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NAVIGATING THE POLITICS OF BORDER CARBON ADJUSTMENTS

JOHANNA LEHNE AND OLIVER SARTOR

Border carbon adjustments (BCAs) are among the most controversial elements of the Commission's European Green Deal. They are technically difficult to design and politically challenging to implement. But they could answer a specific need: offering a long-term answer to industry concerns over international competitiveness and helping to drive global climate action.

This brief focuses on the politics of BCAs and how best to navigate them. It looks at alternatives to BCAs, highlighting low-carbon product requirements as a preferred option, and maps out the politics surrounding these measures within and outside Europe.

No matter which tool it picks – BCAs or product requirements, the EU will need to build a complementary cooperation agenda for it to succeed. This requires not just a WTO-compatible mechanism, but a strategy to encourage other countries to partner with the EU on design and implementation. This strategy must include a credible offer for those partners on trade relations and technical and capacity support as part of broader European Green Deal diplomacy.

Context

The idea behind BCAs is relatively simple: The EU would impose a charge on goods imported into the EU from foreign producers who operate without a carbon price to protect its domestic producers, who face a carbon price, from being undercut. In practice, however, designing and implementing BCAs requires overcoming a series of technical, legal and above all political challenges.

BCAs are controversial because they represent the external projection of a country or region's climate policies. They compel trade partners to abide by a minimum standard for carbon emissions. Critics argue that this represents a break from the multilateral approach to climate action: where the emphasis has been on a collective effort to cut carbon emissions. BCAs, by contrast, could unilaterally impose higher standards on trade partners.

As a result, BCAs have a long history in globalisation and trade discourse but very few examples of practical application. Over the years they have been proposed in Europe, Australia and the US among other places.

BCAs, CBAMs, BTAs…

A **border carbon adjustment** is any trade measure that is used to put products from foreign producers who operate without a carbon price on an even footing with products from domestic producers who face a carbon price.[1] They are also referred to as carbon border adjustment mechanisms (CBAMs). BCAs are a type of **border tax adjustment (BTA)**, a coverall term for taxing products where they are consumed rather than where they are produced.[2] BCAs can take different shapes: a tax, a levy, a regulation, a standard. In this paper when we refer to BCAs we strictly mean a tax or levy and we view product requirements as an alternative to such a mechanism.

[1] Cosbey, A., Droege, S., Fischer, C. and Munnings, C. (2019), 'Developing Guidance for Implementing Border Carbon Adjusments : Lessons, Cautions, and Research Needs from the Literature', *review of Environmental Economics and Policy*, 13(1), **https://doi.org/10.1093/reep/rey020** (accessed 9 Mar. 2020).

[2] Mehling, M. A., van Asselt, H., Das, K., Droege, S. And Verkuijl, C. (2019), 'Designing Border Carbon Adjustments for Enhanced Climate Action', *The American Society for International Law*, doi:10.1017/ajil.2019.22 (accessed 30 Jul. 2020).

BCAs in the European Green Deal

In Europe they started to be seriously considered from the mid-2000s.[3] They resurfaced every couple of years, often brought on by another round of EU Emissions Trading System (ETS) reform, usually driven by France.

In their latest iteration they came from a different source. In her bid to become president of the European Commission, Ursula von der Leyen had to win over a new group of Members of the European Parliament (MEPs) who had swept into parliament on the 'green wave' during the 2019 European Parliament elections. She promised to back more ambitious climate goals, explore BCAs and widen the ETS to include shipping and aviation.[4] This was followed up in December with the European Green Deal communication in which the Commission raised the possibility of proposing a BCA "should differences in levels of [climate] ambition" persist worldwide.[5]

The immediate reactions to this proposal were strong both within the EU and among international trade partners. France and Spain quickly positioned themselves as champions. Germany, despite signing onto a French BCA proposal,[6] urged caution and raised concerns that BCAs could trigger a trade war. Industry trade associations came out with different positions on the merit of this proposal and how to design BCAs. International partners watched with interest and concern. China and the US swiftly decried European 'protectionism' and threatened retaliation if such a tool was implemented.[7]

The politics of BCAs have only become more complicated in the wake of the COVID-19 outbreak. In some ways the crisis has reinforced the impetus for

[3] Lamy, P., Pons, G. and Leturq, P. (2020), *Greening EU trade 3: A European Border Carbon Adjustment proposal*, **https://institutdelors.eu/publications/verdir-la-politique-commerciale-de-lue/** (accessed 11 Jun. 2020).

[4] Hall, B. (2019),'Business hopes Ursula von der Leyen will keep doors open', *Financial Times*, 18 July, **https://www.ft.com/content/5426dd2e-a818-11e9-984c-fac8325aaa04** (accessed 28 Apr. 2020).

[5] European Commission (2019), *The European Green Deal*, **https://ec.europa.eu/info/sites/info/files/european-green-deal-communication_en.pdf** (accessed 28 Apr. 2020).

[6] Bundesministerium der Finanzen, Ministere de L'Economie et des Finances, Bundesministerium für Wirtschaft und Energie (2019), *Franco-German priorities for the next European institutional cycle on economic, financial and trade matters,* 9 September, **https://www.economie.gouv.fr/files/2019-09/2019%2009%2019%20joint%20paper%20FR%20GER%20new%20Commission.pdf** (accessed 28 Aug. 2020).

[7] Wettengel, J. (2020), 'US keeps wary eye on EU carbon border tax plans', *Clean Energy Wire*, 23 March, **https://www.cleanenergywire.org/news/us-keeps-wary-eye-eu-carbon-border-tax-plans** (accessed 11 Jun. 2020); Carbon Pulse (2019), 'China lashes out at EU carbon border adjustment initiative ahead of climate talks', 27 November, **https://carbon-pulse.com/87558/** (accessed 11 Jun. 2020).

imposing BCAs. EU industrial competitiveness has become a starker concern as steel, cement and chemicals companies deal with the impacts of supply-chain disruptions. Protectionism suddenly seems to be the default response, in a world where the vulnerability of global supply chains has been laid bare and countries failed to follow trade rules in the fight over scarce medical equipment.[8]

Member states are also looking for new sources of revenue to shore up budgets.[9] In this context, the Commission's Next Generation EU proposal, published on 27 May 2020, suggested that BCAs might be able to raise between €5-14 billion per year in new so-called 'own resources' to repay higher borrowing by the Commission in response to the crisis.[10] Heads of state did not come to a final agreement on BCAs at the July European Council but gave the Commission a mandate to put forward a proposal for such a measure in the first half of 2021.[11]

While the stakes may be higher, the risks involved have also grown. With true commitment to multilateralism being put to the test and countries around the world focused on dealing with this crisis, putting BCAs forward as an 'incentive' for climate action risks being seen as overly punitive.

