

## **EU Monitor**

The Carbon Border Adjustment  
Mechanism (CBAM) and its effects on  
trade with third countries

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# Summary

In the wake of the climate emergency as declared by the European Parliament in 2019, the EU has developed a reputation as being a global leader in the mitigation of climate change. The European Green Deal, adopted by the Parliament in January 2020, outlines a range of policy measures with the aim of making Europe carbon neutral by 2050. With the EU as a bloc possessing the third largest economy in the world in purchasing power parity, the Union has identified trade as a key area in which climate action is most prudent. Trade with third countries is the major component of the EU’s foreign policy, serving as a critical economic, diplomatic and geopolitical tool. As such, the EU is eager to green this area of its activity via a host of policies, one such being the Carbon Border Adjustment Mechanism (CBAM).

Serving essentially as a form of carbon tax on goods imported into the EU, the CBAM aims to instigate more climate friendly production of goods in third countries. In simple terms, the CBAM would, as an incentive for global action against climate change, tax goods imported from countries with less ambitious climate policies.

The CBAM’s intentions are noble and consistent with the EU’s leading role in global climate change mitigation. Similar policies are implemented in other parts of the world with other G7 countries in Japan and Canada developing comparable initiatives. However, implications for trade with third countries remain an area of contention of the CBAM, legal and otherwise. This paper aims to give an overview of the development and aims of the CBAM, its areas of legal and political controversy, how it has been received, and what effect it might have on trade with third countries. The paper then offers some ideas on how best the EU should proceed with the implementation of the CBAM.



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## Overview and development of the CBAM

The idea of a CBAM was proposed on 11 December 2019 during an EU discussion on the European Green Deal. Commissioner-designate for Trade Phil Hogan noted that should there be continuing disparity in the levels of climate action between the EU and its trade partners, a mechanism would be adopted “to reduce the risk of carbon leakage”. This mechanism is known as the CBAM.<sup>1</sup>

In fact, the CBAM is a supplementary measure to the existing EU emissions trading system (EU ETS), which caps emissions from Member States’ “heavy energy using installations”.<sup>2</sup> The EU ETS aims to help Europe deliver on its 2030 emissions reduction target of 55%. There are a couple of shortcomings of the EU ETS, most notably that it only tackles emissions generated from industry within Europe. The EU has also self-highlighted how the ETS also does little in the way of incentivising investment in green production not just abroad, but also in Europe.<sup>3</sup> Given this introspective scope, companies have been and continue to find loopholes in the EU ETS. The obvious concern of the EU lies in the ability of businesses to move their production offshore to countries with less climate regulation in an attempt to bypass the EU’s more strenuous climate mitigating measures applying to production. Commissioner-designate for Trade Phil Hogan defined this problem as “carbon leakage”, and highlighted the problem as the key impetus for the CBAM.

On September 30, 2020, following the CBAM’s proposal and multiple assessments of its impact, the European Roundtable on Climate Change and Sustainable Transition outlined four objectives of the policy via a paper titled *Border Carbon Adjustments in the EU Issues and Options*. The paper stated CBAM would contribute to:

- “(1) Limiting emissions leakage;
- (2) Protecting against reduced competitiveness of domestic industries;
- (3) Incentivising foreign trade partners and foreign producers to adopt measures comparable/equivalent to the EU’s; and
- (4) Yielding revenue that can be used to fund investments in clean technology innovation and infrastructure modernisation or as international climate finance.”<sup>4</sup>

In February 2021, the EU Committee on Environment, Public Health and Food Safety passed with overwhelming support a resolution on a CBAM it viewed as compatible with the World Trade Organisation (WTO) regulations.<sup>5</sup> The European Parliament adopted the resolution on 8 May 2021, once again with strong support.<sup>6</sup> The resolution highlighted the fact that while emissions produced in Europe have substantially declined, emissions related to imported goods remain steadily rising, further pointing out the EU’s need to address carbon emissions outside of its borders.<sup>7</sup>

The European Commission is completed its CBAM proposal in July 2021. The CBAM’s structure is largely the same as earlier proposals, however there are some notable changes vis-à-vis the framework

<sup>1</sup> [https://www.europarl.europa.eu/doceo/document/E-9-2019-004445-ASW\\_EN.html](https://www.europarl.europa.eu/doceo/document/E-9-2019-004445-ASW_EN.html)

