

POLICY

BRIEF

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A WAY FORWARD FOR A CARBON BORDER ADJUSTMENT MECHANISM BY THE EU

EXECUTIVE SUMMARY

In the context of raising its climate ambition, Europe is thinking of introducing a Carbon Border Adjustment Mechanism (CBAM) on imports. This would be to forestall carbon leakage, whereby European production relocates outside Europe, and is intended to encourage other countries to follow Europe's lead and raise climate ambition. How this CBAM would work is as yet unclear, although there is a clear wish for the measure to be compatible with World Trade Organisation (WTO) rules. The purpose of CBAM is not to help, nor protect, European industry beyond preventing carbon leakage. In this Policy Brief, the authors make seven clear and pragmatic recommendations on the implementation of this measure if Europe decides to go ahead with it. Misunderstandings are already arising, partly as a result of the declared use of revenues raised. As so often in policymaking, there are trade-offs to be made, and one of the primary recommendations is to engage early with international partners and explore the possibility of acting in unison with others who share the goal of raising climate ambition and are also concerned about potential carbon leakage. A gradual start for the CBAM is also recommended in order to capture the benefits of learning-by-doing.

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INTRODUCTION

The EU has decided politically to establish a ‘Carbon Border Adjustment Mechanism’ (CBAM) as of 2023.¹ However, to date no clear view has emerged of what it may look like in practice. In September 2020, European Commission President von der Leyen stated in her [State of the Union speech](#) that the EU “will work for a just globalisation” and that “this Carbon Border Adjustment Mechanism should motivate foreign producers and EU importers to reduce their carbon emissions, while ensuring that we level the playing field in a WTO-compatible way.” At the same time, she expressed the intention to “form high ambition coalitions” at international level.

This indicates that the EU is looking for a new way of conducting international cooperation in a rapidly changing global context that would be respectful of the existing international order, both in the field of climate and trade, but be distinct from it. It is not about setting other climate goals from those enshrined in the Paris Agreement, but about a better implementation of these climate commitments by all countries, allowing some to raise their ambition significantly. A group of like-minded countries could facilitate this.

The EUI School of Transnational Governance organised two High Level Policy Dialogues in November 2020 with experts from around the world to create more clarity on the technical and political elements of a CBAM. This paper highlights seven key recommendations drawn by the authors, and more detail can be found in the Chair’s conclusions.²

RECOMMENDATION 1: A CBAM IS A CLIMATE MEASURE

Despite 25 years of active climate diplomacy at the UN level, it is undeniable that greenhouse gas emissions and concentrations in the atmosphere have continued to rise without interruption. The ‘bottom up’ approach of the Paris Agreement, whereby countries determine their own commitments, is showing its limits and may need to be complemented with a mechanism that speeds up the major low-carbon transformation that all countries in the world will ultimately have to undergo.

The EU remains strongly attached to the United Nations Framework Convention on Climate Change (UNFCCC) process and the Paris Agreement. To implement its commitments, it has put a price on carbon that also applies to heavily traded commodities such as cement, chemicals, steel, and non-ferrous metals. Carbon prices are currently around €25 per tonne CO₂ equivalent and are likely to increase following the proposed tightening of the EU’s reduction target for 2030 from 40% to 55% compared to 1990. With carbon prices possibly at levels of €40 to €50 per tonne, Europe does not want there to be ‘carbon leakage’ whereby energy intensive production moves out of Europe to less climate-ambitious jurisdictions because of resulting differences in economic costs.

The EU endorsed the Paris Agreement’s ‘bottom-up’ approach as a way of ensuring wide coverage of commitments while recognising the differences between countries with regard to their economic development, history and natural endowment. It can be expected that the EU will be asked by its international partners to incorporate this differentiation one way or the other into its design of the CBAM.

The problem of carbon leakage can be addressed by a multiplicity of measures. Apart from the CBAM, one could also consider continued free allocation under the EU Emissions Trading System (EU ETS), a further strengthening of provisions in trade agreements, technical standards for imported products, or a more targeted use of auctioning revenues for the purpose of industrial innovation and deployment. Some of these measures could complement a CBAM, and collectively they might even substitute it, knowing that Europe has contained the carbon leakage problem with carbon prices up to €25 per tonne of CO₂.

