POLICY BRIEF

Less confrontation, more cooperation

Increasing the acceptability of the EU Carbon Border Adjustment in key trading partner countries

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GERMANWATCH

Summary

The introduction of a Carbon Border Adjustment Mechanism (CBAM) is often described as a decisive enabling factor for achieving the more ambitious EU 2030 climate goal as well as climate neutrality in the 2040s. This is because the necessary speed-up of the industry transition in the EU requires to reform the EU's Emissions Trading System (ETS), while securing effective carbon leakage protection However, carbon leakage prevention alternatives to CBAM are not yet sufficiently available.

Timing is also an issue. Deciding on and implementing a sufficiently ambitious reform of the EU's ETS would become more difficult should the CBAM not materialize.

However, the EU's CBAM plan, as currently discussed within the bloc, faces strong opposition from inside EU trading partners such as China and Russia where many stakeholders perceive the mechanism as a confrontational, protectionist measure and in some cases already call for retaliation measures.

At the same time, the EU's CBAM plan is creating positive ripple effects on climate ambition discussions in EU trade partners. A CBAM that would be joined by more and more countries may in the mid- to long-term even become a cornerstone of the international climate governance structure. Nonetheless, this momentum can now easily be lost due to a lack of communication, cooperation and funding offers by the EU to trade partners.

This paper provides policy-makers in the EU with a better understanding of the perception and debates around the EU CBAM in relevant trading partner countries. It also provides recommendations on the design of key CBAM features in order to better enable the EU to implement CBAM as a critical instrument for reaching the EU's climate targets, to globally raise climate ambition and to pave the way for more, not less, multilateral cooperation on climate change.

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Content

Introduction

The EU has a problem. Its new 2030 climate target of "at least -55%" GHG emissions implies that the EU's Emissions Trading System (EU ETS) will have to be significantly strengthened. The EU ETS covers the power and industry sectors as well as aviation. However, emissions in the EU's industry sector have barely declined over the last 10 years. As a result, ETS prices now need to reach levels that will be sufficient to trigger the required steep fall of industry emissions, together with additional measures that need to be included in the policy basket. The transformation of EU industry needs to start now, but rising ETS prices and investments associated with producing raw materials with low or zero climate impact currently add to industry's production costs and may decrease the competitiveness of EU industrial products such as steel, cement, aluminum, and chemicals internationally.

In mid-July 2021, the European Commission plans to publish a legislative proposal on the EU ETS reform. The higher EU climate target will translate into a tighter ETS cap, which in turn will increase the carbon price. Higher prices, however, can raise the incentive for firms to relocate production to or make future investments in jurisdictions with less stringent climate policies or no carbon pricing in place. Such a relocation of production or investment, where carbon emissions are not reduced but only moved to other parts of the world, is called carbon leakage. So far, the EU and member states address the carbon leakage risk via free allocation of emission allowances and compensation for indirect costs firms face from higher electricity prices. However, as the cap decreases, the option of giving away free allowances gradually becomes less feasible, starting in the second half of the 2020s.

Against this backdrop, the Commission has announced the introduction of a Carbon Border Adjustment Mechanism (CBAM), a move that enjoys support by France and a significant number of member states. This measure would put some form of levy on goods imported into the EU based on their embedded GHG emissions in order to level the playing field between foreign and domestic firms and to prevent EU producers from facing a competitive disadvantage compared to producers from non-EU countries with less stringent emissions reduction policies which would lead to carbon leakage and reduce the effectiveness of European climate policy in reducing global emissions. The detailed legislative proposal for this instrument is due in July 2021, but the plan has already elicited heated discussions within and outside the EU. Many of the EU's trading partners have voiced concerns or even threatened resistance against the planned measure. Countries would be affected very differently by an EU CBAM, with some of the highest impacts predicted for Ukraine and Bosnia-Herzegovina. However, countries with a relatively low expected impact, such as China, have been the most vocal opponents. These countries' current opposition is rooted not only in the anticipated negative economic impacts of the mechanism, but also in a range of political factors.

In the absence of sufficiently developed carbon leakage prevention alternatives, the EU may well rely on an effective CBAM for reaching its climate targets. An intelligent CBAM design would send a strong signal for international transformation and cooperation with key trading partners in this context. The EU's CBAM can act as an impulse for advancing climate ambition discourses and action in trading partner countries. It could even serve as a starting point for more multilateral climate cooperation, for instance through an international revenue recycling scheme, for setting standards or through the prospect of building up a climate club of countries.

However, a closer look at the current CBAM discussion in the EU reveals that the EU may adopt mechanism design elements that would lead to outright rejection from trading partners.

Additionally, the EU may miss out on the opportunity to connect the CBAM with additional cooperation offers towards affected trading partner countries. If the EU does not urgently address some of these concerns, there is a high risk that conflicts, especially with powerful trading partners such as China, could reduce the CBAM's effectivity as well as prospects for developing an international cooperative approach for higher levels of global climate ambition.

Though several papers have discussed the EU's CBAM from legal and administrative feasibility perspectives, the significance of the international political acceptability of the mechanism has not yet received sufficient attention. This policy brief aims to close the gap by analyzing the ongoing debates in key trading partner countries and suggesting ways forward for the EU in terms of communicating and designing its CBAM.

1 EU Carbon Border Adjustment: What has been happening so far

The idea of a carbon border adjustment has been discussed in academia for over 15 years. It was first brought to the political stage by former French President Jacques Chirac in 2007 when it was included in the conclusions of the Grenelle Environment Forum. Later, the proposal was again brought up by former French Presidents Nicolas Sarkozy and François Hollande.[1] However, other EU member states remained highly skeptical of the proposal. This was particularly true for Germany, which continued to show reluctance out of fear for its export-oriented economy as the mechanism could easily trigger trade conflicts.[2]

The tides changed in 2019 when Ursula von der Leyen became President of the European Commission and made the European Green Deal her flagship project. In light of this new emphasis on climate ambition and the proposed increase in GHG emissions reductions, carbon border adjustment has returned to the political stage. In March 2020, the European Commission published an Inception Impact Assessment report to discuss policy options for an EU carbon border adjustment[3]. In December of the same year, the European Council called on the Commission to make a proposal for a "border adjustment mechanism to ensure the environmental integrity of EU policies and avoid carbon leakage in a WTO-compatible way"[4]. This CBAM proposal is due in mid-July 2021. The idea of a border carbon adjustment has also been discussed and proposed, but eventually not implemented, in the US.

A carbon border adjustment mechanism is a highly complex instrument with many different design elements upon which to decide. Most features of the EU mechanism have not yet been determined, but some of them will likely be decisive for acceptance of the instrument by trading partners.

2 Implications of an adverse CBAM design

The EU's plans to implement a CBAM have elicited strong reactions in many of the EU's trading partner countries. Stakeholders and political decision-makers in heavyweights such as the US, China, Russia and India have especially voiced firm opposition to the instrument. Several of these critical opinions are becoming increasingly vocal.

So far, there is no critical level of mutual consent in sight between countries, which poses a risk at several levels. The instrument is perceived as a tool of confrontation rather than a tool with cooperative elements, clouding the sky of multilateral climate collaboration. Without the right design and implementation features, the EU faces the bad choice between triggering international resentment or even trade retaliation – or weakening the instrument to a degree at which it is barely functional.

[1] Stam & Moscovenko 2020: EU carbon border tax: How a French idea ended up in the limelight. https://www.euractiv.com/section/energy/news/eu-carbon-border-tax-how-a-french-idea-ended-up-in-the-limelight. Last retrieved: 2021-06-16.

[2] Ibid.

[3] European Commission 2020: EU Green Deal (carbon border adjustment mechanism). https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism_de. Last retrieved: 2021-06-16.

[4] European Council 2020: Conclusions of the Council meeting of 11-12 December. https://www.consilium.europa.eu/media/47296/1011-12-20-euco-conclusions-en.pdf. Last retrieved: 2021-06-16.