<sup>2</sup> [https://ec.europa.eu/clima/policies/ets\\_en](https://ec.europa.eu/clima/policies/ets_en)

<sup>3</sup> [https://ec.europa.eu/commission/presscorner/detail/en/qanda\\_21\\_3661](https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661)

<sup>4</sup> <https://ercst.org/border-carbon-adjustments-in-the-eu-issues-and-options/>

<sup>5</sup> <https://www.europarl.europa.eu/news/en/press-room/20210201IPR96812/carbon-levy-on-eu-imports-needed-to-raise-global-climate-ambition>

<sup>6</sup> <https://www.europarl.europa.eu/news/en/press-room/20210304IPR99208/meps-put-a-carbon-price-on-certain-eu-imports-to-raise-global-climate-ambition>

<sup>7</sup> <https://www.pinsentmasons.com/out-law/news/european-parliament-backs-carbon-border-adjustment-mechanism#:~:text=European%20Parliament%20backs%20carb on%20border%20adjustment%20mechanism,- Out%2DLaw%20News&text=The%20European%20Parliament %20has%20adopted,less%20climate%20Dambitious%20countrie s%22.>



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for the policy's implementation and the periods of transition to be afforded by the Commission.<sup>8</sup> The CBAM will initially only target the worst offending sectors of steel, iron, aluminium, fertilisers, electricity and cement.<sup>9</sup> The EU have proposed a transitional period from 1 January 2023 to 31 December 2025, after which the CBAM comes into full force. During this time, producers will be gathering data on their carbon emissions to submit to national climate authorities. While they will not be subject to a carbon tax under the CBAM during the transition phase, they will be taxed according to default values based on EU producers' averages for the same industries.<sup>10</sup>

The EU will not be responsible for collecting and monitoring emissions data. The actual monitoring of third countries emissions arising as a result of production remains with their respective national climate authorities. From here, those who want to export their goods to the EU can purchase 'CBAM certificates' at a price consistent with what European producers must also pay. The price varies given it is dictated by the carbon intensity in the product. The certificates serve as the carbon tax. Upon the good's import to the EU, the CBAM certificates are surrendered.<sup>11</sup>

While in principle the CBAM applies to all imports from non-EU countries, a handful of third-countries are exempt. Those to which the CBAM will not apply are those countries already participating in the EU ETS (e.g. Switzerland and Norway) or have an emissions trading system of similar nature that is connected to the EU's.<sup>12</sup>

The next steps in the CBAM's rollout involve the EU Parliament and the Council of the European Union. These bodies, in consultation with civil society and other trade stakeholders, will review and modify the CBAM's structure and implementation.

## Legality and controversy

The CBAM, like any trade policy, must comply with the rules set out by the WTO's General Agreement on Tariffs and Trade (GATT). In its current proposed form, there are questions around the CBAM's compliance with the WTO's "non-discrimination" principle. For example, if the EU were to separate the same or similar products whose production differs in carbon levels; the EU could then find itself in a legal hitch under the GATT's most favoured nation (MFN) principle.

However, exceptions to the non-discrimination principle for environmental purposes are made possible under the GATT, yet there is a strict framework for compliance when granting such exceptions.<sup>13</sup> It is not always, however, black and white when interpreting the WTO's compliance frameworks, as was pointed out in a study from Charles River Associates indicates that "different interpretations" are possible with regards to WTO compliance.<sup>14</sup>

Despite the murky realm of WTO compliance, Charles River Associates suggest ways in which the EU could improve their chances of avoiding legal trouble. Their study suggests that in order for the CBAM to be compliant with the WTO, the EU must:

<sup>8</sup> <https://www.mayerbrown.com/en/perspectives-events/publications/2021/07/european-commission-presents-proposal-for-carbon-border-adjustment-mechanism-cbam>

<sup>9</sup> [https://ec.europa.eu/commission/presscorner/detail/en/qanda\\_21\\_3661](https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661)

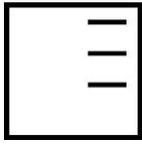
<sup>10</sup> European Commission. (2021). *Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism* (COM(2021) 564 final). European Commission.

