

# Europe's Carbon Border Adjustment Mechanism: the need for an improved dialogue prior to project finalization

## Summary and proposals

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**NOTE**

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The European Union has its back to the wall: it can no longer delay an announced review of the current mechanisms for the "protection" of vulnerable industries, which is necessary to confirm the strengthening of its climate ambition and reform of the EU Emissions Trading Scheme (EU ETS). However, in view of anticipated difficulties on the international stage, the EU must take the lead by being both prepared to listen and flexible, but also by clarifying its intentions—above all, by expressing what it does not intend to do. At this stage, the burden of proof lies with the EU, and it must provide reassurance that its initiative will benefit its trading partners, who are also moving towards neutrality. On such a complex issue, it must scrupulously assess the expected and unintended impacts of the proposed approach and ensure that domestic and international pledges converge on the same expectations.

It is therefore a priority to engage in a more open dialogue with non-EU partners, focusing on four themes:

- *Understanding and responding to the vulnerability of Europe's trading partners*, distinguishing between the real vulnerability of some Least Developed Countries (LDCs) in particular, and the political risk of an argument being used as a rallying cry.
- *Scope of the adjustment mechanism*: in relation to the previous point, short and medium-term objectives must be clarified, bearing in mind that the EU's internal promises, if poorly managed, can undermine diplomatic efforts.
- *Potential attractiveness of an adjustment mechanism for partners that develop domestic carbon pricing*: here the priority should be given to bilateral trade in the first instance, particularly with the United States and China; and at the same time the EU could be clearer in its advocacy of such an approach in international fora.
- *The broader perspective from which countries or regions perceive the proposed adjustment mechanism*. Here the EU must regain control of the trade/environment

agenda, on which it effectively adopts a defensive position: it must strengthen the Green Deal's international dimension, particularly with regard to Africa; and make progress on bilateral trade discussions (and therefore on Mercosur as a priority). The Ambec Commission<sup>1</sup> and the French proposals lay the foundations for negotiations that could become emblematic of the translation of the Green Deal on the international trade scene.

### 1. INTRODUCTION: ANTICIPATING THE POTENTIAL POLITICAL RECEPTION OF EU PROPOSALS

The introduction of the European Union Emissions Trading Scheme (EU ETS) in 2005 quickly triggered debate on the consequences of this mechanism on trade in the affected products (initially primarily energy and energy-intensive industries) and the opportunity to establish compensatory mechanisms. The poor performance of the solutions adopted so far (free allocations, the Linking Directive<sup>2</sup>) and its perverse consequences on ETS effectiveness, along with the changing international context, have given new impetus to the idea of an adjustment at Europe's borders. The European Commission's communication of 27 May 2020<sup>3</sup> integrates this project into the Next Generation EU plan, with a tight timetable (completion by mid-2021).

<sup>1</sup> <https://www.gouvernement.fr/partage/11111-installation-de-la-commission-d-evaluation-du-projet-d-accord-entre-l-union-europeenne-et-le>

<sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32004L0101&from=FR>

<sup>3</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52020DC0456&from=EN>

The reservations, and even opposition, generated among other Member States around ten years ago seem to have dissipated. In the European debate, the introduction of commercial regulations with environmental objectives now not only seems useful, but also legitimate and realistic; and this project is receiving wide support in Europe from the economic community (companies, trade experts), environmentalists and politicians.

There is abundant, well-documented academic output on this subject and its technical dimensions (economic impacts of the ETS on different industrial sectors (trade, profitability, emissions), links between a border mechanism and the ETS, methods for calculating benchmarks, compatibility with the World Trade Organisation (WTO)). While this note does not address all of these debates, it seeks to highlight the fragilities, possible controversies and difficulties that may arise from a complex issue for which there are no clear-cut solutions, and one that has multiple connections with other international issues. The objective is both to identify "risk areas" and to lay the foundations for a more open dialogue between the EU (and/or its Member States) and its partners ahead of future announcements.

