

Brandi, Clara

Research Report

Priorities for a development-friendly EU Carbon Border Adjustment (CBAM)

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Priorities for a Development-Friendly EU Carbon Border Adjustment Mechanism (CBAM)

Summary

The European Commission unveiled the Carbon Border Adjustment Mechanism (CBAM) in July 2021 as part of its “Fit for 55” climate-policy package. The European Commission had announced this trade-policy instrument under the Green Deal in 2019 as a means of implementing more ambitious climate-policy goals without energy-intensive sectors transferring their emissions abroad (carbon leakage). The CBAM proposal envisages imposing a levy on imports in certain energy-intensive European sectors that is proportional to the carbon content of the goods concerned. The proposal complements the EU’s existing Emissions Trading System by requiring importers of goods purchased from especially energy-intensive sectors (steel, cement, electricity, fertiliser and aluminium) abroad to purchase carbon certificates based on emissions data from abroad. CBAM is primarily designed to promote an ambitious climate policy for the EU. However, the EU’s current proposal creates the impression that it is mainly about improving domestic competitiveness at the expense of climate-policy effectiveness and development prospects.

The draft legislation must now be fleshed out in detail by the EU member states and the European Parliament. In addition to addressing climate-policy effectiveness and compatibility with WTO legislation, account must also be taken of the impact on European trading partners, and, in

particular, poor developing countries. Many developing countries are expected to face additional export costs as a result of the CBAM. The EU should carefully evaluate the associated disadvantages for developing countries and work towards achieving a development-friendly design of the mechanism. Corresponding improvements should be made to the CBAM in the EU’s legislative process going forward:

- The EU must ensure that the border adjustments do not have a detrimental impact on poor countries. Least developed countries (LDCs) should be exempted from the CBAM.
- The EU should provide targeted support to the developing countries affected by the mechanism, for instance, by building their capacity for implementing the CBAM and for reducing carbon emissions in the sectors concerned.
- The EU should assist low- and middle-income partner countries with the decarbonisation of their manufacturing industries.
- The EU should also recycle revenue from the CBAM by deploying it primarily for climate-policy purposes abroad.
- The affected countries should be involved to a greater extent in future through consultations and diplomatic dialogue in the process for further developing the mechanism.

Impact on developing countries

The CBAM levy could affect over USD 33 billion in exports from developing countries (as defined by the current OECD-DAC list) to the EU. The Bank of Finland estimates that a levy of USD 28 per imported tonne of carbon is equivalent to an average import duty of two per cent. The levy could be higher or lower than this, depending on the export mix of the developing country in question; exports from India, for instance, would be subject to a four per cent duty. If the carbon price were to rise to USD 75 in order to limit the global temperature rise to below two degrees Celsius, the levy would increase to almost three times the relevant import duty (Lowe, 2021).

The CBAM will hit developing countries especially hard if they export a large number of emission-intensive products to the EU in the sectors of relevance to the CBAM. Trade data (2019) on EU imports from developing countries in relevant sectors (on a CN basis as per the CBAM proposal) shows that several upper-middle income countries (UMICs) and lower-middle income countries (LMICs) rank among the top ten importing nations to the EU in each case (Figure 1 shows the two sectors in which most LMICs are affected):

Iron and steel: 1. Russia (UMIC), 2. Turkey (UMIC), 3. Ukraine (LMIC), 4. China (UMIC), 6. India (LMIC), 7. Brazil (UMIC), 9. Serbia (UMIC); other countries such as Zimbabwe and Zambia would also be affected.

Cement: 1. Turkey (UMIC), 2. Ukraine (LMIC), 3. Belarus (UMIC), 4. Colombia (UMIC), 5. Algeria (LMIC), 6. Morocco (LMIC), 7. Bosnia-Herzegovina (UMIC), 8. Albania (UMIC), 9. Tunisia (LMIC).

