Policy Priorities for 2019-2024

How EU trade policy can enhance climate action

Options to boost low-carbon investment and address carbon leakage

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Summary

In her Political Guidelines, Commission President-elect Ursula von der Leyen sets climate neutrality as one of the central objectives of a proposed European Green Deal. EU member states are now discussing whether to formally agree on an objective for climate neutrality in 2050. Some have already set deadlines – Finland as early as 2035. This has triggered reflection on the adequate policy mix, notably with a view to making a business case for low-carbon innovation and investment while addressing carbon leakage. The Commission President-elect thinks that this will require a carbon border tax.

To address the strategic need for a robust EU framework for low-carbon investment, we recommend that the European Commission i) investigates the economic, legal, and administrative viability and implementation timeline of carbon price adjustments at the border, ii) examines the possibility to extend the EU Emissions Trading System to include consumption of carbon intensive materials and iii) explores the potential of product standards to achieve the same aim. All these approaches have different advantages and shortcomings in terms of political acceptability, effectiveness and implications for the world trade system. To support partner countries in advancing climate action, both bilateral and multilateral measures should be prepared.

Part of an ongoing series of CEPS publications exploring how the incoming Commission can best approach the multiple challenges facing the EU.

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Introduction

The need for more action to meet the Paris Agreement objectives and global climate targets has been highlighted repeatedly, most recently by the 2018 IPCC special report by the Intergovernmental Panel on Climate Change (IPCC) on 1.5°C average global temperature increase (IPCC 2018), and the reports on climate change and land (IPCC 2019a) as well as on oceans (IPCC 2019b). In the June European Council, EU leaders confirmed the urgency of global and EU climate action, and the need for both ambition and leadership to address climate change.[1]

Climate action will increasingly affect all sectors of the economy, rapidly extending from the energy sector to mobility, industry, buildings, infrastructure and finance, for example. Among other measures, the decarbonisation of energy-intensive industries has come into focus in the EU, analytically through a raft of research[2] and politically with the creation of the High-Level expert Group on Energy-Intensive Industries in 2015 by the European Commission. Indeed, more than half of all greenhouse gas (GHG) emissions are related to the management of materials (OECD, 2018, p. 3).

The EU Long-Term Strategy, published by the European Commission in November 2018, kicked off the debate about possible pathways to reach EU and global climate targets, set out necessary policies and offered reflection on EU leadership and how to sustain it.

In the past, the EU has been instrumental in driving progress internationally, namely with its first climate target set in 1990 for the year 2000. Moreover, the EU implemented its Emissions Trading System (ETS) and other energy policies to deliver on the Kyoto Protocol targets and was among the first Parties that submitted a Nationally Determined Contribution (NDC) for the Paris Agreement in 2015.

Recognising that there is a general economic imperative to engage in low-carbon industrial transformation, not least to position Europe's industry competitively for the future, how can the EU build upon its leadership role and continue to offer solutions for reductions and further growth in future industries? Leadership in climate change policies has enhanced the global role of the EU. Can it also do so at a time of multilateralism in crisis?

[1] The European Council of 20 June 2019 emphasised the importance of … "stepping up global climate action so as to achieve the objective of the Paris Agreement, including by pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels". The "European Council invites the Council and the Commission to advance work on the conditions, the incentives and the enabling framework to be put in place so as to ensure a transition to a climate-neutral EU in line with the Paris Agreement that will preserve European competitiveness …" (European Council 2019).

[2] The most comprehensive analysis has been undertaken by Wyns et al., (2018).

1. Why trade matters for climate action

Trade matters for climate action for two reasons: carbon is embedded in imported goods, and low-carbon technology is deployed and diffuses through trade. Both affect the relationship between the trade and climate regimes in several ways.

