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Carbon Border Adjustment Mechanism + WTO = Impasse Totale?

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What's Up?

This policy brief argues that the World Trade Organization (WTO) stands in the way of climate change mitigation. This is because the WTO's "holy law" of non-discrimination conflicts with the differentiation commitments under the Paris Climate Agreement. This conflict points to the need for a thorough review of the WTO rules and disciplines, which is difficult in an organization whose member states diverge even on how to resuscitate a binding dispute resolution mechanism to respect existing rules and disciplines. However, global warming will not wait for trade experts to sort out the present WTO stalemate. A trade organisation must do more than moving deckchairs on the Titanic.

Those D… Like Products

A cow is a cow is a cow? The WTO's holy prohibition of *discriminating*, first, between origins and, second, between "like products", appears to be in sharp contrast with the Paris Climate Agreement's commitment to *differentiate* implementation measures (i) according to different climate footprints and (ii) with a different impact on developed and developing countries. So far, both WTO Delegates and the Secretariat have refused to even discuss this systemic problem. In this *annus horribilis* 2021, three world leader summits have simply eschewed the problem (SDG/Food Systems Summit, G20, COP26)—while the Ministerial segment of the WTO's General Council had to be cancelled. The transatlantic dialogue, restarted in 2021, also failed to design a way forward on other trade, environment, and climate issues. This stalemate is a significant challenge for the European Union's intention to move forward on its "Green Deal" by complementing domestic CO_2 taxation with a Carbon Border Adjustment Mechanism (CBAM).

Carbon Pricing, Carbon Leakage, and the CBAM

Carbon pricing is not new. The *High-Level Commission on Carbon Prices*, co-chaired by Ségolène Royal, Feike Sijbesma, Joseph Stiglitz, and Lord Nicholas Stern, welcomed carbon pricing under Article 6 of the Paris Climate Agreement as an indispensable part of an emissions-reduction strategy (High-Level Commission on Carbon Prices 2017).[2]

Everybody with a sense of economics, and aware of the now most important issue for humankind, loves taxing CO_2, since greenhouse gas (GHG) emissions constitute as a proven and quantifiable threat to climate ambition. Even tax-averse multinational corporations, insurance companies, and free traders are on board—of course only if no WTO rules are infringed, and if no competitor gets

[2] The High-Level Commission concluded that a carbon price of \$40-\$80 per ton of CO_2 equivalent by 2020, rising to \$50-\$100 per ton by 2030, when combined with supportive policies, would allow for the achievement of the Paris goals.

away with loopholes. Lawyers are happy too: Carbon pricing is no problem for WTO's National Treatment (NT) obligation laid down in GATT-Article III:2! With support from brainstormers at the Organisation for Economic Co-operation and Development (OECD), work on tax harmonisation is underway to avoid competition distortions.

Nevertheless, today, a CO_2 tax applicable only to domestic production appears as the easy part of the global decarbonisation effort. The real problem is *carbon leakage*. Even a world-wide comparable CO_2 tax level would not prevent "climate-unsmart" investors from seeking production locations, for instance, where exports benefit from tax incentives. However, taxing domestic footprint only means economic *self-discrimination*, which in turn could lead to investment dislocation out of Europe. Now, a negative global *environmental impact* could still occur, in the form of carbon leakage, which means production relocation due to various reasons including tax differentials, without overall GHG reduction. Climate-wise, carbon leakage is a perfect zero-sum game, because GHG emissions impact on global warming, regardless of their location.

The European Commission argues that to prevent carbon leakage all GHG emissions contained in EU imports must be taxed. Hence it proposes to accompany its domestic CO_2 taxes with a CBAM that taxes the CO_2 content of imports, leading to a European level playing field for all important GHG emitters. The proposal also foresees that CBAM collected would be identical to the domestic tax for the same product, and, in addition, fully reinvested in poor developing countries (European Commission 2021).

The EU's ETS and Aviation

How would the EU's CBAM fare when challenged under WTO law? In the absence of any reports of WTO Panels or the Appellate Body on this question, we can identify potential conflicts by looking at the fate of the EU's proposed extension of its Emissions Trading System (ETS) to aviation. The extension of the ETS to aviation has been repeatedly deferred, but it is now foreseen by the European Commission for 2023 (European Commission 2019, European Commission 2021). The Commission proposal is currently winding its way through the European Parliament and Council. The case of the extension of the ETS to aviation provides a useful basis for a preliminary legal assessment of the CBAM under the relevant WTO rules.

The EU's initial plans were that, in 2012, all planes landing in the EU—and not only those travelling within Europe—were to pay a tax depending on the length of travel. Experts on WTO law were highly sceptical of this proposal. In 2012, Joshua Meltzer expressed doubts on the EU Aviation Directive's compatibility with WTO rules (Meltzer 2012). In 2015, Felicity Deane warned against emissions trading schemes without explicit WTO law compatibility (Deane 2015). Lorand Bartels from Cambridge wrote a devastating legal opinion for the EU's Directorate General (DG) Trade in respect of the EU's decision to extend its ETS to aviation; he showed that border carbon adjustments varying with transport distances might not withstand a WTO legal challenge (Bartels 2012). He also demonstrated that the EU's scheme violated its international civil aviation obligations under the *Chicago Convention*, after it had failed to obtain an international agreement on an aviation ETS within the framework of the International Civil Aviation Organization (ICAO). Bartels argued that this was not only contrary to the Chicago Convention, but also in violation of GATT-Article III:2 and other WTO provisions (Bartels 2012).

