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Insight

Border taxes: should New Zealand be worried?

A number of countries are talking about introducing border taxes to protect their local industry from imports from countries that have no or soft policies to tackle climate change. This is a risk to New Zealand's exports, but overseas consumer perceptions of the sustainability of goods produced in New Zealand are a greater threat.

Recent policy decisions about New Zealand's emissions trading scheme (ETS) and 2020 emissions target have sparked concern from those who believe New Zealand should be doing more to tackle climate change. One oft-mentioned (but little-analysed) possible consequence of New Zealand's allegedly 'soft' climate change stance is the risk that New Zealand's exports could face environmental trade barriers such as border taxes[1] in the future.

The economics of border taxes: a green and level playing field

A border tax is designed to compensate for a difference between domestic and overseas carbon pricing systems. Border taxes usually have three objectives:

(i) Avoid a weakening of the international competitiveness of domestic firms, who may be competing with firms in other countries who do not face a carbon price.

(ii) Prevent 'leakage' of carbon emissions to other countries. Leakage occurs when consumers switch to goods produced in countries that do not have carbon prices, or when producers move country to avoid these extra costs.

(iii) Close a consumption loophole whereby domestic consumers might avoid the domestic carbon price by directly purchasing imported (untaxed) goods instead.

[1] Also referred to as border adjustments, border tax adjustments or carbon tariffs. They can take the form of adjustments on imports, which is the focus of this note, or rebates to exporters who face a carbon price.

As noted by the WTO and UNEP[2] (2009, p.xix) "the objective of a border tax adjustment is to level the playing field between taxed domestic industries and untaxed foreign competition by ensuring that internal taxes on products are trade neutral".

Border taxes are not presently used by any country to compensate for domestic carbon prices[3] Neither New Zealand nor Australia plan to introduce one, preferring instead to use free allocation as way of 'shielding' trade-exposed sectors who may face competitiveness concerns once a domestic carbon price is imposed.[4] But such border adjustments have featured prominently in discussions around US climate change policy[5] and the next phase of the EU's ETS. Countries such as France and Germany have hinted that they may seek to use border taxes in the future as part of any suite of policies to address climate change.

Border taxes and global trade rules: an uneasy fit?

Some commentators have suggested that border taxes might be illegal according to the WTO's global trade rules. And indeed, one of the fundamental principles of the WTO is that a country cannot impose such a tariff solely for the purpose of protecting domestic producers: the measure must not constitute a "means of arbitrary or unjustifiable discrimination" or a "disguised restriction on international trade" (WTO & UNEP, 2009).

But there is in fact explicit recognition in WTO legislation that border adjustments are permissible, under certain circumstances.[6] The general conclusion that most studies have reached is that border taxes *could* legally be imposed, provided they were designed carefully. And even if they were thought to have been applied illegally, it could take many years for the WTO to formally adjudicate on any resultant trade dispute. So there is some uncertainty about just how compatible border taxes are with global trade rules.

Regardless of their legality, border taxes would be very difficult to impose in practice. The main problem is determining the appropriate level of the tariff. To equalise costs between domestic and imported products, a government would ideally need to know the carbon content of each domestic and foreign product along its entire life cycle. This will vary over time and by source. Such measurement is technically and administratively complex. A further concern is the scope of application of the border tax – should it be on all firms in a country, or based on individual

[2] WTO and UNEP. (2009). *Trade and climate change*. Geneva: WTO. Available at http://www.wto.org/english/res_e/booksp_e/trade_climate_change_e.pdf

[3] They have been used for some time in the EU to compensate for sales taxes, but that scheme has not yet been extended to include the ETS. See Ismer, R., and K. Neuhoff. (2007). 'Border tax adjustment: a feasible way to support stringent emission trading'. *European Journal of Law and Economics* 24, no. 2:137-164).

[4] For a discussion of the relative merits of free allocation and border adjustments, see OECD Roundtable for Sustainable Development (RSD). (2009). 'Competitiveness, leakage and border adjustment: climate policy distractions?'. SG/SD/RT(2009)3. http://www.oecd.org/dataoecd/23/20/43441650.pdf

[5] The proposed measure in the US (in the Waxman-Markey Bill that passed the House) takes the form of US importers having to purchase emissions allowances for 'covered goods' from countries who do not have 'commensurate' greenhouse gas regulations. The earliest any measure could be imposed would be 2020. See http://www.eastasiaforum.org/2009/07/10/us-climate-change-bill-how-international-provisions-work/#more-5611 for a simple explanation of the provision.

