

Trade Instruments to Avoid Carbon Leakage

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Overview

Carbon leakage occurs if, for reasons of costs related to climate policies, businesses transfer production to other countries with less stringent emission constraints. Carbon leakage is a concern for countries implementing domestic policies to reduce emissions because it can mean these policies achieve little to no overall reduction in emissions globally, or may even lead to increased global emissions.

Trade instruments affecting imports are one of the main options for avoiding carbon leakage, of which there are two main categories. The first is a **mandatory minimum standard** on the carbon-intensity of imports. The second is a financial charge/tariff imposed by countries that have a domestic carbon tax or price, or regulation they view as equivalent, on products from countries that do not face equivalent pricing or regulation, to equate to the pricing or regulation. The charge is known as a **Border Carbon Adjustment** (BCA). In addition to avoiding domestic carbon leakage, both instruments have the effect of driving reductions in the domestic countries' existing imported emissions.

Currently, neither of these trade policies have been implemented by a country, but there has been increased interest and policy development as Governments seek to make deeper emissions reductions, which are perceived to increase the risk of carbon leakage. The EU has committed to applying a BCA to selected imported industrial products from 2026, based on the carbon price applied to all production within the EU. There have also been discussions in the UK, the USA and Canada about trade instruments, as well as potential coordination through a G7-proposed Climate Club.

There are several challenges and limitations to the development of trade instruments, which countries will need to consider in deciding whether or how to develop them.^{1,2}

- **Emissions measurement / data availability.** To apply a carbon price or minimum carbon standard to imported products, equivalent

to that applied to domestic production, will require data on the carbon intensity of imported products. To produce this will ideally require a multilaterally-agreed standard for measuring the carbon intensity of imported products. This does not yet exist, although some fora, such as the G7 Climate Club, are seeking to develop multilateral consensus. The International Standardisation Organisation (ISO) may be a forum that can play a significant role in this respect.

- **Effectiveness and technical complexity of design.** There is some trade-off between effectiveness and technical complexity in trade instrument design. For example, including a wider scope of products or sectors and wider scope (1, 2 or 3) of emissions would improve carbon leakage protection, but may become increasingly infeasible. The mix of complexities could extend the time it takes to develop and implement these policies, which would be likely to take 5-10 years from starting, depending on country circumstances.
- **Fairness and World Trade Organisation (WTO) compliance.** To comply with WTO rules, the trade instruments will need to be non-discriminatory, non-protectionist and have a clear environmental rationale. This will be challenging while keeping the technical complexity feasible. WTO rules will also require respect for multilateralism, clear evidence of non-discriminatory intent and reliable and transparent data on which decisions on tariffs are made.
- **Wider fairness challenges for developing countries.** WTO compliance would address some fairness issues, by ensuring non-discrimination, which should also mean that firms in these countries are paid higher prices to produce low carbon goods, than previously for high carbon goods. However, despite the availability of higher payments, firms in developing countries may not have as much access to up-front capital to transition their facilities to producing low carbon exports or the capacity to report their embodied emissions. Support may be



necessary to manage these impacts to take account of countries' respective capabilities similar to existing frameworks, such as the Generalised System of Preferences.

- **International relations and trade disputes.** BCAs and carbon standards on imports are contentious, with concerns that they could still be designed to be protectionist or discriminatory. Even with careful design to meet WTO principles, there is risk of a trade dispute. They also provide an opportunity for improving international cooperation and international fairness.

Approaches

There has only been a limited amount of work in this area among councils in the working group. The UK Climate Change Committee has commissioned work to first assess the pros and cons of policies to manage carbon leakage and secondly to review the design options for trade policy. It has used this to underpin advice to the UK Government relating to the development of trade policies to manage carbon leakage risk. Activity by councils outside of the working group has not been explored.

Ways forward

As a next step Climate Councils could:

1. Set out recommended principles for Governments, such as to:

- Engage major trading partners to establish common principles for developing carbon-related trade instruments, with WTO compatibility in mind.
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- Determine priority sectors that should be covered by such trade instruments, assuming a phased approach to implementation.
- Participate in the development of international methodologies for assessing embodied emissions.
- Support complementary approaches to encourage international climate ambition through partnerships and cooperation, including on technology transfer.
- Provide support to Developing and Least Developed Countries to manage any impacts of trade instruments to take account countries' respective capabilities.

2. Work collaboratively to:

- Identify detailed assessments of the impact of trade instruments on developing countries, their communities and gender.
- Identify efforts to develop and agree carbon/environmental measurement standards.

References

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About ICCN

The International Climate Councils Network (ICCN) was launched in 2021 as a forum for climate councils from around the world to share experiences, discuss common challenges and support one another in their work.

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