Indeed, the issue remains politically sensitive on the international scene, in trade and environmental negotiations, where the EU is exposed to the double criticism of protectionism and unilateral action. These criticisms can of course be partially defused by meticulous design, particularly with regard to WTO rules, to define which sectors will be covered, the counting rules, etc. The political reception will also depend on the narratives that the EU and its Member States are able to impose on their partners, and on their ability to listen (and influence design compromises) to avoid a sense of *fait accompli*. The issue then goes beyond carbon adjustment alone to encompass the EU's entire trade policy, its development policy and its role in the Paris Climate Agreement. However, in proposing its Green Deal, the EU did not give much thought to its political acceptance and its potential impact on its international partners.

## **2. CLARIFICATION OF GOALS THAT ARE TODAY TOO NUMEROUS TO GUARANTEE THE PROJECT'S POLITICAL LEGITIMACY**

At first glance, the case seems clear: European industries that are required to pay for carbon emissions are being penalized in an environment where international competitors are not required to adhere to similar constraints, therefore an adjustment measure would help reinstate fair competition.

Several arguments have been advanced to legitimize this approach to fairness:

A first set of arguments explicitly targets EU trading partners that do not play ball on environmental issues.

- *The first argument, widely used to justify a clear departure from market rules, which has been fuelled by the partial participation in Kyoto Protocol commitments (Annex 1), and subsequently by the exit of the United States from the*

*Paris Agreement (PA), goes thus: faced with countries that fail to make commitments to the United Nations Framework Convention on Climate Change (UNFCCC) (or do not respect them), the EU should impose a realistic policy. This could be retaliation for some, encouragement for others to fall into line, but the argument is only valid if the breach is observed, and can only concern a minority of countries of origin.*

- *A variant of this argument is to extend the approach to all countries that "don't do enough within the framework of the PA". However, because the EU cannot make unilateral non-compliance judgements, this argument is politically highly sensitive and potentially dangerous for Paris Agreement dynamics.*

These arguments are typical of a debate that arose in an era when the dominant thinking on trade was that the introduction of restrictions could only reduce the expected benefits, including environmental benefits, and that any intervention could only respond to "dishonest" behaviour by trading partners. Several Member States continue to take this view today, and the Commission's initiative does not meet with unanimous approval. This argument can also be found in the *European Parliament Draft Report*, para E2, which is soon to be voted on: the Parliament declares itself "concerned by the lack of cooperation of some of the Union's trading partners in international climate negotiations". This is also the rhetoric used by Joe Biden in his campaign by promising to impose "carbon adjustment fees or quotas on carbon-intensive goods from countries that are failing to meet their climate and environmental obligations".<sup>4</sup>

However, this assertive approach is supported by a more consensual narrative, which establishes legitimacy for a border adjustment, based on the European climate leadership, the region's progress in the implementation of ambitious policies (especially carbon pricing), and the need to regulate trade so as not to undermine these efforts (to the detriment of all). The argument does not impose a value judgement on the carbon policies of the countries concerned, but recognizes that under the Paris Agreement, the diversity of situations, ambitions and policy instruments mobilized in practice introduces distortions of competition, which must be rebalanced (level playing field). The old narrative with its focus on third countries is being replaced by a discourse centred on the EU, its environmental project and its conditions for success. It also totally avoids the issue of impacts on the EU's partners.

According to the second set of arguments, three areas of motivation are proposed:

- *Carbon leakage and the effectiveness of EU climate policies:* by reducing the competitiveness of European industries, the EU ETS would induce a shift to products manufactured outside the EU, (potentially) resulting in an increase in emissions.
- *Competitiveness of the industries covered by the ETS:* market losses and reduced profitability would weaken companies

<sup>4</sup> <https://www.euractiv.com/section/climate-environment/news/competition-or-cooperation-eu-us-enter-new-era-of-climate-diplomacy/>

covered by the ETS. Conversely, this economic threat is currently hanging over the implementation of substantial ETS reforms.

- *The EU's carbon and "imported carbon" footprint in goods and services:* as a consequence of trade globalization over the last 30 years rather than the implementation of the ETS, this growing part of its "carbon responsibility" nevertheless impacts on the credibility of the EU's domestic policies and must now be the subject of a political response.