In its NDC of 2015, the EU announced that it would reduce emissions from its territory by at least 40% by 2030. This target is under scrutiny in 2019, given that new NDCs and a long-term strategy must be submitted under the Paris Agreement by 2020. Data on embedded carbon in trade flows show that since 1990 the emissions imported into the EU (embodied in traded goods) is nearly equivalent to the amount the EU economy has reduced from production sources on its territory (Wood et al. 2019). Trade therefore plays a key role in the attribution of emissions. Moreover, new technologies can be adopted faster if markets grow beyond national borders through trade. Economies of scale bring down costs and thus work in favour of affordable low-carbon technologies across countries. Politically, however, trade relations have become a very difficult topic.

Technology deployment and innovation diffusion to tackle emissions rapidly and substantially will necessitate investment on a huge scale. Yet companies will only invest if there is a reasonable expectation of a profitable market. For low or near zero-carbon industrial products and related technologies, which compete with currently available carbon-intensive alternatives, the question is: who will buy these goods and why?

Unless there is a dynamic increase in global, regional or national demand for low-carbon products it is unreasonable to expect the global low-carbon economy to develop fast enough to substantially reduce emissions and drive further cost reductions. This demand hinges *inter alia* on national climate action agendas and ambitions, business cases, and consumption trends.

The need for more low-carbon investment and stimulation of related demand is currently unfolding against a backdrop of a global trade regime increasingly marred by conflict. The EU is increasingly challenged on traditional trade issues such as tariffs and dumping. The acceleration of climate action, as for example suggested in the Long-Term Strategy, will increasingly bring to the fore the challenge of how to address the gap with trade partners keeping carbon constraints low for domestic companies and thus creating competitive advantages at the expense of the climate.

In the spirit of the United Nations Framework Convention on Climate Change (UNFCCC), which was re-confirmed by the Paris Agreement, industrial countries will have to reduce emissions at a faster pace than emerging economies and developing countries. There is good reason to include international flows of carbon embodied in trade in this debate.

With the 2050 climate strategy, the EU is positioning itself as the home of a nascent low-carbon industry, including the energy-intensive sectors. A solution to creating stable markets for future low-carbon technologies is yet to be found.

2. The strategic dimension

EU climate policy is targeting domestic greenhouse gas emitters, i.e. making them pay for their emissions or be responsible for actions that reduce emissions. However, if carbon prices under the EU ETS were at levels necessary to facilitate low-carbon investment in the industry sectors (e.g. in the order of 50 euro/t CO_2) producers of basic materials like steel or cement are likely to relocate some production and investment to other regions. This risk of carbon leakage generally is motivating governments to grant exemptions in carbon pricing schemes – in particular to basic material producers. Under the EU ETS, sectors 'at risk' receive free allowances for every tonne of material produced at a benchmark level.[3] Such exemptions largely mute the carbon price signal that would stipulate emission mitigation options along the value chain, and thus largely inhibit incentives for many of the emission reduction opportunities for most industries. From a climate perspective, of particular concern is the production of basic materials such as steel, cement or chemicals, accounting for some 25% of global greenhouse gas emissions (IEA 2017).

While no perfect solution to this conundrum can be found, there are a number of policy options available to the EU. The focus should lie on strengthening the business case for innovation and investment in low-carbon technologies, by creating a stable environment for innovation and investment in low-carbon technologies. The trade aspect of this is acknowledged in the chapter on a European Green Deal in the Political Guidelines of the new Commission President-elect Ursula von der Leyen, in the form of a 'carbon border tax'. However, other options exist and warrant equal attention, as discussed below.

a) Border taxes and adjustments

A tax on imports is among several design options for pricing imported carbon by so-called border carbon adjustment. Border carbon adjustments can internalise emissions that occur abroad by imposing a carbon price on imports. The carbon-based price adjustment at the border leads to a matching of the domestic price. The advantage is that this would allow for a shift from free allowance allocation to auctioning to domestic producers. There have been substantial analyses of the particular design and economics of border carbon adjustments, including a carbon border tax (e.g. Mehling et al. 2019; Horn and Sapir, 2013; Cosbey et al, 2012; Gros and Egenhofer, 2010; Ismer and Neuhoff, 2007).

