

Policy Recommendations drawn from the Study: The EU Carbon Border Adjustment Mechanism: Opportunities, Challenges and Risks Ahead



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Biography

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Introduction to main findings

The European Union's Carbon Border Adjustment Mechanism (CBAM) represents one of the most innovative, but also very complex, policy instruments introduced at the intersection of climate policy, trade governance, and industrial competitiveness. Entering its definitive phase in 2026 after a transitional period beginning in October 2023, CBAM is intended to address the problem of carbon leakage by aligning the carbon costs of imported goods with those under the EU Emissions Trading System (EU ETS). In doing so, it introduces a climate governance that extends the reach of domestic carbon pricing beyond the EU borders.

CBAM applies primarily to a limited number of carbon-intensive sectors, including cement, steel, aluminium, fertilisers, electricity, and hydrogen. Importers of these goods into the European Union must report the embedded emissions in imported products and surrender CBAM certificates linked to the EU ETS carbon price. However, CBAM is more than a technical instrument of environmental policy. Because it operates at the border and directly affects international trade flows, it also raises economic, legal, and geopolitical questions. It influences the competitiveness of industries, the distribution of costs between producers and consumers, and the relationship between developed and developing economies. CBAM is an evolving instrument and will be reassessed in reaction to developments.

There are many expectations concerning CBAM. Most of them relate to climate objectives including reduction of CO₂ emission in Europe and globally, reinforcing other climate policy instruments in Europe and ensuring their consistency, and incentivising other countries to undertake similarly ambitious climate policies. But CBAM is also a border measure which affects economically European producers and consumers, as well as foreign partners. CBAM is therefore a multipurpose instrument and the diverse effects of its implementation have been thoroughly analysed in the paper *"The EU Carbon Border*

Adjustment Mechanism: Opportunities, Challenges and Risks Ahead". The following synopsis presents briefly the main findings of the study and it develops them into some policy recommendations for addressing CBAM evolution.

1. CBAM as a Tool to Prevent Carbon Leakage

The primary justification for the CBAM is the prevention of carbon leakage. Carbon leakage occurs when strict climate policies in one jurisdiction lead to the replacement of carbon-intensive production to regions with weaker environmental regulation, resulting in little or no reduction in global emissions. This phenomenon can occur through several channels, including relocation of production, changes in trade patterns, or adjustments in global energy prices. CBAM attempts to address this problem by equalising the carbon cost of imported goods with that of domestically produced goods. Importers must purchase CBAM certificates corresponding to the emissions embedded in their products, ensuring that foreign producers cannot gain a competitive advantage by avoiding carbon pricing.

CBAM is designed to address the risk of carbon leakage rather than proven cases of leakage. Empirical evidence for large-scale leakage in the past remains limited and inconclusive and there is little evidence that industries displaced production due to carbon pricing. Carbon leakage is considered as a risk that could become more significant when carbon prices will increase and free allowances are phased out.

However, the effectiveness of CBAM in preventing the risk of leakage depends on many aspects including accurate measurement of embedded emissions or preventing circumvention such as product reclassification or changes in trade routes. The transition away from free allowances must be carefully managed to avoid distortions in competitiveness.

2. Levelling the Playing Field

Another major objective of CBAM is to level the playing field between European producers and foreign competitors. Under the EU ETS, European industries face a direct cost for their greenhouse gas emissions. If imported goods are produced in jurisdictions without comparable carbon pricing, they may enjoy a cost advantage unrelated to productivity or efficiency. CBAM seeks to correct this asymmetry. This ensures that competition is based on economic performance rather than regulatory differences.

The “level playing field” argument is particularly important for energy-intensive industries such as steel, cement, and aluminium. These sectors operate in global markets where small cost differences can significantly affect competitiveness.

Nevertheless, the levelling effect of CBAM is limited in several ways. First, CBAM currently applies only to a narrow range of basic materials and downstream products. More processed products could be covered by CBAM but at the expense of complicating the system. Second, differences in competitiveness between regions are caused by factors beyond carbon pricing, including labour costs, energy costs, infrastructure, and government subsidies etc. CBAM can address only one dimension linked to unequal cost of carbon. Therefore, it cannot be a universal tool to restore competitiveness of European industry. Moreover, covering by CBAM one stage more of processing could provoke producers of further downstream products to demand the same. Measures to level the playing field for some industries inevitably tilt the playing field for others.