One might think that an abundance of motivation cannot be a bad thing. While the last three proposals seem legitimate, they are based on partially different economic mechanisms that call for differentiated responses, and all raise criticisms and controversies from the EU's partners. The first is certainly the most robust, and yet it limits the scope and promises that can be made within the EU. Conversely, carbon footprint management is rather popular in Europe, but easily instrumentalized to question the effectiveness of domestic policies. Its legitimacy is also highly contested by the EU's trading partners, who are reversing the argument and calling on importing countries to finance industrial transition at home. Finally, if the reference framework is that of the Paris Agreement, then the EU must consider the fact that, formally, its partners are members of the Agreement and as such pursue policies that it must take into account in its rebalancing. As discussed below, by multiplying the areas of legitimacy, the EU makes design trade-offs more complex and in fact weakens its case.

However, it must be acknowledged that communication from the EU and its Member States remains confused. The initial rather assertive discourse, where adjustment mechanisms resembled retaliatory measures, has gradually changed, but remains vague and fluid. The draft report under discussion in the European Parliament thus successively and explicitly evokes all of these motivations without questioning the possible contradictions. While the Commission's communication of May 2020 added to the confusion by stating that this mechanism would provide "a new own resource for the EU budget". The draft under discussion in the Parliament partly corrects this by proposing to split the revenue between financing the transition and supporting vulnerable countries. These countries are already pointing out that this support is part of the commitments of the Paris Agreement, and that it is paradoxical that the EU finances its contribution through a tax on third countries; that, as mentioned above, the EU has so far raised little awareness on the potentially positive effects of the decarbonization trajectory of emerging or advanced economies that have also implemented ambitious policies, particularly ETS equivalents; and especially that the EU project has so far given only cursory attention to the direct, and negative, economic consequences of this project on the most economically vulnerable countries, especially LDCs (in a debate which, as discussed below, cannot separate the border adjustment initiative from other EU trade discussions).

### **3. DESIGN, EFFICIENCY, EFFECTIVENESS AND WTO COMPATIBILITY: TRADE-OFFS ARE POSSIBLE, BUT ALWAYS FRAGILE**

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Numerous design options have been explored over the past 15 years aiming to find the best harmonization of the EU's economic and environmental objectives with WTO rules. While nothing has been decided yet, the options under consideration are based on a linkage with the ETS whereby imports would be subject to the obligation to cover their induced emissions according to their carbon content and to a reference price derived from market developments. The implementation of this mechanism should go hand in hand with ending the free allocation to companies producing on European soil, which still continues in industrial sectors to compensate for the cost differentials induced by the EU ETS. Under these conditions, it would be possible to propose a non-discriminatory mechanism, in compliance with WTO rules.

It is important to recognize that, even after years of debate, legal experts are not unanimous on the issue of compatibility. Or rather that many of them recognize that compatibility cannot be taken for granted whether based on GATT Articles III.2 or III.4, or claiming exceptional treatment under Article XX. The advantage of these extensive debates is that the EU has been able to modify its approach to be better aligned with trade rules. As a consequence, controversial areas are also well understood and known to all. The political conditions for the introduction of the mechanism, the support or divisions that will then prove important in the balance of an issue which, whatever the efforts made to design the mechanism, will always be fragile.

- *Is the carbon content of imports measurable?* To ensure equal treatment of importers according to European rules, the exact emissions at production sites should be quantified in real time. While current projects aim to give importers this opportunity, the implementation raises both capacity and confidence issues, particularly with regard to traceability, and cannot become a rule at this stage. Moreover, this method only provides good coverage of direct emissions from final production sites, and is therefore applicable to energy-intensive commodities, but not to composite goods. As an important option for claiming the "non-discriminatory" nature of the mechanism, it remains difficult to implement, particularly in developing countries, and in practice limits the products concerned.
- *Benchmarks should be used to assess the average carbon content of imports:* the average European emissions method is proposed, which in effect makes the economic argument (to avoid penalizing European industry) the main justification for its legitimacy, but loses its incentive character for the non-EU industries concerned. Having negotiated a set of benchmarks in the framework of the free allocation mechanisms of the ETS, the EU is aware that this is an arduous task, technically always equivocal for the definition of production

methods, but also of product classes (different qualities of steel, cement, etc.), and therefore has a major impact on the competitiveness of industries.

