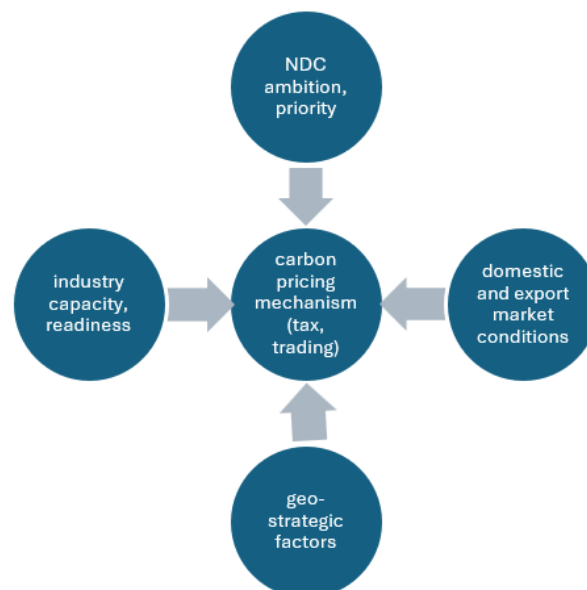


Lessons from the EU ETS for developing countries

Sangeeta Godbole

Any carbon pricing of industrial emissions, such as a tax or emissions trading system, does not function in a vacuum. While instituting a carbon pricing mechanism, a jurisdiction must assess its manufacturing capacity, technological prowess, investment potential, and domestic and export market conditions. It needs to consider its climate ambition amid the background of economic growth and development priorities, availability of climate finance, and increasingly even geo-strategic factors.



Third World Network (TWN) is an independent non-profit international research and advocacy organisation involved in bringing about a greater articulation of the needs, aspirations and rights of the peoples in the South and in promoting just, equitable and ecological development.

Published by Third World Network Berhad (198701004592 (163262-P))

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The carbon pricing mechanism evolved under the European Union (EU)’s Emissions Trading System (ETS) is considered the global path leader in industrial decarbonization (European Commission, n.d., ‘About the EU ETS’). Operational for two decades, it has undergone significant modification in its journey. It is one of the key tools used by the EU to fulfil the commitments set out in its nationally determined contribution (NDC) on climate action under the Paris Agreement. Under the ETS, each ton of carbon emitted by industry is represented and accounted for by one EU Allowance (EUA). A big chunk of carbon emissions was hitherto accounted for by free allowances. Thus, initially and even now to a very large extent, high carbon pricing under the ETS is compensated with free allowances (Godbole, 2024).

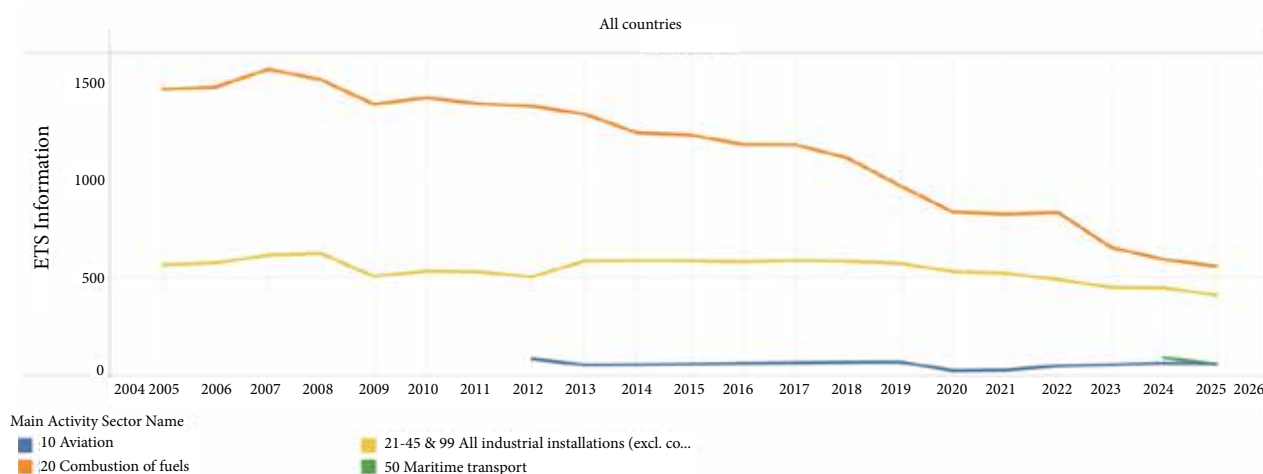
The ETS has without doubt accelerated the carbon pricing effort in various countries. The rigorous monitoring, reporting and verification mechanism developed under the ETS, and perfected over the years, provides an established template for emissions calculations and integrity.

The ETS is up for review in June/July 2026 and the European Commission is making preparations and actively consulting stakeholders (EPRS, 2026). As part of the review, the ETS will be scrutinized from all angles by stakeholders. A few EU think-tanks have, after extensive consultations with EU industry, suggested a number of modifications to the existing design and structure of the ETS.

Some of their suggestions arise out of their observation that emissions have not gone down significantly (European Environment Agency, 2025), except in the power sector, largely on account of a shift of fuel to gas leading the reduction (ERCST, 2026) (Figure 1). However, natural gas, in its production process, emits huge amounts of methane. Methane exhibits 30 times more global warming potential for climate change in a 100-year metric as calculated by the Intergovernmental Panel on Climate Change (IPCC) (Greenhouse Gas Protocol, 2024). Therefore the shift to natural gas that engendered lower carbon emissions may not deliver robustly on the climate change front.

