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EU's Carbon Border Adjustment Mechanism

A Potential Barrier to International Trade or a Possible Solution to Carbon Leakage?

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Abstract

In July 2021, the European Commission presented a legislative package to support the EU's strengthened climate ambitions. As part of the package, a proposal for a Carbon Border Adjustment Mechanism (CBAM) was published. The CBAM is a climate measure that aims to prevent the risk of carbon leakage by introducing a price for greenhouse gas emissions on certain products imported into the EU. However, despite its climate objectives, the CBAM does raise international trade law-related issues. While the CBAM does support the EU's increased ambition on climate mitigation, the mechanism's WTO compatibility has come into question. The EU's proposed CBAM challenges provisions under the GATT concerning border measures, non-discrimination principles and environmental exceptions. The thesis concludes that whether the CBAM can be considered compatible with WTO rules ultimately depend on how the instrument is designed.

Keywords: *Carbon border adjustment mechanism, European Green Deal, WTO, GATT*

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Abbreviations

ASCM	Agreement on Subsidies and Countervailing Measures
CBAM	Carbon Border Adjustment Mechanism
EU	European Union
EU ETS	EU Emissions Trading System
GATT	General Agreement on Tariffs and Trade
NDC	Nationally Determined Contribution
PPM	Processes and Production Method
UNEP	UN Environmental Programme
UNFCCC	United Nations Framework Convention on Climate Change
VCLT	Vienna Convention on the Law of Treaties
WTO	World Trade Organization

1 Introduction

1.1 Background

Climate change is already taking place and is expected to continue. It has emerged as one of the most pressing and urgent environmental challenges that the world is facing today.[1] The effects of climate change and global warming have a detrimental impact on the ecosystem and humans, including biodiversity loss, increased extreme weather events, and continued sea level rise.[2] What is known to be the primary driver of climate change is the greenhouse gas emissions that come from human activities.[3] Hence, to tackle the irreversible effects of climate change and limit global warming, the total cumulative global anthropogenic emissions of carbon dioxide and other greenhouse gases must be reduced.[4] According to the UN Environmental Programme (UNEP) annual Emission Gap Report from 2021, the world needs to halve its annual greenhouse gas emissions in the next eight years to achieve the aspirational goal of the Paris Agreement to keep global warming below 1.5°C.[5]

The EU is a major contributor to global emissions, releasing huge amounts of greenhouse gas emissions into the atmosphere yearly. However, despite vastly contributing to global warming, there has been a constant trend of decrease in emissions in the union. Between 1990 and 2020 EU decreased its greenhouse gas emissions by 30%, significantly exceeding its target for the 2020 emission reduction of 20%. Despite being on the right track in reducing its greenhouse gas emissions, the EU must set a resistant and realistic emissions pathway for the future to achieve its long-term goal of being climate neutral by 2050.[6]

Notwithstanding the EU's leading role in international climate policy and increasing climate ambition, the emission reduction pledges by many other countries in the world lack the same ambitious goals. The failure to reach a common international policy to reduce greenhouse gas

[1] IPCC 2018, p. *v.*
[2] IPCC 2022, p. 15.
[3] IPCC 2018, p. *v.*
[4] IPCC 2018, p. 12.
[5] UNEP 2021), p. 34.
[6] EEA 2021, <https://www.eea.europa.eu/ims/total-greenhouse-gas-emission-trends> (last accessed 13 May 2022).

emissions globally has resulted in uneven climate change mitigation efforts. Consequently, besides increasing the emission reduction cost, these uneven climate policies have also reduced the effect of strengthened climate policies that some countries have adopted.[7] The strengthened emission regulations, or a country's high carbon price, raise the risk of urging producers to relocate their production to a country with more lenient ambitions and standards for emission reduction or where emission charges are lower or absent.[8] The products are later imported to the countries with stricter regulations after avoiding the carbon cost that otherwise would have applied to them would they had been produced there. This problem is called carbon leakage. Furthermore, the relocation of the production undermines the implemented mitigation policies since no reduction has per se been made as it is offset by an increase of emissions somewhere else. Thus, the risk of carbon leakage is that no matter how strict internal policies are adopted, emissions may be displaced and instead lead to an overall increase of greenhouse gases globally.[9]

In the EU, the problem of carbon leakage has been addressed under the EU emissions trading system (EU ETS). According to the EU ETS, industries considered to be at substantial risk of carbon leakage receive special treatment, so-called free allocation of allowances, to safeguard the international competitiveness and to prevent the relocation of their carbon-intensive production outside of the EU.[10] However, free allocations are expected to be phased out for less exposed sectors after 2026. Accordingly, the reduction would decrease from a maximum of 30% to 0 by the end of 2030.[11] Consequently, the outcome of more ambitious climate policies and a strengthened EU ETS results in the need for the EU to urgently address the risk of carbon leakage. Consequently, the EU Commission launched a set of policy incentives in 2019, referred to as the European Green Deal. It provides a detailed vision of making Europe the first climate-neutral continent by 2050 and achieving the target of reducing net greenhouse gas emissions by at least 55% by 2030.[12] As a part of the European Green Deal, the EU Commission

[7] Paroussos et al. 2015, p. 204.
[8] Huang et al. 2021, p. 1887.
[9] Leal-Arcas 2022, p. 5-6.
[10] Directive 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814 [2018] L76/3, para 7.
[11] European Commission, Revision for phase 4 (2021-2030) 2022, <https://ec.europa.eu/clima/eu-action/euemissions-trading-system-eu-ets/revision-phase-4-2021-2030_en> (last accessed 13 May 2022).
[12] COM (2019) 640 final, p. 4.

has proposed a so-called carbon border adjustment mechanism (CBAM).[13] The CBAM aims to prevent carbon leakage and ensure that EU importers pay the same carbon price as producers within the EU do under the EU's carbon pricing system.[14] While this objective would directly impact international trade, it must be recognised that a successful implementation of the EU's proposed CBAM must be compatible with World Trade Organization (WTO) rules. Without careful reconsideration and application, the proposed CBAM may face legal challenges as it potentially is in violation of international trade law.

1.2 Research Question

The link between the EU's increased ambition on climate change mitigation, including the attempt to prevent the risk of carbon leakage, and international trade law raises several interesting questions. Accordingly, this thesis studies and analyses the EU proposal for a CBAM to determine if such a mechanism is compatible with WTO law. More precisely, it undertakes the task of analysing whether the mechanism complies with the existing General Agreement on Tariffs and Trade (GATT)[15] provisions and if WTO rules thus constitute a barrier to ambitious climate mitigation policies.

Accordingly, the following research question and sub-questions are examined in this paper:

- What is the relationship between the EU's proposed CBAM and international trade law?
    - What is the EU's CBAM proposal?
    - What are the relevant GATT provisions?
    - Does the proposed CBAM in its current form comply with WTO law?
    - What is Finland's position on the proposed CBAM?

[13] COM (2021) 564 final, p. 0.
[14] European Commission, Carbon Border Adjustment Mechanism: Questions and Answers 2021, <https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661> (last accessed 13 May 2022).
[15] General Agreement on Tariffs and Trade, 30 October 1947, 55 UNTS 194 [hereinafter GATT].

1.3 Methodology and Material

While analysing the CBAM proposal, the subject is assessed in the legal system as a whole. Hence, legal rules within international trade law and EU law are relevant. Since the thesis' research question relates to the analysis of the proposed legislation and the existing law, the legal doctrinal research methodology is used. The legal doctrinal research involves a presentation, a systematic review and an evaluation of trends regarding applicable rules within the legal subject in question.[16] The doctrinal analysis of sources aims to compare two policy and legal frameworks, the EU proposal of a CBAM and the provisions of GATT, to find out if and how they can coexist.

The thesis' methodology does not only use legal doctrinal research. In addition to legal sources, the thesis also uses and analyses relevant literature. Thus, the legal research will include both doctrinal and analytical research to assess conflicting areas of law and gaps in the current legal framework. Furthermore, the literature analysis aims to present and critically study the scholarly discussions and opinions concerning the topic.

Finland's view on the proposed CBAM is analysed to incorporate a Nordic perspective on the topic. This analysis uses a third methodology to examine Finland's position on the proposed CBAM. It consists of analysing relevant material to describe and discuss the viewpoint. Hence, the analysis is based on data collected from publicly published statements from both companies and the government in Finland. In addition, the outcome of the public consultation that was launched by the EU Commission to gather stakeholders' views on the proposed mechanism is also used. The consultation was addressed to all sectors; however, the target audience was energy-intensive industries and related economic activities.[17]

1.4 Limitations

International trade law is a broad area of law, and the CBAM can be analysed in relation to different provisions regulating trade between the EU and other countries. Consequently, as a

[16] Taekma 2011, p. 34.
[17] European Commission, Summary Report Public consultation on the Carbon Border Adjustment Mechanism (CBAM) 2021, p. 1.

limitation to the scope of this thesis, the CBAM is examined only in relation to relevant WTO provisions that could be invoked against carbon adjustment on *imports*. Hence, this paper deals exclusively with GATT provisions, meaning that other provisions regulating international trade law are not examined. Consequently, relevant WTO provisions that could be invoked against carbon adjustment on *exports*, such as rules under the WTO's Agreement on Subsidies and Countervailing Measures (ASCM)[18] are not included in the analysis.[19] However, it is important to stress that the proposed CBAM will likely raise questions about its WTO compatibility concerning both EU imports and exports. Additionally, bilateral trade agreements also fall beyond the scope of this thesis.

Whether the CBAM is fit for purpose in addressing carbon leakage is without any doubt an essential question to be examined. However, whether the mechanism is an effective instrument in preventing the risk of carbon leakage is a question that falls outside the scope of this thesis. Additionally, as the proposal of the CBAM is just a proposal, it is likely to change before being adopted. Thus, the thesis is limited to analysing the proposal's current form while recognising that it is subject to modifications. It also remains uncertain how the CBAM will be applied to individually traded products in a factual case. Another limitation to the thesis, regarding its literature and document analysis, is that the Commission very recently announced the proposal. Hence, there is still limited detailed evaluation done. Therefore, the legal analysis is merely provisional and preliminary.

Finally, the data collected for analysing Finland's position on the CBAM is limited to publicly published data. Consequently, there is a limitation to the methodology and material since conducting interviews with companies and institutions is not included in the scope of this thesis.

1.5 Structure

This thesis is divided into six chapters. Following this introductory chapter, Chapter 2 describes the relevant framework for the subject. Therefore, the chapter aims to give an overview of both international and EU climate policies, followed by a description of the EU's proposed CBAM

[18] Agreement on Subsidies and Countervailing Measures, 15 April 1994, UNTS 14.
[19] Pauwelyn and Kleimann 2020, p. 6-7.

as a background to the analysis. Chapter 3 outlines the relevant provisions of international trade law. For the purpose of the thesis, the WTO law is thus further examined. This chapter aims to provide an overview of the relevant GATT provision and the legal context to understand the analysis in the following chapter. Chapter 4 analyses the compatibility of the CBAM with international trade law. More precisely, the GATT provisions concerning border tax adjustments, non-discrimination principles and environmental exceptions are at the centre of the examination. Thus, this chapter aims to answer the research question of whether the CBAM is compatible with WTO law. Chapter 5 analyses and incorporates Finland's view on the EU's proposal. Finally, Chapter 6 provides a conclusion that briefly summarises the significant findings presented in this thesis.

2 International and EU Law

In this chapter, both the international treaty on climate change, namely the Paris Agreement[20], as well as the EU's environmental legislation that addresses climate change and strives for climate neutrality, are analysed. The chapter aims to provide an understanding of the relevant climate frameworks and how development in climate change mitigation regulations can affect international trade.

2.1 The International Treaty on Climate Change

In understanding the development of EU's climate regulations, it is essential to highlight the underlying cause of its action. Ever since the 1990s, climate change has been at the centre of both European and international law due to the negotiations of the United Nations Framework Convention on Climate Change (UNFCCC)[21].[22] In December 2015, in Paris, parties to the UNFCCC adopted a new international agreement to regulate global climate action beyond 2020. Adopting the so-called Paris Agreement is considered a significant global climate policy milestone and has considerably advanced international climate cooperation.[23] The goal of the Paris Agreement is to enhance the international response to the threat of climate change by limiting global warming to well below 2°C, preferably to 1.5°C, compared to pre-industrial levels.[24] In achieving this long-term temperature goal, the Agreement calls for Parties to reach the global greenhouse gas emissions peak as soon as possible.[25] Furthermore, the Paris Agreement establishes a new bottom-up system of national climate pledges to reach this objective. The so-called nationally determined contributions (NDCs) represent the commitments of each country to adapt to climate change and reduce greenhouse gas emissions. Since it is up to every country to decide their individual commitments' content and scope, the ambitious level of climate action can vary significantly between different NDCs.[26] While

[20] Paris Agreement on Climate Change, Dec. 12, 2015, TIAS No. 16-1104 [hereinafter Paris Agreement].
[21] United Nations Framework Convention on Climate Change, Art 3(5), May 9, 1992, S. Treaty Doc. No. 102-38, 1771 U.N.T.S. 107 [hereinafter UNFCCC].
[22] Oberthür and Kelly 2008, p. 35.
[23] Mehling et al. 2019, p. 437.
[24] Paris Agreement, Art 2(1).
[25] Paris Agreement, Art 4(1).
[26] Mehling et al. 2019, p. 437.

parties to the Paris Agreement must ensure a progressive sharpening of the national climate mitigation efforts, it becomes more urgent and necessary to adopt approaches to limit or reduce carbon leakage.[27]

Notably, the Paris Agreement does not explicitly refer to trade, unlike UNFCCC, which establishes that "[m]easures taken to combat climate change, [...], should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade."[28] Yet, the Paris Agreement is likely to affect international trade, directly and indirectly, when reaching its goals. Direct trade implications can occur due to countries implementing measures that remove or reduce customs duties on environmental goods and services or subsidy schemes for renewable energy technologies. Furthermore, taking the necessary measures to combat climate change will entail a comprehensive review of domestic regulations toward production and consumption processes with lower emissions. Therefore, an indirect impact on trade may also occur, for example, through the implementation of new rules and standards or by entering market signals and mechanisms such as carbon pricing. Such interventions can also have significant cross-border consequences as, despite being intended initially as domestic measures, they affect the import and export of products and services.[29]

2.2 EU Climate Framework

For almost 30 years, the EU has strived to become a global leader in climate action. Already from the beginning of the 1990s, the EU has developed a complex climate change framework, including an extensive political and legal framework to cut greenhouse gas emissions.[30] Additionally, the EU policymakers and politicians have viewed the issue of climate change as an opportunity to increase the global position and legitimacy of the EU.[31] The evolution of EU climate change mitigation can be linked to the international climate policy development under

[27] Mehling et al. 2019, p. 435.
[28] UNFCCC, Art 3(5).
[29] Mehling et al. 2019, p. 437.
[30] Kulovesi and van Asselt 2021, p. 1.
[31] Lim et al. 2021, p. 2.

the UNFCCC. Thus, the EU's climate commitments are not only enshrined in its internal climate policies but also mirrored in the EU's NDC under the Paris Agreement.[32]

In December 2019, the EU agreed on the so-called European Green Deal. The initiative launched by the European Commission can be regarded as a response to the increased pressure on the need to strengthen climate policy ambitions within the EU and globally. The ambitious adaptation strategy seeks to transform the EU into "a modern, resource-efficient and competitive economy". In addition, the proposal aims to change the EU into a community with no net greenhouse gas emissions by 2050.[33] Hence, it sets out the prospects of EU climate policy.

