



BORDER ADJUSTMENT PROPOSALS

In 2009, Pascal Lamy for the World Trade Organization (“**WTO**”) and Achim Steiner for the United Nations Environment Programme (“**UNEP**”) signed a Report on Trade and Climate Change¹. The Report examined the WTO compatibility of Border Adjustment Mechanisms (“**BAMs**”) as part of a domestic climate change policy. The Report concluded that so long as there is no discrimination in favour of domestic products BAMs were a legitimate and WTO compatible policy option. This paper sets out how a WTO compatible BAM could be implemented in the EU.

4 BAM proposals:

We examine 2 main measures: a **Commercial Policy measure**, based on Article 207 TFEU and an **Environmental Policy measure**, based on article 192 TFEU. These 2 measures could themselves be divided into 2 other propositions:

1) Commercial Policy measures:

- A Customs duty based on EU average cost (option 1)
- A Variable Customs duty based on EU standards (option 2)

2) Environmental Policy measures:

- A Border cash deposit (option 3)
- A Border tax adjustment (option 4)

Alternative combinations of certain features from these options can also be envisaged.

To implement the border adjustment mechanism, the European Union (“**EU**”) will have to adopt a specific law (a Directive or preferably a Regulation), and this law needs to be based on an EU **legal right to act** (legal basis) in the Treaty on the Functioning of the European Union (“**TFEU**”). The legal basis determines the decision-making procedure and voting in the Council.

The choice of the legal basis must rest on objective factors which includes in particular the purpose and the content of the measure.

Regarding BAM implementation, there are 2 possible EU legal bases, which can be WTO compliant:

- The EU Common Commercial Policy² (Article 207 TFEU), which can be defended under Article XX GATT (WTO exceptions), and
- The EU Environmental Policy (Article 192 TFEU), which can be defended both under Article III GATT (non-discrimination principle) and under Article XX GATT

Therefore, to determine the appropriate legal basis in implementing the BAM, the EU will have to consider the **main purpose** and content of the BAM: EU commercial protection³ or environmental protection.

The main advantage of the commercial policy measures is that it would be voted on the qualified majority basis, whereas the environmental approach may be voted either on qualified majority or on unanimity basis if the BAM is qualified as “primarily of a fiscal nature”.

¹ Trade and Climate change. *WTO and UNEP Report*, 2009, p. 103-110.

² The Common commercial policy concerns measures that are related with instruments and measures that influence exports and imports, either through quantities, prices or which goods will be traded or not

³ The use of Article 207 does not prevent non-commercial considerations, like environment, from being used to justify the adoption of the regulation concerned. In other words, to link the regulation to environmental considerations, an appropriate name of the BAM could be found (e.g. “carbon contribution” or “climate adjustment border”).

Main pros and cons of the options:

1. BAM as a commercial measure (Article 207)
 - Advantage is the qualified majority voting
 - WTO compliance can be achieved (but only on one single legal basis (Article XX GATT) compared to the environmental measure that can be WTO compliant on two legal bases (Articles III and XX GATT))
 - The BAM may be politically more difficult to be promoted towards other countries/MS if it is perceived as a trade protection mechanism
2. BAM as an environmental measure (Article 192)
 - Disadvantage, at first glance, is the unanimity vote; however, the unanimity can be avoided by implementing a non-fiscal BAM (see option 3) or if the latest proposal from the Commission on limiting the unanimity voting rule is adopted (see option 4)
 - Advantage is that the BAM is more WTO compliant compared to a commercial measure since it can be considered as being compliant with Article III and, if necessary, justifiable under Article XX GATT (2 legal justifications instead of 1)
 - Moreover, a BAM could be well perceived by other countries/MS as it is based on environmental policy

Whatever the option, the BAM consists in imposing a cost/charge on imports of products coming from non-EU countries when they cross the EU border.

For options 1, 3 and 4 explained below, we first calculate the average cost borne by EU steel producers under the ETS system and then a similar cost is charged on imports.

For option 2 explained below, the charge imposed on imports is directly based on the producer's own carbon performance as compared to the EU benchmarks. Therefore, importers will have to pay only if the producer emissions are above the EU benchmarks, and the cost will reflect the gap between the third country producer performance and the benchmark standards.

1. COMMERCIAL POLICY MEASURES

Option 1: A customs duty based on an EU average cost

The implementation of a customs tariff relies on the assumption that the EU would set in place a customs duty applicable to imported products with a view to ensure that a financial charge equivalent to the internal costs of the ETS scheme for the EU industry is imposed at the EU border. This compensation would take the form of a standard customs duty.

Hence, for this BAM (as for option 3 and 4), the cost to be charged to imports is pre-determined and consists of the average real cost borne by EU steel producers due to the ETS system. The importers will be charged with a similar cost.

The compatibility of the measure with WTO law can be justified under Article XX GATT (exceptions to non-discrimination for environmental protection grounds), or by a multilateral agreement between GATT Contracting Parties.