3. Preserving Policy Integrity and Climate Leadership

CBAM also helps to maintain the integrity of the EU’s climate policy framework. The European Union has committed to achieving climate neutrality by 2050 and has adopted ambitious emission reduction targets. Without border adjustments, ambitious climate policies could undermine efforts if industries perceive them as threatening

competitiveness. CBAM helps address this concern by ensuring that climate ambition does not lead to the displacement of emissions abroad. It allows the EU to increase carbon prices and tighten emission caps without creating incentives for import substitution. At the same time, CBAM contributes to the EU's broader strategy of climate leadership. By implementing the first large-scale border carbon adjustment mechanism, the EU demonstrates that ambitious climate policies can coexist with economic growth.

This leadership creates both opportunities and risks. CBAM could encourage other countries to adopt carbon pricing or strengthen their climate policies in order to curtail CBAM charges. Some countries perceive the mechanism as a form of unilateral economic pressure. The EU should analyse closely the international response to CBAM as it will play a critical role in determining whether it strengthens global climate cooperation or contributes to new trade tensions.

4. CBAM and the Phase-Out of Free Allowances

Historically, the EU ETS addressed carbon leakage through the allocation of free allowances to energy-intensive industries. These allowances reduced the effective carbon cost faced by firms while maintaining incentives for emissions reductions. However, free allowances have several drawbacks. They weaken the carbon price signal, create windfall profits for some firms, and reduce government revenues from carbon pricing. CBAM is intended to help to replace free allowances via a major shift in the design of EU climate policy. Instead of protecting domestic producers by reducing their carbon costs, the EU seeks to equalise carbon costs between domestic and foreign producers.

This approach strengthens the polluter-pays principle and improves the efficiency of carbon pricing. However, the transition also introduces new challenges which should be addressed. One of the most significant concerns is export competitiveness. While CBAM applies to imports, it does not provide compensation for EU exports

to countries without carbon pricing. The recent EU Commission proposal of Temporary Fund is a short term measure, but the issue require a long-term approach.

5. Incentivising Decarbonisation in Other Countries

One of the strategic ambitions of CBAM is to encourage other countries to adopt stronger climate policies. Exporters seeking access to the European market will have an incentive to reduce the carbon intensity of their production in order to diminish the CBAM cost. Alternatively, countries where exporters are located may introduce their own carbon pricing, which can be credited against CBAM obligations. This mechanism extends the influence of the EU's climate policy beyond its borders. Because the European Union is one of the world's largest import markets, the carbon price signal created by CBAM may influence investment decisions across global supply chains.

The effectiveness of CBAM in encouraging decarbonisation abroad depends heavily on the economic structure and institutional capacity of the exporting country. These incentives are not uniform across all countries. For highly industrialised economies and even larger medium developed countries with diversified production and access to capital, low-carbon technologies and strong regulatory institutions, the adjustment required to comply with CBAM may be simple to manage. In contrast, less and least developed countries having less diversified industrial base may face greater challenges due to limited financial resources, technological constraints, or insufficient monitoring and verification systems.

6. Impact on Prices and Global Markets

The introduction of CBAM is expected to affect prices both within the European Union and in global commodity markets. By imposing a carbon cost on imported goods, CBAM alters the relative prices of carbon-intensive materials and low-carbon alternatives. Within the EU market, the mechanism is likely to increase the cost of certain basic

materials, particularly those with high embedded emissions such as steel, cement, aluminium, and fertilisers. Importers must purchase CBAM certificates corresponding to the emissions associated with these goods. In many cases, these additional costs will be passed through the supply chain to downstream industries and ultimately to consumers.

Higher prices for carbon-intensive inputs may encourage substitution toward lower-carbon materials or production processes. This is precisely the intended effect of CBAM. However, it may contribute to increasing prices of these inputs and downstream products. The price impact has to be monitored carefully to avoid sudden increases which would have a negative effect on some consumers of CBAM products.

