The Theory of Carbon Leakage
Simone Borghesi (European University Institute)

Unilateral policies may provoke carbon leakage ie delocalization of polluting production

Little evidence so far but carbon prices were low.

More carbon leakage can be expected if carbon prices are to rise to achieve climate neutrality by 2050 (EU, UK, NZ, CAL.....)

How to safeguard international competitiveness? **Free allowance allocation**, **linking** with other ETSs and **border carbon adjustments** all offer options for this purpose

1) On free allocation, most ETS have carbon leakage provisions

If provisions too low firms delocalize, if too high no incentive to abate

What is the optimal level of free allocation? **Game theoretical model** in which firms' decision on whether to delocalize is also affected by what other firms decide to do.

2) On linking, how to align various ETSs? LIFE DICET

What is the maximum price differential for prospective linking? What is the maximum size differential? Which are the features preventing linking (e.g. absolute vs relative cap)? Strong **strategic component** ("Getting married (and divorced")

3) On border carbon adjustments, how to implement it? Possible time and **retaliation problems.** Avoid trade wars and beggar-thy-neighbour policies