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European Union’s Carbon Border Tax Mechanism

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Why in News: European Parliament lawmakers reached a political deal on the carbon border tax in December last year, but India, along with China, Brazil, and South Africa opposed the plan at the 27th edition of the Conference of Parties (COP27) climate summit in Sharm El Sheikh, saying it could lead to market distortion and impact developing countries which have not originally contributed to industrial emissions.

Background

The 27-member European Union (EU) has been ramping up its climate action efforts with the European Parliament, the bloc’s legislative body, adopting a rapid pace in climate negotiations.

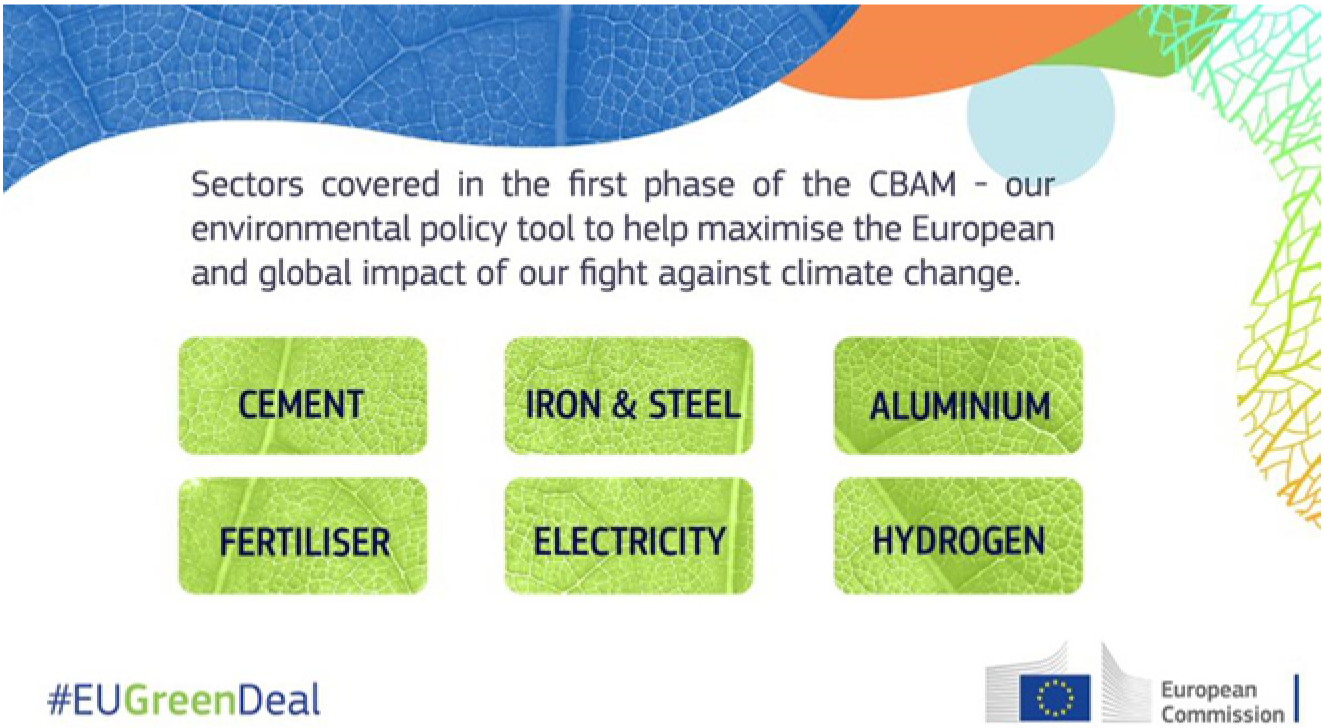
Recently, it voted to approve a sweeping deal to reform the EU’s carbon market to cut emissions by 62% from 2005 levels by 2030.

The carbon market mechanism has helped slashed power plant and factory emissions by 43% since 2005. The new reform, however, will phase out free CO_2 permits to factories by 2034.

Along with this phasing out of free carbon allowances, the EU will phase in another ambitious and first-of-its-kind policy— the Carbon Border Adjustment Mechanism (CBAM), aimed at levelling the playing field for EU and non-EU manufacturers and spurring trading partners to adopt carbon pricing regimes as a critical approach to the climate fight.

While the EU believes the mechanism is a global solution to the global problem of climate change, trading partners such the United States, China, Russia and developing countries including India, have opposed the measure, describing it as unilateral, “protectionist” and even a trade weapon.

About Carbon Border Adjustment Mechanism (CBAM)



In order to prevent this and reach other climate change mitigation goals, the EU in 2021, came up with a proposal for a Carbon Border Adjustment Mechanism (CBAM).

The CBAM plans to impose a tariff on a set of carbon-intensive imports, which will have to be paid by EU importers and companies who export such goods to EU countries.

With the CBAM, the EU also wants to create a level-playing field for business in the bloc with those outside by making equal the price for the carbon content of goods regardless of where they are made.

