Paper Series

Green Deal reloaded – Perspectives for a Sustainable and Just Transition of the EU

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Bridging Divides Over the Carbon Border Adjustment Mechanism

When it comes to climate policy, the world is changing. More than 110 countries have announced that they aim to be carbon-neutral by 2050. Climate change is also becoming increasingly important when it comes to the economy. This is particularly true as current analyses – such as those of the World Economic Forum – show that environmental crises now pose a major risk to the global economy. What's more, the rapid and continued advances – despite the COVID-19 crisis – in areas such as storage technologies and renewable energies have further reinforced this trend.

While such momentum is more than welcome, it comes late in the day. Indeed, we are far from the Paris Agreement goal to limit global warming to well below 2 degrees Celsius compared to pre-industrial levels. According to findings by the UN Environment Programme, the delay is alarming. The international community has thus been called upon to strengthen its collective climate commitments at the COP26 in Glasgow at the start of November 2021.

And within the EU, the European Council has already agreed to raise its 2030 EU emissions reduction target from 40% to at least 55%. President Ursula von der Leyen has made climate protection a political priority for the European Commission and has launched the European Green Deal as an ambitious political program with a concrete plan of action. According to von der Leyen, the green transformation of the economy must serve as a driver for innovation and sustainable growth.

A metamorphosis of this magnitude offers both significant opportunities and potential for conflict. The same can be said of the proposed border adjustment measures. Those who agree see such measures as crucial to achieving Europe's climate protection ambitions; they also hope it will encourage third countries to step up their respective efforts in this area. Others fear such measures lack an appropriate legal basis, would weaken the European economy and trigger a storm of external reactions. To understand the debate, we will first explain why these border adjustment measures are considered necessary and examine certain fundamental legal, administrative and political aspects.

The challenges of an ambitious European climate policy

To implement the European Green Deal, the EU has planned for various far-reaching measures and legislative initiatives in 2021. Examples include reforms to the Emissions Trading Scheme, energy efficiency and renewable energy directives, and specifications for transport networks, vehicles and freight transport. But the implementation process has not been seamless. There are two reasons for this. First, there have been internal challenges. Attempts to reform the Common Agricultural Policy, for example, have shown how inflexible structures and influential lobbies can hinder the achievement of the climate objectives set by the Green Deal.

On the other hand, the global integration of the European economy has also brought challenges. In the European Emissions Trading Scheme, the price of CO_2 emissions has finally gone up – to the satisfaction of climate advocates. Yet, to implement an effective climate policy, we must ensure that the desired effects – reducing emissions and fostering innovation in particular – are not dashed by »carbon leakage,« whereby companies with high emissions transfer production to third countries whose emission constraints are laxer. By the same token, we must also ensure companies do not lose their global market share because of strong climate requirements at home. This issue has long been known, and many possible solutions have already been discussed and implemented. Industries participating in the European Emissions Trading Scheme have received a substantial quantity of free allowances. Simultaneously, these measures may defeat the fundamental purpose of encouraging companies to adopt climate-friendly production practices – as shown in the contribution by Barbara Praetorius on industrial policy. For measures such as emissions trading to be truly effective, it is necessary to phase out exemptions such as free allowances.

The border adjustment mechanism will be a cornerstone of European climate protection

Commission President von der Leyen is now considering a different approach: a carbon border adjustment mechanism (CBAM). This technocratic term means taxing goods from third countries if their CO_2 emission standards are lower than those in the EU. Such measures had already been discussed in the past. In 2009, for example, an important climate protection law was negotiated in the United States – but was unsuccessful. And within the EU, France has repeatedly come out in favor of border adjustment measures, while the German government has long shown reluctance. But in the summer of 2020, the European Council mandated the Commission to present »proposals for a border carbon adjustment system« that would »be in place no later than 1 January 2023.« In principle, the European Parliament also supports the European Commission's approach. Ursula von der Leyen plans to present a draft regulation in the first half of 2021. For the first time, the goal of setting up a CBAM, therefore, seems within reach.

The actors involved are aware that a CBAM raises a multitude of legal, administrative and political issues. From a legal perspective, the challenge lies in ensuring the CBAM complies with international trade law. As multilateralism has been seriously shaken in recent years, respect for international organizations and international law is in the EU's own interest. One of the fundamental principles of the General Agreement on Tariffs and Trade (GATT) is non-discrimination, whereby »like« products from different member countries must be treated in the same way. Legal analysis and WTO jurisprudence now suggest that the intensity of emissions associated with manufacturing a product does not affect the »likeness« of products under law. It is, therefore, difficult to introduce a CBAM based on climate-harming emissions without it being deemed discriminatory under the GATT agreements. However, exceptions, such as those in GATT Article XX, provide some political room for maneuver; basically, a violation of the GATT rules may be justified if it serves to protect the environment. As a result, a border adjustment measure designed for climate purposes may be permissible under international trade law.