2.1 Risk for EU climate ambition

The failure to implement an effective CBAM in a cooperative manner poses a risk at three levels. The first relates to the EU's ability to pursue a meaningful ETS reform that delivers on reaching the "at least -55%" 2030 climate target. The necessary higher ETS price potentially increases the carbon leakage risk for EU industries. Currently, the EU addresses the carbon leakage risk mainly by handing out many emission allowances to certain industry sectors for free. However, there are limits to **free allocation**, which will become more and more severe as the cap begins to steeply decrease.[5] In the second half of the 2020s, the EU will start running out of allowances to distribute for free. Towards the end of the decade, free allocation will no longer be an effective tool to prevent carbon leakage. [6]

Additionally, free allocation in the EU ETS slows down the bloc's urgent industry transformation by reducing the price signal for many carbon emitters. Allocating allowances for free in combination with a benchmark system – as done in the EU[7] – diminishes the incentive for companies to invest in new technologies. Furthermore, it is very difficult to correctly identify industries at risk of leakage and it has been argued that the majority of freely awarded emission permits in the EU has gone to industries with a relatively low risk of leakage.[8]

Finally, by allocating allowances for free, the EU foregoes a significant source of revenue which could be used to support the just transition. In fact, many environmental NGOs advocate for a quick phase-out of free allowances in order to increase the transition incentive for entire industry sectors. All of this means that the EU, if it is serious about transforming its industries, will increasingly rely on alternatives to free allocation in the near future.

However, alternatives to free allocation face unresolved challenges and present a range of disadvantages for which solutions are yet to be found. So far, the EU does not have a sufficiently developed instrument on hand which could be implemented in due time in order to address the potential carbon leakage problem – apart from a CBAM.

Carbon Contracts for Difference (CCfD)[9] will be an important complementary instrument in the industry transition and should be implemented as soon as possible. However, on its own, this instrument has only limited potential to prevent carbon leakage, as implementation on a sufficiently large scale does not seem very likely given the required amount of finance.

Mandatory carbon product requirements is another interesting option for mitigating carbon leakage, especially if implemented in conjunction with CCfD and, potentially, a consumption

[5] Lehne & Sartor 2020: Navigating the Politics of Carbon Border Adjustments. https://www.e3g.org/wp-content/uploads/E3G-Briefing_Politics_Border_Carbon_Adjustment.pdf. Last retrieved: 2021-06-16.

[6] Jakob 2021: Why carbon leakage matters and what can be done against it. https://www.sciencedirect.com/science/article/pii/S2590332221002293. Last retrieved: 2021-06-16.

[7] BMWi 2021: Ein CO2-Grenzausgleich als Baustein eines Klimaclubs. Gutachten des Wissenschaftlichen Beirats beim Bundesministerium für Wirtschaft und Energie (BMWi). https://www.bmwi.de/Redaktion/DE/Publikationen/Ministerium/Veroeffentlichung-Wissenschaftlicher-Beirat/gutachten-co2-grenzausgleich.pdf?__blob=publicationFile&v=12. Last retrieved: 2021-06-16.

[8] Jakob 2021: Why carbon leakage matters and what can be done against it. https://www.sciencedirect.com/science/article/pii/S2590332221002293. Last retrieved: 2021-06-16.

[9] Sartor & Bataille 2019: Decarbonising basic materials in Europe: How Carbon Contracts for Difference could help bring technologies to market. https://www.iddri.org/sites/default/files/PDF/Publications/Catalogue%20Iddri/Etude/201910-ST0619-CCfDs_0.pdf. Last retrieved: 2021-06-16.

surcharge. However, this option is also perceived as a non-tariff trade barrier that can put countries especially in the Global South at a disadvantage. [10] Therefore, more work needs to be done in order to explore ways forward. Mandatory carbon product requirements could, in the future, play a significant role on the policy mix to prevent carbon leakage but do currently not seem to be available in the near-term future. Another alternative under consideration is a **consumption surcharge**, which imposes a levy on a relatively small number of usually carbon-intensive primary goods such as steel when they are placed on the market regardless of where they were produced. One problem with this instrument, however, is that it would very likely use a default benchmark of carbon content such that it would not reflect the embedded CO2-emissions of a certain product. Including lifecycle CO2-emissions in the calculation of the charge would in principle be possible but poses many technical challenges and high administrative efforts.[11] However, neglecting the lifecycle CO2-emissions minimizes the emission reduction incentive for producers.[12] Even more importantly, a consumption surcharge relies on free allocation to continue, as it does largely not protect against carbon leakage by itself. Without free allocation to continue, producers would be charged twice if they were also subject to obligations under an ETS. The consumption surcharge only serves the purpose of restoring the price signal which had been muted through free allocation.[13] A consumption surcharge could thus – at most – serve as a transitional instrument which would need replacing by 2030 when free allocation starts becoming an insufficient anti-carbon-leakage-tool.

Finally, there are calls for a **Climate or Carbon Club** to be implemented as one step to prevent carbon leakage.[14] Such a club would comprise several economies which would coordinate their climate measures and ambition in order to create a level playing field amongst themselves. Membership in the club could focus on industry and power sector transition ambition, which would be sufficient to mitigate carbon leakage risks. For countries outside the club, a CBAM would still be necessary for leakage prevention. A Climate Club would represent a more multilateral approach to dealing with carbon leakage, compared to an EU CBAM. However, setting up a club of zero-carbon transition countries that does not compromise on the EU's climate ambition would take many years. Furthermore, comprehensive membership, including important trade partners such as China or Russia, does not seem likely in the mid-term future. Consequently, also a Climate Club would require an external carbon leakage protection structure.

As the EU will require an updated carbon leakage protection system that starts in the mid-20s and becomes fully functional in the late 20s, only engaging with trade partners to potentially establish a Climate Club without developing a CBAM (or a similarly functional alternative) in parallel is an inadequate approach. What is more, the European Commission, the Member States and the European Parliament need assurance now that a comprehensive carbon leakage protection will be

[10] Lehne & Sartor 2020: Navigating the Politics of Carbon Border Adjustments. https://www.e3g.org/wp-content/uploads/E3G-Briefing_Politics_Border_Carbon_Adjustment.pdf. Last retrieved: 2021-06-16.

[11] CPLC 2018: Executive Briefing. How can consumption-based carbon pricing address carbon leakage and competitiveness concerns? https://climatestrategies.org/publication/cplc-executive-briefing/. Last retrieved: 2021-06-16.

[12] Bierbrauer et al. 2021: A CO2-Border Adjustment Mechanism as a Building Block of a Climate Club. https://www.ifw-kiel.de/publications/kiel-policy-briefs/2021/a-co2-border-adjustment-mechanism-as-a-building-block-of-a-climate-club-16065/. Last retrieved: 2021-06-16.

[13] Neuhoff et al. 2016: Inclusion of Consumption of carbon intensive materials in emissions trading – An option for carbon pricing post-2020. https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2016/06/CS-Report.pdf. Last retrieved: 2021-06-16.

[14] BMWi 2021: Ein CO2-Grenzausgleich als Baustein eines Klimaclubs. Gutachten des Wissenschaftlichen Beirats beim Bundesministerium für Wirtschaft und Energie (BMWi). https://www.bmwi.de/Redaktion/DE/Publikationen/Ministerium/Veroeffentlichung-Wissenschaftlicher-Beirat/gutachten-co2-grenzausgleich.pdf?__blob=publicationFile&v=12. Last retrieved: 2021-06-16.

operational in the 20s. Indeed, a lack of prospect to successfully address carbon leakage could significantly reduce the political space for an ambitious ETS reform that can deliver on the EU's climate targets. The European Commission aims at publishing its ETS draft reform proposal in July 2021, with the following political decision-making process to likely end in 2023.

Given the described lack of readily available alternatives, the EU currently requires the prospect of a functioning CBAM that can start in the mid-20s in order to be fully functional in the late 20s. If the mechanism continues to be perceived mainly as a confrontational tool, leading to conflict internationally and a delay or weakening in the implementation, this could seriously put the EU's climate target achievement at risk.

2.2 Loss of momentum for higher climate ambition and carbon pricing in countries outside the EU

The second risk associated with an EU CBAM failure relates to the incentive for increased climate action the mechanism could spur in trading partner countries. Already, the EU's announcement to introduce a CBAM has demonstrably enhanced discussions and given additional impetus to carbon pricing and climate action in a number of trade partners. The EU has not yet officially published any details on the mechanism. However, the prevailing assumption is that the EU will acknowledge climate policies in other economies and therefore charge only the carbon price difference between the EU ETS and the system in the respective country[15] or even altogether exempt countries from the border levy in case they have comparable climate policies in place for their industry. As stakeholders in trading partner countries hope to be exempted from paying a (or the full) CBAM levy on the basis of their domestic carbon price or other carbon emissions mitigation instruments, the prospect of an EU border levy is bringing new momentum to industrial transition discussions in non-EU countries, with a focus on putting a price on carbon emissions. In addition to these policy-level effects, the CBAM announcement has likely added new impetus for companies considering a faster decarbonization of their industrial processes, in order to not lose the EU market.

