

Commissioner Gentiloni
DG TAXUD
European Commission

28 October 2020

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Subject: Consultation on the Carbon Border Adjustment Mechanism

Dear Commissioner Gentiloni,

Please find attached our views on the Carbon Border Adjustment Mechanism (CBAM).

A COORDINATED AND COHERENT APPROACH TO ENERGY IN THE EU

We believe that the CBAM is an important addition to the EU's suite of tax measures to help combat climate change. The CBAM may have a dual economic role for the EU – as both an anti-avoidance measure to prevent EU based businesses relocating production to third countries, and as a tool to encourage companies to invest in, or relocate to, Europe.

There are still large uncertainties about the best design of a CBAM and the potential impacts of its introduction. More information, from research and fact-finding, is required for policy makers to design an efficient CBAM, and to make proper policy decisions to deliver on the EU Green Deal as a whole.

The mechanics of the CBAM should be as simple as possible (to understand, implement, administer and control) and fair. The proper functioning of the CBAM will also require the addition of a strong regulatory framework, especially in respect of the determination and measurement of the carbon content of products in scope, and monitoring and control of such measurements. A robust dispute resolution mechanism, with formal rulings, will also be necessary.

That being said, urgent action is needed to mitigate the climate crisis. Properly targeted tax measures are an important tool in changing behaviour and helping to reduce greenhouse gas (GHG) emissions. Consequently, whilst it is important that the EU's responses are as data- and science-led as possible, we would call on the European Commission to publish formal legislative proposals in respect of both the CBAM and revisions to the Energy Tax Directive as soon as possible. Equally, we call on the Member States to reach agreement on these proposals as soon as possible after their publication.

Thus, we would welcome a holistic and coherent policy approach for the implementation of taxation measures on pollution and resources consumption in Europe, which would cover all uses of energy. The implementation of the CBAM should be coordinated with the other policies foreseen by the EU Commission and the EU Member States in that field, such as the revision of the Energy Taxation Directive, the EU Emission Trading System, etc.

However, we must recognise that tax policy in itself will not provide all the answers to reducing GHG emissions and provide a stable EU energy framework – a broader harmonisation of all aspects of energy policy across Europe will be required to achieve all the EU's climate change ambitions.

PROTECTING EU CITIZENS, BUSINESSES AND COMPETITIVENESS

Ideally, international agreement would be sought in respect of tariffs on products derived from high-GHG emission processes. Realistically, however, this seems unlikely given the current geopolitical situation – as demonstrated by the difficulties in getting international agreement on, and implementation of, the Paris Agreement and Kyoto Accords.

Consequently, the European Union is in the position of taking the lead and, effectively, imposing unilateral tariffs on goods imported derived from high GHG emission power sources.

Consequently, it is necessary to perform a thorough risk assessment of what sectors are most at risk of additional tariffs and to target them with support taking into account existing WTO rules and \ or bilateral trade agreements.

Whilst it is desirable that products with embedded carbon are also covered by the mechanism, in the short term this would cause a great deal of disruption and cost for all involved and will particularly affect smaller entities. Consequently, the scope of the mechanism should first deal with those sectors that include the highest emissions and the greatest possibility of carbon leakage and then be expanded to include a broader range of items once the systems are in place and the impacts have been properly measured.

Ultimately it is hoped that by the EU investing in carbon neutral and sustainable products and processes, it increases its global competitiveness as other regions bring in their own taxes and regulations on GHG emissions.

Please find below our detailed thoughts on certain questions in the public consultation.

General context for the Carbon Border Adjustment Mechanism

Question 2 a and b – A carbon border tax or mechanism is a necessary adjunct to other national or regional carbon taxes (or regulations) to ensure that carbon leakage doesn't occur – either by EU businesses relocating activities to third countries or further down the supply chain. Consequently, it will help the EU meet its climate neutrality objectives. It will not, however, achieve the EU ambitions on its own, which will require a concerted change in attitude, and possibly regulation, to meaningfully decrease energy use.

