AIB REVIEW
By the Australian Institute of Business

# Canada's Carbon Policy in a Global Trade Context

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## Introduction

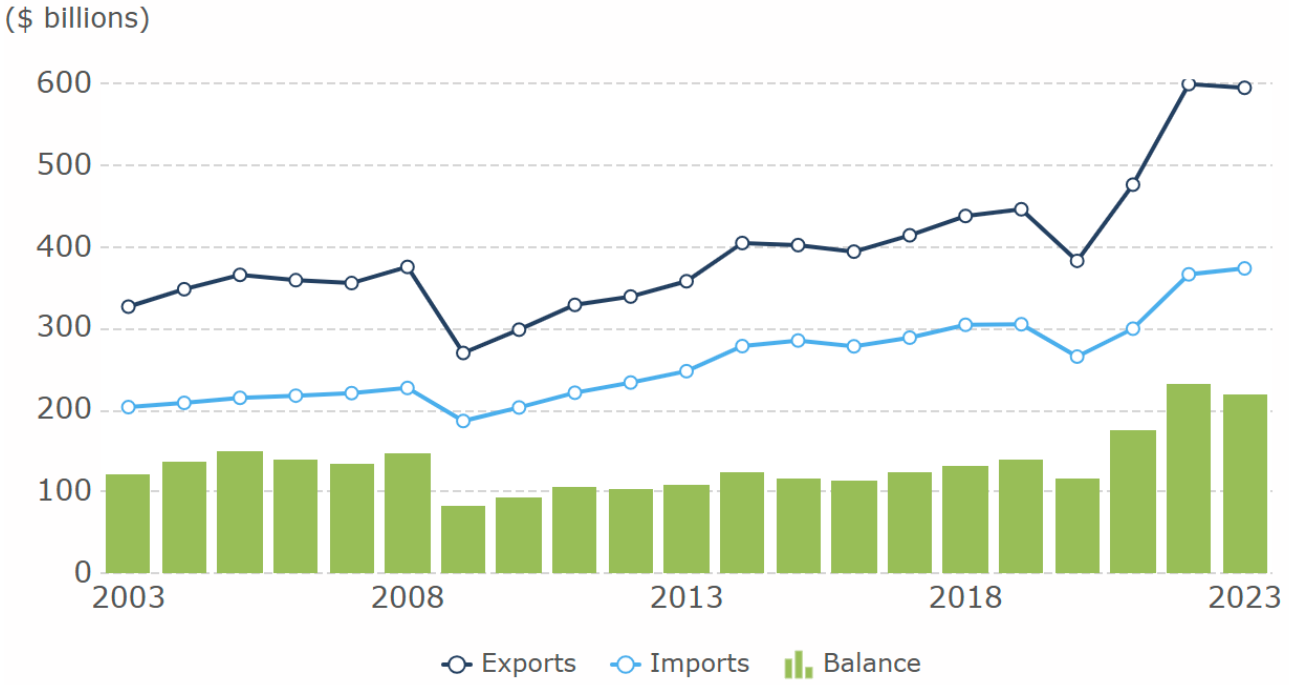
Carbon emission reduction policies are becoming increasingly common worldwide as countries implement stricter regulations to reduce so-called greenhouse gas emissions. These policies could affect both national and international trade for countries like Canada. Canada's federal carbon pricing system was introduced in 2019 and comprises two components: a fuel charge and an output-based pricing system (OBPS). The fuel charge constitutes a tax on fossil fuels, gasoline, and natural gas, serving as a regulatory charge. The OBPS functions as a performance-based system for industries (Government of Canada 2023). Recently, Canada has faced some geopolitical tensions with the United States (US), by far its largest trading partner (Bhattacharjee & Kamatham 2025). These tensions have led Canada to reassess its global trade relationships and explore new opportunities to diversify its export markets.

While the European Union (EU) accounts for only 4.3% of Canada's total exports, it remains the country's second-largest trading partner after the US, which absorbs more than 76% of Canadian exports (European Commission, 2025). To reduce its heavy reliance on the US and mitigate risks from potential tariffs, Canada may seek to expand trade with the EU. However, this strategy faces challenges, as Canadian exports could encounter increasing friction under the EU's Carbon Border Adjustment Mechanism (CBAM), which imposes a levy on imports from high-carbon-emitting industries, including oil and gas (European Commission, 2025). This article explores how the difference in carbon emission policies could affect the international trade relationship between Canada and the EU and may shape the future of their trade relations.

