# The CBAM Effect

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Netherlands Institute of International Relations

Clingendael Alert

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MAY 2022

# The CBAM Effect: how the world is responding to the EU's new climate stick




The EU is currently in the process of legislating for a levy on carbon-heavy imports. The so-called Carbon Border Adjustment Mechanism (CBAM) will affect goods imports for a number of industrial sectors, including iron and steel, cement, fertiliser, aluminium and electricity generation. This will be the first EU policy to explicitly affect industry emissions in third countries, rather than emissions only from industries within the EU. The innovative mechanism is still under development but has already attracted a lot of attention and responses from EU trading partners.

In order to identify the potential of CBAM as an instrument of climate diplomacy, this Alert discusses initial responses to CBAM by several important EU trading partners. It concludes that CBAM has already had a positive effect on trading partners' climate policies. However, the EU needs to continue to engage its trading partners in the further development and implementation of the mechanism. While it might feel natural to focus on the EU's most important trading partners, it is important not to lose sight of CBAM's impact on vulnerable economies and their continued support for the EU in

international climate negotiations. One of the guiding principles should therefore be to use CBAM to incentivise other countries to begin pricing their own carbon-heavy industries, although some countries might need support to do this.

## CBAM in a snapshot

In July 2021, the European Commission adopted a proposal for a Carbon Border Adjustment Mechanism (CBAM) as part of part of the EU's 'Fit for 55' policy package. That policy aims to reduce greenhouse gas (GHG) emissions by at least 55% compared to 1990 levels by 2030 and to achieve climate neutrality by 2050.

Carbon border taxes or levies have been discussed in the academic literature for more than 15 years. Historically, they have been sponsored by countries like France and are now in place in some regions of the world, such as California, where a levy is applied to certain imported electricity. In the EU, the climate ambitions of the Von der Leyen Commission brought CBAM back to the political table. CBAM will require exporters to report embedded emissions in certain carbon-intensive products. In order to export to the EU, companies with no carbon price or a lower one than applied in the EU, will be required to buy certificates to account for these emissions. Simultaneously, the EU would phase out free emissions allowances for domestic industries. In this way, CBAM is intended to level the playing field between EU and non-EU industries.

As a climate policy instrument, an effective CBAM would have four major benefits. First, it would ensure that production of carbon-intensive goods does not shift from the EU to third countries in order to take advantage of less stringent climate policies (so called 'carbon leakage'). Second, CBAM would increase the visibility of countries' carbon pricing policies for heavy industries and also create a wealth of data on companies' emissions, both of which could be used to strengthen international climate policy. Third, CBAM would reduce the potential benefit to third countries of being 'last movers' towards stricter environmental regulations, thus encouraging EU trading partners to adopt their own carbon pricing and reduce carbon emissions. Finally, if CBAM is introduced in close cooperation with trading partners, it could lead to international coordination on the use of carbon pricing mechanisms. This is considered key to reducing greenhouse gas emissions by G20 Finance Ministers.

However, introducing CBAM is not without risks. If designed poorly, CBAM could increase administrative costs for both European and foreign exporting companies, raise prices for basic products, spur international trade conflicts and undermine the multilateral rules-based system. Given that many details still need to be worked out, the impact and effectiveness of CBAM is hard to estimate. Yet the fact that the EU has put CBAM on the table illustrates that the EU is willing to use its market power for emission-reduction objectives internally and internationally. This underlines the EU's global commitment to address the climate crisis.

The CBAM proposal is now subject to a legislative process. The Council of the EU took an initial position in March and European Parliament (EP) lawmakers are formulating their say and will vote on the proposal in Plenary on 6 June. Further negotiations in the Council and between the Council and the EP will likely lead to further amendments, with the Commission monitoring their feasibility.

One of the issues subject to negotiation is which sectors will be covered by CBAM. The Commission's original proposal targets five goods at high risk of carbon leakage – iron and steel, cement, fertiliser, aluminium, and electricity generation. The draft report of the EP Environment Committee (ENVI) proposes to extend the scope of goods covered by including organic chemicals, hydrogen and polymers, as well as indirect emissions in all sectors. Other committees of the EP and the EU Council are likely to prefer a more limited sectoral reach. Another contentious issue is the implication for European industry: the border levy would imply the gradual decline of free emissions for domestic industries, thereby increasing

their production costs and potentially harming competitiveness and their global market share. The pace at which CBAM will replace the free allowances has not yet been clearly defined.

## Initial international reactions

When the Commission opened the discussion on CBAM, the initial reflex from third countries was to push back. Among other things, some countries accused the EU of protectionism by using emission reduction objectives as a disguise for installing a levy on imports. For example, the BRICS countries (Brazil, Russia, India, China, and South Africa) called CBAM discriminatory and Australian Minister for Trade, Dan Tehan, said it 'would be detrimental to global growth and to free trade globally'.

