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The EU’s Carbon Border Adjustment Mechanism: An Opportunity for the EU to Assume Leadership over Environmental Protection Standards

Tatiana Falcão · Monday, August 24th, 2020

It was noted in my previous blog of this common series published on 18 August 2020 that the European Commission opened a public consultation on the Carbon Border Adjustment proposal put forward as part of the EU Green Deal. This is not the first document issued under that initiative. In March 2020 the European Commission in fact published an **Inception Impact Assessment Report (Impact Assessment Report)** to discuss policy options for a Carbon Border Adjustment Mechanism (CBAM). The CBAM is part of the EU Commission’s plan to modernize the **Energy Tax Directive**, in order to align it with environmental objectives. In this blog, I will discuss the impacts of a potential CBAM on developing countries, and how the EU might use the CBAM to foster environmentally sound policies in developing countries and trade partners more generally, bringing the EU to a position of leadership when it comes to environmental protection.[1]

The three policy approaches considered in this blog aim to account for the equitable and fair redistribution of revenues accumulated via the CBAM. They furthermore showcase the CBAM’s potential to foster climate objectives in the Global South, and help those countries transition towards a carbon neutral economy. They rely on the premise that, to be effective, carbon neutrality ought to be achieved on a global scale, and not just at a regional or domestic level.

1. Potential Impact on Developing Countries

A border carbon adjustment is a tax levied at the border at a price that is commensurate with the carbon tax (or price) being applied domestically. In speaking of an EU wide carbon border adjustment, the CBAM would either: (i) correspond to the carbon tax applied by each of the EU Member States (if the policy allows for different States to employ different tax rates); or (ii) be commensurate with a potential EU-wide carbon tax, introduced into the common area (provided the EU Commission succeeds in introducing qualified majority voting to pass new legislation on tax or environmental issues, and the majority of Member States approve the introduction of an EU-wide carbon tax).

Therefore, the introduction of a CBAM does not directly impact developing countries *per se*. The objective of such a policy is rather to provide parity between the domestically produced and the imported product, so that they are both negotiated at equivalent prices within the EU common market and so that the domestically produced products are not disproportionately affected by the tax.

An export border carbon adjustment (which basically translates into the crediting back of the tax applied either domestically or at the border) fulfills the purpose of allowing products that are either produced in the internal market or imported into the common market, to be negotiated internationally at prices that are at par with other products not burdened by the tax in their countries of origin. It is a mechanism that is employed to: (i) avoid carbon leakage; and (ii) avoid a loss in international competitiveness by domestic producers in the internal market.

Despite that, it is to be acknowledged that the CBAM, as a border carbon adjustment detracts from third countries' and, in particular, developing countries' own right to benefit from the revenues derived from the application of a domestic carbon tax. That is because the EU would be employing the CBAM in lieu of the country of origin, and employing the revenues derived from the application of the CBAM towards its own budgetary objectives.

This point did not go unnoticed by some companies located in developing countries that have answered to the aforementioned Impact Assessment Report. The EU Commission received feedback from 219 interested parties, of which seven are located in lesser developed and developing countries like Ecuador, Kenya, Russia, South Africa, Turkey and Ukraine. Of the developing country responders, five are companies, one represents the national government's point of view (i.e., the Ministry of Trade in Ukraine) and two are NGOs.

Of particular interest is the submission provided by *Cluster Bananero*, a representative of the banana industry in Ecuador, pledging the EU to take into account the impact that the CBAM may have in the economic and social development of Ecuador, given that the banana industry is the second biggest commodity exported by the country. The submission requests the CBAM to be drafted in accordance with the principles of fairness, equity, progressivity, policy coherence for development and global environmental benefit, taking into account the particular needs of developing countries.

The Ministry of Development of Economy, Trade and Agriculture of Ukraine (Ukraine Ministry) also highlights the need for the EU to safeguard the interest of third countries, considering the significance of its trade relationship with the Ukraine, representing more than 40 percent of share in Ukraine's international trade. The submission highlights concerns over how the CBAM might affect the steel industry in particular, an energy intense industry. Both the Ukrainian Ministry and the Turkish Business and Industry Association (TUSIAD) express an interest in aligning policies in order to approximate their legislations to the EU standard. These submissions provide a preliminary indication of how climate change policies may be perceived by some to be instruments of geopolitical influence, if not carefully drafted.

The Climate Change Adaptation Program of the University of Notre Dame's Environmental Change Initiative (ND-ECI) developed the **Notre Dame-Global Adaptation Index** ("ND-GAIN" or "Index") Country Index, a free opensource index that shows a country's current vulnerability to climate disruptions. According to the Index, the Global South, and in particular Africa, is the area that is both least ready to deal with the effects of climate change, and most vulnerable to the effects of climate change. In fact, all the EU Member-States are ranked top 50 in the world in terms of preparedness to cope with climate change. From a tax justice perspective, there is perhaps a point to be made that the revenues accumulated via the CBAM might be put to better use if employed in the Global South, where most of the adaptation to climate change ought to take place.[2]

The question that follows is how to make the most efficient use of the revenues accumulated via the CBAM, in such a way that stimulates climate protection and carbon reduction in the Global South and helps the region, and particularly Africa, reduce its vulnerability to climate change and prepare for the potential negative effects derived from the phenomenon.