The European Green Deal is an ambitious package of various climate action initiatives. Its different elements consist of increasing the EU's climate ambition for 2030 and 2050, supplying clean, affordable and secure energy, mobilising industry for a clean and circular economy and building and renovating in an energy and resource efficient way. It also includes accelerating the shift to sustainable and smart mobility, designing a fair, healthy and environmentally-friendly food system, preserving and restoring ecosystems and biodiversity and introducing a zero-pollution ambition for a toxic-free environment.[34]

In increasing its climate ambition for 2030 and 2050, the EU has introduced, *inter alia*, a proposal for a new climate law, the European Climate Law[35], that would enshrine the 2050 climate-neutrality objective into EU law. Furthermore, in strengthening the EU's emission reduction target for 2030, the Commission has proposed a plan to increase the target to at least 50% and towards 55% compared with 1990 levels. Additionally, in expanding its climate ambition, the Commission has established that it will propose a carbon border adjustment mechanism for specific sectors if needed. Hence, the idea of an EU CBAM was initially proposed in the European Green Deal. Accordingly, the initiative aims to reduce the risk of carbon leakage and serve as an alternative to the measures that already address the risk in the EU ETS.[36]

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[32] Kulovesi and van Asselt 2021, p. 1.
[33] COM (2019) 640 final, p. 1.
[34] COM (2019) 640 final, p. 3.
[35] COM (2020) 80 final.
[36] COM (2019) 640 final, p. 4-5.

The problem of carbon leakage is further acknowledged and stressed in the European Green Deal. It emphasises that

> "[a] s long as many international partners do not share the same ambition as the EU, there is a risk of carbon leakage, either because production is transferred from the EU to other countries with lower ambition for emission reduction, or because EU products are replaced by more carbon-intensive imports. If this risk materialises, there will be no reduction in global emissions, and this will frustrate the efforts of the EU and its industries to meet the global climate objectives of the Paris Agreement."[37]

For the EU to meet its goal of reducing greenhouse gas emissions by 55% by 2030 from the levels in 1990, a strengthened version of the European Green Deal was introduced on 14 July 2021 by the European Commission.[38] The so-called "Fit for 55" package presents a set of comprehensive and interconnected proposals to deliver the target established in the European Climate Law. Overall, the package strengthens already existing legislation, such as the EU ETS Directive, and presents a few new initiatives, including the proposal for a regulation establishing a CBAM.[39]

In the following, the EU ETS is further analysed to understand how the problem of carbon leakage has been addressed. Additionally, an overview of the proposed CBAM is provided.

2.2.1 The EU ETS

One of the EU's most significant policies to combat climate change includes putting a price on greenhouse gas emissions through the EU ETS. The trading scheme was set up in 2005 and is the world's first major carbon market and global emissions trading system.[40] Today, the EU's Green Deal builds upon the EU ETS by pursuing carbon neutrality by 2050.[41]

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[37] COM (2019) 640 final, p. 5.
[38] COM (2021) 550 final, p. 1.
[39] COM (2021) 550 final, p. 3.
[40] European Commission, EU Emissions Trading System (EU ETS), <https://ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets_en> (last accessed 15 May 2022).
[41] Bacchus 2021, p. 2.

The EU ETS aims to combat climate change by reducing greenhouse gas emissions cost-effectively.[42] It does so by establishing a cap and trade system. The cap limits the total greenhouse gas emissions allowed by all installations covered by the EU ETS and is converted into emission allowances that are tradable between the participants as needed. In the EU ETS, companies buy the emission allowances mainly on auctioning. One emission right gives the holder the right to emit one ton of carbon. The sectors covered by the EU ETS must monitor and report their emissions yearly and surrender as many emission allowances needed to cover how much they have emitted.[43] The cap is decreased over time to reduce the total emissions, whereby emission allowances become more and more expensive. Consequently, the decrease in allowances incentivises adopting measures to reduce greenhouse gas emissions, such as investing in cleaner production techniques. The purpose of the EU ETS is thus to send a price signal to the EU producers to move away from carbon-based production.[44]

Accordingly, by putting a price on carbon, the EU ETS aims to charge the polluters for the carbon emission they release.[45] However, the potential risk of carbon leakage has evolved with the introduction of a carbon price through the ETS. Therefore, the EU included some provisions addressing the issue in the EU ETS Directive to address the risk of carbon leakage.[46] Accordingly, the installations within sectors or subsectors that are regarded to be exposed to a significant risk of carbon leakage receive special treatment under the EU ETS. As a result, these installations receive a higher share of free allowances than other installations covered by the trading system. According to the Commission, the free allocations to these installations safeguards their competitiveness globally.[47] However, on the other hand, the free allocation under the EU ETS has been inefficient in incentivising investment in further reductions in greenhouse gas emissions since it weakens the price signal to the installations that receive free

[42] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community and amending Council Directive 96/61 [2003] OJ L275/32, Art 1.
[43] Boutabba and Lardic 2017, p. 48.
[44] Bacchus 2021, p. 2.
[45] Bacchus 2021, p. 2.
[46] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community and amending Council Directive 96/61 [2003] OJ L275/32.
[47] Prentice 2013, p. 134.

allocations compared to those which do not.[48] Consequently, it limits the incentives by these sectors to engage in the EU's goal to be climate neutral by 2050.

Today, the EU ETS covers 30 countries and more than 11,000 installations in emission-intensive sectors, which account for about 40% of all greenhouse gas emissions in the EU. Initially, the EU ETS was divided into three different phases of increasing length, firstly, phase I: 2005–2007, secondly, phase II: 2008–2012 and thirdly, phase III: 2013–2020.[49] However, the EU ETS has been prolonged with phase IV (2021–2030). Furthermore, the EU ETS framework was revised and strengthened for the fourth trading period in 2018 to ensure that the EU achieves its 40% emission reduction target of 2030 and contributes to the long-term goal of the Paris Agreement.[50] The revision focused, *inter alia,* on strengthening the annual cap. In phase 4, the cap on emissions is consequently decreased each year by a linear reduction factor of 2.2%, compared to 1.74% in phase 3. While strengthening the cap and contributing to the greenhouse gas emission reduction, the Council also emphasised that the free allowances will continue after 2020 to safeguard industrial sectors from the risk of carbon leakage.[51]

As mentioned earlier, the Commission has proposed further enhancing the ambition of the existing EU ETS as part of its "Fit for 55" legislative package. The overall objective of this initiative is to revise the ETS Directive so that it corresponds to the EU's 2030 climate ambition and contributes to the 2050 carbon neutrality goal.[52] Hence, to achieve its goal of reducing net greenhouse gas emissions by at least 55% by 2030, compared to the previous 40%, the Commission has proposed a steeper annual emissions reduction of 4.2%, instead of 2.2% annually under the current system. In addition, the decrease is combined with a one-off reduction of the overall emissions cap by 117 million allowances.[53]

Despite the ambitious policies for strengthening the EU ETS, the system still has limitations. According to the Commission, the current issue with the EU ETS is that it both aims to

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[48] COM (2021) 564 final, p. 1-2
[49] Borghesi and Flori 2018, p. 602.
[50] Directive 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814 [2018] L76/3, paras 2-3.
[51] Directive 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814 [2018] L76/3, para 5.
[52] COM (2021) 551 final, p. 1.
[53] COM (2021) 551 final, p. 17.

ambitiously reduce the carbon emissions in the EU while at the same time intending to prevent these emission reductions from being offset globally.[54] In addition, imported products account currently for approximately 20% of the EU's greenhouse gas footprint, and emissions embedded in imports are increasing continuously.[55] Since the linear reduction factor is also applicable to those industries that receive free allowances, this will result in there will not be enough allowances to cover the emissions caused by sectors with a risk of carbon leakage. Hence, this may increase the risk of carbon leakage in the future, even though the free allocations are continued.[56] Accordingly, this has resulted in a CBAM being considered particularly important for the EU to implement.

2.2.2 The CBAM Proposal

The CBAM is a climate policy measure put forward by the European Commission under the European Green Deal. The proposal for establishing a carbon border adjustment mechanism was announced on the 14 of July 2021 by the EU Commission as a part of the "Fit for 55" package.[57] According to the European Commission's proposal, the overall objective of the CBAM would be to contribute to the achievement of climate neutrality by 2050 by addressing the risk of carbon leakage resulting from the EU's increased climate ambition, including the strengthened EU ETS.[58] It is also emphasised that the CBAM intends to decarbonise the global economy and provide for freer and greener trade.[59] The CBAM is a measure that guarantees that the carbon price for EU-imported production on selected goods is comparable to the price producers inside the EU pay under the EU ETS. In other words, to place CBAM-targeted goods on the EU market, EU importers must pay for carbon at prices equal to those under the EU ETS. Hence, the CBAM will ensure equal treatment for domestic and imported products, according

[54] COM (2021) 564 final, p. 2.
[55] Oharenko 2021, <https://sdg.iisd.org/commentary/guest-articles/an-eu-carbon-border-adjustment-mechanism-can-it-make-global-trade-greener-while-respecting-wto-rules/> (last accessed 18 May 2022).
[56] Gisselman and Eriksson 2020, p. 20.
[57] COM (2021) 564 final.
[58] COM (2021) 564 final, p. 0.
[59] COM (2019) 640 final, p. 21.

to the Commission.[60] The additional price also intends to motivate non-EU countries to cut their emissions and green their production process to be competitive in the EU market.[61]

Accordingly, the CBAM is considered a policy measure in the form of allowances and tariffs that makes the prices of traded goods reflect importing country's greenhouse gas emission standards. [62] In practice, the CBAM system intends to operate as follows: Industries that want to import goods produced outside the EU will have to buy carbon certificates corresponding to the number of emissions produced. These certificates shall cover the imported products' direct emissions that occur during the production, the so-called embedded emissions. The certificate cost would be comparable to the carbon price the producer would have been paying under the carbon pricing rules in the EU. This implies that the CBAM certificates will be closely linked to the EU ETS since they will mirror the average trading prices of the EU ETS allowances, calculated on a weekly basis. [63] One CBAM certificate covers one tonne of embedded greenhouse gas emissions measured in the imported goods. This implies that the required number of CBAM certificates must cover the imported goods' total emissions.[64] However, should an importer already have paid, or claim to have, for the greenhouse gas emissions emitted in the production of the goods in a non-EU country, the corresponding cost should be possible to remove from the initial amount the EU importer would have to pay under the CBAM.[65]

The ultimate objective of the EU is that the CBAM would cover a broad range of products. However, to secure legal certainty for both companies and countries, the CBAM is designed to be phased in progressively. Hence, in the early stages of its implementation, only the most emission-intensive and trade-exposed industries at high risk of carbon leakage are targeted.[66] These industries are listed in the Commission Delegated Decision 2019/708.[67] To narrow the

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[60] European Commission, Carbon Border Adjustment Mechanism: Questions and Answers 2021, <https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661> (last accessed 13 May 2022).
[61] Ruggiero 2022, p. 3.
[62] Leal-Arcas 2022, p. 2.
[63] European Commission, Carbon Border Adjustment Mechanism: Questions and Answers 2021, <https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661> (last accessed 13 May 2022).
[64] COM (2021) 564 final, p. 27.
[65] COM (2021) 564 final, p. 27.
[66] COM (2021) 564 final, p. 19.
[67] Commission Delegated Decision (EU) 2019/708 of 15 February 2019 supplementing Directive 2003/87/EC of the European Parliament and of the Council concerning the determination of sectors and subsectors deemed at risk of carbon leakage for the period 2021 to 2030 [2019] OJ L 120/20.

selection, the industrial sectors which constitute the largest emitters of greenhouse gas emissions collectively are initially covered by the CBAM.[68] Correspondingly, the CBAM will put a carbon price on imports of iron and steel, aluminium, cement, fertilisers, and electricity in its initial stage.[69]

The proposed CBAM intends to withdraw free allowances for the production of these categories and, as a replacement, levy import tariffs founded on their carbon content. As a result of removing the free allowances for producers of iron, steel, aluminium, cement, fertilisers and electricity within the EU, the EU producers must pay for what they emit. Hence, the CBAM intends to level the playing field by extending the requirement to pay for emissions to non-EU countries who wish to sell their products to the EU.[70] Consequently, it is possible to see a change in how the EU deals with carbon leakage, from aiding EU producers to imposing the burden on foreign producers. In other words, EU producers have so far been given laxer rules to be on an equal footing with producers outside the EU. However, now the EU is instead seeking to stop compensating domestic producers with free allowances and instead increase the demands on foreign producers.

