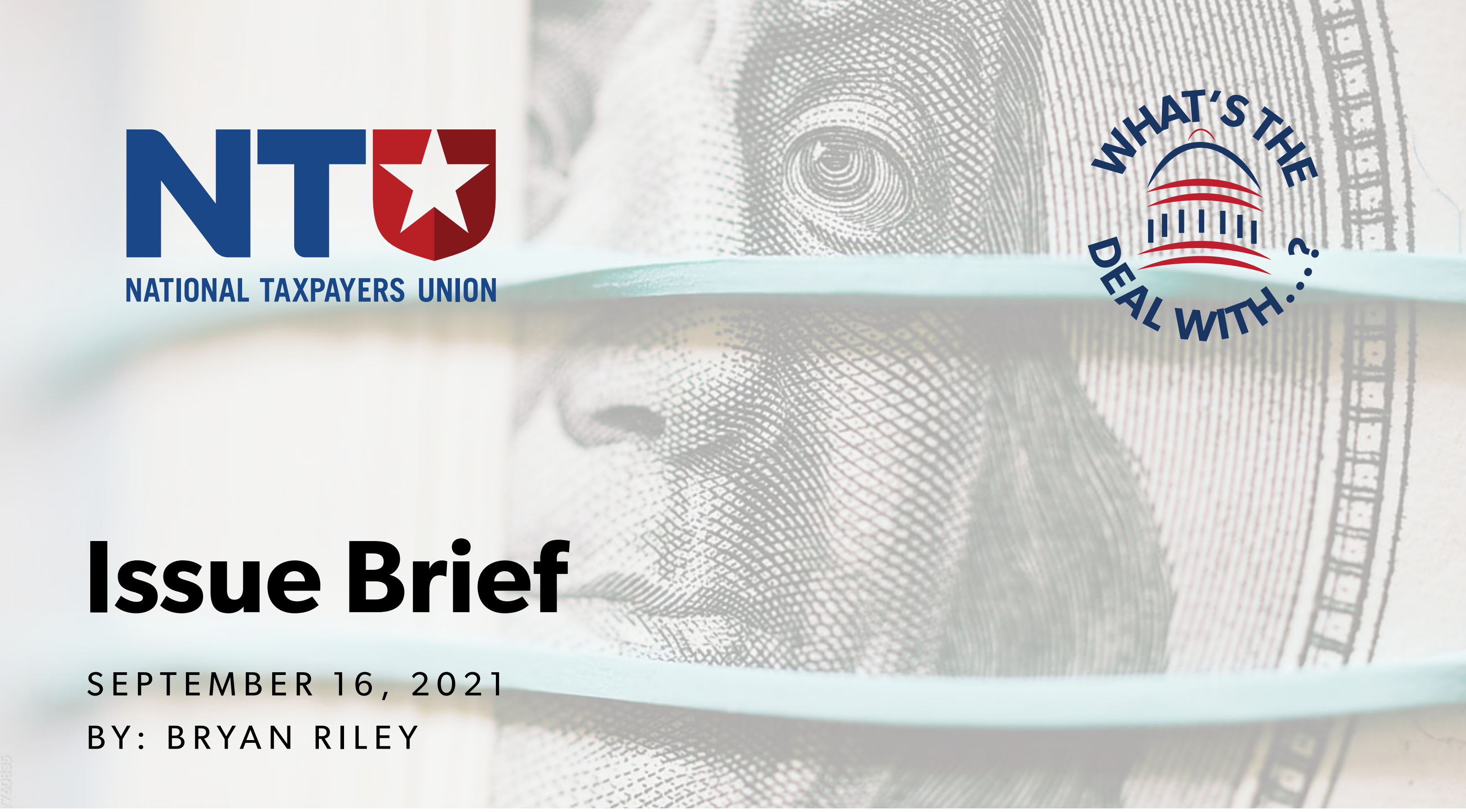

NATIONAL TAXPAYERS UNION

WHAT'S THE DEAL WITH...?

Issue Brief

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BY: BRYAN RILEY

What's the Deal with Carbon Tariffs?