1.1. Policy Options: How to Remedy Potential Negative Impacts on Developing Countries

Considering the details of the CBAM are yet to be defined, a few policy options exist which might guarantee an opportunity for the Global South – i.e., the countries that are most vulnerable to climate change – to also benefit from the policies administered at EU level. These alternatives would allow the EU to take the lead in policies related to climate protection, which is one of the stated objectives of the **Green New Deal announced by Ursula von der Leyen**, and allow Europe the opportunity to be the first continent to in fact achieve carbon neutrality by 2050.

To that point , this blog will consider the following three policy options: (i) revenue redistribution; (ii) full or partial carbon tax policy coordination with third countries (non-EU Member-States); and (iii) connection of the CBAM framework to other Overseas Development Assistance (ODA) projects envisaging climate protection, disaster relief as well as other projects that would enable just transition.

1.1.1. Revenue Redistribution

One approach would be to earmark or designate a fund to redistribute part of the proceeds of the CBAM to more vulnerable countries in the Global South. One policy approach might be to have partial redistribution at first, so that the EU can also employ part of the revenues obtained via the CBAM towards its own climatic objectives (carbon neutrality by 2050), and so that the application of a CBAM concomitantly to a carbon tax in the internal market is well perceived by the EU Member States and the EU electorate. Once the climate objectives are achieved, the EU could consider total revenue redistribution of the proceeds of the CBAM when the product burdened by the carbon tax originates from the Global South, so that the tax revenue is allocated equitably across the globe.

Revenue redistribution of the proceeds of environmental taxes on a cross-border basis has, as of yet, not been tested. None of the existing carbon tax regimes foresee revenue redistribution to other countries under the equity and fairness agenda. It would therefore be up to the EU to communicate its policy to the Member States and the wider electorate of the internal market to portray the notion that international redistribution may ultimately lead to global fairness in the administration of tax policies.

1.1.2. Full or Partial Carbon Tax Policy Coordination with Third Countries

Another alternative option might be for the EU to grant full CBAM exemption towards countries (particularly those of the Global South) administering equivalent carbon taxes. This option would in fact be in line with the EU's policy objective to become a leader in the field of climate protection. To the extent the EU announces this as an option, it will be providing stimulus for countries in the Global South to issue equivalent taxes in their own domestic jurisdictions, and hence source the proceeds of a carbon tax to their own jurisdictions, employing them to meet their own budgetary targets. Achieving equity and fairness in the administration of the carbon tax policy would then be within the competence of each country administering the carbon tax.

By recognizing the carbon tax applied in foreign jurisdictions, the EU would likewise be setting the tax rate benchmark for other countries to employ their own carbon taxes. Should the EU tax rate be too high for an initial carbon tax assessment in less developed countries, a similar system of partial exemption from the tax could be administered in the EU, corresponding to the rate employed in the third country of origin. Under a partial exemption system, the CBAM rate would correspond to the EU tax rate minus x, where x stands for the rate already employed by the third country. The overall result would be to assess the CBAM at the full EU rate, while avoiding double taxation.

This policy option is in fact contemplated in two of the submissions put forward for feedback (Pepsi co and the Environmental Defense Fund (an American NGO)), as a technique to allow frictionless bilateral trade while sharing a common CBAM externally.

To the extent that countries clearly identify their carbon taxation (or externality pricing) policies, the idea of introducing unifying measures, capable of addressing issues pertaining to a continent, a region, and eventually the globe becomes ever less controversial. This may ultimately lead to a universal agreement on a price for carbon based on existing principles of environmental law and international taxation and make use of the international environmental agreements to which the international community at large is bound.[3]

This option could be combined with policy option 1.1.1, under the partial exemption modality also allowing the EU the opportunity to either: (i) redistribute part of the proceeds of the revenues accumulated via the CBAM to developing countries; or (ii) invest the proceeds into the administration of specific capacity development projects, climate related projects, or funds aimed to counter extreme weather events, where the EU would assist third countries to achieve an optimal level of taxation and design fair and equitable pricing approaches for the administration of carbon based policies.

1.1.3. Connecting the CBAM Framework with ODA Initiatives

The third option would be to tie the revenue redistribution approach to specific Overseas Development Assistance (ODA) projects, that might allow the EU to administer how the budget would be employed in the Global South, if that were a pre-requisite for redistribution.

ODA is an aid transfer that developed countries pay to developing countries to assist development. The word ‘aid’ is not synonymous with a cash transfer, however. The aid may be in cash, but it can also be in kind, a grant, a ‘soft loan’ (in which the grant element is at least 25 percent of the total) or technical assistance.