A border adjustment can be made WTO-compatible in principle, notably by the general exemption clause of the General Agreement on Tariffs and Trade (GATT) and needs to clearly address the carbon leakage risk. Additional requirements are i) no rebates of carbon costs to exporters, ii) measures should be limited to primary goods, for example cement, steel and aluminium, which would then no longer receive free allowances, iii) no discrimination against

[3] A benchmark to calculate the number of free allowances is applied based on a technical formula along industrial products under the EU ETS. Generally speaking, a product benchmark is based on the average greenhouse gas emissions of the best performing 10% of the installations making that product in the EU: https://ec.europa.eu/clima/policies/ets/allowances/industrial_en

international producers and trade partners, i.e. by singling out specific countries, iv) the design and implementation of a border adjustment should occur through a deliberate process that ensures fairness, transparency and predictability to improve political acceptance by trade partners. For further details see Mehling et al., 2019 and Lamy, Pons and Leturcq 2019.[4] Some industries, typically those with high export intensity, have argued that border adjustments without rebates will neither address the lack of incentive for low-carbon investment nor carbon leakage itself; others argue that export rebates can be made compatible with WTO. Border adjustments would become obsolete once producers that face this charge have ramped up their climate performance.

Measuring the carbon content of traded materials in such a system is complex. One way to deal with it is via a benchmark value, for example based on the national average emissions of an industry. With the adjustment, products sold to European consumers bear carbon costs at the benchmark level, which is typically at or below the carbon cost faced by domestic producers. Thus, imported products would be treated in the same manner as domestic goods in the EU market. In this way the carbon price would be fully passed on to consumers as there would be no cost disadvantage to domestic producers. This price signal would create incentives for mitigation, clarity on cost allocation, and revenues to fund other climate policy measures, including supporting research & development (R&D) and innovation.

Even if justified from a climate perspective, there can be political and economic risks in pursuing an agenda that may be perceived as protectionist or may create protectionist results, if not monitored with sufficient care. For example, at some point the level of adjustments could exceed what is required to level the playing field. Thus, border measures risk trade conflicts and, if formulated carefully enough to reduce the risk of such conflicts, they will not eliminate all cost differences relating to climate policy. The inclusion of indirect costs would furthermore be difficult. Also, importers should be granted the right to a reduced adjustment rate if they can demonstrate a carbon intensity below the applied benchmark rate (Cosbey et al., 2012). This would provide incentives to encourage climate-friendly production abroad but may also create windfall profits for foreign production based, for example, on existing hydro power stations. Furthermore, including indirect costs increases complexity.

b) Consumption charges

Producers of basic materials fall under the category of 'at risk' of carbon leakage and are shielded, to an extent, from the cost impact of climate policies in the EU. For example, steel producers receive free allowances per tonne of steel according to the benchmark of a best available technology for steel production (Zipperer, Sato, Neuhoff, 2017). Firms therefore only face costs for emissions that exceed the benchmark. As this only comprises a fraction of overall emissions, they will thus not pass most of the carbon price on to material prices.5 The carbon

[4] See Harro van Asselt; Susanne Dröge, Michael Mehling (2019), *How von der Leyen could make a carbon border tax work*, 22.7.2019, Climate Home News https://www.climatechangenews.com/2019/07/22/von-der-leyen-make-carbon-border-tax-work/.

[5] This was different in early periods of EU ETS where allocation was linked to historic emissions or production volume.

price signal is therefore muted.

This shortcoming could be addressed by including consumption in the emission trading system to 'reinstate' the carbon price (Climate Strategies, 2016). The consumption charge – as in the case of free allocation – would be levied at the ETS benchmark used for free allowance allocation to primary production (Ismer and Haußner, 2016). The charge is thus indifferent to location or production processes. In contrast to border adjustments, the consumption charge applies to any producers, whether European or not. This would make it compatible with WTO rules.

