

The Carbon Border Adjustment Mechanism: Collaboration or Confrontation? ¹

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Key developments

1. EC announces plans to establish a carbon border adjustment mechanism

On July 14, 2021, the European Commission (EC), the executive arm of the European Union (EU), published a proposal² for a regulation to establish the world's first carbon border adjustment mechanism (CBAM). CBAM is a mechanism under which countries that bear the carbon costs for taking strict climate measures to impose taxes, surcharges, and emission permits purchase duties on imported goods from countries that do not take such measures, thereby adjusting the differences in such costs. The purpose of this paper is to offer a summary of the EC's CBAM regulation proposal brief and its implications for Japan.

The EC's proposed CBAM designates products of iron and steel, cement, aluminum, fertilizers, and imported electricity as target products. The revenue generated by the CBAM is estimated to amount to 2.1 billion euros in 2030 and will source the NextGenerationEU, a more than 800 billion euro temporary recovery fund for repairing the economic damage caused by COVID-19. According to IEEJ estimates based on Combined Nomenclature ('CN') goods codes using Eurostat, imports from Russia, Ukraine, Turkey, and China are expected to be subject to CBAM.

¹ The report was updated based on the IEEJ reporting material dated July 27, 2021.

² European Commission(2021) "Proposal for a regulation of the European parliament and of the council establishing a carbon border adjustment mechanism" 2021/0214 (COD), Brussels, 14.7.2021..
<https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52021PC0564>

