Trade Protectionism Turns “Green”

Europe’s New Colonialism – Carbon Border Adjustment Mechanism

Robert Lyman

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Cover image: https://www.visualcapitalist.com/cp/mapped-carbon-dioxide-emissions-around-the-world/

TRADE PROTECTIONISM TURNS "GREEN"

EXECUTIVE SUMMARY

The European Union has agreed to impose a carbon dioxide border tariff. This is a tariff, or tax, on the import of goods from other countries based on an estimate of the "embedded carbon" or the carbon dioxide emissions associated with the production of the goods. The tariff, which is called a "Carbon Border Adjustment Mechanism", or CBAM, will be implemented in phases starting in 2023 and extending initially over three years. During that period, the CBAM will apply only to a small number of products – cement, iron and steel, aluminum, fertilizers and electricity. Its coverage will be expanded later.

The ostensible purpose of the tariff is to discourage "carbon leakage", the term used to describe the loss of sales, investment and activity by industrial plants in Europe. European industry has called for such measures to protect them from being undercut by less expensive goods made in countries that either do not share the EU's obsession with greenhouse gas (GHG) emissions reduction, or have lower carbon dioxide tax rates.

The legislation to authorize the CBAM will require importers to register with national authorities and seek authorization to import goods covered by the tariff. The price of the certificates to import will be calculated on the weekly average auction price of EU Emissions Trading System (ETS) allowances expressed in euros per tonne of CO2 emitted. In 2021, according to the European Commission, the average emissions trading permit price was US $95 per tonne of carbon dioxide equivalent. As the EU lowers the cap on emissions in future to meet its "net-zero" emissions target, the level of the emissions permit price will rise correspondingly.

The advocates of the CBAM believe that the rest of the world will so value its access to the EU market that it will be forced by circumstances to adopt the same or similar schemes. In other words, they think that other countries will introduce carbon dioxide taxes or emissions trading system that raise the cost of carbon dioxide emissions to their consumers to the same levels that prevail in Europe.

Advocates of CBAM have shrugged off concerns that the introduction of new and large tariffs on international trade will run counter to the rules of the World Trade Organization. However, there are good reasons to doubt that the EU's CBAM tariffs will avoid successful challenges under international trade law. The CBAM thus still poses some risk of inciting a trade war.

The design of the CBAM as developed so far is a bureaucrat's dream and business nightmare. A host of officials will have to be employed figuring out how to identify and quantify the carbon dioxide emissions associated with each imported good. Even for the relatively short list of goods initially covered by the new regime, the temptation will be to use industry averages, thus disadvantaging some firms whose emissions per unit of production are lower than the average. Another army of officials will be required to register, review, track and verify the applications for certificates. A counterpart set of thousands of staff and consultants will be employed by industry to comply.

The CBAM will eventually apply to tens of thousands of traded goods for which the embedded carbon dioxide is a substantial share of the costs. The magnitude of the regulatory effort that may be involved is breathtaking.

Ultimately, the idea that all other countries would adopt European-style taxes and restrictions on products made using hydrocarbons, including the highest carbon dioxide tax rates in the world, is not credible. The European Union may view itself as a model for the world but this alleged form of environmental leadership, and the reality behind it, will not inspire most other countries to harm their economies and standards of living.

TRADE PROTECTIONISM TURNS "GREEN"

EUROPE'S NEW COLONIALISM – CARBON BORDER ADJUSTMENT MECHANISM

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HOW IT WILL WORK

Some details of the CBAM are yet to be determined. This will be done during related negotiations on the reform of the EU carbon trading market. That market imposes costs on companies that produce and sell products based on the carbon dioxide associated with their hydrocarbons consumption, but it gives some larger EU industrial firms free carbon credits to shield them from foreign competition. With the introduction of the CBAM, the use of free carbon credits will be phased out, but exactly how and when this will be done is unclear.

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[1] https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets_en

price was US $95 per tonne of carbon dioxide equivalent. As the EU lowers the cap on emissions in future to meet its "net-zero" emissions target, the level of the emissions permit price will rise correspondingly.

National governments will authorize the registration of applicants to the CBAM system, as well as reviewing and verifying declarations concerning the level of embedded emissions in each imported product. In order to import into the EU goods covered by the CBAM, applicants must declare by May 31 each year the quantity of goods and the embedded emissions in those goods imported in the preceding year.

