

# Implications of the European Union's Carbon Border Adjustment Mechanism for the Western Balkan Countries

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This paper examines the potential implications of the **Carbon Border Adjustment Mechanism (CBAM)** implemented by the European Union (EU) on the Western Balkan (WB) countries.

The primary focus is to **explore policy options** that the WB-6 countries could adopt to align themselves with the EU's Green Deal initiative, particularly CBAM. Furthermore, the paper analyses the most suitable solution and its benefits for the region. The paper finds that a **joint regional approach**, involving the development of a regional carbon pricing mechanism and its integration with the EU's Emissions Trading Scheme (ETS), offers the most promising solution for a smooth energy transition in the Western Balkan region.

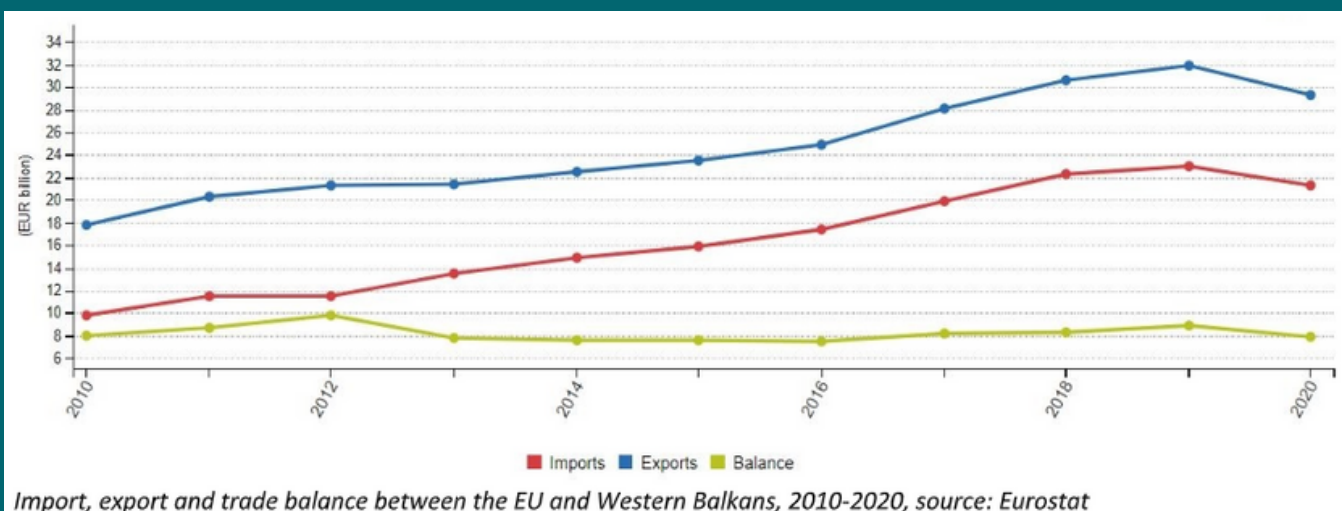
Authors: Jelena Stojković Terzić, PhD, University of Belgrade  
Milan Terzić, portfolio management, MET SRB doo

# Introduction

EU is at the forefront of climate neutrality. As a part of its "Green Deal" policy package, on the 14th of July 2021, the European Commission proposed the implementation of the **Carbon Border Adjustment Mechanism** - CBAM, as a measure to prevent carbon leakage and further support EU's climate mitigation ambitions (European Commission, 2021). Currently, the EU's mechanism for pricing carbon emissions, the **Emissions Trading Scheme (ETS)**, is the world's largest carbon-pricing system and proved to be an incremental climate-fighting tool. Nevertheless, with rising climate ambitions there is a danger that the EU companies will move production abroad, to countries with looser carbon policies.

Hence, the idea behind the CBAM is to motivate the partner countries to decarbonize their **high-polluting sectors** (energy and industry) and prevent carbon leakage. Initially, the CBAM will be focused on the following sectors: cement, iron and steel, aluminum, fertilizers, electricity, and hydrogen. CBAM will eventually – when fully phased in – capture more than 50% of the emissions in ETS-covered sectors (European Union, 2023). Consequently, the system will apply the carbon price on import equivalents for similar goods produced in the EU (and subject to the ETS).

Further on, the impact of CBAM will have significant effects on the Western Balkan countries since they have high annual trading growth with the EU. According to Eurostat, trade between the EU and the Western Balkan had a constant growth path since 2010 (Eurostat, n.d.), as shown below.