For the time being, it is expected that the CBAM will enter into force as early as the beginning of 2023. However, only a reporting system is applied during the first three years where EU importers will only be required to give reports of the emissions embedded in their goods. Accordingly, there will be no financial adjustments during the so-called transition period. From 2026 onwards, importers will start purchasing CBAM certificates when the mechanism becomes fully operational.[71]

Commonly, a trade measure such as the proposed CBAM can be seen as a means to "level the playing field" between those aiming to strengthen their climate policies and those deciding to limit or advocate more lenient climate ambitions. However, while the Paris Agreement, with its bottom-up approach, allows parties to determine their contributions nationally to address climate change, a CBAM might thus be understood as disregarding other countries' flexibility to decide the level of their climate ambition concerning their domestic resources and

[68] COM (2021) 564 final, p. 19.
[69] COM (2021) 564 final, Annex I: List of goods and greenhouse gases.
[70] Leal-Arcas 2022, p. 2.
[71] European Commission, Carbon Border Adjustment Mechanism: Questions and Answers 2021, <https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661> (last accessed 13 May 2022).

capabilities. What can be settled is that the uneven climate action globally and the different measures that are adopted, including the potential EU proposed CBAM, may have substantial trade implications.[72]

The EU proposal is subject to extensive discussion and analysis by third countries regarding its WTO compatibility and by EU industries regarding the potential implications for their competitive position as a result of the phase-out of free allowances. Additionally, since the CBAM proposal will follow the ordinary legislative procedure[73], which entails the approval of both the European Parliament and the Council before it enters into force, it is likely to be revised in the procedure, and potential changes can thus be made.[74]

[72] Mehling et al. 2019, p. 438.
[73] COM (2021) 564 final, p. 14.
[74] Killick et al. 2021, <https://www.whitecase.com/publications/alert/fit-55-eu-moves-introduce-carbon-border-adjustment-mechanism> (18 May 2021).

3 WTO Law and GATT Provisions

This chapter aims to give an overview of the relevant WTO framework and provide a description of the core international trade law provisions that are relevant within the context of the EU's proposed CBAM.

Countries have adopted free trade agreements worldwide to allow for a cross-border movement of goods, services and capital to enhance financial markets, economic development and investments.[75] Generally, international trade law establishes the rules and customs that regulate trade between countries. The WTO is an international organization with the main purpose of opening trade to which everyone benefits.[76] It commits to "an open, non-discriminatory and equitable multilateral trading system on the one hand" and "protection of the environment, and the promotion of sustainable development on the other."[77] In 1994 the agreement establishing WTO was signed; namely the Agreement Establishing the World Trade Organization, also referred to as the Marrakesh Agreement.[78] According to the Marrakesh Agreement, the goal of the WTO is essentially to provide a common institutional framework for managing trade relations among its members in matters related to the Agreement and associated legal agreements regulating trade in, *inter alia*, goods, services and trade related aspects of intellectual property rights.[79]

These WTO agreements are at the core of the WTO's operation and have been negotiated and signed by most of the world's trading countries.[80] Today, there are 167 WTO member states. Since 1995, the EU has been a member of the WTO and is a signatory to the Marrakesh Agreement.[81] The EU is not only a single market but also a customs union and implements a common EU trade policy. However, due to its membership of the WTO, trade-related

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[75] Leal-Arcas 2022 p. 14.
[76] WTO, What is the WTO?, <https://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm> (last accessed 18 May 2022).
[77] GATT Secretariat, A Decision on Trade and Environment, MTN.TNC/MIN (94)/1/Rev. 1 (14 April 1994), p. 4.
[78] The Agreement Establishing the World Trade Organization, (15 April 1994) 1867 UNTS 154 [hereinafter Marrakesh Agreement].
[79] Marrakesh Agreement, Art II:1 and Annex 1.
[80] WTO, What is the WTO?, <https://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm> (last accessed 18 May 2022).
[81] WTO, Members and Observers, <https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm> (last accessed 30 May 2022).

arrangements of the EU must comply with the WTO agreements.[82] Accordingly, the EU's customs and foreign trade laws have been greatly influenced by the provisions of the WTO, in particular by the GATT.[83]

The GATT, signed in 1947, is a multilateral agreement regulating trade in goods. According to its preamble, the purpose of the GATT is to reduce "tariffs and other barriers to trade" and to eliminate "discriminatory treatment in international commerce" on "reciprocal and mutually advantageous arrangements".[84] The GATT provisions can be divided into two categories. First, the substantive rules and secondly, the exception rules. The relevant substantive rules for the scope of this thesis are established in Articles I, II and III of the GATT, as explained below. To be exempted from these substantive rules and hence still be allowed to adopt a trade-restrictive measure, member states may refer to Article XX.[85]

3.1 Article I: General Most-Favoured-Nation Treatment

Article I is considered to be the most fundamental GATT principle prohibiting discriminatory treatment between members and is thus considered one of the cornerstones of WTO law. The principle lays down the most-favoured-nation treatment, which requires member states to ensure that a particular product gets similar benefits if compared to all "like" products from other member states. Hence, any discriminatory trade practices must be avoided by WTO members.[86]

Article I:1 stipulates that "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."[87] The most-favoured-nation treatment applies to customs duties and any imposed charges on imports or in connection to it. Pursuant to the article, regardless of the origin of the imported product, reductions or reliefs of taxes and other

[82] Rogmann 2019, p. 237.
[83] Rogmann 2019, p. 234.
[84] GATT, Preamble.
[85] Krenek 2020, p. 4.
[86] Lim et al. 2021, p. 5–6.
[87] GATT, Art I:1.

charges must therefore be applied equally to all like products.[88] The most-favoured-nation treatment also covers "all matters referred to in paragraphs 2 and 4 of Article III" that deals with national treatment.[89] Consequently, any discrimination regarding internal taxes and other internal charges and laws, regulations and requirements are also prohibited for all WTO members.[90]

Since the article prohibits discrimination against "like products", examining the concept's definition is essential. However, the WTO law does not define the term "like product". However, the debate regarding what the concept of a like product constitutes has been interpreted into four guiding criteria by the WTO Appellate Body.

In the *EC-Asbestos case*[91], the Appellate Body held that when assessing the likeness of the products involved, the first criterion to be examined is the physical properties of the products, including their nature and quality. The second criterion analyses the end use of the products, which implies that the products must share the extent to which the products are capable of serving the same or similar end-uses. Thirdly, the consumers' tastes and habits are examined. If the consumer perceives and treats the products "as alternative means of performing particular functions to satisfy a particular want or demand", the third criterion is fulfilled. Lastly, the fourth criterion analyses whether the products share the international classification of the products for tariff purposes.[92] Hence, the likeness of products involved depends on the outcome of these criteria.

Importantly, these criteria have been interpreted regarding Article III:4. Hence, the question is whether the "like" concept is the same under Articles I and III of the GATT. Though, it has been argued that the same analysis applies to Article I:1.[93]

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[88] Englisch and Falcão 2021, EU Carbon Border Adjustments for Imported Products and WTO Law, p. 51.
[89] GATT, Art I:1 and Art III.
[90] Lim et al. 2021, p. 5–6.
[91] WTO Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/AB/R (12 March 2001) [*EC — Asbestos*].
[92] *EC — Asbestos,* para 101.
[93] Quick, p. 579.

3.2 Article II: Schedule of Concessions

GATT Article II applies to customs duties that WTO members may levy. Article II imposes an obligation on WTO members to accord no less favourable treatment to products of other members than what it has set out in its Schedule.[94] The WTO schedules define the treatment a WTO member must give to traded goods of other WTO members, including maximum duties.[95]

According to Article II:1(b), imported "products shall […] be exempt from all other duties or charges of any kind imposed on or in connection with the importation" more than what has been agreed on in the member states' Schedules of Concessions.[96] Accordingly, the provision clarifies that the tariff bindings provided in the Schedule are a ceiling. Hence, if a charge is considered in excess of the ceiling, it would be contrary to the provision.

However, following Article II:2(a), WTO members shall not be permitted to impose, at any time, on the importation of any product "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of 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".[97] Consequently, WTO members may impose a charge on an imported product if it is equivalent to an internal tax already imposed on "like" domestic products in the concerned member state.

3.3 Article III: National Treatment on Internal Taxation and Regulation

Another core non-discrimination obligation under the GATT is established in Article III, the so-called national treatment principle. Article III's comprehensive and primary purpose is to avoid protectionism when internal taxes or regulatory measures are applied. Pursuant to Article III:1, "internal taxes and other internal charges, and laws, regulations and requirements […] should not be applied to imported or domestic products to afford protection to domestic

[94] GATT, Art II.
[95] WTO, Schedules of concessions, <https://www.wto.org/english/tratop_e/schedules_e/goods_schedules_e.htm> (last accessed 30 May 2022).
[96] GATT, Art II:1.
[97] GATT, Art II:2(a).

production." [98] It is worth emphasising that this provision refers to internal taxes, charges, and regulations. This is regulated in more detail in Article III:2 and Article III:4.

Article III:2 emphasises that internal taxes or other charges of any kind that are generally not imposed directly or indirectly on domestic goods should therefore not be imposed directly or indirectly on "like" foreign goods to comply with the non-discrimination principle.[99] Moreover, Article III:4 further underlines that the national treatment principle also prevents the discriminatory imposition of more stringent "laws, regulations and requirements affecting […] internal sale, offering for sale, purchase, transportation, distribution or use."[100] Accordingly, Article III:4 provides that, in respect of all such regulations and requirements, imported products shall not be given treatment that is less favourable than what is given to "like" domestic products. The concept of "like" follows the same interpretation as under Article I.

The objective of the national treatment principle under Article III is ultimately to ensure WTO members equal conditions for the competition between "like" domestic and imported products. [101] Consequently, the GATT's non-discrimination principles imply that WTO members must not only treat two "like" imported products equally. It also implies that they must not treat one imported product once it has entered the country differently from a "like" domestically produced product.

3.4 Article XX: General Exceptions

Whether the previously discussed provisions of GATT would be considered violated, they can potentially still be justified under the Agreement. Namely, GATT Article XX on General Exceptions sets out some specific cases in which WTO members may be exempted from GATT provisions.[102] Even though climate policy is not explicitly mentioned in Article XX, there is still room for interpretation under these exceptions. In the context of this thesis, two of the exception clauses are of particular relevance since they relate to the protection of the

[98] GATT, Art III:1.
[99] GATT, Art III:2.
[100] GATT, Art III:4.
[101] WTO Appellate Body Report, *Japan — Taxes on Alcoholic Beverages*, WT/DS8/ABR, WT/DS10/ABR, WT/DS11/AB/R (4 October 1996), p. 16 [*Japan — Alcoholic Beverages II*].
[102] GATT, Art XX.

environment. Hence, paragraphs (b) and (g) of Article XX may justify policy measures implemented by WTO members despite not complying with GATT's other rules. Accordingly, under paragraph (b), adopted measures "necessary to protect human, animal or plant life or health" might be justified.[103] Such trade restrictive measures may be implemented to avoid threats following environmental pollution.[104] Paragraph (g), on the other hand, exempts measures "relating to the conservation of exhaustible natural resources".[105]

It is well established in WTO disputes that the applicability of GATT exception clauses is not enough for the restrictive trade measure to be justified. In other words, it is not sufficient for the measure to be excepted on the mere premise that it falls within the terms of Article XX paragraph (b) or (g). The measure must, in addition, also satisfy the requirements enforced by the opening clauses of Article XX, the so-called chapeau. Accordingly, a two-tiered analysis must be conducted. Firstly, it must be proved that the measure falls under at least one of the exceptions. Secondly, it must fulfil the chapeau, which requires that the measure is not applied in a way which would constitute "a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail" and is not "a disguised restriction on international trade"[106].[107] Hence, for the justification protection of Article XX to be extended to the adopted measure, the measure at issue must satisfy the two cumulative requirements. If the measure is not assumed provisionally justified under paragraph (b) or (g), it cannot be justified under the chapeau of Article XX. Meanwhile, it cannot be presumed that a measure that falls within the terms of one of the paragraphs automatically complies with the requirements established in the chapeau.[108] The chapeau is therefore aimed at precluding an abusive application of the exceptions to Article XX. In the *US-Shrimp case*, the Appellate Body stated that "the ultimate availability of the exception is subject to the compliance by the invoking Member with the requirements of the chapeau."[109]

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[103] GATT, Art XX para (b).
[104] Jingxia and Xingxing 2015, p. 538-539.
[105] GATT, Art XX para (g).
[106] GATT, Art XX.
[107] WTO Appellate Body Report, United States — Standards for Reformulated and Conventional Gasoline, WT/DS2/AB/R (29 April 1996), p. 22 [*US — Gasoline*].
[108] WTO Appellate Body Report, United States — Import Prohibition of Certain Shrimp and Shrimp Products, WT/DS58/AB/R (12 October 1998), para 149 [*US — Shrimp*].
[109] *US — Shrimp*, para 157.

In the context of Article XX paragraph (b), it is relevant to analyse the term "necessary". Two GATT panels have comprehensively interpreted the term in cases concerning the enforcement of patent law in the US and the restrictions on importation of and internal taxes on cigarettes in Thailand.[110] In the first case, the Panel did, however, interpret the term "necessary" within the context of Article XX paragraph (d), not paragraph (b). Nevertheless, its decision established that an adopted measure would not be considered "necessary" under Article XX paragraph (d) if an alternative measure was available. However, such an alternative measure must not be inconsistent with other GATT rules and should be regarded as a measure a WTO member "could reasonably be expected to employ". Moreover, if there is no other reasonably available measure that would comply with GATT, the WTO member would be required to use the measure that "entails the least degree of inconsistency with other GATT provisions". However, the Panel did acknowledge that this would not imply that a WTO member should have to change its substantive law or its intended level of enforcement of the law.[111] The importance of the second case was that the Panel decided that the term "necessary" in Article XX paragraph (b) should be given the same interpretation as the previous Panel established for Article XX paragraph (d).[112]

Additionally, regarding Article XX paragraph (g), the interpretation of the "relating to the conservation" concept was clarified in the landmark case for this provision, *Canada – Measures Affecting Exports of Unprocessed Herring and Salmon*. In the case, the Panel concluded that for a measure to be "relating to" the conservation, the measure in question had to be "primarily aimed at" the conservation of an exhaustible natural resource within the meaning of Article XX paragraph (g).[113] Consequently, the condition stipulates a practical means to filter measures with conservation only as their secondarily aim.[114]

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[110] WTO Panel Report, *United States—Section 337 of the Tariff Act of 1930*, L/6439 - 36S/345 (16 January 1989) *337 of the Tariff Act of* 1930]and WTO Panel Report, *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes*, DS10/R - 37S/200 (5 October 1990).
[111] *United States—Section 337 of the Tariff Act of 1930*, para 5.26.
[112] *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes*, para 74.
[113] WTO Panel Report, Canada – Measures Affecting Exports of Unprocessed Herring and Salmon, L/6268 - 35S/98 (20 November 1987), para 4.6.
[114] Charnovitz 1991, p. 50.