EFFECTS ON OTHER COUNTRIES AND TRADE

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The advocates of the CBAM believe that it will have effects that go far beyond "leveling the playing field" for European industry. In essence, they consider that the rest of the world will so value its access to the EU market that it will be forced by circumstances to adopt the same or similar schemes. In other words, they think that other countries will introduce carbon dioxide taxes or emissions trading system that raise the cost of carbon dioxide emissions to their consumers to the same levels that prevail in Europe. According to the European Commission:

"The EU is the largest economy in the world. It has a GDP per head of 25,000 euros for its 440 million consumers. It is the world's largest trader of manufactured goods and services, and is

the top trading partner for 89 countries. (By comparison, the US is the top trading partner for a little over 20 countries.) The EU is the most open to developing countries. Fuels excluded, the EU imports more from developing countries than the USA, Canada, Japan and China put together."

European analysts have commented that the CBAM "*is certain to have a transformational impact on companies engaged in international trade of the foreseeable growing list of covered commodities and is expected to shape global trade at large…To sell covered goods to the EU, non-EU companies will have to implement carbon accounting to track the embedded emissions associated with these products and to have these embedded emissions independently verified, as this information must be provided to the authorized declaration upon importation*.[2]"

Advocates of CBAM have also shrugged off concerns that the introduction of new and large tariffs on international trade will run counter to the rules of the World Trade Organization. They cite the remarks of Jean-Marie Paugam, Deputy Director General of the WTO to a public hearing of the European Economic and Social Committee in September 2021. In his remarks, Mr. Paugam stated that:

- Nothing in the multilateral trade rules precludes the implementation of an ambitious environmental policy by any WTO Member, provided it is not discriminatory or does not disguise primarily competitive or protectionist motives.
- When it was adopted in 1947, the WTO system included an environmental exception to trade rules, that is to say the possibility of taking trade restrictive measures on behalf of the environment, subject to good faith and non-discrimination.
- The WTO's approach to environmental issues has changed over time from "how to derogate from trade rules to serve the environmental cause?" to "how can trade make a positive contribution to the achievement of environmental public goods pursued by international society?".
- The best solution for pricing carbon would be a global agreement.[3]

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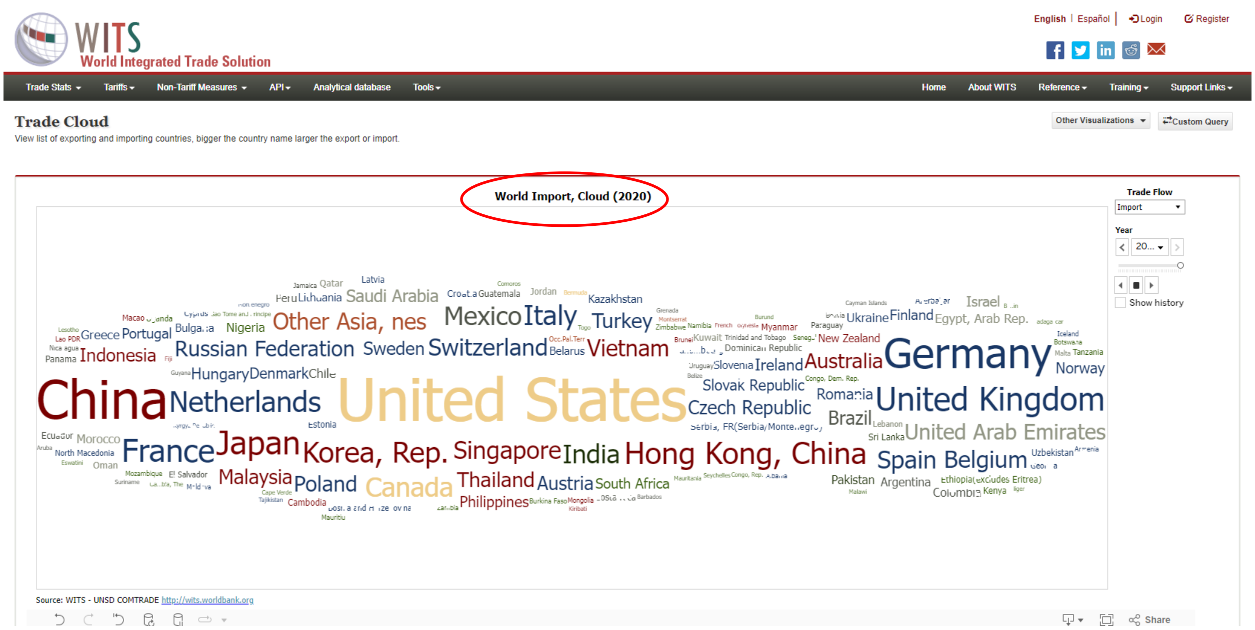
[2] KPMG. *Impact of the EU's Carbon Border Adjustment System*, 2022