At the same time, CBAM may influence global commodity prices. If the mechanism reduces European demand for carbon-intensive imports, global market prices for those goods could decline. Restrictions by large importers (and the EU is a large importer) always negatively impinge on prices of small exporters. Lower global prices could offset some of the competitive advantage that CBAM provides to the EU producers. Another potential effect concerns the restructuring of global supply chains. Firms may adjust sourcing decisions to minimise CBAM costs by purchasing materials from producers with lower emissions intensity. However, the distribution of costs along value chains may be uneven.

In highly competitive markets, producers may absorb some of the cost increases in order to maintain market share. In other cases, especially where supply is concentrated or substitutes are limited, price increases may become more significant. The extent of price pass-through depends on market structure, the availability of alternative suppliers, and the elasticity of demand for the CBAM products. Vulnerable consumers might be distressed beyond their ability to absorb.

7. CBAM as a Source of Revenue

In addition to its environmental objectives, CBAM is expected to generate revenue for the European Union. Importers must purchase CBAM certificates and the revenues from these certificates will contribute to the EU budget. Estimates of potential CBAM revenues vary widely depending on assumptions about carbon prices, trade volumes, and emissions intensity. Some projections suggest that annual revenues could reach several billion Euros once the mechanism is fully operational. However, these revenues are inherently uncertain because they depend on behavioural responses by producers and governments. If main exporters to the EU reduce emissions or countries adopt carbon pricing systems of their own, the CBAM revenue may decline. Similarly, changes in trade patterns could affect the volume of imports subject to the mechanism. Initially there have been suggestions that portion of CBAM revenues should be allocated to support climate transition in developing countries. However, under the current EU budget framework, revenues are expected to contribute primarily to EU financial budget. Another important issue concerns the distributional implications of CBAM revenues among the EU member states and their industries, as well as on different exporting countries.

8. Circumvention and Enforcement Challenges

As with any regulatory mechanism affecting international trade, CBAM faces the risk of circumvention. Firms may attempt to avoid CBAM obligations through various strategies that alter the apparent carbon content or classification of goods. To address these risks, the CBAM Regulation includes several anti-circumvention provisions. Authorities are empowered to investigate suspicious trade patterns and apply corrective measures if necessary. Coping with fraud is a standard component of any border and customs services. However circumvention might have a form more difficult to detect of avoidance of full CBAM costs. One possible market reaction – avoidance rather than circumvention - is “resource reshuffling”, in which producers

allocate their lowest-emission production to exports destined for the EU while directing higher-emission products to other markets.

Another potential strategy involves changes in product classification. Slight modifications, additional processing of goods could allow exporters to classify them under tariff categories not covered by CBAM, thereby avoiding the associated carbon cost. Trade routing may also create opportunities for circumvention. Goods could be processed or relabelled in intermediate countries before being exported to the EU, complicating the determination of their origin and embedded emissions. Ensuring the integrity of CBAM while maintaining proportional administrative requirements will therefore be a key challenge for policymakers.

9. WTO Compatibility and Legal Challenges

Because CBAM directly affects international trade, its compatibility with World Trade Organization (WTO) rules has been a subject of intense debate. The EU has designed the mechanism carefully in order to minimise the risk of legal challenges.

Two key principles of WTO law are particularly relevant: the Most-Favoured Nation (MFN) principle and the national treatment principle. The MFN principle requires that all trading partners be treated equally, while national treatment requires that imported goods be treated no less favourably than domestically produced goods. CBAM attempts to comply with these principles by applying the same carbon price to imports as to domestic production under the EU ETS. Foreign producers are also allowed to deduct any carbon price already paid in their country of origin, which helps ensure that the mechanism does not discriminate against countries with their own climate policies.

Nevertheless, legal uncertainties remain. Under Article XX of the General Agreement on Tariffs and Trade (GATT), trade measures may be justified if they are necessary to protect human, animal, or plant life or health, or if they relate to the conservation of exhaustible

natural resources. The EU is likely to rely on these exceptions in defending CBAM. However, the application of Article XX also requires that measures not constitute arbitrary or unjustifiable discrimination between countries. The design and implementation of CBAM will therefore play a critical role in determining its legal defensibility.