Even though both the European Council and Parliament had adopted this proposal, by which all airlines would have had to acquire and "surrender" to the EU allowances for the CO_2 emissions produced by their aircrafts, the EU had to "suspend" *sine die* this positively climate-friendly measure.

What are the CBAM plans today?

The European Green Deal was first proposed on 11 December 2019 and further developed in multiple steps during the next two years (European Commission 2019).[3] The European Commission was, and is, ambitious but careful. On 14 July 2021, Commission President Ursula von der Leyen announced with grand fanfare a very ambitious package of measures for "the transformation of [the] EU economy and crucial to Europe becoming the world's first climate-neutral continent by 2050 [and for] society to meet [its] climate ambitions" (European Commission 2021). To ensure that ambitious climate action in Europe does not lead to carbon leakage, the new CBAM is to put a carbon price on imports in five industrial sectors: iron and steel, cement, fertiliser, aluminium, and electricity generation. Moreover, in following the global Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), it also phases out free emission allowances for aviation, and, in addition, it will include shipping emissions for the first time in the EU ETS.[4]

In the EU, some of its member states are either reticent or, on the contrary, seem to especially welcome the "buy local" implications of CBAM. Meanwhile, similar schemes have cropped up elsewhere, for instance in Canada or US states like California or Vermont.

A few independent, tentative assessments of the CBAM exist. Again, economists applaud, agreeing that carbon leakage follows when governments apply taxes only to the domestic industries. Taxing unilaterally not only domestic CO_2 but also the GHG content of imports would nevertheless be a daring move, even if each tonne of CO_2 emissions is taxed only once.

Tentative Conclusions

The CBAM ink from Brussels is not yet dry, and the small print is still missing. The OECD has offered to help here too but without providing any details on how to bridge the appearing transatlantic gap in mindset. Hence, any conclusion must remain tentative.

But what about WTO? The main problem for climate-smart policies is the non-discrimination obligation applicable to "like" products differing only in respect of their embedded carbon footprint. Here, the infamous saga of different process and production methods (PPM) continues. For instance, a CBAM on imported commodities produced with a high GHG output cannot exceed taxes applied to "the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part" (GATT-Art.II:2(a)). The "likeness test", generally applied in WTO disputes, has worked against "positive discrimination", until today, without major exceptions. Even the highest WTO organ, the General Council, has so far allowed

[3] For the timeline, see European Commission, "A European Green Deal", accessed on 24 November 2021. https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en#timeline.
[4] For details and CBAM Q/A, see European Commission Press Corner (2021 July 14), "Carbon Border Adjustment Mechanism: Questions and Answers." https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661.

discrimination only for one product, the so-called "blood diamonds". As for the WTO, only *peremptory international law or mandatory intergovernmental standards* might in a not too distant future allow non-trade concerns to prevail over WTO Law.

The negotiators of the Climate Agreement failed to see the climate problem of those infamous PPM when they delegated implementation of the "differentiation" commitment to trade ministries and national regulators. In her 2016 description of the nationally determined contributions (NDCs) under the Paris Agreement, Clara Brandi noted a particular difficulty for a legal assessment of the so-called "non-product related PPMs" (npr-PPM) which leave no trace in the final product (Brandi 2017). She correctly pointed out that the multilateral trading system does not make a clear distinction between products solely based on their levels of embedded carbon. At any rate, whether such products could be considered "unlike" (and, hence, justifying a different treatment) has never been settled in a WTO legal dispute. Incidentally, *differentiation* is not limited to border measures: in the COP 26 debates, fossil fuel subsidies ranked high, unfortunately mainly for coal exports.[5]

While the Commission did warn of the social cost of climate change mitigation in Europe, only a few scholars had realised, before COP 26 in Glasgow, that the uneven impact of CBAM within the European Green Deal also requires investment support, e.g., for African countries to address their vulnerabilities and increase resilience. The main issue for mine owners and operators is that, with CBAM, the longevity of the investment cycle can turn energy-intensive industries very quickly into stranded assets (Eicke et al 2021).

The way forward

Is there a quick way out? Might the absence of a coercing dispute settlement mechanism in the WTO open a window for the EU to proceed with a "clean and green" CBAM not entirely WTO-compatible?

My own view for this dilemma is that global warming will not wait for WTO members to sort out the mess which colour-blind trade ministers continue to ignore. And my hope is that those trade lawyers who still argue that free trade is best upheld by a WTO that doesn't take account of non-trade concerns will now come out of their ivory towers: it does matter how and for what product we mitigate GHG emissions, with what taxes and other measures, and what impact such measures actually have not only on the global climate, but also on poor developing countries and their vulnerable people.

[5] Total fossil fuel subsidies in 40 (mostly developing) countries reached US$548 billion in 2013, or 5 percent of GDP and 25–30 percent of government revenues (IEA 2014). For climate economics, such subsidies act like a negative emissions price (HLCCP 2017).

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