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What Has Climate to Fear from Trade?

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E15 Expert Group on
Measures to Address Climate Change and the Trade System

Think Piece

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ABSTRACT

The long-standing reaction of the trade community to attempts to embroil trade law and policy in the resolution of the climate change issue has been to say, "Solve your own problems on the basis of your own agreed multilateral instruments, and when you have, if there are interfaces or overlaps between your regime and the trade regime, we will find means of resolving them constructively." While this is understandable, it is rendered impractical, first by that an effective set of agreed international climate mitigation policies, which stand a chance of allowing the achievement of the agreed objectives, is probably as far away now as it has ever been; and second by that the development of domestic politics in both developed and developing countries has revealed trade to be in principle a major source of carbon and political leakage from any aggressive mitigation regime, and thus a serious constraint on national and international mitigation plans.

So it is not as if the climate community has cast around randomly for a potential source of leverage and happened upon trade. The basic presumptions of the trade regime appear to favour the continued promotion of economic development through trade over environmental objectives that require at least some deferral of economic growth, and the premise that any restriction on international trade must be avoided if at all possible. And some World Trade Organization (WTO) principles appear directly to impede actions apparently necessary to build domestic constituencies for stronger climate action. The existence of these principles casts a chilling effect over the development of climate action. If the principles are not adjusted, global climate action may depend even more on national willingness to risk or undertake economic self-sacrifice without regard to perceived fairness—a willingness that is shallow in most countries, and which may remain so until after it is too late to prevent many more decades of damaging climate change.

On the basis of a non-professional understanding of WTO instruments and jurisprudence, the paper suggests five proposals, ranging from GATT Article XX to border adjustment measures that seem to need to be seriously debated. But it adds that even if these changes are accepted, this is self-evidently not a politically realistic prospectus for amended global trade legislation or a revised approach to trade in international climate policy. More indirect approaches, via declarations, guidelines, or the development of jurisprudence, are far more likely to work, though at the expense of long processes and uncertain outcomes when the urgency of climate action is mounting.

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LIST OF ABBREVIATIONS

BAMs	border adjustment measures
CBDR	common but differentiated responsibilities
COP	Conference of the Parties
EGA	Environmental Goods Agreement
EGS	Environmental Goods and Services
ETS	Emissions Trading Scheme
EU	European Union
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GHG	greenhouse gas
ICAO	International Civil Aviation Organization
MEAs	multilateral environmental agreements
ODS	ozone-depleting substances
UNFCCC	United Nations Framework Convention on Climate Change
US	United States
WTO	World Trade Organization

INTRODUCTION

This note attempts to set out the fears and suspicions that the climate community has about the edifice of world trade governance, and the way the World Trade Organization (WTO) and the policies and assumptions on which it is based may wittingly or unwittingly hamper global progress on meeting the climate change challenge. It does not attempt to be balanced, sophisticated, or politically realistic, or to represent the views and preoccupations of any one stakeholder or group of stakeholders in the climate community. Rather it tries to list the totality of the most significant fears that the climate community harbours, as an aid to deeper analysis and assessment of the potential responses.

At one of the early workshops of the E15 Trade and Climate group, which had focussed on the possibility of clubs of like-minded countries arising out of the stagnation of the United Nations Framework Convention on Climate Change (UNFCCC) process and joining together to pursue climate-sensitive trade policies, Michael Grubb, Professor of International Energy and Climate Policy at University College London,, suggested that “before reaching for the clubs, understand the tribes.” This note is a contribution to the understanding of the climate tribe.

THE BASIC PROBLEM

Climate is, in economic terms, an externality. Impacts on climate are not willed. In particular, the incremental changes to the atmosphere and biosphere that are created by actions in pursuit of conventional economic growth, primarily production and energy processes, are external to those actions. To the extent that those changes and impacts produce costs, they are not felt by the relevant economic actors—or if felt, are felt extremely weakly (usually weakened further by those actors’ time-discounting practices) in comparison to the benefits of the economic action.

Changing the production and energy processes to avoid or even significantly reduce the climate effects almost always involves costs to the economic actors way out of proportion to the direct benefits to them. This is a merely contingent fact—it is possible in theory that new non-polluting production processes, with superior economics to the current polluting ones, could be discovered and applied. It is also possible that there could be a major change in global economic values reducing the demand for energy and for greenhouse gas (GHG)-intensive production of goods. And it could also be possible that consumer demand worldwide becomes so sensitive to GHG footprints of goods and services that it becomes conventional business sense for economic actors to absorb the relevant costs.

