Gianmarco Ottaviano

The EU Carbon Border Adjustment Mechanism between Ambition and Delusion

A GLOBAL SOLUTION FOR A GLOBAL PROBLEM

The European Union is adamant about the fact that climate change is a global problem that calls for global solutions. An important cause of climate change are the greenhouse gas (GHG) emissions associated with carbon-intensive production. Left to their own devices, firms typically do not consider the negative impact their emissions will have on the climate when making their production decisions. Hence, the idea of levying a "carbon tax" on GHG emissions to make firms face a "fair price" for such emissions forces them to internalize the damage carbon-intensive production has on the climate.

Unfortunately, not all countries tax carbon. As a result, according to the World Bank, less than 25 percent of global emissions are taxed, and only 5 percent of them face a carbon price compatible with achieving the Paris Agreement's goal of ensuring that global temperatures this century rise no more than 2 degrees Celsius above pre-industrial levels. Moreover, countries with higher carbon taxes face the risk of "carbon leakage," which occurs when their domestic companies move carbon-intensive production abroad to countries with lower or no carbon taxes, or when their products are replaced by more carbon-intensive imports.

KEY MESSAGES

- **Climate change is a global problem that calls for, among other measures, global carbon taxation**
- **As not all countries tax carbon, those with higher carbon taxes, such as the EU members, face the risk of "carbon leakage"**
- **The Carbon Border Adjustment Mechanism (CBAM) makes the carbon price of imports equivalent to that of EU domestic production, and creates incentives for its trade partners to tax carbon to improve access to the single market**
- **It does little, however, to help EU firms compete in foreign markets with producers from countries that do not tax carbon**
- **Moreover, as trade relations increasingly follow geopolitical fault lines, the EU might overestimate the incentives CBAM creates unless its coordination with the US improves**

AMBITIOUS GOALS

Due to its carbon taxation ambitions, the European Union would be particularly exposed to that risk. For this reason, it has planned the introduction of the Carbon Border Adjustment Mechanism (CBAM), whereby a carbon tariff is imposed on imported carbon-intensive products that are at risk of carbon leakage (such as cement, iron and steel, aluminum, fertilizers, electricity, and hydrogen). As part of the European Green Deal, CBAM entered into force last May and will take effect in 2026.

By requiring that certain imports pay a price for the embedded carbon emissions generated during their production, the objective of CBAM is to make sure that the carbon price of imports is equivalent to the carbon price of EU domestic production. That way, by putting a "fair price" on the carbon emitted during the production of goods entering the single market, CBAM should make the pursuit of the EU's climate ambitions incentive-compatible for domestic firms and, hopefully, encourage cleaner industrial production in non-EU countries that pay less attention to emissions. CBAM's "fair price" will be linked to the price of the EU allowances as determined within the European Union Emissions Trading System (ETS) and its gradual introduction will parallel the phaseout of the free allocation of those allowances.

DELUSIONAL OUTCOMES?

As highlighted in a recent review by the French economists Lionel Fontagné and Katheline Schubert, while there is broad agreement that the risk of leakage is real, whether CBAM will succeed in removing it is the subject of intense debate.

Two main aspects have been stressed by its critics. First, taxing imports to ensure that their carbon price is equivalent to the carbon price of domestic production may succeed in leveling the playing field in the EU domestic market. However, it does little to help EU firms compete in foreign markets with producers from countries that do not tax carbon. This would require an export subsidy, which is hardly compatible with the rules of the World Trade Organization.

Gianmarco I.P. Ottaviano

is Professor of Economics and Achille and Giulia Boroli Chair in European Studies at Bocconi University, where he is Codirector of the Globalization and Industry Dynamics Research Unit of Baffi-CAREFIN.

Second, the EU might be overestimating the incentive to introduce adequate carbon taxes that CBAM creates for countries that do not have any. The idea is that the single market is important enough to incentivize such countries to price carbon so as to avoid compensation through CBAM. In a changing world economy, in which trade relations are reorganizing around geopolitical fault lines, the attractiveness of the single market is fading for several lower carbon tax countries, and with it also the incentivizing leverage of CBAM.

POLICY CONCLUSIONS

A briefing by the European Parliamentary Research Service stresses the importance of tighter coordination with the US. As one of the world's largest markets and emitters, the US should be a key partner in bringing the world closer to reaching the goals of the Paris Agreement. However, so far it has largely gone its own way, especially after the Inflation Reduction Act (IRA) invested billions of dollars of public money to favor clean energy and technology "made in America."