As Congress considers a massive $3.5 trillion budget reconciliation bill, legislators continue to scramble to craft new tax increases to pay for (some of) it. One idea that has gained traction in recent months aims to kill three birds with one stone — raising revenue and protecting domestic manufacturing while mitigating the effects of climate change. Unfortunately, this proposal — a carbon tariff — is likely to miss all three birds and hit the American taxpayer in the wallet instead.

The most noteworthy carbon tariff proposal is the FAIR Transition and Competition Act (FAIR Act) from Sen. Chris Coons (D-DE) and Rep. Scott Peters (D-CA), which would impose a "fee" on carbon-intensive products when they reach the U.S. border.[1] As lawmakers debate whether this legislation or similar proposals belong in the budget reconciliation bill, it's worth investigating whether such a policy would accomplish any of its stated objectives.

Raising Revenue

One suggested rationale for carbon tariffs is to help pay for unprecedented levels of federal spending being considered by Congress. While every tax increase brings certain complications, tariffs are particularly harmful. They distort the economy and create incentives for special interest groups to manipulate the system for their own benefit. The FAIR Act, described by one report as being "mind-bendingly complicated," is especially problematic in this regard.[2]

The FAIR Act seeks to apply a difficult-to-measure cost of complying with U.S. environmental regulations in order to provide a comparison to carbon-intensive imports. With some exceptions, it would impose

[1] Sen. Chris Coons (D-DE) and Rep. Scott Peters (D-CA-52). "FAIR Transition and Competition Act of 2021" one-pager, July 19, 2021.
[2] Aronoff, Kate. "Does Anyone Understand the Democrats' Mind-Bendingly Complicated Carbon Tariff Bill?." *The New Republic*. July 21, 2021, p. 4.

a tariff on imports of carbon-intensive products from countries whose efforts to limit greenhouse gas emissions do not meet U.S. standards.

It is difficult to see how such a tariff would work in practice. Regulators would have to somehow calculate the domestic cost of government laws and regulations on various industries and products, and then apply an equivalent tariff to imported goods.[3] That is, as the U.S. Chamber of Commerce called it, "a Herculean task," and it opens the door to the imposition of protectionist tariffs based on ill-defined environmental justifications by the executive branch in the future.[4] If we've learned anything from the Trump administration's trade policies, it's that Congress should make it more difficult for the executive branch to unilaterally impose tariffs, not easier.[5]

Protecting Domestic Jobs

Advocates of protectionist tariffs often argue that they will protect jobs. That approach has also been adopted by advocates of carbon tariffs. For example, FAIR Act author Chris Coons said that "Imposing a BCA [Border Carbon Adjustment] will *protect U.S. jobs*, reduce global emissions, and *drive resilience in frontline communities*." (Emphasis added.)

Unfortunately, protectionist policies that are justified based on a desire to shield domestic production are likely to encourage our trading partners to retaliate with tariffs of their own. The results would be harmful both to the U.S. economy and to the global trading system, while complicating efforts to work with other countries to address common environmental goals. As a WTO working paper put it, "Potential clearly exists for friction that could both weaken climate change efforts and undermine the trading system."

In general, carbon tariffs — as opposed to more broad-based carbon taxes — violate a foundational principle of trade policy: Countries should not discriminate between domestic and imported products. This ideal is memorialized in U.S. trade agreements, including the recent U.S.-Mexico-Canada Agreement (USMCA) that was overwhelmingly approved by Congress.

This principle helps guard against the imposition of protectionist tariffs designed to benefit specific industries at the expense of Americans as a whole. It also prevents foreign countries from arbitrarily restricting imports of U.S.-made goods and services. For example, USMCA advocates specifically noted the benefits of non-discrimination for U.S. financial services firms and digital services providers.[6]

U.S. trade agreements do allow countries to pursue domestic measures to protect the environment as long as they are not protectionist in nature. According to USMCA, for example, "The Parties recognize the sovereign right of each Party to establish its own levels of domestic environmental protection and its own environmental priorities, and to establish, adopt, or modify its environmental laws and policies accordingly."[7]

The World Trade Organization (WTO) also explicitly permits countries to adopt measures necessary to protect human health, and allows for measures designed to conserve natural resources as long as such measures are made in conjunction with restrictions on domestic production or consumption.[8] However, our trade agreements leave little room for the imposition of tariffs based on a desire to "protect U.S. jobs."

