

**THE CASE FOR A CARBON BORDER TAX**

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*Speaking at the Centre for Policy Studies on Thursday 27<sup>th</sup> May 2021 at 12:00hrs, The Rt Hon Dr Liam Fox MP is expected to say:*

**INTRODUCTION**

When I left the Cabinet in 2019, with the Prime Minister having given me additional reading time, I decided to put it to good use.

I delved into the literature to determine for myself whether there was overwhelming evidence for human driven global warming or whether it was, as some claim, a great global conspiracy.

There were, and are, two basic questions to answer – whether global warming is real and, if it is, what is the cause?

The evidence of climatic change is all around us. Today, the sea level is 10-20 cm (4-8 in) higher than it was a century ago. Why has this happened?

Firstly, over the past 100 years Mountain Glaciers, Arctic Glaciers, and Greenland's ice have decreased dramatically in size with melting water flowing into the ocean.

Equally importantly, ocean water expands as it warms, increasing its volume, so the water in the ocean takes up more space and sea level is higher. This is a direct effect of rising temperatures and the trend is amplified by the effects of water itself.

With every extra degree of air temperature, the atmosphere can retain around 7% more water vapour. Water vapour is a strong and fast feedback that amplifies changes in surface temperature in response to other changes (for example increasing CO<sub>2</sub>) by about a factor of 2.

Globally, water vapour concentration in the lower atmosphere has increased by 3-4% since the 1970s.

In his excellent book, *Paleoclimate*, Michael Bender points out that in the history of our planet there have been huge swings in our climate.

We have had multiple periods where the earth was glaciated to the equator lasting millions of years and others when it was so warm dinosaurs lived on Antarctica.

He set out the four factors that have caused these climate modifications: changes in atmospheric greenhouse gas concentrations, changes in the amount of sun's radiation reflected directly back to space, changes in the position of the continents that guide winds and ocean currents, and changes in the brightness of the sun.

I think it is very difficult to come to any conclusion other than global warming and climate change with unpredictable consequences are real and that changes in greenhouse gas concentrations are by far the most likely reason.

## **THE GLOBAL PICTURE**

So, let's look at the current picture of global greenhouse emissions. There are two ways I find helpful to do this.

The first is to look at which countries produce the most. Today, 17 countries are each responsible for producing more than 1% of the world's CO<sub>2</sub> emissions. Of the top 6, China produces 27.9%, followed by the United States on 14.5% with India on 7.2%, Russia 4.6%, Japan 3% and Iran 2.14%.

11 countries produce between 1% and 2% ranging from Germany's 1.93% all the way down to the U.K.'s 1.01%.

Another way to look at it is to examine which countries are increasing the production of CO<sub>2</sub> and which ones are reducing. Between 2009 and 2019 we have seen some big reductions in a number of countries.

The US has reduced by 3.75%, Japan by 4.82%, Germany by 11.14%, France by 15.2% with the UK top with 25.1%.

By contrast, Canada has increased by 6.3%, Russia by 9.7%, South Korea by 20.5%, Turkey 28.6%, China 31%, Brazil 33%, Indonesia 38% and India 62%.

### **GLOBAL PROBLEMS NEED GLOBAL SOLUTIONS**

Any attempt to deal with the situation must accept the basic premise that this is a global problem and global problems require global solutions.

We would do well to remember the words of Margaret Thatcher at the second world climate conference in November 1990 when she said *“The danger of global warming is as yet unseen, but real enough for us to make changes and sacrifices, so that we do not live at the expense of future generations. Our ability to come together to stop or limit damage to the world's environment will be perhaps the greatest test of how far we can act as a world community”*.

If we are to deal effectively with the challenge, we need to establish policies and mechanisms that will encourage a shift away from CO2 production in those countries who are contributing most to the global problem.

With a huge reduction in UK emissions in recent years there is little point in introducing domestic measures that will overstress our economy and our society while others continue to increase their emissions.

There is no point in damaging the competitiveness of economies such as the UK, while other countries maintain their competitive edge at a cost to the global climate.

So, what in practical terms, can be done? I believe that using market mechanisms offer the best hope and a carbon border adjustment mechanism of some sort is being considered in different parts of the world.

John Kerry recently said that *“President Biden, I know, is particularly interested in evaluating the border adjustment mechanism. He wants to look at that and see whether that’s something that we need to deploy”*.

Western countries do not want to see their own companies moving their manufacturing to places like China or India because of their less stringent environmental rules and consequent lower costs. President Biden’s administration certainly listed carbon border adjustments as part of its 2021 Trade Agenda.

Let’s consider the politics.

For the Biden administration such a mechanism would allow the US to be simultaneously tough on countries like China while emphasising their environmental credentials. It will be highly tempting with a politically split Congress and mid-term elections already looming. Of course, the U.S. President could use the precedent of his predecessor and unilaterally impose the tax if carbon-intensive products were deemed to be a national security risk.

President Trump did it on steel and aluminium imports, including from the UK, though I doubt if there will be much appetite to repeat this dubious tactic.

The EU is also committed to a carbon border adjustment mechanism as part of its Green Deal agenda.