<sup>11</sup> [https://ec.europa.eu/info/sites/default/files/carbon\\_border\\_adjustment\\_mechanism\\_0.pdf](https://ec.europa.eu/info/sites/default/files/carbon_border_adjustment_mechanism_0.pdf)

<sup>12</sup> [https://ec.europa.eu/commission/presscorner/detail/en/qanda\\_21\\_3661](https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661)

<sup>13</sup> <https://www.cleanenergywire.org/factsheets/emission-reduction-panacea-or-recipe-trade-war-eus-carbon-border-tax-debate>

<sup>14</sup> <https://media.crai.com/wp-content/uploads/2020/09/16164525/Implications-of-CBAM-Initial-Views-0520.pdf>



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- Focus solely on industries with a high risk of carbon leakage;
- Treat imports in a manner no less favourable than that enjoyed by domestic producers;
- “Avoid discriminating between different countries of origin”;
- Set benchmarks (e.g. average carbon emission performance) in order to ascertain what level of tax is to be applied.<sup>15</sup>

In order to avoid potential clashes with the WTO and the MFN principle, the EU’s July 2021 proposal outlines that third countries can apply for exemption from the CBAM should they possess a carbon pricing mechanism of comparable scope.<sup>16</sup>

Obvious controversy is that compliance with such an ambitious policy is reserved for developed economies. The CBAM would hurt developing countries, particularly those in Africa who are dependent on trade with the EU and whose products exported are predominately carbon intensive.<sup>17</sup> Looking to the medium to long term, Africa possesses an abundance of potential for producing climate friendly hydrogen at a relatively cheap cost. The EU itself has already identified its own shortcomings in this capacity and understands that the continents demand for cheap green hydrogen will grow. As such, it will be important for the EU not to hamper developing economies in Africa and elsewhere so that they can achieve their potential to become green in the future.<sup>18</sup> The EU could look to better stimulate green economic growth in African markets via a range of methods. More comprehensive dialogue with the African Union resulting in tangible outcomes is one such measure.

Another avenue could be greater levels of EU investment into Africa’s sustainable energy transition and circular economy with improved guidance and monitoring frameworks.<sup>19</sup> These are challenging tasks but certainly feasible given the wealth of experience the EU has in promoting and monitoring reform in its neighbourhood.

The EU understandably wants to tow a consistent line, however some compromise may be necessary for developing countries. Given that these states do not yet always have the luxury of imposing ambitious climate policies, given their low GDPs, greater trade liberalisation in the short to medium term with these types of states could be the remedy. Moreover, the EU might consider allocating to developing countries some of the revenue generated from the CBAM to assist in their own green transition.<sup>20</sup> Alternatively, the EU might even consider completely exempting developing countries, or at least those with whom it trades heavily, from the CBAM. There is legal precedent for such discrimination in favour of developing countries. The EU already harnesses the flexibility afforded on the WTO’s ‘enabling clause’ so that developing countries gain special access to its markets.<sup>21</sup>

The sectors to be most affected by the CBAM include iron, steel, cement and petroleum. Other industries to be significantly hampered include aluminium, chemicals, fertilisers and industrial gases.<sup>22</sup> Certain countries, including major economic powers, are substantial producers of the aforementioned products, thus the reception of their governments to the prospect of a carbon tariff has

<sup>15</sup> <https://media.crai.com/wp-content/uploads/2020/09/16164525/Implications-of-CBAM-Initial-Views-0520.pdf>

<sup>16</sup> <https://www.mayerbrown.com/en/perspectives-events/publications/2021/07/european-commission-presents-proposal-for-carbon-border-adjustment-mechanism-cbam>

<sup>17</sup> <https://www.forbes.com/sites/tilakdoshi/2021/04/05/belong-to-the-climate-club-or-get-penalized-the-eus-new-trade-protectionism/>

<sup>18</sup> [https://www.eulerhermes.com/en\\_global/news-insights/economic-insights/EU-Climate-policy-goes-global-Introducing-a-Carbon-Border-Adjustment-Mechanism.html](https://www.eulerhermes.com/en_global/news-insights/economic-insights/EU-Climate-policy-goes-global-Introducing-a-Carbon-Border-Adjustment-Mechanism.html)

<sup>19</sup> <https://ettg.eu/wp-content/uploads/2021/04/ETTg-paper-22Green-Transitions-in-Africa-Europe-relations22-pdf.pdf>

<sup>20</sup> <https://unctad.org/news/eu-should-consider-trade-impacts-new-climate-change-mechanism>

<sup>21</sup> <https://www.cer.eu/publications/archive/policy-brief/2021/eus-carbon-border-adjustment-mechanism-how-make-it-work>