Question 2 c and d This of would increase the cost to consumer of certain imported goods. However, it is unclear as to the amount by which costs would increase and, particularly, affect low earners. More research would be required in this area.

The CBAM would undoubtedly impose a cost and administrative burden on EU businesses. The degree of impact on EU industries depends on their supply chain. It is likely to have a disproportionate impact on importers. However, we would dispute that the burdens are 'unnecessary' given the huge potential impacts that unmitigated carbon release is likely to have on the world and its economy.

It would also be an incentive for European businesses to innovate with new technologies – ultimately improving the EU's global competitiveness in an important future business area. It is possible that this innovation could be further enhanced with targeted investment incentives, compliant with current state aid rules.

Justification and objectives

Question 3a – We believe that carbon leakage is a reality - as a side effect of other business decisions. Manufacturing has shifted globally in the last 30 years. Many of the new manufacturing countries (such as India and China) are still heavily dependent on coal to power their manufacturing processes – with high CO₂ emissions and high levels of localised pollution. Even if the relocation of manufacture was primarily to save costs, it has led to carbon leakage. As the EU increases the cost of carbon, it is possible that carbon leakage will become a more relevant factor for businesses in considering moving manufacturing to regions with lower emission standards.

However, studies¹² do not indicate that carbon leakage has occurred as a direct result of the introduction of the ETS. On the other hand, a study has indicated that there may have been carbon leakage as a result of the Kyoto Protocol. Clearly this is an area that requires further research and, had we been given the choice, our response would probably have been ‘neutral’ for this question.

Question 3b – Given the limited scope of the current ETS and the amount of free allowances still granted, we believe that current measures to limit the **current** risk of carbon leakage are more than sufficient.

However, we feel that in future the ETS should be more ambitious.

Free allocation of allowances was arguably necessary in the early stages of the ETS to give existing businesses with high CO₂ emissions a chance to adapt their processes without imposing too damaging a burden. This also applied to the ability for Member States to compensate the highest electricity consumers through domestic state aid, under Art 10a(6) of the Directive.

However, auctions of allowances, combined with the periodic reduction of the allowances available, is a better way to stimulate genuine reductions in CO₂ emissions. Continuing free allocation of allowances gives some producers continued windfall profits from selling their excess allowances. These excess allowances can then be used by highly polluting industries (or regions) to continue to emit pollutants at existing levels and make no efforts to improve their processes.

Consequently, even though there has been a move from free allocation to auction of allowances, we believe that the current ETS is not stringent enough to achieve the EU’s climate ambition.

Question 3.c-f - As mentioned in the answer for 3.b, measures to address the current risk of carbon leakage are more than sufficient and would probably remain so until the scope of the ETS is raised dramatically.

The ETS currently allows additional highly energy intensive industries a higher share of free allowances to avoid production being moved to third countries. However, as mentioned above, free allowances provide only limited incentives (such as reducing emissions so that excess allowances can be sold to make a profit) to invest in new technologies or processes.

It could be argued that an increased tariff on the import of equivalent products created from high CO₂-emitting power is a better way to ensure both that manufacturing capacity is not moved to 3rd countries with lower standards, and that overall emissions are reduced globally. Also, if energy prices fall, as could happen again, the ETS will be less effective in reducing overall carbon emissions unless the availability of allowances is cut considerably.

To affect consumer behaviour, the scope of the ETS would have to be broadened considerably. This increases the risk of a trade war or retaliatory tariffs – which could potentially be reduced if the CBAM

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https://ec.europa.eu/clima/sites/clima/files/ets/allowances/leakage/docs/cl_evidence_factsheets_en.pdf

² <https://www.sciencedirect.com/science/article/abs/pii/S0095069617306836>

is designed to be compatible with WTO rules. The most obvious way of ensuring WTO compatibility would be to apply equivalent tariffs within the EU itself, making the tariffs non-discriminatory for imported goods.