We observe these dynamics in several relevant countries: Whether in Russia, where the government told businesses to start preparing for tougher EU rules,[16] or in China, where the EU's CBAM announcement strengthened the discussion on enhancing the Chinese ETS.[17] The EU CBAM will continue to have a tangible effect on global climate action as long as the EU pushes ahead with its plans for the mechanism. The observed positive dynamic would be lost the moment the EU stops implementing the instrument. These implications need to be considered given the fact that EU emissions are smaller than to those of some of the bloc's trading partners. In fact, the implications of EU action abroad could exceed the domestic benefits/impacts of the instrument.

[15] This is what a leaked early draft of the Commission's CBAM proposal suggests.

[16] Doff 2020: Putin Aide Tells Companies to Prepare for Harsh EU Carbon Tax. https://www.bloombergquint.com/business/kremlin-aide-tells-companies-to-prepare-for-harsh-eu-carbon-tax. Last retrieved: 2021-06-16.

[17] Liang Xi 2021: EU carbon tariffs may give rise to a carbon pricing-focused energy, environment and industrial policy system in China. https://mp.weixin.qq.com/s/73qozmG73YBiEwdbk2TlTg; Li Hongze 2021: EU plans carbon border regulation tax, tariffs on imports that don't meet environmental standards. https://www.thepaper.cn/newsDetail_forward_8454483. Last retrieved: 2021-06-16.

Importantly, however, the EU must not make the mistake of framing its CBAM motivation in terms of international climate action. Such a framing would contradict the non-interference spirit of the United Nations. It would also go against the Paris Agreement, which is centered on nationally determined contributions. While the international perspective should be taken into consideration, EU representatives should clearly refer to preventing carbon leakage as the EU's primary motivation for implementing the CBAM.

2.3 Backlash for multilateralism and international climate cooperation

The third risk pertains to the damage insufficient cooperation offers and careless communication on the CBAM by the EU can have on multilateralism and international climate collaboration. In recent years, multilateralism has been under attack from different sides. At the same time, international climate action cooperation and especially the Paris Agreement have proved to be a strong anchor for multilateral cooperation. For climate action in particular, a spirit of global cooperation and mutual trust is paramount. Given the nature of climate change as one of a collective action problem and free-rider issue, international cooperation and trust are key for countries to increase their climate ambition.

An imprudent introduction of the EU CBAM, coupled with poor communication and a lack of cooperation engagement with affected countries, has the potential to significantly harm both the trust and momentum of global climate cooperation. As we will discuss in section 4, there is a great risk that the EU's CBAM will be (further on) perceived as a unilateral, unfair, protectionist measure which primarily serves the purpose of advantaging the already advantaged EU industry. Advantaged here refers to the perspective of a typical Indian or Russian decision maker that would perceive the EU's industry as being more innovative and advanced with regard to the zero-carbon transition than the own domestic industry.

If the EU does not find a way – by means of communication, truthful engagement and well-thought-through instrument design – to counter this damaging perspective and enhance acceptance in key trading partners, the CBAM could become a serious set-back to the multilateral spirit and global cooperation of the Paris Agreement. The EU might also harm its standing as an honest broker in the UNFCCC negotiations. On the other hand, if well managed, the CBAM could potentially advance international climate cooperation and play an important role for building the international climate governance of the future.

3 Impact on and vulnerability of key trading partner countries

Before looking at the EU CBAM's reception in relevant trading partner countries, it is worthwhile to briefly examine how different countries would be affected by the measure. While the exact sectoral coverage has not yet been published, it can be assumed – and a leaked early draft proposal confirms that assumption – that the EU will want to apply the CBAM to cement, fertilizers, iron and steel, aluminum and electricity. With this list in mind, it is clear that countries will be affected at very different levels. Decisive factors include the share of exports of the specific good to the EU compared to the overall value of exports and the dependence on exports for a country's GDP. Particularly vulnerable

countries are those with limited economic diversification (i.e., high export concentration in terms of a small number of goods), a one-sided export orientation towards the EU market and a low GDP.

Interestingly, countries whose governments are especially vocal about the EU's CBAM plans are not necessarily the most exposed to the instrument. This is especially true for China[18] and the USA. Countries where the CBAM would have a high impact include Ukraine, Turkey, Russia, Belarus and Bosnia-Herzegovina.[19] For example, Ukraine will be strongly affected due to its significant export share of iron, steel, electricity and cement and its high dependency on the EU market. Russia would be particularly affected by a border levy on non-ferrous metals, iron, steel, fertilizer and electricity. A CBAM on cement would have the highest impact on Turkey.[20] Impacts on China will strongly depend on the design and sectoral coverage of the mechanism. An estimation from Tsinghua University shows that if the EU CBAM is extended to cover all industrial commodities, the costs of Chinese exports to the EU would increase by USD 10.8 billion/year at an adjustment price of USD 40/tCO2, accounting for around 2.6% of the total exports value.[21]

Table 1: Most heavily impacted EU trading partner countries and share of total EU imports[22]

Sector covered	**Cement**		**Fertilizers**		**Iron & Steel**		**Aluminum**		**Electricity**	
1	Turkey	34%	Russia	31%	Russia	15%	Norway	18%	Switzer-land	29%
2	Colombia	8%	Egypt	9%	Turkey	11%	Russia	14%	Norway	18%
3	Ukraine	7%	Belarus	8%	Ukraine	10%	China	9%	Russia	13%
4	Belarus	7%	Algeria	8%	China	8%	UAE	7%	Ukraine	7%
5	Bosnia-Herzegovi-na	4%	Morocco	7%	South Korea	8%	Switzer-land	7%	Bosnia-Herzegovi-na	6%

Grey: focus countries in this policy brief; orange: according to the leaked draft regulation, CBAM will not apply to countries within the customs union – Iceland, Liechtenstein, Norway and Switzerland.

[18] Wang Chen 2021: Europe's carbon price tops 56 euros, global carbon pricing system gaining momentum [in Chinese]. https://m.21jingji.com/article/20210518/herald/7ee5b63f334ff88d7d105a7637bb2d6c.html. Last retrieved: 2021-06-16.

[19] Dybka et al. 2021: Border Carbon Adjustments in the EU: Sectoral Deep Dive. https://secureservercdn.net/160.153.137.163/z7r.689.myftpupload.com/wp-content/uploads/2021/03/20210317-CBAM-II_Report-I-Sectors.pdf.

[20] Ibid.

[21] Adelphi 2021: The EU Carbon Border Adjustment Mechanism (CBAM) and China: unpacking options on policy design, potential responses, and possible impacts. Forthcoming.

[22] Source: Dybka et al. 2021: Border Carbon Adjustments in the EU: Sectoral Deep Dive. https://secureservercdn.net/160.153.137.163/z7r.689.myftpupload.com/wp-content/uploads/2021/03/20210317-CBAM-II_Report-I-Sectors.pdf.

4 Reception in non-EU countries

While the Commission has not yet published detailed EU CBAM design elements such as sectoral coverage and crediting of trade partners' climate action, the mere announcement to introduce some form of CBAM has elicited strong reactions from major exporting countries. The EU is facing strong criticism and various accusations. US climate envoy John Kerry said the CBAM should be a "last resort"[23]. In a joint statement in April 2021, Brazil, South Africa, India and China expressed "grave concern regarding the proposal for introducing trade barriers such as unilateral carbon border adjustment"[24]. This statement illustrates two of the main critiques that the EU's CBAM faces:

First, its alleged protectionist nature, with the CBAM seen as a trade barrier introduced under a climate pretext, a phenomenon sometimes referred to as green protectionism. The EU is suspected to predominantly aim at boosting the competitiveness of its (already rather innovative and modern) industry through "punishing" competitors.

