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Closing the emissions loophole: The case for a carbon border tax

NEW DIPLOMACY PROJECT

TOP LINES

- A UK carbon border tax (CBT) could kill two birds with one stone: reducing global carbon emissions while also reducing UK reliance on Chinese and Russian energy and metal imports.

- Without a carbon border tax, imported goods produced without internalising the cost of carbon emissions can undercut British and European producers. This represents a significant loophole that can lead to 'carbon leakage'.

- British steel, aluminium and other industrial inputs have been severely undercut by competition from China and Russia. This not only threatens jobs and investment in the UK, but also increases reliance on countries that pose a security risk to the UK.

- A carbon border tax, if poorly designed, could disadvantage developing countries who rely more on fossil-fuel energy. Labour should support an exemption for all countries covered by the UK's trade preferences system for low-income partners.

- Ahead of COP26, Labour should push for a carbon border tax to ensure that the UK meets its climate ambitions. As things stand, the Government has failed to outline a green trade strategy despite the UK's leadership of the G7 and COP26 this year.

BACKGROUND

A carbon border tax is a levy applied to imported goods which are deemed to be carbon intensive, normally through their production processes, and have not already been taxed through a carbon taxation system.

The UK has largely replicated the EU's Emissions Trading System (ETS), which means that firms must pay to produce carbon emissions. The aim of an ETS is to internalise the cost of emissions so that companies are incentivised to seek greener alternatives for production. Revenue raised by the ETS can be spent on green technology, energy transition and other infrastructure to combat climate change.

There is strong evidence that an ETS is effective in reducing emissions; indeed a carbon tax has been cited as the most effective single climate policy, according to a majority of economists.[1]

However, a domestic carbon tax or Emissions Trading System can be avoided by moving economic activity abroad. This is known as 'carbon leakage'. This can happen in two ways:

1) A company intentionally moves its operations to countries without carbon taxes or lower production regulations. For example, if a UK-based car manufacturer shifts its operations to China, where carbon trading is less developed and there is far greater reliance on coal power.

2) Domestic companies lose business to and are undercut by foreign producers which face different taxes and regulations. The activity has 'organically' shifted abroad due to market forces favouring cheaper or less regulated production.

In both cases, economic activity moves to areas without a carbon tax and more goods are produced with higher emissions. This is bad for global emissions, and also creates a perverse incentive structure whereby domestic companies are encouraged to shift operations abroad, and UK businesses and consumers find it more affordable to import products produced without a carbon tax, often to lower standards.

This disadvantages UK businesses and increases reliance on imports from other countries, including some which may pose a security threat to the UK, such as China and Russia.

A further issue with carbon leakage is that it allows wealthy countries to claim that they have low emissions without reducing their over-consumption. For example, if British steel manufacturing is relocated to India, this radically reduces UK emissions even if the same steel is bought back by UK car manufacturers and, ultimately, UK households who keep buying cars. Meanwhile, India's emissions rise significantly despite the 'consumption' of cars taking place entirely in the UK.

The EU is planning to introduce its own carbon border tax (called the 'Carbon Border Adjustment Mechanism', or CBAM), despite some opposition from Russia, China, the US and developing countries.[2] The tax will apply to iron and steel, aluminium, cement, ammonia and some fertilizers, and electricity. Since then, however, both the US and China have explored introducing their own emissions trading system and/or similar border taxes.[3] [4]

CLIMATE BENEFITS OF A CARBON BORDER TAX

A carbon border tax can deal with carbon leakage and close the emissions loophole. By taxing high-emission imported goods in the same way that they would be taxed domestically, there is no incentive to move operations to lower-tax countries, and these countries lose the ability to undercut UK producers.

Ultimately this leads to a reduction in carbon emissions through a number of mechanisms:

[1] Climate Leadership Council, Economists' Statement on Carbon Dividends, January 2019
[2] Reuters, Analysis: Europe faces sceptical globe with carbon border levy, 5 July 2021
[3] New York Times, Democrats Propose a Border Tax Based on Countries' Greenhouse Gas Emissions, 19 July 2021
[4] Nature, China launches world's largest carbon market: but is it ambitious enough?, 20 July 2021