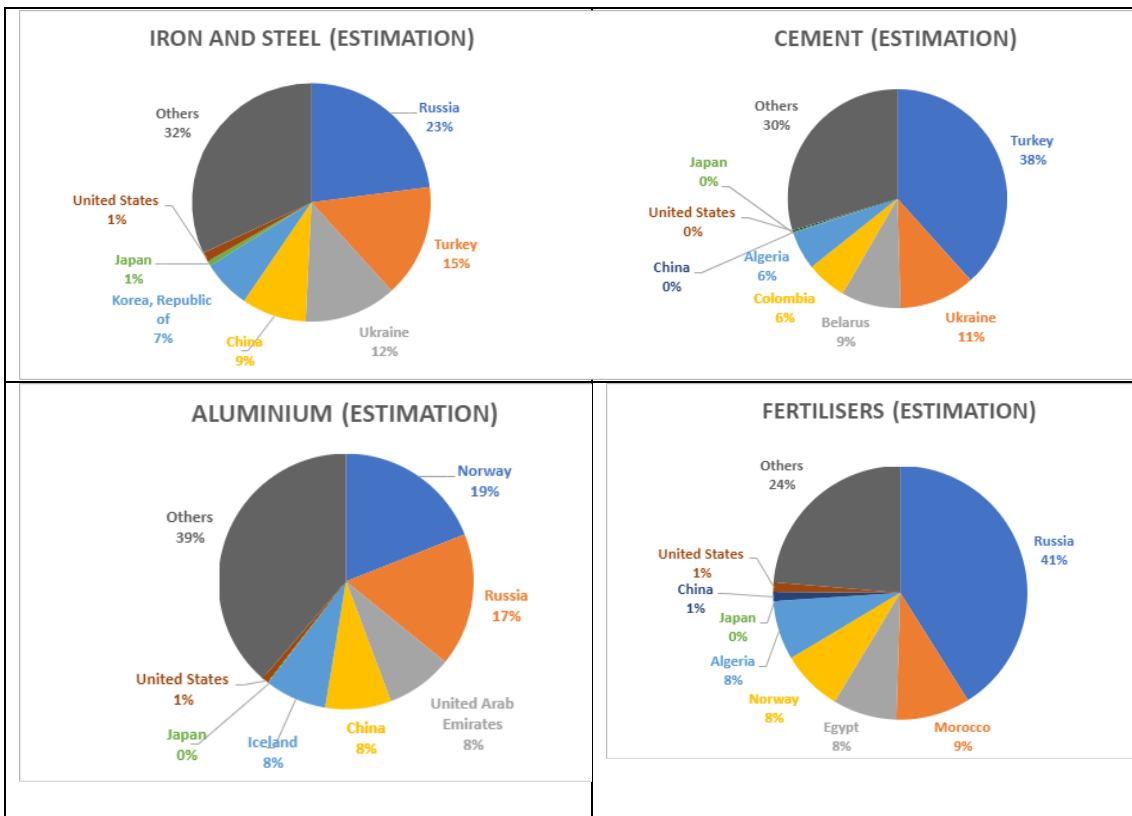


Figure: EU imports goods share estimation based on EC regulation proposal, in 2019

(Source) Based on Eurostat (“Extra-EU imports since 2010 by country of origin and country of consignment, by HS2-4-6 and CN8 (DS-059071)”), the author’s estimations

(Note) In the statistics, the U.K. is included in the EU. The graph covers the top five import partner countries, as well as Japan, the US and China.

2. A “transitional period” will start in 2023 through 2025

CBAM will impose obligations to report the embedded emissions of the imported product, which includes not only direct emissions from the manufacturing process but also indirect emissions from electricity and heat. The carbon price due in the country of origin should be reported as well. The reports must be submitted to authorities quarterly. The methodology for measuring emissions will be prescribed in an implementing act to be determined, and the EC will continue to engage in dialog with third countries on the detailed design of the system during the transitional period. The EC will submit an assessment report on the measurement of indirect emissions and other topics to the European Parliament and the European Council before the transitional period ends.

3. CBAM is scheduled for implementation in 2026

The obligation to pay the carbon price for imported products through CBAM certificates will begin in 2026, according to the EC proposal. A CBAM certificate is a certificate corresponding to one tonne of embedded emission in goods. Importers (termed “declarants” in the proposal) will thereafter be required to pay for the embedded carbon emissions of their products with CBAM certificates, whose prices will mirror the EU Emission Trading System (EU-ETS) price. Carbon emissions will initially be calculated for only direct emissions, such as those from fuels consumed in manufacturing plants. However, based on assessment results by the EC during the transitional period, the CBAM could eventually be expanded to include indirect emissions associated with purchased electricity, heat etc. Furthermore, the proposal states that the CBAM will allow carbon prices that have been paid in the country of origin to be deducted; however, this will basically apply only to explicit carbon taxes and explicit carbon prices used in emissions trading.

From 2026, CBAM will be rolled out in stages, in step with the phasing-out of free emission allowances, which have served as a carbon leakage countermeasure under the EU-ETS. In 2035, free allowances will be suspended completely, and CBAM will be fully implemented.

4. Next steps and implications for Japan ³

The European Parliament and the European Council will conduct deliberations based on the EC’s proposal. At present, prospects for final approval of the proposal and the actual design of the system, if approved, remain unclear. Japan’s exports of the target products to the EU are miniscule; and therefore, the impact on Japan will be limited even if the proposal is passed. However, Japanese companies may be affected if products from Russia, China, and other economies that are shut out of the EU flow into Asian markets. Attention must also be paid to the risk that CBAM may hamper free trade and exacerbate the North-South divide.

On the other hand, it is desirable, from a trade perspective, to standardize the methodology for measuring emissions for each product, and Japan should play an active role in developing such standards. It is also essential to confirm whether the proposal is consistent with WTO rules. This includes monitoring for any arbitrary or unjustifiable discrimination, including using the proceeds from auctioning free allowances to provide technological support such as CCS technologies to targeted sectors, in effect,

³ A METI study group has also made references to CBAM: METI, Japan, “Interim report of a study group on ideal economic and other approaches for achieving worldwide carbon neutrality” <https://www.meti.go.jp/press/2021/08/20210825002/20210825002-1.pdf>

compensating for the free allowances they would have earned, and thus subsidizing domestic products while imposing charges only on imported goods.