[3] World Trade Organization. *DDG Paugam: WTO rules no barrier to ambitious environmental policies* September 2021

Despite Mr. Paugam's assurances, there are good reasons to doubt that the EU's CBAM tariffs will avoid successful challenges under international trade law. Treating imported goods differently than domestic goods violates both the GATT and WTO "national treatment" obligations unless a country invokes GATT Article XX, which includes exceptions for protecting human, animal of plant life or health and for conservation of exhaustible natural resources. These are possibilities but there are no assurances that either will apply. Moreover, regardless of the WTO's interpretation of the rules, several countries, including Brazil, South Africa, India and China, strongly oppose carbon border adjustments. Further, developing countries will insist on special and differential treatment, which WTO law sanctions.[4] The CBAM thus still poses some risk of inciting a trade war.



Many more interesting graphs and visualizations of world trade here: https://wits.worldbank.org/trade-visualization.aspx

There are undoubtedly many developing countries for which access to the European market is very important. Whether they would see that as so important that they should impose high carbon taxes on their industry and consumers is another matter – it certainly will require a difficult tradeoff. The larger industrialized economies, however, seem less

[4] Jon Johnson. *Latest Congressional Carbon Border Adjustment Mechanism Initiative- For real or for Show?* June 29, 2022

vulnerable. For example, the EU receives less than two percent of US exports by value and just over four percent of Canadian exports by value.[5]

There has been speculation that the United States Congress would pass legislation that would introduce an American version of the CBAM. In fact, a number of Democratic Party Senators introduced the Clean Competition Act (S. 4355), which includes a carbon border adjustment on imported goods that are "cleaner" than their American-made counterparts. If passed, it would have applied to imports of iron, steel, aluminum, cement, glass, pulp and paper and many other manufactured goods. The legislation went nowhere. Senate passage is now highly unlikely following the U.S. mid-term elections that gave the Republicans control of the Senate.

Like the European CBAM, the industrial policy approach embodied in the Inflation Reduction Act runs the risk of protectionism triggering a wider trade conflict. Image licensed from Adobe Stock.

The US will use other means to help its domestic industries overcome the cost disadvantages of climate-inspired subsidies and tax exemptions in other countries. The *Inflation Reduction Act*, passed by the US Congress in 2022, contains no border tariffs, but instead authorizes a wide range of subsidies and restrictions that will favour so-called "clean energy" manufactured in the United States. Like the European CBAM, the industrial policy approach embodied in the *Inflation Reduction Act* runs the risk of protectionism triggering a wider trade conflict.

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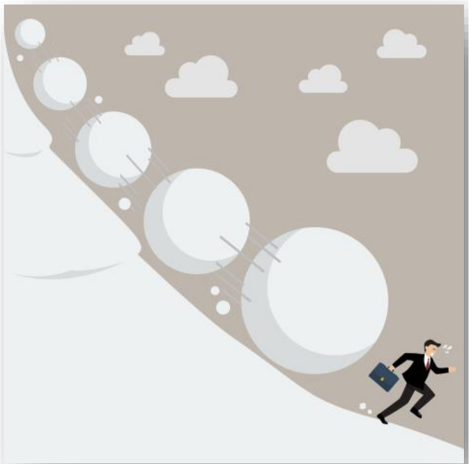
[5] United Nations COMTRADE database



