RESOURCES *for the* FUTURE

Addressing the Leakage and Competitiveness Risks of Climate Policy

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1. Context

Over the past year, governments across the world have called for more ambitious goals to combat climate change. The European Union, Japan, the United Kingdom, and many other countries have **pledged net-zero emission goals** by mid-century, with China aiming to do so by 2060. In April, the Biden Administration **pledged to cut its emissions in half by 2030** as part of a broader set of aims that includes a carbon-free power sector by 2035 and net-zero emissions economy-wide by 2050.

At the same time, a number of governments have raised concerns about how ambitious domestic mitigation policies may impose adverse competitiveness pressures on domestic energy-intensive industries that in turn result in emissions leakage. To address such risks, policymakers have turned their attention to **carbon border adjustments**, a surcharge on imports from countries that do not have comparable climate policies.

1.1. Challenges in Implementing Ambitious US Climate Goals

Under current law, the United States has imperfect tools to deliver on the Biden Administration's ambitious climate change goals. US climate policy is characterized by a patchwork of energy and environmental tax expenditures, appropriated spending, and regulations at federal, state, and local levels of government. These are subject to legal uncertainty, such as emissions regulatory standards; political uncertainty, such as tax credits with sunset provisions; technological uncertainty, such as on the innovation necessary to decarbonize the economy; and environmental uncertainty, such as the eventual emissions-cutting outcomes of the complicated, overlapping policy patchwork. Crafting an economy-wide, long-term emissions-cutting program requires new legislation. In the interim, making progress in combatting climate change, driving innovation, and leveraging partners around the world necessitate the Biden Administration's use of all existing authorities as effectively as possible until Congress acts on a credible, durable climate change policy.

1.2. Applying US Trade Law to Address Competitiveness Concerns

As a part of this effort, the Biden Administration can explore ways of applying existing trade law to ensure that competitiveness pressures do not result in the leakage of emissions and the shifting of jobs to other jurisdictions with insufficient domestic emissions mitigation policies. Below, I describe briefly the policy principles that could guide this effort to use trade law to mitigate competitiveness risks, before elaborating on how US countervailing duty law could effectively satisfy these principles.

2. Policy Principles for Mitigating Leakage and Competitiveness Risks

Three policy principles can guide the design and application of trade policy to reduce leakage and competitiveness risks associated with a more ambitious US domestic climate policy program.

2.1. Enable Broader Political Support for Domestic Climate Policy

Legislative efforts to address climate change may be stymied, in part, due to the perception that new climate policy and regulatory measures will impose costs on and disadvantage American businesses and workers compared to their foreign competitors. Trade-related measures can help to level the playing field and prevent energy-intensive companies from moving to less restrictive countries, taking jobs and emissions with them. Business and labor stakeholders may be more willing to support an ambitious domestic emissions mitigation program if they recognize that it will not spur relocation of economic activity to other countries. In addition, reducing the prospect that the environmental benefits would be undermined through this carbon leakage may broaden support among the public.

2.2. Ensure Administrative Feasibility

An administratively feasible—and, ideally, administratively simple—policy design to counter competitiveness and leakage risks can increase its effectiveness. The US government is more likely to implement an administratively simple approach quickly and clearly. This makes it more likely that businesses will respond to the policy promptly and efficiently consistent with the objective of reducing competitiveness risks. The transparency of implementation will send stronger signals to governments of our major trade partners about what is expected in their domestic mitigation programs.

2.3. Leverage More Ambitious Climate Policy Abroad

The design of trade policy should empower the executive branch in how it engages other governments around the world on climate policy. Given the emergence of this issue on the international agenda, it is important for the US government to have tools at its disposal now and to have the discretion in their deployment. This will enable the United States to leverage more ambitious emissions goals and domestic mitigation efforts among our trade partners. Ideally, the design and prospect of applying a trade instrument is sufficient to spur more ambitious actions by trade partners, thereby precluding the need to implement the instrument in practice. This also highlights the importance of integrating flexibility in its implementation, so that the executive can use its discretion in applying the trade policy to imports from countries that are "climate laggards" and to lift the instrument when these laggards step up and enhance the ambition of their domestic mitigation programs.

3. Countervailing Duties

To satisfy these principles, policymakers could apply an existing trade remedy tool—***countervailing duty law*** (CVD)—as an interim measure to help level the playing field for American businesses and workers and reduce carbon leakage as part of domestic climate action. The Commerce Department could implement the CVD tool through a regulation under existing statutory authorities, thereby avoiding the need for new legislation. Like much of current US energy and climate policy, this tool is imperfect, but it can provide a means for taking action now to advance more ambitious climate goals here and abroad.

3.1. Overview of US CVD Law and Implementation

US countervailing duty law provides a remedy for US workers and businesses injured by unfairly subsidized imports. The CVD mechanism is based on the recognition that certain government interventions in the market cause distortions to trade and confer unfair advantages on certain economic actors. Countervailing duties are a **recognized mechanism** under international trade law.