5. Developments in the United States

Under these circumstances, at the margin of the G20 Finance Ministers meeting in July 2021, Secretary of the Treasury Janet Yellen commented as follows, questioning the EC CBAM proposal, which focuses only on explicit carbon prices: “It is important that any carbon border adjustment system focus on the degree to which a country’s climate policies reduce emissions (and hence carbon content), rather than focus only on explicit carbon pricing.”⁴

However, the situation is not so simple. During the election campaign, President Biden made reference to applying a carbon adjustment fee at the border in conjunction with regulatory measures on domestic manufacturers (“Democratic Platform”⁵). Meyer & Tucker (2020) also point out the possibility of introducing carbon border adjustments on national security grounds based on Section 232 of the 1962 Trade Expansion Act⁶.

Meanwhile, there were moves by Congress Democrats in connection with carbon border adjustments that deserved attention. These include a proposal by Senator Coons and Representative Peters on a carbon border adjustment mechanism that includes implicit carbon prices that are linked with standards or regulations, to be applied to iron and steel, cement, aluminum (and products containing at least 50% of these materials), as well as oil, gas, coal, and other fossil fuels (July 2021⁷). In August, a “carbon polluter import fee” was included in the 3.5 trillion-dollar budget resolution introduced by Senator Coons and Representative Peters. Although the reconciliation legislation was expected to be based on their bill, the carbon border adjustment mechanism has been excluded from the “Build Back Better Framework”⁸ (October 2021).

⁴ “Remarks from Secretary of the Treasury Janet L. Yellen at the G20 Finance Ministers and Central Bank Governors Meeting’s High Level Symposium on International Tax”, U.S. Department of the Treasury, July 9, 2021

<https://home.treasury.gov/news/press-releases/jy0266>

⁵ The 2020 Democratic Party Platform said, “We will apply a carbon adjustment fee at the border to products from countries that fail to live up to their commitments under the Paris Climate Agreement, because we won’t let polluters undermine American competitiveness.”

⁶ Meyer & Tucker (2021) “Trump’s Trade Strategy Points the Way to a U.S. Carbon Tariff”, August 24, 2020.

<https://www.lawfareblog.com/trumps-trade-strategy-points-way-us-carbon-tariff>⁷ H.R. 4524, S. 2378,

⁷ H.R. 4524, S. 2378,

<https://www.congress.gov/117/bills/hr/4534/BILLS-117hr4534ih.pdf>

<https://www.congress.gov/117/bills/s/2378/BILLS-117s2378is.pdf>

⁸ The Whitehouse, “The Build Back Better Framework, President Biden’s plan to rebuild the middle class”

<https://www.whitehouse.gov/build-back-better/>

https://rules.house.gov/sites/democrats.rules.house.gov/files/Section-by-Section-117HR5376RH-RCP117-17_0.pdf

6. Conclusion and implications

A trial run of the carbon border adjustment mechanism is being pursued mainly in the EU as the world's first such effort. Future challenges include verification in terms of international trade law, including consistency with WTO rules.

- (1) The EC's CBAM proposal seeks dialog and international cooperation with non-EU countries during the 2023–2025 transitional period. It is strategically important for Japan to become actively engaged in dialog with Europe and to collaborate with relevant non-EU countries.
- (2) Furthermore, the development of methodology will be the world's first attempt to calculate all the emissions embodied in products. Establishing the methodology will be a technical challenge.
- (3) From 2026, when the mechanism is gradually implemented, it will be important to verify that the system is compatible with WTO/GATT rules, and thus does not discriminate between countries in and outside the EU. The most important discussion point is whether the obligations imposed are equivalent for both the EU companies that are subject to the EU-ETS and the non-EU companies that will be required to purchase CBAM certificates and to comply with reporting obligations. In addition, to avoid trade frictions, the international community is urged to actively engage and discuss CBAM in the meetings offered in various forums such as the EU, G20, etc.

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