GREEN
EUROPEAN
JOURNAL

# The Environmental Bias of Trade Policy

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December 22, 2021

**Despite the climate law, the Fit for 55 package, the emission trading market, and all the climate ambitions the European Green Deal comes with, the EU still offers carbon-heavy industries an implicit subsidy to pollute. How? Through the environmental bias of its trade policy: trade regulation helps dirty industries who can lobby on obscure details without much opposition. The process creates a global subsidy on pollution that weighs against efforts to mitigate and prevent climate change.**

While the speed of European Union climate action is debatable, the EU's legislative push to decarbonise stretches back decades. Putting a price on carbon emissions is a major part of such efforts. First enacted in 2005, the Emissions Trading System (ETS) was the first international carbon market in the world. It remains the largest, covering all EU countries plus Iceland, Liechtenstein, and Norway.

In this system, factories, power stations, and other plants buy or receive tradable emissions allowances. At the end of each year, these installations need to surrender enough allowances to fully cover their emissions. Paired with a set cap on total emissions that diminishes over time, the mechanism forces installations to progressively reduce their emissions.

While the system functions well in the European framework, it also poses the risk of carbon leakage – namely that carbon-intensive production will move outside the EU, only for the output to be imported back into the European market at a lower price. Hence, EU proposals for a carbon border adjustment mechanism (CBAM) were first put forward in 2019.

Formally proposed by the Commission in July 2021, the CBAM will apply to the iron and steel, cement, fertiliser, aluminium, and electricity generation sectors. A tax on imports equivalent to any difference in the level of carbon taxation between the EU and other countries will ensure that domestic products and imports remain competitive. More broadly, the CBAM falls under the ETS system reform. If the current ETS scheme puts a price on every ton of $CO_2$ emitted by the electric, aviation, steel, and chemicals sectors, the reform aims to extend it to marine and road transport, shipping, and heating fuels. The CBAM also addresses the issue of free ETS credit allocations – emissions permits granted for free to carbon-intensive industries – which currently represent an implicit subsidy to pollute, and are bound to be phased out in 10 years' time.

Under the newly proposed scheme, EU importers would need to buy carbon certificates corresponding to the carbon price that would have been paid had the production taken place in the EU. If a non-EU producer has already paid a carbon tax in a third country, the

EU importer can deduct the corresponding cost.

The proposal is supported by industrial trade unions. "CBAM is a must-have to keep energy-intensive industries in Europe while decarbonising. A situation where all steel or chemical products are produced outside of Europe in much more carbon-intensive ways would be bad economically speaking but also a disaster for the environment" explains Benjamin Denis of IndustriAll. However, this position of trade unions also reflects the ambiguity that leads to the environmental bias of trade policy: concerns about competitiveness can serve as a rhetorical basis to lobby against the environment.



## Trade policy and decarbonisation

Writing in the pages of *The Guardian*, correspondent Jennifer Rankin predicted that the EU's Fit for 55 proposals would be met by a "frenzy of lobbying" from campaigners, business groups and non-EU countries. While the risk of carbon-intensive stakeholders watering the reforms down is real, it is not the only issue. There is a further environmental bias of trade policy that the current legislative package does not tackle.

Let's assume that the mechanism works perfectly. One would think that incentives for firms are now in line with the societal need to reduce emissions: since firms pay the CBAM amount if they want to import dirty goods into the EU, higher costs will lower the supply of the dirty goods. Not quite, because the mechanism only covers the tip of the iceberg; a significant part of total costs remains underwater.

Research from the economist Joseph Shapiro demonstrates how environmental policy cannot afford to overlook the details of trade policy. As Shapiro explains, import tariffs and non-tariff barriers are "substantially lower on dirty than clean industries" in most countries. Dirtier industries might face higher carbon costs – which means they are punished by environmental policy – but they pay less in tariffs – which means they are rewarded by trade policy. "This difference in trade policy creates a global implicit subsidy to $CO_2$ emissions in internationally traded goods," writes Shapiro. This subsidy is global because all trading partners benefit from cheaper goods, not just the origin country.

*The carbon border adjustment mechanism only covers the tip of the iceberg*

To bullet-proof climate policy, the other incentives to pollute that come from trade policy need to be tackled. Here is where non-tariff barriers become especially important. "People tend to focus on the tariff part of the paper – but most of the effect is driven by non-tariff barriers", Shapiro tells us. Non-tariff barriers are mostly regulation, for example, the quality of a certain product. We can then say that non-tariff barriers are the very source of this environmental bias. Lobbyists love non-tariff barriers because, compared to tariffs, they are more specific, technical, and harder to analyse. Worst of all, the CBAM does not cover them, as it only tackles the differences in carbon price (or absence thereof) between the EU and non-EU countries. In other words, it focuses on the tariffs linked to greenhouse gas emissions, while the wider regulatory framework for carbon-heavy products is out of the picture.