However while some types of renewable energy production are challenging conventional fossil fuel-based energy in some locations, on the whole, and for that period of the foreseeable future in which major changes to the global volume of GHG pollution are necessary to avoid major changes to the climate, in the absence of artificial price or other constraints, GHG-heavy fossil fuel-based energy and goods production is, and will for some time continue to be, the most economic choice. While the energy intensity of economic growth in some parts of the world has diminished, the increasing volume of demand is more than enough to make up for it and looks set to continue to be so over that same foreseeable period. And finally while consumer demand is on the whole more sensitive to some carbon footprints than it was, it is unrealistic to expect revolutionary changes over a short time scale here, either.

So reducing GHG pollution and climate impacts is economically inefficient from the perspective of most individual economic actors, and will continue to be so. In short, it costs money, which will not be spent unless legal obligations are created to force those actors’ hands. Individual actors voluntarily spending the additional money will, other things being equal, open up an obvious competitive opportunity for new or existing commercial rivals to undercut them, and will lose market share. If legal obligations are created that are binding on all the relevant actors (and effectively enforced), then this problem should not exist. The “tragedy of the commons” will be avoided by the action of a superior power capable of constraining all those who consume the commons. None of the economic actors will welcome the cost imposition, which at the margin will tend to reduce the size of the market a little, but at least the legal obligation will seem fair. “Fairness” is a political requirement for cost differences imposed by governments, in contrast to those created by geography or other “natural” advantages. No one, it seems, should get a free ride as a result of a political decision.

However, where some of the actual or potential commercial rivals are outside the reach of those legal obligations, there will inevitably be free riders—unless governments or other creators of the relevant legal obligations act (and are perceived to be acting) in coordination, including coordination of the quantum of price where pricing is used in preference to direct regulation, of timing, and of effectiveness of enforcement. The great majority of relevant legal obligations are imposed and enforced at the level of national governments (or regional economic integration organisations such as the European Union [EU]). Economic activities between, rather than within, these national/regional units constitute international trade, and the coordination of their treatment of international trade activities is very largely undertaken via the institutions around the WTO. Thus economic actors fearful of free riders undercutting their competitive position by avoiding costs imposed on the "home team" will look very carefully at relevant WTO rules. If free riding on climate costs is not prevented by those rules, expect trouble.

This is not only a question of competitiveness. The world's atmosphere is a single unit, even if its governments are not—so any measures that simply have the effect of moving emissions from one government's jurisdiction to another, a process often described as carbon leakage, are ultimately pointless, whatever they do to the terms of trade.

UNITED NATIONS FRAMEWORK CONVENTION ON CLIMATE CHANGE

The UNFCCC in theory offers an alternative forum for international coordination of climate policies giving rise to legal obligations. However, at least in the minds of the most significant economic actors with a stake in international trade, the UNFCCC is in principle weaker than the WTO, its members are arguably less united about its objectives, it is rightly or wrongly frequently perceived as fundamentally unfair in its approach to cost comparability (see below), it has little or no enforcement capability, and in practice it has failed to have much practical impact. While not a direct institution-to-institution stand-off, many economic observers saw the withdrawal of the EU from its climate-driven attempts to impose common levels of cost in international aviation at the 2013 International Civil Aviation Organization (ICAO) Council as a significant indication that trade objectives will beat climate ones at the international level. Significantly, this test of strength happened in the field of transportation, reminding all parties that international climate objectives cannot be achieved without (among other things) a significant increase in the cost of transport worldwide, which has a direct and negative impact on the volume of global trade, a primary concern of the WTO.

So from the perspective of many climate—and business—stakeholders, the edifice of global control over GHG emissions can only stand, in national political terms, if there is a system preventing international imports escaping from national cost impositions (through price or regulation) designed to reduce emissions, and allowing exporters to slough off those costs where they compete against those who do not have to bear them. In the absence of a strong UNFCCC, the guardian of that system could only be the WTO.

BUT HOLD ON ...

