ROUND TABLE
ON SUSTAINABLE DEVELOPMENT

The Climate Challenge and Trade: Would Border Carbon Adjustments Accelerate or Hinder Climate Action?

Summary of the 39th Round Table on Sustainable Development[1]
25 February 2020

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The 39th Round Table on Sustainable Development gathered a group of 25 high-level experts and influencers from the private and public sectors to discuss the evolving landscape of climate and trade policies, with a particular focus on border carbon adjustment (BCA) mechanisms, following proposals for such a mechanism in the European Green Deal.

Both trade and climate policies have been evolving rapidly in recent months. Given the urgency to accelerate deep and systemic decarbonisation to reach the objectives of the Paris Agreement, some countries and regions, including the EU, are stepping up their ambition on climate policy. Meanwhile, other countries are taking action at very different speeds. These mixed responses come at a time when trade tensions between major economies have heightened, prompting unilateral tariff responses and contributing to a more regional, rather than global, approach to governing trade.

These developments have led to a renewed debate about measures to counter potential "carbon leakage" and to level the playing field for firms exposed to stringent carbon regulation. Moving to a trajectory in line with long-term objectives to achieve carbon neutrality by 2050, such as that enshrined in the European Green Deal package, would require considerable changes in policy, including rapid and sustained increases in carbon prices. Without similar action internationally, the risk of future carbon leakage would considerably increase. Several energy-intensive industries have expressed concerns about the potential impact on their international competitiveness.

Although rarely implemented to date, BCAs benefit from a rich literature going back at least ten years, highlighting significant legal, technical and political challenges that could be faced when implementing these measures. In the current context, the legal challenges appear solvable, and the technical challenges, while still severe, are potentially surmountable. The political challenge is by its nature less tangible and more fluid. One concern is whether the new landscape for trade and climate has changed to such an extent that political barriers preventing BCAs in the past may now be overcome.

The RTSD discussion was preceded by a presentation by Pascal Lamy and Genevieve Pons of the Institut Jacques Delors, who gave a preview of their forthcoming paper proposing options for a possible European BCA mechanism. Thereafter, the RTSD discussion was steered by the following questions:

1. A BCA mechanism is one option being considered by the EU: What are the positive and negative implications of introducing such a system?

[1] This Chair's Summary reflects views heard at the RTSD discussion, which was held under the Chatham House rule. It does not reflect the views of the OECD Secretariat or its member countries. The RTSD is grateful to the European Climate Foundation for financial support. The RTSD is chaired by Connie Hedegaard, who served as European Commissioner for Climate Action during 2010-14, and is managed by Ziga Zarnic, Advisor in the OECD Office of the Secretary-General. The Chair's Summary was prepared together with Andrew Prag, Advisor in the OECD Environment Directorate and author of the background paper.

2. What features of a BCA mechanism would be necessary to make it work legally, technically and politically?
3. If divergence in climate ambition persists, what other promising policy approaches could counter risks of carbon leakage and support the transition to competitive low-carbon economies?

A background paper that supported the discussion is available here.

Main messages

- **To set a path towards net-zero emissions, it is likely that carbon prices need to rise significantly.** In this context, and with divergent levels of ambition internationally, concerns about carbon leakage are increasing and a considered policy response may be necessary. Discussion of BCAs as a tool to tackle leakage is not new; what is new is the concrete proposal from the EU to invoke a BCA mechanism should the EU's climate ambition not be paralleled by major trading partners.
- **The new European Green Deal has sent a strong message** internationally that the EU is putting climate at the core of its future development and interactions with other countries and regions, and that ensuring a level playing field for decarbonisation of economies is a key component. However, governments need to use the entire policy toolbox that is well-aligned across different areas, including, for example, removing fossil-fuel subsidies and seeking to reduce distortions rather than creating new ones. The social dimension is at the heart of the European Green Deal and climate measures need to be considered in this light to limit potential resistance.
- **BCA mechanisms are complex.** Main criteria for success concern, first, *necessity and proportionality* that imply a BCA needs to be applied based on the need to avoid "a quantifiable risk of carbon leakage" and not on competiveness; second, *fairness* that calls for no unjustified discrimination between domestic and imported products; and third, *transparency and predictability* that imply a possibility for importers to pay less by demonstrating and proving lower carbon content. The legal WTO challenges facing BCAs can be overcome with good design, provided that mechanisms are clearly aimed at tackling carbon leakage rather than protecting competitiveness. However, technical issues around measurement and scope, and political issues around coverage, exemptions and potential retaliation, remain challenging.
- **A BCA could begin with a small number of key energy-intensive sectors.** The cement sector was mentioned as a key candidate for a pilot BCA as cement is a relatively homogeneous product and traded less across continents when compared to other energy-intensive sectors such as steel and aluminium. Concerns were however raised that the cement sector could face competition from other actors in the construction sector.
- **Where BCAs are combined with emissions trading, as would be the case in the EU, free allowances would need to be phased out** (under the EU Emissions Trading System) to avoid going down the protectionism road. Many participants stated that a BCA would be incompatible with free allocation of permits – parallel application of the measures could be challenged at the WTO – but reform of the EU ETS to ensure a complete phase-out of free allocation will bring its own political challenges.
- **The purpose of BCA mechanisms should be clearly communicated and consulted widely.** Even if BCAs are intended to encourage greater action on climate by trading partners, there is a risk that they could have the opposite effect. BCAs could be seen by trading partners as an "EU initiative" as well as "a protectionist measure in disguise". The path towards implementation of BCAs needs to take this into account by expanding the dialogue among key trading partners, particularly with governments and multinationals based and operating in carbon-intensive economies. This prompts pursuing the links between different ETS systems, a special treatment for the least developed countries, and

looking at BCA from a perspective of other domestic policies and approaches including regulations, standards and due diligence obligations for businesses.

