Australian Government
Productivity Commission

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Carbon leakage review

Productivity Commission submission

Submission to the Department of Climate Change, Energy, the Environment and Water's *Carbon Leakage Review – Consultation Paper 2*

The Productivity Commission acknowledges the Traditional Owners of Country throughout Australia and their continuing connection to land, waters and community. We pay our respects to their Cultures, Country and Elders past and present.

The Productivity Commission

The Productivity Commission (PC) is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long-term interest of the Australian community.

The PC's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

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The Productivity Commission (PC) welcomes the opportunity to make a submission to the Department of Climate Change, Energy, the Environment and Water's Carbon Leakage Review (the Review).

The PC has considered carbon leakage and potential measures to address it in several previous reports, including in the last three *Trade and assistance reviews* (PC 2022, 2023b, 2024) and *Managing the climate transition*, volume 6 of the most recent 5-yearly productivity review (PC 2023a).

The Review is a valuable contribution to the public discussion regarding carbon leakage

Measures to reduce carbon leakage risk can be consistent with domestic and international emissions reduction and trade goals. Poorly designed or implemented measures can act as a form of trade protection and shift the burden of emissions reductions to other sectors (PC 2023b, p. 60).

In this context, the PC welcomes the Review's emphasis on maintaining open and liberal trade relationships while promoting 'economically efficient low and zero emissions industrial production as a contribution to climate change objectives' (DCCEEW 2024, p. 5).

The PC has previously observed that there are questions about the extent to which carbon leakage will occur in response to domestic climate policy, recognising the range of non-carbon price considerations that impact business location choice, the prevalence of carbon constraints globally and the measures that already address carbon leakage risk in Australia's climate policy settings (PC 2023b, pp. 59–60).

Given the need for evidence-based approaches to assessing carbon leakage risks, the Review is a valuable contribution to any government decision regarding the introduction of a border carbon adjustment (BCA) mechanism in Australia. The Review's modelling suggests that Australia's carbon leakage risks are confined to a very small number of industries and products under current policy settings, and that the risks of carbon leakage are likely to be very small, at least in the short to medium term, but that these become more significant over time.

Measures to address carbon leakage are a legitimate part of the climate policy framework

The risk of carbon leakage has been a longstanding concern for governments. The risk is that differences in the stringency of countries' climate policy will produce differences in effective carbon prices and lead to the relocation of production and investment to countries with less stringent policy. This is of most concern for emissions-intensive trade-exposed (EITE) industries, and will continue to be a concern for at least the short to medium term while there is divergence in global climate action ambition (DCCEEW 2024, pp. 15–16).

To date, Australia has sought to manage the risk of carbon leakage using blunt measures that exempt EITEs from the cost of some domestic climate policy measures or provide concessional treatment; a BCA mechanism mirroring the impact of domestic emissions policy settings would be an alternative way of addressing carbon leakage risk, at least for EITE production that is sold into the Australian market.[1] The

[1] Existing EITE protection measures relate to all production by EITE facilities, whether their output is sold into the Australian market or exported. A BCA that was imposed on imports into Australia would principally protect the competitiveness of domestic EITE facilities selling into the Australian market.

Review's modelling suggests that introducing such a mechanism would have a marginal impact on real GDP and a marginal impact on prices. For example, a 0.01% increase in the cost of an average house due to increases in the cost of concrete and steel (DCCEEW 2024, pp. 72, 78).

Introducing a BCA mechanism would make it possible to phase out trade-exposed baseline-adjusted (TEBA) concessions and expose more facilities to a consistent carbon signal without exposing them to carbon leakage risk in the Australian market. (This logic is playing out in the EU, where the introduction of the EU's Carbon Border Adjustment Mechanism is tied to the phase out of free allocations under the EU ETS.) As the Review notes, 'A border carbon adjustment for a particular sector would remove the policy basis for TEBA provisions for that sector' and there are international trade law concerns with retaining TEBA provisions in the presence of a BCA mechanism (DCCEEW 2024, pp. 11, 70).