To reinforce WTO compliance, each steel importer is offered the possibility to provide counterproof demonstrating that the actual volume of CO₂ emissions per ton produced/imported is lower than the EU

average (approach based on the “best available fact” mechanism existing for TDI) or that the steel has already been exposed to CO₂ costs equal or superior to the costs in the EU.

Advantages:

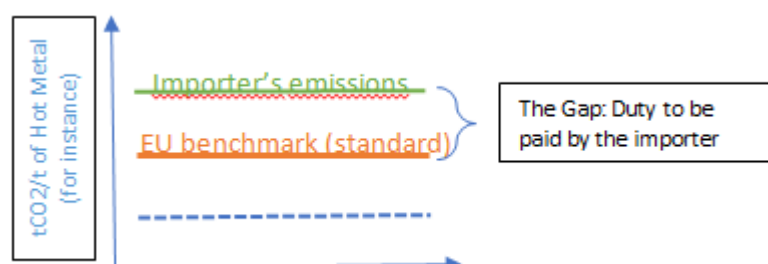
- simplicity of the measure
- easier to implement as we impose an EU average cost on imports (not necessary for EU to audit actual emissions of the third country exporting producers)
- the customs duty gives certainty to exporters. It is GATT friendly because exporters know what they will have to pay at the border before making the commercial decision to export.
- the mechanism takes into account the production process of products (EAF v. BOF)
- this BAM has good chances to be voted on a qualified majority basis
- useful precedents may be found in other EU law

Disadvantages:

- this option is politically sensitive as it was agreed in WTO agreement that Contracting Parties consolidated their border tariffs schedules of commitments
- EU would have to reimburse a part of the customs duty to importers if they can prove that their emissions were lower than the EU average
- the mechanism would need to be justified under the Article XX GATT exception (here Article XX is not a backup solution, but the default solution compared to a tax measure), unless customs duty can be agreed multilaterally (modification of the schedules of commitments).

Option 2: A variable customs duty based on EU standards

This option is the same as the first option but with a difference in the determination of the cost to be paid on imports. Here, EU does not impose to importers a pre-determined cost based on EU average, the BAM is based on the CO₂ performance of the third country producers, as compared to the EU ETS benchmark (used as standard). For each imported product, the importers will have to show an audit of the associated emissions (of company-wide production), e.g. based on EU norms and certified by organisms approved by the EU Commission, and declare them at the EU border. Then, EU/Member States will compare these emissions with the appropriate benchmark. If the emissions are below the benchmark, the importer will have nothing to pay; however, if they are above, the importer will have to pay the difference between the benchmark and the declared emissions: the gap, taking the form of a customs duty, (see the graph below) multiplied by the average EU CO₂ price.



Advantages:

- Mechanism based on real measured emissions of importers (instead of imposing an EU average cost), i.e. fair/non-discriminatory mechanism

- The costs beyond the EU CO₂ average can be considered: compared with option 1 where the cost borne by importers is fixed whatever their CO₂ performance, in option 2 they will have to pay a higher cost to the extent their emissions exceed the EU average
- This mechanism has an important incentive effect: the more imports have low carbon emissions (i.e. the more producers make CO₂ reduction efforts), the less producers of these imports pay
- Easy to support politically
- This BAM has good chances to be voted on a qualified majority basis

Disadvantages:

- Need to make sure that importers audit their emissions according to EU rules
- Audit systems may represent a cost for EU institutions (unless the audit cost is charged to importers⁴)
- How to deal with imports which have real emissions below the benchmark (in blue in the graph) and with non-EU producers which may therefore ask for free allowances (to cover emission savings as the difference between benchmark and their good performance)?
 - o On this point, it is important to note that in practice, no producers are below EU benchmarks, so regarding importers, there are low risks that this may happen.
- This option is politically sensitive as it was agreed in WTO agreement that Contracting Parties consolidated their border tariffs schedules of commitments
- Mechanism would need to be justified under the article XX GATT exception (here Article XX is not a backup solution, but the default solution compared to a tax measure), unless customs duty can be agreed multilaterally (modification of the schedules of commitments).

2. ENVIRONMENTAL POLICY MEASURES

Option 3: A border cash deposit

This BAM is similar to a tax measure but nevertheless can avoid being defined as “primarily of a fiscal nature” and therefore unanimity voting, compared to the option 4 (border tax adjustment). This BAM could be introduced through an amendment of the ETS Directive. It would take the form of a cash deposit (which is different from having the importers paying a fee), which amount will be determined by the average cost borne by EU steel producers under the ETS system. The imports will be charged a similar environmental cost.

Main difference with a pure border tax adjustment is that the border charge would be deposited on a specific EU account opened in the name of the importer and reallocated to non-EU countries (“poor countries” as per Paris COP 21 Agreement) to help them invest in decarbonization projects. By using a cash deposit (instead of a payment), we make sure that money does not “enrich” EU/Member States’ budget and therefore arguably avoids the qualification as “primarily of a fiscal nature”.