CVD cases are initiated when an injured US company or industry petitions the Commerce Department. These petitions usually cover a discrete "class or kind" of goods such as off-the-road tires, corrosion-resistant steel, or frozen shrimp. The Commerce Department determines whether a subsidy has been provided and the US International Trade Commission separately determines whether the domestic industry is injured. The countervailing duty on subsidized imports is designed to offset the portion of the subsidy attributable to the imported goods.

A "subsidy" exists when: (a) a government, directly or indirectly, provides a financial contribution; and (b) that financial contribution confers a benefit. The subsidy must also be "specific" to an industry. US law describes four types of government financial contributions: direct fund transfers, foregoing or not collecting revenue that is otherwise due, the provision of goods and services, and purchasing goods. While the Commerce CVD rules provide some methods for calculating the benefit provided by a subsidy, they grant the Commerce Secretary discretion in determining a methodology for calculating a benefit in appropriate circumstances. Similarly, while US law addresses the specificity of subsidies, Commerce has made clear that a subsidy is specific if it is targeted at a group of enterprises or industries.

3.2. Recent Trade Policy Precedent: Currency Manipulation

The implementation of climate policies (or lack thereof) by our trading partners does not squarely align with traditional considerations involving subsidy definitions under US trade law. Nonetheless, the US government has already **identified flexibility** in the subsidy rules in some circumstances, for example, to treat foreign currency manipulation as a countervailable subsidy. As a result, US workers and companies that have been injured by imports, which have benefited from currency manipulation, have been able to obtain countervailing duties in order to level the playing field. In May 2021, in response to a petition involving imports of Vietnamese tires, Commerce **found** that Vietnam undervalued its currency and that such undervaluation constituted a countervailable subsidy.

This decision reflected recent modifications to the Commerce Department's CVD regulations to address the circumstances of currency manipulation. Commerce **determined** that enterprises buying or selling goods internationally (i.e., enterprises in the traded goods sector of an economy) can comprise a "group" of enterprises to satisfy the requirement that a subsidy be "specific." It further **modified** its regulations to tailor the "benefit" conferred by the currency manipulation "subsidy" to macroeconomic principles applicable to currency valuation. In coordination with the Treasury Department, the lead US government agency on foreign exchange matters, Commerce applied these revised rules in the Vietnamese tires case.

The Commerce currency manipulation rule is not without controversy. Leading observers of trade and macroeconomic policy, such as **Fred Bergsten** and **Mark Sobel**, have noted that it is the wrong tool and have highlighted questions about consistency with global trading rules, effectiveness, and potential retaliation. There could be litigation about the consistency of the Commerce approach with existing domestic trade law. Nonetheless, in the face of unrestrained currency manipulation by foreign governments to benefit their own exporting industries, many in Congress and in the private sector have applauded the effort as an aggressive use of an available authority to ensure that US workers and business are treated fairly.

3.3. Applying CVD to Address Climate Change

The existing countervailing duty statutory authority can be tailored to address variation in the ambition of climate policies among countries. Although not a precise fit, and with many of the potential drawbacks identified by observers in the context of currency manipulation, a tailored CVD approach for climate can provide a stopgap measure to level the playing field. In doing so, it can counter criticisms that new climate change policies and regulations could shift jobs overseas and highlight the need for our trading partners to enhance the ambition of their domestic programs.

The absence of effective foreign action to address climate change can, in the current environment. be viewed as a financial contribution by a foreign government. Indeed, the US government **has already** suggested this to the WTO. Climate policies such as a carbon tax, an emissions trading system, a clean energy standard, or specific climate-related regulations, impose economic costs, particularly on energy-intensive sectors, as an incentive or requirement to reduce carbon emissions. These costs include mitigation costs to reduce carbon emissions and, in some cases, payments to the government. Importantly, particular structural and policy design decisions are essentially political choices made in a national context. These policy measures are also universally recognized to be fundamental to achieving the Paris Agreement's emissions reduction goals. It is not an unreasonable step to treat a failure by a government to regulate adequately carbon emissions as comparable to a decision to forgo or not collect revenue. This is particularly true where a country has taken climate action that contains revenue collection elements such as a carbon tax or emissions trading system. It would be form-over-function to draw a fine distinction between policies that are squarely revenue collection mechanisms and those designed to achieve similar goals based on national circumstances.

To implement a climate-oriented CVD policy, Commerce could promulgate a new regulation that would focus attention on the competitiveness impacts of climate change rules and policies affecting energy- and trade-intensive sectors, e.g., steel, aluminum, cement, and paper. Consistent with the treatment of currency manipulation, a targeted group of energy- and trade-intensive industries can be viewed as "specific" under US CVD trade law.