It is also recommended that the EU introduce a narrow corridor for its allowances such that the lower level of the corridor represents the base tariff. This would give businesses a chance to plan for the potentially large increases in allowance price that would be required if the EU is truly ambitious in its GHG emission reduction targets.

Question 3.g Current thinking seems to be that a mixture of regulatory measures and tax measures is the best way to tackle GHG emissions. Emissions allowances (effectively a tax on energy consumption), and the trade thereof, can help reduce overall emissions. However, the effectiveness would be improved if the allowances are obtained by auction and the overall cap is reduced on a regular basis.

Emissions allowances also allow the movement of capital globally and this can be useful in helping developing countries meet improved emissions standards.

However, CO₂ emissions as a *stock*³ problem require a global solution. China, the US, the EU and India individually could make significant impacts on the build-up of GHGs but a global agreement on emissions is required. Without full global coverage, emissions trading cannot provide the entire solution to slow down the increasing stock of CO₂ in the atmosphere - so regulation can play a role in 'incentivising' countries or regions that won't agree to global caps to deal with their emissions.

This would especially be the case if the adjustment mechanism were to eventually incorporate embedded carbon in all products, rather than the relatively small range of primary products currently covered. This would effectively create a mechanism that captures CHG emission performance in a codified set of price parameters that makes it easier to compare like products, thereby changing consumer and producer behaviour.

Question 4 - In the context of a 'cap and trade' system (rather than regulation), such as the ETS, the CBAM is essential both to reduce overall global CO₂ emissions and to stop leakage to 3rd countries. However, the CBAM would not necessarily lead to a reduction in EU emissions (if this is meant as a geographical rather than economic boundary) as these would reduce in the EU if carbon leakage were to occur and production switched to third countries. The CBAM is important in the context of reducing the **global** stock of GHGs.

In respect of sub-question 4.c, ensuring a level playing field, it would quite difficult to fine tune this as it would need a detailed analysis of third country production costs and the degree to which these may have been reduced by laxer GHG emission standards.

Question 5 - All these factors rank as important overall, but we believe the priority must be climate change - energy taxation is important element of tackling this. The other factors are important, but it is not immediately apparent how some of them could be factored into the CBAM. This is particularly the case with the circular economy, which is concerned with returning materials back into the consumption cycle rather than with direct energy consumption.

The Carbon Border Adjustment Mechanism in detail

Question 6 As mentioned, a CBAM is an essential add-on to the ETS but is not an end in itself – it is more of an anti-avoidance tool. However, it is likely to be complex, difficult to define, monitor and police. This complexity would further increase if it is eventually expanded to cover all industrial and

³ i.e. it is the build up of a stock of GHGs in the atmosphere, which remain in the atmosphere for a long time even if all further GHG emissions were to cease, that is the cause of global heating. In this respect, it differs from pollution, which is a *flow* problem – if the flow is stopped the problem would stop (apart from residual clean-up)

consumer products – rather than just the primary industrial products it covers today. We believe that further research is required to determine the level to which differences in energy prices are a key element in changing behaviour.

The issue with **question 6.1.1** is that there is no fixed proposal to base the answer on – it refers merely to a *'selection of products whose production is in sectors that are at the risk of carbon leakage'*. Our answer assumes some expansion in the scope beyond those industries currently affected by ETS but falling short of applying it to all industrial and consumer products. The potential benefits increase as the scope increases.

However, the potential for additional administrative burden and the need for compliance monitoring also increases as the scope is expanded.

If the scope is restricted to carbon intensive industrial products, some additional burden on all parties can be expected but it is unlikely to affect the majority of producers and importers and few SMEs.

If, however, the scope of the mechanism is expanded to cover most or all imported products, the potential benefits in respect of reduced emissions would be maximised but the mechanism would be complex to design and administer and probably prone to mistakes or fraud. It would also affect many smaller enterprises. Of course, this does depend on the design of the mechanism and the effectiveness of any digitalisation of the processes.

