Smooth transition for graduating LDCs under the EU Carbon Border Adjustment Mechanism

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It is widely accepted that least developed countries (LDCs) leaving the category need special measures to smooth the transition.[1] The next graduates include Bangladesh, Bhutan, Lao PDR and Solomon Islands, but others will soon follow. For those countries not only will smooth transition include the gradual phasing out of existing support like trade preferences and capacity-building assistance, it must also encompass any new support measures put in place before they graduate.

One of these new measures seems likely be an exemption for LDCs to the European Union's (EU's) proposed Carbon-Border Adjustment Mechanism (CBAM). Although the exact design was unknown at the time of writing, the EU was due to launch the mechanism in mid-2021.

LDCs are likely to be exempt, ensuring that the CBAM doesn't unfairly penalise their exports, which currently enter the EU without duties or quotas under the Everything But Arms (EBA) scheme.

Under the CBAM, products would be taxed at the European border depending on the amount of carbon emitted during their production. The mechanism is needed because efforts inside the EU to cut Co2 would otherwise encourage companies to produce their products elsewhere – known as carbon 'leakage' – and European producers would be undercut by cheaper, high-carbon imports.

Chief among the EU's internal carbon-cutting initiatives is its emissions trading scheme, whereby companies in Europe face a (gradually falling) carbon limit on production. Companies can either produce up to the cap, save or sell carbon allowances, or buy more to go over the limit. Putting a price on carbon disincentivises corporations from using carbon and allows it to be used where it costs the least do so. Without CBAM, companies might simply make their products in countries where there is no constraint on carbon usage.

It is unfair to expect developing countries – and in particular LDCs – to shoulder the same burden as developed nations. The EU has made a multilateral commitment to common but differentiated responsibilities on climate, meaning that it should allow LDCs to contribute where they can but not oblige them to make the same undertakings as developed countries. And an exemption from the CBAM would ensure consistency with the duty and quota-free EBA.

Currently the EU directly imports only a small volume of carbon-intensive products from LDCs. Only aluminium forms any significant proportion of the total, mostly from African LDCs, at just under 5 per cent of all EU aluminium imports, according to a recent paper by

[1] For more information on LDC graduation and smooth transition, see "Preparing for LDC graduation and smooth transition", UN Department for Economic and Social Affairs, https://www.un.org/development/desa/dpad/least-developed-country-category/preparing-for-ldc-graduation-and-smooth-transition.html

Sam Lowe from the Centre for European Reform.[2] A CBAM exemption therefore holds little prospect of carbon leakage. The forthcoming LDC graduates don't directly export much that is carbon-intensive. Yet even if imports are insignificant from the EU side, any CBAM tariff might be meaningful for small LDC exporters.

None of the possible forthcoming African LDC graduates – including Comoros, Djibouti, Senegal and Zambia -- are major aluminium exporters, but it seems possible that some of their exports, and those of others, might in future be subject to a Co2 levy. To be legally defensible under WTO rules, the CBAM can only apply to sectors which are also subject to an internal EU carbon price: currently energy-intensive industries such as oil refineries, steel and metal works, cement, paper, and some basic chemicals. The EU couldn't, for example, include agriculture in the CBAM.

But the scope could expand if the EU develops further internal carbon pricing mechanisms or extends the coverage of the emissions trading scheme to new areas, as currently under discussion. If new products are added – or services such as aviation or maritime transport – it is conceivable that the mechanism could distort the composition of LDC exports, or even environmental sustainability and the economic structure.

Calculating the quantity of carbon can be expensive and might even be more expensive than the CBAM levy. Here the EU should take on some of the cost, particularly for SMEs. It could, for example, create and fund third-party certification bodies to assess carbon content. This would particularly help LDC exporters, who may otherwise find the process costly and difficult.

It will also be difficult to ensure that indirect LDC inputs are not penalised by the CBAM. Raw materials from an LDC may form part of the final product exported from another country, and which is then taxed at the EU border. For example Guinean bauxite may be exported to China, used to make aluminium for the EU market and taxed under CBAM, indirectly affecting Guinean producers. How should the Chinese aluminium export be treated, and would any cost increase be passed on along the supply chain?

As with all trade mechanisms, rules of origin (RoO) will need to be put in place so that the EU knows where imports under CBAM exemptions come from – but the devil will be in the detail. The scheme is also likely to involve safeguards, triggered in the unlikely case that an LDC import could be linked directly to carbon leakage.

Given the potential implications, LDCs and other developing countries need to be involved in the design and consultation on the CBAM and associated provisions such as RoO and safeguards. At the time of writing no bilateral discussions had taken place with the LDC Group at the WTO.

Graduating LDCs and possible forthcoming graduates should have a prominent seat in discussions given that a transition period is in their interests and that the scope of CBAM is likely to increase. Smooth transition is particularly important given that other non-LDC

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[2] Sam Lowe, "The EU's Carbon Border Adjustment Mechanism: How to Make it Work for Developing Countries", Centre for European Reform/Open Society European Policy Institute, 22 April 2021. https://www.cer.eu/sites/default/files/pbrief_cbam_sl_21.4.21.pdf

developing countries might gain an exemption from the CBAM, rendering recent graduates at a potential disadvantage.

Another reason to bring LDCs to the table is that CBAM revenues should be used partly to help build green productive capacity in developing countries and LDCs. The historical reasons why developing countries have been locked into carbon-intensive and extractive industrialization need to be acknowledged.

Demands for new and additional finance have so far not been met. Using CBAM revenues to further subsidise European companies may even further disadvantage LDC producers and exporters. It would be in the interests of the EU to support the green transition in LDCs, so that future imports are low-carbon.

Cutting carbon is an inevitably global endeavour, the rules of which must involve the LDCs but not hamper their development prospects. In the run-up to LDC-V in January 2022, LDC exemptions from CBAM, along with smooth transition, would be a small piece of welcome relief for LDCs already struggling to recover from the Covid crisis.

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