

QRIUS

When two global agendas collide: how the EU's climate change mechanism could fall afoul of international trade rules

James Bacchus

July 7, 2021

James Bacchus, Adjunct Scholar, Cato Institute, Distinguished University Professor of Global Affairs, and Director of the Center for Global Economic and Environmental Governance, University of Central Florida

- On July 14, the European Commission will release details of its proposed 'carbon border adjustment mechanism' (CBAM).
- Under CBAM, importers will likely be required to buy emissions certificates to account for the carbon emissions embedded in certain carbon-intensive products.
- Brazil, South Africa, India, and China have already expressed "grave concern" that CBAM could impose unfair discrimination on European imports of their products.

The European Commission has launched an ambitious roadmap termed the Green Deal that aims to make Europe the first carbon-neutral continent by 2050. The deal proposes several pioneer trade restrictions aimed at mitigating climate change. And although this proposed measure may not be implemented for several years, its mere proposition will open a new front for trade confrontations. The proposed measure would attempt to minimise the effects of climate change using an economic approach. As such, its consistency with the rules of world trade could become a matter of global debate.

A few immediate concerns arise. The first is the World Trade Organization (WTO) and how its other members will react. Could the deal prompt other regional blocs to implement similar climate-related trade measures, or could it instead provoke a wide wave of global criticism? But perhaps more pertinently, could the proposed new measure shape the future of trade, climate ambitions and governance globally?

The commission has stated that the new measures were crafted in alignment with the European Union's (EU) WTO obligations. Nevertheless, Brazil, South Africa, India, and China have already expressed their "grave concern" that they will impose unfair discrimination on European imports of their products. A recent European study concluded that the most affected products would be Colombia's cement, China's plastics, North Africa's fertilizers, and South America's pulp exports.

Against this backdrop, the European Commission will release the details of its proposed new measure, which will be packaged as the 'carbon border adjustment mechanism' (CBAM). The mechanism will be launched officially on 14 July 2021 and will introduce the new measures transitionally in 2023 and finalize them before 2026.

Under CBAM, importers will likely be required to buy emissions certificates to account for the carbon emissions embedded in certain carbon-intensive products. They will be required to buy one certificate for every tonne of emissions. One tonne of emissions can retail for as much as €50 (\$59). Traders will pay for direct emissions of the CO₂ embedded in their products, as well as the indirect emissions that result from the electricity used in production processes.

Certificates will probably be required for items that emit high amounts of electricity, plus iron, steel, aluminium, cement, and fertilizer products. And payments may be collected by a new import authority that will work alongside the existing EU Emissions Trade System (EU ETS). The cost of the certificates will be linked to carbon prices under the EU ETS system.

American Climate Envoy John Kerry has warned that CBAM should be a "last resort" because it could detract from efforts to get more countries to elevate their climate ambitions before the upcoming United Nations (UN) climate summit (COP26) in November. The EU's other major trading partners have not stated their position.

At this early stage, any legal analysis is preliminary and provisional. However, the legal issues raised by CBAM regarding its compliance with the EU's WTO obligations appear to include the following:

1. CBAM could be inconsistent with the WTO's rule of non-discrimination, which requires that any advantage granted to the imported products of one WTO member must be accorded immediately and unconditionally to like products originating from all other WTO members. In judging some WTO members on the extent and quality of their climate actions, and thus picking and choosing whose products will need emissions certificates, the European Union will be showing a bias towards certain WTO member states.
2. Second, by applying a charge on imported products that could be higher than the EU's agreed customs duty ceilings and other charges connected with importation, CBAM could be in contravention of the EU's WTO obligations.
3. Third, CBAM could potentially be inconsistent with the WTO's 'national treatment rule', which requires that imported products be given "no less favourable" treatment than that given to like domestic products. If European producers continue to receive free emissions allowances, then the EU will be acting inconsistently with the "national treatment" rule. This is because imported products will be denied an equal opportunity to compete competitively with like domestic products within the European market.

A way out?

Assuming the EU commits one or more of these violations, the legal question then becomes: could the violations be excused by one of the general exceptions permitted under WTO rules for health and environmental measures?

Potentially, exceptions are available for measures that are necessary to protect human health, and those relating to the conservation of exhaustible natural resources. The EU is unlikely to be able to prove that CBAM is necessary to protect human health. This is in part because there is at least one reasonably available alternative: a carbon tax. A carbon tax would be less restrictive on trade and would also achieve the EU's desired level of protection from climate change.

However, the EU should be able to prove that CBAM is a measure relating to the conservation of exhaustible natural resources – in this case, the air we breathe – if it can demonstrate that there is a close and genuine relationship between the means used in the mechanism and the end it seeks.

But there is another legal hurdle that CBAM would have to clear. To prove that CBAM is entitled to the WTO's general exceptions, the European Commission would have to establish that it will not be “applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail”. And in addition, that it is not “a disguised restriction on international trade.”

WTO obligations

It is important to note that WTO obligations are instituted with respect to the treatment of individually traded products. Thus, to prevent CBAM from being “arbitrary or unjustifiable,” it can be argued that any discrimination must be based on assessments of the actual carbon emissions that result from the production of individual products.

The EU should refrain from simply making a judgment call on the overall emissions cuts that have been made or promised by the countries from which those products may have originated. Emissions certificates must not be required for climate-friendly products just because they originated in member states that have taken no meaningful action to reduce emissions.

Lastly, with reference to any “disguised restriction on international trade,” the greatest legal vulnerability for the EU would be the continuation of the free emissions allowances for a select group of domestic producers. To fulfil its WTO obligations, the best course for the EU would be to resist domestic industry pressures and abolish the allowances.

Keeping them as they are, might be a fatal legal mistake. And phasing them out over time – even with the addition of purportedly equivalent price offsets for certificates required of like products – may not be enough to survive legal scrutiny in any WTO dispute settlement. Rather, a process of dialogue involving all key stakeholders may be the best solution once the EU releases the CBAM proposal on 14 July.

James Bacchus, Adjunct Scholar, Cato Institute, Distinguished University Professor of Global Affairs, and Director of the Center for Global Economic and Environmental Governance, University of Central Florida