The mechanism is WTO compliant as it is an indirect charge (i.e. a charge on products) and it is not discriminatory, according to GATT provisions (Article III GATT). Moreover, as a backup solution, the mechanism would also fall within the WTO exemptions (Article XX GATT).

Indeed, the BAM is WTO compliant as long as it applies on products and not on producers. Question is whether “product” and “process” can be assimilated as being equivalent with each other. In other words, question is to know if it is equally legally valid to apply a charge either on a product or on a process. This question has been answered by the affirmative in an assessment made both by WTO in the 2009 report with UNEP and also in a WTO decision panel (Superfund case – L/6175 – 34S/136) where the dispute

⁴ In such as case, the only cost to the EU should be the cost of auditing auditors.

panel found that a US tax on substances used as inputs (i.e. process) in the production process of certain chemicals was eligible for border adjustment.

The ETS cost borne by EU producers can be defined as an environmental charge on inputs which are physically **incorporated into products by applying a process**, i.e. charge on CO₂. Then, **charges on inputs⁵ used during the production process of a product** are to be understood as charges applying to products and not on producers. Hence, a charge on CO₂ (emitted during production) can be eligible for BAM.

Furthermore, as long as the BAM treats equally all non-EU and EU products and all countries in the same way, the mechanism is non-discriminatory. In this BAM, WTO non-discrimination is achieved as (i) the calculation method would be applied equally for all non-EU products regardless of the origin of steel as it is based on objective criteria (carbon footprint), and (ii) foreign steel products would be subject to the same constraints and benefits as European products since non-EU importers would pay costs at the EU border equivalent to ETS calculated CO₂ costs.

Advantages:

- Easy to implement as we impose a EU average cost to the importers (not necessary for EU to audit actual emissions of importers)
- The mechanism takes into account the production process of products (EAF v. BOF)
- Unanimity voting risk limited by avoiding “provisions primarily of a fiscal nature” qualification (as legally no payment made or no advantage given to EU/Member State budget)
- No advantage given to EU industry (=> no competition issue => no possible qualification for Subsidy or any unfair trade practice)
- WTO compliance with Article III GATT (non-discrimination principle), and, as a backup solution, under Article XX GATT (exceptions to discriminatory measure for environmental reasons)
- No qualification as a Customs Tariff (easier to support politically, and reinforce the Article XX GATT justification of environmental exception as back up if needed)
- Possibility to quantify positive CO₂ impacts from cash allocations to decarbonization initiatives (further reinforce the article XX GATT justification of environmental exception as back up if needed)
- EU leading by example (first to apply voluntary provision of the Paris Agreement + would also reactivate the legitimacy and credibility of the Paris Agreement) and potential to get active support from northern country (like Scandinavian countries)
- Possibility to relay on existing Financial Mechanisms from the Paris Agreement.

Disadvantages:

- The avoidance of unanimity voting is based on EU case law relating to the concept of tax in other areas and could be challenged
- This BAM does not generate revenues for EU or Members States which could be allocated to EU projects⁶ (but in our view, this is not a problem as ETS Directive include the support to vulnerable third countries for their climate objectives, which justifies compliance of the proposal with the ETS Directive)

⁵ It results from the WTO report and the panel decision that **CO₂ is considered as an input**, as “used during the production process of a product”.

⁶ EU ETS directive determines that 50% of the revenues generated by the system should be used to support specific climate changes/clean energy transition

Option 4: A border tax adjustment (“BTA”)

The BTA consists in imposing a "carbon tax" at the EU border, i.e. to tax non-EU imports regarding the carbon footprint of the import products. Satisfying the WTO non-discrimination principle will require a demonstration that the charge on the domestic product and the corresponding BTA were determined on a fair and objective basis that relates to the specific products being taxed and not to their national origin.

To reinforce WTO compliance, each third country steel producer is offered the possibility to provide counterproof demonstrating that its actual volume of CO₂ emissions per ton produced/imported is lower than the retained EU average (approach based on the “best available fact” mechanism existing for TDI).

Such a mechanism is simple and WTO compliant (it is a charge on products and a non-discriminatory mechanism, as in option 3) but is of a “fiscal nature”, which leads to the unanimity voting, unless the EU authorities adopt the latest proposal from the Commission to avoid the unanimity voting rule with regard to tax measures in the field of the EU environmental policy (COM (2019) 177 final of 9 April 2019 (*A more efficient and democratic decision making in EU energy and climate policy*)). This BTA could benefit from this new position by being closely linked to the environmental ETS Directive (e.g. by being introduced as an amendment of the ETS Directive).

Advantages:

- This BTA is the simplest to implement: it only requires a price, that importers will pay
- The mechanism takes into account the production process of products (EAF v. BOF)
- It is robust according to WTO compliance
- Border Tax Adjustment still exists in the world for domestic taxes on consumption or sales (best example is VAT)

Disadvantages:

- Unanimity voting, unless the latest proposal from the Commission on limiting the unanimity voting rule can be followed
- This BTA is not supported politically (badly perceived)