## Canada-US Trade Relations

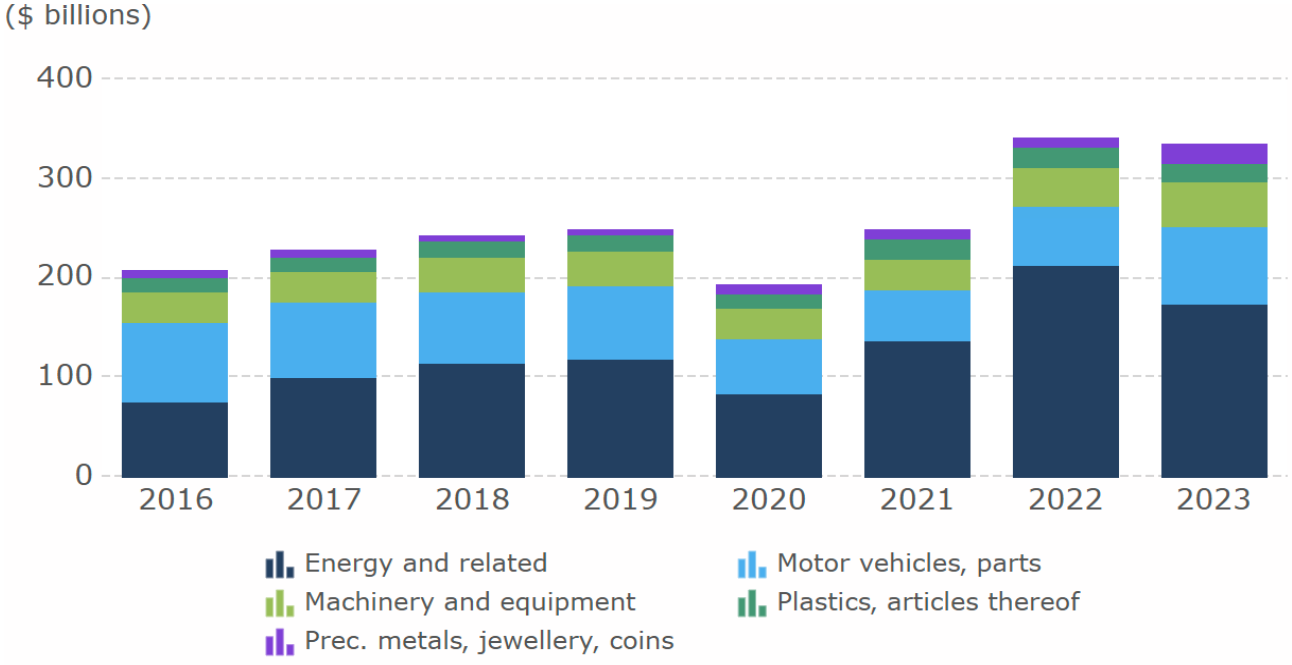
The US remains by far Canada's dominant trading partner, accounting for approximately 76% of Canada's total goods exports in 2023, valued at around CAD $600 billion (Sood 2025) (see Figure 1). Key export sectors include automotive manufacturing, energy, and agriculture (see Figure 2). While this reliance has long underpinned Canada's economy, recent shifts in US trade policy have exposed the risks of such dependency. As of August 1, 2025, the US has announced a 35% tariff on all Canadian imports that fall outside the Canada–United States–Mexico Agreement (CUSMA) framework. These tariff measures are expected to significantly disrupt Canada's export flows, pushing Canada to diversify its trade relationships.

**Figure 1:** Canadian Merchandise Exports and Imports with the US in Canadian Dollars (CAD)




Source: Library of Parliament (2024)

**Figure 2:** Major Canadian Merchandise Exports to the US by Sectors in Canadian Dollars (CAD)




**Source:** Library of Parliament (2024)

If the US proceeds with its tariff increase on Canadian imports, Canadian businesses could be left vulnerable, facing job losses, reduced revenue, and supply chain disruptions nationwide (Bhattacharjee & Kamatham 2025). To reduce this dependency, Canada may view the EU as an attractive alternative trading partner (Prime Minister of Canada, 2025). For Canada to fill the gaps in its trade relationship with the US, exports to the EU (and other countries) need to be increased significantly.