The EU Commission clearly stated that a CBAM needs to contribute to reducing global emissions and avoid the undermining of Europe’s climate ambition due to carbon leakage. The CBAM is therefore primarily a climate policy instrument that should nevertheless respect WTO rules and may create fresh revenues.

¹ European Council Conclusions EUCO 10/20 dated 21 July 2020, pages 8 and 64.
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RECOMMENDATION 2: A CBAM IS TECHNICALLY COMPLEX BUT NO MORE SO THAN NORMAL TRADE RULES

The most feasible approach would be to start from Europe's main climate policy instrument relating to energy-intensive sectors, namely the EU ETS. The CBAM would impose a liability upon certain categories of goods imported into the EU based upon the CO₂ emissions related to their production, as is the principle of the EU ETS.

Calculation of the carbon content of goods covered would be linked to the existing EU ETS monitoring methodologies – with suitable adaptation – and liabilities would be settled using EU Allowances (EUAs). Normal liability would be based upon the EU average of embedded emissions for similar goods. This would at least entail a regulatory burden comparable with that faced by EU producers of similar goods. Furthermore, imports would be eligible for lower liability based on the computation of actual embedded emissions if the importer could adequately demonstrate this. Designation of a responsible legal entity established in the EU would be required to fulfil legal obligations and payments with respect to the importation of products, similar to other environmental regulations such as the chemicals legislative model of 'REACH.' Not all sectors covered by the EU ETS need be covered but only high-emitting traded goods. Goods in this context may include energy products, such as electricity or hydrogen.

Technically speaking, the territorial specific act of importation into the EU would be the trigger for liability and the carbon content of the imported goods would determine the extent of liability. 'Declarations', or reports, would be made by the importer or the importer's representative, as is already the case for customs and indirect taxation purposes. These declarations could be verified either by customs officials or independent verifiers, given that independent verification is already a necessity for EU producers.

Treatment of a CBAM should be as similar to the treatment of EU energy intensive industries as possible, and the modalities should not be so complex as to be unworkable. As the basic approach is data

intensive, some simplifications or differences of treatment, such as the use of EU or country averages of carbon content, would be necessary. A specific amount of EU ETS allowances could be auctioned to cover liabilities with respect to the carbon content of imports. Alternatively, direct payments could be made based on the price of EU allowances.

RECOMMENDATION 3: A CBAM SHOULD NOT BE PORTRAYED AS A NEW SOURCE OF REVENUE NOR AS PROTECTIONIST

Using revenues arising from a CBAM as an EU 'own resource' or as a revenue for Member States is not a good idea. The fact that CBAM may entail payment to the EU in respect of imports from developing countries is a reversal of orthodox climate finance funding flows. What happens to the revenues collected is likely to serve as a lightning rod for opposition to the CBAM. The EU will recall very harsh criticism made when the EU tried to include international flights in the EU ETS, which was partly seen as a revenue-raising instrument for Europe.

Any revenues should rather be channelled towards developing countries (especially Least Developed Countries (LDCs) and Small Island Developing States (SIDS)) for climate purposes, or towards helping global industry decarbonise.

It is somewhat unfortunate that the European Council endorsed the principle of a CBAM as part of its agreement on the EU's multiannual budget and the 'Next Generation EU' recovery funds. Any new EU 'own resource' based on CBAM will require unanimity among Member States, which will be very difficult to obtain, whereas developing a CBAM on the basis of EU ETS and without a specific 'own resource' component would allow for qualified majority voting and faster agreement on a CBAM.

If fresh financial resources are to be found and in view of the higher carbon prices that are generally expected as a consequence of the EU's more ambitious 2030 target, one could rather look at revenues arising from reduced free allocation under the EU ETS. The present justification for free allocation under the EU ETS is to prevent carbon leakage. It is therefore difficult to see how free allocation could

justifiably continue in the case of a CBAM for those sectors covered by the CBAM. Similarly, indirect cost compensation for increased electricity bills would have to be discontinued if the so-called 'scope 2' emissions were included in the CBAM methodologies.

