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NAVIGATING THE CARBON BORDER ADJUSTMENT MECHANISM FRAMEWORK

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The EU argues that the higher standard of environmental compliance in its domestic industries will reduce their competitiveness and it intends to impose an import duty on carbon-intensive industries from non-EU countries. File | Photo Credit: Reuters

A concerning development for India is the European Union (EU)'s Carbon Border Adjustment Mechanism (CBAM). The policy, which intends to tax carbon-intensive products coming into the EU from 2026, is divided into two phases, with the first phase (transitional phase) kicking in from October 1, 2023. There has been constant exchange between the EU and India on the implications of the CBAM. The Commerce and Industry Minister said recently that the proposed carbon tax on imports is an "ill-conceived" move that would become the "death knell" for India's manufacturing sector.

The EU contended, while providing context for the CBAM, that it intends to achieve the target of a 55% reduction in greenhouse gas (GHG) emissions by 2030, compared to 1990 levels, under the European Green Deal. The CBAM is part of the package planned to achieve this. Second, there is a threat to EU products being replaced by carbon-intensive imports from other countries such as India or China. The EU argues that the higher standard of environmental compliance in its domestic industries will reduce their competitiveness. Thus, it intends to impose an import duty on carbon-intensive industries from non-EU countries to meet both these objectives.

The CBAM is intended to work like the EU's Emission Trading System (ETS), which sets a cap on the amount of GHG emissions permitted. Under the EU-ETS, companies covered by the scheme have to 'buy' allowances corresponding to their GHG emissions. Financial incentives are provided to them to cut emissions. But energy-intensive industries receive free allowances to ensure their competitiveness. This is also a way of preventing carbon leakage, wherein carbon-intensive production by EU-based producers could move to non-EU countries with lax environmental regulations. The CBAM has been pitched to replace this allocation of EU-ETS allowances.

The CBAM's transitional phase will last until December 2025. In this stage, all EU manufacturers and importers of energy-intensive industries will need to report the GHG emissions embedded in their imports without any financial obligations. From January 1, 2026, the CBAM will enter the definitive phase wherein, upon declaration of the emissions embedded in imports, the importers will be required to surrender annually the corresponding number of CBAM certificates.

The CBAM will be applied to the actual declared carbon content embedded in the goods imported to the EU. The formulae devised to calculate this content will be based on the EU-ETS mechanism, barring for the first year. In the first reporting year, to allow some flexibility, use of default values for the embedded emission or using the monitoring, reporting, or verification rules of the country of production is permitted. However, there is a fundamental difference between how the actual carbon content embedded is calculated and valued in other jurisdictions.

India has just started working on its own carbon trading mechanism. In December 2022, it amended the Energy Conservation Act, 2001, to introduce the Carbon Credit Trading System (CCTS). This is proposed to combat climate change by incentivising actions for emission reductions leading to increased investments in clean energy by the private sector. The Ministry of Power is still working on the specifics to operationalise the CCTS, including carbon valuation.

In India, the obligatory CCTS model is also coupled with the voluntary market-based mechanism called the Green Credit Programme Rules, notified by the Ministry of Environment in 2023. The scheme is aimed to encourage more environmentally proactive actions going beyond the carbon reduction mandate.

India is reportedly among the top eight countries that will be adversely affected by the CBAM. As per the Global Trade Research Initiative report, in 2022, 27% of India's exports of iron, steel, and aluminum products worth $8.2 billion went to the EU. It is estimated that a few of its core sectors such as steel will be greatly affected by the CBAM.

India seems to have limited options to navigate the CBAM framework. The first would be to challenge the practice as being violative of the common but differentiated responsibilities principle agreed upon under the Paris Agreement. Second, the EU could collect the tax and return the funds to such countries to invest in their green technologies. This appears pragmatic, especially as the CBAM will enter the definitive phase in 2026. Thus the ongoing negotiations with the EU must be closely observed for this purpose. India has already challenged the CBAM before the World Trade Organization under the special and differential treatment provisions.

The EU has failed to take cognisance of the other factors that might dictate the shift of production by EU industries outside the EU. These include the availability of cheap labour and other modes of production, and the opportunity to expand in other geographies.

Recently, the U.K. declared the enforcement of its own CBAM by 2027. This is expected to cause a significant upheaval for India's exports in the forthcoming years. As a consequence, there arises a pressing need for India to formulate its own carbon taxation measures that align with the principles of the Paris Agreement while simultaneously safeguarding its industries' interests. However, given the limited time available, it is imperative for India to act swiftly in this regard.

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European Union / taxes and duties / carbon emissions / trade policy / climate change (politics)

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