- Lower-emission goods are made more competitive against high-emission goods, reducing the production of the latter
- More production shifts towards countries and technologies which use greener technologies, through this being made more competitive
- Countries and companies are incentivised to invest in renewable energy sources to avoid the carbon border tax. Those countries which have already adopted greener technologies and policies are rewarded, while those which have not no longer enjoy the same level of competitiveness.
- Countries are incentivised to introduce their own carbon tax, to avoid the carbon border tax
- Increased revenues from the carbon border tax, and other countries' carbon taxes, can be spent on green infrastructure and hastening the energy transition

While it is difficult to measure all of these potential effects, the EU estimates that the sectors covered by its proposed CBAM make up the equivalent of around 47% of the free emission allowances now allocated to European firms, despite only covering around 3% of imports coming into the EU each year.[5] The EU's CBAM is expected to reduce global emissions by 0.1%, which does not seem like a high amount, however it only applies to a handful of goods and the EU itself is only responsible for 18% of global emissions.[6] A more ambitious CBAM could have a larger impact.

Furthermore, this is likely to be a shorter run impact which does not take into account the value of making carbon taxes the global norm. If the US and China were to introduce carbon taxes, perhaps in response to a UK + EU carbon border tax, this could have an enormous impact on the global fight against climate change.

The US, China and Russia are particular offenders when it comes to global emissions, but they are also countries that have a strong trade and investment relationship with the EU and the UK. China has a particular problem when it comes to reliance on coal power, while Russia dominates the natural gas market and the US has sought energy security through fracking, while having extremely high per-capita emissions. It is important not to underestimate the importance of bringing these countries into line with European standards on climate change.

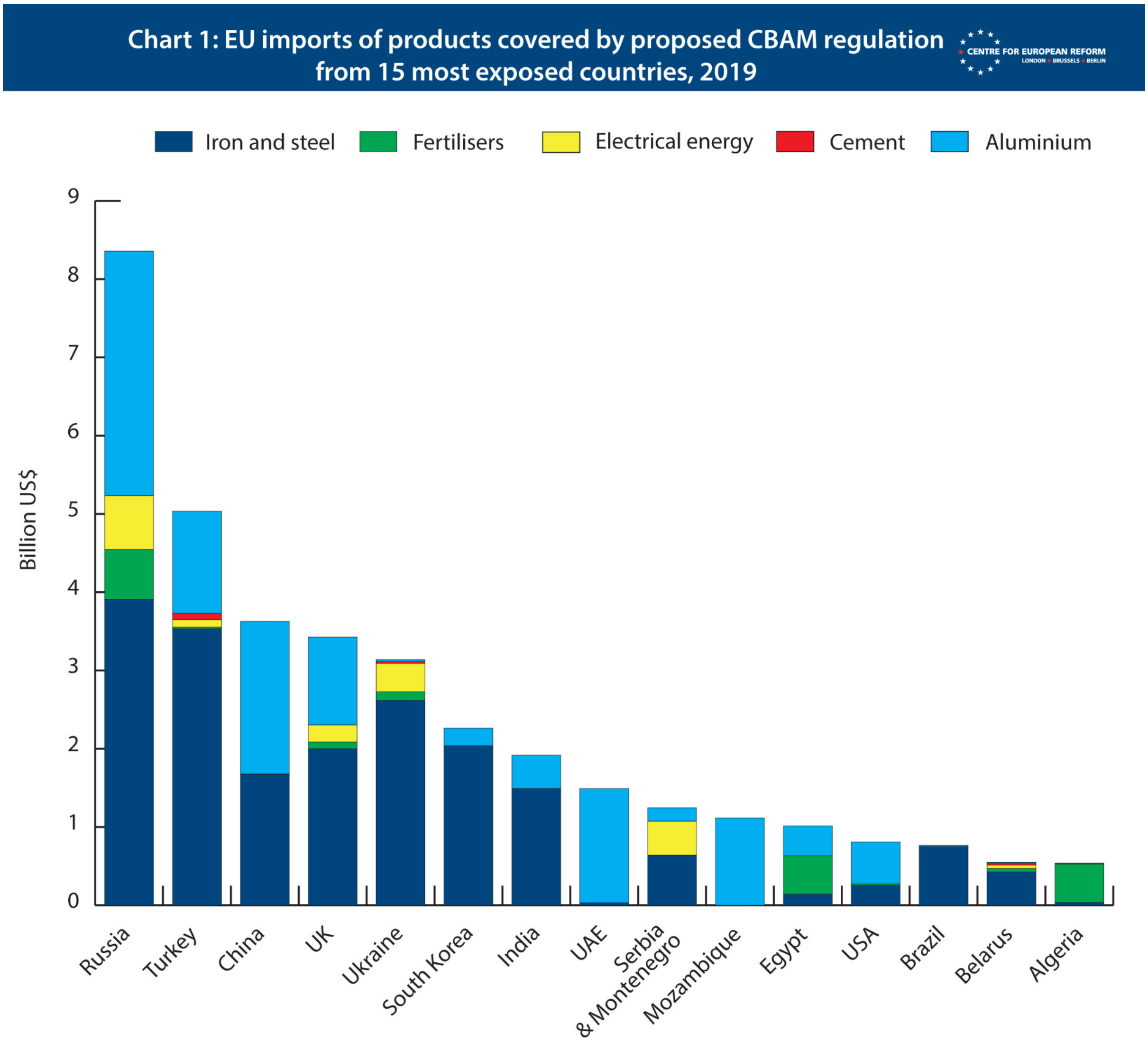
STRATEGIC BENEFITS OF A CARBON BORDER TAX