4 Compatibility Analysis

Following the rules analysed in the previous chapter, it has become rather apparent that if the EU wants to implement a measure compatible with the GATT, the measure must impose an equal benefit or a corresponding burden on products produced within the EU and those imported from abroad. Hence, if the EU's proposed CBAM prescribes an unjustified burden on foreign products, it is likely to be deemed a discriminatory measure under the provisions of GATT. Consequently, for the CBAM to be permissible under the WTO rules, it must fulfil some requirements. It must thus be designed thoroughly to ensure its compatibility with international trade law regulations.

A border carbon adjustment is, in principle, a climate-related alternative to a border adjustment, implying that a country can impose domestic taxes and charges on imported products.[115] The potential danger of border adjustments to the international trading system is not a problem that has arisen recently in connection with the EU's proposed CBAM. On the contrary, already in 1969, the problem was raced by scholars stating, *inter alia*:

> *"In any event, border tax adjustments are posing a serious challenge to the methods of international trade regulation heretofore followed and touch the center of a growing long-range problem of reconciling freedom for each nation to pursue domestic goals while maintaining international trade to an extent that helps to efficiently and fairly allocate world resources".*[116]

So far, the WTO has not decided on a carbon border adjustment mechanism nor a carbon tax compatibility under WTO law.[117] However, the WTO compatibility of such measures is recurrently presumed given the discussion within the EU institutions. According to the EU Commission and the European Parliament, the proposed CBAM is recognised to fit within the international trade law regulations. Accordingly, the European Parliament adopted a resolution supporting the adoption of a WTO compatible EU CBAM on the 10th of March, 2021.[118] Additionally, the Commission has emphasised that the proposed CBAM is fully compliant with

[115] Mehling et al. 2019, p. 457.
[116] Jackson 1969, p. 302-303.
[117] Falcão 2021, p. 42.
[118] European Parliament resolution of 10 March 2021 towards a WTO-compatible EU carbon border adjustment mechanism (2020/2043(INI)) T9-0071/2021.

WTO rules: "Designed in compliance with World Trade Organization (WTO) rules […] EU importers will buy carbon certificates corresponding to the carbon price that would have been paid, had the goods been produced under the EU's carbon pricing rules."[119]

However, the EU proposal has faced much criticism internationally, and the EU proposed CBAM is not without controversies.[120] The shift in the EU's means to address the problem of carbon leakage has led to CBAM being considered an 'extraterritorial outreach' attempt by the EU to regulate beyond its borders.[121] Without little doubt, the CBAM does expand the scope of the influence of the EU's climate change policies to an international sphere.[122] In addition, the CBAM has been particularly questioned regarding its use as a potential form of trade protectionism.[123] Both EU trade partners and members of the EU Parliament have stressed the importance of the EU Commission's proposed CBAM to be compatible with the WTO rules without being used as a means to foster protectionism and hence undermine its intended climate objectives.[124]

If a measure is designed to pursue economic objectives, as opposed to climate objectives, it is more likely to conflict with WTO rules. Therefore, it has been affirmed that the EU requires a CBAM, which will be "effective, legitimate and fair" considering its objectives. Effective since it must tackle the issue of carbon leakage more efficiently than current mechanisms do. It is legitimate because it must comply with WTO regulations and follow the Paris Agreement's objectives. Lastly, it must be fair since the measure must be adopted transparently where communication with the EU's trading partners ensures no discrimination between domestic producers and importers.[125]

This chapter continues to analyse the EU proposed CBAM through a trade law lens to assess if the measure complies with the WTO rules defined in Chapter 3. Despite that WTO provisions

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[119] European Commission, Carbon Border Adjustment Mechanism: Questions and Answers 2021, <https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661> (last accessed 13 May 2022).
[120] Bauer-Babef 2021, <https://www.euractiv.com/section/energy-environment/news/developing-countries-deem-eu-carbon-border-levy-protectionist/> (last accessed 13 May 2022), and Simon 2021, <https://www.euractiv.com/section/energy-environment/news/asian-countries-see-eu-carbon-border-levy-as-protectionist-survey/> (last accessed 17 May 2022).
[121] Leal-Arcas 2022, p. 1-3.
[122] Sakai and Barrett 2016, p. 103.
[123] Leal-Arcas 2022, p. 1-3.
[124] Khan 2021, <https://www.ft.com/content/8800128f-eec6-4272-acc7-a51132c6c931> (last accessed 24 April 2022).
[125] Leal-Arcas 2022, p. 14.

may, on the one hand, protect EU trade interests abroad equally to the protection of other countries' trade interests, they might, on the other hand, also restrict the EU's climate action.[126] Since the CBAM is likely to impose a trade restriction, the importance of it being non-discriminatory to comply with the WTO rules is significant. Accordingly, the CBAM will be considered a non-discriminatory and WTO compliant measure if it is compatible with the key provisions of the GATT. These are the most-favoured-nation clause in Article I, the schedule of concessions for tariffs in Article II, the national treatment principle in Article III and the general exceptions established in Article XX. If the CBAM complies with Articles I, II, and III or is found to be justified under Article XX, there will be no margin for dispute. Consequently, the critical question becomes: under what circumstances would the proposed CBAM in its current form be considered non-discriminatory, and if deemed discriminatory, would it be justified under one of the environmental exemptions of the GATT?

The following legal analysis of the CBAM's WTO compatibility is divided into three parts. Firstly, the assessment covers the legal status of the CBAM and analyses which articles and paragraphs are likely to be applicable. Hence, the first part analyses how the CBAM should be designed to comply with the substantive rules of the GATT. Secondly, whether the CBAM complies with the two non-discrimination principles is analysed. The obligations under these principles apply irrespective of the outcome of the first part. Thirdly, the possibilities to justify the CBAM under one of the exception rules are examined.

4.1 A Customs Duty, a Tax or an Internal Regulation?

Firstly, the proposed CBAM risks being incompatible with Article II:1(b) since it could impose a charge on imported products above the ceilings on customs duties and other charges linked to imports that the EU has agreed on in its WTO schedule of commitments.[127]

Accordingly, Article II:1(b) could rapidly halt any efforts on the EU's proposed CBAM if it intends to impose higher tariffs on "like" products with a larger carbon footprint. Even if there were an internationally accepted method for calculating the carbon footprint of imported

[126] Leal-Arcas 2022, p. 14.
[127] GATT, Art II:1(b).

products, the CBAM would still not comply with the article. Since there are already agreements concerning tariff rates for most traded goods, it would be impossible to increase the tariff rates unilaterally while respecting the existing national tariff schedules.[128] In the *Korea – Procurement case*, the WTO Panel recognised the implicit development of the principle of *pacta sunt servanda* in respect of the GATT.[129] The principle is expressed in Article 26 of the Vienna Convention on the Law of Treaties (VCLT) in the following manner: *"Every treaty in force is binding upon the parties to it and must be performed by them in good faith."*[130] According to the principle, parties to an agreement must be able to trust that the rights and obligations expressed within it will hold. The Panel further established in the *Korea – Procurement case* that "the basic premise is that Members should not take actions, […] which might serve to undermine the reasonable expectations of negotiating partners." The Panel also highlights that this has usually appeared in the context of arrangements which could undermine the value of negotiated tariff concessions[131] Accordingly, the increase of tariff rates would thus need to be subject to negotiation and agreement between WTO members and cannot be adopted as a unilateral act.[132] Hence, the EU's proposed CBAM might be incompatible with Article II:1(b) since the measure would impose a charge on imported products in addition to the customs duties and other charges that are already imposed on or are in connection with the importation. Such an additional charge would exceed what has already been agreed by the EU in its WTO concession schedule.[133] The excess is likely because the new emission certificates introduced by the EU are most likely to be relatively expensive and only continue to rise due to the development of EU climate policy and measures. Moreover, any additional measures that the EU adopts, such as broadening the scope of the CBAM to cover more sectors, will only raise the price of the emission certificates in the future.[134]

However, as discussed in Chapter 3, Article II provides some circumstances where a charge on imported products in excess of the ceiling would not violate the article. Accordingly, a central issue to the EU's proposed CBAM's compliance with WTO rules is if it falls under Article

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[128] Krenek 2020, p. 4.
[129] WTO Panel Report, *Korea – Measures Affecting Government Procurement*, WT/DS163/R (1 May 2000), para 7.93 [*Korea — Procurement*].
[130] Vienna Convention on the Law of Treaties, opened for signature 23 May 1969, 1155 UNTS 331 (entered into force 27 January 1980), Art 26.
[131] *Korea — Procurement*, para 7.93.
[132] Krenek 2020, p. 4.
[133] Baccus 2021, p. 3.
[134] Baccus 2021, p. 3.

II:2(a) and is thus considered a border tax adjustment. In understanding the provisions applied to border tax adjustments under the GATT, the Report of the Working Party on Border Tax Adjustments is essential.[135] In its report, the Working Party applied the definition of border tax adjustments implemented by the Organisation for Economic Co-operation and Development (OECD). Consequently, a border tax adjustment is to be considered

> *"as any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. […] which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)".*[136]

In addition, the Working Party established that the primary articles to assess border tax adjustments under GATT considering imports are Articles II and III.[137]

Hence, according to Article II, WTO members are not *per se* prohibited from imposing charges equivalent to an internal tax on the importation of any product. Following Article II:2(a), it is clear that WTO members are allowed to impose a charge equivalent to an internal tax, including a border tax adjustment if it is imposed consistently with the provisions of Article III:2. According to Article III:2, "internal taxes or other internal charges of any kind" that are directly or indirectly applied to the products are included. Consequently, only indirect taxes can be adjusted at the border since these are applied to 'products'. Since direct taxes are taxes applied to 'producers' they cannot be adjusted at the border. [138] Thus, in line with the Working Party, for the principles of border tax adjustment to be applied to the CBAM, it must be designed as a tax levied on products to be eligible for tax adjustment.[139] However, if a tax on carbon emitted by a product can be regarded as an indirect tax adjustable at the border remains uncertain.

According to Article II:2(a), two taxes may be adjusted at the border; first, taxes on products, and secondly, taxes on "an article from which the imported product has been manufactured or

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[135] Mehling et al. 2019, p. 457.
[136] GATT, Border Tax Adjustments: Report of the Working Party, L/3464, BISD 18S/97 (2 December 1970), para 4.
[137] GATT, Border Tax Adjustments: Report of the Working Party, L/3464, BISD 18S/97 (2 December 1970), para 7.
[138] Gisselman and Eriksson 2020, p. 40.
[139] GATT, Border Tax Adjustments: Report of the Working Party, L/3464, BISD 18S/97 (2 December 1970), para 14.

produced in whole or in part". The second tax refers principally to so-called input products. Since carbon emissions do not exist in the product after it has been manufactured, it can be presumed that the emissions are consumed when it is produced. Furthermore, what remains uncertain is if input products that vanish in the production process, like carbon emissions, are covered by Article II:2(a) and consequently can be adjusted at the border. The WTO dispute settlement bodies have not had an opportunity to resolve this issue.[140] However, a relevant precedent is the *US-Superfund case,* where the Panel found that taxes on some input products used in the production of the final product can be adjusted at the border.[141] However, in this case, it was unclear whether the substances had disappeared in the production process or if they remained in the final product, and the Panel made no distinction on that point.[142] Consequently, it remains uncertain whether the interpretation of Article II:2(a) would only permit taxes imposed on physically incorporated inputs to be entitled to adjustments or if inputs not physically incorporated in the final product, the case with carbon emissions, would also be entitled to such. The fact that the interpretation of Article II:2(a) on carbon emission as an input product is unclear is problematic for the EU's proposed CBAM's design.

According to the EU, the CBAM could be examined as an internal measure under Article III. This is because the EU will likely continue to maintain its position in arguing that the CBAM is a requirement of internal regulation. The CBAM would consequently fall under Article III:4, which does not apply any quantitative constraints on such requirements. Correspondingly, suppose the prices for the emission certificates would increase over the years and surpass the limits of what the EU has agreed on when it comes to its customs duties, the CBAM could still be compatible with the WTO laws as it could fall under Article III:4.[143] Even if the CBAM is not recognised as a border tax adjustment but as a requirement for internal regulation, the burden on EU importers will nevertheless increase as a result of rising prices on emission certificates which exceeds the limits for the charges that the EU has agreed. Consequently, the CBAM will likely introduce additional barriers to trade for non-EU countries, even if increased charges would not be a legal violation *per se* under Article III:4.[144] Such a requirement could

[140] Gisselman and Eriksson 2020, p. 41.
[141] WTO Panel Report, *United States – Taxes on petroleum and certain imported substances,* L/6175 - 34S/136 (5 June 1987), para 5.2.10 [*US — Superfund*].
[142] Mehling et al. 2019, p. 458-459.
[143] Baccus 2021, p. 3.
[144] Lim et al. 2021, p. 6-7.

be discriminatory against WTO members outside the EU and consequently subject to GATT's non-discrimination principles.

