

Klima

Carbon Border Adjustment Mechanism

Position

Status: July 2020

vbw

Die bayerische Wirtschaft



Note

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Preface

Multilateral Solutions rather than Unilateral Measures

Climate protection is one of the greatest challenges of the 21st century. Owing to its economic strength the European Union bears a special responsibility. Global climate protection, however, is not going to benefit in any way if Europe's industry moves to countries with less stringent emission standards. Climate protection and industrial policy go hand in hand.

The idea of a Carbon Border Adjustment Mechanism (CBAM) is understandable against this background because in theory it balances out competition distortion. In practice, however, besides involving massive implementation hurdles, there would also be substantial risks. For this reason, our current position is to reject the introduction of such a system. Instead, we should further develop the European Emissions Trading Scheme in an international context and strive to implement a global carbon price. A border adjustment mechanism would only be conceivable in close collaboration with our most important trading partners around the world to avoid far-reaching distortions up to and including trade wars.

The CBAM does not in itself offer reliable protection against carbon leakage for energy-intensive companies and therefore does not help to achieve the international climate targets. It is far more important now to help our local industry develop climate-friendly technologies and bring them to market maturity. Such technologies are vital for global climate protection and they are becoming an increasingly significant area of activity for our companies.

Bertram Brossardt
27 July 2020

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The Position in a Nutshell

A Border Adjustment Mechanism Entails Many Uncertainties

A Carbon Border Adjustment Mechanism (CBAM) is currently to be rejected. With a view to the competitiveness of Europe as an industry location, it is particularly the trade risks that should be seen very critically as well as the uncertainty as to whether such a mechanism offers a reliable and at least equally strong and comprehensive protection against carbon leakage as the free allocation of emission allowances and electricity price compensation. We can neither afford serious trade conflicts, nor can we risk stricter regulations and additional burdens that lead to production being relocated to countries with laxer emission constraints.

Rather than introducing a CBAM it would be better to further develop the European Union Emissions Trading Scheme (EU ETS) in an international context and enhance efforts towards a global carbon price. The European Commission is therefore called upon to work on an alternative solution in collaboration with other WTO countries.

Should a CBAM nevertheless be introduced, it is essential for it to meet the following requirements:

- The proven carbon leakage prevention measures should only be replaced if the new measures provide at least equivalent protection. Due to the unforeseeable consequences of a system change, the free allocation of emission allowances and the electricity price compensation should be maintained, at least for a transitional period.
- Carbon footprinting for the respective imported product must be transparent, internationally recognized and easy to implement administratively. It will nevertheless be necessary to establish a calculation method that is as accurate and specific as possible. Generalised methods are counterproductive for reaching climate targets and are therefore to be avoided.
- In the first stage, only basic raw materials should be covered by the CBAM.
- There is to be no discrimination based on country of origin. Trade wars must be avoided.
- In view of the unanimity on tax policy issues required by the European Treaties the concept of designing the CBAM as a tax is inappropriate because it would be far too ineffective a tool.

1 Current Status

The European Commission Is Developing a Carbon Border Adjustment Mechanism

The communication on the European Green Deal adopted by the European Commission on 11 December 2019, includes the goals of enshrining climate neutrality by 2050 in legislation and cutting greenhouse gas emissions by 50 to 55 percent from 1990 levels by 2030. Recently, the European Commission has announced a 55-percent target. In the communication, the Commission underlined that there is a risk of carbon leakage as long as many of the international partners pursue a less ambitious climate policy than the European Union. European production will then either relocate to non-European countries with laxer emission constraints or European products will be replaced by imported products manufactured with higher emissions. Should carbon leakage materialise, global emissions are not going to decrease. This would undermine the efforts of the EU and its industry towards achieving the global climate goals of the Paris Agreement and, at the same time, would weaken the business location.

The ambitious climate targets set out in the European Green Deal are intended as a means to achieve the goals of the Paris Agreement which aims to limit global warming to well below two degrees Celsius, and possibly even down to 1.5 degrees Celsius. So far, the Earth has warmed up by more than one degree Celsius. Already a rise in temperature of two degrees can lead to tipping points that result in a self-perpetuating and irreversible global warming with catastrophic consequences for the world population.

In spite of this huge challenge and the narrowing time window, climate protection efforts of individual countries still vary significantly. The USA is even set to leave the Paris Agreement on November 4, 2020. There can therefore be no question of an international level playing field with comparable climate protection measures and comparable competitive conditions.

The Commission announced that it is going to propose a Carbon Border Adjustment Mechanism for selected sectors in order to reduce the risk of carbon leakage. The CBAM is to ensure that the price of imported goods accurately reflects their carbon content. The Commission intends to make the CBAM compatible with the rules of the World Trade Organisation (WTO) and other international regulations. The CBAM is intended as an alternative to the instruments of the EU ETS which currently serve to prevent carbon leakage, these being the free allocation of emission allowances and the electricity price compensation through EU Member States.

