BORDER TAX ADJUSTMENT
RAISE WAGES, CUT CARBON WHITE PAPER SERIES
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EXECUTIVE SUMMARY

Border adjustment poses a particular challenge for climate mitigation programs. Several articles of the General Agreement on Tariffs and Trade (GATT 1947) seem to specifically rule out some of the recent proposals for border adjustment in "cap and trade" programs. A White Paper by the Energy & Commerce Committee from January 2008 was inconclusive about whether any of the proposals associated with "cap and trade" would survive a challenge at the WTO.

The Raise Wages, Cut Carbon Act of 2009 implements a "destination principle" border adjustment through Part III (imports) and Section 4693 (c) (exports). The provisions were drafted to be as compliant as possible with Articles I & III of the GATT, recognizing the difficulty of harmonizing a process tax. This paper outlines the philosophical basis and practical implementation of border adjustment under a revenue-neutral carbon tax. It will be updated as expert testimony is received.

PRINCIPLES OF BORDER ADJUSTMENT

Taxes can be applied either in the country of production (origin principle) or the country of consumption (destination principle). The choice of system depends on where the tax burden should fall. Under the origin principle, the tax burden falls primarily on producers; under the destination principle, the tax burden falls primarily on consumers. In the case of a revenue-neutral carbon tax, we want the behavior of consumers to react to a price signal; therefore, the destination principle is consistent with the goal of the tax.

The European Union (EU) primarily uses the destination principle to tax the production of goods through the Value Added Tax (VAT) system. The VAT is fully incorporated into WTO agreements and is border adjustable, meaning that the amount of the VAT borne by a manufacturer depends on where the good is used. By contrast, the EU Emissions Trading Scheme (ETS) applies the origin principle, applying the same amount of emission allowance costs to a manufacturer regardless of where the good is consumed. In this case, the origin principle creates an incentive to shift manufacturing capacity and associated emissions to foreign nations that do not bear ETS or other carbon compliance costs. Theoretically, the EU could attempt to harmonize the ETS with the destination principle by rebating costs from the ETS for exported goods and applying ETS costs to imported goods, shifting the ETS costs to consumers who will react by selecting products that are produced with fewer emissions.

Product vs. Process Tax

The WTO allows for a straightforward application of the destination principle when applied to products, but applying the tax to any part of the process of production (such as the type of energy used) becomes more difficult. For example, a tax on the carbon dioxide potential of coal would be simple to rebate at export and apply at the border to like coal products. A tax on the carbon dioxide potential of a product that consumed coal in the production process may be possible to rebate at export (by looking at electricity bills and isolating the proportion of coal-based electricity used in each unit of production). But how does one calculate the process tax for importers when the importer does not have such information available? We propose a solution in the next section.

Energy Taxes in the Uruguay Round

As noted by Hufbauer in *Fundamental Tax Reform and Border Tax Adjustments*, the energy taxes in GATT negotiations first appeared in the Tokyo Round under the name of *taxes occult* (taxes which cannot be identified in the finished product). While these taxes were not eligible for border adjustment because they were not "physically incorporated," the definition for eligible taxes was later expanded in the Uruguay round to include taxes on items "consumed in production."[1]

Footnote 61 to Annex II of the Uruguay Round states:

> Inputs consumed in the production process are inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product.

The meaning and application of this text have yet to be determined (deferred to the Organization for Economic Cooperation and Development to be explored further). We propose that this language supports rebating the cost of carbon dioxide under a border adjusted carbon tax.

National Treatment

Article III of the GATT can be summed up as "foreign goods cannot be taxed in excess of domestic goods." A process tax applied in equal measure to like domestic and foreign goods would satisfy this requirement if domestic and foreign manufacturers were supplying necessary information to equally apply the tax. This is rarely the case for foreign manufacturers. In this case, it may be possible to approximate equal application by taking the average of the domestic tax for each product and applying that level of taxation to foreign producers who do not supply information. A foreign producer would still have an incentive to supply information if it could secure a lower taxable base upon which to apply the same tax rate.

Most Favored Nation

Article I of the GATT can be summed up as "each country must share its best tax/tariff treatment with all WTO members." As it relates to carbon border taxes, it could be rephrased as "a

[1] For a more detailed treatment, see Chapter 4 in Fundamental Tax Reform and Border Tax Adjustments by Gary Hufbauer.

government or country cannot give preferential treatment to some WTO members just because they have a program to reduce carbon dioxide."

Article XXIV allows for free trade agreements to reduce tariff levels below MFN levels for the purposes of closer economic integration. This article would not apply if all countries with greenhouse gas (GHG) mitigation programs rebated carbon taxes for exports and applied carbon taxes for imports according to the destination principle. The administrative difficulties of these adjustments may encourage some countries to negotiate a lower border tax rate or no border tax rate through a free trade agreement under Article XXIV.

Environmental Exception

Article XX (b) & (g) of the GATT allow for the so called "environmental exception" to other articles of the GATT. Complying with other articles of the GATT helps determine whether a law will be considered eligible for an environmental exception.

