

Analysis of the Legitimacy of Carbon Border Adjustment Mechanisms and China's Legal Response

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Abstract. Carbon Border Adjustment Mechanism (CBAM) (has been established as the world's inaugural climate-related trade regulatory measure. The imposition of levies on carbon-intensive products entering the European Union (EU) market is intended to prevent carbon leakage and serve as a complementary scheme to the EU Emissions Trading System, thereby ensuring a level competitive playing field between domestic and foreign enterprises. However, it has been alleged that this practice may potentially contravene legal principles. The present paper employs a dual-pronged approach of literature review and legal text analysis to elucidate the conflicts between CBAM and the 'common area principle' in climate governance, as well as its inconsistencies with World Trade Organization (WTO) and most-favored-nation (MFN) treatment principles. The proposal sets out China's response strategies from both domestic and international perspectives. Internally, the strategy involves refining the legal framework for carbon markets and exploring the potential for domestic carbon tax legislation. Externally, it advocates for the effective utilization of the WTO dispute settlement mechanism to safeguard the legitimate rights of export enterprises. The objective of this paper is to furnish a reference point for China's response to CBAM.

Keywords: CBAM, climate governance, WTO regulations, Chinese strategy.

1. Introduction

CBAM emerged as a response to the challenge of effectively mitigating carbon leakage in contemporary international trade and reducing carbon emissions. However, this system, which leverages trade measures to coordinate national climate policies, carries inherent tensions and irreconcilable conflicts between legal rules across different domains, which is also the root cause of CBAM's legitimate disputes. It has been posited by certain scholars that the CBAM is a win-win measure for both climate governance and international trade [1]. However, some opponents argue that the CBAM represents a novel manifestation of trade protectionism [2]. There are also divergent views on the matter with a cautious stance maintained by some scholars, arguing that it remains uncertain whether the general exception clause can be invoked to mount a legitimacy defense [3]. The present paper focuses on analyzing the compatibility of CBAM with multilateral rules. Drawing upon an analysis of CBAM's legitimacy challenges, it puts forward a Chinese approach that offers valuable insights for other nations seeking to design and implement climate trade measures within the international law framework. Such measures should employ technical tools in a lawful and compliant manner to achieve coordinated development across multiple sectors.

2. The Legitimacy Controversy of CBAM and Conflicts with Relevant Principles

Concerning the legitimacy of CBAM within the international climate convention framework, CBAM may constitute a violation of the principle of Common but Differentiated Responsibilities (CBDR) under the United Nations Framework Convention on Climate Change (UNFCCC). It is evident that by leveraging CBAM to export the EU benchmark on a global scale, developing countries are susceptible to censure for their comparatively lenient domestic emissions reduction policies [4].

Regarding the contention surrounding the legitimacy of CBAM in the context of the MFN treatment principle, as outlined in this report, scholars represented by Professor Bian Yongmin assert

that, while the CBAM is consistent with the MFN principle, it does not fully comply with the national treatment principle [5]. Moreover, certain scholars have posited that, despite the fact that the transitional rules for CBAM published on the European Commission's official website do not comply with the MFN principle, the EU may invoke general exceptions clause to defend the legitimacy of its mechanism [6]. However, other scholars also asserted that CBAM is a surreptitious barrier in essence, probably perceived as discriminatory without clear justification [7].

The present paper posits that the mechanism in question is in violation of CBDR in climate governance, as well as the WTO's MFN treatment principle, without meeting the criteria for invoking the general exception clause as a defense of legitimacy.

2.1. Legislative Objectives and Institutional Design Logic of the EU CBAM

The ongoing deepening of multipolarity in international politics underscores the equitable yet anarchic nature of the global community, thereby creating a scenario in which pollution knows borders, while the circulation of goods does not. In the event that a nation's competitive edge is compromised by measures to combat climate change, it may resort to unilateral or multilateral actions to avert such competitive disadvantage [8]. The CBAM fulfils its legislative purpose of preventing carbon leakage and safeguarding fair competition between EU and non-EU products by focusing on carbon price differentials rather than carbon emission differentials among comparable goods, and levying charges accordingly [9].

Consequently, the mechanism's foundational logic stems from circumventing EU's competitive disadvantage. Centered on the 'product carbon footprint', effectively transfer the EU's carbon costs to importing enterprises. Per se, it entails the extension of domestic carbon regulation into international trade channels, thereby engendering the phenomenon known as the Green Brussels Effect, which not only illustrates how rules established in Europe frequently evolve into globally adopted standards, with EU industry norms exerting a significant influence on the production types and business models of enterprises in other countries, but also can be explained through the 'inside-out' regulatory diffusion theory in international politics [10]. In instances where domestic legal rules demonstrate a marked propensity towards internationalization and extraterritorial application, the propagation of unilateral regulations may serve to facilitate the establishment of multilateral frameworks. However, it may also provoke discomfort and countermeasures from trading partners [11].