How BCAs come across in this moment is also a question of who is on the receiving end of that messaging. The EU is clearly targeting major economies – China, the US and Russia – with its call for enhanced climate action and BCAs have been useful in keeping high-level political attention in these countries on climate. However, BCAs could also impact a huge number of emerging and developing economies for whom this approach will seem unfair unless they are accompanied by extensive cooperation and capacity building measures.

Making sense of BCAs

The basic logic behind BCAs is two-fold:

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[8] Van Wagtendonk, A. (2020), 'US allies express dismay over US handling of global medical supply chain', *Vox*, 4 April, **https://www.vox.com/2020/4/4/21208250/coronavirus-trump-canada-germany-spain-brazil** (accessed 28 Aug. 2020).

[9] Schotter, J. (2020), 'Poland urges tax haven crackdown to fund EU virus recovery', *The Financial Times*, 21 April, **https://www.ft.com/content/23f5ee2e-47fb-4580-9f80-8e80517a60bc** (accessed 29 Apr. 2020).

[10] European Commission (27.05.2020) Communication from the Commission on "The EU budget powering the recovery plan for Europe", COM(2020) 442, 27.5.2020 Brussels **https://eur-lex.europa.eu/resource.html?uri=cellar:4524c01c-a0e6-11ea-9d2d-01aa75ed71a1.0003.02/DOC_1&format=PDF** p15

[11] European Council (2020), *Conclusions Special European Council, 17-21 July 2020*, **https://www.consilium.europa.eu/en/meetings/european-council/2020/07/17-21/** (accessed 29 Jul. 2020).

On one level, this is about avoiding carbon leakage: production shifting from a country with high carbon prices to another country with low or no carbon prices and, therefore, simply shifting emissions from one location to another rather than reducing the overall level of emissions.

The EU has committed to achieving climate-neutrality by 2050 and is currently negotiating an increase to its 2030 climate goal (from -40% to -55% emissions reductions and possibly higher). A steeper decarbonisation pathway is likely to require a significant rise in EU ETS carbon prices.[12] This could, in turn, increase the risk of carbon leakage. At a carbon price of 50€/tCO_2, the increase in costs per tonne of products like cement, chemicals and crude iron and steel is in the order of 200-250% of per unit profit margins.[13] At this price level shipping cement clinker, crude iron and steel, or chemicals from neighbouring non-EU countries could become attractive despite transport costs.

BCAs are an alternative to the current system designed to prevent carbon leakage: the allocation of free emissions allowances to industrial sectors. This system is seen as increasingly untenable.[14] First, it has a built-in expiration date. Free allowances are drawn from a fixed share of an overall pot of allowances that is decreasing in line with the EU ETS cap. Depending on the level of ambition the EU adopts for 2030, free allocation may have to be phased down somewhere between 2026 and 2030. Second, free allocation creates distortions in the way the carbon price operates, dampening the carbon price signal, generating windfall profits for heavy industry sectors and slowing down their transition to cleaner production processes.

On another level, this is about raising climate ambition elsewhere. BCAs, as framed in the European Green Deal communication, are a measure of last resort. They are supposed to act as a form of leverage vis-à-vis the US and China, a message that if the EU is left alone in forging a more ambitious path the Commission will, in its new guise as a "geopolitical Commission," seek to protect EU domestic interests with implications for foreign producers. In her speech at

[12] Zachmann, G. and McWilliams, B. (2020), *A European carbon border tax: much pain, little gain*, Bruegel Policy Contribution Issue n. 5, **https://www.bruegel.org/wp-content/uploads/2020/03/PC-05-2020-050320v2.pdf** (accessed 28 Apr. 2020).

[13] Own analysis based on analysis by Sartor, O. (2017) Essays on Climate Policy, Trade and Competitiveness, PhD thesis, l'Université Paris I Panthéon-Sorbonne, Eurostat SBS data.

[14] European Court of Auditors (2020), *EU emissions trading system: free allowances must be better targeted*, **https://eca.europa.eu/en/Pages/NewsItem.aspx?nid=14336** (accessed 15 Sept. 2020).

Davos last winter, von der Leyen emphasised this component: “I prefer to encourage our trading partners, to work with us for a global level playing field.”[15]

Raising climate ambition elsewhere can be an indirect benefit, BCAs would address imported products into the EU – one of the world’s biggest markets. They would require anyone buying from, or selling into, the EU market to take account of enhanced EU climate ambition, and the manifestation of that enhanced ambition in the form of stricter standards and rules.

But the difficulty with this framing is that it clashes with international legal obligations. Framing the primary objective of BCAs as having greater leverage over trade partners in regards to their domestic climate policy runs contrary to the principle of common but differentiated responsibilities in UNFCCC negotiations[16] and would not fall under the legally acceptable objectives for such a measure under the General Agreement on Tariffs and Trade.[17] The EU would need to evaluate what support, capacity building and responsibilities towards developing countries would need to accompany a BCA to mitigate this risk.

Moreover, the idea of BCAs as leverage is incompatible with the logic of the Paris Agreement, with its carefully chosen wording around ‘Nationally Determined Contributions’ to climate action. BCAs cannot reasonably be designed to fulfil both a punitive function vis-à-vis very specific trading partners and a non-discriminatory protection instrument that applies across the board. The EU is on firmer ground where it emphasises the role of BCAs in enabling the achievement of its own climate commitments under the Paris Agreement and its own efforts to raise climate ambition to align with the goals of that accord.

Designing BCAs

In designing BCAs to achieve these two objectives, policy makers must make a series of decisions:

- Which policies, sectors and goods to include?
- How to assess the differential impact of carbon price/climate policy on foreign vs. domestic goods?

[15] European Commission (2020), *Keynote speech by President von der Leyen at the World Economic Forum*, 22 January 2020, **https://ec.europa.eu/commission/presscorner/detail/en/speech_20_102** (accessed 28 Apr. 2020).

[16] Ravikumar, A. (2020), ‘Carbon border taxes are unjust’, *MIT Technology Review*, 27 July, **https://www.technologyreview.com/2020/07/27/1005641/carbon-border-taxes-eu-climate-change-opinion/** (accessed 31 Aug. 2020).

[17] Cosbey, A., Droege, S., Fischer, C. and Munnings, C. (2019), ‘Developing Guidance for Implementing Border Carbon Adjusments : Lessons, Cautions, and Research Needs from the Literature’.

- What legal form the instrument should take? What types and price of adjustment?
- How to deal with exported products?
- How to avoid risks related to 'resource shuffling'?
- How to account for indirect emissions?
- What to do with the revenues?

Each of these decisions requires a balancing act between three (sometimes) competing axes (Figure 1): the feasibility of administering the mechanism, meeting environmental objectives and adhering to international legal obligations.

