

The European Union's Carbon Border Adjustment Mechanism and the Limitations of WTO Rules on Climate Action

Introduction

In 2005, the European Union implemented the EU Emissions Trading System (EU ETS) with the goal of creating a financial incentive for polluting industries to reduce greenhouse gas emissions in order to fight climate change. The EU ETS was the first emissions trading system of its kind and today remains the largest carbon market in the world. The EU ETS functions as a 'cap and trade' system, in which the EU sets a 'cap' on the amount of greenhouse gases that can be emitted domestically from certain sectors over a period of time. The EU then issues a fixed number of 'allowances' to companies, which correspond to the number of tons of carbon dioxide that a given company can emit for a calendar year. If companies emit more CO₂ than they are allowed, they must purchase extra allowances from companies that emitted less carbon and therefore have extra allowances (hence the 'trade' part of 'cap and trade'). The system not only limits emissions from European companies to a fixed goal, but also incentivizes them to transition to cleaner technologies in the future. This is achieved by lowering the overall emissions cap over time, reducing the number of allowances that are distributed and driving up the price of allowances on the market place.¹

One potential hazard of implementing an emissions trading system is carbon leakage, which occurs when businesses transfer their production to countries with more relaxed regulations in order to avoid the costs of complying with domestic climate policies.² This practice not only allows companies a means of circumventing policies aimed at reducing emissions, but the increased transportation involved in moving an industry abroad also further

¹ European Commission, *EU Emissions Trading System (EU ETS)*, Climate Action - European Commission (2016), https://ec.europa.eu/clima/policies/ets_en (last visited Sep 13, 2021).

² European Commission, *Carbon leakage*, Climate Action - European Commission (2016), https://ec.europa.eu/clima/policies/ets/allowances/leakage_en (last visited Sep 13, 2021).

increases carbon emissions. Alternatively, complying with emissions standards could drive up the price of goods produced in the EU, leading consumers to turn to ‘dirtier’ imported products with lower price tags.³ The EU ETS prevents carbon leakage from occurring by allocating a certain number of free emissions allowances to industries deemed most at risk of carbon leakage. As companies in these sectors are allowed to emit for free, they have no incentive to move their production outside of the EU. However, in order to meet the EU’s goal of producing no net greenhouse gas emissions by 2050, these industries cannot be allowed free emissions indefinitely and must be integrated into the EU ETS in a way that will not lead to excessive carbon leakage.

As of July 2021, the European Commission has adopted a proposal that establishes a carbon border adjustment mechanism (CBAM) within the EU as a part of the new European Green Deal. The CBAM is intended to function as both a solution to the problem of carbon leakage and as a means of incentivising other countries to make good on their Paris Agreement commitments to reduce emissions. According to the text of the proposal, the CBAM functions by putting a price on the carbon emissions of imported products that mirrors the price that it would have been paid had the products been produced within the EU. Alternatively, for goods produced in countries with their own carbon prices, the price already paid for the product’s emissions will not have to be paid again by the importer.⁴ Although the parameters of the CBAM have already been fully developed and are publicly available, the measure will not become operational until 2026 in order to give industries time to transition to the system. Initially, the mechanism will apply only to imports of goods from high-emitting sectors that are most at risk of carbon leakage.

³ European Commission, *Carbon Border Adjustment Mechanism*, Taxation and Customs Union , https://ec.europa.eu/taxation_customs/green-taxation-0/carbon-border-adjustment-mechanism_en (last visited Sep 13, 2021).

⁴ *ibid.*

This will include the import of cement, iron and steel, aluminum, fertilisers, and electricity.⁵ Eventually, the CBAM will likely be expanded into other sectors.

While the European Commission has stated that the CBAM has been designed in order to comply with World Trade Organization (WTO) rules, some countries have expressed concern that the mechanism is overly protectionist and unjustly discriminates against imports.⁶ A possible complaint that could be raised against the CBAM is that, in attaching an additional cost to products imported from countries without a carbon price, the policy could be violating the most favored-nation treatment rule, which states that any special advantage afforded to one WTO member's imports must also be applied to other member countries.⁷ Another possible point of contention within the CBAM is the allocation of free emissions allowances within the EU ETS. While the European Commission has stated that the number of free allowances will decline as the EU prepares to implement the CBAM, any remaining allowances will likely be seen as a violation of the national treatment rule. This states that imported products and domestically produced products must be treated equally.⁸

However, even if the CBAM is found to violate WTO trade rules, there are several exceptions allowed in the General Agreement on Tariffs and Trade (GATT) that could possibly apply to the mechanism, specifically within Article XX of the agreement. In this thesis, I plan to examine the text of the CBAM in light of several of these exceptions. I will focus on how the Article XX exceptions have been applied to cases involving environmental protection in the past

⁵ European Commission, *Carbon Border Adjustment Mechanism: Questions and Answers* (2021), https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661 (last visited Sep 13, 2021).

⁶ James Bacchus, *Legal Issues with the European Carbon Border Adjustment Mechanism*, Cato Institute (2021), <https://www.cato.org/briefing-paper/legal-issues-european-carbon-border-adjustment-mechanism> (last visited Sep 13, 2021).

⁷ *ibid.*

⁸ *ibid.*

to determine whether a convincing case could be made that they apply to the goals of the CBAM. Furthermore, I would like to explore the question of whether the fact that the CBAM may have to rely on exceptions to the GATT in order to be permitted by the WTO indicates that current trade agreements are too restrictive on climate related policies, and therefore hinder the ability of countries to address the current climate crisis and strive for climate justice through trade measures.

Research Question

Is the European Union's proposed Carbon Border Adjustment Mechanism permissible under WTO rules, and how might the restrictiveness of WTO rules affect the development of environmental protection measures and shape the global effort to fight climate change?

Methodology

Primary sources for the thesis will include the European Commission's proposal for the establishment of the carbon border adjustment mechanism, Articles III and XX of the GATT, the WTO Agreement on Technical Barriers to Trade (TBT), and several WTO dispute settlements. The GATT exceptions that will be examined include Article XX(a), which allows for measures "necessary to protect public morals," XX(b), those "necessary to protect human, animal or plant life or health," and XX(g), those "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption."⁹ The cases examined in the thesis will include *US – Shrimp*, *US – Gasoline*, *Brazil – Tyres*, and *EC – Seal Products*, all of which are relevant to one or more of the exceptions stated above.

⁹ World Trade Organization, *The General Agreement on Tariffs and Trade (GATT 1947)*.

The research for this thesis will be done by reviewing existing WTO dispute settlements and scholarship on the parameters of the stated exceptions to the GATT in order to examine the relevance of these exceptions to the EU's CBAM. It should be noted that, as the CBAM is years away from being fully implemented, the terms of the mechanism may change in the years to come. Therefore, the analysis of the CBAM and its compliance to WTO rules in this thesis is preliminary and limited to what the European Commission's current CBAM proposal outlines.

Chapter Outline

Introduction

- I. Overview of the Carbon Border Adjustment Mechanism
- II. GATT Article XX exceptions and CBAM
 - A. Article XX(a) "Public Morals"
 - B. Article XX(b) "necessary to protect human, animal or plant life or health"
 - C. Article XX(g) "relating to the conservation of exhaustible natural resources"
 - D. Article XX Chapeau
- III. Limitations to the CBAM
- IV. Climate Justice and the limitations of WTO rules

Conclusion

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