Rethinking carbon pricing and taxes

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India's free trade agreement (FTA) with the U.K., heralded as the gold standard by the Minister for Commerce and Industry, Piyush Goyal, has a lot going for it. Yet, it does not address the one imminent policy instrument that is likely to significantly upend its possible benefits for India.

The U.K.'s Carbon Border Adjustment Mechanism (UK-CBAM), similar in principle to the European Union (EU)'s CBAM, will be implemented from January 2027. It covers both direct and indirect emissions for hard-to-abate sectors such as steel and aluminum, including the electricity used in their production. CBAM's scope will later be expanded to other products.

Mr. Goyal noted that India would retaliate against any harmful impacts of CBAM. However, any prospective action may not provide the desired relief for the imminent cost impact. This is an issue that needs to be addressed upfront in a bilateral agreement. For instance, in the recently announced U.S.-EU trade agreement, the EU has agreed to address U.S. concerns on CBAM and other rules relating to corporate sustainability, through flexibilities.

CBAM effect on India's exports

Before the FTA, the U.K.'s MFN rates for aluminium and iron and steel were in the range of 0-6%. Under the India-U.K. FTA, these duties will be reduced to zero for Indian exports. At first glance, this appears beneficial for India. But from January 2027, aluminium and steel imports will need to match the U.K.'s carbon price, which, as of now, is approximately \$66/tCO_2, translating to a cost increase of at least 20% to 40% for exporters.

The U.K.'s CBAM permits deductions for carbon pricing in exporting countries, including carbon taxes or prices paid under emissions trading schemes. While Indian industry pays levies such as coal cess, bears costs under the renewable purchase obligation, and now an explicit carbon price under the recently announced Carbon Credit Trading Scheme (CCTS), it is unclear whether the U.K. will allow deductions beyond the CCTS. Even with respect to the CCTS, a major challenge is the large gap between India's projected carbon price, estimated by the Bureau of Energy Efficiency at around \$8-10 per tonne of CO_2, and the U.K.'s carbon price, currently at \$66 per tonne.

As with the EU's CBAM, the U.K.'s approach is focused on levying a charge on exports into the U.K. to match the embedded carbon price paid by domestic producers. By levying the same price as paid by U.K. producers in specific sectors where the U.K. perceives a competitive disadvantage, the unilateral setting of carbon price upends multilateral commitments on emission reductions under the United Nations Framework Convention on Climate Change and the Paris Agreement.

There can never be a singular carbon price across economies as emissions vary across countries based on energy mix, industry structure, and technological availability and viability. A joint report by multilateral institutions in October 2024 urged greater coordination on carbon markets, warning that fragmented systems cause distortions, leakage, and undermine net-zero goals.

Fragmented markets will only raise compliance costs, disrupt supply chains, and hinder both growth and climate goals. A global carbon pricing agreement is essential to align methods for measuring emissions, streamline reporting requirements, and ensure support for green tech transfer. The International Monetary Fund in 2021 proposed an International Carbon Price Floor (ICPF) with tiered pricing: \$25 for low-income, \$50 for middle-income, and \$75 for high-income countries. Building on this, the World Economic Forum proposed a three-phased approach to facilitate a smooth transition to global carbon prici starting with minimum standard for pricing and reporting, and linking this to regional systems and harmonising monitoring an verification processes. It also proposed linking regional carbo markets (EU, China, India, othe parts of Asia) to reduce fragmentation and move toward unified global system.

It is important for the Indian government to assess whether t model would work and explore synergies with like-minded developing countries. In an era rising tariff and non-tariff barrie we cannot risk fragmented carb pricing turning into massive compliance costs.

National action

Amidst rising protectionism glo consensus is unlikely in the sho term. Hence Indian industry mu view clean technologies as tools for efficiency and competitiven and not just as export compliance. The government needs to act as an enabler by streamlining various implicit carbon taxes into a unified carb market framework. Implementi stricter emission reduction targ under a single explicit carbon ta through the CCTS, instead of multiple taxes on carbon-intens sectors, will improve carbon pri discovery, simplify compliance and monitoring, and preserve o competitiveness. It would positi India to build a stronger carbon pricing system, capable of joini a cohesive global carbon marke the future. Revenues from these carbon taxes should be ploughe back for industrial decarbonisation. The draft clim finance taxonomy developed by the Ministry of Finance, is anot initiative that will enable invest to boost clean tech investment.

In a world where multilateral rules are being undermined, an bilateral free trade deals are fail to secure equity, proactive actio between government and indus within the country is the only answer.

In an era of rising tariff and non-tariff barriers, we cannot risk fragmented carbon pricing turning into massive compliance costs