10. Trade Between Unequal Partners

CBAM has important implications for trade relations between developed and developing economies. Because the mechanism applies uniformly to imports regardless of the income level of the exporting country, it represents a departure from the traditional approach of differentiated responsibilities in international climate policy. For many developing countries, exports of carbon-intensive basic materials play an important role in industrialisation strategies. CBAM may therefore affect their access to the EU market and reducing the competitiveness of their exports have implications to their development plans.

The impact of CBAM on developing countries may vary widely depending on the structure of their economies and their trade relationships with the EU. Some countries export relatively small volumes of CBAM-covered goods and may therefore experience only limited effects. However, for some of them these small exports represent significant fraction of their external revenue affecting significantly their development. Countries with old industrial structure, limited access to clean technologies, renewable energy or financial resources may find it difficult to reduce the emissions intensity of their production.

The concerns about equity and fairness remain central to the global debate over CBAM. The mechanism places additional burdens on countries that have contributed relatively little to historical greenhouse gas emissions and that often have fewer resources to invest in decarbonisation. Addressing these concerns require complementary policies, including financial assistance, technology transfer, and cooperation on emissions monitoring systems.

The most radical way of helping the most poorest countries would not be to offer more funds but to lift CBAM obligations for them, provided that the new export potential installed in these countries will be fully covered by CBAM obligations. Such measure could not be applied to other developing countries, especially large and more advanced as their achieved level of industrialization could have benefited from lower environmental and climate actions.

11. Administrative and Compliance Challenges

The administrative dimension of CBAM is often underestimated but represents one of the most critical factors for its success. Implementing the mechanism requires a complex system of monitoring, reporting, and verification (MRV) to ensure that emissions data are accurate and comparable. Importers must collect detailed information about the production processes used by foreign suppliers, including energy consumption and emissions factors. Verification by accredited auditors adds another layer of complexity and cost. These requirements are necessary to ensure environmental integrity, but they also create significant administrative burdens.

CBAM is a complex instrument and therefore it requires complex documentation of compliance. Particularly providing necessary evidence of actual embedded emissions might be challenging especially in the situation of CBAM products using precursors originating in several countries. The cost of compliance is nearly the same, irrespective of the amount of products imported. Developing a broad registry of such data to be used by all CBAM importers is a promising way forward.

Even existing requirements create fixed administrative costs that may disproportionately affect smaller companies or occasional importers. Large multinational firms may find it easier to manage the compliance burden due to their greater resources and experience with complex regulatory frameworks. The fixed costs associated with compliance may be particularly challenging for small and medium-sized

enterprises (SMEs). Smaller firms may lack the resources or expertise needed to manage complex reporting systems or coordinate with suppliers across global supply chains. It should be facilitated, or the EU will face a concentration of imports of CBAM products in the hands of a few large companies exclusively. Balancing the need for robust environmental standards with the principle of proportionality will therefore be an ongoing challenge in CBAM implementation.

12. A World of Multiple Carbon Border Mechanisms

The EU is currently the first major jurisdiction to implement a carbon border adjustment mechanism on a large scale. However, it is unlikely to remain the only one. Several countries, including the United Kingdom, Canada, and others, have begun exploring the possibility of introducing similar measures. If multiple CBAM-type mechanisms emerge globally, the international trade system could become significantly more complex. The issue is closely linked to the differences in domestic climate policies, instruments and diverse approaches worldwide. In different countries CBAM will function unlike if is referred to differences in carbon intensity of production, widespread voluntary carbon schemas or reliance on carbon sinks. Different jurisdictions might adopt distinct methodologies for calculating embedded emissions, varying sectoral coverage, and carbon price levels. Fragmentation could create overlapping regulatory requirements for companies operating in global markets. The efforts should be made to align global standards leading to common or uniform solutions of carbon border mechanisms limiting excessive patchwork of approaches.

At the same time, the proliferation of such mechanisms could also create opportunities for international cooperation. Countries might seek to harmonise methodologies, recognise each other's carbon pricing systems, or develop common standards for emissions accounting. However, multiple and different CBAMs would raise the issue of "rules of origin" as the current rules do not address the issue of carbon content.