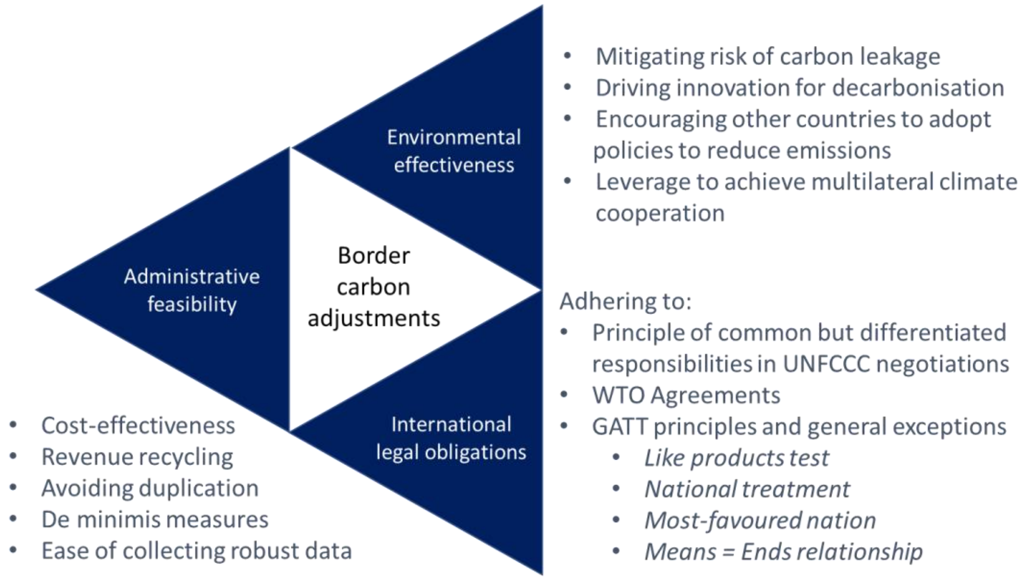

Figure 1. Three (sometimes) competing axes in designing BCAs

To give one example of this balancing act, perfectly mitigating the risk of carbon leakage and sending the 'right' signal to foreign producers would call for measuring the 'real' carbon-content of goods, i.e. firm-level emissions data. This, however, conflicts with administrative feasibility: it will be immensely difficult and costly to collect robust data in many of the countries affected. As a result, many papers call for using benchmark emissions data based on common emissions benchmarks for scope 1 and country-specific benchmarks for scope 2 emissions.[18] The latter, in turn, may be problematic from a legal perspective. Measuring average carbon intensity of electricity at a country rather than a

[18] Cosbey, A., Droege, S., Fischer, C., Reinaud, J., and Stephenson, J. (2012), *A Guide for the Concerned: Guidance on the elaboration and implementation of border carbon adjustment,* IISD **https://www.iisd.org/pdf/2012/bca_guidance.pdf**.

producer-level may violate the WTO Most Favoured Nations principle, which prevents discrimination of products based on their country of origin.

Over time, the relative weight of these axes has shifted. Administrative feasibility has changed with the increasing use of certification to determine the origin of products and the development of better digital and other technologies for tracking and measuring emissions and the movement of products. Environmental objectives have shifted with changing climate policies and carbon pricing schemes in third countries. Maybe most fundamentally, the perceived importance of international legal obligations has declined. US-China trade disputes and the refusal by US President Trump to appoint new judges to the WTO appellate body have battered faith in the multilateral trade system. In circumstances such as these, is anyone going to care if the EU imposes a measure that violates the Most Favoured Nations principle and if a given country does care, where can it turn to voice that concern?

The reality is that the EU cares. The EU sees itself as a major beneficiary of the multilateral trade architecture.[19] It has consistently defended multilateralism and made the case for upholding a binding dispute mechanism within the WTO. Although some member states are calling for more assertive approaches to trade policy, these calls are still couched in language that emphasises the value of fair, open and rules-based trade. This tension is reflected in the Commission's slightly contradictory new goal of pursuing 'open strategic autonomy:' strengthening the EU's capacity to act independently and in its own interests, while continuing to collaborate with partners internationally to strengthen multilateralism.[20]

What we know about the Commission's BCA proposal

The Commission is committed to presenting proposals for a BCA in 2021. At time of writing, here is what we know:

Objectives: To reduce risk of carbon leakage and encourage international climate action.

[19] Zachmann, G. and McWilliams, B. (2020), *A European carbon border tax: much pain, little gain*.

[20] European Commission (2020), *Intro remarks by Commissioner Phil Hogan at Second G20 Extraordinary Trade and Investment Ministers Meeting on COVID-19*, **https://ec.europa.eu/commission/commissioners/2019-2024/hogan/announcements/intro-remarks-commissioner-phil-hogan-second-g20-extraordinary-trade-and-investment-ministers_en** (accessed 16 Jun. 2020).

Scope: Still to be determined but likely to be piloted with only cement, basic steel products and power.[21]
Type of measure: The Commission refers to the measure as an 'adjustment mechanism' rather than a tax. Taxation is a national competence in the EU and would require a vote by unanimity in the Council. This means the measure is likely to be either an extension of the ETS or a customs duty.
What happens to existing instruments: The Commission has stated that BCAs would be an alternative to existing measures to mitigate carbon leakage, although transitional periods (involving a gradual phase in of BCAs as free allowances are phased out) have also been floated.[22]
Use of revenues: In its recovery package, the Commission lists BCAs as one of the possible future so-called 'own resources' that will allow the Commission to repay higher borrowing to respond to the crisis.[23]

Timeline

- **July 2019:** President-elect Ursula von der Leyen announces her intention to explore BCAs.
- **December 2019:** The Commission announces a BCA for selected sectors as a key instrument to deliver the European Green Deal.
- **July – October 2020:** Series of public consultations on BCAs.[24]
- **Q2 2021:** Commission expected to release its BCA proposal.[25]
- **2023:** BCAs introduced. However, commentators expect it could take much longer to implement.[26]

[21] Hall, S. (2020), 'EC to include power in EU carbon border import tax plans', *S&P Global Platts*, **https://www.spglobal.com/platts/en/market-insights/latest-news/metals/030520-ec-to-include-power-in-eu-carbon-border-import-tax-plans** (accessed 16 Jun. 2020).

[22] European Commission (2019), *The European Green Deal*, **https://ec.europa.eu/info/sites/info/files/european-green-deal-communication_en.pdf** (accessed 28 Apr. 2020).

[23] European Commission (2020), Communication from the Commission on "The EU budget powering the recovery plan for Europe", **https://eur-lex.europa.eu/resource.html?uri=cellar:4524c01c-a0e6-11ea-9d2d-01aa75ed71a1.0003.02/DOC_1&format=PDF** p15.

[24] European Commission (2020), European Green Deal (carbon border adjustment mechanism), **https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism/public-consultation.**

[25] European Council (2020), *Conclusions Special European Council, 17-21 July 2020*, **https://www.consilium.europa.eu/en/meetings/european-council/2020/07/17-21/** (accessed 29 Jul. 2020).