Electricity: 2. Russia (UMIC), 3. Serbia (UMIC), 5. Ukraine (LMIC), 6. Bosnia-Herzegovina (UMIC), 7. North Macedonia (UMIC), 8. Albania (UMIC), 9. Turkey (UMIC), 10. Belarus (UMIC).

Fertiliser: 1. Russia (UMIC), 2. Egypt (LMIC), 3. Algeria (LMIC), 4. Morocco (LMIC), 5. Belarus (UMIC), 8. Ukraine (LMIC), 9. Turkey (UMIC).

Aluminium: 2. Russia (UMIC), 4. China (UMIC), 6. Mozambique (LDC), 8. Turkey (UMIC), 10. Egypt (LMIC); other countries potentially affected comprise Guinea (LDC), Sierra Leone (LDC), Ghana (LMIC) and Cameroon (LMIC).

To what extent are LDCs affected? LDCs account for less than 0.1 per cent of EU iron and steel, fertiliser and cement imports. Nonetheless, there are exceptions, such as Mozambique, which accounts for over seven per cent of EU aluminium imports; more than 50 per cent of Mozambican aluminium exports are destined for the EU. And while CBAM-related exports from LDCs are limited in number, the relative importance of these exports to LDCs can be comparatively great. According to the European Commission, fertiliser exports from Senegal to the EU account for between two and five per cent of the country's gross domestic product (GDP).

LDCs can be affected not only directly, but also indirectly by the CBAM. Raw materials from one LDC could constitute

components of a finished product exported from another country that is subject to the CBAM levy on the EU border.

The EU should also check the potential impact of the mechanism on developing countries other than LDCs. Consideration should be given in this context to the fact that the costs for complying with the CBAM will be relatively higher in poorer countries than they are in industrialised nations, where governments and companies have higher capacities and better access to relevant certification authorities and data, such as information on the carbon intensity of production processes, which is required in order to identify the emissions embedded in exports to the EU.

From a development perspective (Brandt & Dröge, 2021), the EU member states and the European Parliament should elaborate the CBAM proposal with a focus on (1) exemptions for developing countries and (2) the use of CBAM revenues for fighting the climate crisis.