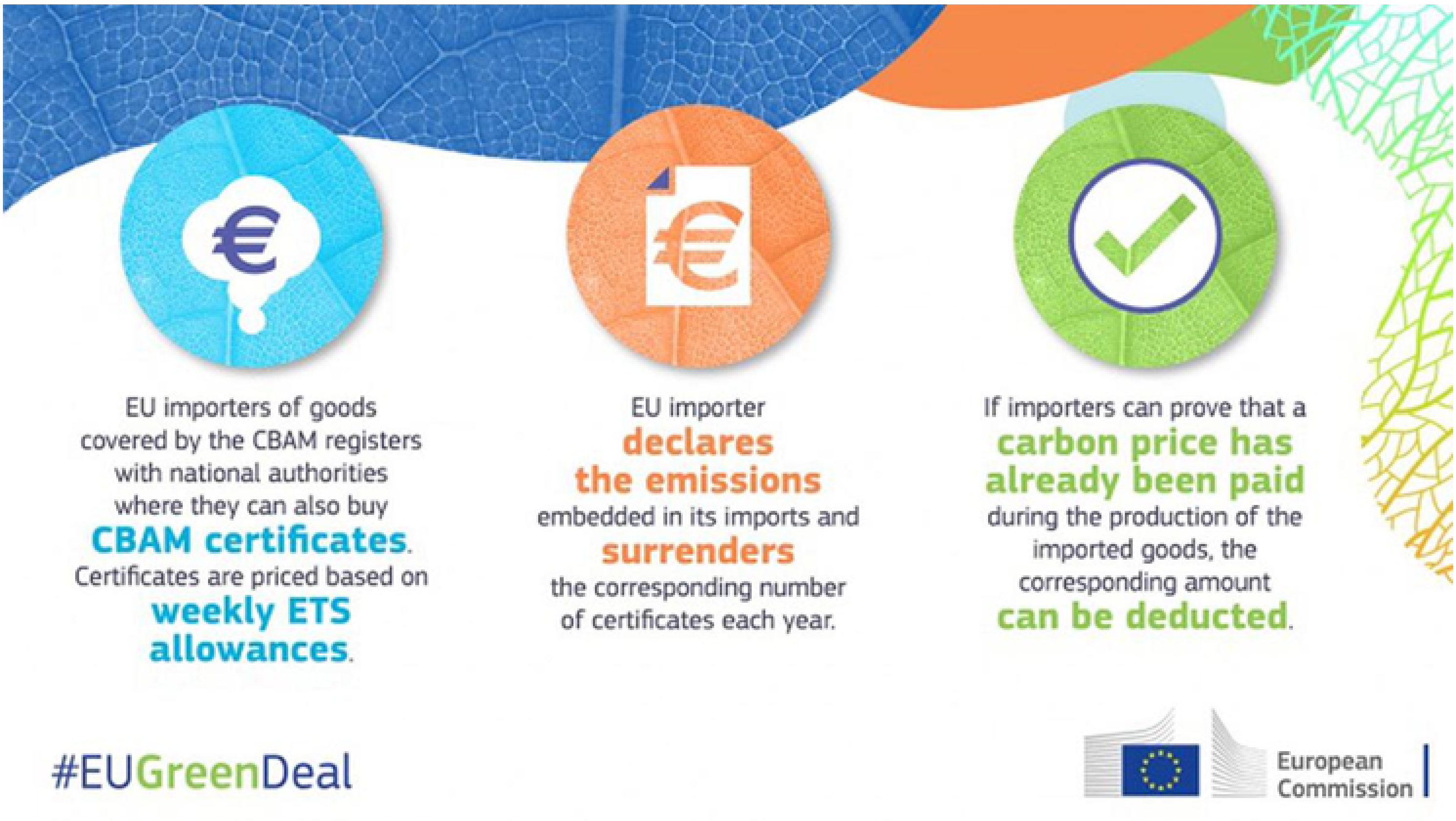
Under the EU's carbon market mechanism called the Emissions Trading System, industries have to buy carbon certificates to emit carbon during manufacturing.

There is a cap on the amount of emissions, after which they would have to buy more certificates, either from the issuing authorities or industries with surplus certificates (meaning they emitted less than the cap).

The EU argues that with the CBAM, domestic businesses, who currently risk being disadvantaged by cheaper, carbon-tax free imported products, would be put on a fairer footing.

Presently, EU businesses get their initial carbon allowances or certificates for free. The bloc, thus, wants to phase in the CBAM with the phasing out of free carbon allowances to domestic business, so that it doesn't get in a tangle with the World Trade Organisation's rules.

How will the CBAM work?



The CBAM initially plans to impose a carbon border tax on the most carbon-intensive imports—iron and steel, cement, fertilisers, aluminium and electricity.

The CBAM will start phasing in from October 2023, if all approvals go through, first requiring importers in the EU to collect data about the number of metric tons of carbon dioxide released during the manufacture of the goods they import.

After that, importers will need to buy a new type of pollution certificate to reflect that discharge at prices aligned with the bloc's Emissions Trading System.

The fee could be partially waived if a carbon tax has already been paid in the country where the goods were the goods were originally manufactured.

About the problem of carbon leakage

The fact that most high-income countries have become net importers of carbon dioxide while a large proportion of developing economies are net exporters indicates that leakage is a serious problem, notes Brookings Institute.

According to World Bank data, less than 4% of global emissions are currently under carbon pricing regimes as envisioned by the Paris Agreement.

Environmentalists also contend most levies aren't high enough to effect an actual change in polluter behaviour.

After emissions prices have increased in the EU, the risk of carbon leakage has become a matter of intense debate. The issue will become more challenging as free carbon permits from governments are phased out.

Impact of CBAM on developing nations

India has invoked climate justice on the global fora and contends that it places a carbon charge on companies from countries that did not primarily or historically cause climate change.

According to the Global Trade Research Initiative, the tax will translate into a 20-35% tariff on India's exports of steel, aluminium and cement, which now attract an MFN duty of less than 3%.

As much as 27% of India's exports of steel, iron and aluminium products, or $8.2 billion, head to the EU.

Other countries will suffer heavy losses too. Mozambique's GDP, for example, would drop by about 1.5% due to the tariffs on aluminium exports alone, according to the Center for Global Development.

This has led to calls for funds from the sale of CBAM certificates to be diverted in part to support climate action efforts in less developed countries. The final agreement for the proposal did not, however, include this.