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From: Glen Hodgson

To: Canadians Concerned About Climate Policy and Competitiveness

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Re: **EU Climate Policy and Implications for Canadian Competitiveness**

Joe Biden's US *Inflation Reduction Act* is not the only climate and industrial policy-related competitive challenge to Canada.

The European Union – Canada's second largest trading partner with a free trade and investment agreement in place – has introduced its own sweeping green legislation and policies. The EU is using a multi-layered combination of targets, carbon prices, taxes, subsidies, and regulations to reduce emissions and reposition the EU economy.

Does this present a competitive challenge to Canada?

The EU's emission reduction targets are ambitious. Legislation was adopted to reduce them by 55 per cent by 2030 compared to 1990 levels, with a goal of net zero by 2050. A significant July 2021 policy package is based on a number of building blocks:

- An EU emissions trading mechanism, covering electricity, energy and other high-intensity sectors. Emitters are required to obtain emissions permits and the number of permits being issued is slowly being reduced. As a result, the EU carbon price from permit trading has steadily increased and recently reached €100/tonne (more than double the current Canadian carbon price).
- Updated targets and regulations for road transport, agriculture, buildings, small industry, and waste.
- Taxes on conventional energy – fuels and electricity – but also consumer subsidies to offset high energy prices.
- Targets for renewable energy and energy efficiency, but no subsidies, so far, for clean energy investment or production.
- These EU policies are largely internal, and do not pose a competitive threat *per se* to other nations.

However, there is one area where a competitive threat could exist.

The EU has announced plans to introduce a Carbon Border Adjustment Mechanism (CBAM), which is intended to reduce what is called "carbon leakage," or the shifting of high-emissions production activity outside the EU. The CBAM will equalize the price of carbon between domestic production and imports, and ensure that the EU's climate objectives are not undermined by imports from countries with less ambitious climate policies.

How does the CBAM system work? EU importers will be required to buy carbon certificates at the same carbon price as comparable goods produced in the EU. If a non-EU producer can show it has already paid for carbon emitted in the production process, such as to a third country, the corresponding cost could be deducted. The CBAM will thus help reduce the risk of carbon leakage by encouraging producers in non-EU countries to reduce carbon in their production processes, and by encouraging other countries to put their own price on carbon. It is designed to be compliant with World Trade Organization (WTO) rules and other international EU obligations of the EU, treating non-EU goods the same as those originating in the EU.

To build stability and provide legal certainty, the CBAM will be phased in gradually and will initially apply only to select goods at high risk of carbon leakage, notably iron and steel, cement, fertilizer, aluminum and electricity generation. Beginning this year, a reporting system will begin for those products, to help with a smooth rollout, and to facilitate dialogue with third countries. Importers will start paying a financial adjustment in 2026.

Two US attempts at a federal-level CBAM have failed, although CBAM is in place in some other jurisdictions, notably in California where an adjustment is applied to certain imports of electricity. Canada and Japan have announced plans for their own versions.

Meanwhile, the US, China, India and Brazil have all expressed concerns with the EU plan.

Trade retaliation could come into play as a response, but a more constructive way forward would be to engage is a serious global discussion about the role of trade in tackling climate change. The IMF and OECD are working on elements of what could become an agreed international framework and G20 finance ministers have called for closer international coordination on the use of carbon pricing mechanisms.

There are a number of implications from the EU scheme.

EU imports from countries without carbon pricing are obviously exposed to being fully subject to the CBAM, at the price set in the EU permit trading market. Conversely, imports from countries with carbon pricing would be less affected.

The pan-Canadian carbon pricing framework provides Canada with policy architecture to address any impacts on Canadian exports to the EU. However, elimination of our carbon tax, as some have suggested, would expose Canadian exports to the CBAM. In that case, any revenues would be captured and used in the EU, not recycled in Canada as at present.

Full CBAM details have yet to emerge, such as how to manage any difference in carbon prices between the EU and other countries. With both a free trade deal with the EU and its own carbon pricing system, Canada has important cornerstones in place for managing its economic and climate interests with the EU. Removing one of those cornerstones would create a less stable foundation.

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