**Canada-EU trade relations**

In 2017, Canada and the EU started a new agreement called the Comprehensive Economic and Trade Agreement (CETA) to eliminate or lower trade barriers, tariffs and export-related costs. CETA immediately eliminated 98% of tariffs, and by 2024, 99% of all tariff lines will have been abolished. This agreement has also enhanced regulatory partnerships across various sectors by simplifying the paperwork and creating additional markets in specific sectors, including energy, pharmaceuticals, agriculture, and financial services. CETA leads to better mobility options for professionals by facilitating the mutual recognition of their qualifications in Canada and the EU. It also promotes high-quality investment between the two countries. Due to CETA, Canadian merchandise exports to the European Union increased by 3.1% to reach CAD $2.8 billion in 2024, while imports from the EU declined by 6.4% to CAD $6.0 billion (Government of Nova Scotia 2024). This shift reduced Canada's trade deficit with the EU by roughly CAD $490.9 million, bringing it down to CAD $3.19 billion. However, while the EU is Canada's second-largest trading partner after the US, accounting for over CAD $100 billion in goods and services (European Commission 2025) the EU has recently implemented a new environmental policy called Carbon Border Adjustment Mechanism (CBAM) to encourage cleaner industrial production in non-EU countries. Considering this new development, deeper integration with the EU will require Canadian exporters to comply with these new regulatory mechanisms.

**Impacts of CBAM on Canadian Exports to the EU**

CBAM aims to reduce carbon emissions by imposing carbon fees on high-emission imports such as steel, aluminium and energy. The purpose of this mechanism is to put a price on the carbon emissions embedded in the production of certain imported carbon-intensive goods entering the EU. CBAM will be fully implemented from January 2026. The EU offers exemptions for countries that have carbon pricing systems equivalent to EU standards, such as Canada. However, Canada has recently changed its national carbon pricing system, removing its consumer portion of the carbon tax. The change may jeopardise Canada's current EU equivalent status of carbon reduction systems, which could result in Canada losing the exemptions it currently holds for its exports, including energy (Jebeli et al. 2025).

Without a strong equivalent carbon pricing system in place, Canadian exporters of emissions-intensive goods may face additional fees under CBAM (Yue & Liu et al. 2025). This could reduce Canada's relative competitiveness in key sectors, such as steel, oil, and gas, and may result in fewer Canadian exports. This is because the CBAM's design offers carbon price exemption for carbon prices already paid in the country of origin; without sufficient equivalency, Canadian firms face a competitive disadvantage (Yue & Liu et al. 2025). Despite the market opportunities created under CETA, the EU's CBAM presents new

challenges for Canadian exporters of high-carbon-intensity products. CBAM raises essential questions about the compatibility of Canada's domestic carbon policies with the EU's approach, as well as the potential adjustment costs for Canadian businesses seeking to expand exports to the EU. Consequently, the EU's CBAM compel Canada to reassess and potentially recalibrate its domestic carbon pricing policies to maintain competitiveness, safeguard export revenues, and ensure compliance with emerging international trade standards.

**Mitigating CBAM`s Impacts on Canadian Trade**

To mitigate these risks, Canada may consider strengthening its carbon pricing on industrial emissions via the Output-Based Pricing System (OBPS). A strong OBPS with clear benchmarks could demonstrate an equivalent system to the EU's carbon pricing and qualify Canadian goods, such as oil and gas, for partial or complete exemption from additional fees under CBAM (Samuel 2025). Additionally, Canada could pursue industrial agreements with the EU to ensure that Canadian carbon pricing mechanisms, where they exist, are recognised under CBAM (Otto 2025). This may help mirror how the EU accommodates carbon policies for all EU goods and services, which may benefit Canadian exports by offsetting the costs of CBAM fees, because of the mutual industrial carbon pricing mechanisms between Canada and the EU.

Moreover, Canada could benefit from investing in a comprehensive carbon reporting infrastructure, requiring all domestic companies to disclose the actual emissions intensity of their products. By demonstrating lower emissions intensity through a cleaner energy transition, Canadian exporters may be able to reduce their CBAM liabilities, even in the absence of a domestic carbon price, if recognised by the EU. For Canadian exporters, verified lower emissions intensity provides a strategic advantage: goods produced with cleaner processes could face lower border charges, enhancing their competitiveness in the European market. Consequently, Canada may be incentivised to prioritise trade in low-carbon goods and services, such as clean technology, renewable energy, and critical minerals, which are less exposed to CBAM and align more closely with the EU's green industrial policy and sustainability objectives.

**Conclusion**

As geopolitical dynamics affect Canada's trade relationships, environmental policy coherence becomes an economic imperative. The removal of the consumer carbon tax may weaken Canada's position under the EU's CBAM, potentially leading to economic disadvantages for key export sectors. To remain competitive, Canada may consider strengthening its carbon pricing system for high-carbon-emission industries, strengthening carbon transparency and disclosures, and negotiating with the EU for policy harmonisation. Strategic alignment with CBAM objectives may be crucial for Canada to maintain economic resilience and environmental integrity in its trade relations with partners.

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