Like other Western democracies, the UK is reliant on supply chains and investment from countries that pose a strategic challenge and domestic security threat. Some particular examples, not restricted to the UK context, include:

- Reliance on China and Taiwan for global semiconductor production. This is a particular challenge for the UK and EU, which do not have their own autonomous semiconductor production capacity.
- Reliance on China for particular green technologies, including those which will be essential in the energy transition, such as lithium-ion batteries and solar panels.
- Reliance on China, Russia and India for steel and aluminium, which is a key input in car, defence and aerospace manufacturing

[5] Reuters, [EU's planned carbon border tax to impact Russia the most -study](), 1 September 2021
[6] UNCTAD, [EU should consider trade impacts of new climate change mechanism](), 14 July 2021

- In the case of the EU, particularly Germany and Eastern European countries, reliance on Russia for natural gas
- In the case of the UK, France and other European countries, reliance on China for investment in nuclear energy
- Reliance on various Middle Eastern countries for crude oil
- Reliance on various African countries for precious metals, including some countries which are increasingly influenced by Chinese interests



*This chart shows which countries will be hit hardest by the EU's CBAM, based on current import levels. Note that the UK will not be affected if its own carbon tax / emissions trading system is deemed equivalent to the EU's. Source: [Centre for European Reform](). *

In a number of these cases, industry is heavily subsidised by national governments. This has been the trigger for trade wars, namely between the EU, US and China on steel. Sometimes subsidy breaches World Trade Organization rules, which can lead to drawn out legal challenges. At other times, subsidies are more subtle. For instance, the UK previously subsidised fossil fuel investments through UK Export Finance, avoiding WTO challenge.[7]

This threat goes beyond job losses and lack of investment in local communities, it also leads to a fundamental security challenge if the UK (and its allies) are overly dependent on strategic rivals such as China and Russia for raw materials.

For obvious reasons, energy is fundamental to both national security and the entire economy, powering everything from hospital ventilators and code-breaking supercomputers to satellite navigation systems and food delivery. Energy dependence on Russia and China, whether through direct supply or through investment relationships, is particularly risky. In 2020, 26% of the EU's petroleum oil imports and 43% of total gas imports came from Russia, a relationship that is unlikely to become less reliant with the construction of Nord Stream 2, a major gas pipeline between Russia and Germany.[8]

Metals and raw materials are also incredibly important. Semiconductors, mobile phone chips, lithium-ion batteries and solar panels all depend on raw metals whose production is centred in a few key countries. In the case of semiconductors, about a third of global supply is from China and Taiwan,[9] while China produces 80% of the world's solar panels.[10]

While it is not realistic to expect the UK or EU to develop its own semiconductor industry overnight, it is possible to protect the productive capacity that we already have from competition in sensitive areas. In particular, UK steel production, which could benefit directly from a carbon border tax. Other sectors that could benefit include UK renewable energy, car production, aerospace and battery production.

IMPLICATIONS FOR DEVELOPING COUNTRIES

A number of low-income are concerned about the introduction of a carbon border tax, which could hit them disproportionately. This is for two main reasons:

1) Developing countries are often particularly reliant on exports to developed countries, including the UK. This often takes the form of raw materials, agricultural produce, textiles and small-scale manufacturing.
2) Developing countries are often particularly reliant on fossil fuel sources of energy, and may lack the technology for greener energy production.