This point constitutes a major weakness in the matter of GATT compatibility, in a unilateral approach, since benchmarks are conventions (and not measures). The benchmark approach creates a risk of discrimination – positive or negative – between imported products that are “taxed” on average reference values, and European products that are “taxed” on the basis of their actual marginal emissions. Exporters to the EU whose actual emissions are lower than the reference emissions would have grounds to criticize the system. The introduction of compensation for the latter on the grounds that they are unduly taxed is a possible solution on paper, albeit with possible overbearing bureaucracy. Many experts are therefore calling for negotiation efforts with the main partners affected at a very early stage.

- *Should the mechanism be restricted to a few commodities, or preserve the competitiveness of all activities?* The impact of carbon pricing is obviously considerable for energy-intensive industries, which are the first to be affected by competitiveness issues. However, if there is a rise in the price of commodities (electricity, steel, cement, etc.) it is the downstream industries (automotive industry, for example) that become concerned about a fall in their market share compared to competing importers. Should the adjustment mechanism therefore be extended to all imports, and at what pace? While this measure seems logical, it is not compatible with the difficulties and precautions identified so far: the definition of benchmarks, which serve as a basis for pricing, does not present the same challenges as that of an informative “carbon footprint”. The task, already difficult for commodities, seems impractical for complex products without being qualified as arbitrary and becoming a source of dispute. By charging tariffs on all imports, Europe would multiply the grounds for conflict and make the task easier for those who already speak of “green protectionism”.
- *Competitiveness issues may also be modified by future ETS reforms*, in particular the integration of sectors such as construction and transport, the integration of these cost components in benchmarks for manufactured products being even more difficult.
- *The issues of competitiveness and carbon leakage also arise on the export market*, since European manufacturers could see a reduction of their overall market share (unless the climatic qualities of their products are enhanced by an increased market price) and, if their production were to emit less, this would result in a substitution by more carbon-intensive products. Solutions are possible (and are being considered by the European Commission and the European Parliament) which ultimately consist of granting an export rebate to European manufacturers, mirroring the tax imposed on importers according to a mechanism similar to that adopted for VAT. The VAT analogy teaches us that the export tax exemption is only acceptable to the WTO if Europe’s customers themselves adopt a VAT on their own territory

(*the main destination*), otherwise this exemption is tantamount to a subsidy. This solution weakens the argument for ending free allowances and opens up a new field of litigation that will have to be addressed: here again, a mechanism restricted to a few commodities will be easier to sell than a generalized export support system.

## **1. POLITICAL RECEPTION OF THE EU INITIATIVE: JUSTIFIABLE CONCERNS, BUT ALSO MISUNDERSTANDINGS, A BREEDING GROUND FOR UNFOUNDED ACCUSATIONS**

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Unsurprisingly, ever since the very first announcements, the EU has drawn strong criticism on this issue, not only from countries but also from international and sometimes multilateral organizations. For many, “free trade” and particularly access to the markets of industrialized countries remains a prerequisite for development; European leadership in the climate field, which is real although weakened, does not in their eyes justify the EU’s imposition of costs on other economic areas, particularly those under development. Moreover, the issue is codified by the Rio Convention (art. 4.8),<sup>5</sup> but it is so instrumentalized that the clause is in fact inoperative.

Nothing in the Paris Climate Agreement formally opposes the implementation of such an instrument. The agreement recognizes the diversity of situations, calls for action by all countries without requiring uniformity or equivalence of effort; but nevertheless enjoins countries to take strong and rapid action that is capable of putting them on the path to carbon neutrality before the end of the century, and proposes a set of procedures based on trust, cooperation and accountability. A narrative based on the idea that trade must not be used as a threat to the detriment of countries that, like Europe, wish to embark on ambitious pathways, can be convincing. On the other hand, a rhetoric of protection (or even retaliation) towards countries described as “insufficiently ambitious” can hardly be unilaterally supported without endangering the dialogue. The European narrative has already been sniped from the sidelines by countries which, like Russia and Belarus, see this as an opportunity to easily rally support (Like-Minded Developing Countries, Gulf countries) for their strategy of obstruction. A poorly managed controversy could undermine diplomatic attempts to re-mobilize Paris Agreement parties towards greater ambition.

