Gianmarco Ottaviano

**The EU Carbon Border Adjustment Mechanism between ambition and delusion**

The [European Union](https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en) is adamant about the fact that climate change is a global problem that calls for global solutions. An important cause of climate change is Greenhouse Gas (GHG) emissions associated with carbon-intensive production. Left to their own devices, firms typically do not consider the negative impact of their emissions on climate when making their production decisions. Hence, the idea of using a tax on GHG emissions (a.k.a. “carbon tax”) that, by making firms face a “fair price” for such emissions, forces them to internalize the damage carbon-intensive production makes to climate.

Unfortunately, not all countries tax carbon. As a result, according to the [World Bank](https://carbonpricingdashboard.worldbank.org/), less than 25% of global emissions are taxed, and only 5% of them face a carbon price compatible with achieving the Paris Agreement's goal of keeping a global temperature rise this century below 2 degrees Celsius above pre-industrial levels. Moreover, countries with higher carbon taxes face the risk of “carbon leakage”, which occurs when their domestic companies move carbon-intensive production abroad to countries with lower or no taxes, or when their products are replaced by more carbon-intensive imports.

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

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

As highlighted in a [recent review](https://www.annualreviews.org/doi/abs/10.1146/annurev-economics-082322-034040?journalCode=economics) by the French economists Lionel Fontagné and Katheline Schubert, while there is broad agreement that the risk of leakage is real, whether the CBAM will succeed in removing it is subject to an intense debate.

Two main aspects among others have been stressed by its critics. The first is that taxing imports to ensure that their carbon price is equivalent to the carbon price of domestic production may succeed in leveling the playing field in the EU domestic market. It does little, however, to help EU firms compete in foreign markets with producers from countries that do not tax carbon. To this aim an export subsidy would be needed, which is hardly compatible with the rules of the World Trade Organization.

A second aspect is that the EU might overestimate the incentive to introduce adequate carbon taxation the CBAM creates for countries that do not have one. The idea is that the Single Market is important enough to incentivize such countries to also price carbon to avoid compensation through the CBAM. In a changing world economy, in which trade relations are reorganizing around geopolitical fault lines, for several lower carbon tax countries the attractiveness of the Single Market is fading, and with it also the incentivizing leverage of the CBAM.

In this respect, a [briefing](https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2023)739300) by the European Parliamentary Research Service stresses the importance of tighter coordination with the US. As one of the world's largest markets and emitters, the US should be a key partner in bringing the world closer to reaching the goals of the Paris Agreement. However, so far it has largely gone its own way, especially after the Inflation Reduction Act (IRA) invested billions of dollars of public funds favoring clean energy and technology “made in America”.