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Title

The EU Carbon Border Adjustment Mechanism: an overview of its legality and equity under international climate and trade law

Abstract

The paper analyses the Carbon Border Adjustment Mechanism (CBAM) proposed by the European Commission in July 2021 within its 'Fit for 55' Package. The measure would complement the reformed EU Emission Trading Scheme (ETS) since the latter will raise the level of ambition of the European emissions reduction goals and, consequently, the costs faced by EU firms and the price of their goods. The strengthening of the EU ETS is required by the bloc's commitments under the Paris Agreement but could result in an increased risk of carbon leakage, *i.e.* the relocation of production – and emissions – from the EU toward jurisdictions with less stringent climate policies.

Through the imposition of an obligation equivalent to the one faced by EU producers under the ETS, the policy would reduce both carbon leakage and the economic advantage enjoyed by non-EU firms that maintain carbon-intensive production methods. Importers of products under the policy's scope would have to purchase a certain amount of 'CBAM certificates' to be surrendered later, depending on the embedded emissions of the goods and, possibly, the carbon price already in the country of origin. Embedded emissions would be defined based on the actual CO2 emitted by each specific manufacturing facility. In other words, the EU CBAM would recognise and encourage the climate efforts of individual firms and foreign governments: if producers reduce emissions, on their own initiative or under government pressure, they will need to buy fewer CBAM certificates.

As such, the EU CBAM is a domestic climate tool, based on the Paris Agreement's mission, with impacts on the multilateral trade system. Ultimately, it penalises goods from countries that have lower emissions reduction goals than the EU and requires such countries to raise their climate ambition. The policy could be perceived as a form of 'green protectionism' to shield European companies from foreign competition under the pretext of climate action. If that was the case, the EU would contradict its pledge to foster multilateralism in international climate and trade policy. Even more, the CBAM could be deemed incompatible with the law of the World Trade Organization (WTO) and provoke trade tensions or, at worst, a tariff war between countries.

Such tensions would make it more difficult to reach the required consensus to move forward with the common climate agenda. For these reasons, the European Commission has prioritised WTO compatibility in designing the CBAM. Yet, the EU should also consider the core principles of international climate law, *i.e.* equity and differentiation (enshrined, *inter alia*, in Art. 4 of the Paris Agreement). A unilateral climate

measure, if it does not consider the necessities of developing countries – and especially least developed countries (LDCs) –, would violate the 'common but differentiated responsibilities and respective capabilities' principle. The European legislator should find a balance between effectiveness and equity of the measure. In particular, will the EU demand its partners to adopt explicit carbon pricing policies like the EU ETS to receive a CBAM deduction – as requested by the European Parliament – or will it give some flexibility to them, recognising also implicit carbon pricing measures? Vulnerable countries may lack the capacity and resources needed to develop carbon pricing tools, especially explicit but the EU could (and should) decide to allocate the CBAM revenues to fund cooperation in this field.

The paper then examines the CBAM compatibility with WTO law with specific attention to Articles I, III and XX of the GATT, while also outlining similar legislative initiatives taken by other countries (Canada, Japan, the US) which may synergise with the EU proposal. Art. I requires domestic legislation to not discriminate between imports from different countries. Since the policy is based on the embedded emissions of each product, it treats more favourably climate-friendly products, regardless of their country of origin and without according any favourable treatment to a specific WTO Member against another. Yet, if the measure will acknowledge only explicit carbon pricing policies in the end, this may create a distinction between countries based on their policy choices.

Art. III also imposes a substantive test on the EU CBAM: are imported CBAM products treated less favourably than like European CBAM products? Since the EU CBAM applies the same carbon price as the EU ETS and the calculation methods of emissions are the same for imports and domestic goods, there is no discrimination under Art. III(2). It is essential that the EU CBAM mirrors the charges imposed under EU ETS for value and scope, *e.g.* the phasing-in of the CBAM requires a coordinated phasing-out of the ETS free allowances.

Finally, if the EU CBAM was not found compatible with Art. III or I, it could still be justified under the General Exceptions of Art. XX. The paper argues that the measure may pass the two-tier test required by Art. XX: the EU CBAM 'relates to' one of the exceptions of Art. XX and satisfies the conditions outlined by the Article's *chapeau*.

Provided that the EU CBAM Proposal, in its current status, appears well posed to pass a potential WTO scrutiny, this is not sufficient to shield the Regulation from controversy in international fora. In the end, how the EU CBAM will be perceived by third countries depends on its socio-economic impacts. The paper presents a short literature review on the economic impacts of the EU CBAM on third countries, in particular LDCs, and the position of international organisations on the Proposal (UNCTAD, IMF, World Bank, OECD). The economic impacts will differ depending on the relevance of CBAM sectors in the exports to the EU and the overall importance of the European market for each trade partner. LDCs are more exposed to the CBAM, even if they account for a quite small part of the EU trade of CBAM products. In fact, these exports sometimes contribute to a significant part of these nations' wealth, *e.g.* aluminium exports from Mozambique produce 7% of the whole country's GDP and will be deeply affected by the measure.

Even so, the Commission is cautious in granting preferential treatment to LDCs regarding the EU CBAM, as it happens usually in trade policy, since a temporary 'blanket exemption' would contradict the climate goals of the measure. There are other potential solutions, such as a gradual phasing-in of the policy limited to existing production capacities in LDCs and compensating mechanisms in the form of technology transfers, capacity building and financial aid. The paper recommends the incorporation of such provisions in the final EU CBAM Regulation to make the measure equitable and inclusive.

In its conclusion, the paper tries to determine what role the CBAM could play in achieving and enforcing the Paris Agreement goals. Will it be a unilateral tool to compel climate action, potentially perceived as unfair and criticised by third countries? Or will it be the first step toward a global carbon price and open a new phase for climate policy? If the EU wants to take the second path, it should make sure that the final Regulation

is compatible with international (trade and climate) law, does not have unfair impacts on its partners and opens the door for further cooperation in climate action.