[6] See OECD RSD (2009, p.24).

shipments? The former risks penalising efficient producers unduly, and the latter would be vastly expensive with high compliance costs.

Is New Zealand really at risk from border taxes?

In order for a country to impose a punitive border tax on imports from New Zealand, all of the following criteria must apply:

(i) The trading partner has a carbon pricing scheme.

(ii) The trading partner imposes a domestic carbon price on products that New Zealand also exports to that market.

(iii) The trading partner's domestic firms face a higher carbon burden than their New Zealand competitors.

Immediately, this starts to narrow the potential for border taxes to be imposed on New Zealand exports. First, there are relatively few countries who have carbon prices in place or have announced plans to introduce one in the short run. Second, those countries who do have (or plan to have) a carbon price are unlikely to force their heavy emitters to face the full cost of their carbon immediately.

As long as the carbon burden that New Zealand's competitors face is lower than the one that New Zealand firms face, a punitive border tax makes no sense. So it's the carbon cost *differential* between New Zealand and its competitors that matters, not the cost in New Zealand.

Furthermore, it is clear from the US's proposed climate change legislation[7] as it currently stands that New Zealand would be *not* the target of any possible US border tax. Rather, it is large industrial countries such as China and India who compete with the US on a significant scale and who may not sign up to a future binding international climate change agreement. The legislation approved by the House in the US has a *de minimis* clause that exempts from border taxes countries who emit less than 0.5% of total global GHG emissions and accounts for less than 5% of US imports of the good in question. New Zealand falls well below this threshold, at least on the former aspect.

In summary, based on current proposals, it seems unlikely that New Zealand exporters would be targeted by punitive border taxes in the immediate future.

[7] The American Clean Energy and Security Act of 2009 (also known as the Waxman-Markey Bill) passed the House (just) in early July 2009. Text available at http://www.govtrack.us/congress/bill.xpd?bill=h111-2454. The Senate version, named The Clean Energy Jobs and American Power Act and introduced by Senators John Kerry and Barbara Boxer, is available at http://kerry.senate.gov/cleanenergyjobsandamericanpower/pdf/bill.pdf. Its provisions on border adjustments are vague, noting that "It is the sense of the Senate that this Act will contain a trade title that will include a border measure that is consistent with our international obligations and designed to work in conjunction with provisions that allocate allowances to energy-intensive and trade-exposed industries" (section 765).

So no need to worry then? Well, no…

Although New Zealand may not be explicitly targeted by border taxes in the short term, there remain some longer term risks to our exporters from the increased global focus on the environmental impacts of trade.

First, there is a possibility of border taxes and other environmental trade barriers being used in a protectionist way between major global players (e.g. the US and China). Retaliatory action may occur, as often happens with trade disputes. This raises the possibility of 'trade wars' which are expensive to resolve and damaging to the global trading system. And they could have a negative impact on the prospects for further beneficial global trade liberalisation, which are already fairly dim.

Second, even if no border taxes are imposed, consumer preferences matter. As has been demonstrated with the food miles fallacy[8] and recent comments about the environmental benefits of moving towards a less meat-intensive diet, overseas consumers are being buffeted with suggestions about how green their shopping baskets are.

Over time, consumers may start to adjust their buying behaviour towards what they perceive as more sustainable products.[9] Canny producers already brand their products as being natural and environmentally friendly, and retailers such as large supermarkets reinforce this by adjusting their own purchasing requirements to take into account of changing consumer demands around sustainability. They are looking to "green their supply chain" by demanding that the products they buy and stock are sustainably produced.

If New Zealand's agricultural exports are *perceived* as being unsustainable, even if in reality they are energy efficient, then our market share in key export markets is at risk. Competition for the consumer dollar has already fuelled misinformation and mischievous marketing. This suggests that New Zealand exporters need to continue monitoring offshore consumer trends and investing in demonstrating their sustainability credentials. This is not cost-free of course, but is a natural, commercial reaction to changes in the marketplace.

The government has a key role to play in actively engaging in international climate change and trade discussions to try to ensure that new and unfair trade barriers do not emerge in the guise of climate friendly policies.

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8 See Ballingall and Winchester. (2009). 'Distance isn't dead - an empirical evaluation of food miles based preference changes'. NZIER WP 2009/01 http://www.nzier.org.nz/includes/download.aspx?ID=100168

9 As well as the direct effects of changes in the goods and services that shoppers buy, there could also be some indirect political economy effects. Heightened consumer and retailer concern over environmental issues and the populist nature of protectionist measures may lead to increased public demand for, and political acceptance of, climate-related trade barriers.