A second set of criticisms is motivated by the position of the European Council and the European Parliament[25] to use CBAM revenues as a source of own EU income into the overall EU budget and, in the case of the Parliament, as a dedicated source for greening the EU's economy. These plans have further exacerbated the protectionism claim and are fiercely criticized by many stakeholders in affected non-EU countries. Stakeholders and policy makers criticize the potential extracting of money from less affluent countries in order to make EU industry (even) more innovative and competitive or to pay for consolidating the EU's budget. In a leaked early draft of the European Commission's proposal, Commission services suggest to apply the mechanism only to companies that are registered in the EU, which would mean foreign producers do not directly contribute to the EU budget. However, even if this suggestion is implemented, it will very likely be still strongly criticized in trade partners as consolidating the EU budget through reducing imports from competitors. How the EU can mitigate this concern is part of our Recommendations chapter.

Third, the EU is criticized for acting unilaterally and not sufficiently consulting with partners. While the EU argues that it is consulting trading partners but cannot provide detailed information as the legislation is still in the drafting process, many countries accuse the EU of deliberately and arrogantly pursuing unilateral action.

A fourth layer of criticism relates to the alleged violation of WTO rules. A critical element in this regard is the transition from free allocation of ETS allowances to carbon leakage protection through a CBAM. The EP narrowly voted to introduce a CBAM while maintaining the system of free allowances and the leaked CBAM draft regulation is silent on the respective phase-out The

[23] Gordon 2021: EU presses ahead with tariff on embedded emissions. https://chinadialogue.net/en/business/eu-presses-ahead-with-tariff-on-embedded-emissions/. Last retrieved: 2021-06-16

[24] South African Government 2021: Joint Statement issued at the conclusion of the 30th BASIC Ministerial Meeting on Climate Change hosted by India on 8th April 2021. https://www.gov.za/nr/speeches/joint-statement-issued-conclusion-30th-basic-ministerial-meeting-climate-change-hosted. Last retrieved: 2021-06-16.

[25] European Parliament 2021: Report – Towards a WTO-compatible EU carbon border adjustment mechanism. https://www.europarl.europa.eu/doceo/document/A-9-2021-0019_EN.html. Last retrieved: 2021-06-16. The report "supports the Commission's intention to use revenues generated by the CBAM as new own resources for the EU budget" and "believes that those new revenues should allow for greater support for climate action and the objectives of the Green Deal, such as the just transition and the decarbonisation of Europe's economy, and for an increase in the EU's contribution to international climate finance in favour of Least Developed Countries and Small Island Developing States".

simultaneous implementation of a system of free allowances and a CBAM, however, faces heavy criticism by many non-EU stakeholders who point to the incompatibility with WTO rules and regard such an approach as double subsidization. Similarly, it is not yet clear whether the EU will apply the CBAM only to imports or also to exports.[26] Export rebates, where EU exporters would be compensated for their EU ETS expenses, are seen in non-EU countries to increase the competitiveness of EU firms in non-EU markets and, as a result, face fierce opposition and would likely violate WTO principles.

A fifth criticism by stakeholders and decision-makers from various countries is that the EU is ignoring the UNFCCC principle of common but differentiated responsibilities and respective capacities (CBDRRC). They argue that, given the historical responsibility for emissions of the Global North and with regard to the spirit of the Paris Agreement, countries from the Global North should take the lead on emissions reductions, while countries from the Global South should be given more time to transition, a differentiation which the CBAM could possibly largely or completely neglect.

A final point of critique relates to the alleged disrespect of countries' sovereignty and the alleged violation of the Paris Agreement's bottom-up approach. The EU is generally perceived as aiming to introduce the CBAM in order to incentivize more climate action in non-EU countries. Decision-makers and stakeholders in many trading partner countries feel that this objective disrespects their sovereignty and the principle of "nationally determined contributions" set forth in the Paris Agreement.

4.1 China*

China is not only the EU's biggest trading partner but also among the most vocal critics of the EU's planned CBAM. Narratives in China echo many points discussed in other major trading partners. Stakeholders and decision-makers in China typically argue that a CBAM would contradict the CBDR principle, stressing the historical responsibility of industrialized countries in terms of cumulated greenhouse gas emissions. The instrument is therefore usually perceived as unfair in China, as it forces other countries to strengthen emission reduction measures towards an ambition similar to the EU's. The EU is also strongly criticized for unilaterally implementing the CBAM, without early consultations with other countries.[27]

Discussions in China should serve as a warning signal. The Chinese government is serious about its resistance. The country's opposition is real and should not be dismissed as pure rhetoric.[28] The EU's CBAM is strongly perceived as a confrontational tool and many experts see the potential for an escalation into a trade conflict.[29] Some Chinese commentators even make the point that it will "inevitably" lead to political conflict and trade retaliation, such as the imposition of tariffs or technical

[26] A first CBAM regulation draft, leaked in the beginning of June 2021, does not include export rebates.

* Lina Li and Christopher Kardish of adelphi have contributed to the China analysis.

[27] Konrad-Adenauer-Stiftung 2021: Perception of the Planned EU Carbon Border Adjustment Mechanism in Asia Pacific – An Expert Survey. https://www.kas.de/de/web/recap/publikationen/einzeltitel/-/content/perception-of-the-planned-eu-carbon-border-adjustment-mechanism-in-asia-pacific-an-expert-survey; Seminar – EU Carbon Border Adjustment Mechanism (CBAM). University of International Business and Economics (UIBE) American Environmental Defense Association (ADEA). https://mp.weixin.qq.com/s/hxqV1-UzIE8o4GLc69waag. Last retrieved: 2021-06-16.

[28] Germanwatch Expert Interviews.

[29] Germanwatch Expert Interviews.

barriers to trade or the cancellation of important orders. [30] Another option would involve entering a legal dispute – alone or in an alliance with other non-EU countries, as was threatened when the EU attempted to include international aviation in its ETS. Several experts even expect China to resist any form of CBAM which applies to its exports, either in a bilateral manner or by joining forces with countries such as India or Russia.[31] This section examines three key issues of the Chinese debate, which the EU should carefully take into consideration when proposing detailed legislation.

Negotiations instead of unilateral imposition of the instrument

Many voices from China strongly criticize the EU's unilateral approach, the perceived lack of cooperation and condescending treatment of China. They emphasize the lack of information and engagement from the side of the EU and often call for much more consultation or, indeed, negotiations. Chinese stakeholders are expecting to be on equal footing with the EU during dialogues and negotiations. They want the EU to acknowledge China's position as a powerful and serious veto player instead of presenting accomplished facts.

Experts and policy-makers in China argue that the EU is violating the underlying principle of nationally determined contributions, set forth in the Paris Agreement as a bottom-up approach of voluntary contributions.[32] In their view, a CBAM would be a means to force countries into stricter climate policies. This is pivotal, as the Chinese government will, under current conditions, probably not accept a measure that it perceives as forced upon it, i.e., infringing on its sovereignty.

This view is linked to the prevailing narrative in China that the EU is trying to act from a moral high-ground of environmental protection to impose value-based trade policies onto China.[33] This perceived presumptuousness is triggering considerable irritation in China, linked not only to a sense of interference in internal affairs, but also to a perceived degradation of China.

Recent years have seen a positive spirit of collaboration on climate and environmental policy between China and the EU. Should the CBAM cause serious tension between the two countries, it could severely damage the positive momentum.[34] If the CBAM conflict hinders the collaborative climate action momentum, this could by far outweigh the possible climate benefits in terms of prevented carbon leakage. A deterioration of the relationship might have negative effects on China's willingness to act on climate change and cooperate with the EU to curb GHG emissions.

[30] Seminar – EU Carbon Border Adjustment Mechanism (CBAM). University of International Business and Economics (UIBE) American Environmental Defense Association (ADEA). https://mp.weixin.qq.com/s/hxqV1-UzIE8o4GLc69waag. Last retrieved: 2021-06-16.

[31] Konrad-Adenauer-Stiftung 2021: Perception of the Planned EU Carbon Border Adjustment Mechanism in Asia Pacific – An Expert Survey. https://www.kas.de/de/web/recap/publikationen/einzeltitel/-/content/perception-of-the-planned-eu-carbon-border-adjustment-mechanism-in-asia-pacific-an-expert-survey. Last retrieved: 2021-06-16.

[32] Seminar – EU Carbon Border Adjustment Mechanism (CBAM). University of International Business and Economics (UIBE) American Environmental Defense Association (ADEA). https://mp.weixin.qq.com/s/hxqV1-UzIE8o4GLc69waag. Last retrieved: 2021-06-16.

