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'The EU is showing real courage'

The EU is planning a tax on carbon-intensive imports. Joachim Monkelbaan on the legality of the carbon border tax and the risk of retaliation

In order to protect the climate, carbon prices are rising sharply in the EU. This is good for the environment, but increases the price of many products. To protect domestic industry from climate-damaging and cheaper imports, the EU is planning a carbon border adjustment mechanism (CBAM) on certain goods. What does this mean practically?

The EU sees the CBAM as a component of its climate policies and of the EU ETS. The main purpose of the CBAM is to prevent carbon leakage — the phenomenon that industry for example leaves the EU and starts producing in countries with less stringent climate policies, then exports those products back to the EU — by creating a level playing field for EU producers.

The CBAM is supposed to replace the free EU ETS allowances currently granted to EU producers assessed to be at high risk of carbon leakage. The CBAM will be implemented in 2026, following a transition period of three years characterised by data collection only.

The initial proposal from the European Commission applies to imports of electricity, cement, aluminum, fertiliser, as well as iron and steel products. The levy is to be paid by EU importers of non-EU products. Countries with equivalent carbon pricing could be exempted from the CBAM in the future. The price of the CBAM certificates will reflect the EU ETS prices corrected for any free allowances EU producers still receive.

Tariffs are commonly seen as a protectionist weapon in trade disputes. Can the EU expect its trading partners to show understanding for its CO2 border adjustment or are they expected to impose tariffs on EU imports in turn?

This is the big question. There is the risk that outside nations retaliate and introduce trade barriers, with escalating trade wars and

protectionism. However, the risk of protectionism has to be balanced against the risks of climate change, and one argument for the CBAM is that climate change is more devastating.

Retaliatory measures imposed in response to the CBAM could be seen as illegal in case the CBAM is decided to be legitimate in the WTO. I hope that a situation in which other countries also impose carbon pricing and BCAs — as Canada is considering to do — and then collaborate with the EU — meaning that there is no need for a CBAM between the EU and Canada for example — is more realistic.

The World Trade Organisation (WTO) is watching very closely when it comes to the introduction of new tariffs. Are the EU's plans at all compatible with WTO rules? Or how would the CBAM have to be designed in order not to violate WTO rules?

The legality of the CBAM indeed is not fully clarified; although most legal scholars argue that the CBAM could be designed and applied in a way compatible with the rules of the WTO. WTO rules allow countries to impose compensating charges on similar imported products in order to equalise the tax burden on domestic production. So, direct environmental taxes levied on imported fuel could align with WTO rules as long as the charges are not in excess of those facing domestic products.

However, border charges on products manufactured through GHG intensive processes and production methods (PPMs) might be WTO-inconsistent if they are viewed as discriminatory. Past WTO disputes suggest there is flexibility though around policies to protect human, animal or plant life, health and to conserve finite natural resources — as enshrined in Article XX of the GATT —, but that any climate policies that discriminate against third countries or show preference for domestic products will fall foul of WTO rules.

The concept of 'like' — similar in terms of nature, end-use, and consumer tastes for example — products is critical here as it is a part of the foundation of the trade system. Under WTO jurisprudence, a distinction made between products on the basis of the amount of carbon that is used in making them is not justified. No legal determination in WTO dispute settlement has been made yet that says that two products can be considered not 'like' based on the amount of carbon used in making them.

First, it would be important to demonstrate that the CBAM is motivated by environmental (climate) reasons and not in pursuit of economic motivations. Second, the EU cannot distribute free allowances anymore to domestic industries that make products for which importers have to buy EU ETS allowances.

Currently, exceptions for neighbouring states of the EU or for poorer states of the Global South are being discussed. Are such preferences for certain groups of states even feasible?

Indeed, European Free Trade Association (EFTA) countries are exempted due to their participation in or link to the EU ETS. Other countries that have equivalent carbon pricing in place could follow in the future.

A general exception for all developing countries could be seen as a violation of the WTO most-favoured-nation (MFN) principle. Such a broad exemption for poorer states of the Global South would be arbitrary and unjustifiable discrimination that would run foul of WTO rules. What the EU could do however is exempt the 46 least-developed countries (LDCs), which could be justified under one of the general exceptions in the WTO treaty. The EU has been mindful of the fact that the LDCs have contributed the least to climate change, will be suffering the most from climate change, and have the least means to deal with it.

Critics warn that although the CBAM might protect domestic markets, European goods would still be more expensive on world markets and thus not competitive. But other countries, above all China and the US, must also fulfil their commitments under the Paris climate agreement and make CO2 more expensive. So where does the EU really stand – is it a pioneer or is it fooling itself in terms of industrial policy with its ambitions?

In my view, the EU is showing real leadership and courage if it can impose the CBAM. It might cause some frictions domestically and with trading partners and require some experimentation at first. But so did the EU ETS require some trial and a lot of error before it became the example for the rest of the world that it currently is. Yannick Jadot, Member of the European Parliament, said that 'we must stop being naive and impose the same carbon price on products, whether they are produced in or outside the EU, to ensure the most polluting sectors also take part in fighting climate change and innovate towards zero carbon'.

China now has the biggest carbon market in the world, although initial allowances are generous and allowance prices are low while penalties for failing to comply are not severe. In the US, carbon pricing is not likely to be taken up by Congress anytime soon. The Biden Administration is for now going for 'lighter' measures such as a Clean Energy Standard.

In the climate area, it is difficult to implement perfect policies from scratch. It will be interesting to see whether the CBAM can play a

systemic role in the EU's climate policies in terms of raising domestic ambition and taking away concerns in terms of loss of competitiveness. More importantly, I hope that the CBAM can be the first step to the climate club approach.

This interview was conducted by Claudia Detsch.



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