However, plenty of stakeholders inside and outside the climate community would and do object vigorously to the idea that serious government action to reduce GHG emissions just will not happen without firm safeguards against changes in business competitiveness. Their counter-arguments may look reasonable in their own terms, but they have not prevailed in many politically crucial forums, at least so far.

The first objection raised is that changes to a company's international competitiveness from domestic climate actions and their costs are a myth. There is a background of constant changes to absolute and relative costs of many different key factors of production (raw energy sources and other commodities being the most obvious example), and the naturally varying factors of geography, history, skill levels, and intellectual property. Few if any accredited and peer-reviewed examples can be found of changes in cost created by climate action clearly affecting the location or quantum of production of relevant goods and services.

But this point tends regularly to be met by a number of responses that have raw political force. First, the representatives of the companies and industries complaining about unfairness and loss of competitiveness can say with some plausibility that they understand the true reasons for their locational and production decisions better than anyone else. Second, they say that even if a few examples of company closures due to relocations can be found at current levels of cost associated with regulation, tax or pricing, the increases in prices which the climate community says are needed would change the position entirely. Third, it stands to reason, they say, that increasing costs to any extent at all when competitiveness is balanced on a knife-edge risks tipping the situation into a loss, with consequences that cannot be recovered.

The second objection is similar, but looks at the position from the perspective of national competitiveness. Even if it is true that certain companies or even industries will be adversely affected and will no longer be able to contribute as they had in the past to national gross domestic product (GDP), the impact on national prosperity as a whole will be lost in the constant noise of changes, growth, and decline in comparative advantage. Moreover, if the impact is that high-carbon industries will be squeezed out, surely that should be accepted as a necessary and desirable outcome, and one which may make the national economy more fit for an inevitable low-carbon global future. The problem here is the iron law of politics that makes the complaints of the incumbents who would lose out, often well-integrated into the political system, ring louder than support from less powerful or not fully formed potential beneficiaries. The big six industries that tend to lose from a serious price on carbon are cement, aluminium, iron and steel, refining, chemicals, and pulp and paper. Few governments can harden their hearts to all those, particularly if they can coordinate their complaints with users, employees and customers, and with business and domestic consumers of energy as well.

The third objection is that the history of social progress is a history of government imposition of costs on business, in one form or another, because certain externalities are found to be socially and politically unacceptable—from slavery to child labour to a wide variety of sources of pollution. Petty considerations of commercial or national advantage forgone are not enough to prevent action here, so there is no reason why they should be decisive in the face of the global emergency of climate change. Unfortunately, the reason that the economic consequences of these changes were eventually set aside was the political demand from voters and the changing moral environment, which grew strong enough to overcome, often by straight democratic means, though sometimes more violently, the economic interests in the status quo. For whatever reason, that does not seem to have happened with climate yet, which remains a public concern in most of the world, but rarely at levels that lead politicians to rank it higher than more traditional economic objectives. Moreover, some of the changes were accompanied by protection of trade measures that predated the construction of the current institutional and legislative framework for world trade, and would not survive within that framework.

COMMON BUT DIFFERENTIATED RESPONSIBILITIES

The fourth, and perhaps most difficult, counter is that the UNFCCC was founded on a key principle that trumps competitiveness considerations—the principle of common but differentiated responsibilities (CBDR). Bluntly, it can be argued that by signing the UNFCCC the developed world accepted right from the start that in penance for having created the climate problem, it would bear costs that would not be borne by developing countries, thus tipping the international competitiveness playing field for relevant goods and services in their favour. Even under probable forthcoming changes to the CBDR system to graduate the difference between developed and developing countries, the principle of a tilted playing field remains, and it remains highly sensitive. It is a bit late—it can be argued—to start trying to change the principle now.

Other features of the UNFCCC founding documents and political landscape suggest that developed countries have no business trying to manipulate or avoid normal world trade rules to protect themselves from this economic consequence, and must take into consideration the impacts on international trade of their climate mitigation “response measures” even if these are alterations in underlying demand rather than specific alterations to the terms of trade.

However, whatever the logic of these arguments, developed country businesses tend, particularly since the global financial downturn of 2008, to reject them or limit them severely, and most developed country politicians have not been willing to defend them in the face of national economic concerns.