### **WHAT IS A CBT (Carbon Border Tax)?**

So, what are the policy options that we have? I believe that the most obvious tool is a Carbon Border Tax – perhaps best seen as a Carbon Border Tariff.

This is simply a charge on carbon emissions attributed to imported goods that have not been carbon-taxed at source.

The aim is to put an additional price on imports from countries where it is cheaper to pollute and level the playing field for domestic industries that produce goods with lower levels of greenhouse gas emissions.

Countries such as the UK, or those in the EU, argue that producers in their own countries who have already applied measures to reduce emissions, through carbon pricing, are handing foreign suppliers who do not bear these costs an advantage.

Over time, they argue, it will shift production to low cost high emission countries. This will have the net effect of punishing our own industries and jobs, damaging our international competitiveness yet doing little to limit global emissions.

It is useful to distinguish between a National Carbon Tax and a Carbon Border Tax.

A National Carbon Tax is a fee that a government imposes to encourage reduced greenhouse emissions, but which can increase costs for household consumers and businesses alike.

By contrast, a Carbon Border Tax or Tariff is able to protect a country's national manufacturers, while motivating them to adhere to green regulations.

Many EU companies complain at having been at a cost disadvantage as they have been paying for carbon emissions since 2005 under the EU's Emissions Trading System.

Obviously, this includes UK companies while we were in the European Union. A Carbon Border Tax can therefore lead to a rebalancing against importers from those nations with more lax environmental standards.

It can also be argued that a Carbon Border Tax can improve domestic support for climate change policies by securing the buy-in of local industry for deeper decarbonization policies.

In recent months there has been growing pressure on the European Union to hasten the introduction of a Carbon Border Tax as record prices for carbon dioxide allowances have raised the cost of polluting in the bloc far above any other region.

Carbon prices in the EU's flagship Emissions Trading System, a key part of the plan to cut emissions by 55 per cent by 2030, are close to €50 a tonne — more than double their pre-pandemic level.

Many across industry argue that pricing of this level is counter-productive as it can starve companies of funds to invest in decarbonisation.

Steel producers estimate that the EU carbon price is now costing them approximately €95 per tonne of steel produced (the production of one tonne, on average, emits two tonnes of CO<sub>2</sub>).

That is almost 10 per cent of the current steel price of close to €1,000 a tonne. This clearly inhibits the national and global competitiveness of companies that fall within the regime.

So, what effect would a CBT have on the steel sector?

The answer is that it would have different impacts on steel imports depending on the country of origin.

For example, Chinese steel manufacturers primarily use blast furnaces and basic oxygen furnaces emitting about 2 metric tons of CO<sub>2</sub> equivalent per metric ton of steel produced, while Turkish companies mainly use electric arc furnaces emitting 1 metric ton of CO<sub>2</sub> equivalent per metric ton of steel produced.

A Carbon Border Tax would then differentially affect Chinese and Turkish steel exports.

### **WHAT ARE THE PROBLEMS?**

The principles of our Carbon Border Tax are, therefore, relatively straightforward but, as ever, there are complex practical issues to be resolved.

- Which countries and which industries should be covered and on what basis?
- How do we measure emissions and how do we ensure that there is sufficient verification to avoid cheating?

- How do we determine equivalence between systems that have different carbon pricing mechanisms and levels?
- How do we set an appropriate level for a carbon border tax?
- How do we ensure that any measures are in line with existing World Trade Organisation obligations?

And, how do we ensure that we do not disproportionately affect developing countries and undermine our own development agenda?

Developing countries have argued that such a policy runs counter to the Paris Agreement's bottom-up, nationally determined contributions. Emerging economies such as Brazil, South Africa, India and China, have already criticised the unpublished EU plan as "discriminatory" and unfair to developing nations.

Working out which countries are subject to the tax requires some way of balancing differing carbon regimes, something that Jonathan Pershing, a member of the US climate envoy's team has warned will be "extremely complicated".

The early discussions between the United States and the European Union were a good example of some of the practical challenges.

The United States does not have a harmonised carbon price, because it chose not to implement an emissions trading scheme at a Federal level.

It is pretty inconceivable that President Biden would get bipartisan congressional support for imposing one especially in the current political climate.

Jonathan Pershing has pointed out that the US does *“have substantial and rigorous investments and regulatory programmes, but those are somewhat harder to compare and contrast”*.

Whether there is a direct price like an Emissions Trading Scheme (ETS), or a direct carbon tax, or a regulatory measure, mechanisms will need to be found to weigh them against one another if equivalence regimes are to be established.

When it comes to compliance with international rules, any scheme that a country or trading bloc chooses to implement will need to apply to every other country that imports goods into that country or bloc in order to be compatible with World Trade Organisation (WTO) obligations but there may well be room to exempt some of the world's poorest nations.

On the issue of setting an appropriate price, Nikos Tsafos, a senior fellow with the Energy and National Security Program at the Center for Strategic and International Studies in Washington, D.C. talks about finding a sweet spot.