[26] Khan, M. and Fleming, S. (2020), 'Brussels' carbon border levy could face long delay, warn officials', *Financial Times*, 9 March, **https://www.ft.com/content/a72116ea-60c6-11ea-b3f3-fe4680ea68b5** (accessed 16 Jun. 2020).

Alternatives to BCAs

BCAs are not the only tools the EU has to achieve the two ends outlined above: mitigating carbon leakage and increasing international climate ambition. Examples of alternative measures include consumption charges,[27] increasing public support for the development of clean industrial production technologies, international carbon clubs[28] and new trade agreements to promote environmentally friendly policies.

Among these, is an alternative that fares strong on environmental effectiveness, international compliance and administrative feasibility – but could also send a much stronger political signal for international cooperation. This is the development of **mandatory carbon product requirements for industrial materials such as cement, steel and non-ferrous metals and certain chemicals.**[29] These requirements would cover materials sold in the EU's single market, applying both to domestic and foreign producers. Product requirements have several advantages over BCAs:

- Product requirements are likely to be WTO compatible provided they meet certain basic criteria,[30] such as consultation with trading partners, proportionality to the policy objective and non-discrimination.[31]
- If major trading partners, such as the United States, do not opt for carbon pricing as a way to decarbonise industry, but prefer regulatory approaches instead, low-carbon product requirements could be more easily aligned across jurisdictions, until a global standard was reached.
- They speak to an EU strength as a global standard setter and complement existing plans to strengthen product requirements in the Sustainable

[27] Neuhoff et al. (2019), *Building blocks for a climate-neutral European industrial sector*, **https://climatestrategies.org/wp-content/uploads/2019/10/Building-Blocks-for-a-Climate-Neutral-European-Industrial-Sector.pdf** (accessed 28 Aug. 2020).

[28] Groups of countries pursuing carbon pricing in collaboration with a view to eventually linking up carbon markets.

[29] Blot, E., Kettunen, M. and Charveriat, C. (2020), *Making trade work for EU climate policy: Carbon border adjustment or product standards*, **https://ieep.eu/publications/making-trade-work-for-eu-climate-policy-carbon-border-adjustment-or-product-standards** (accessed 30 Jul. 2020).

[30] The WTO's Agreement on Technical Barriers to Trade requires that any technical regulations must use, as their basis relevant international standards where they exist – this may constrain governments from applying mandatory requirements that are higher than internationally agreed standards.

[31] Gerres, T., Haussner, M., Neuhoff, K. And Pirlot A. (2019), *Can Governments Ban Materials with Large Carbon Footprint? Legal and Administrative Assessment of Product Carbon Requirements*, **https://www.diw.de/de/diw_01.c.699293.de/publikationen/diskussionspapiere/2019_1834/can_governments_ban_materials_with_large_carbon_footprint__l___and_administrative_assessment_of_product_carbon_requirements.html** (accessed 16 Sept. 2020).

Product Policy Framework proposed in the Circular Economy Action Plan.[32]

- They would provide an irrefutable business case for investment decisions into climate friendly production technologies for industrial stakeholders – both in the EU and externally.
- They could be implemented in a transitional way via a low-carbon product quota introduced for sellers of the relevant product in the EU's market. This would have some advantages in terms of easing political acceptance and mitigating the risk of 'resource shuffling.'[33]
- They could go beyond carbon-intensity to also cover resource-intensity and broader environmental criteria.[34]

However, carbon product requirements face some similar challenges to BCAs:

- The process for certifying that a foreign-produced good meets EU climate-friendly requirements runs into many of the same technical and administrative challenges outlined above for BCAs, such as gathering data from third countries and establishing a robust verification system.
- Like BCAs, product requirements run the risk of reducing developing country access to the single market unless accompanied by sufficient development cooperation and capacity building initiatives.
- A solution would still be needed to protect exports from a potential loss of market share abroad. Since some plants will produce both for the domestic and foreign market, this would require them to manage two (or more) sets of product requirements across their different jurisdictions.

Therefore, either option will require careful design, planning and diplomatic groundwork in advance of implementation.

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[32] European Commission (2020), *A new Circular Economy Action Plan*, **https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1583933814386&uri=COM:2020:98:FIN** (accessed 30 Jul. 2020).

[33] Resource shuffling refers to a situation where a non-EU country would seek to shuffle its domestic production based on its relative carbon intensity: to avoid paying a border adjustment it may decide to sell its most CO_2-intensive products domestically, where carbon regulation is less stringent and instead sell only its least CO_2-intensive products into the EU's market. A common product requirement for imported and domestic produced products avoids this concern.

[34] Blot, E., Kettunen, M. and Charveriat, C. (2020), *Making trade work for EU climate policy: Carbon border adjustment or product standards*.

Product requirements may also require more lead-time before they could be introduced. It will be difficult to implement sufficiently robust and ambitious product requirements until the technology portfolio for cleaner industrial production processes has developed sufficiently. Climate-neutral primary steel production technologies are, for example, still at the pilot and demonstration stage. It is unlikely that ambitious clean steel standards could be introduced on a timescale similar to that set out for BCAs. It may also be more difficult to set product requirements for some sectors with a relatively broad range of immature decarbonisation technologies (like chemicals or cement) than others (like steel or aluminium) where the solutions are clearer.

However, given the advantages laid out above and the opportunity a longer implementation period would offer for bringing more countries on board, this might be a better option in any case. In the absence of introducing a specific measure in the next few years, the EU could lay the groundwork for an international process to signal that such requirements would be introduced in the 2030s.

Understanding the politics at home

Beyond the technical and legal challenges laid out above, BCAs will face immense political hurdles both at home and abroad. This section unpacks the main dividing lines within the EU.

Whether or not to introduce BCAs

Successfully implementing a BCA would require a qualified majority of member states backing it. So far, only a handful have publicly commented on the mechanism and a coherent position is still a long way off.

A set of countries with strong concerns over foreign competition from carbon-intensive producers have come out as clear proponents of BCAs. France, which has historically favoured a more protectionist stance on trade, championed the proposal from the start. Spain, with its worries about importing carbon-intensive electricity from Morocco, backed the French proposal and called for a faster implementation timetable.[35] The Netherlands, which is forging ahead with an ambitious set of policies to decarbonise its heavy industry sectors, joined France

[35] Morgan, S. (2020), 'Brussels' anti-climate-dumping quest in the spotlight', *Euractiv*, 28 February, **https://www.euractiv.com/section/climate-environment/news/brussels-anti-climate-dumping-tool-in-the-spotlight/** (accessed 11 May 2020).

in issuing a call to the Commission to press ahead with plans for a BCA.[36] Poland has also publicly come out in support of the proposal, although its focus has been on the possible revenues that may accrue.[37]

By contrast, Germany, with its more export-oriented industrial sectors,[38] has struck a more cautious note. There have been notable differences between statements by Chancellor Angela Merkel, who has tended to be more positive in supporting BCAs, and MPs and industry associations[39] who have raised concerns about sparking a trade war.[40] Merkel has faced pushback on BCAs from within her own party, with critics arguing that BCAs would be "fatal" for Germany's industrial sectors,[41] which would be hit hard by any retaliatory trade measures.

