EXECUTIVE SUMMARY

CLIMATE LEADERSHIP COUNCIL

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Carbon Import Fees and the WTO

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KEY TAKEAWAYS

- **There are WTO defenses for various approaches to carbon import fees, including carbon fees without a corresponding domestic carbon price.**
- **Economic motives, in addition to climate goals, do not invalidate carbon import fees; alternatives to the WTO's environmental exceptions can apply to policies that address both climate change and economic issues like non-market excess capacity.**
- **The EU's CBAM, like other carbon import fee proposals, will likely require justification under one of the WTO's exceptions. Accordingly, the U.S. and the EU have a shared interest in promoting interpretations of the exceptions that accommodate carbon import fees.**
- **Carbon import fees linked to explicit domestic carbon prices are likely permissible without requiring justification under one of the WTO's exceptions.**

I. INTRODUCTION

There is growing support for imposing charges on imports of carbon-intensive products, like steel and aluminum, as instruments of climate policy. Governments around the world are considering a range of approaches, including border adjustments of both explicit and implicit carbon pricing, fees based on emissions intensity, and punitive tariffs. A number of approaches to these so-called "carbon import fees" have recently been introduced in the U.S. Congress, including the Clean Competition Act by Senator Sheldon Whitehouse (D-RI) and the MARKET CHOICE Act by Representative Brian Fitzpatrick (R-PA-01).

These policies could create incentives for lowering global carbon emissions and reducing the "leakage" that results if production of energy-intensive products shifts out of countries with more ambitious climate policies to those with lower standards.[1] They could also serve as important tools for addressing the broader challenge of the "carbon loophole"—i.e., the 20-25% percent of global greenhouse gas emissions that are associated with internationally traded goods.[2]

Commentators and some WTO member countries have raised concerns about the consistency of these proposals with the rules of the World Trade Organization (WTO).[3] The WTO is an intergovernmental organization with 164 Member countries—including the United States—that administers the multilateral trading system. It was established in 1995, building on the earlier General Agreement on Tariffs and Trade (GATT), which applies to trade in goods and continues to constitute the centerpiece of the WTO agreements. Provisions of the GATT that limit tariffs and prohibit discrimination against "like" products from member countries are the primary source of concern that carbon import fees, like those being considered in the U.S. Congress, may not be consistent with obligations under the WTO.

This analysis finds that existing WTO treaty text and precedent offer credible defenses for carbon import fees. Not only are carbon import fees promising climate policy tools, they are also likely to pass muster at the WTO.

II. FORMS OF CARBON IMPORT FEES

A variety of climate policies have been proposed or are under development that would impose climate-related charges on imported products, typically based on their "emissions intensity"— the amount of greenhouse gas emissions associated with the manufacture of a unit of a product. The different approaches to imposing carbon import fees can be classified into four groups: (1) border adjustments of explicit domestic carbon prices, (2) border adjustments of implicit carbon prices imposed by a variety of domestic climate policies, (3) emissions intensity-based import fees, and (4) punitive carbon tariffs.

A. Border Adjustments of Explicit Carbon Pricing

One approach to carbon import fees would charge imports at the same rate that domestically produced goods are charged under a domestic carbon price. Domestic carbon prices can be implemented either through an explicit carbon tax or an emissions trading system (ETS).

Explicit carbon prices allow for border tax adjustments (BTAs). Commonly used internationally, BTAs are the application of domestic "indirect" taxes (i.e., taxes on consumption of goods or services, like sales or value added taxes) to imported products and, in some instances, the rebate of those taxes on exports of the products. BTAs are generally considered to be non-trade distorting and are permitted under the relevant WTO rules. The term "carbon border adjustment," accordingly, refers to the application of domestic carbon pricing to imported products and potentially the rebate of that pricing on exports. A variety of U.S. proposals, including the MARKET CHOICE Act introduced by Representative Brian Fitzpatrick (R-PA-1), have included a BTA of a domestic carbon tax.

Alternative schemes for carbon pricing, like an emissions trading system (ETS), may also be adjusted at the border. The European Union's Carbon Border Adjustment Mechanism ("CBAM"), which will begin its transitional phase on October 1, 2023, will be the first major carbon border adjustment of any domestic carbon price. The border charge will reflect the price for EU ETS allowances on the open market.

B. Border Adjustments of Implicit Carbon Pricing

An alternative to border adjustment of explicit carbon pricing is to impose a charge on imports based on implicit carbon pricing—i.e., the cost of complying with all domestic policies, whether taxes or regulations, that reduce greenhouse gas emissions. Just like carbon prices, these policies carry costs for manufacturers. Policymakers may wish to extend these implicit prices to imported goods competing in the domestic market. This approach was taken by the FAIR Transition and Competition Act, introduced by Senator Chris Coons (D-DE) and Representative Scott Peters (D-CA-50) in July of 2021.[4]