At the same time, implementation is relatively simple compared to carbon foot-printing approaches. There is no need to trace specific materials along the value chain. Administrative effort would be further reduced because the consumption charge only needs to be levied on a few basic materials (e.g. steel, cement, and aluminium) that represent the bulk of industrial emissions in the EU ETS. Most importantly, its main merit is that it creates economic incentives for innovation and investment in climate-friendly material production (see Elkerbout and Egenhofer, 2018) as it allows clarity on cost allocation for over half of industrial emissions. Thus, it would serve a key objective of the EU Long-Term Strategy.[6]

A limitation is that such a system for foreign producers only creates incentives to use carbon intensive materials efficient but does not create incentives for international material producers to reduce their emissions. The charge remains the same for both efficient and inefficient production processes. Instead, the national policies of the country hosting the respective material producers will be required to create such incentives and may be supported through international climate cooperation. Moreover, it requires a continuation of free allocation, which may be politically challenging. A consumption charge will however open the way to develop a mechanism for international financial or technological cooperation to support innovation and investment in climate-friendly material production in other jurisdictions.

c) Environmental standards

There is a long tradition of environmental standards in the EU and they can take different forms. They are implemented as part of legislative processes, which can either take place at EU level or – under certain conditions – as part of member states' decisions to implement EU directives.[7] Standards ensure that only products that meet certain specifications can be sold to consumers and apply both to domestic and international producers. Examples are mandatory bio-fuel standards, the now-abolished Fuels Quality Directive, product design standards, and voluntary certification through private labelling programmes (e.g. for food or wood).

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[6] For a detailed analysis see Climate Strategies Report and technical papers at https://climatestrategies.org/projects/inclusion-of-consumption-in-emissions-trading/.

[7] An overview on EU regulation tools can be accessed here: https://ec.europa.eu/info/sites/info/files/file_import/better-regulation-toolbox-18_en_0.pdf.

Under the WTO regime, standards are split into two groups, technical regulations and standards. Standards are specifications enabling safety and quality benchmarks to be met by a traded good, a production process and services. In this way, they define market access. Mostly, these standards are set by private bodies such as industry associations or internationally, by the International Standardization Organization (ISO) in order to meet demand from customers and reduce companies' transaction costs. Technical regulations, including standards decided on by governments define the group of 'technical regulations' under international trade law. The Technical Barriers to Trade (TBT) Agreement takes care of eliminating the diversity of standards as far as possible through a 'Code of Good Practice'. It ensures common principles for trade partners and thus reduces obstacle to trade. Any new technical barrier to trade must be reported under the TBT notification procedure at the WTO.[8]

Climate protection can be advanced effectively via standards in all cases where the emissions from a product or from the production process can be monitored, measured and reported. With respect to production, the basic materials sectors' carbon neutrality could define a new standard, either voluntarily or mandatorily. This, however, requires a technological reference point (e.g. a pilot plant for carbon-neutral steel production) and pioneering technologies. The prescription of standards by policymakers therefore depends on knowledge of technological options. This is a critical point for regulators; the lack of knowledge is a strong argument for 'technology-neutral' environmental policy approaches such as pricing instruments for the introduction of low-carbon processes.

Basic materials production with near carbon neutrality is at an early stage of innovation, demonstration and commercialisation. As such, there is no benchmark technology that could or should be used to define a production standard. Instead, the EU policy agenda could include announcements that from a certain date onwards only climate-friendly (produced) materials will be allowed within and into the EU, and that a technical regulation cannot be ruled out if carbon pricing does not deliver fast enough. This might further encourage basic material producers to engage in innovation and investment in climate-friendly materials and production processes. It may thus encourage the private initiative and prioritisation necessary to make public innovation support at national and EU level effective. In the best of cases, industries would develop their own approaches to technical standards across countries.

Given the potential of standards to hinder trade flows, the EU should also look for trade partner cooperation on this tool, creating a bigger market for goods with a carbon-neutral performance. Trade agreements need to specify how to handle the different levels of standards, either by agreeing on mutual recognition or by negotiating a common approach. Mutual recognition is the least intrusive way of alignment of such standards, while common standards are the highest possible form of convergence on the rules applied.