Heavy industry trade associations and companies across the EU have been scrambling to formulate positions on BCAs. Many are still unsure whether implementing BCAs would in fact benefit them. On the one hand, they are pleased to see the risk of carbon leakage 'taken seriously' and a strong narrative on shoring up EU industrial competitiveness take hold. On the other hand, they oppose any move to limit free allowances and worry about shifting to an 'untested' mechanism.

The bottom line, for both member state governments and industry stakeholders, is that they still do not know enough about the "how" of BCAs to take clear positions. There are too many open questions on design and implementation – and thus on who emerges as beneficiary or who loses out.

[36] Brunsden, J. and Mallet, V. (2020), 'France and Netherlands call for tougher EU trade conditions', *The Financial Times*, 4 May, **https://www.ft.com/content/e14f082c-42e1-4bd8-ad68-54714b995dff** (accessed 16 Jun. 2020).

[37] Krukowska, E. (2020), 'Carbon Border Tax in Europe Gets Backing From Polish Premier', *Bloomberg Green*, 6 February, **https://www.bloomberg.com/news/articles/2020-02-06/carbon-border-tax-in-europe-gets-backing-from-polish-premier** (accessed 11 May 2020).

[38] In 2019 Germany's export-to-GDP ratio was 46.9 vs. 31.4 and 34.9 in France and Spain respectively. Eurostat (2020), *Exports of goods and services in % of GDP*, **https://ec.europa.eu/eurostat/databrowser/view/tet00003/default/table?lang=en** (accessed 11 May 2020).

[39] Nienaber, M. (2019), 'German industry sounds alarm over EU carbon border tax', *Reuters*, 25 September, **https://www.reuters.com/article/us-germany-industry-carbon/german-industry-sounds-alarm-over-eu-carbon-border-tax-idUSKBN1WA1BB** (accessed 11 May 2020).

[40] Wettengel, J. (2020), 'EU should not rush carbon border tax – German official', *Clean Energy Wire*, 11 February, **https://www.cleanenergywire.org/news/eu-should-not-rush-carbon-border-tax-german-official** (accessed 11 May 2020).

[41] Reuters (2020), *Unions-Wirtschaftsflügel läuft Sturm gegen Merkels CO2-Grenzsteuerplan*, **https://www.onvista.de/news/unions-wirtschaftsfluegel-laeuft-sturm-gegen-merkels-co2-grenzsteuerplan-374053577** (accessed 30 Jul. 2020).

Where the Commission lands on each of the decision points outlined above will have vastly different implications for different member states and industries.

Moreover, that uncertainty will not disappear with a Commission proposal on BCAs next year. To give one example of this, there tends to be unanimous agreement that BCAs will need to be WTO compatible but very little knowledge of what that means in practice. WTO treatment of trade measures such as these is ambiguous and BCAs have never been introduced on this scale. There may be no clear answer on WTO compatibility and how risky this measure is until a trade dispute actually happens.

Each of the open questions on scope, use of revenues, what happens to free allowances and export rebates, will be subject to huge lobbying efforts by governments and industry stakeholders. Some countries and industrial sectors have started to take clearer positions on specific elements.

Scope

Spain wants to bring the power sector into the mix of sectors that could be included to target electricity imports from Morocco and deal with coal power leakage. Between 2018 and 2019, net power imports from Morocco increased by 4TWh. This electricity was twice as carbon intensive as Spain's domestic supply with no price paid on emissions.[42]

Cement, with its lower trade exposure and simpler supply chains, has also been highlighted as a likely candidate for piloting the mechanism. The sector, which has successfully lobbied against moves to impose BCAs in the past,[43] has responded that it should not be singled out and has called for all ETS sectors to be included in the scheme.[44] The steel sector, by contrast, in particular ArcelorMittal SA, which faces strong foreign competition has been supportive of the proposal and the inclusion of steel in such a mechanism.[45]

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[42] Ember (2020), *The Path of Least Resistance: How electricity generated from coal is leaking in the EU*, **https://ember-climate.org/wp-content/uploads/2020/01/2020-SB-Path-of-least-resistance-1.2b_DIGI.pdf** (accessed 30 Jul. 2020).

[43] Euractiv (2017) Split cement lobby forces MEPs to choose ahead of climate emissions vote **https://www.euractiv.com/section/energy/opinion/split-cement-lobby-forces-meps-to-choose-ahead-of-climate-emissions-vote/** ; Carbon Pulse (2017) Why is the EU cement sector resisting a CO2 border measure? www.CarbonPulse.com, **https://carbon-pulse.com/29833/**

[44] Cembureau (2020) Cembureau Position Paper on Carbon Border Mechanisms, Brussels. **https://cembureau.eu/media/1922/17542-cembureau-position-paper-carbon-border-mechanisms-2020-02-11-025.pdf**

[45] Eurometal (2020), *ArcelorMittal asks EU to impose Border Carbon Adjustment,* **http://eurometal.net/arcelormittal-asks-eu-to-impose-carbon-border-adjustment/.**

Another dividing line on scope is the question of which emissions to target. In contrast to steel and cement, aluminium is much more electricity intensive. As a result, the critical factor for the sector is whether and how indirect emissions will be factored in. Raising questions over how this could be done, the sector has stated that it does not believe BCAs would be a good fit for aluminium.[46]

Similarly, questions remain over whether BCAs should go beyond CO_2. Comprehensively tackling emissions from gas imports would, for example, require accounting for methane.[47] However, this would likely raise challenges from member states, like Germany, who are particularly dependent on gas imports and would worry about the potential impact on import prices from Russia.[48] There are also many advantages to keeping the scope narrow: transparency, feasibility, clarity of purpose and limiting the impact on partners.[49]

Use of revenues

Poland's Prime Minister, Mateusz Morawiecki views BCAs as a potential source of new domestic revenue[50] a stance which clashes with the Commission proposal to earmark BCA revenues as a new 'own resource.' Both of these proposals are also likely to raise legal and political challenges. Several academic papers suggest that revenues should be earmarked for international climate funds or disbursed to third countries to clearly position BCAs as a non-protectionist measure and to garner support among international partners.[51] Finally, there is a critical question of the flow of potential revenues over time. Theoretically, if BCAs are effective they should catalyse climate action internationally leading to declining revenues as countries invest in cleaner production processes.

