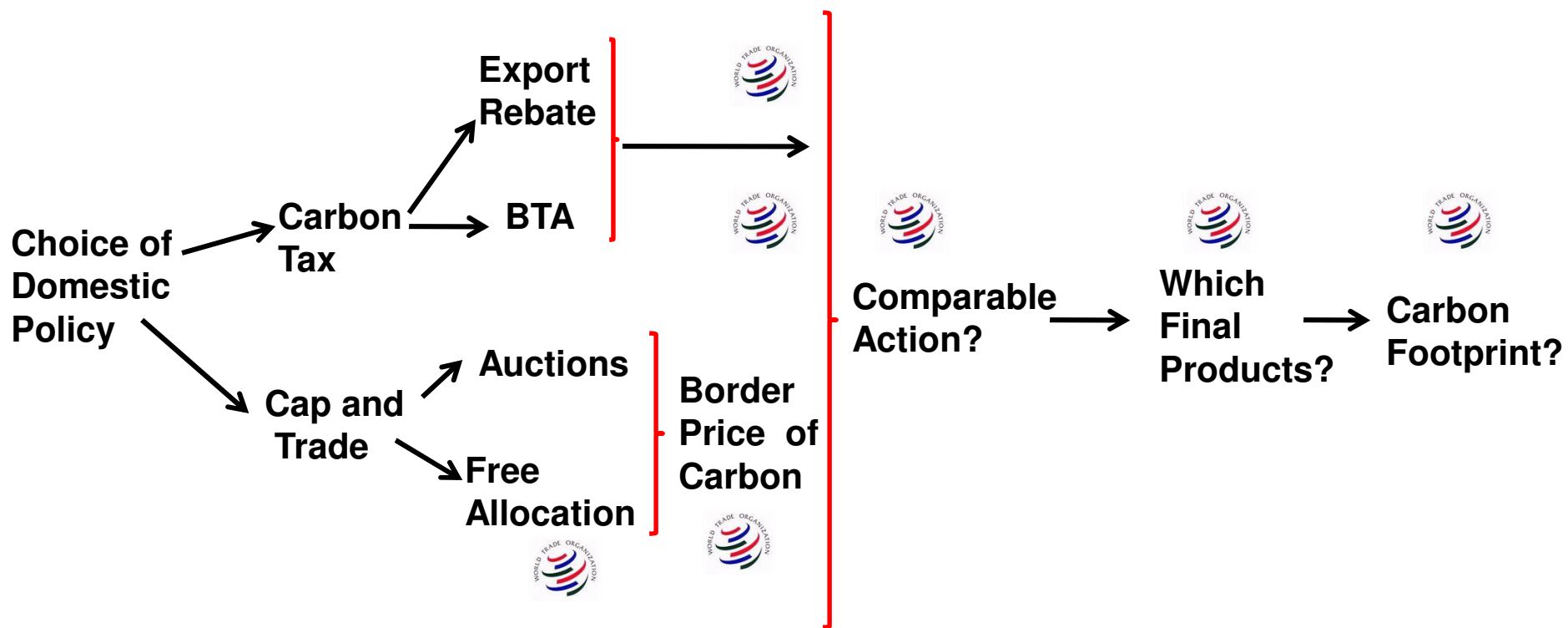


Figure 2: Import Share Neutrality



Some Implementation Issues



 = Potential for WTO challenge

Potential for WTO Challenge

- **With free allocation of emission allowances, might be non-compliant with WTO Agreement on Subsidies and Countervailing Measures**
- **A subsidy if it: (i) were a “financial contribution”; (ii) conferred economic benefit; (iii) and was specific to certain industries – WTO-inconsistent if other WTO members adversely affected**
- **However – if cap and trade restricts emissions, even if firms receive a transfer, they will still have to pass on opportunity cost of using allowances in higher prices to consumers**

Potential for WTO Challenge

- **As well as satisfying non-discrimination principle under GATT Article III, any BTA must also satisfy GATT Article I (Most Favored Nation)**
- **If BTA is applied to a “like” product (steel), based on a country (China) not having a “comparably effective” climate policy - WTO might rule it is discrimination**
- **Even if differential treatment is permitted by WTO, it will be difficult to determine which countries actually have “comparably effective” climate policies**

Potential for WTO Challenge

- **Given complexities of implementation, several reasons why BTA may violate GATT Article XX:**
 - (i) Impact on domestic firms large relative to reduction in emissions - “stealth protectionism”**
 - (ii) Failure to allow exporters to demonstrate level of their emissions**
 - (iii) Exporting country cannot be required to implement market mechanism such as cap and trade**
 - (iv) Failure to recognize impact of stage of development on cumulative emissions**
 - (v) Failure to make good-faith efforts to engage in negotiations with exporting countries**

Summary and Conclusions

- **Connection between trade and environment is not a new issue – significant debate since early-1990s**
- **Economic and legal issues also not new, although only a ruling on BTAs in presence of domestic climate policies will resolve legal uncertainty**
- **Climate policies present additional layer(s) of complexity to problem of determining appropriate BTAs – there is “*some new wine mixed with old wine in new green bottles*”!!**