*“Set the carbon price too high”, he said “and you splinter the world trading system - one world becomes low carbon, another becomes high carbon, with limited trade between them. Set the price too low and it becomes a modest cost that is absorbed into final prices without much decarbonization impact. The price, therefore, must be just right: it should allow the most technologically advanced firms in emerging economies to be competitive and incentivize the rest to invest in lower-carbon approaches. Otherwise, whatever gains are made inside the low-carbon bloc will be offset by what happens outside of it”.*

How any exporting country would be affected by a carbon border tax will be dependent on the economic sectors within the scope of the tax, the level of fossil fuels used in the industries of the exporting country, the proportion of its exports going to the CBT jurisdiction and the proportion of high emission products in its overall export mix.

This will be of particular importance to developing countries. Of course, many of these will not export either large volumes or proportions of energy intensive products.

For example, over 90% of exports from East African Community (EAC) countries are primary products, 81% of which are agricultural products and 8% fishery products.

These products are currently exempted from the European Emissions Trading System and they might reasonably expect exemption, at least in the short term, from any carbon border tax imposed by countries such as the UK or trading blocs such as the EU.

One sector which is likely to prove problematic is the textile industry which has a substantial greenhouse gas footprint contributing around 10% of global emissions.

While clearly there would be a strong incentive to see these reduced, many of the textile exporters are amongst the world's poorest countries.

It is certainly unavoidable that the carbon border tax will result in the reshaping of global trade policy, but this needs to be seen against the backdrop of other changes.

Energy transition itself will benefit those with good solar and wind resources while it will disadvantage those producing coal and oil.

Just as with these wider changes, the development of carbon border taxes will need to be accompanied by policies that help poorer nations transition to a new global environment.

The obligation of developed countries, then, is to accompany it with fair transition policies.

It is possible that a carbon border adjustment could positively shape the development path of these countries going forward.

With the cost of clean energy dropping dramatically, the right support from developed countries could help these countries leapfrog those with legacy assets.

For the UK, re-orientating our development funding towards those countries whose development is based on clean energy clearly makes sense from a climate perspective as well as offering export opportunities to UK businesses in the sector.

The alternative is to fund those who may be using, for example, Chinese built, coal fired power stations, undermining our own climate objectives with our own taxpayers' money.

I do not, incidentally, believe that Whitehall would not be capable of producing such an outcome, which is why there needs to be a substantial re-engineering of the mechanics of government if Global Britain is to be more than a worthy aspiration.

Let me make a separate mention about China, the world's second biggest economy and the driver of much of recent global economic growth.

China's continuing reliance on non-renewable energy to power its economy leaves it particularly vulnerable in this matter.

For example, given that China produces steel with blast furnaces that release a large amount of carbon, as I have already mentioned, it will have to pay an additional layer of carbon border tax, which will increase its costs and its market price.

This will obviously reduce the competitiveness of steel produced in China, compared to steel from other countries that is made in more carbon-efficient mills not requiring to pay this additional tax.

While this will be welcome to domestic steel producers here, it has already provoked a strong reaction in Beijing with the government declaring that *“We need to prevent unilateralism and protectionism from hurting global growth expectations and the will of countries to combat climate change together”*.

Beijing also claims that the new tax would violate the core principle of the Paris accord, which is that richer countries should bear greater responsibility for cutting emissions.

China, as one of the most influential countries in the world right now, and as the largest greenhouse gas producer, plays a crucial role in tackling climate change.

We cannot afford to lose China in the fight against the climate crisis.

BUT... the UK, EU and US play a more substantial role in China’s economy than the other way around, as we purchase more goods from China than China does from us.

This suggests that China would pay a more substantial price by losing big Western economies as key export markets.

Consequently, I believe China is likely to comply with a Carbon Border Tax, however unwillingly, especially if there is close cooperation and coordination among those western nations applying it.

### **GEOPOLITICAL EFFECTS**

There may also be other geopolitical consequences of following such a policy approach.

One could be the impact on the crude oil market. It could become cheaper, for example, for chemical producers (particularly in Europe) to import more oil from Saudi Arabia and less from Russia, as the Saudi extraction methods have a much lower carbon footprint than the Russians.

This may actually have a political attraction to a number of countries though it does leave Germany in a difficult position where its selfish commitment to Nordstream 2 is undiminished despite opposition from EU and NATO partners.

### **LEAD NOT CHAIR**

As a passionate free-trader, I have wrestled with the wider consequences of following a Carbon Border Tax policy.

But, as I often repeated as International Trade Secretary, Free Trade does not and has never meant a free-for-all.

Ricardo's comparative advantage still has plenty of room for expression given the range of divergences in the global economy including labour rates and the built-in welfare costs of the developed economies.

But, if we believe that the need to deal with climate change is an imperative, and I believe it is, then we must find and apply global solutions to this most global problem.

We have a great opportunity to do so with our Chairmanship of the G7. And, as we head towards COP26 in Glasgow, we must use the opportunity not simply to Chair but to Lead.

As Mrs Thatcher put it *“No-one should under-estimate the imagination that will be required, nor the scientific effort, nor the unprecedented co-operation we shall have to show. We shall need statesmanship of a rare order”*.

It is a historic challenge to which it is our duty to rise.

**ENDS**