Carbon Water Tax

Anchor:

Teena Jha

Participants:

- Dr. Prodipto Ghosh, Distinguished Fellow, TERI & Former Secretary, Ministry of Environment, Forest And Climate Change.
- Dilip Sinha, Former Ambassador.

Context:

At the two-day G-20 ministerial meeting on environment and climate change in Italy, developing countries, including India, are expected to raise their concerns over the European Union's recent proposal on a first-of-its-kind carbon border tax.

Read more on the G20 in the linked article.

What is the Carbon Water Tax?

- A carbon border tax is a tax on carbon emissions imposed on imported goods from countries with less strict climate policies. It aims to create a level playing field between imports and domestic production.
- The EU Commission is pushing for the world's first carbon border tax on imported goods. It plans to levy the tax in a phased manner from 2026.
- The main purpose of the EU's proposed Carbon Border Adjustment Mechanism (CBAM) is to address "carbon leakage" when companies decamp to places with cheaper pollution costs and looser climate regulations.
- The idea behind this tax is to incentivize companies outside the European Union that is, companies that are exporting to the EU certain carbon intensive goods namely, steel, cement, fertilizers and aluminium. The EU wants these countries to adopt carbon friendly technologies and to do that, it has proposed to impose a tax on these countries' goods being exported to the EU at the border.
- The tax will be imposed through a system of digital certificates which these companies or the importer in the EU will have to buy that will reflect the amount of carbon emission that has taken place in the production of these goods.
- So, whatever is the prevailing price of carbon in the EU at that time will have to be paid part-time and the EU has an emission trading system so there is a carbon price that is already there in the EU.
- In case the exporting country already has a carbon trading system in its own country, then the exporting country can claim a rebate equal to the amount of tax that is already paid. Hence, countries with their own carbon trading system will benefit from this.

Challenges that the tax may face:

- European Union has a long history of imposing its own environmental and labour standards on other countries through unilateral action and this is one of the examples. In the private dialogues with the interlocutors, the EU is saying that it has looked at all the legal aspects of imposing this tax and this would be able to survive all the challenges in the World Trade Organization (WTO) council.

    - However, it is a very ill-disguised form of protectionism and the entire WTO system has been negotiated and agreed upon under certain unstated assumptions and among these assumptions is that there would be no large-scale disruption through unilateral action by countries and this tax is one such example of that.
    - Hence, on these grounds, the tax may face challenges and retaliation by the WTO regime and the countries and this will drive a spike through the existing world trading arrangements.

- Article 12 of the Rio Declaration clearly states that the standards applicable to the developed countries cannot be applied to developing countries. So, clearly, a unilateral uniform standard by the EU does not meet any test of reasonableness in terms of the accepted international environmental laws.

Why Carbon "adjustment" instead of "tax"?

- The term adjustment can have implications that mean the greenhouse content of these imports would also have to be adjusted in the greenhouse gas inventories of the importing countries which essentially means that greenhouse gas inventories would have to be reckoned not as of now on a point of production basis but on a point of consumption basis.
- This would actually be turning the entire existing climate change regime on its head. This has very serious implications beyond the question of the border adjustment of the water tax.

Effects on countries including India:

- For India, the EU is the second-largest buyer and currently, India has a surplus in the trading of both goods as well as in services with the European Union. So, for India, it is a market that needs to be nurtured and protected.
- As far as the developing countries are concerned regarding the impacts of carbon water tax, many of the smaller countries do not have any concerns with this at all. India should look at the exports with the EU before jumping directly into the battle especially in a multilateral forum. India is not the exporter of cement and fertilizers to the EU and on steel and aluminum, the share of India is relatively smaller than the other countries.
- The countries most badly affected will be Russia, Turkey, and China and China is also protesting against this tax. But, it must be remembered that China recently started its carbon trading system which it claims is the largest carbon trading system. So, even though China is contesting the scheme, it is also preparing for it and that's the policy China has always followed – while contesting, keep preparing for the eventuality of this happening.
- We also have to remember that the EU has a battery of lawyers and their economic commissioner has said that this tax is WTO compatible. Whether it is or it is not will go to the WTO dispute settlement mechanism which might take time to get resolved. So, if the EU decides to impose it in let's say another five years' time, then we will be badly affected by it whereas China will be able to bypass the system and get around to connecting with exports.
- India has a difficulty in meeting EU standards inside the sanitary and phytosanitary standards. If India does not get its own carbon standards and compliance mechanism in place, India would be the

worst hit even though our exports are relatively smaller than the exports of the above-mentioned countries.

What should be India's approach?

- India should look at the EU's scheme, talk to them bilaterally to ensure that the exports of India to the EU are protected through a Free Trade Agreement (FTA) or through other means.
- If there are adjustments and standards that India needs to set, then it must go ahead and do that or at least start making preparations for those.
- India doesn't have any carbon tax or carbon trading system but if the energy taxes imposed by India are converted into carbon equivalents, it would rank as very high in terms of the carbon tax.
    - India also has surrogate carbon taxes, for example, the fat mechanism which has been recognized in the Paris Agreement under Article 6.2 by which trades in these certificates can be considered as Greenhouse Gas Mechanism actions.
    - So, it means India has different mechanisms than what China and Russia have, but it does not mean that they don't exist.
- India should not be caught off guard in 2026 when this scheme comes and it should protect its national interests and its exports in an important market like the EU.

Will the tax lead to a trade war?

- If the tax is implemented, this will be a wide-ranging general tool of protectionism. So, India has to guard against that.
- If that potential arises, the global trade regime will be badly affected.

Where does India stand?

- India has a strong primary climate action plan and India's nationally determined goals to the Paris Agreement are very ambitious and importantly, India is one of the few countries which is on track to meet its goals.
- India has low greenhouse gas intensity as well, so there is no ground for complaint against it.

Is there any alternative to this tax?

- Earlier the EU had come up with this proposal but it stepped back because of protests from countries like the US and China.
- There should be a talk at the diplomatic level in the United Nations Framework Convention on Climate Change (UNFCCC) negotiations, in the WTO negotiations, and bilaterally with the European Union.
- But, India must remember that it is not the target of the EU action, the target would really be Russia and China, and perhaps to a smaller extent Turkey. So, there is no reason for India to expose itself and take bullets in its chest.

Way Forward:

- The commitment to climate action by various countries has fluctuated and the EU itself had lost interest in climate action after the global financial crisis. But now, they have come up with a bang and it has to be seen how long this enthusiasm lasts.
- The emission profile of India has always been very benign in comparison to the rest of the world. But, India should be careful about having a principle enshrined in international trade law which may be used against us in the future, maybe by the EU or by others.