At the same time, in this approach to environmental protection, the »how« also counts. For example, in the EU, the possibility of basing the CBAM on the average emission rate of a product is currently being discussed in order to protect European producers from unfair competition. Yet, the flat-rate application of an average value would provide no incentive for producers in third countries to improve the carbon balance of the product involved. Worse still, climate-conscious producers from third countries whose emissions are below the average would be treated more unfavorably than EU producers with the same carbon balance. This situation could be avoided by offering importers the possibility to prove that the carbon balance of the product coming from the third country is better than the set average value. In such a case, the amount required under the CBAM would be reduced accordingly. The possibility of such a differentiation would be an advantage not only in terms of climate action but also from a trade law perspective.

Nevertheless, there is potential for abuse and substantial additional administrative costs. The specific modalities of the CBAM should minimize the potential for abuse. And to limit the additional administrative costs, impact and expenditure must be balanced when choosing the products and sectors in question. Sectors such as cement and steel are generally considered to meet this criterion. The Commission has already made it clear that the border adjustment mechanism is only intended for certain selected sectors. However, the European Parliament, in its CBAM report, has provided for a much broader scope.

Much-needed diplomacy, many opportunities

But perhaps the greatest difficulty faced by the CBAM is its integration into the international framework. The potential for conflict in this area is considerable, both in trade law and climate policy. While most countries have already made commitments to climate protection, the approaches chosen are difficult to compare, as the Paris Agreement is largely based on voluntarism. A global price for carbon remains a long way off. Instead, the vast range of national approaches reflects the whole spectrum of preferences, priorities and assumptions of countries as diverse as Russia, Tuvalu, Saudi Arabia, Sweden, Canada and Costa Rica.

Introducing the CBAM into this extremely heterogeneous landscape could be perceived as a shift towards economic protectionism. The CBAM could thus be misunderstood and discredited while raising the risk of retaliatory trade measures, which is what the Federation of German Industry (Bundesverband der Deutschen Industrie) fears. If major economic powers such as the United States and China, or countries such as India and Brazil, joined forces against the CBAM, it would become near impossible to impose, politically speaking. The EU has already learned this the hard way, but for a slightly different issue – including international flights in the EU Emissions Trading Scheme. And although the CBAM is not intentionally targeting developing countries, they could also be hit hard, especially those with administratively weak or poorly diversified economies. This requires careful consideration at an early stage.

A successful diplomatic offensive could pave the way for cooperation that would strengthen international climate protection. To achieve this, we could build on all the climate action projects and pledges made around the world. The European Commission already seems to be inviting discussion with key trading partners and top CO_2 emitters such as the United States, China and Russia. To avoid border adjustment measures between trading partners, consideration should be given, for example, to how we judge which climate protection measures have an equivalent impact.

In 2021, European climate diplomacy will have more than one ace in the hole. First of all, there is the political reorientation of the United States. Meanwhile, the G20 summit will be hosted by EU Member State Italy and the UN Climate Change Conference will take place in Glasgow after being organized jointly by Italy and the United Kingdom. According to some media sources, Boris Johnson is considering putting the carbon border adjustment mechanism on the agenda for the British presidency of the G7 in 2021. Furthermore, the WTO has recently established a Trade and Environmental Sustainability joint initiative group which includes the EU and which is beginning to show some interest – at least informally – in the CBAM. Multilateral forums could thus be used to encourage discussions between states as well as between climate and trade policy actors.

That said, the revenue generated by the border adjustment scheme would also open up certain possibilities for external policy. The Commission estimates this revenue to be between 5 and 14 billion euros annually. These funds should be used to pursue climate goals. For example, they could be included in the funding provided by the UN climate change regime to support developing countries in building climate-friendly economic structures. Unfortunately, the EU currently seems to be moving in a different direction. Revenue from the CBAM will likely go back into the EU budget to increase its own resources and to participate in the financing of the post-COVID-19 recovery plan for Europe.

This issue will be of critical importance throughout the year and is sure to provoke lively debate. The European Commission sometimes asserts that, ideally, there would be no need to establish the CBAM. And indeed, if other countries committed to equally ambitious climate policies, it would no longer be necessary. But the alarming trend in emissions continues to show us how far we are from a climate-friendly economy. That is why we must try and achieve these long-term goals through the most appropriate short-term measures and structural decisions, globally. Implemented with ambition, the European Green Deal has a major role to play. A CBAM that takes both trade law regulations and climate goals into consideration can be a valuable part of this scheme. Now the EU must have the confidence not only to guarantee this to its partners – but also to win them over.

Author
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