CBAM is about preserving the ambition of EU climate policy, not about protecting domestic EU producers on global markets. More study is therefore useful to find out what 'other than climate policy' factors influenced the loss of competitiveness of some EU industries in recent decades. It is strongly advised not to overstretch a possible CBAM with a view to protect EU industry against international competition. Such protection, as for a possible exemption for exports, would be incompatible with WTO rules.

RECOMMENDATION 4: A CBAM MUST ALLOW FOR EXEMPTIONS IN CASE OF EQUIVALENCE OF CLIMATE POLICY EFFORTS

Some countries may have as heavy a regulatory burden as the EU, in which case the justification of carbon leakage would be spurious. 'Equivalence' is a key concept to CBAM: no border adjustment should be applied to products from countries with an equivalent cost burden resulting from climate regulation. The perspective of a CBAM may encourage countries to strive to attain equivalence, which could reinforce the global climate impact of the instrument.

It is often assumed, even presumed, that EU production is cleaner than elsewhere in the world. While this might be true as an average for the whole range of manufactured traded goods, it is not necessarily true for energy intensive industries whose products are most likely to be covered by the CBAM. Emerging economies often have more recent facilities that may be more efficient than some European installations. The EU should be careful what it wishes for, and the Impact Assessment of the CBAM should produce more evidence on this. In considering whether to include 'scope 2' emissions within the scope of the CBAM, account might also be taken not only of the emissions from manufacturing installations, but also emissions from electricity and heat generation used in manufacturing processes.

A method would be needed to evaluate the 'climate policy burden' of Europe's trading partners, and ideally this should be done by an international body. Default values would have to apply to products originating from 'non-equivalent' countries. For products subject to the CBAM it would be possible to substantiate lower emissions than EU averages, in which case the burden of proof would rest on the importer and be signed off by an independent verifier. Customs and tax authorities could undertake their own investigations in the case of doubt. Judicial redress would be available for importers. Similar rules apply for the substantiation of rules of origin for customs duty purposes.

RECOMMENDATION 5: A CBAM SHOULD HAVE A LIMITED SCOPE AT THE START AND POTENTIALLY EXPAND OVER TIME

The above description of the CBAM's functioning shows the complexities of the measure, its heavy reliance on data to ensure fairness and the presumption to start from the basis of European regulatory approaches. There is clearly considerable potential scope for disputes. Moreover, if the EU introduces a CBAM, it would be a new instrument on which experience is lacking. It is therefore strongly advised to apply a CBAM to a limited, specific sector or sectors rather than apply a CBAM to a wide range of sectors. This will reduce the scope for disputes and would make assessment of equivalence more feasible. In this way a 'pilot phase' could provide valuable information in view of later modifications where needed.

The power sector, for which free allocation is not the norm under the EU ETS, is an option to start a CBAM with. It concerns neighbouring countries that in some cases are candidates to become EU Member States. They may have concrete plans to implement the EU ETS as part of their preparations for accession. Another frequently mentioned sector is cement. As a share of the cement market in Europe, imports represent a larger share than is the case for electricity, but similarly to electricity, cement imports originate from a limited number of neighbouring countries. The EU should urgently talk to the countries likely to be impacted by the envisaged scope of a CBAM.

Starting small also has the benefit of moderating possible opposition to CBAM while maximising the learning opportunities of a new feature of EU climate policy in the light of the European Green Deal. The CBAM does not have to be implemented in a ‘big bang,’ but as a new tool should be operationalised progressively based on solid political and technical preparation. The legal proposal itself and the consequential amendments to the EU ETS Directive scheduled for June 2021 could perhaps entail principles for CBAM and only minimum framework requirements for a CBAM to be established, potentially applying to all sectors within the scope of the EU ETS. However, details, such as the specific criteria (and process) for determining equivalence and the products to be covered in an initial stage, should be left open to later technical regulatory instruments, such as happens today for EU ETS benchmarks for free allocation.

RECOMMENDATION 6: A CBAM SHOULD URGENTLY START WITH A SUBSTANTIVE DIPLOMATIC EFFORT

Europe must engage early with international partners to explain its ideas, framing the CBAM in terms of enhancing, and not undermining, global efforts to address climate change. The two obvious fora in which to initiate dialogue would be the UNFCCC and WTO contexts, in addition to the G7 and G20. In 2021 the UK will be hosting the United Nations Climate Change Conference (COP-26) as well as Chairing the G7, while Italy will be at the helm of the G20. Under the incoming Administration, the US is likely to re-activate the ‘Major Economies Forum’ to discuss climate change. All these fora should discuss CBAM.

