A SCRAP GAME

Impacts of the EU Carbon Border Adjustment Mechanism

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Executive Summary

Following the European Commission's initial proposal for a Carbon Border Adjustment Mechanism (CBAM) in July 2021, a mechanism that would put a carbon levy on imports of certain carbon- intensive products from third countries into the EU, Sandbag and E3G released the report *A Storm in a Teacup: Impacts and Geopolitical Risks of the European Carbon Border Adjustment Mechanism*.

That 2021 report raised points made by different stakeholders on the multi-faceted motivations of the CBAM, such as preventing "carbon leakage", driving climate ambition globally, and increasing new revenues internally, as well as some doubts and criticisms concerning legal, administrative and fairness matters. It also showed through scenarios and data analysis that the impact of the CBAM on EU imports of Chinese goods will be very small due to (i) its narrow sectoral scope, (ii) the 10-year phase-in of the system (only fully operational in 2034), including the transitional period during which no fees are applied, and (iii) the proportion of increased costs that will be directly passed on to EU consumers.

Over the following two years, the CBAM underwent a legislative process that led to its formal adoption on 17 May 2023. Some of the uncertainties present in 2021 (before lawmakers agreed on the text) were lifted, regarding, for example, the CBAM's coverage, implementation timeline and governance framework. However, some still remain. It will take another 13 pieces of legislation to hammer out the details of the regulation by 2026, including developing a detailed methodology to calculate the carbon emissions and carbon price of imports. While the CBAM only targets a limited list of products, it will – in its current scope – enable the removal of nearly 50% of the emission allowances currently given for free to ETS-covered installations once it is fully phased-in.

Complementing our previous work, this report takes stock of the legislative situation and evaluates the impact of the CBAM on the EU's main trade partners from a revenue-cost perspective, based on new rules and updated data, with a particular focus on China.

Key findings

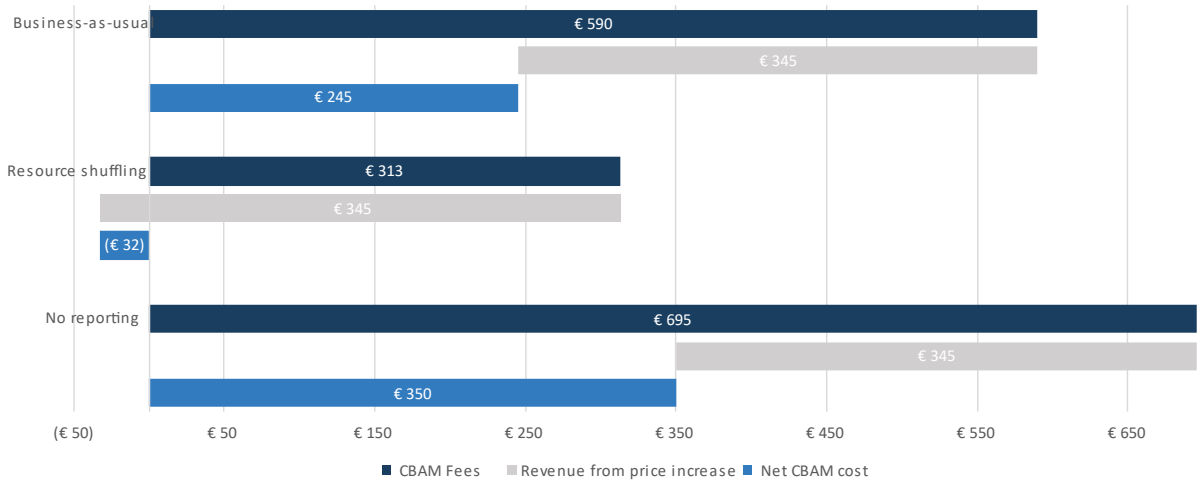
- The impact of the CBAM on the EU's trade partners will partly depend on the way these partners will react to the scheme. The estimated CBAM fees and *net costs* (i.e. CBAM fees minus additional profits resulting from higher market prices) are shown after the full implementation of the CBAM (and the full phase-out of free allocation under the EU ETS).

- If the rules set up for the transitional period remain in force, metal products (included in the list of covered goods) made from recycled materials such as recycled steel and aluminium will be **nearly exempt of CBAM charges**. This report describes a scenario in which non-EU manufacturers circumvent the system by voluntarily exporting only their low-emission goods to Europe and selling their high-emission goods on other markets to enjoy lower CBAM charges – a process known otherwise as "**resource shuffling**". Although the EU has already made clear it would try to prevent such practice, the current rules may not be sufficient to address this risk.

- With the simultaneous phase-in of the CBAM and the phase-out of free allocation under the EU ETS, carbon costs will increase for both importers and EU manufacturers. These additional costs will result in higher prices for products sold in the EU and will likely be directly passed on to EU consumers.[1] In a scenario where non-EU manufacturers engage in **"resource shuffling"**, importers could even manage to profit from the system, by avoiding to pay carbon charges equivalent to their EU competitors while selling their products at the new high prices. According to our calculations, in this 'resource shuffling' scenario, EU importers of Chinese goods would make a **net profit** of €32 million.

- The other scenarios detailed in this report illustrate the cases of unchanged export flows to the EU with the correct application of the CBAM charges ("**business-as-usual" scenario**), and of CBAM charges imposed on imports based on default emission intensity values due to missing information ("**no reporting" scenario**). Our analysis shows that these two scenarios would result in a **net loss** of €245 million and €350 million respectively for EU importers of Chinese goods.