<sup>22</sup> [https://www.eulerhermes.com/en\\_global/news-insights/economic-insights/EU-Climate-policy-goes-global-Introducing-a-Carbon-Border-Adjustment-Mechanism.html](https://www.eulerhermes.com/en_global/news-insights/economic-insights/EU-Climate-policy-goes-global-Introducing-a-Carbon-Border-Adjustment-Mechanism.html)



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been mostly negative. The industry representatives of these sectors have themselves had mixed reactions.<sup>23</sup>

## Reception and implications for third countries

The EU, a champion of free trade (at least on paper), is no stranger to being labelled protectionist. This is in large part due to its restrictive agricultural trade policies, which have been negatively received and fiercely criticised among countries with which the EU has or is negotiating FTAs.

Many third countries have expressed their concern as what they see as a drastic measure. The US, Europe's second largest trading partner and a major exporter of carbon intensive products, has expressed hesitation toward the CBAM. US President Joe Biden's climate envoy, John Kerry, noted that the CBAM ought to remain a "last resort", and requested that the EU refrain from its implementation until more comprehensive discussions can be held on the matter at the forthcoming COP26 climate change conference in November 2021.<sup>24</sup> The US appears to be on a more ambitious climate trajectory under the Biden administration. Indeed, attitudes toward the EU carbon tax seem to be modestly shifting following the CBAM proposal in July 2021. US lawmakers have expressed their interest in pursuing a similar measure in the form of a "polluter import fee".<sup>25</sup>

Many countries in the Asia-Pacific have also expressed their opposition or apprehension to the CBAM. China, the EU's number one trading partner,

has shifted somewhat in its rhetoric toward the policy. In a similar vein to the US, China initially showed hesitation, imploring the EU to engage in more discussion as to the policy's nature and potential impact. More recently in April 2021, China labelled the EU's proposal as an "excuse for geopolitics" according to Chinese state media.<sup>26</sup> Indeed, the EU's trading relationship with China is by no means straightforward. While China is certainly a pioneer on the green technology front, its recent actions such as its coal expansion suggest its picky approach to climate policy.<sup>27</sup> Beijing's rhetoric has become predictable when policies are unfavourable, often labelling similar actions in this vein of language. Moreover, the comments are made in, among other things, the context over the EU's expressed concerns of human rights violations in Xinjiang and the stalling of the EU-China investment deal. Thus, China has several qualms on the trade front vis a vis the EU and its reaction to the CBAM proposal ought to be considered in this context.

The United Kingdom as the EU's third largest trading partner is also set to be affected by the CBAM. A recent seceder from the EU, estimations suggest that the UK can expect something in the realm of US\$1.4 billion of extra taxes be applied to their exports to Europe under a new carbon tariff.<sup>28</sup> The UK's steel and plastic sectors naturally will bear the brunt of the taxes. The UK is considering its own carbon pricing mechanism, and as such it could become exempt from the EU's CBAM.<sup>29</sup>

The country set to be most affected by the CBAM is Russia, whose exports to the EU are both

<sup>23</sup> <https://www.economist.com/business/2021/08/07/the-eus-proposed-carbon-tariff-gets-a-mixed-reaction-from-industry>

<sup>24</sup> <https://www.pinsentmasons.com/out-law/news/european-parliament-backs-carbon-border-adjustment-mechanism#:~:text=European%20Parliament%20backs%20carbon%20border%20adjustment%20mechanism,-Out%2DLaw%20News&text=The%20European%20Parliament%20has%20adopted,less%20climate%2Dambitious%20countries%22.>

<sup>25</sup> <https://www.euractiv.com/section/energy-environment/news/us-lawmakers-push-carbon-border-tariff-similar-to-eus-cbam/>

<sup>26</sup> [http://www.xinhuanet.com/politics/leaders/2021-04/16/c\\_1127339605.htm](http://www.xinhuanet.com/politics/leaders/2021-04/16/c_1127339605.htm)

<sup>27</sup> <https://www.csis.org/east-green-chinas-global-leadership-renewable-energy>

<sup>28</sup> [https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2021/04/What-does-an-EU-Carbon-Border-Adjustment-Mechanism-mean-for-the-UK\\_FULL-REPORT.pdf](https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2021/04/What-does-an-EU-Carbon-Border-Adjustment-Mechanism-mean-for-the-UK_FULL-REPORT.pdf)

<sup>29</sup> <http://sdg.iisd.org/commentary/guest-articles/an-eu-carbon-border-adjustment-mechanism-can-it-make-global-trade-greener-while-respecting-wto-rules/>



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considerable and almost exclusively carbon intensive. Russia is Europe's number one supplier of carbon concentrated goods and it does not have its own domestic carbon tax nor an emissions trading scheme. Russian foreign ministry representatives have voiced their opposition to what they see as a policy serving Europe's economic interests instead of its proposed climate mitigation.<sup>30</sup> Russia is set to face hefty amounts of additional tariffs on top of wide-ranging economic sanctions imposed following its aggressive behaviour toward Europe and the European neighbourhood.