C. Emissions Intensity-Based Import Fees

Another option for carbon import fees is to impose charges on imported products based on their emissions intensity, without directly linking the charge to domestic climate policies. This option is typically motivated by an interest in insulating the domestic market, with higher carbon efficiency, from imported goods produced in countries with unrestrained carbon emissions. Legislation being developed by Republicans in the Senate would impose a "foreign pollution fee" on imports of certain products based on their emissions intensity.[5] The Biden administration is taking a similar approach in negotiations with the EU on the Global Arrangement on Sustainable Steel and Aluminum ("Global Arrangement"), proposing that the arrangement be based on a system of tariffs on steel and aluminum tied to tiers of emissions intensity above the U.S. average for the relevant product.[6]

D. Punitive Carbon Tariffs

One final category considered in this analysis is a broadly applied tariff instrument based on a country's participation in international climate efforts. One such approach, initially proposed by Nobel laureate William Nordhaus, would impose uniform tariffs on all products from countries that do not agree to adopt a minimum carbon price.[7] These tariffs would not be targeted at specific goods or pegged to specific carbon intensities; their intended purpose is to penalize countries that lack climate ambition broadly, not to address specific leakage or competitiveness concerns.[8]

III. POTENTIAL WTO DEFENSES

Several viable pathways exist for approval of carbon border fees at the WTO. The first is the "front door" approach wherein the policy does not violate any WTO rule. The remaining pathways require that member states invoke one of the WTO's exceptions for environmental measures, intergovernmental commodity agreements, or essential security. Each of the proposals for carbon import fees have plausible defenses under at least one of these pathways.

The present challenges to the WTO's legitimacy and the uncertainty concerning its future leave the WTO strongly incentivized to avoid the perception that it is an impediment to aggressive action on climate change.[9] The ongoing impasse over the appointment of new members to the WTO's Appellate Body prevents it from hearing any appeals, which allows countries to block adoption of unfavorable panel decisions by "appealing into the void."[10] Definitive resolution of the status of carbon import fees is unlikely anytime soon.

That said, if and when the impasse ends and the Appellate Body resumes functioning, lawmakers exploring carbon import fee policies should have confidence that there a several viable WTO defenses available. The flexibility afforded by relevant WTO jurisprudence provides the Appellate Body with substantial latitude to adopt interpretations of the GATT that would permit even some of the more innovative approaches to carbon import fees.

A. Permissible Border Tax Adjustments

A carbon import fee that applies a domestic "indirect" carbon tax to imported products would likely be found permissible under the WTO's rules on border tax adjustments without the need to invoke any of the GATT's exceptions. This design would follow the model of BTAs, which are commonly implemented for other forms of "indirect" taxes on products. It is unclear, however, whether cap-and-trade programs like the EU's ETS would be considered indirect taxes. Accordingly, the EU CBAM, like other proposals that are not paired with a qualifying domestic tax, could require justification under one of the GATT's exceptions.

B. The Environmental Exceptions

The environmental exceptions under GATT Article XX apply to policies designed to safeguard the environment by "protect[ing] human, animal, or plant life or health" or "conserv[ing] exhaustible natural resources."[11] These policies must also comply with the introductory clause ("chapeau") of Article XX, which precludes policies that would constitute "arbitrary or unjustifiable discrimination between countries … or a disguised restriction on international trade."[12]

The EU CBAM and other carbon import fees that are not tied to a domestic indirect tax, like those linked to an ETS or a calculated implicit carbon price, could be provisionally justified under the GATT's environmental exceptions. These may also serve as a viable defense for emissions intensity-based import fees, especially if those programs are designed in conjunction with other measures to reduce emissions.

However, certain design elements may be impermissibly coercive under the chapeau of Article XX. For example, the EU CBAM treats imports differently depending on whether the exporting country has an explicit carbon pricing program; this may be considered unjustifiable discrimination between countries. Similarly, punitive carbon tariffs that are designed to pressure other countries to adopt a particular approach to reducing emissions may be prohibited under the chapeau. Import fees aimed at economic goals that lack a sufficiently close nexus with their environmental purpose may also be inconsistent with the chapeau.

C. The Intergovernmental Commodity Agreement Exception

The intergovernmental commodity agreement (ICA) exception in Article XX(h) is a largely untested but potentially broad source of protection for carbon import fees.[13] ICAs are agreements between governments to regulate trade in specified commodities. They can be used to address imbalances between production and consumption caused by normal market forces or to promote conservation of natural resources. Consequently, the ICA exception could provide a defense for carbon import fees that are intended to achieve both environmental and economic objectives.

Unlike some pathways for carbon import fees that can be implemented on a unilateral basis, invoking the ICA exception would require countries to negotiate an ICA authorizing the carbon import fees on a bilateral or plurilateral basis. Once an ICA authorizing carbon import fees has been negotiated, however, a participating WTO member could invoke the ICA exception. It would then require the consensus of all WTO Members—including those who join the ICA—to block its provisional justification under Article XX(h).

D. The Essential Security Exception

The exception for essential security measures in Article XXI(b) could provide the broadest scope of defense for all forms of carbon import fees. The exception allows a country to take "any action which it considers necessary for the protection of its essential security interests ... taken in time of war or other emergency in international relations."[14]

To successfully invoke the exception, a country would need to demonstrate that climate change constitutes an "emergency in international relations." However, recent WTO panel reports suggest that once that emergency has been established, the country would be afforded substantial deference regarding whether the policies it chooses to address that emergency—presumably including various forms of carbon import fees—were "necessary."