[3] Lautz, Andrew. "Flawed New Carbon Tariff Bill Belongs in the Dustbin." National Taxpayers Union. August 2, 2021.
[4] U.S. Chamber of Commerce. (2021). "U.S. Chamber Feedback on the FAIR Transition and Competition Act."
[5] Swift, Nan (National Taxpayers Union Director of Federal Affairs). Letter to: Senator Bob Corker (R-TN) and Senator Pat Toomey (R-PA). National Taxpayers Union. July 10, 2018.
[6] Office of the U.S. Trade Representative. (2018). "USMCA Trade Fact Sheet: Modernizing NAFTA into a 21st Century Trade Agreement," and "USMCA Agreement, Chapter 19: Digital Trade."
[7] Office of the U.S. Trade Representative. (2018). "USMCA Chapter 24: Environment."
[8] World Trade Organization. (1994). "WTO rules and environmental policies: GATT exceptions."

Mitigating Climate Impacts

The FAIR Act and similar measures are allegedly designed to address the problem of so-called "carbon leakage," which results when production moves to foreign countries to avoid the United States's stricter environmental regulation. While this is an interesting theoretical concept, it is less of a problem in reality.

Although U.S. environmental regulations impose costs on U.S. producers, these regulations have not led to an exodus of American firms to foreign pollution havens. For example, real U.S. manufacturing output reached a record high in 2019, just before the COVID-19 pandemic arrived.[9]

Similarly, most international investment flows do not go to pollution havens. In 2019, more than half of global foreign direct investment (FDI) flows went to the 38 countries that belong to the Organization for Economic Cooperation and Development (OECD).[10] In other words, environmental regulation may be a factor in businesses' decisions on where to locate production, but it is far from the only one.

Broadly speaking, there is little evidence that carbon leakage is a particularly widespread phenomenon. A study by the Intergovernmental Panel on Climate Change concluded that carbon leakage was "unlikely to be substantial" due to other costs associated with shifting manufacturing to less developed nations, including transportation costs, market conditions, and a lack of specialized suppliers. Similarly, according to a Tax Policy Center report, "arguably the primary goal of BCAs is to address the economic and political concerns of the most vulnerable industries, not to prevent emissions leakage."[11]

And to the extent that carbon leakage is an issue, the FAIR Act would do "close to nothing" to address the problem, as David Kleimann with Georgetown University's Institute of International Economic Law points out.

Better Alternatives

A more effective way to encourage environmental progress would be for the Biden administration to commit to an Environmental Goods Agreement designed to eliminate barriers to goods ranging from wind turbines to water quality monitors.[12] And because tariffs tend to *protect* some jobs at the expense of others (often based on who's got the most political clout), it would be more effective to focus on policies designed to make it easier for companies to create jobs in the United States.

As Congress tries to scrounge up $3.5 trillion more after already exploding the national debt over the past two years, taxpayers would be right to question whether taxing and spending is the way forward at the moment. Yet regardless, tariffs that would invite retaliation, jeopardize U.S. jobs, and potentially harm environmental progress should be off the table.

About the Author

Bryan Riley is the Director of NTUF's Free Trade Initiative.

[9] Bureau of Economic Analysis. (2021). "Real Value Added by Industry."
[10] The World Bank. (2019). "Foreign direct investment, net inflows (BoP, current US$)."
[11] Morris, Adele C. "Making Border Carbon Adjustments Work in Law and Practice," Tax Policy Center, July 26, 2018.
[12] Office of the U.S. Trade Representative. (2018). "Environmental Goods Agreement."

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122 C Street NW, Suite 650, Washington, DC 20001
ntu@ntu.org