Policy Recommendations and Conclusions

By implementing CBAM which links carbon pricing with border adjustments, the EU has created a new instrument designed to address the global nature of climate change in a world of unevenly ambitious climate policies. CBAM offers several important opportunities. It can strengthen the credibility of the EU ETS, reduce the risk of carbon leakage, and create incentives for low-carbon production across global supply chains. It may also encourage other countries to adopt stronger climate policies or introduce their own carbon pricing systems. At the same time, the mechanism faces significant challenges. These include administrative complexity, legal uncertainty, potential trade tensions, and concerns about equity between developed and developing countries. Ultimately, CBAM should be understood not as a final solution but as an evolving instrument. Its effectiveness will depend on how it interacts with other policies, how it is perceived by international partners, and how policymakers address its economic and political implications. To maximise the effectiveness and legitimacy of CBAM, several policy approaches should be kept in focus along with its further development:

a. Strengthen international cooperation

The European Union should intensify cooperation with its trading partners to improve transparency and comparability of climate policies affecting international trade. Because countries use different instruments to reduce emissions, such as carbon pricing, regulatory standards, subsidies for low-carbon technologies, or support for carbon sinks, international dialogue is needed to clarify how these measures relate to each other and how their effects can be assessed. In particular, the EU should work toward an understanding of equivalence of different climate policies, including carbon taxes,

emissions trading systems, regulatory decarbonisation measures, and credible carbon removal activities. International cooperation is also essential in developing common standards for measuring and verifying embedded emissions in traded products. Harmonised monitoring, reporting, and verification (MRV) methodologies and mutual recognition of entities engaged in MRV would improve trust between trading partners, reduce administrative burdens for firms, and support the environmental credibility of border carbon measures.

b. Support developing countries, in particular least developed ones

The EU should complement CBAM with targeted measures supporting developing countries, especially least developed countries (LDCs), in their transition toward low-carbon production. Without such support, including financial and technological transfers the mechanism risks being perceived as imposing additional constraints on economies that have contributed little to global emissions and that often lack the resources needed for rapid technological transformation.

Politically, the EU could gain significant credibility by suspending CBAM obligations for traditional export volumes from least developed countries, whose overall emissions are very small and whose exports to the EU are generally negligible. At the same time, any new industrial facilities in these countries intending to export to the EU should remain subject to CBAM. Such a limited exclusion, based on a grandfathering approach, would protect existing trade flows while still encouraging new investments to follow a low-carbon industrialisation pathway. In addition, the EU should strengthen technical and financial cooperation with developing countries. This could include support for establishing emissions monitoring and reporting systems (MRV), assistance in adopting low-carbon technologies and renewable energy, and targeted investment partnerships in sectors affected by CBAM.

c. Improve administrative efficiency

Simplified reporting procedures and digital monitoring systems should be further developed to reduce compliance costs, particularly for small and medium-sized enterprises (SMEs). For many companies, particularly smaller importers, the compliance procedures rather than the carbon price itself represents the main cost. While some progress has already been made, CBAM procedures remain demanding and costly, especially for smaller businesses and for relatively small import volumes. Importantly, these administrative requirements affect not only imports of carbon-intensive products but also trade in goods with low embedded emissions or originating from countries with ambitious climate policies and high carbon prices. In practice, companies must still complete the full set of reporting and verification formalities even when the actual carbon cost adjustment is minimal. As a result, the paperwork and compliance costs can themselves become a barrier to trade. A clear example is trade between the European Union and the United Kingdom, where both partners apply stringent climate policies and maintain relatively high carbon prices through their respective emissions trading systems. Despite this, trade between the EU and the UK remains subject to the same administrative requirements as imports from countries without comparable climate policies. Further simplification of procedures, such as streamlined reporting formats, greater use of digital tools, or simplified regimes for small shipments, would significantly reduce unnecessary administrative costs.