[8] See TBT notification procedure, https://ec.europa.eu/growth/single-market/barriers-to-trade/tbt/.

3. Trade policy as a tactical way to encourage climate action

Tactical measures can involve tackling specific issues and interactions by incorporating them into trade agreements, including technology transfer, intellectual property rights of breakthrough technologies or subsidy control.

a) Trade conflicts and trade agreements

EU climate policy can benefit from a closer link with EU trade policy – and possibly vice versa (Droege and Schenuit, 2018). Following the 2017 announcement of US-President Donald Trump to leave the Paris Agreement, a number of governments advanced the idea to sanction this move via trade measures, for example those of Mexico and France. Moreover, the Trump administration has repeatedly announced tariffs on EU goods, such as cars, which has challenged EU trade policymakers in an unprecedented way. One possible response is to link the EU's multilateral trade approach to the multilateral approach to climate policy (Mehling et al., 2018). The EU's response to the US tariff threat has so far centred on hurting Trump-voters by putting countervailing tariffs on whisky and Harley Davidson exports to the EU. A closer look at the embedded carbon of US materials and basic products could offer a tactical approach that would at least serve the political purpose of responding to US threats with a clear EU stance on multilateral concerns, namely delivering on the Paris Agreement.

b) Bilateral cooperation

A more positive and thus politically more viable option is to offer preferential status to climate-friendly products from countries that also implement stringent climate action and are ready to join a club of like-minded trade partners. An example is the Environmental Goods Agreement under the WTO, which has been on hold since 2016 (WTO and UN environment, 2018, p. 64). The EU has turned to bilateral trade agreements in recent years and a more detailed approach to the sustainability chapters of such deals could pave the way for concrete climate policy cooperation in trade. In any case, the trade-climate nexus might benefit from a strategic reflection, not only because of trade tensions but also in the light of delayed climate action and the role of trade agreements in enabling cooperation (Droege et al. 2017; Das et al. 2019).

4. What possible next step?

The next cycles of NDC submissions in 2020 and the first global stocktake in 2023 under the Paris Agreement both require a careful assessment of the right policy mix, notably with a view to making a business case for low-carbon innovation and investment. The process will also create transparency regarding climate actions across countries. It has the potential to intensify the debate on who causes what emissions where, and who is responsible for their internalisation and, ultimately, their mitigation. Naturally, this will entail a closer look at trade flows in embedded carbon. As part of the EU Long-Term Strategy, the European Commission should consider how to approach this issue, not necessarily as a substitute for but certainly as a complement to addressing emissions from production.

As we have argued, basic materials are of particular relevance for an extension of policy from the production to the consumption sphere, because data and knowledge about their production exist across countries and because they are an early input for products traded among countries. The European Commission will have to investigate the economic, legal, and administrative viability and implementation timeline of three options to make a business case for low-carbon investment while addressing carbon leakage: i) a border adjustment ii) an extension of the EU ETS to include the consumption of carbon-intensive materials and iii) the potential of product standards.

To enhance cooperation with key trading partners or groups of countries with a stated interest in accelerating climate action, the monitoring of the carbon flows could be introduced into both trade and climate talks, with an explicit interest in implanting this in NDCs. Cooperation could develop ways to support information on embedded carbon as a matter of common interest in actual trade agreements.[9] Joint commitments to reducing the emissions intensity of products could also be included in the EU's economic cooperation and trade agreements. This would have the additional advantage of rendering the general sustainable development clauses in agreements more concrete.

[9] As an example of such a supportive policy approach, see the German NDC partnership initiative with developing countries http://www.bmz.de/en/press/aktuelleMeldungen/2017/november/171114_pm_123_One-year-of-the-NDC-Partnership-new-members-and-more-funds-for-climate-action-at-COP23/index.html

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