There is likely to be opportunity for error and fraud in labelling and carbon pricing, particularly if a third country does not agree to the imposition of the tax.

We anticipate that the CBAM would be particularly burdensome on:

- EU importers
- 3rd country exporters
- Businesses with complex supply chains – especially if they make complex products with elements sourced from multiple countries globally.

This would increase as more and more consumer products are brought within the scope.

Question 6.2 and 6.2.1a - Research indicates that such schemes can be beneficial and there is some linkage in data between the introduction of the ETS and a fall in EU emissions.

However, the ETS did initially have some serious issues, such as too much free allowance, susceptibility to VAT fraud, windfall profits and issues of pricing in falling energy markets. Our support for the ETS is predicated on the assumption that many of these problems have largely been rectified and the ETS will be further improved – by, for example, further reducing the free allowances over time (from the current level of around 40%) by increasing the proportion of allowances that are auctioned.

Question 6.2.c – This option has the potential to be quite burdensome for multi-national businesses who may have to participate in several national \ regional schemes and offset costs arising in different markets.

Question 6.2.1d – This answer is based on the current scheme. This still suffers from the legacy impacts of some Member States giving their highest energy users excessive free allowances, providing little incentive to de-carbonise. Free allowances still represent around 40% of total allowances, with the balance being auctioned. Circumvention can be reduced by successively decreasing the amounts of free allowances.

The ETS has also been prone to VAT fraud based around the registries where the allowances are recorded and traded. A reverse charge facility was introduced in 2015 to cut down on VAT fraud. However, despite certain Member States being warned very early as to the potential for fraud, Member States were late in implementing the reverse charge and it is uncertain whether it has been successful.

Question 6.2.1e - The answer is on the basis of balancing the past weaknesses (https://www.eca.europa.eu/Lists/ECADocuments/SR15_06/SR15_06_EN.pdf) of the ETS with improvements made and further improvements that could be made.

Question 6.4.1 - This response assumes that if the carbon adjustment is reflected through the price of all goods to consumers, then they may 'vote with their wallets' and choose the less carbon intensive option. However, this effect would depend on the elasticity of demand of the product, the availability and pricing of carbon neutral alternative, the amount of the price increase and how aware consumers are of the reason behind the price increase.

Some element of additional social support may be required to compensate the poorest households for price increases, depending on the scope of the products affected by the CBAM. A detailed impact study must be undertaken on this issue.

Question 6.4.2b to d - It is difficult to answer these questions without more solid proposals on the scope of the mechanism and how it would be implemented.

Our response is on the assumption that establishing and monitoring the mechanism would be complicated – especially in determining the amount of embedded carbon, if this were to be in scope. Some of the administrative burden could be alleviated by 'bundling' the mechanism with the existing customs and/or VAT systems (such as One Stop Shop) – at least for reporting purposes.

We have assumed that the tax would be fully creditable for exports from the EU.

Question 6.4.2e - Again, this answer depends how the carbon tax would be applied in practice. For example, using thresholds to determine the scope of the application of the CBAM could introduce cliff-edge effects around the thresholds, requiring anti-avoidance measures and monitoring.

Question 7 - Ideally, all products in the supply chain should be subject to the same rules to avoid market distortion and avoidance \ evasion. Also, global focus is still primarily based around primary CO2 emissions. Measures taken internationally, regionally and nationally fail to take into account the inherent CO2 output 'inbuilt' in finished goods. This is a major limitation of the scope of the current measures, as inbuilt GHGs are a significant issue.

However, it will be very complex to build these calculations into the entire supply chain – especially if some form of international agreement is sought. SMEs, in particular, will need time to adapt and will need access to readily available sources of information before they are brought within the mechanism. Therefore we have chosen choice 'iii' for **Question 7.c**.