## – Coping with the CBAM: Potential Approaches –

In the forefront, our primary focus lies on the power sector, which is anticipated to be the most directly impacted by the proposed measures. In accordance with a comprehensive Ember study (Ember, 2021), it was revealed that the Western Balkan (WB-6) countries exported approximately **6.3 terawatt-hours (TWh) of electric power** to the EU, while **importing around 6.7 TWh** in the year 2019.

Despite being a net importer of electricity, the exported power from the WB-6 countries accounted for approximately 5.2 million metric tons of CO<sub>2</sub> emissions, constituting approximately 20% of the total CO<sub>2</sub> emissions resulting from all electricity imports to the EU during that period. Consequently, the forthcoming implementation of the Carbon Border Adjustment Mechanism (CBAM) on electric power exports will undeniably exert a significant impact on the delicate economies of the Western Balkan region.

To mitigate any potential adverse consequences, it is imperative for the WB-6 countries to take prompt action and align themselves with the EU's green energy transition trajectory.

However, it remains a critical question as to how the WB-6 countries can effectively mitigate the CBAM and achieve **harmonization with the EU's "Green Deal" objectives**. Consequently, careful consideration of potential options for implementing an equivalent emissions trading scheme or carbon pricing mechanism becomes imperative. An examination of the WB-6 energy mix reveals a prevailing reliance on lignite crude for power generation, particularly evident in Serbia, Bosnia, and North Macedonia. In contrast, Albania and Montenegro possess significant hydroelectric capacities. The worrisome aspect, however, lies in the climate targets of the WB countries, which indicate a persistent dominance of coal in their energy portfolios in the years to come.

The WB-6 countries could choose from various approaches to address this issue.

1

Firstly, WB countries can **disregard the implementation of any actions**, thus by encountering the CBAM, all the exported electricity and other affected products, after entering the EU, would be priced the same as the electricity (and other goods) produced within the EU. In this scenario, power exports to the EU for which an equivalent carbon price was not paid in the country of origin, would have to be “followed” with the required number of CBAM certificates.

The price of certificates will be equivalent to an average trading price of EU ETS allowances applicable in the week before the import of the product to the EU (European Union, 2021).

Thus, the negative effect of this is that the CBAM charges would not be recycled to the Western Balkan economies, instead, they will be utilized within the EU, while the produced power from WB-6 countries will lose its price competitiveness.

Countries have the option to “act”, that is, **implement a carbon tax or an emission trading scheme**, such as the European Union Emissions Trading System (EU ETS).

2

In the case of a carbon tax, the government sets a tax rate for each ton of CO<sub>2</sub> emissions, and entities are obligated to pay this rate for their emissions. While a carbon tax provides price certainty for emissions, there is no certainty regarding the actual emission decrease. If the carbon tax rate is set too low and energy prices rise significantly, power producers may lack the incentive to reduce emissions.

This would result in governments losing control over emissions and facing uncertainty in revenue. Additionally, if the tax rate is set lower than the EU ETS allowance price, carbon border adjustment mechanism (CBAM) charges would apply for the difference between the allowance price and the carbon tax rate.

3

Governments may choose to implement an **emissions limit** similar to the EU ETS, where affected companies need allowances for each ton of CO<sub>2</sub> emitted. WB-6 governments can either auction or allocate permits (allowances) that can be traded among companies. This approach allows them to regulate emissions by reducing the number of allowances in line with their targets. However, the **potential risk** with this scheme is that the West Balkan countries, being relatively small in terms of industrial and power generation capacities, may face liquidity challenges in supporting such schemes.

This was exemplified when Montenegro introduced a cap-and-trade scheme in February 2020, whereas the shortcomings were exposed within a year, as highlighted by energy expert P. Gallop (Bankwatch Network, 2022).

4

The optimal solution could be hidden in a **joint initiative from the West Balkan countries**. Namely, an option involving the establishment of a regional carbon pricing mechanism with the aim of its integration within the EU's ETS can be a promising solution for a favorable energy transition in the region.

The approach could be a combination of a carbon tax while setting up a context for the implementation of a regional ETS system, that would be further integrated within EU ETS. In this way, both WB region could tackle the advantages of both carbon pricing mechanisms, while recycling the carbon charges within domestic economies.

## In conclusion...

To successfully address the implications of the CBAM, the Western Balkan region should proactively collaborate and adopt a joint regional approach. A joint “venture” would not just utilize the benefits of both carbon pricing mechanisms, but it would also create a singular carbon market, which could bear a stronger position for future integration with the EU ETS.

Nevertheless, timely and unified actions of the WB-6 countries are crucial for a successful energy transition and realization of the shared goals for a sustainable future.

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