1) Exemptions for developing countries

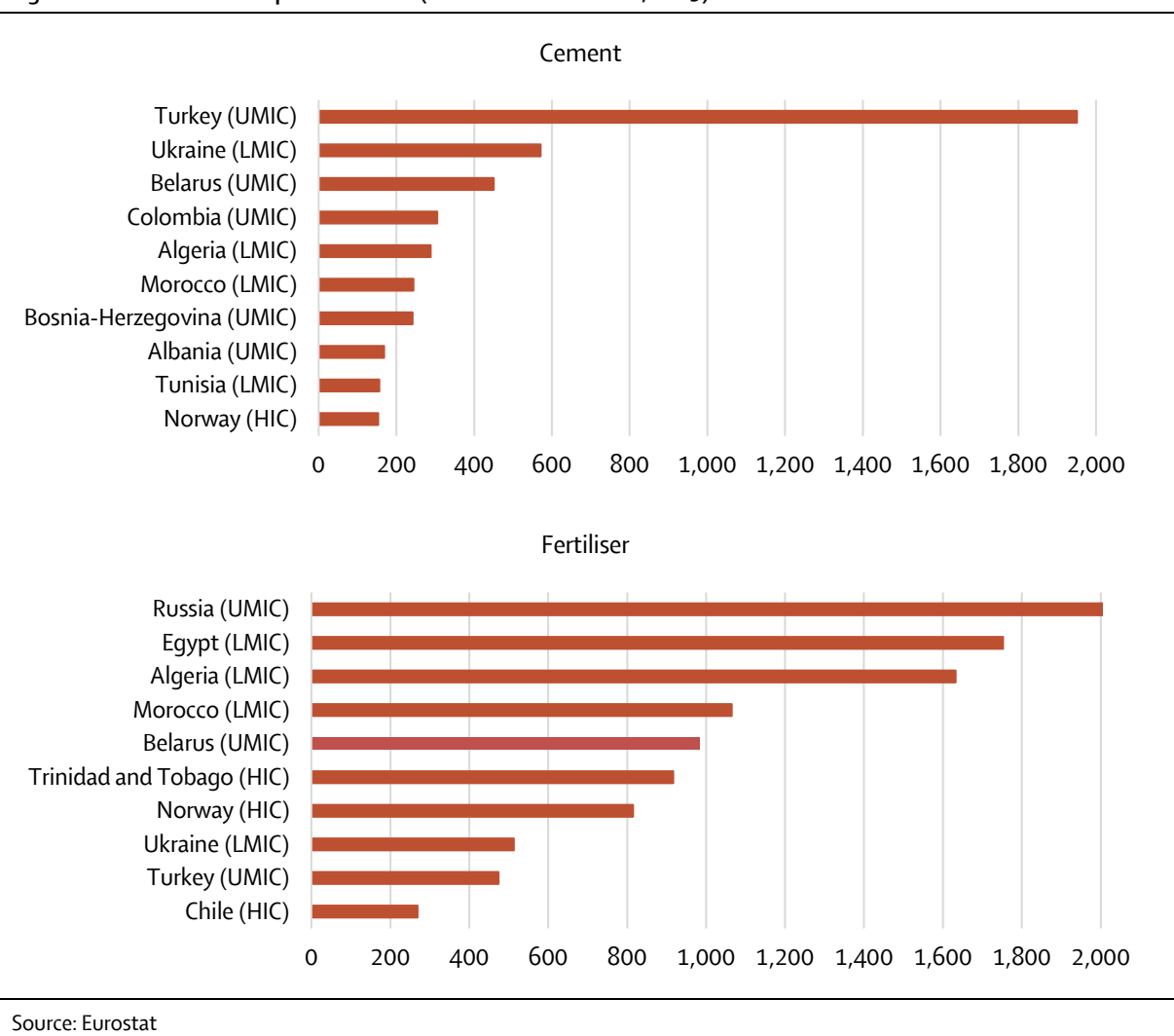
The European Commission should take account of the impact of the CBAM on developing countries and exempt particularly poor nations from the mechanism. However, the EU proposal does not envisage any exemptions for developing countries, let alone LDCs. This is where the EU needs to adjust the CBAM, not least in light of the "Common but Differentiated Responsibilities" principle of the United Nations Framework Convention on Climate Change (UNFCCC) and the WTO's Enabling Clause that allows for the special and differential treatment (SDT) of developing countries.

The CBAM should not counteract key goals for supporting poor countries (e.g. UNCTAD, 2021). The Sustainable Development Goals (SDGs), for instance, envisage an increase in exports from LDCs (SDG 17), and the EU's "Everything But Arms" (EBA) initiative affords LDCs access to the EU market without customs duties or quotas. The EU should thus introduce a blanket CBAM exemption for LDCs. The US Democrats' current proposal for a border carbon adjustment in The Fair, Affordable, Innovative, and Resilient Transition and Competition Act also provides for such an exception.

Exemptions for other low-income countries (LICs) and middle-income countries (MICs) raise complex questions. A blanket exemption from the EU's CBAM could diminish the incentive to transition to lower-carbon production methods, while full implementation of the mechanism could put emerging industries in developing countries at an unfair disadvantage. One starting point could be the introduction of a *de minimis* clause for LICs and LMICs, according to which nations that export very few of the relevant goods to the EU are not included in the CBAM.

In order to prevent the relocation of emission-intensive production processes to poor countries as a means of getting around the CBAM, the EU should draft safeguards (Lowe, 2021), which would enter into effect, for instance, if there were an increase in certain imports from a country exempted from the mechanism.

