ERCST

Roundtable on
Climate Change and
Sustainable Transition

2021

Guide to the European Carbon Border Adjustment Mechanism

BRIEF FOR POLICY MAKERS

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[EMGARGOED UNTIL 27 SEPTEMBER 2021, 13:00 CEST]

ERCST Guide to EU CBAM

Brief for Policy Makers

A new solution is needed to address carbon leakage in the EU, as asymmetrical climate policies under the Paris Agreement are very real and can impact competitiveness, leading to carbon leakage. The current approach of free allocation cannot continue to provide sufficient assurances against such leakage.

However, while the proposed alternative, the Carbon Border Adjustment Mechanism (CBAM), has supporters in the EU, it is also becoming increasingly clear that maybe an increasing number have serious questions about it. Some Member States have voiced concerns about it, and while initially it had strong support in the business community, the sands have shifted over the last 18 months.

The draft regulation proposed by the European Commission in July 2021 presented a measured, pragmatic compromise – but in doing so, the EU opts for safety and takes few risks, arguably losing valuable time for the industrial transition, and punting the most difficult design choices further down the road.

On the one hand, the deliberate pace of implementation with a transition phase and then gradual phase-in over ten years (alongside declining free allocation) buys the EU and its trade partners time: more time to retain the tried-and-tested free allocation approach, time to understand the CBAM and how it works, time to elaborate the technical and procedural details, and time for trade partners to advance domestic carbon pricing as well as for low-carbon technologies to progress to commercial scale.

In a sense, the current proposal can be seen as having punted the hard choices to a time when they will either solve themselves, or the environment will change allowing for solutions that are not possible today. That is where time is a friend.

On the other hand, time is a luxury we may not have. The European Green Deal and the Climate Law both demand ambition. And with that ambition come economic and financial pressures for European emitters – pressures to which they are already exposed, as evidenced by the more than twofold increase in the price of ETS allowances over the past year. If these are not credibly addressed, we risk seeing emissions leakage, with tremendous potential to set back the politics of climate ambition in the EU and internationally.

There is thus a tension between the pragmatic and gradual approach chosen with the proposed CBAM, and the interest of enabling an ambitious timeline for industrial decarbonization. Importantly, however, the CBAM must contribute to the decarbonization—and not the deindustrialization—of Europe.

While the proposed CBAM approach can be deemed appropriate and justified from one perspective, as described above, it is also vital to acknowledge that its pragmatic and gradual approach is misaligned with the "hard" ambition expressed by the EU climate policy, and does not really live up to Commission President Ursula von der Leyen's initial rhetoric on the CBAM.

The CBAM can be seen as addressing multiple objectives, with the European Commission squarely focusing on carbon leakage. Other objectives, such as the elimination of free allocation, are high on the list of many stakeholders, but one metric which seems to have already achieved success is getting the attention of many trade partners, especially of those most affected in the EU neighbourhood. That may also be its main intention for the time being and possibly the greatest impact in the final analysis.

For the CBAM to be truly effective over the longer term as a tool to enable the pace and scale of European climate policy ambition set out with the European Green Deal, it will have to offer a convincing solution to issues that have been deferred or left unaddressed in the current proposal:

Partly out of concern of violating WTO disciplines, the CBAM proposal provides no protection for European exports, which are on average less carbon-intensive than competing foreign products. Initially free allocation will still shield these against leakage, but its elimination, gradual as it is, will likely give rise to increasingly serious economic and political challenges.

By initially excluding indirect emissions, the proposal avoids addressing the challenge of tackling indirect carbon costs, which differ from indirect emissions. For some carbon-intensive sectors, indirect emissions related to electricity use represent the largest climate impact: a solution is therefore needed. There is widespread expectation that the inclusion of indirect emissions is likely to be strongly considered for inclusion after the CBAM review.

The lack of provisions for recognizing non-price-based foreign climate policies was predictably met with criticism abroad, especially by diplomatic and trade partners whose political economy simply will not allow passing a national carbon price in the foreseeable future. Excluding ambitious climate policy efforts because they do not take the form of an explicit price risks alienating allies and seems to be misaligned with the bottom-up approach that is the hallmark of the Paris Agreement. Focusing only on carbon prices may be more feasible but is unlikely to work in the long-term. If this instrument is to be operational in the long-term, finding a way to include non-pricing costs is probably inevitable, despite the obvious complexities and legal and political risks that might entail.

Sectoral choice in the proposed product coverage may only be a bridge to a gradually expanded scope, but in the short term it may already be a bridge too far: focusing on a more limited spectrum of sectors may be preferable while we still debug the software and check international reactions.

Including Scope 3 emissions of covered inputs in the proposed coverage is the right choice, even if it entails clear WTO legal risks, and complicates the administration of the scheme. To do otherwise simply shifts the risk of leakage further down the value chain and impacts value-added producers in the EU.

"How to spend it", an echo from the media that no politician or bureaucrat can resist, is a very real issue in the CBAM debate. While the current proposal is to retain revenue for the EU's own resources, it bears recognizing that the amount of revenue may be much lower than expected, as it seems irrational that any country would allow funds to go to the EU budget when it could retain those funds by taxing the same products at home. Given the likelihood of low revenues, and the legitimate concerns about impacts on producers in low-income countries, the EU should give serious consideration to directing a significant portion of revenues from the CBAM back to affected developing country producers or governments.

That applies even more since the proposal sets out no exemptions for Least-Developed Countries (LDCs). Very few exports from LDCs are impacted under the proposed approach, and for those countries where there are effects in specific sectors, those effects may be warranted due to the related leakage risk. Any blanket exemption creates real risks of perverse strategic shifts in trade patterns and trans-shipment. While the principle of common but differentiated responsibilities and respective capabilities (CBDR-RC) is a legitimate concern, it should be addressed through revenue sharing. Also, it will not escape EU trade partners that there is no CBAM impact assessment for effects outside the EU.

In conclusion, the CBAM as proposed is pragmatic – a sensible approach given the political and economic challenges facing the EU. It shows the art of the possible and is a tool to get the EU to a high universal carbon price. The two critical issues that will be central in the now ensuing political debate are the pace at which free allocation is removed without having had an opportunity to test the CBAM under real world conditions, and the lack of any provisions for export.

At the same time, that sensibility stands in contrast to the urgency of decarbonizing the EU's materials-producing sectors, the ambition of the EU's climate target, and the mitigation needs. It will be important that the process of finalizing the legislation not exacerbate that contrast.

In our view, the proposal can be improved in tangible ways, as noted above. But some of the most critical challenges will probably have to be addressed in parallel policies outside the CBAM – policies that support the objective of decarbonizing the EU's industrial sectors and maintaining their place as leaders in the global green markets of the future, but also ensure that the end result is still a prosperous and industrial Europe – and with the current proposal, that is not a given.