

Making trade work for EU climate policy: Carbon border adjustment or product standards

To adjust or not to adjust for carbon, that is the question for the EU's climate policy

The COVID-19 pandemic has rapidly changed the economic and social landscape we live in, putting the EU's climate policy into a different context.

It seems, therefore, sensible to review one of the foreseen centrepieces of the EU's climate action – the **carbon border adjustment mechanism** (CBAM) – not only as a stand-alone measure but also as a measure implemented in the broader policy mix of a post-COVID-19 economy.

There is a particular need to consider the role **improved product standards**, as put forward by the EU Circular Economy Action Plan, can play as an alternative or complementary to a CBAM.

The final policy outcome is likely to be a combination of the two measures, requiring dedicated attention to ensure complementarity and coherence between the two policies – resulting, hopefully, in the best of both worlds.

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Authors:

Eline Blot, Marianne Kettunen, Céline Charveriat

The EU endeavours to become the first carbon-neutral bloc by 2050 by increasing its climate ambition as outlined in the European Green Deal (European Commission, 2019).

However, within the international trade regime that we live in, the EU's climate objective is influenced by climate ambition, or lack thereof, in other countries.

To counteract this problem, the European Green Deal foresees the implementation of a Carbon Border Adjustment Mechanism (CBAM), for selected sectors, to reduce the risk of carbon leakage.

The prospect of implementing a CBAM has drawn critique in the past. In addition, there is now a need to reflect on the role and effectiveness of CBAM in a post-COVID-19 economy.

The economic response to the health crisis is a global priority with implications for the implementation of a CBAM. For example, subsidies given to industries impacted by the COVID-19 crisis could affect competitiveness, clouding the effectiveness of a CBAM as a tool to level the playing field.

In planning for the economic recovery, the debate on the CBAM is likely to restart in the EU. For instance, the French authorities have already called for policy measures to avoid significant drops in the carbon price, such as a carbon price floor and a CBAM (Simon, 2020).

In the current context, it is necessary to reflect on the CBAM not only as a stand-alone measure but also as a measure implemented in the broader policy mix of a post-COVID-19 economy.

What is a carbon border adjustment?

The European Commission's [inception impact assessment](#) (2020a) on the implementation of a CBAM states that carbon leakage occurs “when production is transferred from the EU to other countries with lower ambition for emission reduction, or when EU products are replaced by more carbon-intensive imports”. To put this plainly: in the case of carbon leakage, there would be no reduction of global greenhouse gas (GHG) emissions, despite EU efforts.

In practice, the EU's CBAM could be a customs duty on imported products – or a tax on selected products (foreign and domestic) – reflecting their carbon content, corresponding with the EU's internal carbon pricing. To determine which products this measure would apply to, the CBAM could be based on benchmarks on products' carbon content, very similar to the EU Emissions Trading System (ETS). These benchmarks are commonly determined by “the average GHG emissions of the best performing 10% of the installations producing that product in the EU and EEA-EFTA states” (European Commission, n.d.). Installations meeting the respective benchmark receive all the allowances they need to cover their emissions, whereas installations unable to meet the benchmark receive fewer allowances than they need. Hence, underperforming installations need to either reduce their emissions and/or buy additional allowances.

The ETS allocates free emissions allowances to industries with the highest assessed risk of carbon leakage. The Commission states that the CBAM would be an alternative to the allocation of these free allowances, as the CBAM is

foreseen to apply to selected sectors where the risk of carbon leakage is highest (e.g. steel, cement, chemicals, energy). The current system of free allocation of ETS allowances to address carbon leakage is set to continue until at least 2030. Therefore, it is still unclear if the implementation of the CBAM would be phased-in, parallel to the current free allocation system, or if the CBAM would replace free allocations by 2030.

The policy – and political – rationale behind the Commission's push for implementing a CBAM is to fight climate change by avoiding carbon leakage and level the playing field for EU and non-EU producers. As long as international partners do not follow the EU's climate ambition, the risk of carbon leakage remains.

Is a CBAM what the EU really wants to double-down on?