[33] Ibid.

[34] Ibid.

Acknowledgement of Chinese ETS

The second crucial aspect determining Chinese reactions relates to China's domestic ETS. China started operating its national ETS in 2021. At its initial stage, the system is restricted to the power sector and operates as an intensity-based system with generous free allocation and limited compliance costs for covered facilities. Prices are expected to be far lower than those in the EU ETS. During the 14th Five Year Plan (2021-2025) period and beyond, the system is expected to expand to other sectors, such as iron and steel, cement, petrochemicals, chemical, building materials, non-ferrous metals, paper and domestic aviation. In addition, China has eight regional ETS pilots in operation, of which the earliest ones dated back to 2013.

While the European Commission has not decided if it wants to exempt countries from the CBAM, if they have comparable climate policies in place, there is consensus that the EU will consider other countries' carbon pricing policies.[35] China's reaction to the CBAM proposal will to some extent depend on whether the EU recognizes China's national and regional ETSs as sufficiently equivalent to the EU system. There is strong demand for China to be exempted as such because of its domestic carbon market.[36] This claim is all the more vehement as most of China's regional pilot ETSs already cover relevant industrial sectors. This applies to the ETSs of Bejing, Chongqing, Fujian, Guangdong, Hubei, Shanghai and Tianjin.[37] Politicians and stakeholders in China are expecting to negotiate with the EU on how the Chinese carbon price will be acknowledged in the framework of the EU CBAM – instead of being presented with a fait accompli.

Interestingly, within China, there are also widespread calls on China itself to act. The EU's announcement to introduce a CBAM has led many Chinese experts to call for a much more ambitious Chinese ETS in order for Chinese companies to avoid payments at the EU border. The EU can build on these internal dynamics to receive a positive outcome, both in terms of the EU's domestic carbon leakage risk and Chinese decarbonization efforts. Importantly, these Chinese narratives, which show a degree of willingness for give-and-take, might be a useful starting point for negotiations with China, in which both partners might be able to find a compromise.

Revenue use

A third important aspect concerns the use of the revenues generated through a CBAM. Statements and a leaked first CBAM regulation draft suggest that the EU plans to use the revenues for its own budget. This approach, however, is fiercely criticized in China. Using the CBAM revenue for the EU budget is perceived as introducing a new subsidy to enhance the competitiveness of EU industries, amounting to protectionism.[38]

Whether revenues will be used for international climate finance or for supporting countries directly affected by the CBAM - what matters to many Chinese counterparts is that the money will not

[35] A first CBAM regulation draft, leaked in beginning of June 2021 supports this assessment.

[36] Seminar – EU Carbon Border Adjustment Mechanism (CBAM). University of International Business and Economics (UIBE) American Environmental Defense Association (ADEA), https://mp.weixin.qq.com/s/hxqV1-UzIE8o4GLc69waag. Last retrieved: 2021-06-16.

[37] ICAP 2021: Emissions Trading Worldwide – Status Report 2021. https://icapcarbonaction.com/en/?option=com_attach&task=download&id=723. Last retrieved: 2021-06-16.

[38] Seminar – EU Carbon Border Adjustment Mechanism (CBAM). University of International Business and Economics (UIBE) American Environmental Defense Association (ADEA). https://mp.weixin.qq.com/s/hxqV1-UzIE8o4GLc69waag. Last retrieved: 2021-06-16.

contribute to the EU budget and that China and other trading partners will be involved in the decision-making process with respect to revenue use. If the EU does not take these concerns into account, it might harm its own global reputation as (a more or less) honest broker in the multilateral global climate effort.

4.2 Russia*

Russia is one of the major exporters of carbon-intensive goods to the EU (comprising, for example, 14.8% of overall EU iron and steel imports, 14.5% non-ferrous metals, 15.8% electricity, and 1.8% chemicals).[39] As a consequence, Russia would be particularly vulnerable to the EU CBAM, especially as the country has no carbon regulation at the national level and very modest greenhouse gas reduction goals.

The EU CBAM has become an important factor in the development of the climate agenda in Russia in 2020-2021. The EU's declarations on the introduction of this measure have provoked a wide discussion in Russia among both business and the government. Russian think tanks and consulting agencies estimate potential losses for Russian companies as a result of the CBAM could range from 4 to 50 billion dollars per year.[40] The think tank European Roundtable on Climate and Sustainable Transition, however, estimates possible losses of Russian exporters to the EU would be much lower, with a range from 80 million to 1.2 billion euro per year depending on the sectoral coverage and other specific CBAM design elements.[41]

Some representatives of the Russian business and political elite (including the President's advisor on climate, Ruslan Edelgeriyev, and the President's Special Envoy for Relations with International Organizations, Anatoliy Chubais) **insist the best option for Russia to respond to the CBAM would be to introduce a domestic carbon pricing scheme.** They argue this move would not only make payments to the EU unnecessary, but also all carbon revenues would stay in the country. Such representatives receive support from those experts who believe carbon regulation is necessary in order to diversify the economy, decrease dependence on fossil fuels and mitigate the risks associated with the decrease in global fossil fuel demand as a result of the green transition.[42]

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* Igor A. Makarov (PhD), Associate Professor at Higher School of Economics University, Moscow, has contributed this chapter. Responsibility with the content of this chapter lies exclusively with the author. Views expressed in the chapter are not necessarily views of Germanwatch.

[39] European Commission 2021: European Union, Trade in goods with Russia. https://webgate.ec.europa.eu/isdb_results/factsheets/country/details_russia_en.pdf. Last retrieved: 2021-06-16.

[40] BCG 2020: Uglerodniy vyzov rossiyskim eksporteram [in Russian]. https://www.bcg.com/ru-ru/press/29july2020-carbon-challenge-to-russian-exporters; KPMG otsenila uscherb dlya Rossii ot vvedeniya uglerodnykh tamozhennykh poshlin [in Russian], RBK (July 2020). https://www.rbc.ru/business/07/07/2020/5f0339a39a79470b2fdb51be; Shirov 2021: Stsenarii escshye ostayutsya nedostatochno prozrachnymi [in Russian], Kommersant (January 2021). https://www.kommersant.ru/doc/4653101. Last retrieved: 2021-06-16.

[41] Marcu/Mehling/Cosbey 2020: Border Carbon Adjustments in the EU. Issues and Options. ERCST Roundtable on Climate Change and Sustainable Transition. https://secureservercdn.net/160.153.137.163/z7r.689.myftpupload.com/wp-content/uploads/2020/09/20200929-CBAM-Issues-and-Options-Paper-F-2.pdf. Last retrieved: 2021-06-16.

[42] For instance Bashmakov 2020: Russian low carbon development strategy. Voprosy Ekonomiki, Vol. 7., pp. 51-74. [in Russian]; Makarov et al. 2021: Turning to Nature: Russia's New Environmental Policy in "Green" Transformation of the Global Economy and Politics. https://eng.globalaffairs.ru/wp-content/uploads/2021/04/report_turning-to-nature.pdf. Last retrieved: 2021-06-16.

The Russian Union of Industrialists and Entrepreneurs (RUIE) – a lobby group promoting the interests of large and often energy-intensive businesses – and other actors argue the CBAM is a protectionist measure and contradicts the spirit of both the Paris Agreement (asserting Russia should face no additional burden as it fulfills its NDC) and the WTO (which promotes the principles of free trade). Consequently, RUIE believes Russia should appeal against the mechanism's implementation through the WTO dispute settlement mechanism. The Russian government generally supports this argument. Indeed, Russia has already started consultations with other WTO members on the issue,[43] but more actions would depend on the CBAM's design.

RUIE and various experts[44] further believe that domestic carbon pricing would lead to even greater losses for the national economy. Large companies would rather pay money to the EU for the carbon footprint of their exports than to pay the carbon price for all their production within the country. Moreover, companies worry that, given the current state of relations between the EU and Russia, the EU will not recognize current or future Russian GHG regulation measures. As a result, Russian companies would pay twice: once in Russia and again at the EU border. Due to the strong influence of RUIE on political decision-making, its position is largely shared by most of the implicated state agencies, including the Ministry of Economic Development.