Nonetheless, the EU's position on its CBAM being an internal regulation might fall short if analysing what triggers the obligation to pay for the emission certificates.[145] Accordingly, the Appellate Body has established that deciding if a measure constitutes an internal regulation or an import measure depends on the actual cause of the payment obligation. For a measure to fall within the scope of Article III:4, the charges it imposes must apply to products that have already been "imported", and the obligation to pay must be triggered solely by an "internal" factor, namely "something that takes place *within* the customs territory."[146] Contrarily, if the obligation to pay is triggered by or on importation of the products, the charge would form an ordinary customs duty and hence an import measure.[147] When analysing the EU's proposed CBAM, it seems to fall under the latter and could thus not qualify as an internal regulation. The fact that the CBAM would require that the emission certificates are purchased due to the act of importation of a product and not because of an internal event, such as the use, sale or shipping of the imported product, argues against the EU's position that CBAM would form an internal regulation.[148] Consequently, the EU's proposed CBAM is highly likely to be interpreted as a border measure that infringes WTO law under Article III: 4.

There is, however, a possible way forward under Article II that could allow for implementing a WTO compatible CBAM. Accordingly, it has been argued that the only possible way for the EU to introduce a WTO compatible CBAM would be to charge a tax or a tariff equal to an internal tax imposed on a like domestic product, regardless of the carbon content of the imported product. Consequently, the uncertain interpretation of whether taxes not physically incorporated in the imported product are entitled to adjustment can be disregarded as it applies to the carbon content of the product. This argument would be in line with Article II:2. However, it establishes two requirements; firstly, there must be a transparent calculation of the tax or tariff base, and second, a transparent tax or tariff rate must be determined. Regarding the tax base, the already existing ETS benchmarks used to allocate free allowances could be the basis for

[145] Baccus 2021, p. 3.
[146] WTO Appellate Body Report, *China—Measures Affecting Imports of Automobile Parts*, WT/DS339/AB/R, WT/DS340/AB/R, WT/DS342/AB/R (15 December 2008), para 161 [*China — Auto Parts*].
[147] *China — Auto Parts*, para 158.
[148] Baccus 2021, p. 3.

determining an "EU standard for best technology". The fact that the existing ETS benchmarks are already, to a great extent, product-based makes the first requirement not so challenging to fulfil. Indeed, what would need to be done before it establishes the basis for the EU's proposed CBAM is a re-examination of the calculation of the benchmarks. This is, however, neither very time consuming nor difficult.

Nonetheless, what becomes difficult with this line of argument concerns the second requirement; to identify and determine an acceptable tax rate. For the producers to estimate their additional costs in the future, it is of high importance that the carbon pricing within the EU ETS is predictable and stable. An unpredictable and unstable price on the allowances would result in difficulties for the producers to arrange for technological adjustments or investments that are vital for the technological transition of EU production to less carbon-intensive systems. Thus, it has been argued that a very narrow price corridor for the EU ETS carbon prices should be determined to help avoid excessive price fluctuations, whereby the floor price could be used as the import tax rate.[149]

Accordingly, if the EU's proposed CBAM is adopted in a manner provided that "a charge equivalent to an internal tax [is] imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic products or in respect of an article from which the imported product has been manufactured or produced", the implementation might be possible.[150] Hence, the CBAM is compatible with WTO law as long as it imposes charges on imported products equivalent to an internal tax, or charges, on "like" domestic products. Accordingly, if the CBAM is designed as a carbon tax on imports at the border and consequently covered by Articles II and III it is assumed that the imported products are treated in a non-discriminatory manner compared to "like" domestic products. Nevertheless, this implies that the presumption is that the imported products' carbon content would be equal to the "like" domestic products. Hence, a disadvantage of this approach is that even though it is regarded as compatible with the WTO rules, it does not consider the actual greenhouse gas emissions of imported products.[151] Consequently, such an assessment would undermine the objectives of the CBAM to incentivise non-EU countries to strengthen their climate change

[149] Krenek 2020, p. 4-5.
[150] GATT, Art II:2(a).
[151] Leal-Arcas 2022, p. 16.

policies and prevent the risk of carbon leakage. The next section further analyses the interpretation of "like" products with regard to the CBAM.

4.2 The Two Non-Discrimination Principles

4.2.1 The National Treatment Principle

Whether the EU's proposed CBAM is considered a border tax adjustment under Article II:2(a), it could still be incompatible with the national treatment principle. Consequently, the CBAM would still have to comply with the national treatment requirements of the second paragraph of Article III. Furthermore, some arguments can be made concerning the CBAM that could result in imported products being treated less favourably than "like" products produced within the EU. Hence the measure still stands a potential risk of treating products in a discriminatory manner.[152]

The first argument could be based on the fact that during the last trading period that ended in 2020, 43% of the total amount of emission allowances under the EU ETS was allocated for free to companies in the EU.[153] According to the Commission's new proposal for a revised EU ETS, the number of free allowances for all sectors would decrease over time and eventually be phased out. However, by phasing out the free allowances for the CBAM sectors only as of 2026, their allocation would thus continue for a few years after the CBAM has become fully operational.[154] This would result in non-EU countries being less advantaged compared to EU countries benefitting from the free allowances. Hence, a discriminatory situation between "like" domestic and imported products would occur, contrary to Article III.

Additionally, since the EU's proposed CBAM is linked with the EU ETS, the risk of imported products being charged higher taxes compared to "like" domestic products containing higher carbon content remains. Since the EU ETS follows a cap-and-trade system, the carbon prices will fluctuate. Consequently, non-EU producers might be paying more or less than what

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[152] Mehling et al. 2019, p. 459.
[153] European Commission, Free allocation, <https://ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets/free-allocation_en> (last accessed 17 May 2022).
[154] European Commission, Carbon Border Adjustment Mechanism: Questions and Answers 2021<https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661> (last accessed 13 May 2022).

producers within the EU do. In a situation where they would pay more, their products would be treated less favourably than the "like" domestic products, resulting in the proposed CBAM violating the national treatment rule. It is, *inter alia*, in this context the EU's trading partners would claim that the EU's proposed CBAM is to be regarded as trade protectionism. Contrarily, the national treatment rule is not being violated when a non-EU producer is paying less. However, the objective of the EU's proposed CBAM to prevent carbon leakage would be undermined if the price covered only a part of the total emissions.[155]

When it comes to the issue of what constitutes "like" products under the CBAM, the problem of the processes and production methods (PPMs) arises. Since the proposed CBAM would impose a border charge on imported products based on their production, this issue will be fundamental in deciding whether the measure is WTO compatible or not. The central question is thus whether two otherwise "like" products could ever be treated as *not* like conditional only on the PPMs used. Moreover, the question is relevant in the context of Article III because if an imported product with a high carbon footprint is to be considered as a like product with a low carbon footprint, then the charges imposed by the CBAM on the imported product would violate the national treatment principle.[156] Thus, for the CBAM to be WTO compatible and hence not in violation of Article III, two otherwise like products must be assumed to not be like if one product would have a high carbon footprint and the other one have a low carbon footprint.

However, in determining whether or not two products are "like" products, the "production method" is not an established criterion in assessing product likeness, as described in Chapter 3. Therefore, if products differ in their carbon footprints, i.e. the total amount of greenhouse gases that are generated in the production, as a result of using different production methods, they are still to be considered alike by member states. Otherwise, they do not comply with the non-discrimination obligation.[157] This was established in the *Tuna Dolphin dispute case*[158], where the Panels found that the United States was discriminating against 'like products' based on their production process as they did not meet US standards.[159]

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[155] Leal-Arcas 2022, p. 17.
[156] Charnovitz 2016, p. 40.
[157] Krenek 2020, p. 4.
[158] GATT Panel Report, *United States - Restrictions on Imports of Tuna*, GATT BISD 39th Supp.155, DS21/R (3 September 1991, unadopted) [*Tuna Dolphin I]* and GATT Panel Report, *United States - Restrictions on Imports of Tuna*, DS29/R (16 June 1994) [*Tuna Dolphin II*] [collectively *Tuna Dolphin dispute*].
[159] Schultz and Ball 2007, p. 52.

Despite the WTO jurisprudence rejecting the argument that two like products should be considered unlike based on PPMs, the WTO's case law has developed when it comes to assessing the four criteria of a product likeness, especially regarding the third criterion regarding consumers' tastes and habits.[160] It has been argued that "a consumer (in the eyes of the Appellate Body) who is aware of the environmental (and eventually health) hazard that global warming might represent, will treat the two goods (Kyoto Protocol-compatible, Kyoto Protocol-incompatible) as unlike goods.[161] This argument was made before the adoption of the Paris Agreement; however, it can be assumed that the same reasoning could be done in the context of the latter agreement. Hence, this argument could support the perception that high carbon footprint and low carbon footprint products should not be considered "like".

Additionally, in the *Canada-Renewable Energy case*, the Appellate Body made an important decision in determining the relevant market for electricity. Even if it did not concern the product likeness, the Appellate Body's decision confirmed that the relevant market in question was not the market for electricity generated from all energy sources but the market for electricity produced from specific renewable energy.[162] Despite the Appellate Body not explicitly affirming that electricity produced from clean energy is not considered a "like" product to polluting energy, previous case law has established that two products not competing in the same market cannot be considered "like".[163] Consequently, the legal importance of these findings concerning the CBAM is that the differentiation of the market depending on the energy source allows for different treatment of otherwise "like" products. Accordingly, such an assessment would consider the difference in products' carbon footprint while being WTO compliant under Article III. Hence, treating an imported product with a high carbon footprint compared to a domestic "like" product with a low carbon footprint less favourably would not violate the national treatment principle. Although the findings in the Canada-Renewable Energy case bode well for distinguishing between clean and polluting energy products in the future, no decisive answer has been given in the existing WTO case law.[164] Hence, for the EU to treat imports of

[160] Charnovitz 2016, p. 40.
[161] Bhagwati and Mavroidis 2007, p. 308.
[162] WTO Appellate Body Report, *Canada - Certain Measures Affecting the Renewable Energy Generation Sector - Canada - Measures Relating to the Feed-In Tariff Program*, WT/DS412/AB/R; WT/DS426/AB/R (6 May 2013), para 5.178 [*Canada — Renewable Energy*].
[163] Charnovitz 2016, p. 40.
[164] Marhold 2021, p. 72-73.

clean energy products differently from polluting energy, it might have to refer to Article XX to pursue its legitimate policy objectives and justify the otherwise WTO incompatible CBAM.

4.2.2 The Most-Favoured-Nation Principle

The EU's proposed CBAM could also be incompliant with GATT's other non-discrimination principle in Article I. The CBAM would breach the most-favoured-nation treatment rule if it discriminated against "like" products imported from different WTO member states.

In line with Article I, there should be no discrimination between WTO member states, whether it comes to tariffs, import regulations or procedures. However, the EU's proposed CBAM intends to assess the border adjustment levy in various ways. This includes considering the products' carbon content, the countries' environmental regulations and climate policies, the possibility of participating in an emission trading system like the EU ETS, and the technology used by non-EU countries on a specific product. Such an assessment and distinction are incompatible with the most-favoured-nation treatment principle since it would not allow equal benefits from a particular product to all "like" products from other WTO member states.[165]

The CBAM is also likely to breach the most-favoured-nation principle if it is applied to "like" products based on their country of origin and consequently disadvantages products from countries with laxer or absent climate policies and promotes products from countries with ambitious policies.[166] In other words, the CBAM would, in such a situation, differentiate countries depending on their commitments to reduce greenhouse gas emissions. Furthermore, any rebate or waiver to the CBAM would confer a benefit for the imported product. However, granting such preferential treatment for the imported product since they are produced with less carbon-intensive technologies than the emission benchmark or because a notional ETS is used in their country of origin may initially be considered incompatible with Article I:1.[167] The benefit given to the products from countries that adopt climate policies, comparable to those

[165] Lim et al. 2021, p. 6.
[166] Mehling et al. 2019, p. 463.
[167] Englisch and Falcão 2021, EU Carbon Border Adjustments for Imported Products and WTO Law, p. 52-53.

taken by the EU, is consequently not "immediately and unconditionally" granted to the "like" products originating in other countries.[168]

According to the Article I:1, an "unconditional" extension of the preferential treatment to all "like" imports is required.[169] However, the WTO Panel has decided in various cases that the requirement of the unconditional extension of the preferential treatment must be interpreted in its context and hence in a restrictive manner. For example, in the *Canada-Autos case*, the Panel underlined that the benefits extension "may not be made subject to conditions with respect to the situation or conduct of those countries" to whom it has been granted.[170] However, other conditions unrelated to the product's origin are allowed, such as those related to the imported product itself.[171] Following this reasoning, reducing the amount of border carbon tax would be legitimate. Since it would not be considered a condition related to the imported product itself, it would be admissible on this ground alone because such a benefit would, in any event, have no direct connection with a particular product's origin. On the other hand, to make an exception or a reduction depending on the climate policies and the measures in a specific country of origin, such as a carbon pricing scheme or an emission trading scheme equal to the EU ETS, would be incompatible with Article I:1.[172] Since this is something that the Commission has proposed in its proposed EU CBAM[173], such conditions would consequently have to be justified in accordance with the requirements of Article XX to be admissible.

Contrarily, if the EU's proposed CBAM would be applied equally to all imported products, notwithstanding their country of origin or what climate policies they are regulated under, it could be assumed that it would fulfil the requirements of Article I. However, in such a case, the CBAM could be considered a discriminatory measure by WTO members that already have adopted a policy instrument for emission reduction. Accordingly, products from such countries would subsequently fall under emission constraints not once but twice.[174] Such double burdening could potentially make an imported product less competitive on the EU market.[175]

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[168] Quick 2021, p. 579
[169] GATT, Art I:1.
[170] WTO Panel Report, *Canada – Certain Measures Affecting the Automotive Industry*, WT/DS139, 142/R (19 June 2000), para 10.23 [*Canada – Autos*].
[171] *Canada – Autos*, para 10.24.
[172] Englisch and Falcão 2021, EU Carbon Border Adjustments for Imported Products and WTO Law, p. 53.
[173] COM (2021) 564 final, p. 7-8.
[174] Mehling et al. 2019, p. 463.
[175] Charnovitz 2016, p. 41.