Impact on existing anti-leakage protection

This is possibly the most controversial issue in that the positions on both sides are far apart and difficult to reconcile. In the European Green Deal

[46] European Aluminium Association (April 2020): Position on the Inception Impact Assessment Roadmap for an EU Carbon Border Adjustment Mechanism, EAA, Brussels. **https://www.european-aluminium.eu/media/2900/2020-04-01-european-aluminium-position-paper-on-ec-iia-roadmap-for-an-eu-carbon-border-adjustment-measure.pdf**

[47] European Space Agency (2020), *Mapping methane emissions on a global scale*, **https://www.esa.int/Applications/Observing_the_Earth/Copernicus/Sentinel-5P/Mapping_methane_emissions_on_a_global_scale** (accessed 28 Aug. 2020).

[48] Zachmann, G. and McWilliams, B. (2020), *A European carbon border tax: much pain, little gain*.

[49] Sapir, A. and Horn, H. (2020), *Political Assessment of Possible Reactions of EU Main Trading Partners to EU Border Carbon Measures*, **https://www.bruegel.org/wp-content/uploads/2020/06/EXPO_BRI2020603503_EN.pdf** (accessed 28 Aug.2020).

[50] Krukowska, E. (2020), 'Carbon Border Tax in Europe Gets Backing From Polish Premier.'

[51] Cosbey, A., Droege, S., Fischer, C. and Munnings, C. (2019), 'Developing Guidance for Implementing Border Carbon Adjusments : Lessons, Cautions, and Research Needs from the Literature'.

communication the Commission clearly states that BCAs are an "alternative" to existing anti-leakage measures such as free allowances and compensation for electricity costs. Civil society organisations, even ones who are not sold on the idea of BCAs[52], are emphatic that they will not accept "double compensation" for industry and that BCAs can only be introduced at the cost of free allowances.

Meanwhile industry stakeholders strongly oppose any move to limit free allowances. In response to the Commission's first public consultation on BCAs, steel, cement and aluminium companies insisted that BCAs should complement rather than replace free allowances and that if free allowances are discontinued, they would like to see a gradual phase out, a period during which they receive free allowances while BCAs are still in place.[53] They worry that free allowances could be phased out and that BCAs may be legally challenged leaving them without anti-leakage protection.

A hybrid system will not only be unacceptable from the perspective of climate groups but also legally and politically challenging. Continuing to shield industry sectors from the full carbon price, would make it harder for the Commission to make the case that BCAs are not a protectionist measure and that they will help to achieve the environmental objectives intended. Trade partners will raise concerns over their producers being subject to a carbon adjustment as EU companies continue to be shielded domestically.

Export rebates and resource shuffling

Export-intensive sectors, such as chemicals, are unlikely to accept a BCA that is not symmetric, i.e. one that does not rebate the CO_2 cost to exported products. To accommodate this the EU would need to either take the legal risk of an export rebate mechanism as part of the BCA or provide free allocation to the share of exported products to compensate for upstream CO_2 costs.

Similarly, sectors where the CO_2 intensity of production facilities in the EU is high enough to be undercut by resource shuffling by trading partners, will also strongly resist a BCA. This may be the case in sectors where hydro-based electrification or gas is used abroad but not in the EU due to lower production costs abroad. The Commission will need to establish where these risks lie and

[52] Carbon Market Watch (2020), *Carbon Border Adjustments: Climate Protection of Climate Protectionism?*, **https://carbonmarketwatch.org/wp-content/uploads/2020/03/CMW-position-on-CBAM.pdf** (accessed 28 Aug. 2020).

[53] Abnett, K. and Jessop, S. (2020), 'Investors caution cement, steel firms on EU climate lobbying', *Reuters*, 9 April, **https://www.reuters.com/article/us-health-coronavirus-eu-climatechange/investors-caution-cement-steel-firms-on-eu-climate-lobbying-idUSKCN21R2LU** (accessed 10 May 2020).

factor them in while designing and implementing BCAs. Once EU production is decarbonised to the level of foreign producers the risk of resource shuffling will disappear. This risk can, therefore, be mitigated by faster domestic climate action in EU industries.

Managing the politics at home

These different stances have politically significant implications in the short term. Domestically, for the EU to agree to adopt higher 2030 climate ambition, a robust answer to member state and industry concerns over future competitiveness will be necessary. Without such an answer, industrial stakeholders affected by the increase in ambition – and potentially others who may seek to "hide behind" such arguments – will try very hard to shoot down attempts to raise ambition.

BCAs may not be "the answer", for all the reasons outlined above and they will take time to implement if pursued. But by putting them on the table, the Commission has opened up a conversation about industrial competitiveness, the flaws in the current free allowance system and the need for EU industries to transform that could yet prove useful in the attempt to agree a more ambitious 2030 goal.

For BCAs to remain a useful tool rather than a liability it will be key to not lose sight of the wider policy package. There is a significant risk that discussions around the symbolically attractive, but politically charged, topic of BCAs will consume political and administrative capital, taking the focus off arguably more urgent measures that are needed to deliver industrial decarbonisation. BCAs do not by themselves offer a sufficient incentive for industrial stakeholders to make the necessary capital investments to decarbonise their operations. A range of other policies will be necessary to put energy-intensive industries on track towards climate neutrality. Risk capital, subsidy instruments, markets for green products, infrastructure, the development of a renewable hydrogen economy, CCS infrastructure and regulation, reinforced innovation policies are just some of the policy priorities that need to be tackled during this Commission. BCAs will only be justifiable on the basis that these measures are also undertaken.

Understanding the politics internationally

The EU's top trading partners have been paying close attention to the BCA conversation in Europe, with major economies quick to raise their concerns. Ahead of COP25, China's vice environment minister, Zhao Yingmin, emphasised that BCAs will damage global efforts to tackle climate change and urged a pushback against climate protectionism.[54] US Commerce Secretary Wilbur Ross warned of possible retaliation by the US against any imposition of a BCA on US producers. More recently, Russia's economic development minister warned that BCAs are unlikely to be in line with WTO rules.[55]

However, it has also seen European commitment to transitioning to a net-zero economy being taken more seriously in some of these countries. In Russia, Putin's top adviser on climate warned big businesses that they need to start preparing for harsher EU rules or face difficulties selling products[56] and there are reports that BCAs are already being factored into investment decisions.[57]

A broad set of developing and emerging economies are likely to be hit by such a measure, if not accompanied by extensive capacity building and technology transfer (Figure 2). Ukraine is, for example, likely to be highly impacted by any EU-imposed BCAs[58] and the government has flagged concerns over the mechanism.[59] Without access to lower carbon technologies or the skills and financial assets to convert processes, these countries could easily argue that BCAs will be a disproportionate burden for them and that they conflict with the UNFCCC principle of common but differentiated responsibility.[60]

Moreover, many of these countries have received support from EU member states and multilateral development banks to expand their fossil fuel infrastructure. The idea that they will now be 'punished' for carbon-intensive

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[54] Cadell, C. (2019), 'China says CO2 border tax will damage global climate change fight', *Reuters*, 27 November, **https://www.reuters.com/article/us-climate-change-accord-china/china-says-co2-border-tax-will-damage-global-climate-change-fight-idUSKBN1Y105T** (accessed 11 May 2020).