As a consequence and depending on the EU's ultimate strategy, **the EU CBAM may not lead to more stringent climate policies in Russia but rather to reactive trade measures and, consequently, a trade war between Russia and the EU. In order to mitigate this risk, the EU should:**

1. Engage, in the short-term, in more talks with the Russian government, thereby better explaining the goals of the CBAM and making Russia a partner on this mechanism rather than the victim Russia considers itself now.
2. Develop, as soon as possible, a scheme under which payments collected from the CBAM are directed to low-carbon projects in Russia chosen jointly with the Russian government.
3. The EU should create the opportunity for European companies covered by the EU ETS to – in the mid-term – finance projects in Russia as a part of their reduction commitments.
4. The EU should propose to Russia that a future Russian carbon pricing system could be build-up with EU support, with the perspective of later linking it with the EU ETS.

Steps 3 and 4 are economically efficient: Russia has plenty of opportunities for GHG emissions reductions that are cheaper than those in the European Union. Russia is also the starting point of many value chains that finish in the EU, and emissions reductions in Russia would help to reduce the carbon footprint of complex European products.

[43] WTO 2020: Goods Council considers EU plans for carbon taxes on certain imports. https://www.wto.org/english/news_e/news20_e/good_11jun20_e.htm. Last retrieved: 2021-06-16.

[44] Porfiriev/Shirov/Kolpakov 2020: Strategiya nizkouglerodnogo razvitiya: perspektivy dlya ekonomiki Rossii [in Russian], Mirovaya ekonomika i mezhdunarodnye otnosheniya, Vol. 64 (9).

4.3 Ukraine*

The EU CBAM has already had a tangible effect on Ukrainian climate policy. The announced introduction of an EU CBAM has brought observable changes into the Ukrainian climate policy debate. Before 2020, climate policy was the exclusive domain of the Ministry of Environment (MENR). Ukraine's climate targets never included emissions reductions, as they were based on the reference year of 1990, before the collapse of the Soviet Union. Thus, the debate around climate targets did not attract particular attention from economic players. In response to the EU CBAM, other government actors (notably the Ministry of Economy) and Ukrainian industry have become active players in climate policy discussions. The readiness to contribute to the European Green Deal (EGD) and work on a more ambitious climate target has now been declared by the President and the Prime Minister. In December 2020, the President of Ukraine announced that "Ukraine's long-term goal is to achieve carbon neutrality" and that the country considered setting a 2030 GHG reduction target of 58-64% compared to 1990 emission levels, an increase from the previous -40% target (in pre-Covid 2018 emissions stand at 36%).[45] Many Ukrainian stakeholders connect these developments with the announced EU CBAM and often refer to the CBAM as "the most important part of the EGD" for Ukraine.

However, the positive development in climate narratives has not yet materialized into sufficient political support for a new and more ambitious NDC. In April 2021, MENR proposed a new NDC that includes a slight reduction in overall GHG emissions, compared to 2021 levels. Business associations attacked the proposal for lacking economic justification and funding sources[46], and the Ministry of Economy also does not support the proposal. Should the EU move forward with a CBAM that affects Ukrainian exporters and business actors in Ukraine see ambitious climate policy as providing access to European markets, the MENR proposal will experience greater support than without the pressure from the EU CBAM.

The EU CBAM is perceived as a protectionist instrument by many stakeholders in Ukraine. Most Ukrainian business, non-governmental and governmental actors alike perceive the EU CBAM as European protectionism. This perception is strengthened by the EU's apparent decision to keep CBAM revenues for its own budget instead of earmarking them for climate action in third countries. Nevertheless, there is also an understanding of why the EU might need "protection". Many Ukrainian stakeholders note that EU industry is in a precarious position in light of the EU's increased climate policy goals and the heightened risk of carbon leakage.

Export-oriented, carbon-intensive industry was the first to react to the upcoming EU CBAM and remains the most active organizer and participant of the critical domestic discussion on the issue. Ukrainian steelmakers fear losing competitiveness in the European market due to the high carbon intensity of their products and their already high operational costs.

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[45] The Presidential Office of Ukraine 2020: Ukraine will intensify its participation in the global fight against climate change – President at the International Climate Ambition Summit. https://www.president.gov.ua/en/news/ukrayina-posilit-svoyu-uchast-u-globalnij-borotbi-zi-zminoyu-65569. Last retrieved: 2021-06-16.

[46] Ukraine Business and Trade Association (UBTA) letter to the Prime Minister Shmygal on the draft second NDC dated 9. April 2021. https://ubta.com.ua/files/090421_Zvernennia_UBTA_ta_TsEV_do_PM.pdf. Last retrieved: 2021-06-16.

As the EU market receives over one-quarter[47] of all steel produced in Ukraine, the loss of this market poses a substantial threat for the government. It could lead to facilities' closure, resulting in reduced budget transfers and job losses. The prospect of unemployment is an especially sensitive issue as most facilities are located in the eastern part of Ukraine, which suffers from armed conflict in the Donbass region and the downturn of state coal mining. At the same time, however, some non-governmental actors express cautious optimism about the EU CBAM, as they hope the mechanism could provide much anticipated stimulus to launch industry's decarbonization process.

The Ukrainian government hopes to be exempted based on its Association Agreement with the EU. The current governmental strategy[48] is to persuade the EU to exempt Ukrainian products from the CBAM or give them "special treatment" based on the country's climate obligations under the EU-Ukraine Association Agreement (that includes the introduction of an ETS in 2025), which over time creates a regulatory environment for carbon emissions similar to that of the EU. The EU and Ukraine are already engaged in an intense bilateral governmental dialogue on Ukraine's engagement in the EGD, including on the application of the EU CBAM. This dialogue needs to be further advanced with a focus on support and solutions that would kick-off industry modernization in Ukraine.

Stakeholders demand that CBAM revenues should support decarbonisation in Ukraine. The business sector expects the Ukrainian government to engage with the European Commission on possible exemptions, or, as a second-best option, on softer conditions (lower payment rate), a phase-in period, and revenue returns.

Many stakeholders, both from the business and non-governmental sectors, mention a revenue return as a good idea, satisfying (at least partially) the objectives of both sides. Doing so could mitigate the adverse economic and social effects of the EU CBAM and provide much-needed resources for launching decarbonization processes in Ukraine's industrial sector. A revenue return could also make a significant difference for the extraordinarily high capital costs for investments in Ukraine. As such, access to affordable investment funding for modernization is a key issue for and demand of Ukraine's industry companies. Returning a large part of the CBAM's revenues back to exporting countries could not only provide important seed investment funding for the industry transition but also help increase the general acceptance of CBAM as a climate policy tool in Ukraine. Ukrainian stakeholders from the non-governmental and business sectors see two possible options for such returns: providing them through low-rate loan facilities for business (managed, for example, by the IFIs), or through dedicated international or national climate fund(s) for decarbonization projects in the public and private sector. Non-governmental actors believe the return of revenues should be strictly earmarked for climate purposes, with clearly defined eligibility criteria and a robust monitoring system.

5 Recommendations

So far, we have argued that the EU CBAM is a critical factor for achieving climate neutrality in the EU, given the current lack of other readily available alternative carbon-leakage prevention tools. We have outlined that the mechanism currently faces strong opposition from EU trading partners, which may

[47] GMK Center 2021: The impact of the EU CBAM on Ukrainian steel sector. Presentation from 9. April 2021.

[48] The government does not have its strategy towards the EU CBAM officially published, however, there are op-eds from governmental officials where the strategy is discussed, e.g. an op-ed from Petrashko, deputy Minister of Economy of Ukraine 2021: https://www.eurointegration.com.ua/experts/2021/01/20/7118731/ [in Ukrainian]. Last retrieved: 2021-06-16.

become a risk for transformative climate cooperation or even the CBAM's implementation. At the same time, if well-crafted and accompanied by additional measures, an EU CBAM can also become a starting point for advanced levels of international climate cooperation and governance. Against this backdrop, the EU should adapt its approach as quickly as possible. Three aspects should be reconsidered: bilateral diplomacy and engagement with trade partners; the use of CBAM revenues; and specific CBAM design elements.

5.1 Consultation and cooperation with trade partner countries

One of the main criticisms from exporting countries is the EU's limited engagement with them on the CBAM. Moreover, stakeholders and decision-makers from many countries are highly skeptical about the EU's motivation for pursuing the mechanism: Is it primarily to protect EU businesses from increasing competition by ever stronger foreign competitors? To generate revenue for the EU budget? To create export markets for EU green industry products via imposing climate efforts on non-EU countries? Or indeed purely to enable greater climate ambition within the EU? Against this backdrop, comprehensive early-on engagement and **proactive, clear and open communication** are vital to eventually reach some form of acceptance and cooperation readiness on the side of key exporting countries.