Emissions from the international transport of goods should be included in the CBAM – although this will undoubtedly add to the complexity of the mechanism and, depending on the mode of transport, potentially result in increased prices for consumers.

Question 8 - In principle, the CBAM should cover all sectors and activities that could suffer from carbon leakage. Practically, however, it would be more appropriate in the initial stage to limit it to the highest risk sectors and limit its impact on the entire supply chain until smaller entities are able to

prepare. With application to the entire supply chain, a ruling process would probably be required to deal with disputes – especially in the absence of international agreement.

This is the rationale behind our answers of ‘somewhat agree’ to **Questions 8.1.a** and **8.1.b** and somewhat disagree to **Question 8.1.c**. Ultimately, the CBAM should cover all products, but focusing on those covered by the ETS or those with the highest risk may be the best way to proceed in the short term. This would increase the complexity of the scheme initially but would give smaller businesses more time to prepare.

Specific implementation issues

Question 10

International standards on the carbon content of products would be the best solution but this would be extremely politically difficult and very complex technically. Ideally these international standards would be detailed and cover the entire value chain and include a factor for transport related emissions. Many emissions that are embedded in finished products are not accounted for under current Kyoto protocols, so most products do not have the cost of all their climate related externalities built into their purchase price. Consequently, there is reduced incentives for producers to de-carbonise their production process as the costs of externalities are opaque to consumers.

Europe, through the development of the CBAM and its processes, could play a leading role in developing such standards and promoting their adoption internationally.

Question 10a to 10f - The preferred ranking for both direct and indirect emissions would be:

1. International standards – in an ideal world, international standards would increase effectiveness and compliance and reduce the chance of trade wars but will be very difficult to achieve, even in the long term. This could include global product benchmarks, but these are likely to require constant updating and monitoring and may prove impractical for complex supply chains.
2. Using third country measurements (based on implementation of the Kyoto protocols) – this could be lower or higher depending on the degree of strictness of these benchmarks. This would require an initial process to establish the level of equivalence together with constant monitoring of changes in the third countries. It could, however, differentiate between 'high-emitting' countries and 'lower-emitting' countries for the individual products and thus result in more transparency on the impact of emissions on prices
3. More comprehensive European standards to fill some of the inconsistencies and lacunas in the current ETS and to incorporate indirect emissions
4. Using the existing ETS as a template – an easier solution but potentially lacking in effectiveness. It is also likely to require a dispute resolution \ ruling process at EU level. Also, in principle, if free allowances were to be abolished, the current benchmarks would no longer be relevant.
5. Global emissions factors for indirect emissions are not supported as they fail to properly take into account the efforts that specific countries \ regions have made to reduce their emissions below the global average.

Question 10.g – i - The preferred ranking would be:

1. A method of tracing the build-up of emissions across the supply chain – this would be the most accurate and comprehensive option but is likely to require substantial investment in developing the system and automating processes

2. A factor covering direct and indirect emissions based on local emissions factors – this is likely to be less accurate than tracing but could be easier to design and implement and may be easier for SMEs to deal with
3. Giving importers the opportunity to demonstrate how the product was manufactured – this should be included as a fall back but likely to be expensive for both the importer and competent authorities to administer. It could also potentially lead to more opportunities to circumvent the mechanism. It would also require a legally binding ruling process.

Question 11

Depending on the scope of the CBAM, the mechanism could be highly susceptible to avoidance and fraud so some level of third-party assurance would be invaluable, at least for the largest producers \ importers.

Self-certification with occasional audit would increase the risk of avoidance and should be limited to smaller entities or those in sectors with less risk of carbon leakage. The self-certification process should also include a legally binding rulings procedure to protect taxpayers.

As we are discussing an import tariff, it would make sense to operationalise, as far as possible, the CBAM certification through current EU customs processes.

Question 12.

We have assumed that this question relates to the possibility of retaliatory measures by third countries in response to the unilateral introduction of the CBAM by the EU. In the absence of international agreement, a rebate could prove essential.