Because EU importers with strict climate policies would need to follow their domestic policy in addition to CBAM, they would not be granted the same advantage as EU importers without a demanding emission reduction policy. Accordingly, the CBAM would approach these countries' products differently and pose unequal requirements for the non-EU countries.[176]

Since the EU's proposed CBAM will apply the border adjustment tax on products depending on their carbon content, the environmental regulations the producers are subject to or the technology used in the procedure, there will be a different treatment for products. Consequently, an unequal grant of benefits between WTO members is provided. Hence, an apparent incompatibility with the WTO rule on the most-favoured-nation principle exists. According to some scholars, no current solutions would solve the CBAM being incompatible with Article I. Hence, the CBAM must be exempted under Article XX to be WTO compatible.[177]

Consequently, the EU proposed CBAM is most likely violating the fundamental GATT principle that bans discriminatory treatment, even though it would be applied under consistent standards from the outset.

4.3 The Environmental Exceptions

The EU proposed CBAM raises what can be seen as severe compatibility issues under the substantive rules of the GATT. Still, the CBAM runs the opportunity of potentially being justified under the general exceptions in Article XX of the GATT.

As described in the previous sections, it is much up to the design of the proposed CBAM whether or not it is likely to decrease the possibility of breaching the non-discriminatory principles under GATT Articles I and III. However, if the CBAM is designed to achieve its objectives effectively, it would almost unavoidably violate both the national treatment principle and the most-favoured-nation principle. Accordingly, it is considered a discriminatory measure since the underlying basis of the mechanism is to distinguish between low and high carbon

[176] Mehling et al. 2019, p. 463.
[177] Lim et al. 2021, p. 5 and Englisch and Falcão 2021, EU Carbon Border Adjustments for Imported Products and WTO Law, p. 76.

products that are otherwise considered "like". Consequently, it will essentially depend on the environmental exceptions in Article XX whether such violation could be allowed.[178]

The relevant paragraphs in Article XX, namely (b) and (g), have been subject to many rulings by the Appellate Body. Additionally, the literature also covers a comprehensive examination of these paragraphs. According to the findings in the WTO jurisprudence and scholarly work, there appears to be a reasonable chance that the CBAM is likely to be covered by either of these two paragraphs.[179] However, since there are not a lot of influential or prominent case law on border adjustment mechanisms, a substantial legal uncertainty will still prevail. Thus, facing the uncertainties of whether the adoption of the CBAM would comply with the substantive rules of GATT, the role of the environmental exceptions in Article XX is of significant importance for the measure's implementation in a WTO compatible manner.[180] Importantly, in fulfilling the conditions of Article XX, particularly the chapeau criteria, the environmental objective of the CBAM becomes decisive.

4.3.1 Paragraph (b)

As discussed in Chapter 3, according to Article XX paragraph (b), measures that are "necessary to protect human, animal or plant life or health" might be exempted. For a measure to be conditionally justified under paragraph (b), it must both be designed to protect human, animal or plant life or health and necessary for the protection.[181]

To invoke environmental objectives, it is not enough to only determine that there is a risk to the "environment" generally. However, the risk must be specific to the life or health of animals or plants.[182] In previous case law, the Panel has established "that the reduction of CO2 emissions is one of the policies covered by subparagraph (b) of Article XX, given that it can fall within the range of policies that protect human life or health."[183] In this case, Brazil reasoned that the measures put in place to reduce the emissions had a clear connection to the risk of respiratory

[178] Marcu et al. 2020, p. 4.
[179] Quick 2021, p. 583.
[180] Mehling et al. 2019, p. 464.
[181] Gisselman and Eriksson 2020, p. 54.
[182] Gisselman and Eriksson 2020, p. 54.
[183] WTO Panel Report, *Brazil—Certain Measures Concerning Taxation and Charges*, WT/DS472/R, WT/DS497/R (30 August 2017), para 7.880. [*Brazil — Taxation*].

problems among the citizens and hence argued that the measures were necessary to protect human health or life.[184] Consequently, since climate change may pose risks for these significant objectives, it can be reasoned that the EU's proposed CBAM with its objective to sustain a resistant climate falls under the exception clause in paragraph (b).[185]

Accordingly, the EU must explicitly realise the CBAM as a measure preventing carbon leakage since Article XX requires the measure to be exclusively environmental in its interpretation and implementation. Any other possible objectives for the CBAM, including preserving the EU industry's competitiveness or compelling climate ambition in non-EU countries, could not be reasonable. Consequently, if the CBAM is adopted on economic reasoning, for example, to protect the energy-intensive industries' competitiveness, the objective would not be exempted under Article XX paragraph (b).[186] Another finding that could question the pure climate objective is that the European Parliament has defined the CBAM as an EU own resource.[187] Consequently, this could give the impression that CBAM is just a tax rather than a means for promoting climate objectives.

However, the requirement of the measure being "necessary" may become difficult in assessing whether the EU proposed CBAM could be exempted under Article XX paragraph (b).[188] The necessity requirement has generally been quite challenging to fulfil. Despite the requirements being given more flexibility by the WTO dispute settlement bodies, it might still be hard to prove that the CBAM is necessary. It is conceivable possible to prove that the CBAM can contribute to its policy goal; to prevent the risk of carbon leakage from the EU and reduce emissions globally. However, proving that there is no less trade-restrictive alternative to the CBAM that could reach the same goal remains challenging. Even though the CBAM can be considered the most effective unilateral measure, it might not be recognised as the most effective measure by all WTO members. A multilateral measure on emission reduction introduced by all WTO members could be considered less restrictive.[189]

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[184] *Brazil — Taxation*, para 7.878.
[185] Mehling et al. 2019, p. 465.
[186] Marcu et al. 2021, p. 13-14.
[187] European Parliament resolution of 10 March 2021 towards a WTO-compatible EU carbon border adjustment mechanism (2020/2043(INI)) T9-0071/2021.
[188] Mehling et al. 2019, p. 465-466.
[189] Gisselman and Eriksson 2020, p. 55-56.

Additionally, to further note the necessity requirement, a material contribution to the achievement of the CBAM's objective must be justified under paragraph (b). The material contribution can be questioned in a situation where the EU's proposed CBAM would increase greenhouse gas emissions globally, outside the EU borders, without being compensated by the reduction in the EU.[190] In a research conducted in 2020, an analysis was made on the EU's most ambitious pathway for decarbonisation. The simulations provided a carbon leakage rate of 61.5% for this pathway. According to this ambitious pathway, for each tonne of CO2e emissions reduction achieved within the EU, the estimated increase of greenhouse gas emissions in the rest of the world would be approximately 0.615 tCO2 e. Consequently, the net reduction in atmospheric emissions would only be 0.385 t CO2 e.[191] In the case of a potential WTO dispute concerning the EU proposed CBAM would arise in future, and if such data is available for the time being, the analysis could result in the CBAM not being necessary to protect the human, animal or plant life or health as it would not contribute effectively to the policy goal.[192]

4.3.2 Paragraph (g)

For the CBAM to be deemed justified under Article XX paragraph (g), it must be assessed that it is related to the conservation of exhaustible natural resources, provided that it is made effective with restrictions on domestic production or consumption.

Hence, one of the crucial questions to assess is which natural resource the EU's proposed CBAM aims to conserve. The Appellate Body and the WTO panel have regularly affirmed that "exhaustible natural resources" include living and non-living resources.[193] It has been established that clean air and by-products of fossil fuels such as gasoline and petroleum can be considered non-living resources. Consequently, the issue of clean air is most relevant to the assessment concerning the CBAM. In the *US-Gasoline case,* the Panel established that clean air is an exhaustive natural resource that could be depleted and "that a policy to reduce the depletion of clean air was a policy to conserve a natural resource within the meaning of Article

[190] Quick 2021, p. 583.
[191] Wusheng and Clora 2020, p. 1.
[192] Quick 2021, p. 583.
[193] *US — Shrimp*, paras 128 and 131.

XX(g).”[194] Hence, this case is particularly relevant to the question about the admissibility of the proposed CBAM to the existing conditions under Article XX paragraph (g). [195]

On the premise that clean air has been acknowledged as an exhaustible natural resource, the EU could claim that the CBAM contributes to this objective since the measure intends to prevent the risk of carbon leakage from the EU to third countries and hence decrease the global greenhouse gas emissions. Consequently, the EU would have to prove that its CBAM relates to protecting clean air. Hence, similarly to the line of argument made concerning paragraph (b), a genuine relationship between the EU proposed CBAM and its objective is required. Nevertheless, the actual relationship could be questioned if the CBAM would increase greenhouse gases globally, although a reduction would occur within the EU.[196]

However, exempting the CBAM under paragraph (g) might become less challenging than justifying it under paragraph (b). This is a consequence of the wording of the two paragraphs where paragraph (b) requires the measure to be “necessary” while paragraph (g) only requires the measure to “relate” to the objective. Accordingly, the “necessity” requirement is more demanding than the “relating to” condition.[197] For a measure to be conditionally justified under paragraph (g), it is regarded as adequate if the measure is reasonably related to the pursued policy goal. However, its scope cannot be disproportionately extensive. Since the CBAM initially only covers five carbon-intensive sectors most likely at risk of carbon leakage, the measure should not be regarded as disproportionately broad in scope. Hence, paragraph (g) should possibly justify the CBAM if the measure is considered to violate the substantive rules of the GATT.[198] However, if the EU intends to include more sectors under the CBAM, it may risk becoming disproportionately broad in scope.

4.3.3 The Chapeau

Following WTO case law, the EU must also prove that the CBAM, in addition to being justified by a general exemption, also complies with the requirements of the chapeau. This constitutes

[194] WTO Panel Report, *US — Gasoline*, para 6.37.
[195] Falcão 2021, p. 45.
[196] Quick 2021, p. 583.
[197] Bhagwati and Mavroidis 2007, p. 308.
[198] Gisselman and Eriksson 2020, p. 58.

the final test in the analysis of a WTO-compatible CBAM. Thus, after it is found that an environmental measure, the CBAM, conditionally falls under one of the relevant paragraphs in Article XX; paragraphs (b) or (g), the measure must then fulfil the criteria established in the chapeau of Article XX.[199] Accordingly, the CBAM must not be "applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail", and additionally, it should not be "a disguised restriction on international trade".[200] The first part concerns whether the proposed CBAM would discriminate against other countries. The second part examines whether the CBAM establishes a market restriction on trade for products subject to the measure.[201] Hence, the adoption of the CBAM triggers questions about whether these additional legal requirements can be fulfilled.

When assessing whether the EU's proposed CBAM will be "arbitrary or unjustifiable discrimination", a wide range of WTO case law from several years illustrates that for a measure to be permissible to any of the general exemptions, it must be applied even-handedly. For example, in the *US-Shrimp case*, the US presented the absence of any "unjustifiable discrimination between countries where the same conditions prevail" by demonstrating that it applied the restrictions on import even-handedly for all countries that engaged in the same fishing activity in similar waters.[202] Hence, a question concerning the CBAM is whether the measure will be even-handed if the EU enforces its climate requirements on its trading partners without providing them with the possibility to propose changes to the requirements or appeal the application for the requirement on their products. Furthermore, to avoid unfair or partial application, the EU must be involved in mutual dialogues with its trading partners to consider their views before the requirements are established and applied. Therefore, it would not be sufficient if the EU only explained its selected and preferred requirements.[203]

Correspondingly, a public consultation has been undertaken by the EU about the adoption of the proposed CBAM. The consultation was open from July to October 2020 and the target audience for the consultation was all stakeholders, such as companies and business associations

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[199] Englisch and Falcão 2021, EU Carbon Border Adjustments for Imported Products and WTO Law, p. 69.
[200] GATT, Art XX.
[201] Englisch and Falcão 2021, EU Carbon Border Adjustments for Imported Products and WTO Law, p. 69-70.
[202] WTO Appellate Body Report, *United States - Import Prohibition of Certain Shrimp and Shrimp Products - Recourse to Article 21.5 of the DSU by Malaysia*, WT/DS58/AB/RW (22 October 2001), para 35 [*US — Shrimp*].
[203] Baccus 2021, p. 5.

in the EU and globally. It addressed all sectors but particularly energy intensive industries and related economic activities. Accordingly, the consultation aimed to gather the stakeholders' views on the proposed CBAM.[204] However, out of the 609 respondents, only a minor share of the responses, approximately 17%, comes from countries outside the EU.[205] If this number mirrors the EU's inclusion of its trading partners in a mutual dialogue, it does not seem that their views are comprehensively considered.

Another question relating to the assessment of whether the EU's proposed CBAM will be "arbitrary or unjustifiable discrimination" is the notion of the possible exceptions, permitted by the EU, to the requirements of CBAM emission certificates for some WTO members. Since the approval of such exceptions would be based only on what the EU identifies as the adequate level of a member's climate action or carbon pricing, it might appear unclear if such discrimination would be considered "arbitrary or unjustifiable". Additionally, as no internationally common way of calculating greenhouse gas emissions exists today, applying its standards and requiring other countries to comply with them could be considered a questionable act of the EU. Hence, for the CBAM to not be regarded as arbitrary or unjustifiable discriminatory, the assessment must be based on the carbon emitted in the production of the individual product. Therefore, the assessment cannot be founded on the overall emission reductions made or pledged by the country where the product originated. Finally, it is worth emphasising that the obligations within the WTO framework are not obligations towards other countries or individual traders. Contrarily, the obligations are connected solely to the treatment of individual products traded between WTO members. Consequently, emission certificates cannot be required for a product produced in a climate-friendly manner simply because it originates in a WTO member state that has not adopted any measures or climate policies to reduce emissions. Hence, it seems unlikely that the EU unilaterally can go so far as to enforce its requirements on a product's production processes in a non-EU country under WTO regulations.[206]

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[204] European Commission, EU Green Deal (carbon border adjustment mechanism): Public consultation, <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-EU-Green-Deal-carbon-border-adjustment-mechanism-/F_en> (last accessed 18 May).
[205] European Commission, Summary Report Public consultation on the Carbon Border Adjustment Mechanism (CBAM) 2021, p. 1.
[206] Baccus 2021, p. 5.