The EU should make a major diplomatic effort in consulting with the affected parties. It might be beneficial to involve not only governments, but also private sector stakeholders as well as non-governmental experts from academia, research institutes and NGOs in trading partner countries. The EU should focus communication and coordination efforts both on powerful veto players such as China or Russia and on vulnerable, highly-affected countries such as Ukraine, Bosnia-Herzegovina and Serbia. While only larger countries may be willing to pressure the EU into abandoning its CBAM plans, it is crucial to also listen to vulnerable countries whose critical export sectors might suffer most from a CBAM due to their limited ability or political willingness to swiftly diversify and/or transform their industries.

The EU and its member states should use all available resources to **reinforce climate diplomacy around the CBAM**. Larger member states such as France and Germany should especially better engage their embassies to enter into close dialogue with affected countries. The EU should coordinate these bilateral efforts, for instance through its own delegations, and support member states by providing communications tools on the CBAM. However, the EU itself should also step-up bilateral talks and communication efforts with stakeholders and political decision-makers in concerned countries. Both the EU and member states could further support civil society organizations and think tanks in their respective outreach activities.

In the framework of such an enhanced diplomatic effort, the EU must pay much more attention to its **framing and narratives of the CBAM**. So far, very different CBAM motives have been expressed and policy-makers in the Commission, European Parliament and Council have done little to shed light on the details of the planned instrument in order to mitigate the confusion around its motives and appease the concerns of potentially affected countries.

For example, many trade partner countries take issue with the framing that the mechanism aims to trigger faster decarbonization in other countries. This motive is widely regarded as an overreach and disrespect of countries' sovereignty and as incompatible with the nationally determined contribution approach of the Paris Agreement. Instead of presenting the CBAM as an instrument to

nudge trading partners, the EU should focus its narrative on the domestic objective of enabling higher climate ambition within the EU. In the communication accompanying its upcoming proposal, the Commission should make clear that its motivation for introducing a CBAM is strictly one of preventing carbon leakage as the precondition for an EU industry transition and climate neutrality. As it is critical to center the narrative around a purely environmental goal, the Commission should also emphasize that the instrument's objective is not to raise revenue.

Finally, the EU or its member states should **offer bilateral Paris partnerships** to low- and middle-income countries which will be particularly affected by the CBAM.[49] These climate partnerships would target the Paris-compatible transformation of the economy in these countries, in this case in particular the green transformation of heavy industries and the power sector. Paris partnerships with bigger countries should be developed at EU level. Member states should offer additional climate partnerships to medium-sized countries. The EU could assume the role of coordinating the member states' bilateral cooperation efforts and should encourage climate partnerships by member states.

The EU and especially its bigger members states should also offer talks on a **selective green industry/power sector transition cooperation** to affected trade partners with which establishing a full-fledged climate partnership is not a realistic near-term option. Russia would be such a case. The EU should especially offer affected trading partners targeted support for establishing or advancing existing carbon pricing regimes for industry and electricity production.

Furthermore, the EU and member states should offer capacity building and increased technical support for affected low- and middle-income countries, such as in the framework of climate partnerships. In addition, the EU could consider setting up an international body similar to the International Carbon Action Partnership (ICAP), which would provide countries with technical advice on the industry transition.[50]

5.2 Use of CBAM revenues

The European Commission estimates annual CBAM revenues at 5 to 14 billion euro.[51] It is essential for the CBAM's success that revenues will not remain within the EU – whether as a contribution to the EU's overall budget or to a fund that finances the industry transition. This finding contrasts with an opinion by the European Parliament, statements from different high-level representatives of the European Commission and July 2020 conclusions of the European Council. The EP in its non-binding Own Initiative Report[52] of 15 February 2021 called for revenues to be used as new resources for the EU budget – in addition to using part of the revenues to support the EU's contribution to international climate finance for so-called Least Developed Countries (LDCs).

The question of revenue recycling is significant for two reasons. First, experts agree the EU will likely need to employ Art. XX of the GATT for the CBAM to be WTO-compatible, and revenue use could be an important argument for successfully doing so.[53] Using revenues for the general EU budget will

[49] See also https://germanwatch.org/sites/default/files/Studie_Paris-Partnerschaften.pdf. Last retrieved: 2021-06-16.

[50] See https://icapcarbonaction.com/en/. Last retrieved: 2021-06-16.

[51] European Commission 2020: Communication from the Commission on "The EU budget powering the recovery plan for Europe", COM (2020) 442, Brussels. https://eur-lex.europa.eu/resource.html?uri=cellar:4524c01c-a0e6-11ea-9d2d-01aa75ed71a1.0003.02/DOC_1&format=PD. Last retrieved: 2021-06-16.

[52] European Parliament 2021: Report – Towards a WTO-compatible EU carbon border adjustment mechanism. https://www.europarl.europa.eu/doceo/document/A-9-2021-0019_EN.html. Last retrieved: 2021-06-16.

[53] Cosbey et al. 2021: CBAM for the EU: A Policy Proposal. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3838167. Last retrieved: 2021-06-16.

likely diminish the EU's chances to win a WTO dispute. Therefore, in order to ensure WTO conformity, a significant share of the revenues should be spent internationally as climate finance or made available to low- and middle-income countries.

Second, a clear EU decision to use the revenues for supporting the green transition of other economies would go a long way in fostering international acceptance. Many stakeholders in countries such as Ukraine and India refer to revenue recycling as a decisive factor for possible acceptance of the CBAM. This option would open the door to affected countries by demonstrating that the EU is purely motivated by preventing carbon leakage and that it is willing to support countries on their path to climate neutrality, thereby alleviating the CBAM burden in these countries.

The EU would be well-advised to recycle the CBAM revenue in the following ways. **The largest part should be used to support the low-carbon transition in CBAM-affected low- and middle-income countries. Another part of the CBAM revenues should be earmarked for general, clearly additional climate finance, i.e., for supporting mitigation and adaptation and for addressing loss & damage in vulnerable low-income but not necessarily CBAM-affected countries.** This portion could come from CBAM revenues the EU receives from high-income countries, such as Australia or Japan.

In close coordination with its international partners, the EU should evaluate the option of **setting up an investment fund** from which CBAM-affected low- and middle-income countries can draw to support the transition of their economies. The fund would foster access to low-interest loans and other means of finance such as grants and R&D support, thereby attracting investments into the modernization of industry and electricity production. The fund could focus on long-term investments that are otherwise often difficult to realize in low-and middle-income countries.[54] Countries should have a degree of autonomy over how to use the money from the fund in order to avoid the impression that the EU wants to exert unjustified influence beyond its borders. The fund could be managed by an international finance institution that enjoys a high level of trust amongst all affected.

All involved parties should be aware that the faster the transformation in exporting countries, the earlier the EU can do without a border carbon adjustment. By supporting the green transition in affected countries, the EU would both help put these countries in a position to decrease their exposure to a CBAM over time and help accelerate international mitigation efforts.

The EU must **ensure that the recycled CBAM revenues reserved for vulnerable low-income countries are completely additional and separable from existing international climate finance**. CBAM revenues should not be counted towards the EU's international obligation for climate finance. To guarantee that, the funding must fulfill the highest transparency standards and be administered in a way that allows for a clear distinction.

Using CBAM revenues as described above is a major prerequisite to maintain a high level of trust and a spirit of cooperation with trade partners. In the absence of such external revenue recycling the EU may significantly harm its position as an honest broker and cooperative partner when it comes to the global climate effort. External revenue use is a key element, if the EU wants to indirectly advance international climate ambition with its CBAM.

[54] Prof. Ottmar Edenhofers has proposed a similar investment fund design in April 2020: https://www.pik-potsdam.de/de/aktuelles/nachrichten/g20-und-klima-edenhofer-spricht-auf-dem-global-solutions-summit. Last retrieved: 2021-06-16.