In its Inception Impact Assessment the Commission only gives a very general description of the CBAM. The objective of the measure is to combat climate change by preventing carbon leakage. The type of measure, however, remains open. The options listed by the Commission include a carbon tax on selected imported and domestic products, an import

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tax on imports and the expansion of the EU ETS to cover imports. The CBAM is to be applied to sectors where the carbon leakage risk is highest. These are generally energy-intensive and import-intensive sectors. The method to be used to determine the carbon content of imported goods is not yet clear. According to the Commission, benchmarks similar to those used in the EU ETS would be conceivable. Alternative determination methods are also being considered. In order to ensure compatibility of the CBAM with WTO rules, technical consultations with the WTO are to be held. WTO channels are to be used to seek dialogue with international trade partners and to avoid retaliation in trade relations.

The Commission has announced that the legislative proposal for the CBAM will be presented by June 2021.

2 Position of the Bavarian Industry

Securing Protection against Carbon Leakage and Avoiding Trade Wars

2.1 Trade Policy Assessment

2.1.1 WTO Compatibility Possible, Although Difficult

As already underscored by the Commission, a Carbon Border Adjustment Mechanism must be compatible with WTO rules. Article III of the General Agreement on Tariffs and Trade (GATT) is one of the core GATT provisions. It stipulates that imported goods must be treated in the same way as domestic goods. This means that products imported from the territory of one WTO member into the territory of another WTO member must not be subjected directly or indirectly to higher taxes or other charges than equivalent domestic products.

At a first glance it would appear that a Carbon Border Adjustment Mechanism that imposes an additional border tax on foreign goods puts imported goods at a disadvantage against domestic products and violates GATT Article III. The assessment of the compatibility of climate and environmental policy measures with WTO rules, however, requires a more detailed analysis. WTO members' autonomy to determine their own environmental standards has been reaffirmed on a number of occasions by the WTO Appellate Body. In the U.S. *Shrimp* case, for example, the Panel ruled for the first time that market access restrictions based on climate and environmental concerns can be legitimate as long as they fall within the realm of an exception under GATT Article XX.

Relating to the environment and the climate, paragraphs b and g of Article XX are relevant. These stipulate that WTO members may adopt measures necessary to protect humans, animals or plants life or health (paragraph b) and measures relating to the conservation of exhaustible natural resources (paragraph g). In order for a trade-related environmental measure to be eligible for an exception under Article XX an adequate connection between the measure at issue and its stated environmental policy goal must be established. The chosen measure needs to be primarily aimed at achieving the stated climate and environmental objective. It also has to be carefully considered whether alternative measures that are less trade restrictive could possibly achieve the same goal.

The configuration of the trade-related climate protection measure is crucial for WTO compatibility. Article XX stipulates that the measure shall not constitute "arbitrary and unjustifiable discrimination" or a "disguised restriction on international trade". These conditions are designed to ensure that WTO members exercise their right to benefit from exemptions in good faith and do not circumvent their obligations towards other WTO members. The following may be helpful in this regard:

- Before introducing the measure the WTO member must coordinate with other WTO members and seek a multilateral approach. Wherever possible, the conclusion of multilateral agreements is preferable to unilateral action.
- Special conditions applying to other WTO members must be taken into account. Rigid application of the measure without regard to special conditions in other countries, may constitute unjustifiable discrimination.
- The application of the measure and the reasons given for its introduction must not reveal any hidden protectionism.

Some analysts argue that measures for reducing carbon emissions such as the Carbon Border Adjustment Mechanism could fall under Article XX (b) because they are aimed to protect humans against the negative impact of climate change, such as flooding, for example, or under Article XX (g) because they are aimed to preserve not only the planet's climate but also certain plant and animal species that could disappear as a result of global warming. However, it is not possible to make a definite statement regarding compliance of the planned CBAM with WTO rules until the exact details are known. Only the WTO Appellate Body can conclusively determine whether the CBAM is WTO compatible. The Appellate Body has, however, been incapacitated since December 2019 as the USA has been blocking the appointment of members for several years.

Conflicts are very likely to occur with international trading partners on whether the CBAM will actually be implemented in a non-discriminatory manner. Retaliatory measures by other WTO members cannot be ruled out. These can quickly escalate into trade wars, which must be avoided at all costs.

