

From: Jon Johnson

To: Global Affairs Canada

Date: July 27, 2021

Re: **EU CARBON BORDER TAX PROPOSAL BREAKS NEW GROUND**

On July 14 the EU released its [proposal](#) for establishing a carbon border adjustment mechanism (CBAM).

The proposal states that as “long as significant numbers of the EU’s international partners have policy approaches that do not result in the same level of climate ambition as the Union, and differences in the price applied to GHG emissions remain, there is a risk of carbon leakage,” which occurs when businesses transfer production to countries with less stringent rules. The proposal is concerned with emissions of carbon dioxide, nitrous oxide and perfluorocarbons.

The proposal emphasizes that EU action must be taken at the Union level through the EU’s Emissions Trading System or EU ETS. Under this system, allowances are granted to producers who then must remain within an emissions cap and purchase allowances if the cap is exceeded. The cap and the number of allowances are reduced over time.

The EU’s CBAM will initially apply to imports of steel, fertilizer, cement and unfinished aluminum, as well as imports of electricity.

The proposal sets out six options. The first imposes an import carbon tax reflecting the price of carbon in the EU combined with a default carbon intensity of the imported products. Carbon taxes are currently imposed by individual EU countries, ranging from Sweden’s high (€108.81 per tonne) to a Poland’s low (€0.09 per tonne) with some EU countries not imposing any carbon tax. How these would fit with the first option is not described. The sixth option involves a vaguely described excise tax.

The second through to the fifth options all involve the surrender by the importer of “CBAM certificates” which the importer purchases at prices based on values related to the carbon intensity of the imported products. The preferred option is the fourth with a phasing-in period.

The number of CBAM certificates required to be surrendered is reduced if a carbon price is paid in the exporting country respecting the “embedded emissions” in the imported product. How this would work is unclear.

Consider steel. Canada’s *Output-Based Pricing System Regulations* cover various steel products and require that the operator of a facility pay “compensation” if emissions exceed certain limits. Will the fact that Canadian regulations provide a regime for steel suffice to reduce the number of CBAM certificates to be surrendered? Or will a detailed comparison of the two pricing regimes be required, with CBAM certificates required if the Canadian pricing for a product falls short of the EU pricing? On the flip side, will extra certificates be issued if Canadian pricing is superior to the EU pricing?

The EU ETS provides for the allocation of free allowances (i.e. an allowance to emit one tonne of carbon dioxide equivalent during a specified period). The EU CBAM will be vulnerable to retaliation (whether or not under WTO rules) from any trading partner that maintains controls over carbon emissions (however accomplished) more stringent than in corresponding sectors benefitting from EU ETS allowances.

The proposal emphasizes that the regime will comply with WTO requirements. However, agreements with third countries will be considered as an alternative to the application of the CBAM. Such agreements could easily be inconsistent with WTO most-favoured-nation obligations. A recent [article](#) by former Appellate Body member James Bacchus describes multiple ways that the EU’s CBAM could violate WTO requirements.

The possibility of a WTO challenge is real. A powerful group of developing countries (Brazil, South Africa, India and China, known as the “BASIC” countries) expressed “grave concern” regarding as unilateral carbon border adjustments in a recent [Joint Statement](#).

And last week, Democratic Party Senator Chris Coons and Representative Scott Peters introduced the *FAIR Transition and Competition Act*, which provides for a “border carbon adjustment on carbon-intensive imports to account for the cost incurred by US businesses to comply with laws and regulations limiting greenhouse gas emissions.” More on this to come.

Reaction to these proposals will provide valuable lessons for Canada as it considers proceeding with a CBAM of its own.

Jon Johnson is a former advisor to the Canadian government during NAFTA negotiations and is a Senior Fellow at the C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the author. The C.D. Howe Institute does not take corporate positions on policy matters.