While exports from low-income countries are expected to make up a small proportion of the EU's overall Carbon Border Adjustment Mechanism revenue, they may make up a high proportion of low-income countries' exports, and therefore have significant economic consequences. There is a perception among some countries that the EU's CBAM is a protectionist measure, primarily designed to benefit its own 'carbon club'.[11]

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[7] 10 Downing Street, PM announces the UK will end support for fossil fuel sector overseas, December 2020

[8] European Union, EU imports of energy products - recent developments, June 2021

[9] European Semiconductor Industry Association, Trends in worldwide semiconductor production capacity, June 2021

[10] Reuters, China's solar glass shortage to drag on panel output into 2021, December 2020

[11] World Economic Forum, Why the EU's proposed carbon border must not be used to launch a carbon club, June 2021

This disadvantage for developing producers seems particularly unjust in the context of historic relations between Global North and Global South: while Western European, North American and some East Asian countries were free to rapidly industrialise through carbon-intensive production (e.g. coal power in Victorian Britain), those same developed countries are now imposing taxes on fossil fuel-based production in the Global South.

Furthermore, many developing countries liberalised their energy and manufacturing industries under pressure from Global North countries, whose 'Washington Consensus' ideology dictated the policies of the International Monetary Fund, World Bank and other institutions from the 1980s through to today (although some of this 'consensus' is now rightly being challenged). Partly as a result of these relations, many developing countries lack the resources to shift to lower-carbon production.

Developed countries have failed to deliver on the $100 billion in promised climate financing as part of the Paris Agreement.[12] and the UK and the EU have been reluctant to move away from Investor-State Dispute Settlement (ISDS), which allows fossil fuel firms to challenge climate regulations that damage their profits.[13] There is a risk that the trade and climate debate becomes dominated by CBAM, at the expense of other policy interventions.

Although the EU's Carbon Border Adjustment Mechanism currently only applies to particularly carbon-intensive goods, namely steel, other metals and energy production, a carbon border tax could theoretically be applied to other industries such as agriculture, manufactured goods or textiles. This could hit developing countries which have high rates of poverty, and could affect small-scale farmers.

Finally, there is also a risk that a carbon border tax could push high-carbon emerging economies (such as Brazil and Indonesia) into closer economic relations with China, where they can trade without the same constraints. Mitigating against this risk could also be tricky; for example, many are understandably opposed to the EU doing a trade deal with Brazil.[14]

Because a carbon border tax acts effectively as a tariff, it has the potential to damage political relations with other countries, which are disadvantaged by it. It could also improve trade relations with countries that already have emissions trading systems, or those which do not rely on exporting carbon-intensive goods to the UK.

RECOMMENDATIONS FOR LABOUR POLICY

Labour should fully support and push for a carbon border tax, and make the case on two fronts:

(1) The climate benefits of taxing emissions, closing the 'carbon leakage' loophole, and incentivising companies and countries to adopt cleaner methods of production.
(2) The strategic and security benefits of levelling the playing field in sensitive industries, to reduce reliance on imports of and investment in raw materials and energy, particularly from China and Russia.

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[12] Oxfam, Climate Finance Shadow Report, 2020
[13] House of Commons International Trade Committee, International Trade Committee Inquiry on Inward Foreign Direct Investment, Evidence from the Trade Justice Movement, February 2021
[14] Joss Garman, COP26: What will China do?, 20 September 2021

These two benefits are not only important for the UK's climate ambitions and national security, but are also likely to play well politically, who are rightly concerned about both climate change and UK security. Furthermore, **these points offer a good way to hold the Government to account**, since it claims to be the "greenest government ever", hopes for the UK to be a global leader on climate change, while also claiming to take seriously the challenges posed by China and Russia in its recent Integrated Review.

However, **Labour should ensure that a UK carbon border tax does not apply to developing countries**, for the reasons outlined earlier in this document. These countries could either be defined by existing trade preferences schemes, or else a more targeted approach could select specific countries and industries. **Labour must push the Government to meet its promises on climate finance for developing countries, as outlined in the Paris Agreement.**

It is also important that Labour pushes for the carbon border tax to be developed democratically, with full consultation with vulnerable groups, and for it not to be pursued in isolation to other important climate and security policies. Designed in the right way, a carbon border tax could play a key role in ensuring a greener, more prosperous and safer Britain.

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