

Is the EU's Carbon Border Adjustment Mechanism Proposal in Accordance with WTO Regulations?

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Abstract: The European Union's proposed Carbon Border Adjustment Mechanism (CBAM) is a cornerstone initiative of the European Green Deal, designed to address both environmental and economic challenges. At its core, the CBAM seeks to tackle carbon leakage, which occurs when businesses transfer production to countries with laxer carbon regulations. This not only undermines domestic climate policies but also threatens fair competition in global markets. This paper breaks down the dual purposes of CBAM: levelling the economic playing field by adjusting the price of imports based on their carbon content and encouraging nations to adopt stronger climate policies. It critically examines CBAM's alignment with World Trade Organisation (WTO) standards to avoid potential trade conflicts, emphasising the balance between environmental aims and trade norms. Moreover, the paper assesses CBAM's compatibility with global climate goals. Conclusively, while highlighting the mechanism's legislative intricacies, the study proposes refinements ensuring its effectiveness and compliance with international trade rules. This analysis offers policymakers a clear framework for advancing environmentally conscious strategies without violating trade agreements.

Keywords: European Union, Carbon Border Adjustment Mechanism, low carbon transition, WTO rules, climate change law

1. Introduction

Within the context of the European Green Deal (EGD), a comprehensive plan to make the European Union more sustainable, the European Commission is actively working on formulating legislation for a new initiative known as the Carbon Border Adjustment Mechanism (CBAM). This proposed mechanism is specifically designed with dual objectives: first, to control the escape or 'leakage' of greenhouse gas emissions that may occur when production is shifted to countries with less stringent environmental regulations; and second, to create a level competitive playing field by ensuring that both European and non-European companies are held to similar environmental standards. In this way, the Commission aims to strengthen the EU's efforts to combat climate change while also maintaining fair competition in the global marketplace. This research aims to evaluate the EU's Carbon Border Adjustment Mechanism (CBAM) proposal through the lens of World Trade Organisation (WTO) directives. It begins by dissecting the dual objectives of CBAM—minimising carbon leakage and ensuring fair competition—and considers how these goals interact in a complex manner. The study proceeds to analyse the fundamental elements of CBAM, scrutinising their alignment with both WTO

norms and global climate change policies. In its final section, the research highlights pivotal aspects of the suggested legislative blueprint and discusses potential adaptations or substitutions that could better align the CBAM with its intended environmental aims.

2. Literature Review

This literature review aims to explore the relationship between CBAM and the World Trade Organisation (WTO), examining the potential implications for global trade and the compatibility of CBAM with WTO rules and principles. Through a thorough analysis of academic literature, reports, and legal analyses, challenges and opportunities arising from the integration of CBAM within the WTO framework have been found. Studies by authors such as Sapir [1], Englisch & Falcao [2], Espa, Francois & van Asselt [3] examine potential justifications for CBAM under Article XX of the GATT, which permits trade measures for environmental protection. Their papers discuss how CBAM's design, transparency, and non-discrimination will be crucial for its WTO compliance. Ultimately, the authors conclude that while CBAM could face challenges under WTO rules, it also presents an opportunity to align trade and climate objectives. With careful design and compliance with WTO principles, CBAM can serve as an effective policy tool in the EU's efforts to address climate change without violating international trade rules.

2.1. Background

In a global context characterised by disparate carbon pricing mechanisms and the latitude for varying carbon constraints as sanctioned by the Paris Agreement, the implementation of aggressive climate policies by some nations could inadvertently trigger a phenomenon known as carbon leakage. This involves the unintended consequence of increasing greenhouse gas emissions in foreign countries when industries relocate their production activities to jurisdictions that have less stringent or no carbon emission controls. Essentially, while aiming to reduce their own carbon footprint, countries with robust climate policies may inadvertently push industrial activities to regions with lax environmental regulations, thereby resulting in a net increase in global emissions [4]. The ambitious objective of the European Commission to achieve climate neutrality by 2050 would be compromised by carbon leakage in the absence of a globally coordinated and cooperative strategy [5]. Therefore, to avoid the leakage, the European Commission proposes a Carbon Border Adjustment Mechanism (CBAM), which aims to address “the risk of carbon leakage in order to fight climate change by reducing GHG [greenhouse gas] emissions in the Union and globally.” [6] The European Commission acknowledges that in order to achieve this aim, EU products and imported products must be treated equally when it comes to EU Emissions Trading Systems (ETS) carbon price. The proposed approach will resemble a notional ETS, requiring importers of covered goods to pay a price that reflects the EU price for non-tradable “CBAM certificates” and surrender those certificates to cover the hidden emissions in their imports.

