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EUROPE'S CARBON BURDEN

India must innovate its pricing policy to counter EU's tax

THE EUROPEAN UNION'S (EU) recent announcement of a gradual implementation of the carbon border adjustment mechanism (CBAM) is viewed as a resurgence of frictions in an inherently unequal trading system. The CBAM is not separate from the EU's attempts at mitigating the effects of climate change that include an emission trading system used to price emissions. In the early phases, plenty of exemptions in the trading system undermined its efficacy. As the EU ramps up its efforts to withdraw free allowances in the system, there is a worry that businesses will relocate to jurisdictions with no such comparable regulations. Carbon leakage has compelled the EU to supplement its "Fit for 55 Agenda" with a levy on imports from countries that do not price carbon. Developing countries are taking notice of this development as it kicks in this October.

The EU is an important trading partner. Even though its regional trade is significant, the composition of trade in specific commodities and services is not EU dominated. For example, Turkey, Russia, South Korea, India and China are the top five sources of steel imports for the EU. Similarly, Russia and Mozambique account for 50 per cent of its aluminum imports. Both these products along with cement, fertiliser, electricity and hydrogen will be covered under the initial phase of the CBAM. The worry is this will significantly impact trade with countries such

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as India that depend on the EU for its exports — 26.4 per cent of India's exports of products are potentially covered by CBAM.

Many within the Indian corporate sector have been preparing for this. For example, Tata Steel operates in the EU market and has experience with transitioning to green steel. As per its annual report 2022-23, CBAM will encourage the company to transition faster and the experience will help with the transition in India. The report also mentions the potential carbon-related costs (not CBAM) at its TSE plant in the Netherlands would be borne by the society, either through higher steel prices or through public spending or subsidies. This raises more important concerns than the CBAM itself. Large firms are relatively prepared and the costs may be passed forward. If this is the case, then should the CBAM be a worry from a trade perspective? Or, is there a need to expand the vision to market structures that may become even more concentrated, and to consumers who would have to bear the costs imposed by the transition?

It is possible that the EU may end up losing on account of higher input costs as they may be passed on to consumers. Steel and aluminum are crucial not just for its major exports such as vehicles but also for green transition (aluminum). CBAM will apply to aluminum even as the EU lists it as a critical mineral and struggles to lift its production.

It is hard to reconcile these with the application of a tariff on imports except for the reason that CBAM is designed to keep countries such as China — suppliers of minerals — out of the EU. A similar approach was adopted in the past to protect smelters.

So how should India respond to this tax? There is the WTO to contest the measure as discriminatory. However, CBAM raises more serious concerns on the structure of the manufacturing sector that will be dominated by companies and countries that are able to withstand the winds of change. The EU and the US have responded to the challenge by designing incentive schemes to attract investments and to remain competitive. India too may have to innovate. With limited fiscal space, an internal carbon market along with an effective taxing mechanism may not only nudge firms in that direction, but also can support consumers and smaller businesses. Such pricing mechanisms can also work as a tool to negotiate equivalence with the CBAM, as common but differentiated responsibility would mean that India can price carbon differently as per its level of development.

The EU's hypocrisy is hard to miss. India must respond with a policy that ensures pricing of carbon in line with its development priorities.

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