2.2. Conflict between CBAM and the Principle of CBDR in Climate Governances

Firstly, CBAM imposes limitations on the autonomy of other countries in pursuing voluntary emissions reductions. Article 4 of the UNFCCC explicitly stipulates that countries must assume common but differentiated responsibilities according to their respective capabilities. The Paris Agreement served to reaffirm this principle while introducing the framework of NDCs (Nationally Determined Contributions) with a view to fulfilling nations' obligations to reduce carbon emissions. There is no legal conflict between these two provisions; rather, they can operate in parallel without contradiction. But the European Commission's officially published transitional rules for this mechanism do not directly address or articulate this fundamental principle. Moreover, nations with least development as well as those in the lowest and middle-income categories are those that are most supported by CBAM, meaning that most developing countries are excluded. This suggests that the financial and technical assistance provided by the mechanism is not universally accessible to all developing countries. Additionally, while EU aims to assist countries significantly affected by the mechanism in adapting and mitigating losses, it remains crucial to note that the mechanism still applies to these target groups. This indiscriminate application fails to acknowledge the historical disparities in carbon emissions and levels of development among nations. Furthermore, CBAM does not take into account the most vulnerable entities affected by climate change, i.e. least developed countries and small island states. With regard to exemptions from this mechanism, the provisions do not explicitly state whether the CBAM would accept greenhouse gas emission plans or schemes

formulated by such entities based on their specific national circumstances. This directly restricts the range of differentiated emission reduction pathways available to nations, thereby indirectly denying other countries their autonomy in determining their own emission reduction approaches.

Secondly, the perspective that the CBAM imposes equivalent carbon emission responsibilities on all countries, due to concomitantly providing assistance disregards the fact that the increase in carbon emissions from developing nations' exports is attributable to the transfer of high-carbon industries from developed nations to these economies. The implementation of this mechanism will achieve the effect of obtaining additional tax revenue whilst simultaneously assuming the role of the ultimate consumer of the product. According to simulations conducted by the United Nations Conference on Trade and Development (UNCTAD), CBAM would generate an annual revenue of nearly \$6 billion for the EU, if a price of \$88 per ton of carbon were to be established. The issues are as follows: first, the EU has adopted an ambiguous stance regarding the allocation of this substantial revenue for financial support for other nations, as promised. Second, while the mechanism generates significant annual income for the EU, it simultaneously imposes losses of \$14.2 billion upon other countries. When evaluated in comparison to one another, these figures do not demonstrate substantive assistance to other nations.

Finally, CBAM exclusively focused on the impact of market-based instruments, such as carbon market pricing, on emissions reductions, while the mitigation efforts undertaken by different countries through non-market means, such as administrative measures, were overlooked [12].

2.3. Conflict between CBAM and the WTO's MFN Treatment Principle

Firstly, CBAM is inherently unilateral by establishing differential treatment, predicated on self-interest. The legislation stipulates that the EU may exempt carbon tariffs unilaterally, provided that an exporting nation's carbon market is integrated with the EU ETS. This approach effectively obliges nations that export goods to integrate their carbon markets with the EU Emissions Trading System (EU ETS), thereby building a global system centered on EU ETS and extending unilateral rules beyond the EU's borders.

Secondly, CBAM exhibits self-assessment characteristics. CBAM Regulations mandate that importers of extra-territorial products into the EU must purchase corresponding CBAM carbon emission certificates. These metrics are utilized to determine the carbon emissions of carbon-intensive imported products within designated sectors. Then, the carbon price benchmarked against the EU ETS market is then compared with the carbon price in the domestic carbon market of the country engaged in exports. In instances where a price differential is identified, it falls upon the importer to cover the difference. Later, based on the extent and quality of emissions reduction achievements by WTO members, the EU establishes the requisite quantity of certificates for importers, which confers upon the EU the sole authority to differentiate between like products from different WTO members based on carbon content. The most salient issue pertains to developing countries, whose technological limitations frequently result in higher carbon emissions per unit of product compared to developed countries. Consequently, developing countries have to acquire more certificates. The EU asserts that its ETS mechanism retains free carbon allowances, a claim that merits closer examination. Because in accordance with the most recent amendments to the ETS, the bloc is planning to reduce emissions subject to the scheme by 62% compared to 2005 levels by 2030, with the phase-out of free allowances for industrial carbon dioxide emissions scheduled to be completed by 2034. A further critical point is worthy of note: nearly half of the current ETS allowances are allocated to EU member states, leaving a very limited amount for developing countries.

2.4. The EU Faces Difficulties in Invoking General Exception Clauses to Mount a Legal Defense for the CBAM

The latest advisory opinion on climate change of the ICJ (International Court of Justice) asserts that the right to a clean, healthy and sustainable environment constitutes a fundamental human right, one which is rooted in international human rights law and customary international law. This

confirmatory provision is consistent with the legislative core of GATT Article XX(b) to protect life and health. However, the implementation of the CBAM appears to lack necessity, and it also fails to meet the more stringent requirements of the preamble to Article XX.

Firstly, the implementation of CBAM lacks necessity. The requirement of necessity demands that the EU demonstrates not only that the measure is both necessary and irreplaceable, but also that a genuine link exists between the mechanism and its objectives. CBAM fails to meet both of these criteria. With regard to irreplaceability, the ICJ states that if a risk can be addressed through existing technology, that technology should be employed. The EU is distinguished by its possession of state-of-the-art carbon reduction technologies, which could be employed in lieu of the highly contentious CBAM. With regard to the question of the existence of a genuine link between the mechanism and its objectives, the WTO has yet to establish precedent on whether the EU may adopt unilateral actions to address environmental or health issues that are not related to its territory.