2.1.2 Seeking Multilateral Solutions

A CBAM would definitely have to be conceived in such a way that it complies with the conditions set out in the WTO rules. To this end, the following actions are required:

- The European Commission needs to seek a solution with other WTO countries in advance. In the light of the blocking of the WTO Appellate Body and the collapse of international trade due to the Covid-19 pandemic, it is particularly important for the Commission to avoid trade wars.
- It is important to consider alternatives to the CBAM that have a less trade restrictive impact, yet still reduce the risk of carbon leakage and contribute to achieving reduced carbon emissions. A detailed impact assessment must be carried out for each alternative proposal.
- Foreign products are only to be treated differently from domestic products on the basis of their carbon performance (e.g. using sectoral benchmarks) and not according to country of origin. Exceptions can be made for Least Developed Countries for which WTO rules provide a "special and differential treatment". Pursuant to the EU's General Scheme of Preferences products from Least Developed Countries shall not be burdened by new border taxes.

2.2 Tax Policy Assessment

The European Treaties do not confer taxation competence on the EU at present. Within the framework of the treaties a tax could only be used as a basis for a CBAM if adopted unanimously and if any future development is agreed unanimously. Against this background, the EU should consider very carefully whether to opt for a tax in the context of the CBAM. Without an amendment to the Treaties this would be an extremely slow and sluggish instrument that is not recommended considering the need to be able to react in a very complex environment. Based on past experience and in view of the high value Member States attach to taxation powers, an amendment to the Treaties to this end does not appear very promising.

Moreover, in the transitional period it would have to be ensured that a tax-based CBAM would not lead to price distortions in the Single Market due to regulation. In the light of the very different national systems and their respective steering mechanisms, such distortions could occur if the tax was not just introduced as a border adjustment measure, but rather as a general carbon tax with border adjustment – as has been repeatedly called for.

2.3 Climate Policy Assessment

Differing levels of climate action lead to effects that are counterproductive for climate protection. For instance, stricter regulations and additional burdens drive production to countries with laxer emission constraints. Particularly the energy-intensive sectors with carbon-intensive products (such as chemicals, cement, steel, aluminium) have a high carbon leakage risk and need to be reliably protected. Reducing the use of fossil fuels can also contribute to carbon leakage if falling prices for coal, oil and gas lead to a higher demand in other countries.

Against this background, the introduction of a CBAM is a plausible consideration. By compensating the carbon cost difference to imports it serves as a carbon leakage prevention measure for the domestic industry. At the same time, it is to incentivise other countries and companies abroad to adopt a more ambitious climate protection policy in order to remain competitive with their products on the European market.

Theoretically, the CBAM can thus contribute towards harmonising climate protection on an international scale and serve as an instrument for solving the so-called free-rider problem, where countries with low-level climate protection standards continue to benefit from significant economic advantages while the costs of the impact of climate change ultimately have to be borne by all. What may sound right in theory, therefore faces massive problems in practice.

2.3.1 Ensuring Reliable Protection against Carbon Leakage

So far it has not yet been possible to explain how a CBAM can be implemented in an appropriate and economically viable manner, and gain the necessary international acceptance. The existing instruments for carbon leakage prevention can on no account be scaled back on this basis.

The EU ETS, with its free allocation of emission allowances for sectors exposed to a particularly high risk of carbon leakage and with electricity price compensation for indirect carbon costs, has proven to be a valid measure for carbon leakage prevention. It is therefore important to examine any system change carefully. Any alteration to the proven carbon leakage prevention measures should only be approached with extreme caution in order to avoid any unforeseen systemic effects. These measures should only be replaced by a different measure if the new instrument is at least equivalent. In addition, any shift of carbon leakage prevention to the sensitive trade policy sector would entail many risks (see 2.1. Trade policy assessment).

2.3.2 Determination of the Carbon Footprint – A Difficult Task

The methodology used for carbon footprinting needs to be clarified. The method must be transparent, internationally recognised and easy to implement administratively. The main problem is that the two objectives of the CBAM (effective protection against carbon leakage and incentivising greater international climate action) strongly depend on how accurately and reliably the carbon footprint of a certain imported product can be determined. However, the more specific and more stringent the calculation method is, the more complex its implementation is in practice.

One possibility would be to align the CBAM to *product benchmarks* that follow the principle of best available technologies (BAT). Product benchmarks are already applied in the EU ETS. Here, the average emissions of the best performing ten percent of the installations producing the individual products in the EU are determined. Using these benchmarks, the free allocation of emission allowances is then determined in the EU ETS. Consequently, the more climate friendly an installation is, the more free emission allowances it receives. Benchmarks of this kind are also used in the ETS of other countries, such as South Korea or Switzerland.

If this method was used for the CBAM, importers would have to prove that their products meet the applicable benchmark. An integration of imports into the EU ETS would then be a possible solution. For imported products from installations with higher carbon emissions than the relevant product benchmarks, allowances would have to be purchased accordingly.