The prospect of implementing a CBAM draws some critique. The key elements of this critique include:

- **Impacts on wider EU climate policy:** the CBAM faces many significant obstacles such as its legal and political complexity, technical methodology and environmental effectiveness (Lamy et al., 2019; Mehling et al., 2019; Zachmann & McWilliams, 2020). Overcoming these barriers runs the risk of redirecting technical and political resources and attention away from other, likely more effective climate policies. If the CBAM, and by extension carbon leakage, become seen as central to EU climate policy, there is a significant political risk that this will give political room for domestic sceptics of climate action to slow down the implementation of ambitious climate policy while the complexities of a CBAM are worked out, likely over the space of numerous years.
- **Determining benchmarks and scope:** ETS benchmarks for carbon content are determined by installations producing in the EU and EEA-EFTA states. If the CBAM adopts the ETS approach of sector benchmarks to determine the average carbon content of products, it effectively assumes that the most carbon-efficient production takes place within the EU and EEA-EFTA area. To mitigate against this assumption, the EU CBAM would need to provide rebates to foreign producers that can prove their production is more efficient than the EU benchmark. Furthermore, as initially described by the Commission, the CBAM applied in carbon-intensive sectors can only cover the emissions for the production of raw materials and does not account for the downstream emissions. While it is possible to include consumption in emissions trading,

as presented by Neuhoff et al. (2016), this would add yet another level of complexity in the benchmarking system.

- **Effectiveness to address carbon leakage:** Bruegel's policy contribution by Zachmann & McWilliams (2020) provides an in-depth literature review on the existence of carbon leakage. The literature on *ex-post* studies concludes that there is little evidence of carbon leakage at the aggregate and carbon-intensive sector level. The lack of empirical evidence on carbon leakage could be explained by two factors. The first being the low emission prices from 2006 to 2018, meaning the cost of excessive pollution by carbon-intensive firms was relatively low so there was no need to relocate. The second being the allocation of free emission allowances, which is specifically intended to reduce carbon leakage.

Given these factors, the existence of carbon leakage is not disproven. It is possible that in the future, carbon prices will rise significantly, incentivising firms to move production outside the EU's borders. On this, Zachmann & McWilliams (2020) also provide a review of *ex-ante* modelling analyses, concluding that in carbon-intensive sectors the rates of carbon leakage largely differ, mostly as a result of modelling assumptions. At the aggregate level, there is some evidence of carbon leakage. However, when a CBAM is introduced to the models, its effectiveness at reducing carbon leakage is limited as indirect carbon leakage persists through energy prices.

Finally, there are concerns that a CBAM may lead to similar failings as those faced by the ETS in its initial phases. Overallocation of emission allowances and a low carbon price have reduced the ETS's effectiveness in lowering the EU's GHG emissions (Ellerman et al., 2016), although the ETS has steadily reduced emissions in the power sector.

Recently, the Commission closed the first feedback period for the CBAM (European Commission, 2020a). As reported in Reuters, feedback provided by stakeholders in the steel, aluminium and cement sectors called for the CBAM to be implemented to complement – rather than replace – the free allowances under ETS, leading to fears of free allowances to industry sectors again undermining climate policy (Abnett & Jessop, 2020). The fear that industry lobbying could overshadow climate policy ambition also looms in the aftermath of the post-COVID-19 economic recovery, as speculated by [Carbon Pulse](#). Specifically, the ETS free allocation rules are set to be adjusted to changing activity levels in 2021. Certain industries are asking to exclude 2020 from the calculations due to the sudden economic downturn, however, free allowances that remain unused in 2020 are still valid in the future

(Carbon Pulse, 2020). So, these industries may make a profit from both unused and potential future overallocation of free allowances.

- **Political complexity:** As previously mentioned, a CBAM is politically complex. International criticism of a CBAM is that it is just a disguised protectionist measure, implying that its main objective is to protect domestic producers from competitive imports (Mehling et al., 2019). Moreover, veiled protectionism paired with the accusations of regulatory overreach leaves the EU open to retaliation from trade partners that do not see eye-to-eye when it comes to climate policy (Zachmann & McWilliams, 2020). Also, the Commission must consider if a CBAM is compatible with the spirit of the Paris Agreement. The CBAM indirectly extends the EU's climate policy beyond its own borders, potentially conflicting with the principle of “common but differentiated responsibilities” as enshrined in the UNFCCC treaty and Paris Agreement (Davidson Ladly, 2012).
- **Risk of disincentivising progress in third countries:** A final issue of the CBAM with regards to third countries is that it risks disincentivising promising firms making headway on low-carbon production. For example, if the CBAM is based on the average production method in a given country's sector, and that average is worse than the EU's average in the concerned sector, then the few promising firms in that sector would be penalised by the CBAM. To account for this, the EU would need to allow individual firms to prove they are more efficient than the average in their country, however, this may increase complexity as individual requests can create a backlog.

Taken together, all the above points raise the question: is a CBAM the climate policy measure the EU wants to double-down on?

Elevating product standards as an alternative?

In lieu of a CBAM, the Commission could focus on alternative measures that would complement the ETS while addressing other objectives set out in the European Green Deal. Examples of alternative policy measures – internal and trade-related alike – that can be undertaken to incentivise carbon emissions reductions are consumption charges, public financial injections into clean technologies and the formation of international climate clubs (Dröge et al., 2019; Nordhaus, 2015; Zachmann & McWilliams, 2020).