In light of these considerations, the Review's preliminary finding that implementation of a BCA mechanism 'could' involve removing or phasing out TEBA provisions (DCCEEW 2024, p. 9) could be strengthened. If a BCA mechanism is implemented, this *should* involve phasing out or removing TEBA provisions. If the Australian Government does decide to introduce a BCA mechanism, which would be implemented over several years, these considerations should be addressed as part of the 2026-27 review of the Safeguard Mechanism. Further consideration should also be given to the need for any future extension of other policy settings, such as the Powering the Regions Fund which was partly motivated by a desire to reduce carbon leakage risks.

The Review does not recommend a BCA for export industries, and the PC broadly agrees with this approach given the range of trade and other considerations. Any future policies aimed at addressing leakage in export industries must be carefully assessed to ensure they support both trade and climate policy objectives.

Looking to global climate policy, while Australia is a small market, implementing a BCA mechanism could potentially increase other countries' incentive to implement more stringent emissions reduction policies – doing so would reduce or eliminate any BCA liabilities their businesses face when exporting to Australia. And implementing a BCA mechanism could also facilitate Australia's engagement with countries implementing or considering similar approaches, including in working towards efficient global standards and approaches.

Any BCA mechanism must not become trade protection

Measures to address carbon leakage straddle the boundary between climate and trade policy but the objective of a BCA mechanism 'should not be protection of domestic industries' (DCCEEW 2024, p. 61).

The PC has previously argued that a BCA mechanism could act more as a form of trade protection than a means of addressing carbon leakage risks where adjustments applied to imports are more than required to equalise effective carbon prices between domestic and foreign producers, or where administrative costs of complying with the mechanism raise the effective cost of imports (PC 2024, p. 44). The PC welcomes the Review's acknowledgement of these risks, and its proposals for minimising administrative burdens, including the use of appropriate default emissions intensity values. Care should be taken to ensure that default emissions factors used in any future scheme are representative of the actual emissions intensities of both domestic and foreign competition (PC 2024, p. 46).

The Review's proposed BCA mechanism would – if implemented well – create BCA liabilities only where foreign producers' effective carbon liability is lower than that facing Safeguard Mechanism facilities. Under the proposed design, this would include consideration of emissions baselines for Safeguard facilities (similar to free allocations), including the effects of lower baseline reductions for TEBA facilities. The BCA would only be applied to explicit costs faced for above-baseline emissions (net of any explicit carbon costs paid in the source country or in transit).

The Review's proposed mechanism would not, however, include consideration of fiscal support for decarbonisation like the Powering the Regions Fund. To the extent that such support reduces the cost of domestic abatement it should arguably be reflected in some sort of discount in a BCA mechanism that aims to mirror domestic policy settings. Interactions between fiscal support for decarbonisation and a BCA mechanism would need to be carefully considered to ensure it does not act as a form of trade protection. Over time a BCA should facilitate the phasing out of fiscal support aimed at addressing carbon leakage.

Any BCA mechanism would be monitored annually by the PC and should be reviewed every five years

For 50 years, the PC has monitored and reported on industry assistance through the *Trade and Assistance Review* (TAR). Over that period there have been large reductions in trade barriers, most obviously in 'at the border' measures like quotas and tariffs. This reduction in at-the-border policy measures has been partially offset by 'behind-the-border' measures like tax concessions, budget spending on favoured sectors, local content rules, and concessional finance in Australia's industry assistance mechanisms.

The PC would include any future BCA mechanism in its annual TAR reporting. This would be in keeping with the PC's obligations under s. 10 of the *Productivity Commission Act 1998* (Cth) to annually report on assistance and regulations affecting industry. The PC's ongoing monitoring of any BCA mechanism would also focus on whether the mechanism, in practice, adjusts (increases) the cost of imports more than is consistent with mirroring domestic policy settings.

In addition to this regular monitoring, any BCA mechanism should be subject to a broader review after introduction. This review would need to consider its implementation, cost effectiveness and its ongoing achievement of policy goals, and be undertaken on an independent basis. This would also be an opportunity to consider the measure's ongoing consistency with both trade and emissions reduction policy, including in light of policy developments in our trading partners.

References

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