The new CVD regulation would also need to elaborate a method for calculating the benefit of the subsidy, i.e., **comparing the mitigation effort** among trade partners. This is challenging, considering the mix of mitigation policies—some that explicitly price carbon (carbon tax) or reveal a price on carbon (cap-and-trade) and others that are opaque about their costs and implicit carbon prices (emission standards, renewable power mandates, etc.)—used around the world. This is especially the case for the United States, which appears likely to continue with the complicated patchwork of non-price climate change policies, although there are some **recent ideas meriting consideration.** I address three options for how to benchmark such a calculation below.

First, Commerce could draw from President Biden's **Executive Order 13990** issued on January 20, 2021 in which it calls for consideration of the **social cost of carbon** in an array of decision-making beyond its past use in regulatory evaluation. The notion that the failure to price carbon equal to its damages constitutes a subsidy is not new. The International Monetary Fund's measure of a **"post-tax consumer subsidy"** on fossil fuels includes the economic damage of emitting a ton of carbon dioxide, i.e., the social cost of carbon.

Second, Commerce could coordinate with the State and Treasury Departments to negotiate an acceptable carbon price among trade partners. Those countries agreeing to and implementing policies with explicit and implicit prices comparable to the United States would be exempt from the CVD, and those with lower explicit and implicit prices would be subject to the CVD up to the level of the agreed-upon price. This is similar to the **climate clubs** proposal by William Nordhaus (although with notable differences in the nature of the trade penalties), and could build upon the recent proposal for an **international carbon price floor** by the International Monetary Fund. Alternatively, a country could be deemed to have satisfied comparability and reciprocity in ambition through an EPA **Clean Air Act section 115** rule-making.

Third, Commerce could work with many US government agencies and attempt to estimate the cumulative regulatory burden associated with an array of energy, environmental, and climate rules on specific sectors in the United States. Such an ex post, cumulative estimate of regulatory costs would be daunting and unprecedented. US regulatory agencies have a mixed record in estimating prospective costs of new regulations and **a poor record in ex post evaluation of regulatory costs** and performance. Even for the Clean Air Act, which has been subject to extensive government and academic studies, there are **few rules for which we have credible estimates of their compliance costs** in practice. A recent **legislative proposal** calls for a similar approach—to estimate the average domestic cost incurred by each sector to comply with federal, state, regional, or local laws, regulations, policies, and programs—as the basis of a carbon border adjustment. Given current analyses and methods, this would not be feasible to implement for the foreseeable future absent an ambitious effort to design and implement a program evaluation framework for US climate policy.

In each of these three options, the comparability of such policies in foreign countries could be established by reference to the level of ambition contained in a foreign country's NDC under the Paris Agreement (e.g., **through modeling analyses**) or based on a more structured examination of climate regulations undertaken by foreign governments in relation to the sectors for which a countervailing duty is sought. Regardless, Commerce could establish an effective consultation mechanism with US environmental and economic agencies taking the lead—in a manner similar to the consultation mechanism with Treasury for currency undervaluation—to screen a foreign country's climate policy relative to those in the United States.

4. Advancing US Climate Policy

As with currency manipulation, the extension of CVD rules to climate change policies faces **challenges**. The application of the subsidy rules to climate inaction requires some interpretive flexibility. There will be WTO legal challenges around questions regarding the applicability of WTO rules for actionable subsidies. The resolution of such challenges is likely to be slowed by disagreements among WTO member countries about the composition of and rules governing the WTO dispute settlement mechanism.

The elephant in the room is the question of the ambition of US domestic climate change policy. Some have noted how the recent interest in designing a tax on imports in the absence of a domestic price on carbon in the United States is **"unusual" and "extraordinary."** The imposition of a CVD regime combined with the failure by the United States to implement particularly effective climate policies could invite retaliatory action by other countries. At a minimum, the United States would need to pursue a regulatory approach to carbon emissions in which it could demonstrate that the social cost of carbon **justifies** the stringency of rules (if under the first option above) or deliver an implicit carbon price consistent with an international price floor (if under the second option above). The simplest domestic mitigation policy approach that would legitimize a CVD or a carbon border adjustment mechanism more generally would be a **carbon tax**.

Broader international support might be garnered by creating a linkage to successful participation in an internationally agreed regime, whether around the social cost of carbon or a price floor. Suspension agreements could also be negotiated to help promote climate action and avoid the potential for countervailing duties. Finally, there are more effective and lasting mechanisms to address trade friction through negotiation in the context of bilateral agreements with trading partners, groupings such as the G-20, and G-7, and APEC, the Glasgow climate conference, and the World Trade Organization. These can achieve mutually acceptable approaches to achieve global climate goals at the national level, in ways in which countries recognize and accept defined disparate treatment.

Ultimately, any trade remedy tool—whether a carbon border adjustment mechanism or otherwise—should only be needed on a time-limited basis to address limited non-compliance with global climate policy goals. Such an approach would reflect a consensus regarding each participant's efforts and contributions to address the climate crisis and avoid the need for remediation or enforcement mechanisms. Against the backdrop of domestic political pressures, however, a CVD mechanism focused on climate policies may provide an interim and targeted approach to level the playing field as global negotiations continue.

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