The issue of whether a CBAM would violate the free trade rules outlined in the General Agreement on Tariffs and Trade (GATT) is frequently at the forefront of discussions concerning WTO compatibility [7]. Due to the fact that an effective CBAM is by definition intended to distinguish between low- and high-carbon items that are otherwise equivalent, it is contradictory to the EU's responsibilities under the WTO treaties [8]. Many countries argue that the CBAM would almost certainly violate GATT's non-discrimination clauses. The GATT Article XX with its environmental provisions, which may permit such a breach, is therefore the main legal conflict. However, since complying with those requirements becomes difficult, the CBAM's environmental purpose becomes crucial, but so does the decision-making process, which must be impartial, open, and inclusive.

2.2. CBAM under the WTO Law

The CBAM may run afoul of the Most-Favoured-Nation (MFN) clause as laid out in Article I of the General Agreement on Tariffs and Trade (GATT). This rule mandates that if a WTO member grants any kind of advantage or special treatment to one trading partner, the same must be extended to all other WTO members [9]. If the CBAM made distinctions based on the carbon content of similar imported items coming from other WTO member nations, it would be in violation of the MFN norm. By independently judging the climate initiatives of other WTO countries based on their extent and effectiveness, and then deciding the categories and amounts of emissions permits that imports from those countries must carry, the European Union could be unfairly discriminating both against and among its WTO trading partners in commerce involving comparable goods.

Moreover, the fact that the EU Commission's plan will exclude some nations from the CBAM is one claim of discrimination that cannot be made against it. The CBAM is set to affect all countries with the noted exceptions of Iceland, Liechtenstein, and Norway, which participate in the EU Emissions Trading Scheme (ETS), and Switzerland, which has an ETS connected to the EU's version. According to the supplementary notes that come with the Commission's CBAM outline, countries that have a carbon pricing model that sets a carbon cost on targeted products at a level similar to that determined by the EU ETS could be considered for exemptions. Switzerland is explicitly cited as an illustrative case [10]. In practice, nations having an ETS connected to the EU ETS, like Switzerland, may take such an approach into account. This remark raises the issue of what the Commission meant by "equivalence," nevertheless. In two aspects, the carbon pricing system in Switzerland is identical to the one in the EU: first, Switzerland has an ETS, and second, its ETS is connected to the EU ETS. As a result, the costs for carbon are the same across systems.

However, it would be difficult to decide whether to exclude a nation from CBAM if it utilises a carbon tax rather than an ETS and imposes a carbon price that is equal to or higher than the EU ETS, or if a nation that has an ETS that is separate from the EU ETS but nonetheless charges a price for carbon that is the same as or even more than the EU ETS. As a result, various elements of the CBAM, such as omitting particular nations, accounting for carbon costs incurred in the source country, and estimating inherent emissions through methods and processes not directly related to the product, might contravene GATT Article I, which disallows unequal treatment of imports based on their country of origin.

Former WTO Appellate Body chair James Bacchus provided a thorough analysis of the CBAM's WTO compatibility in a recent publication. He contended that the CBAM might not adhere to WTO fundamental principles and be challenging to exclude under GATT Article XX since it might be viewed as "arbitrary or unjustifiable discrimination" or a "disguised restriction on international trade" [11]. Moreover, the WTO's Technical Barriers to Trade Agreement could be invoked to question components like the procedures for measuring, documenting, and authenticating built-in emissions, along with additional reporting mandates.

Therefore, the legal quandary at hand is: Should the EU breach one or more of these three identified WTO regulations, could such violations be deemed permissible under the expansive exceptions that the WTO allows for health and environmental initiatives? The CBAM must be enforced for environmental or health grounds in order to qualify for the benefit of a general exemption. The CBAM would be a climate measure driven purely by climate-related health and environmental issues, the EU has said with caution. These EU comments, however, are not legally significant in and of themselves. The EU might be able to demonstrate that the CBAM is a conservation measure for limited resources, for example, air at a liveable temperature in a climate suitable for human habitation. The EU might manage to do this by effectively proving that there is a strong and authentic connection between the CBAM's procedures and its objectives, and that any imposed limitations on imported goods are

executed in a fair manner, consistent with the terms of the initiative. Importantly, the CBAM will be implemented alongside corresponding domestic measures in order to achieve this.

Nonetheless, the challenge lies in establishing the CBAM as a primarily climate-related measure when faced with legal scrutiny from WTO arbitrators in the context of a trade dispute. Although WTO regulations do carve out exceptions for measures essential for the preservation of human, animal, or plant life and health, as well as for conservation actions that are linked with limitations on domestic production, these exceptions are not straightforward to apply [12]. In this context, the presence of alternative solutions complicates the EU's position. Specifically, a carbon tax could serve as a more straightforward option that is aligned with WTO obligations. This alternative would not only be less trade-restrictive but would also offer the level of climate protection that the EU is aiming for. Given this viable alternative, it becomes increasingly difficult for the EU to argue that the CBAM is necessary for achieving its climate objectives, as the WTO generally expects members to opt for the least trade-restrictive measures when other options are available that accomplish the same policy goals [13].