Donor countries tend to prefer to tie their donations to a particular project through targeted assistance (for example, building schools or hospitals, or running a vaccination campaign). Donations can also be connected with an emergency situation, such as a natural disaster, humanitarian crisis, or event that requires peacekeeping operations and may be one-off deals where the recipient country cannot rely on the replenishment of the funds. Therefore, countries cannot plan ahead based on targeted assistance of non-budgeted funds (where the funds are connected to a particular project), to make investments in infrastructure, education, and health — key investment areas within any country’s government structure.

According to the United Nations 2018 Inter-Agency Task Force Report (IATF report), both Country programable aid (CPA) and budget support — the two types of aid over which partner countries can have a significant say in fund deployment — have declined in recent years.

Budget support — the type of aid that is paid directly to a country's general budget, and therefore allows the recipient country complete ownership over the resources — amounted to 1.9 percent of DAC donors' total bilateral aid commitments in 2016.

The United Nations supports the view that sustainable and long-lasting development relies on national ownership. However, ownership over projects can only be achieved through the untying of funds. Revenue redistribution of the proceeds of a CBAM could occur through the regular ODA project assistance type of investment, or through budget support. Were revenue redistribution to occur via budgetary support, EU countries might have an opportunity to insert environmental targets into their ODA commitments and make this a default form of aid. A novel concept of 'overseas environmental aid' (OEA) could be conceived, on which developed countries use funds derived from environmental taxes to assist developing countries through targeted assistance in climate-related projects.

2. Conclusion

This blog considered how the employment of revenue redistribution (either directly or via ODA's project-based assistance) could help the EU foster climate protection in the Global South. It also considered how the administration of an EU-wide approach might actually lead third countries to introduce their own domestic carbon tax policies, in a manner that is compatible with the EU approach.

Global problems require global solutions. Climate change that is caused by the release of carbon dioxide emissions is an issue of global concern, but the effects of climate change are not evenly perceived across the globe, nor are they proportionate to the harm caused by each country. The EU's new plan is an important step to tackle this issue on a global scale and to move from nationalism and regionalism in environmental law towards internationalism through direct assistance of the more vulnerable countries.

[1] T. Falcão, *Toward Carbon Tax Internationalism: The EU Border Carbon Adjustment Proposal*, Tax Notes International, June 1, 2020, p. 1047

[2] *See* the graph produced by the ND-GAI through this link: https://gain.nd.edu/our-work/country-index/ Country rankings are available here: https://gain.nd.edu/our-work/country-index/rankings/

[3] Falcão, *A Proposition for a Multilateral Carbon Tax Treaty* IBFD Publications, (Apr. 2019) (putting forth a proposal for an international approach to carbon taxation).

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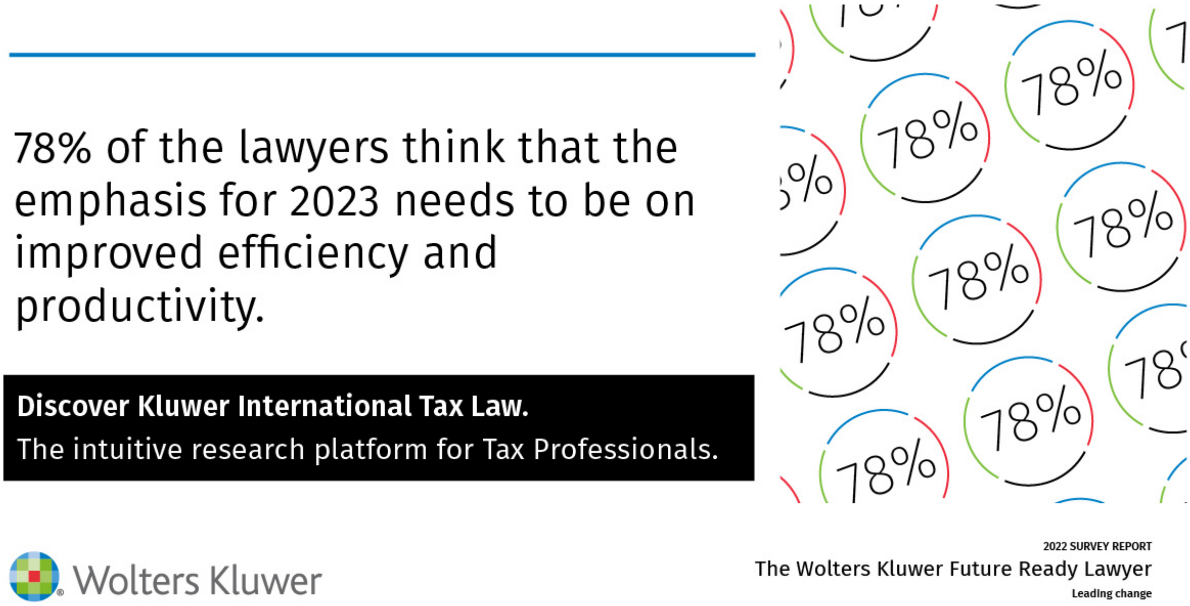

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