Secondly, it is conceivable that CBAM may be considered arbitrary and unjustifiable discrimination, as well as a disguised restriction on international trade. First, some cases demonstrate that determining whether a measure constitutes 'arbitrary and unjustifiable discrimination' requires consideration of the actual circumstances of other countries, the flexibility of standards, and whether both parties have engaged in sincere and comprehensive negotiations. Second, determining whether a measure constitutes a disguised restriction on international trade requires consideration of whether the contested trade measure's restrictive effect on trade significantly outweighs its environmental protection effect.

As previously stated, the CBAM fails to account for differences in the public interest of carbon reduction among countries, historical emission responsibilities between countries, or diverse pathways to emission reduction. Instead, it imposes a 'one-size-fits-all' approach to mandatory emission reduction obligations, applying the mechanism indiscriminately worldwide and requiring developed and developing countries to bear equal carbon emission responsibilities. This has been demonstrated to be advantageous for the EU, but disadvantageous for other countries, with the resulting losses far exceeding the gains.

3. China's Strategy to Address the Carbon Border Adjustment Mechanism

Domestically, the focus is on the Interim Regulations on the Management of Carbon Emission Trading, with an emphasis on the auxiliary role of government functions. These regulations elucidate that China's carbon emission trading market functions under a carbon market orientation, with the ecological environment authorities of the State Council and local people's governments supervising the trading and management of carbon emission allowances for key emitters. However, it should be noted that the regulations in question do not provide for the right of key emitters to appeal for review when disputing their quotas. Moreover, the financial nature of the market itself makes disputes pertaining to carbon emissions trading more complex, as evidenced by cases involving various financial derivatives. Consequently, these disputes cannot be addressed by applying general civil rules. Consequently, when selecting litigation as a remedy, emphasis should be placed on the coordination between administrative, criminal, and civil proceedings to establish a multi-faceted, collaborative governance framework for redress. Administrative bodies possess professional expertise and logistical advantages in data oversight, making litigation models centered on environmental public interest actions a priority consideration. However, it is crucial to recognize that in the context of 'climate litigation', the government's role should be that of an auxiliary overseer, rather than one that exceeds its boundaries into the domain of intervention. Secondly, while adhering to a market-oriented approach, the market exhibits inherent deficiencies, including lagging effects. In the event of the government exercising administrative powers with a view to the imposition of penalties, it is considered good practice for it to avoid the use of direct administrative coercive measures such as the revocation of quotas. Instead, a more nuanced approach may be adopted,

involving the reservation of a portion of carbon emission quotas on an annual basis, with these reserves being released into the market when necessary to stabilize or reduce carbon prices.

Internationally, China steadfastly advocates multilateralism, joining forces with developing countries to advance revisions to WTO rules. As previously observed, the EU has been exhausted of the unproductive global multilateral trade mechanism, the sentiment exacerbated by the paralysis of the WTO Appellate Body. Consequently, EU has resorted to unilateral trade measures, such as the CBAM, in an attempt to maintain its competitive edge. However, this has resulted in significant losses for numerous developing countries. China has issued joint statements with multiple nations, and WTO has established Multi-Party Interim Appeal Arbitration Arrangement (MPIA). It is evident that China has the capacity to engage in collaborative endeavors with developing countries, thereby initiating appeals and arbitration against the CBAM through the utilization of this specific mechanism. Furthermore, even within the broader context of Sino-American competition, China and the United States have consistently pursued dialogue and cooperation to accelerate concrete climate action in recent years. Concurrently, the Belt and Road Initiative has fostered broad consensus, steadily enhancing its international influence and voice. Consequently, China's actions regarding CBAM will resonate profoundly with developing countries, generating international pressure to advance WTO rules towards greater fairness, reasonableness, and justice.

4. Conclusion

The present paper employs a range of methodologies, incorporating the literature analysis and legal text analysis method, such as CBAM legislation published on the European Commission's official website. The paper studies the legal disputes surrounding CBAM, concluding that the EU aims to export its standards and strengthen its international influence through this mechanism. The analysis further demonstrates that CBAM contravenes the MFN principle and CBDR and cannot invoke general exception clauses to mount a legitimate defense. Finally, the paper elaborates on China's proposed pathways for addressing these issues. Nationally, use administrative authority for the regulation of the construction of a carbon institutional framework. Internationally, China seeks for multilateral cooperation.

Notwithstanding, the present report is unfinished in certain respects. The period from 2023 to 2025 is a transitional phase for the implementation of CBAM Regulations. This means that the rules must be transformed into policy and then applied in practice, but this process will take time. Consequently, this paper offers only theoretical exploration of scholarly perspectives, supplemented by past analogous cases. In the future, it is hoped that the formal implementation of the CBAM mechanism will result in an increasing number of scholars closely monitoring the specific issues arising from its practical application.

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