- **The private sector can be an ally in the push towards better measures against carbon leakage**. Most businesses are not seeking protectionism but looking for a business case with a transition period in parallel to help reduce the “green premia”, i.e. the costs associated with low-carbon investments. Further, the most progressive firms with genuine transformation strategies and a focus on supply chain emissions transparency can be influential in countries where governments are less open to climate measures and BCA in particular, including in some major emerging economies.
- **Differentiated responsibilities among countries need to be carefully taken into account, and BCA design should be made as cooperative as possible.** The Paris Agreement is based on a country-led approach of national commitments based on countries’ different capabilities. This could make it challenging to assess where countries’ climate efforts are stringent enough to warrant exemption from a BCA. Further, the Paris Agreement’s accounting process is rooted in “production-based” emissions, making a wholesale shift towards “consumption-based” accounting challenging. Yet, if BCAs are framed as a first step towards a consumption-based approach, this could help to shift the narrative away from protectionism and towards a fairer means of assessing burden-sharing internationally. For example, the EU imports a considerable amount of carbon embedded in consumption: roughly 30% of the EU carbon footprint is related to imports, the bulk of it from emerging economies.
- **BCAs could generate significant revenue, which would provide an opportunity to trigger innovation and ensure political buy-in** of key constituencies both at home and abroad. For example, revenues could be used to support innovation and transition measures for impacted firms or more generally the development in developing countries. For the EU, one option proposed was a dedicated fund to manage revenues from BCAs, which could be used to support innovation. The fund could be significant: for example, one sector with already measurable carbon leakage is electricity; the EU imported 21 million MWh of coal-based electricity in 2019 that would translate into some EUR 500 million with an ETS price of 25EUR/tCO2.
- **There are several geo-political dimensions to BCA design and implementation, which could be taken into account for the evolving concept of “climate clubs”.** In one sense, trade discussions could be an opening for engagement with countries otherwise less willing to engage on climate, though the BCA angle could also create an additional element of tension in already tense trade discussions. In another sense, global competition for access to infrastructure markets – which are expanding rapidly in the developing world – is an additional geopolitical factor for BCAs. It was mentioned that the EU is responding with a “connectivity strategy” including sustainability in transport, energy and digital infrastructure, and that the US and Japan are working closely with the EU on this. These geopolitical dimensions could help to reframe the concept of “climate clubs”, which have often been invoked when discussing BCAs, in particular to refine the possible incentives for countries to participate in such clubs.
- **If implemented, BCA should not take on excessive proportions within the climate debate.** It should not come at the expense of making progress on other (and broader) climate policies, including potential alternatives to BCAs (such as progress on fossil fuel subsidies or reducing tariffs on low-carbon goods). BCA aims at resolving the particular issues of level-playing-field and carbon leakage, but should not hamper efforts to strengthen emissions reduction policies within borders. BCAs could be an important tool, but they are only one element of a much bigger question about “greening” trade agreements and the WTO process.

Suggestions for next steps

During the discussion, several interventions emphasised the importance of a more international BCA discussion that is cooperative and looks beyond Europe, as well as a need to better understand real-world challenges to implementation. In this light, a number of participants highlighted the strong and natural role for the OECD to take forward discussions in this area. The following next steps are therefore proposed:

1. The timeliness and complexity of the topic suggests that the next Round Table on Sustainable Development could be focused on steering **BCA implementation**, by bringing together high-level policy makers, CEOs and thought leaders. This could bring in **the wider OECD and global perspective** by initiating conversation with other countries, including from emerging economies, to avoid BCA being perceived as an "EU way of coping with carbon leakage".
2. The OECD could play a key role in helping address **political concerns about BCAs**, both for targeted firms and trading partner government, for example through improved data and analytics to assess the magnitude of potential carbon leakage and emissions embedded in trade, and making progress on tracking "consumption-based emissions" alongside "production-side emissions".
3. Elaborating **the business case**, highlighting that a package of measures to level the playing field, potentially including BCA, could be advantageous to progressive businesses looking to get ahead in the low-carbon transition, in particular highlighting implications of shifting away from subsidising carbon-inefficient business with "free allowances" towards less carbon-intensive modes of production and consumption and exploring means to create incentives for "a race to the top" through high standards of carbon disclosure.
4. Better understanding how different BCA measures can layer into the **ecosystem of innovation policies.** For example, how BCA revenues can support innovation policies – not only the ramping up of R&D support but also measures to improve effectiveness in deploying, scaling-up and commercialising low-carbon innovations and business models.