d. Address downstream leakage risks

Gradual expansion of CBAM coverage to selected downstream products can address the risk that carbon leakage shifts further along the value chain. The European Commission has already begun examining this issue and proposals to extend CBAM to certain downstream goods. However, extending CBAM coverage does not fully eliminate the underlying problem. Trade flows may still be diverted toward more highly processed goods that are not covered by even extended CBAM,

thereby relocating emissions further along global value chains rather than reducing them. There is also a risk of trade deflection, where goods are rerouted through third countries for additional processing before entering the EU market. Countries better prepared to cope with CBAM requirements could become intermediate processing hubs, complicating the assessment of embedded emissions. Overly broad coverage by CBAM could unintentionally lead to overprotection of European industries, particularly in sectors where the carbon content of upstream materials represents only a small share of the final product's value. In such cases, applying CBAM to highly processed goods might impose disproportionate administrative costs while providing only limited environmental benefits. Another important challenge concerns the complexity of measuring embedded emissions in more sophisticated products. As value chains become more complex, determining the carbon content of intermediate inputs and processing stages becomes increasingly difficult and costly, and would increase administrative burdens for businesses and authorities alike.

e. Monitor trade and competitiveness impacts

Continuous evaluation of CBAM's economic effects is necessary to ensure that it achieves its climate objectives without causing unintended disruption to industrial activity or trade. This should be done by comparing the impact of any new modification of CBAM on emissions of CO₂ within the EU and globally, with the cost to be borne by the EU importers, consumers, public administration as well as by the exporters from other countries. Marginal CO₂ abatements invoking high costs – both private and public – should be avoided. As CBAM becomes fully operational, it should be closely monitored, how it affects supply chains, market structures, and the competitiveness of European industries. CBAM procedures are relatively easier to manage in the context of large, continuous or regularly repeated trade contracts, where companies can spread compliance costs over substantial volumes of trade and maintain specialised administrative capacity. By contrast, the system is much less well adapted to large but occasional transactions or to small import volumes, which are

common among many small and medium-sized enterprises (SMEs). The fixed administrative requirements, monitoring emissions data, reporting, verification, and registry procedures, can represent a disproportionately high burden when applied to irregular or small shipments. CBAM may unintentionally encourage the concentration of imports among a smaller number of large operators that have the resources and organisational capacity to manage complex compliance requirements. Smaller firms may increasingly rely on intermediaries or larger trading partners. While this may improve administrative efficiency for some operators, it risks reducing the diversity and flexibility of European supply chains. SMEs being the backbone of Europe's economic structure play a crucial role in ensuring flexibility, adaptability, and competitiveness across industrial ecosystems. Many large industrial firms rely on networks of specialised SMEs for inputs, services, and innovation. If CBAM make the operations of SMEs more difficult or costly, the effects will inevitably be detrimental to European competitiveness. The impact of CBAM on SMEs and on the structure of supply chains should be monitored very carefully. Additional simplifications, thresholds for small shipments, or tailored compliance procedures could help preserve the participation of SMEs in international trade while maintaining the environmental integrity of the mechanism.

f. Promote methodological harmonisation

International standards for measuring embedded emissions are behind fragmentation of global climate governance. European ETS is used as a point of reference for CBAM whereas there are many standards and systems of measuring emissions. It extends to reliance on accredited verifiers who should conform to the European standards and requirements. Greater focus on harmonizing varying methodologies and spectrum of standards would not only help CBAM to be more uniformly applied across the EU partners but it would help to avoid complications when other countries decide to implement similar CBAM.

g. Address uncertainty and clarify the long-term design of CBAM and carbon pricing

CBAM is directly linked to the EU Emissions Trading System (ETS), meaning that developments in the EU carbon market immediately affect the conditions of cross-border trade. Volatility in ETS allowance prices translates into volatility in the CBAM charge, creating uncertainty for import costs, supply chains, and investment decisions. This uncertainty will increase as the ETS cap tightens toward climate neutrality. Carbon prices could rise sharply as allowances become scarce, or decline if deep decarbonisation significantly reduces demand for permits. If CBAM is expected to remain a long-term policy instrument, the EU should urgently clarify how it will function once the European economy approaches full decarbonisation. Businesses and trading partners need a clearer view of the future framework to avoid disruptive adjustments. The EU should therefore begin outlining already now the post-transition architecture of carbon pricing and CBAM, in order to provide predictable rules and prevent instability during the final phase of Europe's decarbonisation.

Final conclusion

CBAM remains an evolving instrument, and therefore further refinement should be guided by a clear principle: **maximising climate effectiveness in the EU and globally, while minimising avoidable economic harm and disproportionate burdens, especially for small and medium sized enterprises and less developed partners.**

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