Another alternative route would be to increase product standards for products placed on the EU market, to reflect the EU's climate objectives. Such product standards could be an appropriate policy measure to reduce carbon emissions linked to both EU and imported goods, developed and executed jointly with the foreseen improvements in product standard put forward by the EU Circular Economy Action Plan (CEAP) (European Commission, 2020b).

Several advantages can be identified that the EU has in implementing product standards:

- **Non-discriminatory:** One of the EU's greatest foreign policy tools is access to the Single Market. As such, a product standard covers all goods sold on the Single market and any producer who wants access must conform to the rules in place. In this way, the product standard is non-discriminatory in nature as the standard applies to both domestic and foreign products to be sold on the Single Market.
- **Comprehensive:** Product standards also speak to the EU's goal of being a frontrunner when it comes to climate policy. As stated in the European Green Deal (European Commission, 2019), the EU is experienced when it comes to "green" regulation, and it can be a trusted leader, setting standards that could end up being (partially) adopted by other countries. Moreover, a product standard can be comprehensive in nature. As opposed to the CBAM, which only covers the emissions from the production of raw materials, product standards can be designed to regulate the environmental impact resulting from both the manufacturing as well as the use of the product. Also, the standards can be designed to incentivise low-carbon production as well as ease and advance the transition to a circular economy.
- **Compatible with wider EU environmental policy:** The European Green Deal puts forward a policy target to set minimum requirements to prevent environmentally harmful products from being placed on the EU market, with the EU Circular Economy Action Plan (CEAP) mapping out a clear pathway for sustainable product policy to support the implementation of this target. The goal is to expand the EU Ecodesign Directive and "make the Ecodesign framework applicable to the broadest possible range of products". Product groups that receive priority are ICT & electronics, batteries & vehicles, packaging, plastics, textiles, furniture and high-impact intermediary goods such as steel, cement and chemicals. The Commission adds that it will "consider establishing sustainability principles" to regulate carbon and environmental footprints, among other sustainability aspects. Moreover, the Commission considers adopting mandatory requirements

to increase the sustainability of goods and services, closing the gap created by voluntary standards (European Commission, 2020b).

However, some challenges would need to be assessed:


- **Consumer costs:** Determining what the set standard *should be* is not entirely straight forward, as we rely on today's technologies to determine tomorrow's policy. A product standard also implies an initial increase in consumer costs as producers adapt their production process to be compliant. However, the same argument can be made for most policy measures that impact the production process – this is a change that is bound to happen. Moreover, if implemented gradually and taken into account with the Just Transition Fund, it does not risk leaving SMEs behind in the transition to a low-carbon economy.
- **Ensuring global cooperation:** Finally, there are important global considerations for implementing a product standard in a way that benefits sustainable development at a global scale, leaving no-one behind. Such a standard can hinder developing countries' access to the Single Market; however, this can be mitigated by certain schemes in places such as development cooperation and [Aid4Trade](#), as is the case with the circular economy (Kettunen et al., 2019). Also, there is a risk of competing international standards that can lead to market fragmentation. However, if the EU decides to become a leader in this field, it can – in cooperation with other ambitious leaders – set standards that could have the potential to become the norm.

Conclusion: getting the best of both worlds?

In the post-COVID-19 economy, carbon prices may prove to be too unstable to support effective industrial decarbonisation. Therefore, there is a need for product policies to push forward new standards on low-carbon, resource-efficient products to secure the transition to a sustainable economy.

While the product standard, like the CBAM, may end up being technically complex, it seems less politically contentious internationally as it is non-discriminatory in nature. The product standards also have the benefit of being designed to apply to many sectors' production processes and products' end-use, whereas the CBAM is already expected to be limited to a select few carbon-intensive sectors (e.g. steel, cement, chemicals) at risk of carbon leakage.

On the other hand, the CBAM continues to receive political support indicating that it is more likely than not to go forward. For example, most recently the Dutch and French governments, while calling for more climate ambition in trade talks, have explicitly stepped forward to welcome the foreseen concrete Commission proposal for a CBAM (Pickstone, 2020).



The final policy outcome is, therefore, likely to be a combination of the two measures, requiring dedicated attention to ensure complementarity and coherence between the two policies, hopefully resulting in getting the best of both worlds.

The EU has expressed the ambition to implement sustainable product standards in the CEAP framework. The CEAP is set to include product standards for high-impact intermediary products flowing from the sectors that are likely also to be targeted by a CBAM. Since the scope of the CBAM is foreseen to be rather limited, to ensure a rapid transition to a sustainable economy, the scope of product standards in the CEAP should be broad enough to help achieve more comprehensive EU policy action on the link between trade and climate.

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