BLOG *Published February 16, 2023 · 8 minute read*

What Does the EU's New Carbon Border Adjustment Mean for the US?

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Takeaways

In December 2022, the EU reached an agreement on a Carbon Border Adjustment Mechanism (CBAM). This means in 2026, importers of iron, steel, cement, fertilizers, aluminium, electricity, and hydrogen will pay a border carbon tax to level the playing field with EU companies. As the CBAM is phased in, EU industries will become subject to the EU's carbon price (also known at the Emissions Trading System (ETS)), from which they were previously exempt. The CBAM is designed to reduce industrial emissions while ensuring EU producers remain competitive and preventing carbon leakage. But what does this mean for the US?

The US has no internal carbon price mechanism, so US industries will be subject to the CBAM. The CBAM will cover an estimated $1.4 billion of US exports to the EU [1] . This might sound like a lot, but it is only 0.3% of US exports to the EU. Additionally, many US industries are well positioned compared to other countries importing to the EU, because they are the cleanest, most energy-efficient in the world. Plus, the Inflation Reduction Act (IRA) positions the US to lead in clean manufacturing. Keep reading to learn more about how the EU CBAM is designed and how US policymakers should respond.

Background on the CBAM

In 2019, the European Commission unveiled an ambitious European Green Deal to set up the roadmap for the EU to become carbon-neutral by 2050. In July 2021, the Commission published an adherend major legislative package to deliver the Green Deal, the Fit-for-55. As part of this legislative package, EU institutions have been discussing for 18 months the design of a CBAM, reaching in December a provisional agreement on the final text. The final text must be adopted by the European Parliament and the Council of the European Union before becoming enforceable, which will likely take several months. During this period, technical details will be defined and outlined. But the key design elements are agreed upon, and we don't expect them to change.

A CBAM is a long-term solution that aims at limiting carbon leakage by levelling the playing field between domestic and foreign production, through the implementation of a border carbon tax that reflects the domestic carbon price. The CBAM is envisioned by EU institutions as a tool that will support the decarbonization of domestic industries that so far have been exempt from the EU's carbon price. This scheme of free allocation clashes with the overall climate objectives of the EU and is therefore of pivotal importance that the unsustainable free allocation regime is replaced by an effective CBAM.

The Emission Trading System

The ETS is a cap-and-trade system first introduced in 2005 that distributes allowances through auctions. Because many countries across the world do not have a carbon pricing mechanism in place, emissions intensive and trade exposed (EITE) industries could shift production in other jurisdictions - with no or less stringent carbon pricing - leading to carbon leakage. For this reason, the EU has been granting special treatment to sectors that have been identified at risk of carbon leakage distributing up to 100% of free allowances to safeguard domestic competitiveness. With the decision taken in December, EU policymakers have agreed on the timeline in which the free allowances scheme needs to be replaced by the regular auction mechanism, which means that industries that have been granted free allocation will soon be responsible for their emissions. In order to avoid carbon leakage, the phase out of free allowances will be implemented in parallel with the phase in of the CBAM. By imposing an equal carbon price on imports and domestic production, the EU can ensure that their industrial sectors can remain competitive while also being subject to the EU's carbon price.

Key CBAM Features

The Parliament and the Council have now reached a compromise for the final text [2] . Here are some of the most important takeaways on key design elements of the CBAM.

Implementation will begin in October 2023, and there will be a transitional period for three years, during which importers will be required to report embodied carbon data through CBAM certificates. Starting in 2026, the CBAM will be gradually phased in (at the same rate that free allowances are phased out) and will be fully operational in 2034.

Iron and steel, cement, fertilizers, aluminium, electricity and hydrogen, as well as downstream products such as screws and bolts and similar articles of iron and steel will initially be covered by the CBAM. The Commission will assess whether to extend the scope to other goods at risk of carbon leakage, including organic chemicals and polymers, with the goal of including all ETS sectors by 2030. Both direct and indirect emissions will be

covered. However, indirect emissions will be applied to sectors under certain conditions, and this will be detailed in the next months.

In the case that the product is being exported from a country that has in place an explicit carbon pricing mechanism, such as a carbon tax or an ETS, the importer would be required to purchase CBAM certificates only to the extent of what was not already covered in the country of origin. There will be more details outlined in the final text on how this will specifically apply.

