Carbon pricing and international trade: the EU CBAM

The green transition is a compelling challenge for all countries in the world. Among its several efforts, the EU has adopted an internal system to price and trade carbon emissions. The recent attempt to extend this mechanism to all imports to the EU has provoked discontent and posed interesting questions in the fields of geopolitics, international trade and green policymaking.

The EU ETS

In 2005 the European Union introduced the first emissions trading system (ETS), with the aim to reduce carbon emissions over time "in a cost-effective and economically efficient manner"[1]. The system is based on a "cap and trade" principle. This means that the overall amount of greenhouse gasses (GHG) that firms operating in a given sector and situated in EU Member States can release in the atmosphere is capped. The cap is expressed in terms of tonnes of carbon dioxide equivalent (CO2eq) and represents the number of emission allowances (with each allowance giving right to emit one tonne of CO2eq) that countries make available to firms over a given time period. Allowances are usually sold in auctions, allowing Member States to raise funds to support the green transition. Nevertheless, they can also be granted for free under some conditions, so as to discourage companies from moving to countries with less stringent green policies, where they would pollute more (a phenomenon known as "carbon leakage"). Finally, allowances can be traded among undertakings: companies that don't exhaust their reserve of allowances can sell the spare allowances or keep them for future usage.

The sectors that fall under the scope of the EU ETS are: 1) electricity and heat generation; 2) industrial manufacturing; 3) aviation (since 2012); 4) maritime transport (since 2024). The expansion of the scope of the system signals the intention of the European legislator to make emissions regulation stricter. Indeed, the system has undergone several reforms in this direction. In particular, the 2023 reform of the ETS Directive was prompted by the European Climate Law, establishing by law the goal for the EU to become carbon-neutral by 2050 and a medium-term goal of reducing its emissions by at least 55%, compared to 1990 levels, by 2030. This reform – part of "Fit for 55", the larger set of proposals revising EU climate and energy policy - added maritime transport to the list of sectors that must comply, tightened the emissions cap, reduced the number of allowances allocated for free (terminating the issuance of free allowances for the aviation sector by 2026) and introduced the Carbon Border Adjustment Mechanism (CBAM).

The CBAM

The aim of the Carbon Border Adjustment Mechanism is to "ensure the carbon price of imports is equivalent to the carbon price of domestic production"[2]. Indeed, while the EU ETS applies for all undertakings producing in the Union's Member States, it does not extend beyond EU borders. This leaves room also for a different form of carbon leakage: European companies might choose to switch from more expensive EU suppliers to cheaper non-EU ones, as the latter are subject to no or less stringent carbon pricing system. As a matter of fact, several countries around the world have adopted some kind of emissions trading mechanism which, however, are less costly than the European ETS. The CBAM's goal is to level the playing field for EU manufacturers, imposing a fair price on the carbon emitted while producing certain goods - cement, iron and steel, aluminium, fertilisers and hydrogen – which, beyond being carbon intensive, are highly exposed to the risk carbon leakage. In the first phase, companies importing goods listed above will just have to report the GHG emissions related to those goods. In the second phase (starting 2026), importers will have to buy certificates (equivalent to the ETS allowances) by an amount corresponding to the emissions released during production. Although the price of CBAM certificates will reproduce the price of ETS allowances, there will not be an upper limit to the number of certificates issued. Moreover, in order

[1] EUR-Lex - 02003L0087-20230605 - EN - EUR-Lex
[2] Carbon Border Adjustment Mechanism - European Commission

to guarantee "no less favourable treatment" than EU products, imported goods will see the effective carbon prices paid outside the EU (in foreign emissions trading mechanisms) deducted from the adjustment[3].

Fair game?

Economists largely agree on the need for carbon pricing systems. Evidence that also many policymakers do is the spread that such mechanisms witnessed in the last two decades, being now implemented in tens of countries around the world. The Carbon Border Adjustment Mechanism complements the EU ETS by ensuring that, as free allowances are permanently phased out in 2026, domestic producers are not at a disadvantage relative to foreign (possibly more polluting) producers, while trying to trigger follow-up reactions in other countries, incentivised to set up their own emission trading mechanisms. Nevertheless, the European CBAM is far from uncontroversial and several critiques have been raised. Nirmala Sitharaman, India's finance minister, stated that this initiative is a trade barrier that will "stifle" industrialising countries and hamper their green transition[4]. Indeed, non-African middle-income countries – like China, Russia, India, Ukraine and Turkey – are among the main exporters to the EU in the 5 sectors initially falling under the scope of the CBAM and would be the most affected by it[5].