[55] Morgan, S. (2020), *Moscow cries foul over EU's planned carbon border tax*, **https://www.euractiv.com/section/economy-jobs/news/moscow-cries-foul-over-eus-planned-carbon-border-tax/** (accessed 16 Sept. 2020).

[56] Doff, N. (2020), 'Putin Aide Tells Companies to Prepare for Harsh EU Carbon Tax', *Bloomberg*, 6 February, **https://www.bloombergquint.com/business/kremlin-aide-tells-companies-to-prepare-for-harsh-eu-carbon-tax** (accessed 28 Aug. 2020).

[57] Aris, B. (2020), *Europe's plan to introduce a carbon import tax is forcing Russia to go green,* **https://www.intellinews.com/europe-s-plan-to-introduce-a-carbon-import-tax-is-forcing-russia-to-go-green-178003/** (accessed 16 Sept. 2020).

[58] In 2019 Ukraine's exports to the EU amounted to roughly 16% of GDP. European Commission (2020), **Ukraine**, **https://ec.europa.eu/trade/policy/countries-and-regions/countries/ukraine/index_en.htm** (accessed 27 Jun. 2020).

[59] Carbon Pulse (2020), *Ukraine flags concerns over "extremely sensitive" EU carbon border tax plan*, 6 April, **https://carbon-pulse.com/96215/?utm_source=CP+Daily&utm_campaign=4e151ee462-CPdaily06042020&utm_medium=email&utm_term=0_a9d8834f72-4e151ee462-110308210** (accessed 28 Aug. 2020).

[60] Ravikumar, A. (2020), 'Carbon border taxes are unjust'.

production processes that were initially financed by EU-backed funds will seem particularly unjust.[61]

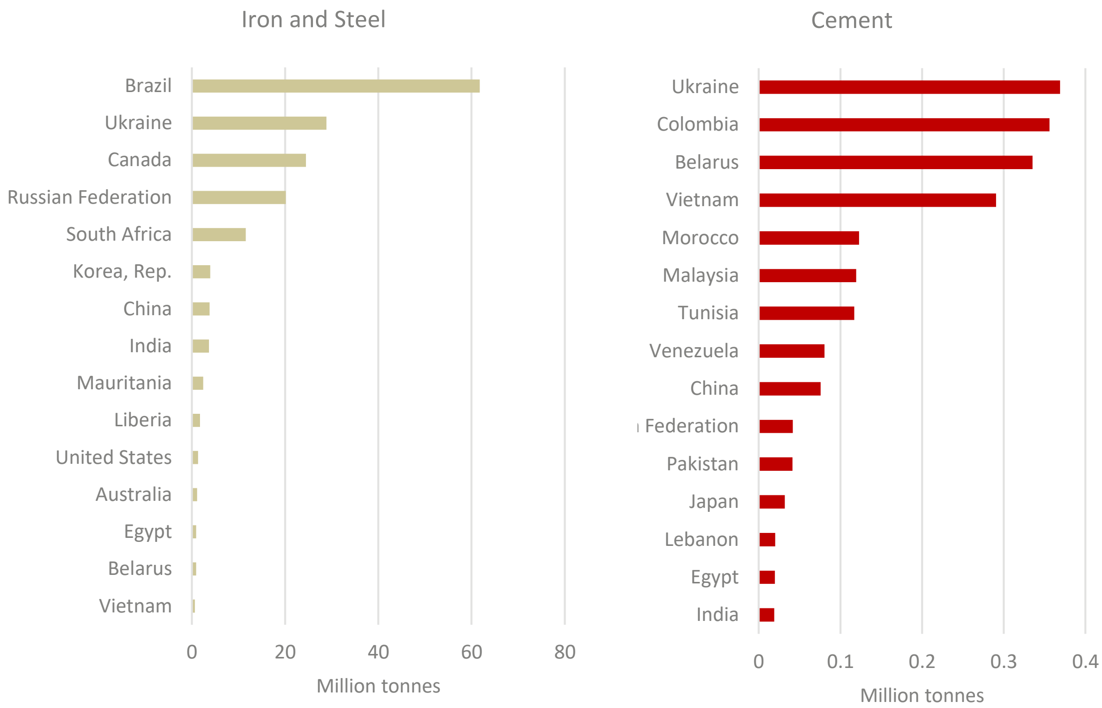

Figure 2. Top 15 steel and cement exporters to the EU in 2018

Source: Authors' analysis of resource.earth (2018 data)

The international politics of BCAs are strongly complicated by COVID-19. The economic crisis induced by the virus has led to overcapacity and falling prices and profit margins, putting industrial commodity producers under pressure internationally. This could increase economic nationalism and populism among trade partners, making it even more risky to implement BCAs for politically symbolic products such as steel.

In the context of the crisis, the EU has also relaxed its normally strict rules on state aid allowing large amounts of public support to flow to domestic industries. This exacerbates a sense of hypocrisy in introducing BCAs. The EU is protecting its own industry in a context where many developing country governments do not have the money to shore up their economies.

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[61] Ibid.

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Managing the politics abroad

Whether the EU opts for BCAs or an alternative such as products requirements, it will need to engage in careful diplomatic work in order to create a viable international political pathway for its choice. The EU will need to:

Consult with trade partners throughout

Building in time to properly consult with trade partners will not just mitigate the risk of retaliatory measures but will also help with the legal case for BCAs.[62] The WTO dispute system favours attempts to reach multilateral solutions.

The manner in which the EU engages in these exchanges will be important. If the EU presents BCAs as a punitive measure to police alignment with the Paris Agreement, it risks encountering increased international resistance. Countries will argue that the Paris Agreement was designed precisely to respect differences in capacity and speed of action across countries. Alternatively, if the EU frames BCAs as necessary and unavoidable elements of its climate-neutral transition, which it is seeking to align more fully with the Paris Agreement, it will start in a stronger position.

Significant diplomatic effort will also be required to demonstrate that BCAs do not amount to protectionism and to explain their true (limited) impacts on trade.[63] The Commission should ensure that the analysis of the cross-border effects of BCAs are integrated into impact assessments for these policies. Such an assessment would need to focus, in particular, on least developed and developing countries and on major trading partners. Finally, the EU should endeavour to regularly update and share information with trade partners on the process to ensure transparency and predictability.