IMPLEMENTATION IN THE RAISE WAGES, CUT CARBON ACT OF 2009

Part III of the *Raise Wages, Cut Carbon Act of 2009* addresses the various requirements of the GATT by taxing foreign producers at the same level as domestic producers. We assume that the default case will be importers that do not supply any information, in which case they would be taxed at the same rate as the average of US industries, according to Sec. 4695 (b) (2). Though not specified in the bill because of questions of jurisdiction and process, we propose that EPA would work with ITC to determine the rates according to headings in the Harmonized Tariff Schedule.

Importers will have the option to supply emissions information to diminish their tax liability if their production methods are cleaner than the average domestic producer, according to Sec. 4695 (b) (1).

Exports from the United States would receive a rebate in Section 4693 (c). Article 1, Section 9 of the U.S. Constitution states "No Tax or Duty shall be laid on Articles exported from any State."

Because border adjustment has not yet been attempted in GHG mitigation schemes, any proposal could be subject to challenge at the WTO. The particular provisions of Part III have been designed to withstand such a challenge.

Future MFN Exemption

Although the United States cannot unilaterally decide (even with objective criteria) who pays a border adjustment without running afoul of MFN, it may be possible to use the trade agreement exemption of Article XXIV to lower the taxes paid by certain countries. We propose the following language:

> (c) EXCEPTION FOR PRODUCTS FROM CERTAIN COUNTRIES.—No tax shall be imposed by subsection (a) on any product substantially all of which is manufactured

> or produced in any foreign country which is determined, pursuant to a trade agreement between the United States and such country, to have a significant and comprehensive program to discourage industrial carbon dioxide emissions. The preceding sentence shall not apply if such program consists of a tax based on the carbon content of products and such tax is rebated on exports from such country.

Even this language contains difficulties related to the definitions of "significant" and "comprehensive." These terms would have to be defined with fair and objective criteria, lest they be misused to "move the goalpost" or pick winning trading partners based on subjective criteria. We welcome feedback to improve this language or suggest alternatives.

Future LDC Exemption

The intent of this legislation is not to harm least developed countries (LDCs) in their quest to raise health, education and living standards. To this end, we are considering the following language:

> (d) DE MINIMIS EXCEPTION FOR PRODUCTS FROM CERTAIN COUNTRIES.—No tax shall be imposed by sub section (a) on any product substantially all of which is manufactured or produced in any foreign country which contributes less than 0.5 percent of global greenhouse gas emissions.

However, this may be disallowed under Article I (Most Favored Nation) of the GATT. We welcome expert testimony that addresses this topic.

"Challenge" Procedure

Section 4695 (c) allows "interested persons" (as defined in 19 US Code 1677 Paragraph 9; generally producers of like products) to examine the information provided by an importer to point out errors in data or calculations. For example, a manufacturer may know that given the limitations of current technology, the numbers provided by a foreign producer are impossibly low. That manufacturer could provide this information to the relevant agency for follow up and investigation.

We did not want this provision to be abused as a barrier to trade, but rather wanted to harness the knowledge and incentive structure of the private sector to keep importers honest. We welcome feedback on how to treat importers and interested parties that repeatedly provide false information.

We also recognize the substantial business interest to keep cost-basis information confidential; we welcome feedback on how the challenge provision might conflict with keeping certain critical information confidential.

APPLICATION TO INDUSTRY

We are seeking feedback from affected industries as to how these provisions would be practically implemented and how they would affect specific industries. According to the Department of Energy's Energy Information Administration (EIA) Manufacturing Energy Consumption Survey[2], the top five carbon emitting industries based on fuel combustion are petroleum refineries, chemicals (including plastics), metals, paper, and cement. Because of the "Use Treated As Sale" provision in Section 4694 (b), oil refineries pose a specific challenge in border adjustment. We are seeking feedback as to how to best provide for border adjustment in this case.

FOR FURTHER READING

Houser, Trevor, Rob Bradley, Britt Childs, Jacob Werksman, and Robert Heilmayr. Leveling the carbon playing field international competition and US climate policy design. Washington, DC: Peterson Institute for International Economics World Resources Institute, 2008.

Hufbauer, Gary C., Steve Charnovitz, and Jisun Kim. Global Warming and the World Trading System. Washington, DC: Peterson Institute for International Economics, 2009.

Hufbauer, Gary Clyde. Fundamental tax reform and border tax adjustments. Washington, D.C: Institute for International Economics, 1996.

Pauwelyn, Joost. U.S. Federal Climate Policy and Competitiveness Concerns: The Limits and Options of International Trade Law. Working paper no. NI WP 07-02. Durham, NC: Nicholas Institute for Environmental Policy Solutions, Duke University, 2007.

[2] For more information on EIA's Manufacturing Energy Consumption Survey, refer to http://www.eia.doe.gov/emeu/mecs/contents.html