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<sup>5</sup> [https://unfccc.int/files/essential\\_background/background\\_publications\\_htmlpdf/application/pdf/conveng.pdf](https://unfccc.int/files/essential_background/background_publications_htmlpdf/application/pdf/conveng.pdf)

## a) Europe and its Member States must therefore mobilize and engage in a more open dialogue with their partners around four themes

- *Vulnerability of Europe's trading partners.* Rhetorically, the adjustment measures are primarily aimed at the major emerging countries, first and foremost China. In practice, studies show that many intermediate or less developed countries, particularly on the African continent, would also be among the most at risk economies, due to their specialization or their lower administrative capacity. This is also the case for nearby countries (Turkey, Egypt, etc.) for which Europe provides stability to certain industrial capacities in counter-cyclical periods. Conversely, European trade with the major emerging countries is more diversified and their capacity to adapt is greater. A distinction must be made here between vulnerability in reality, and the political capacity to make the issue a rallying cry. A country that has not been particularly impacted, can become an advocate; it is therefore in the EU's own interest to engage with a wide range of countries.
- *Perimeter of adjustment mechanism.* Of course, the potential impact depends primarily on the number of countries actually concerned, and therefore on the perimeter envisaged by the EU: should it be reduced to a few commodities such as steel, aluminium and cement? Or gradually extended to all EU imports, including agricultural products? The anxiety and occasional aggression that characterizes the discourse is all the more acute as the European project remains vague on this subject, with some calling for it to be strictly limited to energy-intensive industries, while the first version of the European Parliament's draft calls for all trade to be covered in the near future.
- *Potential attractiveness of an adjustment mechanism for partners developing domestic carbon pricing.* Turning an adjustment mechanism into a trade regulation tool, not only at the borders but also within "pro-active" clubs (where the carbon price can vary, in accordance with the Paris Agreement), enables the deployment of this approach in a different and less stigmatizing political perspective.
- *The broader perspective from which countries, or regions, perceive the proposed adjustment mechanism.* Following the difficulties associated with the Mercosur agreement,<sup>6</sup> the EU is trying to improve the way it takes environmental issues into account in its bilateral agreements, particularly by refuting protectionism lawsuits and including trade in a transformative vision of exchange between the economic areas concerned (Cremers *et al.*, 2021). However, the Green Deal, which according to the President of the Commission Ursula von der Leyen is the EU's "man on the moon moment", gives little attention to the international dimension; and the new Neighbourhood, Development and

International Cooperation Instrument (NDICI), through its priorities and budgets, is in line with historical continuity. By strongly linking it with the border trade mechanism, Europe is muddying the waters and seems to want to carry out its transition in isolation, instead of proposing a set of measures to its partners (in terms of trade, development and cooperation, and investment) that are aligned with the Green Deal's domestic objectives. The adjustment mechanism itself may be accompanied by investment support measures, or capacity building measures, but these will only be of value if they are supported by a broader framework.

## b) Clarifying intentions, both externally and internally

This diplomacy is not only a work of conviction and communication. Of course, the EU and its Member States must be clear about their climate ambitions, the difficulties of unregulated trade competition that may be encountered, and the global (and not only European) consequences of constrained European action. But it must also seek to position, at least partially, the design of the specifications of an adjustment mechanism in a more open and cooperative framework. Finally, it must integrate the parameters of its international discussion into its design choices and clarify its intentions. On this issue, a tension is emerging, which will lead to major difficulties if it is not quickly brought under control: experts agree that compatibility with WTO rules, the possibility of finding common ground on the necessary counting conventions (see benchmarks), and minimizing the impact on least developed countries, go hand in hand with a strict limitation of the scope to energy-intensive commodities. These are unquestionably the products most associated with major competitiveness issues (the cost of carbon can equal the added value on certain products) and for which the risk of environmental leakage is real and proven. Conversely, increasing the scope dilutes the argument: the impact of a carbon price – excluding international transport – on manufactured goods is limited, and is a secondary factor in the location of activities and therefore on the environmental dimension. However, the design becomes complex, the transaction costs become significant, the risks of non-compatibility with GATT increase, and the number of countries and actors impacted are more than proportionally amplified.