Developing countries, in particular African lower-income countries, disagreed with CBAM. They worried it would apply an unfair economic burden on them and undermine their right to development, underscoring that the EU would be imposing climate policies on countries with lower levels of economic development. It also came on top of sentiments concerning the EU being neo-colonial about climate policy by aiming to secure raw materials for energy transition and selling instead of sharing its green technology. Indeed, some of the countries with relatively high exposure and vulnerability to CBAM are located in Africa. Experts warn that CBAM could damage some African economies, such as Egypt, Nigeria and Algeria, and could severely affect their ability to continue with industrialisation. Foremost among them is Mozambique, which exports 54.1% of its aluminium to the EU (5.8% of EU imports) and where CBAM impact might cause its GDP to fall by 1.6%.

This is one reason why environmental NGOs have argued that CBAM revenues accruing to the EU budget should be used for international climate finance in order to restore trust among least-developed economies. For example, the EU could increase concessional finance to Africa and offer technical support to introduce carbon pricing, as suggested by the Centre for Global Development. The risk of being accused of economic imperialism is tangible and could undermine trust in the EU in international climate negotiations and bilateral relations, for example with African, Caribbean and Pacific countries.

The Commission appears to have expected such resistance. In fact, the implementation of CBAM is planned to be gradual and incremental, allowing countries time to adapt. Importantly, the EU has also stated that it would explore possibilities for concluding agreements with third countries to take into account their carbon pricing mechanisms. Agreements with third countries could be considered an alternative to the application of CBAM in cases where a country achieves decarbonisation in a carbon-heavy sector.

## From push-back to reluctant acceptance

Despite the international attention on CBAM, it was surprising that the proposal was not a big topic at the UN climate negotiations in Glasgow in November 2021. It shows that either CBAM's opponents had other priorities, or opposition to it was not united. Another reason may be that EU deliberations on the proposal were ongoing, making it difficult for third countries to respond. As more details became known about CBAM, studies showed that after the initial pushback, CBAM had set in motion debates in many countries to reconsider their emission reduction policies for energy intensive industry.

Before the war in Ukraine, the country most exposed to CBAM in terms of the affected aggregated value of exports was **Russia**. The sectors most affected are fertilisers (26.9% of EU imports), iron and steel (13.9% of EU imports) and aluminium (12% of EU imports). Discourse on CBAM shifted from opposition to reluctant acceptance and identifying ways to adapt to new realities, even by considering more stringent climate policies. For example, Russia announced an unexpected carbon neutrality target for 2060, adopted a taxonomy of green and transition projects, and has been working on creating the foundation for a future carbon

monitoring and regulation system. Russia's decarbonisation agenda is described as being triggered by external pressures rather than broad-based domestic sentiment demanding greater climate ambition, and therefore its implementation remains uncertain. Another reason why Russia and other countries have been less antagonistic is a growing understanding that it might be possible to escape CBAM by exporting less emission-intensive materials to the EU, while using high-emission materials at home and for export to other countries, the so-called resource shuffling.

In any case, Russia's war in Ukraine reduces the relevance of CBAM in its trade with the EU, and as a lever for raising Russia's climate ambitions. EU sanctions include a ban on imports from Russia of, among others, cement, iron and steel, the same sectors targeted by CBAM. In other words, if sanctions continue, CBAM would become much less relevant for Russia. Another consequence of this war is clearly visible in **Ukraine**. CBAM would have an impact on exports of cement (10.6% of EU imports) and iron and steel (9.6% of EU imports). While CBAM moved climate policy higher up Ukraine's political agenda because it affects the interests of powerful business groups that have been opposing climate policy, Russia's invasion has deprioritised climate policy development and reduced its export capacity.

Despite earlier serious concerns, the discussion on CBAM in **China** has not been very prominent, possibly because of the current collaboration with Brussels to establish a Chinese emissions trading scheme (ETS). The Chinese imports into the EU covered by CBAM are aluminium (7.9% of EU imports), and iron and steel (12.1% of EU imports). CBAM has the potential to speed up Chinese industries' timeline to implement climate policy objectives. On the one hand, CBAM is still being developed, making it difficult for the industry to prepare specific actions in response. On the other hand, many industry decision makers believe that their participation in China's national ETS will either exempt them from CBAM or the Chinese government will intervene before the mechanism affects them. Leaders of Chinese industry believe that China either will not be greatly affected by CBAM or will even benefit from a competitive advantage in the long term, as many emerging economies that China competes with do not have any carbon pricing instruments in place. Indeed, some argue that an expansion of China's national ETS to cover CBAM-related sectors could be one of China's best policy instruments for responding to the EU's mechanism.

In India, CBAM would mainly affect the iron and steel sector (6.8% of EU imports). **India**, like other BRICS countries, has opposed the CBAM proposal for introducing unilateral and discriminatory trade barriers. Research from the Konrad Adenauer Foundation shows that the prevailing attitude in India is to criticise the proposal for being protectionist and for threatening international trade rules in the United Nations Framework Convention on Climate Change (UNFCCC) and the World Trade Organization (WTO). However, as the third-largest global emitter of $CO_2$ after China and the United States, India is also under pressure to be more ambitious on climate change and has adopted a climate neutrality target (2070). India could be well placed to benefit from CBAM due to its two carbon trading schemes. Other factors include the energy-efficient techniques employed by Indian steel and cement industries, and its national climate policies. In other words, CBAM could give India a competitive advantage to export to the EU as it would face less competition from countries with less advanced climate policies and industrial processes.