In order to engage effectively with international partners, the EU urgently needs to have more detail on how the proposed CBAM would work. Myths, such as the application of CBAM to all globally traded goods from all countries, irrespective of their stage of development, need to be quickly dispelled.

The EU should not act alone in introducing a CBAM but should seek allies supporting the introduction of CBAM. Apart from its natural allies such as Switzerland, Norway and the UK, it should above all engage in a debate with the US and China. Preventing car-

bon leakage is an issue of actual or potential concern also in emerging economies, which often experience pressure from neighbouring developing countries and even least developed countries with lower cost bases.

Ideally, a Commission proposal for a CBAM should be preceded by a White Paper consultation process, for which the Commission elaborates its thinking on how a CBAM would operate. There needs to be a substantial marshalling of views with the EU’s international partners.

It will be difficult for the EU to present CBAM as addressing the risks of carbon leakage without more evidence of the risk of such leakage. If, for example, carbon prices remain at approximately the same levels as today, it is difficult to argue that a CBAM is needed now. One possible mechanism for sequencing would be for the introduction of CBAM to be conditional upon EU carbon prices breaching certain levels for a determined period of time before ‘triggering’ introduction of the instrument. This would enable the EU to implement the preparatory steps without CBAM actually being introduced before the reality of higher carbon pricing in the EU makes itself felt.

RECOMMENDATION 7: A CLIMATE AMBITION COALITION COULD MAKE A CBAM ALMOST SUPERFLUOUS

Intensive CBAM diplomacy could lead to the creation of a coalition focused around higher climate ambition. Such a coalition should not be focused exclusively on CBAM but should cover several areas, such as raising ambition within the Paris Agreement, the introduction and development of tools to enhance cost-efficiency both within and between countries, as well as collaboration on innovation and the deployment of clean technologies. Membership of a possible ‘Climate Ambition Coalition’ could facilitate the establishment of equivalence and hence lead to an exemption from a European CBAM.

The declarations by China, Japan, Korea and South Africa to become carbon neutral in a time frame between 2050 and 2060 could be an excellent start for the creation of such a Climate Ambition Coalition. However, the global climate impact depends more on concrete policies and measures being implemented

in the near term than on headline announcements. In particular policies to phase-out the use of coal are urgently required. That is why a CBAM discussion on emissions related to the use of electricity in carbon-intensive commodities is perhaps more important than the direct emissions from the manufacture of such goods. A coalition could address the coal issue and the related question of how to respect the principle of 'Common but Differentiated Responsibilities and Respective Capabilities'. Revenues raised through a CBAM could be used to facilitate the global energy transition.

The European Green Deal and the global energy transition are likely to generate an important shift in trade patterns. Trade in fossil fuels will go down, while trade in renewable electricity and green hydrogen for example will go up. More importantly the energy transition will create a high demand for new raw materials, used, for example, in batteries and

electrified equipment. It can be expected that the demands on sustainable mining will become more important and these issues could also be addressed by the coalition.

The EU's best potential allies, beyond non-EU states in Europe whose legislation is already closely aligned, would probably be countries that already apply or plan for explicit carbon pricing either through carbon taxes or through emissions trading systems. According to the World Bank Group's Carbon Pricing Dashboard, 46 national jurisdictions are covered by explicit carbon pricing initiatives, and 35 subnational jurisdictions. A dialogue with these jurisdictions would seem an obvious place to start when seeking allies and could perhaps form the basis of further coalition building. There is already an ongoing exercise organised jointly by the European Commission and the European University Institute called the 'Florence Process on International Carbon Markets'.

CONCLUSION

This paper has focused on the design of a workable CBAM and the diplomatic efforts that will need to be made around it. This paper did not examine alternative options to address carbon leakage. In the end, it may be that some combination of approaches,

including a CBAM, will be used. CBAM is no more a silver bullet than other policy instruments. If the debate leads to a more ambitious implementation of climate policies globally, the best CBAM may well be the one that is never used.

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