Figure 1: **CBAM fees paid vs. net costs (including increased revenues)[2] for importers of Chinese goods**



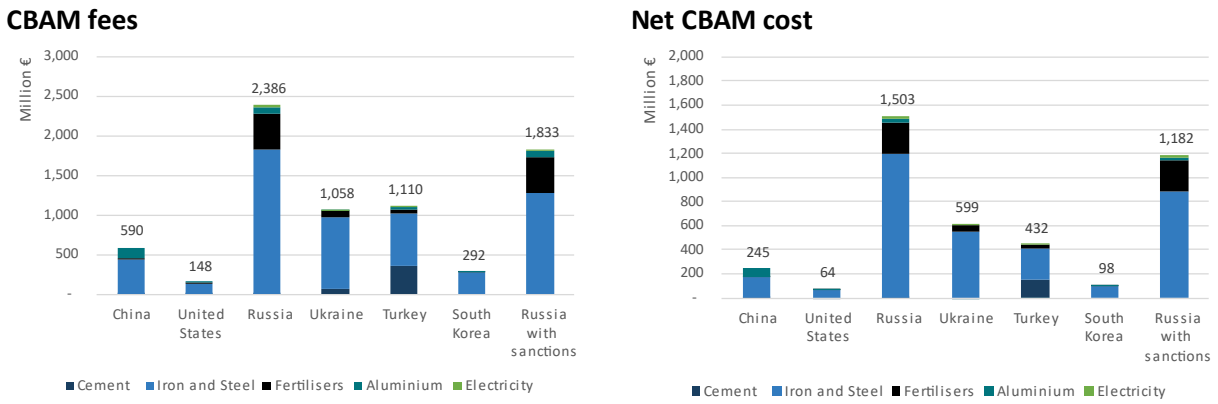
Source: Sandbag, based on data from Eurostat, the European Commission and academic sources

- EU imports from China covered by the CBAM Regulation account for €13.4 billion (2.82%) out of the €474 billion worth of EU imports from China in 2021. In the "business-as-usual" scenario, CBAM fees represent on average only 0.12% of the total value of imports from China. Furthermore, our analysis shows that the impact of the CBAM levy on trade partners will be somewhat limited, since the total net cost will not exceed €1 billion in any single country other than Russia.

[1] The price increase (cost pass-through to consumers) was calculated based on academic (empirical and theoretical) studies.

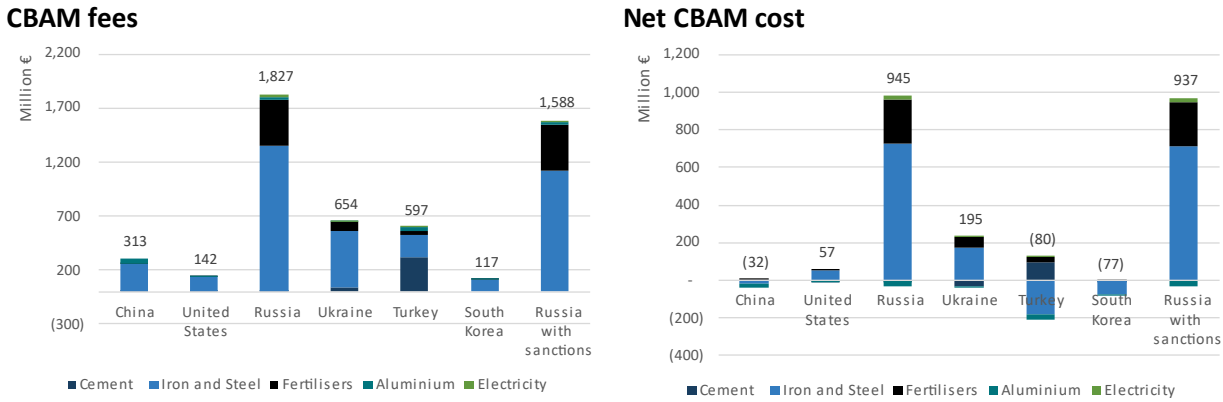
[2] Net CBAM Cost means the CBAM cost minus additional profit made from higher selling prices in the EU; negative Net CBAM Cost means profit.

Figure 2: **CBAM fees and Net CBAM cost for selected trade partners under the Business-as-usual scenario**[3]



Source: Sandbag, based on data from Eurostat, the European Commission

Figure 3: **CBAM fees and Net CBAM cost for selected trade partners under the Resource shuffling scenario**



Source: Sandbag, based on data from Eurostat, the European Commission

Our analysis shows that **the CBAM might hurt industrial manufacturers based in Europe more than those based in third countries**. More specifically, EU manufacturers of intermediary or final goods using more expensive raw materials (due to the end of free allocation under the ETS and CBAM fees on imports) might become **less competitive** than their peers located in third countries, since most **imported finished goods are not covered by the CBAM at this stage** and can be sold on the EU market at no additional cost.

The future of the CBAM is not set in stone yet and some loopholes can still be addressed. The CBAM Regulation was designed to be a moving instrument, with numerous review clauses allowing it to be reshaped and strengthened if necessary. For instance, the rules for assessing the carbon content of imports in force during the transition period allow non-EU exporters of metals to circumvent the system by strategically playing with the scrap content of their goods. However, the European Commission can still address this flaw and apply different rules for the definitive period starting in 2026. The CBAM's flexibility allows the EU to keep its cards close to its chest while trade partners work out how they will respond to it.

[3] The 'Russia with sanctions' bar shows the effect of the economic sanctions and import restrictions imposed by the EU on certain products from Russia since the start of the conflict in Ukraine.