IV. CONCLUSION

The growing interest in using carbon import fees to reduce the 20-25% of global emissions associated with internationally traded goods has prompted questions regarding whether these measures would conflict with WTO rules. The outcomes of any future WTO disputes concerning carbon import fees will depend on the specific elements of these novel policies and the Appellate Body's interpretations, assuming it is reconstituted, of underlying doctrine. Given the delicate state of the WTO and the significant discretion afforded the Appellate Body, it will likely be receptive to interpretive approaches that allow it to reconcile the multilateral trading system with ambitious climate policies. And the relevant treaty text, negotiating history, and jurisprudence offer substantial support for a variety of approaches to carbon import fees.

Summary of Potential WTO Defenses for Carbon Import Fees

Type of Carbon Import Fee	POTENTIAL WTO DEFENSES: Permissible Border Tax Adjustments	Environmental Exceptions	International Commodity Agreement Exception	Essential Security Exception
Border adjustment of carbon tax	LIKELY	LIKELY	LIKELY	LIKELY
Border adjustment of ETS (e.g., CBAM)	POTENTIAL	POTENTIAL	LIKELY	LIKELY
Border adjustment of implicit price	UNLIKELY	POTENTIAL	LIKELY	LIKELY
Emissions intensity-based import fees	UNLIKELY	POTENTIAL	LIKELY	LIKELY
Punitive carbon tariffs	UNLIKELY	UNLIKELY	POTENTIAL	POTENTIAL

ENDNOTES

1. High-Level Commission on Carbon Prices, *Report of the High-Level Commission on Carbon Prices*, at 41 (May 29, 2017) ("Concerns over carbon leakage and unfair competition can also be tackled by ... introducing so-called border carbon adjustments.")

2. *See* Ali Hasanbeigi and Aldy Darwili, *Embodied Carbon in Trade: Carbon Loophole* at 2 (Nov. 2022), https://www.globalefficiencyintel.com/2022-embodied-carbon-in-trade-carbon-loophole.

3. *See, e.g.,* Bart Le Blanc and Isaac de Leon Mendoza, *Potential Conflicts Between the European CBAM and the WTO Rules,* Norton Rose Fulbright (Feb. 2023), https://www.nortonrosefulbright.com/en/knowledge/publications/9c5d9ec6/potential-conflicts-between-the-european-cbam-and-the-wto-rules; Shreya Nandi, *India plans to challenge European Union's carbon border tax at WTO,* Business Standard (June 16, 2023), https://www.business-standard.com/economy/news/india-south-africa-other-developing-nations-to-challenge-cbam-at-wto-123061600716_1.html.

4. S. 2378, 117th Cong. (2021), https://www.congress.gov/117/bills/s2378/BILLS-117s2378is.pdf; H.R. 4534, 117th Cong. (2021), https://www.congress.gov/117/bills/hr4534/BILLS-117hr4534ih.pdf.

5. *See* Press Release, *ICYMI: Cassidy's Plan for a Foreign Pollution Fee* (May 30, 2023), https://www.cassidy.senate.gov/newsroom/press-releases/icymi-cassidys-plan-for-a-foreign-pollution-fee**;** Benjamin J. Hulac, *As European tax looms, a border fee draws bipartisan focus,* Roll Call (April 12, 2023), https://rollcall.com/2023/04/12/as-european-tax-looms-a-border-fee-draws-bipartisan-focus.

6. *See* Ana Swanson, *U.S. Proposes Green Steel Club That Would Levy Tariffs On Outliers,* New York Times (Dec. 7, 2022), https://www.nytimes.com/2022/12/07/business/economy/steel-tariffs-climate-change.html.

7. William Nordhaus, *Climate Clubs: Overcoming Free-Riding in International Climate Policy*, 105 (4) American Economic Review, 1339, 1341 (2015). https://www.aeaweb.org/articles?id=10.1257/aer.15000001.

8. *Id.* at 1949.

9. *See generally* T. Renee Bowen and J. Lawrence Broz, *The Domestic Political-Economy of the WTO Crisis: Lessons for Preserving Multilateralism* (October 1, 2022), https://ssrn.com/abstract=3920630 or http://dx.doi.org/10.2139/ssrn.3920630.

10. *See* Simon Lester, *Ending the WTO Dispute Settlement Crisis: Where to from here?* International Institute for Sustainable Development (March 2022)("losing members have generally appealed ... panel report[s] into the void left by a non-operational Appellate Body, leaving many disputes in a state of limbo"), https://www.iisd.org/articles/united-states-must-propose-solutions-end-wto-dispute-settlement-crisis.

11. General Agreement on Tariffs and Trade 1994 art. XX(b) & (g), Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 187, 33 I.L.M. 1153 (1994).

12*. Id.*

13*. Id.,* art. XX(h).

14. Id., art. XXI(b) (emphasis added).