Figure 1: CBAM-relevant imports to the EU (in thousands of tonnes, 2019)



2) CBAM revenue for fighting the climate crisis

The EU proposal envisages that the vast majority of the revenue generated from the CBAM from 2026 onwards will flow into the EU budget. No mention is made of using this revenue for particular purposes (such as recycling it for climate-change mitigation within and outside of Europe). This is where the EU needs to make improvements. The majority of the CBAM revenue should be used for decarbonisation and adaptation measures in LICs and MICs affected by the mechanism, and possibly also in high-income countries (HICs) in which the mechanism generates revenue. Another substantial portion of the CBAM's returns should be used as additional climate finance, that is, to support mitigation and adaptation efforts and compensate for damage and loss in LICs that are not necessarily affected by the mechanism (Gläser & Caspar, 2021). The reasons for this are as follows:

First, revenue recycling focused on poor countries is of central importance from the perspective of justice. A failure by the EU to invest in other countries would create the impression that it is generating an unfair competitive

advantage for itself at the expense of other countries. The EU should work in particular to offset the negative impacts of the CBAM on poor countries. These nations have contributed the least to the climate crisis, yet are at the same time affected by it most severely. The CBAM would also have a detrimental effect on their competitiveness.

Second, using CBAM funds to promote climate-friendly transformation pathways in developing countries would represent an important step towards strengthening international acceptance of the mechanism. In this way, the EU could underscore the fact that it does not view the CBAM as a punitive instrument of trade policy, but rather that, as a global player, it considers itself a cooperative partner in climate-change mitigation and trade policy, both now and in the future. This is essential when it comes to minimising tensions and any sanctioning effect in the trade system, and at the same time boosting the EU's credibility on a climate-policy front and its leadership role in a multilateral climate-policy context.

Third, revenue recycling could support the EU in its argument that the CBAM is WTO-compatible (within the

meaning of GATT Article XX, which requires that trade-policy measures serve environmental purposes and not constitute a form of disguised protectionism). Additionally, using CBAM revenues for climate-change mitigation would help to expedite achievement of the goal of decarbonisation around the world; in other words, it would enhance the climate-policy effectiveness of the mechanism.

What shape might this kind of revenue recycling take? One option is to launch an investment fund to make finance available to the affected developing countries. The fund could be managed by an international financial institution, such as the Green Climate Fund or the World Bank, and would facilitate access to low-interest loans and other financing resources, including subsidies (and support) for research and development, and thus strengthen investment in modernising industry and electricity generation (e.g. Gläser & Caspar, 2021).

Another option for the EU, and indeed Germany and other EU member states, is to establish bilateral climate partnerships with LICs and MICs (Bauer et al., forthcoming). These partnerships would support the green transformation, for instance, by promoting the decarbonisation of the manufacturing industry or encouraging investment in green production, by expanding renewable energies, and through capacity development and technical assistance. Unlike an investment fund, which is focused on the use of a larger and thus more diffuse pot of money, climate partnerships, such as in the context of the NDC Partnership, facilitate

targeted cooperation with the relevant countries, in particular in the context of trade relations and the CBAM. The partnerships could help the partner countries to restructure their economic systems in such a way that they would no longer be affected by the CBAM; in this case, the mechanism could serve as a lever for a transformation to economic systems compatible with the Paris Agreement.

Recommendations

The CBAM should be made environmentally friendly during the next steps of the EU's legislative process:

- LDCs should be exempted from the CBAM.
- The EU should provide targeted support to the developing countries affected by the CBAM, for example, by means of technical and financial support, technology transfer, and capacity development.
- The EU should support LICs and MICs with decarbonising their economic systems, in particular their manufacturing industries.
- The CBAM revenue should be channelled into decarbonising the economic systems of affected partner countries and into international climate cooperation.
- Because international cooperation is the key to the success of the CBAM, the EU should engage in close dialogue with its trading partners and involve affected countries in the future design process.

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Dr Clara Brandi
Head of Programme
"Transformation of Economic and Social Systems"
German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)

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