The CBAM has also had mixed receptions within Europe. Some Member States, notably Denmark and the Netherlands, identify that such a policy would lead to negative blowback due potential perception of it as a protectionist measure. Many within the EU are also under no illusion of the potential retaliatory measures as a result of the CBAM's implementation, although there is a lack of consensus on this with France and Finland highlighting it as essential to the rollout of the European Green Deal.<sup>31</sup>

## The path ahead for the EU

The CBAM will face challenges in its rollout. Member States first need to agree on how exactly to measure complex nature of third countries' industry emissions. The EU has said that the scheme will be in force by the end of 2022.<sup>32</sup> However, such deliberation within the EU typically takes years, so the EU expects the CBAM to not become fully operational until 2026.<sup>33</sup> Production chains are notoriously difficult to break down, thus the EU will have its hands full analysing this and developing a fair framework respective to each countries' industry with which the EU trades.<sup>34</sup> With that in mind, there is a good argument to send ambitious signals to the rest of the world in relation to climate policy. The

current upheaval in production and supply chains might present as opportune time as ever to chart a new path.

Balancing the EU's well-established reputation as a climate leader, and implementing the CBAM will be a pertinent development. The EU must understand in which areas and with which third countries it comes from a position of strength, notably Turkey, Russia and India – all of whom rely heavily on carbon intensive exports to the EU. Of course, this is a double-edged sword as the EU for the moment remains reliant on these imports. Getting its trade balance right and ensuring its supply chains are of chief importance to the EU. The prospect here is a little brighter as the EU is well known for its gumption during economic negotiations, especially following the Brexit negotiations wherein the EU was able to secure virtually all of which it set out to achieve.

As was aforementioned, the EU must convince the WTO that the CBAM can be excluded from the MFN principle. To improving the CBAM's legal standing in the eyes of the WTO, one suggestion has been to ensure that the revenue generated from the tax goes directly to the EU's efforts to mitigate climate change.<sup>35</sup>

This is all of course being discussed in the context of the EU's response to the COVID-19 pandemic. The EU is heavily reliant on countries such as India for the production of vaccines. Given the difficulties experienced during the EU's vaccination rollout, further blows to this effort potentially resulting from a retaliatory measure from a vaccine supplying country would be problematic to say the least,

<sup>30</sup> <https://www.ft.com/content/0fc621d1-675c-4768-814e-5863b172dd62>

<sup>31</sup> <https://ecfr.eu/publication/europes-green-moment-how-to-meet-the-climate-challenge/>

<sup>32</sup> <https://www.bloomberg.com/news/articles/2021-04-09/how-to-understand-the-eu-s-carbon-import-levy>

<sup>33</sup> [https://ec.europa.eu/commission/presscorner/detail/en/qanda\\_21\\_3661](https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661)

<sup>34</sup> <https://ecfr.eu/publication/europes-green-moment-how-to-meet-the-climate-challenge/>

<sup>35</sup> <https://www.cleanenergywire.org/factsheets/emission-reduction-panacea-or-recipe-trade-war-eus-carbon-border-tax-debate>



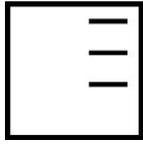
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especially so if booster shots are required into the future.<sup>36</sup>

The CBAM may not yet materialise, at least not in its current proposed form. It appears the EU will only apply it to a handful of industries for the short to medium term. It will certainly not be received favourably by all governments and industry around the world and this will something the EU will have to navigate. Nonetheless, what the CBAM does provide is not just a strong policy response to climate change, but an important symbolic, normative, and innovative step in the battle to mitigate carbon emissions.

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<sup>36</sup> <https://www.euronews.com/2021/04/29/europe-should-stop-waiting-for-the-u-s-on-climate-it-should-lead-view>



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