However, the instrument's popularity in certain European countries and economic circles is due to the fact that it seems to run counter to an unproven thesis, although one that is continually used to curb environmental action: that of the loss of global economic competitiveness of European economic actors, which would also explain the growth of the EU's carbon footprint. This conservative discourse has gradually evolved towards a more consensual notion: industry is ready for change, provided that it is protected against unfair competition; in the meantime, we must be realistic. Built around the ideal scheme of a single carbon price before COP 21, this discourse has since been reshaped around the concept of border adjustment, extended to all trade. However, in the short and medium term, such a model could well prove to be

<sup>6</sup> See IDDRI's study: <https://www.iddri.org/en/publications-and-events/study/future-eu-free-trade-agreements-european-dialogue-light-eu-mercotur>



as utopian as the idea of a global carbon price. By endorsing this thesis, as the European Parliament is doing, or even by allowing it to prosper, the EU risks deadlock: difficulty moving forward with a project that extends to all trade; and an inability to satisfy potentially illegitimate, but mobilizing, demands for economic protection. Europe has already been a victim of this headlong rush when the system of allowances for "exposed industries" was introduced. If its internal debate and external consultation are inconsistent, it could lose out on both fronts.

It should be noted that a number of European economists have proposed other approaches (consumption tax combined with a proportional allocation on the ETS) which, *by design*, impose the same environmental regime on domestic and imported goods, without risk with regard to the WTO and allowing downstream sectors to be taken into account. In the absence here of a detailed discussion on its merits and limitations, it is nevertheless worth noting that although this approach has interested experts, particularly from industry, it has been unable to mobilize public or private decision-makers. Is it possible to think that, by not discriminating against product origin, it lacks the fundamental characteristic of appearing to be a shield at Europe's borders?

### c) The United States, a potential ally?

The new Biden administration didn't take long to make its mark, by adopting the opposite stance to that of the Trump years, on domestic, international and multilateral fields. We know that Biden, as a presidential candidate, showed a certain, albeit moderate, willingness to adopt a proactive stance on climate change, and that his positions have notably reassured business circles of the need to provide some form of trade regulation for countries that don't play ball.

For now, the new administration seems to favour a pragmatic and sectoral approach to climate policy, relying if necessary on the Environmental Protection Agency (EPA), and on an instrumental federal approach such as those discussed in the House of Representatives or Congress in the 2000s. The recent EPA leadership appointment confirms that the Democratic Party has, at least temporarily, abandoned the path of economic instruments in the face of arguments of social discrimination, which is obviously a game changer on the trade issue. Indeed, China remains the major concern, and the new administration may be more in line with the previous one on this issue.

The US, however, is also concerned about the European initiative and its timing. Moreover, in seeking to regain its position and credibility on the international stage, the country is clearly concerned by the possibility of finding itself confronted with a *fait accompli* where it is left outside of a possible EU "free trade area" with a few close partners, on the basis of criteria that it would not have negotiated. Although not necessarily an ardent supporter of the formal approach pursued by Europe, the US is mobilized on the subject and is agnostic regarding the tools at its disposal to impose environmental constraints on trade. As their approach and procedures are not so far removed from European objectives, it would seem appropriate to start a discussion

without delay, and also without any preconceived ideas about their adhesion.

## CONCLUSION

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Reinhard Quick, Professor of economic law, concluded in a recent article: "Saying it will not work is not acceptable as little as the wishful thinking that the carbon border tax will be made WTO-compatible".<sup>7</sup> The European Union has its back to the wall: it can no longer delay an announced review of the current mechanisms for the "protection" of vulnerable industries, which is necessary to confirm the strengthening of its climate ambition and reform of the EU Emissions Trading Scheme (EU ETS). However, in view of anticipated difficulties on the international stage, the EU must take the lead by being both prepared to listen and flexible, but also by clarifying its intentions – above all, by expressing what it does not intend to do. At this stage, the burden of proof lies with the EU, and it must provide reassurance that its initiative will benefit its trading partners, who are also moving towards neutrality. On such a complex issue, it must scrupulously assess the expected and unintended impacts of the proposed approach and ensure that domestic and international pledges converge on the same expectations.

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<sup>7</sup> <https://ielp.worldtradelaw.net/2019/10/guest-post-a-carbon-border-tax-or-a-climate-tariff.html>

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