5.3 Other CBAM design elements

In addition to closer consultation and meaningful recycling of revenues, various further design elements may also be decisive for acceptance or rejection by trading partners. A relatively straightforward approach would be to **exempt so called Least Developed Countries and low-income Small Island Developing States**, as advocated by the European Parliament.[55] In terms of carbon leakage prevention effectiveness, the EU would face few constraints through such an approach while benefitting from the increased perception of fairness of the instrument. As many trading partners are calling for the respect of the UNFCCC principle of common but differentiated responsibilities, exempting these countries represents a low-hanging fruit for fostering acceptance.

A second element is to **limit the CBAM scope to imports**. Not only does this strongly increase the likelihood of WTO compatibility,[56] it would also go a long way in refuting the perception that the CBAM is mostly meant to boost EU industry on global markets. However, only addressing imports leaves EU exporters exposed to competition from countries that do not similarly price emissions The affected firms would thus need a different form of carbon leakage protection.

A third element is the **gradual phase-out of free allocation of allowances**. While the European Parliament has narrowly voted to introduce a CBAM while maintaining the system of free allowances,[57] this approach should be considered very carefully. As the CBAM may not be fully functional at first, there should be a transitional period during which CBAM is being phased in while free allocation is gradually – though as quickly as possible – phased out. It is paramount that free allocation and the CBAM do not exist in parallel for a long period of time and that free allocation be reduced substantially by 2025 and phased out completely by the end of the 2020s.

An altogether different approach that would have a similar effect in terms of acceptability by trading partners and may, under certain circumstances, prove to be feasible is the EU **offering countries the choice of either accepting an EU CBAM or imposing an export tariff** on certain carbon-intensive goods. Under this approach, the EU could establish mutual agreements under which trading partners agree to impose an export tariff at a fair level but sufficient to effectively reduce carbon leakage.[58] For EU firms this would create the same level playing field as would a WTO-conform CBAM (see chapter 3). However, trading partners would have discretionary power over the use of funds, which may help to prevent confrontation.

Implementing a **pilot phase of 3 to 5 years** during which the CBAM would only apply to a limited number of sectors could also alleviate several of the aforementioned issues. By doing so, the EU could buy time (1) for the required diplomatic effort of reaching out to affected countries, (2) for building up the system of revenue recycling in non-EU countries (for instance through an international fund), (3) for negotiating and implementing climate partnerships with lower- and middle-income non-EU countries and (4) for possibly inviting countries to join the EU's CBAM regime.

Lastly, the EU should **offer the option of joining the CBAM** regime. By doing so, the EU would aim to establish a so called Climate or Carbon Club.

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[55] European Parliament 2021: Report – Towards a WTO-compatible EU carbon border adjustment mechanism. https://www.europarl.europa.eu/doceo/document/A-9-2021-0019_EN.html. Last retrieved: 2021-06-16.

[56] Jakob (2021): Why carbon leakage matters and what can be done against it. https://www.sciencedirect.com/science/article/pii/S2590332221002293. Last retrieved: 2021-06-16.

[57] European Parliament 2021: Report – Towards a WTO-compatible EU carbon border adjustment mechanism. https://www.europarl.europa.eu/doceo/document/A-9-2021-0019_EN.html. Last retrieved: 2021-06-16.

[58] Jakob/Steckel/ Edenhofer 2014: Consumption-versus production-based emission policies. Annu. Rev. Resource Econ, Vol. 6, pp. 297–318. https://doi.org/10.1146/annurev-resource-100913-012342. Last retrieved: 2021-06-16.

Summary and conclusion

If the CBAM fails, the EU could face a serious problem. Its updated 2030 target of 55% greenhouse gas emissions reduction necessitates an ambitious reform of the EU's Emissions Trading System, one that needs to address the fact that industry emissions in the EU have not decreased in a decade. However, carbon-leakage prevention tools that could replace the CBAM are currently insufficiently developed, and free allocation of allowances in the EU's Emissions Trading System must be phased-out as swiftly as possible. Consequently, should the EU CBAM be significantly delayed or weakened, deciding on and implementing a sufficiently ambitious reform of the EU's Emissions Trading System would be a difficult task.

On the other hand, CBAM can potentially become a major tool to strengthen international cooperation through offering cooperation to affected trading partners for accelerating their industry transformation or inviting countries to join CBAM. By following a smart CBAM strategy, the EU as a geopolitically relevant player has the chance to significantly advancing the international climate governance system.

However, the observed positive impulse the EU's CBAM represents for climate ambition discussions in EU trading partners can only hold as long as the EU does not backtrack from its plan to implement a comprehensive and effective CBAM.

In addition, even if the CBAM were introduced, a problematic mechanism design and the EU's currently insufficient communication and engagement strategy with trade partners could worsen multilateral cooperation on climate change. If implemented poorly, the CBAM may significantly damage the EU's soft power in the UN climate negotiations.

Given these challenges and opportunities, the EU should take its trade partners' concerns into account for its own way forward. **Main points of critique, frequently voiced by trade partner countries, include:**

a) the **alleged protectionist nature** of the instrument whereby the EU is suspected to predominantly aim to boost the competitiveness of its industry, at the direct or indirect expense of competitors.
b) the announcements of the European Council and the European Parliament to **use CBAM revenues for the EU budget**. These plans have exacerbated the protectionism claim. Using CBAM revenues for domestic EU purposes, especially for the EU's green transition, is perceived as an unfair abuse of the EU's economic clout for gaining a competitive advantage at other economies' expense.
c) the **limited involvement and consultation of governments and stakeholders in affected countries**. This is a point which is, at the moment, especially strongly made in China.
d) potential **violations of WTO rules**, in particular should the CBAM include exports rebates or if the free allocation of the EU Emissions Trading System (EU ETS) allowances continues despite a comprehensive implementation of the CBAM.
e) **not adhering to the UNFCCC's principle of common but differentiated responsibilities and respective capabilities.**
f) **violation of countries' sovereignty.**

The study finds that the EU should not only take trade partner narratives into account for deciding upon a smart CBAM directive but should also urgently accompany its CBAM with a comprehensive

set of outreach and international cooperation tools. **Against this backdrop, we recommend the EU should:**

- engage trade partners – both vulnerable low- and middle-income countries and powerful veto players – in **close consultations** on equal footing in order to achieve a higher level of acceptance and cooperation readiness. In the framework of this engagement, the EU should inter alia:
    - clarify its motives for introducing a CBAM, **focusing strictly on the anti-leakage objective** without confounding it with other motives such as incentivizing climate efforts in non-EU countries or raising revenue.
    - offer especially affected low- and middle-income countries **comprehensive Paris climate partnerships** that include, inter alia, extensive cooperation for a green industry transition. Paris partnerships with bigger countries should be offered by the EU itself. Member states should offer additional climate partnerships to medium-sized countries. At the same time, the EU should encourage and coordinate climate partnership offers by its member states.
    - offer talks on **selective green industry/power sector transition cooperation** to affected trade partners with which establishing a climate partnership is not a realistic near-term option.
    - **support affected trade partners on establishing/advancing carbon pricing** regimes for industry and electricity production.
    - offer the **option of joining the EU's CBAM regime**.
- make sure CBAM **revenues will predominantly be transferred to CBAM-affected countries** while supporting the climate neutrality transition of the industry and power sectors in these countries. A smaller share of CBAM revenues could **additionally** be made available **for mitigation, adaptation and loss & damage purposes in low-income countries** not necessarily affected by the CBAM. However, the use of these funds must not replace but rather supplement the EU's and the EU member states' other international climate finance contributions and be verified as such..
- gradually **phase out the free allocation of allowances** as soon as the CBAM takes effect.
- **exempt so-called LDCs and low-income SIDS**.[59]
- **only apply the CBAM to imports**, i.e., not granting export rebates.

Lastly, implementing a **pilot phase of 3 to 5 years** during which the CBAM would only apply to a limited number of sectors could also alleviate several of the aforementioned issues. By doing so, the EU could win time (1) for the required diplomatic effort of reaching out to affected countries, (2) for building up the system of revenue recycling in non-EU countries (for instance through an international fund), (3) for negotiating and implementing climate partnerships with lower- and middle-income non-EU countries and (4) for possibly inviting countries to join the EU's CBAM regime.

The EU CBAM has the potential to become an important tool to enable higher climate ambition, enhance international cooperation and advance the international climate governance system. It is now up to the EU to use the current window of opportunity to exploit this potential and prove its role as a key and cooperative player in the global fight against climate change.

[59] So called Least Developed Countries and Small Island Developing States

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