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Challenges and Controversies to the European CBAM from a Legal Perspective

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Abstract: The Carbon Border Adjustment Mechanism (CBAM), proposed by the European Union to combat carbon leakage, presents a complex landscape of opportunities and challenges in the realm of global climate governance. This paper explores the problems and controversies surrounding CBAM, including potential WTO incompatibility, violations of UNFCCC principles, and complexities in carbon accounting. It also examines the potential impact of CBAM on developing countries and offers a range of suggested solutions. These solutions encompass designing domestic carbon markets in alignment with the European model, implementing policy and regulatory reforms, fostering China-European bilateral relations, and emphasizing international cooperation and adherence to established legal frameworks. Additionally, at the enterprise level, strategies to invest in green technologies, establish comprehensive carbon accounting systems, and adapt to the evolving low-carbon economy are proposed. By addressing these challenges and embracing these strategies, nations and businesses can contribute to a more sustainable and equitable global climate governance framework.

Keywords: CBAM,WTO Rules, GATT, UNFCCC, Carbon Emissions Trading Market.

1. Introduction

Since the signing and implementation of the Paris Agreement, global climate governance has evolved, with countries predominantly moving towards "carbon neutrality" goals. However, concerns persist among some developed nations about potential carbon leakage, wherein emissions may shift from regions with strict controls to those with more lenient regulations. To address this, the European Union published the proposal of "Establishing a Carbon Border Adjustment Mechanism" (CBAM) on July 14, 2021[1]. The European Parliament approved the proposal on June 22, 2022, with expectations that relevant measures will complete the legislative process in 2023, officially implementing CBAM in 2027. The mechanism mandates carbon tariffs on products imported into the EU, with rates linked to the carbon price of the EU Emissions Trading System (EU ETS). Industries under the scope of CBAM will face "double carbon costs," dealing with EU carbon tariffs and adjusting to China's carbon price policy. However, the development and implementation of CBAM pose challenges, including consistency and compliance with WTO rules, and ensuring effectiveness in global carbon trading markets. Addressing these challenges is crucial for the seamless integration of CBAM into the international climate governance framework.

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2. Problems and Controversies in CBAM Mechanism

2.1. Incompatibility with WTO Rules

Although the EU Parliament carefully clarified in its proposal that CBAM is only a climate regulation measure, it still cannot conceal the possibility that it is inconsistent with the WTO. According to the CATT Art. I, the Most-Favored-Nation (MFN) treatment principle means that any trade advantage given to one country's product must also be given to the same product from all other countries without delay or conditions[2]. By requiring non-EU countries' imported products to bear the same emission reduction obligations as EU-produced goods, CBAM may contravene the WTO's MFN treatment principle. The CBAM system focuses on energy consumption production factors that have nothing to do with product attributes by distinguishing controlled import objects based on the production process and production method standards (PPMs). This will be unfair to exporting countries that have implemented carbon restraint measures and may also result in export products being subject to carbon restrictions twice.

The CBAM carbon pricing mechanism has different standards and scope of application than the EU ETS, which may result in higher tax rates for imported products than for domestic products, thereby violating the national treatment principle of GATT Art.III*[3]. Specifically, the different standards and application scope of CBAM and EU ETS may result in higher taxes on imported products than on domestic products. CBAM also needs to ensure that imported products and domestic products are "similar products" and consider factors such as the product's end use, attributes, properties, laws and regulations, and consumer preferences. The difference in "carbon pricing" is reflected in the EU and exporting countries and regions, as well as between exporting countries and regions. If the tax on imported products from one member state exceeds the tax on similar domestic products from another member state, it will be regarded as Domestic production provides protection.