Which industries benefit from this environmental bias of trade policy? All else equal, the biggest culprits are those closer to raw materials and further away from final consumption goods; firms that are located upstream in the production chain. For example, the EU imposes a non-tariff barrier on steel in the form of performance and quality standards. Steel is an upstream industry as many industries use steel as an input. The ideal scenario for firms operating downstream in the value chain – all the industries using steel as input – is for it to be as cheap as possible. Therefore these firms lobby for lower non-tariff barriers on steel: lower regulation, standards, and quotas. The further away a product is from final demand, the easier it is for lobbyists to push for changes on apparently small, boring, technical details, which greatly matter for the environment.

This ultimately means that even if CBAM forces non-EU states to step up their carbon price game, it is powerless in the face of all things non-tariffs barriers related to trade policy, hence propagating its environmental bias.

## Lobbying over trade policy

Shapiro's research shows that cross-border environmental policy needs to take the details of trade policy into account and the trade policy that matters the most is in the hands of lobbyists and concentrated on upstream industries. Due to the technicality of the trading bias, environmental stakeholders face a difficult challenge. Johanna Lehne of climate change think tank E3G explains that, while the dangers of fossil fuel subsidies are well understood, awareness of tariff and non-tariff issues is less widespread.

Closely linked to the degree of awareness are the challenges faced by environmental NGOs making their voices heard at the European level. This might unfold in a variety of fora – from contributing to impact assessments, bilateral lobbying, to responding to public consultations. Although equal access is offered to different stakeholders, not all actors have the same means to promote their views and ideas. Civil society organisations are "often much less well-resourced and have less capacity to engage on a huge number of different legislative files compared to industry lobbyists", explains Lehne. "There is a power imbalance."

Another aspect pertains to what different stakeholders bring to the European table. "As NGOs and civil society organisations, we have a certain role to play in terms of bringing in perspectives from the broader public. But what an industry player brings to the table, especially around the carbon market discussions, is a huge amount of data, and specific knowledge on relevant and oftentimes commercially sensitive technologies," explains Lehne. The European Commission is particularly interested in accessing this form of information.

Looking at the CBAM and EU ETS reform, NGOs felt partially listened to. “Certain industry players won’t be happy with this free allocation timeline. Even though NGOs aren’t happy either, the Commission has made a compromise and they’re recognising the need to increase pressure on these sectors,” says Lehne.

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The proposed legislation comes with weaknesses and strengths. What is commonly considered positive is the commitment to make the proposal compliant with the World Trade Organisation’s trade law, to avoid potential tit-for-tat retaliation. “Certainly, there will be some uncertainties on how to prove that carbon leakage is actually a problem as there isn’t an established methodology, or how to remove free credits for certain industries. But there isn’t clear discrimination against non-EU producers within the proposal”, explains Wilson. Another positive aspect is the presence of a pilot phase from 2023 to 2025, which will give trade partners time to adapt and allow for bilateral talks.

For some, however, the European objective to reduce carbon leakage was seen as an unfair political demand to increase climate ambitions in other countries. European aspirations of climate leadership can be interpreted as a violation of the principle of differentiated responsibility expressed in the Paris Agreement. “The proposal came out in a year that’s very critical for climate diplomacy at the international level.” says Johanna Lehne.

Another issue is that of winding down the free emissions allocations currently granted to European firms. “If you want to implement the CBAM, you have to cut the free allocation, otherwise you have double subsidies for the industries while all the foreign importers have to pay.”, comments Agnese Ruggiero, Carbon Market Watch. For Lehne, the proposal has been a “classic compromise that kind of annoys everyone”, presenting a 10-year timeline with phasing out 10 per cent of free allowances each year as CBAM phases in from 2026. From the perspective of many climate NGOs, this timeline is far too long, and it means extending free allocation into the 2030s. “It’s definitely something that we would want to shorten but having a phase-out timeline does give the industry a push and it definitely sets the direction of travel”, adds Lehne.

Another question that needs to be addressed is how to deal with modest climate goals by developing countries while respecting trade law and entering uncharted territories, like in the case of the voluntary initiative. “Let’s say, a steel producer in Russia is operating outside a policy framework comparable to the producers in the European Union but voluntarily takes measures to significantly reduce or progressively reduce its emissions footprint. Would they be subject to border adjustment?” asks Wilson.

## What’s next for greening trade?

The proposal is now in the hands of the European Parliament and the Council to analyse, amend, and adopt. A first in-depth discussion on how this instrument would work was held at the beginning of September and the negotiations continue.

While the CBAM is a key first step towards eliminating carbon leakage and achieving thus decarbonisation globally, it does not touch those intricate rules of trade policy with their implicit incentives to trade in dirty goods. True decarbonisation and a sustainable and just form of globalisation will require a much broader reassessment of the rules governing international trade. Policymakers need to pay closer attention to how trade policy intersects with the environment through low-quality regulation and standards or unbalanced quotas, for example, and stakeholders need to understand the environmental bias of trade policy. While the reform of international trade governance is painstakingly slow, this time we will need rapid action.

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Published December 22, 2021
Article in English
Published in the *Green European Journal*