Whether the CBAM will impose any "disguised restriction on international trade" also comes to how the measure will be designed and structured. However, the scope of the wording "disguised restriction on international trade" has not been clearly defined. Nevertheless, some clarification can be found in the WTO jurisprudence. Accordingly, the Appellate Body and panels have established certain guidelines for a measure not be considered a "disguised restriction on international trade". First, the measure must be publicly announced in the form of a trade measure.[207] The EU has accordingly been transparent in its communication on adopting the proposed CBAM recognising its trade-related elements. Secondly, the measure must not constitute an arbitrary or unjustifiable act of discrimination under international trade. In the *US-Gasoline case,* the Appellate Body stated that "[i]t is clear to us that "disguised restriction" includes disguised discrimination in international trade."[208] Hence, the same type of reasoning to determine whether the application of CBAM corresponds to "arbitrary or unjustified discrimination" can be taken into account for this assessment. Thirdly, the measure's structure and design must not show any form of disguised protectionist objectives behind its stated legislative intent. For example, the Panel in the *EC-Asbestos case* admitted that there is always the possibility that a measure might favour domestic producers. However, it further noted that "[t]his is a natural consequence of prohibiting a given product and in itself cannot justify the conclusion that the measure has a protectionist aim, as long as it remains within certain limits." [209] Whether the EU's proposed CBAM will show any form of disguised protectionist objectives depends solely on how carefully the measure will be designed. Nevertheless, a protectionist objective could be assumed if CBAM's objectives are not only environmentally related. Consequently, the same arguments as set out in section 4.1.3 regarding the objectives can be used in this context.

Hence, for the EU's proposed CBAM to survive the legal scrutiny under the chapeau, the EU must, in its adoption of such a unilateral measure, ensure a transparent, fair, and inclusive process of negotiations of the WTO members. Generally, the EU must show no abuse or unjustified application of the exceptions to comply with the chapeau.

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[207] WTO Panel Report, *European Communities — Measures Affecting Asbestos and Products Containing Asbestos,* WT/DS135/R (18 September 2000), para 8.233 [*EC — Asbestos*].
[208] WTO Appellate Body Report, *US — Gasoline*, p. 25.
[209] WTO Panel Report, *EC — Asbestos*, paras 8.238-8.239.

To summarise the analysis, it can be affirmed that in addition to the pursued climate change objectives of the CBAM, the mechanism will also likely result in challenging trade related issues. Hence, a close link between the EU's proposed CBAM and international trade law has been demonstrated. For the EU to adopt the proposed CBAM, it is thus required for the measure to be compatible with WTO rules. Therefore, the following has been concluded after analysing the compatibility of the CBAM under the relevant GATT provisions.

The CBAM is most likely perceived as a border tax adjustment under Article II:2(a) and not as an internal regulation under Article III:4 or a customs duty according to Article II:1(b). However, it remains uncertain whether the tax imposed on inputs not physically incorporated in the final product can be adjustable and hence fall under Article II:2(a). Even if Article II:2(a) applies, the CBAM still faces the risk of being considered discriminatory. Generally, since the mechanism aims to distinguish between, *inter alia*, low and high carbon products and countries' different climate policies, it would almost inevitably violate the non-discrimination principles. However, if polluting energy products could be considered not "like" compared to clean energy products, treating them less favourably would not be considered discriminatory. Nevertheless, it remains uncertain if such a differentiation can be made. Consequently, for the CBAM to survive the legal scrutiny under the substantive rules of GATT, it must most likely be justified under Article XX for its otherwise WTO incompatible characteristics. Accordingly, for the EU to pursue its policy objectives and justify the CBAM's discriminatory approach, an exception in Article XX paragraph (b) or (g) must be invoked to allow the differentiation of clean and polluting energy if considered "like" products. While the necessity requirement may halt the justification under paragraph (b), paragraph (g) might provide the best option for the CBAM to be justified. Even if it is considered likely to exempt the CBAM on the premise that the measure relates to the conservation of exhaustible natural resources, the CBAM must still meet the requirements of the chapeau. Since the CBAM is implemented as a unilateral measure, it can be challenging to justify that it is applied in a manner which would not constitute "a means of arbitrary or unjustifiable discrimination" and "a disguised restriction on international trade". Concludingly, given that the EU's proposed CBAM can be justified considering the climate objectives and fulfils the requirements of paragraph (g) and the chapeau, the CBAM is considered to comply with the WTO law.

5 Finland's Position on CBAM

5.1 Finland's Climate Policy

The fundamental pillar of Finland's national climate policy is the Climate Change Act which entered into force on 1 June 2015.[210] According to the Act, Finland shall reduce its greenhouse gas emissions by at least 80% by 2050 from the levels in 1990.[211] This goal has guided the planning of the country's national climate policy. However, after adopting the Climate Change Act, the EU committed itself to achieve carbon neutrality by 2050. Consequently, the long-term goal of Finland's national climate legislation is no longer in line with the EU's long-term goals.[212] The Climate Change Act is thus being reformed and strengthened to meet the new targets set by the EU. Additionally, the current climate law does not include shorter-term targets. However, in addition to an updated emission reduction target for 2050, the reformed Climate Change Act will incorporate a target of a carbon neutral Finland by 2035.[213]

Finland has ratified the Paris Agreement, and being an EU member state also implies that Finland is a player in achieving climate neutrality by 2050. Hence, the measures taken, and the obligations required under the European Green Deal, the European Climate Law and the "Fit for 55" package, including the proposed CBAM, will apply to Finland. However, the EU does share its competence with the member states in the area of energy and climate policy[214], which implies that some member states can be less ambitious in implementing the EU's climate policy. In contrast, others, including Finland, will pursue even more ambitious targets than what has been set at the EU level.[215]

Regarding the proposed CBAM, the consequences will vary depending on the member states' national commitments, carbon prices, and trade within the covered sector of the CBAM. It is

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[210] Climate Change Act 609/2015.
[211] Climate Change Act 609/2015, sec 6 para 3.
[212] HE 27/2022 vp, p. 12.
[213] Ministry of the Environment, Reform of the Climate Change Act 2022, <https://ym.fi/en/the-reform-of-the-climate-change-act> (last accessed 16 May 2022).
[214] Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C326/47, Art 4.
[215] Siddi 2020, p. 10.

acknowledged that measures to prevent carbon leakage will remain a challenge for EU member states with relatively high carbon prices today and have committed to net-zero emissions targets over the upcoming decades, including Finland.[216]

5.2 Potential Impacts of CBAM on Finland

The following can be affirmed from Finland's perspective when analysing the five sectors initially covered by the CBAM proposal. The first sector, iron and steel, is by far the largest category in terms of production and the value of foreign trade. In 2021, about 20 per cent of the total imports of iron and steel products came to Finland from outside the EU. Following iron and steel, aluminium products are considered the second largest sector. The value of imports of aluminium products accounted for 20 per cent of the total imports of these products to Finland. The ratio of the value of imports to Finland's aluminium production is significant and accounts for about 60 per cent. Thirdly, regarding fertilisers, the amount imported to Finland from outside the EU accounted for more than 70 per cent of their total imports last year, and almost all were imported from Russia. The value of imports is, however, less than five per cent compared to the value of the output of the Finnish fertiliser industry. Fourthly, foreign trade in cement is notably relatively small because it is not worth transporting long distances. Some cement is imported to Finland from the internal market area, but imports are insignificant.[217] Lastly, Finland's production in 2020 covered 82 per cent of the total electricity consumption, whereby net imports covered 18 per cent. Finland imports its electricity mainly from the Nordic countries, Russia and Estonia.[218] However, Russia's share of Finland's energy imports has been predominant and accounted for about ten per cent of Finland's total electricity consumption. Yet, following Finland's current plan to reduce reliance on Russia due to its invasion of Ukraine in February 2022, the import of electricity is likely to change. Accordingly, as 14 of May 2022, Finland has stopped its electricity imports from Russia.[219] Net electricity imports have however

[216] Burke et al. 2021, p. 2.
[217] Kaitila et al. 2022, p. 12.
[218] Statistics Finland 2021, <https://www.stat.fi/til/salatuo/2020/salatuo_2020_2021-11-02_tie_001_en.html> (last accessed 16 May 2022).
[219] Yle 2022, <https://svenska.yle.fi/a/7-10016506> (last accessed 17 May 2022).

already decreased in Finland partly due to increased electricity produced from renewable energy sources.[220]

In a research by the Organisation for Economic Co-operation and Development (OECD) in 2020, the greenhouse gas emissions embodied in international trade and the final domestic demand were studied.[221] According to the research, so-called "imported emissions" are one of the main reasons why Finland's carbon footprint is still high. The study also found that Finland is one of the few countries where about half of its greenhouse gas emissions are generated outside its borders.[222]

In another recent report by the Research Institute of the Finnish Economy (ETLA) and the Finnish Environment Institute (SYKE), the effects of the proposed CBAM in Finland and at the EU level were evaluated.[223] The report published on the 24th of April 2022 assessed the impact of the CBAM on the industrial sectors. However, an analysis regarding the electricity was excluded from the assessment.[224]

According to the report, the most significant effects in Finland would be declined imports from Russia and China, especially in imports of iron, steel and fertilisers from Russia.[225] However, following the EU sanctions in response to Russia's invasion of Ukraine, a prohibition on imports from Russia to the EU of iron, steel, and cement has been established.[226] It has nonetheless been assessed that the EU proposed CBAM would cut imports into Finland by a quarter in products subject to the measure, which are imported from countries subject to the carbon certificates under the CBAM.[227]

However, according to the report, the effects of the EU's proposed CBAM on Finland will remain small at the national economy level. In the benchmark case, the Finnish GDP would grow by less than 0.01 per cent; hence, no significant effects can be assumed. Nevertheless, the

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[220] Statistics Finland 2021, <https://www.stat.fi/til/salatuo/2020/salatuo_2020_2021-11-02_tie_001_en.html> (last accessed 16 May 2022).
[221] Yamano and Guilhoto 2020.
[222] Yamano and Guilhoto 2020, p. 48.
[223] Kaitila et al. 2022.
[224] Kaitila et al. 2022, p. 9.
[225] Kaitila et al. 2022, p. 18.
[226] Consilium 2022, <https://www.consilium.europa.eu/en/policies/sanctions/restrictive-measures-against-russia-over-ukraine/> (last accessed 17 May 2022).
[227] Kaitila et al. 2022, p. 6.

CBAM could affect not only the national economy but also the competitive position of Finnish products. Implementing the CBAM would decrease competition for the CBAM products within the EU but would increase it outside the EU. The CBAM is anticipated to benefit industrial sectors in Finland that produce products subject to the CBAM and those industries that have significant quantities of intermediate products for these sectors. On the other hand, the rest of the industry sectors are likely to suffer from the CBAM due to increased production costs, weakening their competitiveness compared with non-EU producers.[228]

In the EU, imports account for about a quarter of total imports of cement, iron, steel, and aluminium products. In fertilisers, the share of imports rises to more than 40 per cent.[229] In addition, countries importing into the entire EU are, on average, somewhat more polluting than countries importing into Finland. Therefore, the CBAM's effects on the imports at the EU level are also assumed to be more significant compared to Finland.[230]

However, it is worth emphasising that the final impacts of the proposed CBAM are hard to predict and will thus remain somewhat uncertain at this time before its implementation.

5.3 Finland's Position towards the EU's Proposed CBAM

Ensuring the WTO compatibility of the mechanism has been identified as an essential precondition in Finland for introducing the proposed CBAM. However, from Finland's point of view, vital issues concerning the CBAM have not yet been sufficiently discussed by the EU. Hence, due to these ambiguities, Finland's position on many issues in the proposed regulation is yet to remain somewhat uncertain. This section, however, aims to cover the main issues relating to the CBAM proposal that has generated debate within the Finnish government and various Finnish companies. These issues consider the waiver of the free allowances, the CBAM's implementation schedule, the risk of possible circumvention of the CBAM and the potential impacts on the relationship with trading partners outside the EU. The section finishes by analysing Finland's recently published preliminary position on the EU proposed CBAM.

[228] Kaitila et al. 2022, p. 6.
[229] Kaitila et al. 2022, p. 6.
[230] Kaitila et al. 2022, p. 20.

The Finnish government has attached great importance to the objectives set for the proposed CBAM to improve the prevention of carbon leakage, promote the expansion of carbon pricing and strengthen climate measures in third countries. According to the Finnish government, there is a clear need for these objectives as the EU raises its ambition for climate change and strengthens emissions control within its borders. Additionally, the government emphasises that the Commission must consider international competition in planning measures to prevent carbon leakage while also being compatible with WTO rules.[231] Moreover, the government considers that a critical precondition for introducing the CBAM is that the mechanism better prevents carbon leakage and provides more benefits than the current measures to prevent carbon leakage, particularly the free allocation of allowances.[232]

In a letter from the Finnish Ministry of Finance, it is highlighted that Finland has acknowledged the Commission's emphasis that there is no alternative to abandoning the free allocation of allowances if the CBAM is to be introduced following WTO rules. Accordingly, the Ministry underlines that if the mechanism did not abandon free allocation, the EU would place a lighter burden on EU-produced products than on non-EU products, thus favouring EU-produced products at the expense of non-EU products. In this situation, both product groups would be subject to EU-level price control in the EU internal market. However, only products manufactured in the EU would receive part of the allowances free of charge. Following the Commission's statement, the Ministry finds that if EU production were to be protected through both the CBAM and the free allocation of allowances, this arrangement could be interpreted as violating the WTO principle of national treatment in Article III.[233]

However, the Committee on Economic Affairs in Finland has drawn attention to the fact that abandoning existing measures to prevent carbon leakage also involves the risk of carbon leakage. As proposed, the Committee finds that the CBAM will, in principle, promote competitive conditions for production in the EU internal market but will not contribute to the competitive position of EU low carbon production outside the EU. Hence, the Committee on Economic Affairs stresses the need to assess further alternative measures that can be adopted under WTO rules in situations with a risk of carbon leakage. The Committee was especially

[231] Valtioneuvosto 2021, p. 14.
[232] Valtioneuvosto 2021, p. 15.
[233] Valtioneuvosto 2021, p. 5.

concerned about the situation where low-emission production from the EU will be replaced by more emission-intensive production on the international market due to a more ambitious EU climate policy.[234]

Additionally, looking at the position of industry sectors within Finland, removing free allowances is not in favour. According to the Technology Industries of Finland, carbon leakage is most effectively prevented by strengthening already existing carbon leakage risk measures. Hence, they find that free allocation should be maintained in the EU until global carbon pricing is implemented. Therefore, introducing a CBAM should not lead to a premature reduction in the free allocation of allowances.[235] This position is shared by other Finnish companies, including the energy company Fortum which finds that global carbon pricing is the primary solution to prevent carbon leakage. But on the other hand, Fortum also recognises that an international carbon price does not appear feasible currently and that more robust measures such as CBAM are needed.[236] The Finnish Steel and Metal Producers also agree with this line of argument and further find that the coexistence of free allowances and the CBAM would not imply double protection.[237] Several other Finnish industries have affirmed that they consider the current carbon leakage prevention measures effective and had reservations about the introduction of the CBAM, mainly because the Commission is proposing to replace the free allocations for products covered by the mechanism.[238] According to the steel manufacturer Outokumpu Oyj, free allowances are also needed after implementing the CBAM. Hence, in their view, the CBAM should instead be implemented as a complementary instrument.[239] However, these positions seem to be contrary to what the Commission has established; the free allocation of emission allowances cannot directly coexist with CBAM due to WTO rules that do not allow such double protection for domestic production.