Additionally, one of the more disputed aspects in the Commission's proposal is the interim use of free allocation alongside the CBAM, even though such features aim to reflect a genuine commitment to the objective of preventing carbon leakage, which serves as the foundation for the CBAM. The reason this is contentious is because the Commission's proposal often falls short of prioritising climate-conscious solutions over industrial interests. A discarded opportunity from a climate perspective can also be regarded as the absence of exclusions for least developed countries and small island developing nations, as well as the lack of clear promises for the use of CBAM income [14]. Nevertheless, each of these factors has the potential to reduce the likelihood that the proposed CBAM would satisfy the standards of Article XX of the GATT. While the ultimate form of the EU CBAM is still to be determined, readjusting these characteristics in accordance with WTO legal standards would probably better link it with its overarching climate aim.

The extraterritorial applicability of the EU CBAM may be less important in a WTO dispute than how it is enforced. Because the EU must also show that CBAM was used in a way that supports its claim to one of the common exceptions. The CBAM cannot be "applied in such a way as to constitute arbitrary or unjustifiable discrimination between countries where the same conditions prevail," nor can it be "a covert impediment to international trade." [15] The CBAM raises several questions about its ability to conform to these extra-legal norms. However, it might be arbitrary if the EU provides some WTO members exemptions from the CBAM emissions certificate requirements purely based on how the EU feels its carbon price and other climate initiatives are sufficient. It would be difficult to seek an appropriate way to gauge this sufficiency. In order to calculate carbon and other greenhouse gas emissions, climate negotiators have not been able to reach a consensus on a single international standard. If the EU imposes its own norm on other nations, it might be perceived as unjust discrimination.

Furthermore, the EU might be considered arbitrary if it becomes the only one to determine if the climate measures of other WTO members are sufficient. The EU goes so far as to impose its standards on the manufacturing procedures of goods created in other nations in accordance with WTO regulations. With regard to climate change, the EU and the rest of the world have undoubtedly already tested multilateralism via three decades of tense international debates. WTO jurists have also recognised that a WTO member can require that other WTO members adopt or abide by a policy that is unilaterally imposed by the importing country before allowing their products access to the domestic market. However, the WTO's ratification of the CBAM renders other members of the organisation authority to impose their own requirements—and maybe even their own comparable fees—on imported goods from the EU in light of issues other than carbon emissions.

2.3. Alternative Policies

It's crucial to recognise that the guidelines set by the WTO focus primarily on how individual traded goods are treated, rather than on broad commitments that countries may have made to each other or to certain business entities. This distinction is important when considering how the Carbon Border Adjustment Mechanism (CBAM) is implemented.

In the context of the CBAM, any form of discrimination should be carefully justified and should hinge on a detailed analysis of the carbon emissions associated with the production of specific traded goods. It would be inconsistent with WTO guidelines to make these judgments based on an assessment of a country's overall climate policy or their global emissions reduction commitments. In simpler terms, the CBAM should not punish or favour products based on the climate policies of their countries of origin, but rather on the carbon footprint of the products themselves.

For instance, if a product is manufactured using environmentally sustainable methods, it would be counterproductive and possibly in violation of WTO rules to require emissions certificates for that product solely on the grounds that it originated from a country with a poor track record in carbon emissions reductions. This would also run the risk of undermining the CBAM's primary goal of reducing carbon leakage and incentivising sustainable production, as it could discourage individual producers from adopting greener practices if they know that their products will be subject to CBAM penalties due to their country's overall policy.

If the CBAM is found to have violated fundamental nondiscrimination laws, a well-supported climate-based reason may enhance a defence under the broad exclusions allowed under Article XX GATT. One must bear in mind that, while global frameworks like the Paris Agreement and the UNFCCC lack explicit mandates for nations to adopt particular carbon mitigation measures or to control emissions that occur outside their national jurisdictions, achieving the ambitious temperature containment goals of 1.5 °C/2 °C could implicitly necessitate addressing the problem of carbon leakage. This is because failing to control carbon leakage can undermine the effectiveness of a country's own climate policies, as reductions in domestic emissions may be offset by increases in emissions elsewhere. Therefore, in the context of global climate targets, tackling carbon leakage becomes not just a national but potentially a global imperative to ensure the efficacy of each country's climate efforts.

3. Conclusion

As policies that strive to re-establish "fair" competition in order to successfully fight carbon leakage, CBAMs often include a significant industrial component. Therefore, as long as the programs continue to be in line with a rigours equalisation logic, accommodating competitiveness concerns does not inherently undermine CBAMs' basic carbon leakage purpose. The CBAM of the EU would be the first trade prohibition connected to climate change. Yet this isn't the last time a new European limitation will be introduced. It is necessary to enquire and receive an answer to these as well as other issues regarding the legality of such actions under the WTO convention. The EU's established CBAM might not comply with core WTO standards if it isn't revised and applied carefully, and it might not be eligible for one of the general health or environmental exclusions allowed by the WTO treaty. Nevertheless, the CBAM's WTO-proofing could help to resolve this industrial/climate conflict. Insisting on WTO compliance may potentially justify the difficult, protracted, and experimental approach intended to raise the scheme's climate ambition in the face of industry opposition.

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