In the EU neighbourhood, CBAM is perceived as a wake-up call for decarbonisation. For example, research on **Morocco** concludes that CBAM would come at a significant cost in terms of the country's export earnings from fertilisers (13.3% of EU imports) and suggests that Morocco should express its concerns. At the same time, the study argues that the proposed CBAM – regardless of whether it will be adopted, signals that carbon emission regulations and taxation will intensify globally and that Morocco needs to accelerate its own decarbonisation efforts.

In **Turkey**, the CBAM proposal was met with new domestic climate commitments. At COP26, Turkey ratified the Paris Agreement and announced the design of a national ETS similar to the European one. Ankara claimed that the 'big threat' of CBAM certainly played a role in its decision. Indeed, an EBRD (European Bank for Reconstruction and Development) report on the potential effects of CBAM on Turkish exports to Europe estimated that the financial impact of CBAM payments would significantly hit the price of cement (38.6% of EU imports), and aluminium and steel (12.6% of EU imports).

Among the **Western Balkan** countries, CBAM is seen as an opportunity to accelerate alignment with the EU 2050 de-carbonisation target. As part of their EU accession process, they are required to adopt and implement reforms in line with the EU Green Deal. Researchers from the region point to the need to prepare for CBAM by adopting internal carbon pricing or integrating into the EU ETS. The countries of the region most exposed to CBAM in terms of EU imports are Bosnia and Herzegovina (5.1% of EU cement and 8.4% of EU electricity imports), and Serbia (16.5% of EU electricity imports).

Despite initial hesitation, **the United Kingdom** has expressed its willingness to cooperate with the EU and raised the option of developing its own border carbon adjustment. The environmental audit committee of MPs called on the British government to develop plans for a CBAM to meet its domestic Net Zero Target (by 2050) while addressing the risk of carbon leakage. However, this would not automatically exempt the UK from the full EU carbon levy, which would affect its exports of iron and steel (11.9% of EU imports), aluminium (6.5% of EU imports) and electricity (6.8% of EU imports). Brussels left open the possibility of adding the UK to the exemption list, provided that the UK decides to link its own ETS to the EU's. But, so far, there is no indication the UK government wants to move in this direction.

Across the Atlantic, **Canada** has signalled its interest in the EU proposal and is considering the introduction of its own border carbon adjustment. During the Canada-EU Summit in June 2021, both sides committed to cooperating and exchanging approaches 'on carbon pricing and WTO-compatible border carbon adjustments'.

Finally, and subject to much attention, the **United States** initially pushed back against CBAM. The US Special Presidential Envoy for Climate John Kerry expressed his concerns about CBAM's possible implications for the economy, relationships and trade, and suggested that a tax adjustment should be used as 'last resort'. A few months later, some politicians in Washington softened to the possibility of a carbon tax, now perceived as a tool to create a level playing field vis-à-vis, for instance, Chinese producers. In the US Senate, Democrats initiated talks over a 'polluter import fee' similar to the EU's CBAM, but as yet there is no Congressional majority. In policy and think tank circles there is a lot of debate on the establishment of climate clubs, a construction through which transatlantic partners would closely cooperate on climate policy and jointly implement a carbon border levy. However, for the time being the EU does not seem willing to wait for the US to enact the domestic emissions trading scheme that is needed to form a carbon club with common border adjustment measure.

## Towards a CBAM that is part of a globally just transition

The EU has made deeper emission cuts and has comparatively higher emission reduction ambitions than most other countries or blocs. In future, CBAM will be necessary to avoid carbon leakage and to stimulate other countries to formulate more ambitious climate mitigation policies. While the initial reflex of many countries was to push back against CBAM, there now appears to be greater support and commitment to old and new climate targets, as well as to new emission trading or carbon border adjustment schemes in countries as diverse as Turkey, the UK and Canada. In addition, there is a lot of potential for constructive cooperation with major emitters and trade partners of the EU. An important incentive is that countries would rather have their businesses pay taxes at home instead of to

the EU through a carbon levy. CBAM has already had a positive impact on international efforts to address the climate crisis even before it has been enacted.

But more needs to be done. The EU's next steps will be crucial to ensure that constructive responses to CBAM prevail. Continued dialogue with third countries is necessary to foster international coordination on carbon levies. The key to success will be for the EU to continue discussing the purpose and details of CBAM and to listen to the concerns of trade partners impacted by the mechanism. Specific attention is needed for vulnerable developing countries. For this group, the EU may need to give additional concessions, for example through financial support for the decarbonisation of their industries or the development of climate policies such as an emissions trading scheme. This could be part of the external dimension of the European Green Deal, the Global Gateway investment scheme or specific Team Europe Initiatives. At the moment, it looks like CBAM revenues will flow into the EU budget, and the income from selling emissions allowances within the EU as part of its ETS will partially flow into an innovation fund to help European energy-intensive industry transition. The EU thereby currently does not show much sensitivity to claims by other countries about their right to industrialise in a context of a globally just transition that mitigates climate change.



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