Moreover, CBAM's invocation of GATT Article XX, the "General Exceptions," might be seen as overly arbitrary. While CBAM, as a measure to address carbon leakage and promote emissions reduction, may be legitimate under GATT Article XX (b) and (g), the insistence on other countries purchasing CBAM certificates at the EU carbon market's carbon price seems excessively assertive[4]. Although the EU carbon border adjustment mechanism may be consistent with items (b) and (g) of GATT Article XX, this measure would constitute arbitrary or unreasonable discrimination and is not consistent with the preamble to Article XX of GATT[5]. Therefore, it is still difficult for the EU to eliminate the illegality of the carbon border adjustment mechanism proposal through Article XX of GATT.

2.2. Violation of UNFCCC's Common But Differentiated Responsibilities

CBAM may constitute a violation of the principle of "common but differentiated responsibilities". According to the provisions of the UNFCCC, each Party shall take measures to address climate change by its common but differentiated responsibilities and respective capabilities. However, the CBAM mechanism requires other countries to meet EU carbon emission standards without taking into account their historical responsibilities and differences in capabilities, which is inconsistent with the UNFCCC's principle of common but differentiated responsibilities[6]. In addition, CBAM is inconsistent with the principle of fairness. The UNFCCC emphasizes that climate governance should be conducted on an equitable basis. The CBAM mechanism imposes additional fees on importing countries, which may hurt the exports of some developing countries, and these countries may be limited in emission reduction technology and capabilities.

Additionally, the CBAM mechanism ignores differential emission reduction treatment. The UNFCCC recognizes that developing countries need more support and flexibility in reducing

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emissions. However, the CBAM mechanism adopts a relatively rigid approach that requires importing countries to meet EU carbon emission standards without taking into account their special circumstances. The implementation of the CBAM mechanism may lead to some trade disputes and new trade barriers, which may not comply with Article 3, paragraph 5, of the UNFCCC, which requires that measures to address climate change should not constitute arbitrary or unreasonable discrimination or disguised restrictions on international trade.

2.3. Complexity and Feasibility Issues in Carbon Accounting

CBAM's specified accounting system for implicit carbon emissions only covers the production phase, disregarding a product's entire lifecycle emissions. High accounting costs, data acquisition challenges, and technological difficulties may impede the practical implementation of CBAM. Specifically, CBAM has the following disadvantages.

First, the accounting boundaries are not unified. The EU CBAM will calculate the embodied carbon emissions of products based on the actual emissions of producers, while some countries may set the accounting boundary at the enterprise or facility level[7]. Second, accounting standards and databases are not unified. Many countries have inconsistent accounting capabilities and are unable to provide data consistent with EU CBAM requirements, making the accounting of embodied carbon emissions unreliable and difficult to supervise. Third, the cost is high. Accounting for embodied carbon emissions requires additional human, technical and administrative costs, which may be a burden for some developing countries or countries with weak accounting capabilities. Fourth, data availability is poor. The global supply chain of goods is complex, and the carbon content of many imported goods is difficult to monitor in real-time. It also involves issues of business confidentiality or non-disclosure of information, making the accounting of embodied carbon emissions more difficult. Fifth, full life cycle accounting is difficult: CBAM currently only considers carbon emissions in the production stage of products, but does not consider greenhouse gas emissions in the logistics and transportation of goods, consumer use, and commodity end-of-life treatment.

3. The Potential Impact of CBAM on Developing Countries

CBAM will introduce additional carbon emissions taxes on imported goods in the EU market, potentially raising the prices of products from developing countries. This could particularly affect countries heavily reliant on exporting energy-intensive products, diminishing their competitiveness in European export markets. Moreover, some EU companies may contemplate relocating their production to the EU to avoid CBAM taxes, leading to the outsourcing of manufacturing activities and posing a challenge for developing countries[8]. CBAM's implementation may influence carbon tax policies in developing countries and inspire various coping strategies. To alleviate the tax pressure from CBAM, some nations may introduce domestic carbon pricing policies, levying carbon taxes in their domestic markets while reducing or exempting border taxes imposed by CBAM. Such approaches might encourage more countries to adopt domestic carbon taxes to some extent, avoiding the additional tax burden brought about by CBAM.