Outokumpu Oyj's public statement on the CBAM highlighted the risks of the measure, including the possibility for EU importers to misuse the mechanism. Accordingly, EU importers could allocate a smaller footprint to a certain "green" product group sold in the EU, while a similar product from the same producer could be sold with a larger footprint outside the EU.

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[234] Talousvaliokunta 2021, p. 11.
[235] Teknologiateollisuus 2021, p. 1.
[236] Fortum 2020, p. 3.
[237] Finnsh Steel and Metal Producers 2020, p. 2.
[238] Valtiovarainministeriö 2021, p. 1.
[239] Outokumpu Oyj 2020, p. 1-2.

According to Outokumpu Oyj, such a practice should not be allowed under the CBAM.[240] The Finnish Steel and Metal Producers have also brought attention to the risk of possible circumvention of the CBAM. According to them, the CBAM could lead to countries reorganising their trade flows by exporting the products from low carbon productions to the EU, consequently decreasing the CBAM charges, whereas the products from high carbon productions are sold domestically or to other parts of the world. The Finnish Steel and Metal Producers find that such actions would undermine the objective of the proposed CBAM by resulting in no or adverse effect on the overall global greenhouse gas emissions.[241]

According to the Ministry of Finance, Finland and other EU member states have drawn attention to the incentives created by the proposed regulation for EU importers to report actual emissions from production. They find this important because the better the system encourages reporting actual emissions, the better the CBAM would act as a carbon leakage protection. However, the Ministry stresses that according to the Member States, the benchmark of the proposed regulation, based on the EU's lowest performing 10% of installations, would be sensitive to generosity for EU importers as the EU raises the level of its climate action. Hence, the Ministry finds that a too generous default would be a problem for high-emission EU importers, as they could choose to use a generous default instead of reporting actual emissions. Attention has also been drawn to the technical challenges of obtaining the data needed to calculate the emission content of imported products, as well as the potential risk that the application of the default values would be in breach of WTO rules.[242]

Regarding the data, the Central Union of Agricultural Producers and Forest Owners (MTK) in Finland has stated that the reliability of the data and the adequacy of the measurable parameters to verify the climate impact will undoubtedly be critical issues in any potential future disputes concerning the CBAM. Furthermore, MTK notices that there is a lot of talk at the WTO level about transparency and the need to increase it for commitments to be justifiable. Following this, MTK finds that the calculation at the foundation of the CBAM is one significant source of

[240] Outokumpu Oyj 2021, p. 2.
[241] Finnsh Steel and Metal Producers 2020, p. 2.
[242] Valtiovarainministeriö 2022, p. 11.

uncertainty and lack of transparency which can question the WTO compatibility of the measure.[243]

Furthermore, Valmet, the developer and supplier of technologies, automation systems and services for the pulp, paper and energy industries, was the only one to comment on the possibility of exemptions from the CBAM. According to Valmet's comments to the Public Consultation on the CBAM, the company emphasises that having high climate targets and measures does not correlate with the actual carbon content of products. Hence, to ensure a level playing field between all trading partners, it would be good not to exclude any country from the CBAM.[244] Nevertheless, this view is not in line with the Commission's proposal as, according to it, such countries would be exempted from the CBAM.

Additionally, several statements concerning the revenues from CBAM have been made. The Chamber of Commerce has acknowledged that the CBAM is one way of increasing the EU's common resources. However, the Chamber highlighted that it must not lead to a further increase in the burden of climate and environmental taxes on European companies and a disproportionate burden on the European economy vis-à-vis the rest of the world.[245] According to the Environment Committee of the parliament, the starting point for the further development of the EU financial system, including the inclusion of new own resources such as CBAM revenues, must be that changes to the system do not disproportionately increase Finland's payment burden. Additionally, it should not otherwise impose unreasonable additional costs on the Finnish economy and economic actors. Therefore, according to the Committee, decisions on the sources of EU funding must remain with the member states. Furthermore, decisions on own resources should consider that resolutions concerning them may also raise questions about their compatibility with WTO rules.[246] Additionally, ETLA has commented on the Commission's "Fit for 55" package that if the EU introduces a CBAM to finance the recovery package or for any other non-climate-related reasons contrary to WTO rules, it will undermine the EU's credibility in international climate cooperation. For this reason, ETLA stresses that

[243] MTK 2021, p. 7.
[244] Valmet 2020, p. 1.
[245] Kauppakamari 2021, p. 2.
[246] Ympäristövaliokunta 2021, p. 4.

great care must be taken, especially concerning the fact that the mechanism could serve as a source of resources for the EU budget.[247]

A unified position among the Finnish industry is that it is challenging to implement CBAM following international commitments and that its introduction is likely to affect their trade relations with countries outside the EU. The Finnish Forest Industries, for instance, stresses in their comments on the CBAM that even if the mechanism is carefully prepared, it is still expected to be challenged by trading partners. Additionally, they fear that the trading partners will regard the measure as an illegal trade barrier.[248] According to the Confederation of Finnish Industries EK, the uncertainty of whether it is possible to find a WTO compatible CBAM also increases the risk of countermeasures by EU's trading partners. Moreover, in EK's view, would the unilateral decision of the EU to introduce a measure incompatible with the WTO rules, another big hit for the multilateral rules-based trading system could occur.[249]

As recently as March 2022, the Ministry of Finance published a so-called EU memorandum on a proposal from the Commission. The memorandum contains Finland's preliminary position on the EU proposed CBAM. According to it, Finland estimates that the CBAM, to the extent proposed by the Commission, is more compatible with the EU's long-term climate targets to prevent carbon leakage. However, Finland emphasises that since the CBAM is an entirely new EU mechanism, its effectiveness compared to the free allocation of allowances will ultimately depend on the success of its practical implementation.[250]

Additionally, Finland still considers that a more detailed assessment of the functioning of the CBAM with the free allocation of allowances requires a clearer understanding of how the free allocation in the EU ETS would be reformed for installations in the sectors subject to the mechanism. Since these issues will be addressed as part of the negotiations on proposals for the EU ETS, Finland emphasises the importance of the collective effects of the different parts of the "Fit for 55" package when assessing the package's effects on carbon leakage.[251]

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[247] ETLA 2021, p. 3.
[248] Finnish Forest Industries 2020, p. 2.
[249] Confederation of Finnish Industries EK 2020, p. 2.
[250] Valtiovarainministeriö 2022, p. 2.
[251] Valtiovarainministeriö 2022, p. 2.

Regarding the "Fit for 55" package, Finland's Institute for Economic Research VATT has also raised its view concerning the extensive legislative proposals. According to VATT, the simultaneous introduction and coordination of different climate policy instruments and mechanisms is a demanding task. Therefore, a limited CBAM and a step-by-step approach may be justified according to them. On the other hand, the VATT emphasises that if the system to be introduced is very complex and therefore difficult to prepare and ultimately covers only a small part of the EU's carbon-intensive sectors, the proposed CBAM may not meet its objectives. Above all, VATT believes that CBAM would not provide sufficient incentives for countries outside the EU to start pricing their emissions comprehensively. As this is one of the objectives of the proposed CBAM, VATT indicates that the limited scope would jeopardise the purpose of the mechanism.[252]

In addition, in its preliminary position, Finland draws attention to the fact that the time left for national implementation preparations before the planned entry into force of the Regulation at the beginning of 2023 is becoming very short. Yet, many key issues and details for its implementation are still unclear. Therefore, Finland considers that the Commission should assess whether the remaining time for implementation is reasonable. If the assessment is insufficient, the CBAM's entry into force should be postponed.[253]

Finally, Finland emphasises the key role of the Commission in ensuring the uniform and harmonised implementation of the mechanism in the EU.[254]

Concludingly, it can be asserted that Finland supports the ambitious EU climate policy, including the climate neutrality target of 2050, as well as the aim of the EU proposed CBAM to prevent carbon leakage and encourage countries outside the EU's borders to reduce their emissions. Hence, Finland is fully committed to implementing necessary measures to mitigate climate change. However, it is CBAM as a measure that especially the Finnish industry is doubtful about and whether it will achieve its aims without significant risks for the domestic industry, the trade relationships and the global competition. Accordingly, in many companies'

[252] VATT 2021, p. 3.
[253] Valtiovarainministeriö 2022, p. 3.
[254] Valtiovarainministeriö 2022, p. 3.

view, the EU should stick to its current policy tools and, therefore, should the proposed CBAM not replace the existing systems to address the issue of carbon leakage.

6 Conclusion

The thesis has analysed the international trade law-related aspects of the EU's proposed CBAM and assessed whether the mechanism can be considered WTO compliant.

With the proposed CBAM, the EU aims to address the risk of carbon leakage due to its increased climate efforts and the global uneven climate policies. Although unilateral policy options are likely to be considered trade protectionism, the CBAM could still reduce the risk of carbon leakage and incentivise other countries to strengthen their climate ambitions. The CBAM is also likely to prevent future carbon leakage risks that may occur due to the lack of allowances available for free allocation. In the absence of a global carbon pricing agreement, the proposed CBAM may be one of the few tools to help the EU enhance its climate efforts. The CBAM could thus lead to improved preconditions for effectively achieving the EU's climate goals and enabling the EU to contribute to achieving the Paris Agreement's goals. Nevertheless, the CBAM is still perceived as a characteristically complex and controversial mechanism that may be inconsistent with fundamental WTO rules.

According to the analysis, there are uncertainties about how CBAM should be interpreted; whether the requirement of the CBAM to buy certificates is to be considered a customs duty according to Article II:1(b), a border tax adjustment under Article II:2(a) or an internal regulation under Article III:4. However, despite how the proposed CBAM is perceived, the analysis has found it challenging to design the mechanism to comply with the non-discrimination provisions in the GATT.

Although the Commission has stated that the proposed CBAM is designed in accordance with WTO rules, the risk that the mechanism may be regarded as discriminatory against other WTO members or favour domestic products over imported goods may remain. Based on the analysis, it can be concluded that it will likely not be possible to impose a border charge based on the actual carbon content of imported products while considering the decarbonisation efforts of their country of origin without violating the GATT Articles I and III. Hence, if the CBAM is designed to reduce greenhouse gas emissions effectively, it is most likely not in compliance with the non-discrimination principles.

Consequently, the uncertainties concerning the CBAM's compatibility with the substantive rules of the GATT imply that much of the legal assessment of whether the CBAM is compatible

with WTO law will depend on whether the measure is justified following the requirements in Article XX. According to the analysis, the proposed CBAM would most likely fall under the exception of Article XX paragraph (g). However, in the context of Article XX, the climate objective of the proposed CBAM must be emphasised. Hence, the measure should only be exempted if it aims to achieve the objectives set in the EU's climate goals. In addition, complying with the requirements of the chapeau remains quite a challenge for the EU, especially since it might be difficult to prove that a unilateral measure is not to be found discriminatory or arbitrary.

The Finnish position on the proposed CBAM has been examined to incorporate a Nordic perspective into the thesis. In general, it can be settled that Finland support both the targets set out in the Paris Agreement and the EU's ambitions to be climate neutral by 2050. Additionally, Finland have expressed support for the idea of addressing carbon leakage on an EU level to a greater extent. However, there are some parts that Finland is critical of regarding the proposed CBAM. The Finnish industry has expressed concern about, *inter alia*, the removal of free allowances. It stresses the importance of designing the CBAM to coexist with existing carbon leakage measures in the EU. Contrarily, this has been argued to be incompatible with WTO law as it would amount to double protection of domestic producers and hence considered discriminatory. Additionally, the Finnish industry is concerned about the CBAM's effect on trading partners. It emphases the possibility of circumventing the mechanism, which would jeopardise the objective of the CBAM to incentivise third countries to decrease their carbon emissions. Furthermore, the Finnish industry underlines that the consequence of the CBAM not being compliant with WTO law may lead to retaliatory measures by major trading partners.

Concludingly, whether the proposed CBAM will be considered a potential barrier to international trade or a possible solution to carbon leakage will depend on whose perspective you look from; whether it is from the Commission's, the EU member states' or the EU's trading partners' view. However, more importantly, it will ultimately depend on the CBAM's specific design choice rather than what is indicated in the proposal. Without careful application, the EU's proposed CBAM may be incompatible with fundamental WTO rules and not fall under any environmental exemptions under the GATT. Accordingly, the CBAM proposal is a balancing act between EU's enhanced climate goals and the EU's obligations under the WTO.

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