Question 13

Depending on the scope and rate of the CBAM, we believe that there would be considerable incentive to circumvent the CBAM, perhaps with the tacit support of some third country governments.

Question 14.1a and b - In principle all imports should be treated equally, which would indicate that 'strongly agree' is appropriate. However, there is a good argument that developing countries should be given time to make improvements - unless it is obvious that they are seeking direct foreign investment to help businesses with carbon leakage or are systematically being used to re-route products from other third countries that do not benefit from EU exemptions. Hence our choice for 'somewhat agree' for both questions.

Question 14.1c and d - If 3rd countries have verifiably equivalent or better measures, they should be exempt from the CBAM. If their standards are higher, an adjustment credit would benefit consumers and should drive the EU and businesses to improve their standards. However, for administrative and monitoring purposes, there should be a consideration of materiality in determining whether a credit is applied.

Potential impacts

Question 15.1 Economic impacts

Question 15.1a - The potential increase in costs of produced raw materials as a result of the CBAM could increase prices for distributors and end users. There is also likely to be a considerable burden in dealing with CBAM requirements. However, if this additional tariff were to lead to a reduction in other existing tariffs, our answer would be 'somewhat disagree'.

Question 15.1b - To a large degree, its impact on EU industry will depend on the nature of the mechanism, its exemptions etc. However, in the short term, we believe that the CBAM is likely to have a negative impact on EU businesses - due to increased processed material costs, additional administrative burdens and the impact of possible retaliatory tariffs by third countries. In the long term it will hopefully incentivise them to invest in new technology thereby helping to develop a long-term competitive advantage – i.e. in new forms of power generation, carbon sinks etc

Question 15.1c - in the short term, CBAM could lead to retaliatory duties being imposed on EU imports by countries with more lax regulations – hence short-term difficulties for exporters dealing in open markets where there is wide access to competitors. Arguably, in the long-term, it could help exporters as other countries catch up with emissions targets, but local producers don't have the same level of expertise and experience as those in the EU. Its impacts could also be reduced on exporters if there was an equivalent rebate mechanism for exports to third countries, as is the case with VAT.

Question 15.1d – g – The CBAM should help with all these objectives but it is mainly an anti-avoidance tool related to increasing the scope and the rate of the ETS, rather than a primary measure. Consequently, it needs to be seen in the context of broader regulatory measures and incentives to adopt carbon neutral energy and production processes. Also, our response to sub-question d. would be 'neutral' if the option was available. Our response to sub-question g. assumes expansion of the scope of the ETS as, currently, sectors exposed to competition get free allowances.

Question 15.1h - This answer reflects the possibility that some businesses may seek to avoid the impact of CBAM by shifting production processes, such as smelting, to third countries with lower environmental standards. However, the degree to which this would happen is uncertain and could, to some extent, be mitigated by monitoring. However, if full production is based in 3rd countries the CBAM could be avoided unless it covers all products and not just primary production – i.e. finished goods

Question 15.2 Environmental impacts

The CBAM should help with all these objectives but it is mainly an anti-avoidance tool rather than a primary measure. Consequently, the degree to which it will help is questionable, but it is reasonable to assume that it will have some impact on reducing total global emissions – as the ETS appears to have done.

Question 15.3 Social impacts

The social impacts of the CBAM are quite difficult to gauge. The proposed CBAM mostly covers primary production – extraction, steel production, etc. It will increase costs of manufacture. However, as many of the outputs affected will be involved in the production (ultimately) of consumer products, which are not all necessities, it may not impact the poorest members of society to the same degree that, for example, the increased taxation of light and heating would do.

However, it does depend on the scope and if it were to be extended to food production, for example, the need for increased social benefits for the lowest earners would be greater. As mentioned previously, a detailed impact study must be undertaken here.

Sincerely,



Florin Toma
President



Olivier Boutellis-Taft
Chief Executive

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