The launch of CBAM will necessitate adjustments in the global supply chain, significantly impacting the exports of high-carbon industries in developing countries[9]. The International Sustainability Council's standards for sustainable disclosures will require companies to provide information about their supply chains' upstream and downstream aspects. Moreover, they will impose emission reduction requirements on net-zero-emission companies and financial institutions, which may compel high-carbon industries in China and other developing countries to actively reduce emissions and transition to meet international market demands. For instance, downstream EU companies have set procurement standards for low-carbon and zero-carbon steel and have requirements for reducing carbon emissions from steel products, presenting a challenge to the Chinese steel industry[10].

4. Suggested Solutions to Address Drawbacks of CBAM

4.1. Designing the Domestic Carbon Market in Alignment with the European Carbon Market

To effectively address the challenges posed by the Carbon Border Adjustment Mechanism (CBAM), China can draw on the experience of the European carbon market by benchmarking against it and designing and refining its domestic carbon market. Firstly, it is crucial to engage in top-level design for the carbon market, emulating key elements of the EU carbon market, such as the reduction trajectory of carbon quotas, trading mechanisms, and pricing mechanisms. This is to ensure that export enterprises can smoothly offset the carbon reduction costs they have already borne domestically. Secondly, maintaining a moderate separation between the Chinese and European carbon markets in the short term is advisable. This can be achieved through a carbon border adjustment mechanism, gradually aligning domestic carbon prices with EU levels. During this process, establishing a monitoring and early warning mechanism for the trend of domestic carbon prices is essential to ensuring that enterprises bear the emission reduction costs within a reasonable range.

To promote the healthy development of China's carbon market, it is also necessary to actively facilitate the establishment of carbon intermediaries in the country. This includes expediting the cultivation of third-party certification bodies, information service providers, industry associations, and other intermediary institutions. Simultaneously, encouraging the close integration of the carbon trading market and the carbon financial market can improve the liquidity and effectiveness of the carbon market. Ultimately, concerted efforts are required to build China's domestic carbon market to achieve a low-carbon transition. By particularly supporting the development of industries such as new energy vehicles, photovoltaics, wind power, and nuclear energy, a comprehensive system can be established to facilitate the overall development of a low-carbon economy.

4.2. Policy and Regulatory Recommendations for China

To effectively address the challenges posed by the Carbon Border Adjustment Mechanism (CBAM), China can implement a series of measures at the policy and regulatory level. Firstly, exploring and introducing a carbon tax policy is recommended to drive comprehensive reform in environmental taxation. With the infrastructure development of carbon emission trading markets, it is advisable to introduce carbon taxes, complementing the carbon emission trading markets, to promote carbon reduction and enhance energy efficiency[11]. Secondly, enhancing the carbon emission trading market can ensure the recognition of carbon costs incurred by domestic enterprises in their country of origin, consequently reducing the risk of incurring additional charges. To mitigate the risk of carbon tariffs, it is recommended to establish a carbon tax system, with industries having lower emissions and not included in the carbon emission trading market being subject to taxation. Finally, to ensure the standardised and transparent carbon accounting and monitoring of enterprises, it is suggested to develop specific norms for a carbon accounting system and elevate the technological proficiency of carbon monitoring[12]. This can help reduce the risk of additional charges for enterprises and enhance the operational efficiency and fairness of the entire carbon market.

4.3. China-European Bilateral Relations and Investment in the Context of CBAM

To better address the challenges posed by the CBAM, China can establish closer cooperation by optimising China-European bilateral relations and investment. Firstly, active communication with the

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EU is essential, leading to the establishment of a normalised dialogue mechanism[13]. Under this mechanism, negotiations can take place on aspects such as the calculation of implicit carbon emissions, exemption clauses, mutual recognition of carbon prices, etc., minimising potential frictions during the implementation of CBAM. Secondly, advancing China-European bilateral investment cooperation will convey China's positive intentions for further collaboration with the EU. By easing investment barriers and placing special emphasis on China-European green and low-carbon technology investment cooperation to better align with the requirements of the CBAM mechanism. Simultaneously, encouraging and guiding direct investments by Chinese new energy enterprises in Europe will capitalise on the opportunities presented by the EU's clean energy development. Through direct investments in Europe, enterprises can not only meet the continent's demand for clean energy but also enhance their competitiveness in the European market, mitigating potential pressures arising from CBAM.

