

Carbon pricing and industrial competitiveness: Border adjustment or free allocation?

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Abstract

To mitigate concerns about carbon leakage and industrial competitiveness, cap-and-trade systems have typically relied on the free allocation of carbon allowances to trade-exposed sectors. The European Union's Green Deal raises the prospect of free allocation being replaced by a carbon border adjustment mechanism (CBAM) on imported products. This paper provides a simple framework to analyze the competitiveness support provided by these policy instruments. It shows how the rate of carbon leakage can be a "sufficient statistic" to determine the output and profit impacts of the switch to a CBAM. High-leakage sectors will prefer the CBAM while low-leakage sectors will prefer free allocation.

Keywords: Cap-and-trade, carbon border adjustment, carbon leakage, industrial competitiveness

JEL codes: H23 (externalities), L11 (market structure), Q54 (environmental policy)

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