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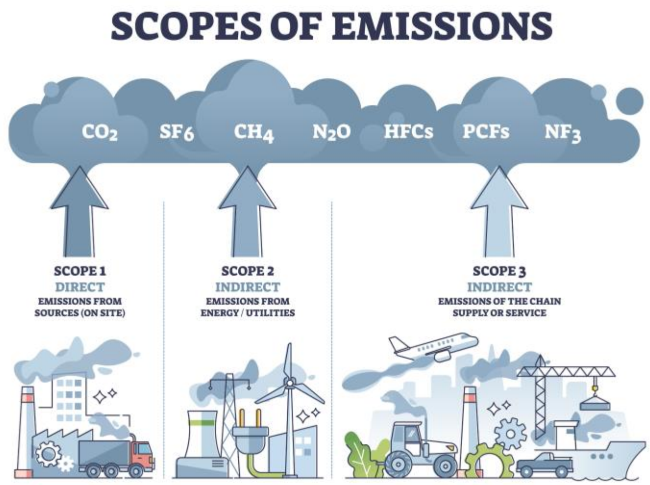
The CBAM is perhaps a classic example of what happens when a new government regulation “snowballs”. By this, I mean that it has effects that are either unintended or contrary to what is intended and the adverse public reaction requires the government to change things using a policy instrument such as regulation, subsidy, or tax. The added “corrective” measure in turn has its own unintended result, and that must be remedied, and so on and so on. Having used the ETS and carbon taxes to raise the costs of hydrocarbons-based products borne by industry, it should hardly have come as a surprise to European policy makers that this would place industry at a competitive disadvantage. The added measures, first discriminatory exemptions and now import tariffs, have their own adverse effects, but the EU seems prepared to take them and probably more rather than depart from the climate policy path it is on.

The design of the CBAM as developed so far is a bureaucrat’s dream and a business nightmare. A host of officials will have to be employed figuring out how to identify and quantify the carbon dioxide emissions associated with each imported good. Even for the relatively short list of goods initially covered by the new regime, the temptation will be to use industry averages, thus disadvantaging some firms whose emissions per unit of production are lower than the average. Another army of officials will be required to register, review, and track the applications for certificates. A counterpart set of thousands of staff and consultants will be employed by industry to comply. The CBAM proposal specifies that the “embedded” declared emissions should be verified by a person accredited by a national accreditation body. The costs of this will ultimately be borne by taxpayers and consumers. Thus, does climate policy create employment.



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It must be remembered that the CBAM will initially apply to only a small number of products and only to the “embedded” carbon dioxide, or the carbon dioxide emissions associated with the production of the good. There are tens of thousands of traded goods for which the embedded carbon dioxide is a substantial share of the costs. The magnitude of the regulatory effort that may be involved is breathtaking. A comprehensive carbon border adjustment would also include the hydrocarbons themselves – oil, natural gas and coal. That would discourage hydrocarbons trade and add yet another headache for producers.

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In none of the EU publications describing the objectives and characteristics of the CBAM did I find any discussion of how the governments of the EU would use the revenues generated by the new tariffs. This is striking, as the revenues would easily add to hundreds of billions of euros.

Ultimately, the idea that all other countries would adopt European-style taxes and restrictions on products made using hydrocarbons, including the highest carbon dioxide tax rates in the world, is not credible. The EU intention to penalize the imports of goods from developing countries unless they comply with Europe's brand of climate alarm is a new form of colonialism. The European Union may view itself as a model for the world, but this alleged form of environmental leadership, and the reality behind it, will not inspire most other countries to harm their economies and standards of living.

ABOUT THE AUTHOR

Robert Lyman is an economist with 27 years' experience as an analyst, policy advisor and manager in the Canadian federal government, primarily in the areas of energy, transportation, and environmental policy. He was also a diplomat for 10 years. Subsequently he has worked as a private consultant conducting policy research and analysis on energy and transportation issues as a principal for Entrans Policy Research Group. He is a frequent contributor of articles and reports for Friends of Science, a Calgary-based independent organization concerned about climate change-related issues. He resides in Ottawa, Canada. Full bio.

ABOUT FRIENDS OF SCIENCE SOCIETY

Friends of Science Society is an independent group of earth, atmospheric and solar scientists, engineers, and citizens that is celebrating its 20th year of offering climate science insights. After a thorough review of a broad spectrum of literature on climate change, Friends of Science Society has concluded that the sun is the main driver of climate change, not carbon dioxide (CO2).

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