Data regularly published by the European Environment Agency indicates that industrial sector emissions intensities have not declined significantly even after two decades of the ETS (ERCST, 2026). Thus, on the climate front, the ETS may need further tweaking to deliver more on industrial decarbonization.

Figure 1
Emissions by sector as reported under the EU Emissions Trading System



Source: <https://www.eea.europa.eu/en/analysis/maps-and-charts/emissions-trading-viewer-1-dashboards>, downloaded on 4 June 2026 (European Environment Agency, 2025)

It must also be noted that while EU growth has stagnated in the region of well below even 0.5% in the last few years, developing countries are projected to grow eight times faster at around 4% (India at 6.5%) even in these times of wars.

It is therefore pertinent to look carefully at the ETS for lessons it may present for nascent carbon pricing mechanisms, particularly in developing countries which have ambitious growth targets as well as decarbonization plans.

1. High carbon price of EU Allowances: Many industry associations and think-tanks in the EU continue to caution against not only job losses but even deindustrialization of the EU due to high carbon pricing (ERCST, 2025). Several EU member countries have argued that planned allowance cuts under the ETS are too severe and do not reflect the technological limits faced by sectors such as steel, cement, chemicals and aluminium (Euronews, 2026a). EU member Portugal has also urged a rethink on carbon market cuts for industry, warning they could damage competitiveness and slow industrial decarbonization (Euronews, 2026b). But the EU uses high carbon pricing as a tool for deeper decarbonization by its industry to achieve the climate goals committed in its NDC.

As part of its climate action, the EU has planned a linear reduction in total allowances available to its industry (European Commission, n.d., 'EU ETS emissions cap'). It is expected that the scarcity of carbon allowances will lead to even higher ETS prices for the manufacturing sector. As high carbon prices start to bite, EU industry may face competitiveness challenges.

Lesson for developing countries with industrial growth ambitions: Keep carbon prices in check. A high carbon price can pose significant challenges for industrial competitiveness and may not necessarily lead to high emissions reduction. As currently seen in the EU, even member countries are facing competitiveness and 'transition' challenges.

2. To protect its industry domestically against high carbon pricing, the EU implemented its carbon border adjustment mechanism (CBAM). The EU CBAM has limited mitigation potential, with only a 0.1% reduction in global carbon dioxide emissions, but with higher trade costs for developing countries (UNCTAD, 2021). The EU has recently published default values of carbon emissions which EU importers will have to pay at EU borders if exporters are unable to prove the quantity of embedded carbon emissions (European Union, 2025). Extremely high default values are adding to the price woes of EU industry importing intermediate goods; imported inputs that had been available cheaply will now be more expensive. Given high input prices, EU sectors like steel and fertilizers which are dependent on exports may face pricing challenges in their export markets (ERCST, 2024).

Lesson for nascent carbon markets (including India's Carbon Credit Trading Scheme (CCTS)): A border carbon adjustment with high pricing may appear feasible in theory, but industry may not find it sustainable for exports.

3. The fear of impacts in export markets is so high that the EU now proposes to subsidize carbon in exports from the revenues generated from the CBAM (Reuters, 2025; Down to Earth, 2025). In effect, carbon prices paid under the ETS for goods manufactured in the EU will be compensated if those goods are exported out of the EU. EU manufacturers will sell 'dirty' high-carbon products to the rest of the world. This completely turns the basic decarbonization premise on its head, and creates incongruity with climate principles. The EU also can be seen as engaging in 'resource-shuffling' itself, even as EU think-tanks have accused developing countries of the same.

Lesson for nascent carbon pricing schemes: Balancing competitiveness and climate action is key. Climate action must follow its own path rooted in domestic realities. The Indian CCTS, with its focus on realistic emissions reduction targets based on the emissions intensity of particular manufacturing installations, represents a pragmatic path (Government of India, Ministry of Power, n.d.).

4. For EU manufacturing to survive the ETS and its pricing, the EU has determined that there is a need to create a lead market for high-price, low-carbon goods. It has proposed an Industrial Accelerator Act (European Commission, 2026a) which promotes principles such as local content requirements, local jobs requirements and compulsory transfer of technology in investments (*New Indian Express*, 2026). It is now commonly being popularized as the ‘Made-in-EU Act’ which embodies a reversal of long-held EU principles of a free and open market (European Commission, 2026b).

Lesson for emerging and developing economies: Excessive focus on high carbon pricing can jeopardize long-held principles such as free and open trade. While pricing carbon, measures to support the domestic market, improve domestic manufacturing and enhance domestic technology capabilities are valuable. Do not dismiss these, but leverage them well.

5. Long-term predetermined linear reduction factors for emission benchmarks create certainty, but in situations like today when inputs may hit sky-high prices and may not even be available (re China and current war), they create an artificial scarcity in available allowances and push the ETS prices further upwards. The ETS risks being perceived as inflexible.

Lesson for developing economies: Installation-wise practicable intensity-based benchmarks (instead of linear reduction for the entire economy), such as under the Indian CCTS, would be far more effective. They create structural change for decarbonization by targeting the emissions intensity of manufacturing. The CCTS with its emissions intensity metric will effect steady real decline in emissions.

As a number of developing countries including the Philippines, Malaysia, Thailand and Vietnam set out on their carbon pricing journeys, it would be useful to consider practicable alternatives to the EU’s ETS (ICAP, n.d.). A carbon pricing mechanism like the Indian CCTS that takes into account industrial growth prospects, ground realities and national priorities, and competitiveness in export markets, could be a more beneficial choice. It would present an opportunity to collaborate, jointly develop, and finetune a carbon pricing mechanism that genuinely responds to developing-country concerns.

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