4.4. International Cooperation, Political, and Legal Recommendations

In addressing the challenges posed by the Carbon Border Adjustment Mechanism (CBAM), China can take a series of measures at the international cooperation, political, and legal levels to ensure a more effective and coordinated response strategy. It is recommended to actively strengthen bilateral and multilateral consultation mechanisms, maintaining close coordination and communication with the European Union, Russia, India, and other countries[14]. Secondly, elevating China's discourse power in the formulation of climate rules is paramount. Through active participation in international negotiations and providing feasibility suggestions, China can enhance its involvement and influence in shaping climate rules, which can also contribute to ensuring the fairness and reasonableness of the CBAM mechanism. Moreover, developing targeted policies to encourage enterprises to adopt clean energy and collaborating with universities and research institutions to promote the development of green industries is essential. Addressing green trade barriers becomes particularly urgent; hence, it is advisable to strengthen cooperation with the European Union and other nations to jointly research and resolve potential trade barriers introduced by carbon border adjustment mechanisms. Lastly, it is emphasised to adhere to international governance based on WTO rules and the international climate convention, opposing any attempts by the European Union to replace the WTO and climate convention.

4.5. Enterprise Level Strategies in Response to CBAM Mechanism

Faced with the challenges of the CBAM, enterprises can implement robust measures. Companies can enhance their technological capabilities by increasing investment in the research and application of green and low-carbon technologies, thereby reducing carbon emissions. Establishing a comprehensive carbon emissions footprint accounting system is essential to accurately understand the carbon footprint data of enterprises, providing support for a more targeted response to the carbon emission costs associated with CBAM. In terms of investments, companies must strengthen risk management by thoroughly assessing policy risks in investment regions, particularly focusing on high-carbon-emitting enterprises and industries. Expediting the top-level design for "dual-carbon" and actively responding to the national "dual-carbon" targets can promote industrial structure upgrades, achieving decoupling of economic growth and carbon emissions. Through this comprehensive series of measures, enterprises will not only be able to address the challenges of the CBAM mechanism but also gain a competitive advantage in the era of a low-carbon economy. It is worth mentioning that China’s Certified Emission Reductions (CCER) trading market has restarted in 2023, and companies are expected to seize the opportunity to promote green and low-carbon development.

5. Conclusion

The CBAM presents both opportunities and challenges in the context of global climate governance. Issues like WTO compliance and global market effectiveness must be addressed for CBAM's seamless integration into the international climate governance framework. While it works to address carbon leakage and promote emissions reduction, there are controversies towards it including potential WTO rule violations due to MFN and national treatment principles, and arbitrary use of GATT Article XX. It also raises concerns about violating UNFCCC's common but differentiated responsibilities, fairness, and differential treatment. Additionally, CBAM faces challenges in carbon accounting complexity and feasibility. It may have negative impacts on developing countries that lead to higher prices for exports and potential supply chain adjustments.

To effectively address the challenges presented by CBAM, China can implement a multifaceted approach. This includes aligning its domestic carbon market with the European model, promoting carbon intermediaries, introducing carbon taxes, and enhancing the carbon emission trading market. Moreover, China can optimize bilateral relations and investment with the EU, participate in international cooperation efforts, and reinforce enterprise-level strategies focused on green technologies and risk management. These comprehensive measures will enable countries to navigate the CBAM's challenges, promote a low-carbon transition, and maintain competitiveness in the global economy.

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