One of the strongest criticisms raised against the EU CBAM is that this would be incompatible with the World Trade Organization (WTO) law. General Agreement on Tariffs and Trade (GATT) provisions II.2 and III.3 require that a price charged at the border must be equivalent to an internal tax applied to a like domestic product. Although there are some technical and legal interpretations that could lead to different opinions on these and other GATT provisions and because there is no record of a prior dispute on this issue, it is difficult to predict how the Appellate body would interpret CBAM's legality in the case of a state vs state dispute. However, as long as there is an environmental justification, which in this specific case would be linked to the carbon leakage risk, which is strictly connected to the existing ETS mechanism, the EU could justify the CBAM mechanism under the general exceptions of the GATT art. XX. For this reason, sectors covered by the CBAM should be only extended to sectors that are at risk of carbon leakage.

What Does This Mean for the US

Because the US does not have an explicit carbon pricing mechanism in place, it will not be granted an exemption from the application of the CBAM. However, it is fundamental to take into consideration that the impact of the EU CBAM will be affected by three factors: the level of fossil fuel intensity of US industries, the share of US GDP generated by exports covered by the CBAM, and the percentage of the sectors covered by the CBAM in its total exports.

If we look at some of the specific industrial sectors that are covered by the CBAM, both the American steel industry [3] and the aluminium industries [4] are among the cleanest and most energy-efficient in the world. The cleaner the product, the less the domestic producer will be impacted by the CBAM as the price will be applied in reference to the certificate that importers provide at EU borders, stating the emissions content of your product.

The overall value of US exports to the EU in 2019 was $468 Billion [5], but only $1.4 billion worth of exports would be subject to the EU CBAM as covered goods. This also needs to be put in the context of the overall US GDP that in 2021 is of $23 Trillion [6].

As with every EU trading partner, the US will be impacted by the CBAM. However, taking into consideration these three fundamental factors and the recent adoption of the IRA, US industries will be well-positioned to lead the race to produce clean goods and can therefore reduce the carbon tax that they will have to pay at the European borders. In other terms, it is likely that US industries will have a competitive advantage in EU markets, once the CBAM will be implemented.

Lastly, a number of US policymakers have expressed support for implementing a CBAM in the US. As Congress and the Biden Administration consider policy designs, the newest EU proposal may help shape elements of a potential policy to limit regulatory uncertainty and foster uninterrupted trade between the two trading blocs.

Conclusion

As the EU and the US are moving forward with implementing ambitious decarbonization plans, we are seeing different approaches because of unique politics, cultures, and economies. These differences have spurred interesting conversations across the Atlantic on how countries can work together to develop clean energy supply chains and reduce emissions while preserving their own competitiveness. These conversations are important as they have spurred higher climate ambition and highlighted how we can positively influence internal discussions. Here some final observations:

- The US shouldn't fear the EU CBAM as the impact would be marginal and it could actually represent an opportunity for the US to become highly competitive in a market where other producers are required to pay a higher carbon tax based on the higher embodied carbon content of their products.
- When considering its own CBAM, the US should look for ways to complement EU policy and maintain strong transatlantic ties.
- Implementing systems to measure and disclose embodied carbon is crucial to ensuring fair and accurate comparisons among products.
- As the US is moving forwards with the IRA and the EU with the CBAM, we should work together in order to support each other's road to net-zero.

ENDNOTES

1. USITC Data Web. For aluminum, fertilizers, hydrogen, iron and steel FAS Value (HTS) were used: for Cement FAS Value (NAICS). Electricity is not being assessed in this calculation. https://dataweb.usitc.gov/

2. Council of the EU, https://www.consilium.europa.eu/en/press/press-releases/2022/12/13/eu-climate-action-provisional-agreement-reached-on-carbon-border-adjustment-mechanism-cbam/

3. American Iron and Steel Institute, https://www.steel.org/sustainability/

4. The Aluminum Association, https://www.aluminum.org/north-american-aluminum-production-carbon-footprint-drops-more-half-1991

5. Office of The United States Representative, https://ustr.gov/countries-regions/europe-middle-east/europe/european-union

6. US Department of Commerce, https://www.bea.gov/news/2022/gross-domestic-product-fourth-quarter-and-year-2021-second-estimate