When determining the carbon emission intensity, the system boundaries have to be taken into account. For direct emissions (scope 1), for example, data collected directly on site have to be used, while for emissions from purchased electricity (scope 2) it is usually the

data from the energy suppliers that are relevant, and for emissions in the supply chain (scope 3) the emission data from the suppliers have to be trusted. Company-specific emission data are hard to determine. It is also necessary to clarify how reliably these data can be collected abroad and verified.

Other key questions include:

- How deep value chains for complex products can be analysed,
- Is it possible to establish internationally uniform measuring standards and benchmarks (possibly requiring new international bodies and institutions),
- Whether and how existing climate protection measures in other countries can be taken into account in the border adjustment and
- Which measures are suitable for avoiding misuse and loopholes.

Considerations to use a *generalised* method for carbon footprinting fail to meet the requirement of capturing as accurately as possible the specific CO₂ emissions efficiency level associated with the respective product or its value chain: it would be inconsistent with the goals of the CBAM if, in the Border Adjustment Mechanism, a tonne of steel produced with a high level of carbon efficiency would be treated in the same way as a tonne produced using electricity from an old coal-fired power plant. This would cause further distortions and lead to the relocation of certain stages in the value chain. Due to the fact that these problems increase with the growing complexity of the product, the CBAM should definitely only cover basic raw materials in a first stage.

Methodologies and databases for evaluating the carbon footprint are becoming more and more comprehensive and accurate. Further progress is to be expected in this field and this will also lead to a growth in acceptance. It is, however, difficult to imagine at this stage that a calculation method will be found that reliably achieves the CBAM goals of secure protection against carbon leakage and greater international climate action. This is comparable to the taxonomy criteria that are being developed as part of the Sustainable Finance Regulation, where it is still not clear how adverse consequences for the entire value chain can be avoided. (see vbw Position *Sustainable Finance*, January 2020).

2.3.3 Further Development of the EU ETS in an International Context

As yet, no convincing concept has been presented explaining how a Carbon Border Adjustment Mechanism could replace the free allocation of emission allowances or the electricity price compensation in at least an equivalent manner, without endangering the competitiveness of European industry. The determination of the carbon footprint of imported products also poses many challenges. The development of alternative strategies and measures is therefore urgently needed. To this end, the European Emissions Trading Scheme (EU ETS) should serve as the key instrument for achieving international climate targets, especially as it is based on a free-market incentive system.

The ultimate goal must be to implement a uniform and global carbon price. For this purpose the EU ETS needs to be further developed, in particular through the integration of

other sectors and through collaboration or interlinking with other Emissions Trading Schemes in the world. In this way, it will be possible to gradually create a global and cost-effective carbon market. Simultaneously, further developing proven carbon leakage prevention measures for the domestic industry and intensifying the promotion of innovative low-carbon technologies is the best way to advance global climate protection. Cooperation and integration are better than exclusion and penalties when it comes to winning over as many players as possible for ambitious climate action.

The cross-sector expansion of the EU ETS is a wise intermediate step. For an integration of the building and transport sectors into the EU ETS, however, it is important to realise that this could lead to a more rapid increase in the price of emission certificates and jeopardise the international competitiveness of European industry in the short and medium term. In the transport and building sectors there is the risk that any steering effect would only be reached at very high carbon prices, and for these sectors the purchase of emission allowances would be the more favourable alternative to corresponding reduction measures.

Therefore, should the sectors of transport and buildings also be regulated by a European emissions trading scheme, an acceptable solution would require trading in a separate system, at least during a transitional phase. As the long-term goal should be an interlinking with the EU ETS, preparations to enable such a connection of the two systems must be undertaken at an early stage.

Especially for the energy-intensive industry, more effective and reliable measures for carbon leakage prevention and for the avoidance of market distortions are required. An expansion of the free allocation of emission allowances or an equally effective solution is indispensable in view of the ambition gap in climate change mitigation in the world, and for the integration of further sectors into the EU ETS. Also, the electricity price compensation needs to be maintained and further developed, possibly by making the use of renewable electricity more attractive for energy-intensive companies, for example in the form of long-term direct purchase agreements.

Contact persons / Imprint

Dr. Manuel Schölles

Economic Policy Department

Phone 089-551 78-246

Fax 089-551 78-91 246

manuel.schoelles@vbw-bayern.de

Tatjana Vargas

Department of Foreign Trade and Investment

Phone 089-551 78-258

Fax 089-551 78-91 258

tatjana.vargas@vbw-bayern.de

Imprint

All details in this publication refer to all genders without any intention of discrimination.

Publisher

vbw

Vereinigung der Bayerischen
Wirtschaft e. V.

Max-Joseph-Straße 5
80333 München

www.vbw-bayern.de

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