Seek to build coalitions

During this time the EU should identify coalitions of countries who could be engaged in different ways on BCAs:

Countries that might be willing to have a joint approach to developing BCAs or product requirements. The EU could face significant risks if it tries to develop

[62] Lamy, Pons and Leturcq propose a two year "test" period. Lamy, P., Pons, G. and Leturq, P. (2020), *Greening EU trade 3: A European Border Carbon Adjustment proposal*.

[63] Neuhoff et al. (2017) estimate that applying carbon charges of 30€/tCO_2 at the border to the 5 most energy intensive materials (i.e. steel, aluminium, pulp and paper, cement and plastic), total carbon liabilities of only 8.8 billion € would be created at the level of the EU 28. This compares with annual imports of a value of 1930 trillion € (Eurostat, n.d.).

BCAs entirely on its own. Given the dividing lines outlined above, it is easy to imagine a scenario in which the EU could find itself isolated, having to hold member states together amid retaliatory attacks on its own products from trade partners. Indeed, the EU has some experience with this: in 2012, the EU was forced to "stop the clock" on the introduction of international aviation into the EU ETS, due to a concerted backlash from major trade partners.[64]

The EU should try to develop a coalition with other jurisdictions that are seriously engaging in carbon pricing and/or have signed up to pledges to decarbonise heavy-industry.[65] These countries – which include, among others, China, India, Canada, Chile, Mexico, South Korea, Kazakhstan, Ukraine, New Zealand – face similar problems in terms of how to tackle carbon leakage. Good faith attempts should be made to reach a multilateral solution to this problem, allowing common approaches on anti-leakage measures to emerge.

The US under a Biden administration may be a key partner in this space. California is one of the few jurisdictions internationally to have introduced BCAs for its power sector.[66] According to a draft of the Democratic Party's election platform, the party would support the introduction of product standards for low-carbon steel and cement and would seek to apply a carbon adjustment fee at the border to products from "countries that fail to live up to their commitments under the Paris Climate Agreement."[67]

In reaching out to possible partners on BCAs, it will be important to ensure that BCAs are not seen as an 'EU thing' but rather as a common response to a challenge faced by a set of like-minded countries trying to accelerate climate action. For this to be possible it may be important to leverage other venues, e.g. the OECD or WTO to convene partners on BCAs.[68] It will also be important to avoid being too prescriptive too early on. Narrowing in on a specific design and type of measure may limit the chance for cooperation.

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[64] European Commission (2021), *Commission proposes to 'stop the clock' on international aviation in the EU ETS pending 2013 ICAO General Assembly*, **https://ec.europa.eu/clima/news/articles/news_2012111202_en** (accessed 16 Sept. 2020).

[65] Leadership Group for Industry Transition. **https://www.industrytransition.org/.**

[66] Sapir, A. and Horn, H. (2020), *Political Assessment of Possible Reactions of EU Main Trading Partners to EU Border Carbon Measures*.

[67] US Democratic Party (2020), *2020 Democratic Party Platform*, **https://mcusercontent.com/b575b9e5364b5673b6f9df3f1/files/8d516a5c-9af5-4d7a-ab02-d5aaff690faa/2020_07_21_DRAFT_Democratic_Party_Platform.01.pdf** (accessed 16 Sept. 2020).

[68] Lamy, Pons and Leturcq propose a two year "test" period. Lamy, P., Pons, G. and Leturq, P. (2020), *Greening EU trade 3: A European Border Carbon Adjustment proposal*, **https://institutdelors.eu/publications/verdir-la-politique-commerciale-de-lue/** (accessed 11 Jun. 2020).

The near neighbourhood, especially in accession or association. A parallel diplomatic effort should be extended to the EU's neighbourhood countries - including north Africa and the Mediterranean, EU accession countries, Turkey, and to the UK. This would ensure that the countries which trade the most with the EU and who are likely to be most affected, are engaged early on. These are all countries with which the EU has a long-established trading and policy coordination relationship and who are, thus, likely to be constructive in pursuing a common solution in this space.

Developing countries. The EU will also need to engage in dialogues with developing countries on how BCAs might affect them and what technical and financial assistance measures might be taken to manage any impacts. In the past the Commission has used trade missions to communicate priorities in the trade and climate space, for example, around circular economy.[69] A similar approach should be undertaken for BCAs, dispatching missions to key countries to communicate and frame the EU's approach and better understand potential concerns. These missions would allow for deeper exchange on potential design and scope, alongside developing an understanding of what kinds of financial, technical and capacity support partner countries might need to meet higher standards.

Offer partners a "package deal"

The EU should seek to turn a potentially negative issue, BCAs, into a broader and more positive discussion with international partners on how to accelerate the decarbonisation of heavy industries. BCAs should be addressed as part of a set of issues, including coordination on ambition, technology, standards, policy learnings and sustainable finance. This would help to address concerns that BCAs are simply a form of protectionism. Furthermore, by offering a "package deal", the EU may be able reduce opposition from those who could be sold on the combination of benefits of involvement in such a coalition.

The EU already engages in cooperation with third countries in many of these areas. The International Platform on Sustainable Finance, for example, brings together many of the countries listed in the first grouping above. Coordination on the Sustainable Finance Taxonomy is a natural steppingstone to greater

[69] European Commission (2020), *Circular Economy Missions*, **https://ec.europa.eu/environment/international_issues/missions_en.htm#:~:text=The%20Circular%20Economy%20Missions%20are,sustainable%20and%20resource%2Defficient%20policies.** (accessed 31 Aug. 2020).

coordination on product requirements and standards, as the taxonomy already delineates benchmarks for “green” activities.

A package deal could be that the EU offers to help develop low carbon industrial sectors in partner countries for a set period of time, e.g. five years during which it also pushes forward with domestic efforts to decarbonise its industry and design BCAs. After that period, BCAs would be introduced but countries within the coalition will have benefitted from cooperating in this area and, thus, be minimally impacted by each other’s trade measures. The extent to which the EU can introduce optionality in discussions with these countries may improve its position. For instance, given a choice between carbon product requirements – under which full market access may be lost – and BCAs, the discussion with trading partners may shift substantially.

One way of formalising these arrangements might be via mutual recognition and conformity assessment agreements on standards and certification procedures. These build on existing regional trade agreements and often include technical and financial assistance packages. Partner countries could also agree to an arrangement that eliminates tariffs and non-tariff barriers on feedstock and technologies required for cleaner industrial production processes over a specified period. This would facilitate trade in environmental goods and services relevant to fast-tracking industrial decarbonisation, for example, for technologies and feedstocks for green hydrogen production.

The deal will also need to entail a strong component of knowledge-sharing and foreign investment to support the roll-out of emerging technologies. Countries could partner on the creation of special low carbon industrial zones and/or laboratories for showcasing best practices in standards and technologies, focusing on exports that might be affected by BCAs.

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About E3G

E3G is an independent, non-profit European organisation operating in the public interest to accelerate the global transition to a climate-safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere.

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