Additionally, significant concerns are due to the fate of least developed countries (LDCs). A study by The African Climate Foundation and the LSE found that Africa would be the most-negatively affected of the major world's regions, since the CBAM could cause significant reductions in exports from the continent to the EU, resulting in lower revenues. Although some exports could be redirected to other buyers (like China and India), consequences would still be sizable: the estimated drop in African GDP is of 0.5%. Africa's greater exposure is due to the fact that: i) its production of several relevant exports is more carbon intensive than in other countries; ii) the EU is a major export market for the continent, including for the CBAM-targeted goods[6]. Nevertheless, the EU has not committed to redress this issue yet. Despite being proposed by the European Parliament, the idea to direct the revenues of the CBAM to finance LDCs' decarbonisation was not backed by the Council of Ministers and was eventually dropped. Moreover, being the CBAM about goods, not countries, no exemption is granted to LDCs. This constitutes a notable deviation from the "Everything but Arms" (EBA) scheme, which provides for the discharge of tariffs and quotas for goods imported in the EU by LDCs, excluding arms and ammunition.

Even though motivated by the urgency of the matter, the CBAM is a unilateral measure that breaks with the UN principle of multilateralism, and some countries have voiced complaints about the policy for being supposedly in breach of the rules of the World Trade Organisation (WTO). The WTO is based on non-discrimination and mandates the equal treatment of all trading partners. To the extent that it applies only to imports to the EU, the CBAM might be found non-compliant with WTO's norms. Yet, policymakers in Brussels believe that this might not be the case, since the same carbon price would apply both to domestic and foreign goods[7].

Finally, under the Paris Agreement, rich countries should contribute more to global decarbonisation efforts. In fact, the CBAM risks to overturn this logic, as it imposes the same carbon emissions price to all goods,

[3] Q&A, Carbon Border Adjustment Mechanism (CBAM), European Commission 013fa763-5dce-4726-a204-69fec04d5ce2_en
[4] India denounces 'stifling' EU carbon tax on imports
[5] An EU Tax on African Carbon – Assessing the Impact and Ways Forward | Center For Global Development
[6] Implication for African countries of a carbon border adjustment mechanism in the EU, African Climate Foundation and LSE 800756-AFC-Implications-for-Africa-of-a-CBAM-in-the-EU-06A-FINAL.pdf
[7] The EU's Carbon Border Tax: How Can Developing Countries Respond? | Center For Global Development

irrespective of the origin. According to critics, European producers should instead pay a higher price, as they have already consumed more of the world's "carbon budget"[8].

Conclusion

Summarising, one of the EU's flagship initiatives to contrast the climate crisis is the ETS, a mechanism to price carbon emissions based on a "cap and trade" principle. So as to prevent "carbon leakage", particularly since free allowances are being phased out, the EU has recently adopted the CBAM, requiring imported goods to pay the same price for the carbon emissions they are responsible for as the one faced by European undertakings. Although this measure allows European producers to breathe a sigh of relief, it has attracted substantial opposition. Indeed, both middle-income industrialising countries and LDCs will likely bear the brunt of the new policy, which runs against some established principles that the EU has been following in the area of international trade. Nonetheless, different options are on the table of European policymakers to try to address the concerns. The letter of the CBAM legislation specifies that the EU is committed to "support climate mitigation and adaptation in low- and middle-income countries" and a way to do that could be to increase the Union's climate finance contributions. [9]. Whatever the means, action by the EU will probably be necessary to make sure that also less developed countries will be able to grow and to achieve their carbon emissions targets.

References:

What is the EU ETS? - European Commission

European Climate Law - European Commission

Reducing carbon emissions: EU targets and policies | Topics | European Parliament

Visualised: how all of G20 is missing climate goals — but some nations are closer than others | Greenhouse gas emissions | The Guardian

The path to global carbon pricing

The EU's Carbon Border Tax: How Can Developing Countries Respond? | Center For Global Development

EUR-Lex - 02003L0087-20230605 - EN - EUR-Lex

Carbon Border Adjustment Mechanism - European Commission

Q&A, Carbon Border Adjustment Mechanism (CBAM), European Commission 013fa763-5dce-4726-a204-69fec04d5ce2_en

India denounces 'stifling' EU carbon tax on imports

An EU Tax on African Carbon – Assessing the Impact and Ways Forward | Center For Global Development

[8] Europe's green trade restrictions are infuriating poor countries

[9] The EU's Carbon Border Tax: How Can Developing Countries Respond? | Center For Global Development

Implication for African countries of a carbon border adjustment mechanism in the EU, African Climate Foundation and LSE 800756-AFC-Implications-for-Africa-of-a-CBAM-in-the-EU-06A-FINAL.pdf

Europe's green trade restrictions are infuriating poor countries