The climate community may treat the initial competitiveness arguments from business and their responses to the counter-arguments with disdain or disbelief. But many in that community recognise that the arguments are a fact of national political life, and some politically effective way has to be found of dealing with them. However, the only serious ways of trying to deal with them lead back to the WTO.

SO WHAT DOES CLIMATE WANT TO DO?

There are three main approaches affecting international trade and competitiveness that the climate community would like to explore. The first is action to counter-balance the economic benefits that will accrue to a “free-riding” country or economic actor, and stop carbon leakage. This would allow countries that would not take more climate action without a more level playing field the ability to even things up, at least in selected areas, without being challenged under world trade rules. The second is the favouring of environmentally friendly goods and services against more carbon-intensive alternatives, both domestically and in international trade. And the third is the use of trade measures as a punishment or retribution against countries that refuse to undertake domestic emissions reduction measures, either to the extent regarded as appropriate for their economic and development status, or at all.

LEVELLING UP

It is generally accepted that there are three broad paths available to achieve a “levelling up”—reducing the national costs of climate change action, increasing the global costs of climate change action, and adding or reducing costs of particular flows of goods and services at the border to accord with the treatment of those goods and services in the target market. Reducing the national costs has been the most popular approach so far—industries regarded as “trade exposed” in an environment where key international competitors have no obvious climate costs are granted some form of exception from the application of costs under national climate policies, typically by exempting them from the cost of purchase of national or regional emissions permits (usually after some sort of incentive regime to ensure maximum movement towards low-carbon norms consistent with retaining competitiveness). Immediately potential WTO warning signs begin to flash—derogations from national regimes purely to increase the competitiveness of national industries in international trade are prima facie illegal. (The question of General Agreement on Tariffs and Trade [GATT] exemptions is dealt with below.) The calculation of the "appropriate" level of climate cost coverage in other countries and the compensatory costs, exemptions, or "subsidies" appropriate for different industries and products is likely to be extremely complex and contentious, but there are examples of rough-justice calculations of thresholds, costs, and benefits used in the EU Emissions Trading Scheme (ETS) and in other spheres, such as tax determinations, that could offer precedents.

The second path is international coordination of the application of climate costs. In essence, this is the approach of the UNFCCC, with the important proviso that the CBDR principle ensures that coordination does not have to mean harmonisation. But costs introduced in pursuit of UNFCCC obligations are a long way from harmonisation—in particular, the progress towards a global carbon market with global pricing for emissions reductions has stalled, perhaps for a very long time. Smaller groups of countries, coming together outside the UNFCCC framework to harmonise prices and treat imports from (and exports to) non-club members on a common basis, are obviously a second best, but again they light up WTO warning signs. In the absence of clearly justified exemptions in international trade legislation, they are obvious instances of departures from the most-favoured nation principle; and without the protection of conformity to a UN-administered, multilaterally agreed regime, they look anomalous in trade law terms.

In principle, the coordination could happen voluntarily within international trade associations or business groups rather than between governments; but the patchy and constrained public motivation that usually characterises businesses, and the difficulty of within-industry sanctions to ensure comprehensive coverage and enforcement systems even at the national level, let alone international, are problems in principle for confidence in business-level action. The problems have been borne out in practice by the few experiments within energy-intensive global industries that have been tried so far. Plus, the inter-business coordinated approach does not in principle look very secure against legal action for price fixing and other anti-competitive practices in one or more national or regional courts or tribunals.

Adding or reducing costs at the border through border adjustment measures (BAMs) is the third path, discussed—and even drafted—more and more frequently but not yet implemented. There are obvious difficulties in choosing and justifying the precise cost level, particularly for products with complex supply chains (it is a nice question whether these product-level calculations are easier or more difficult than appropriate levels of derogation from national climate costs but the addition of costs to imports appears more aggressive than "subsidies" to trade-exposed industries). However, any form of special taxes or their equivalent on imports and exemptions for exports once again lights up warning indicators. There appears to be ambiguity about the WTO status of taxes imposed on energy content, particularly if the pricing measure in the country of import is a variable pricing emissions trading scheme rather than a fixed tax.

From the perspective of the climate community, therefore, all three ways of levelling the playing field in a way that convinces domestic business lobbies that their competitiveness is not being callously sacrificed look difficult and potentially dangerous in WTO terms.

ENVIRONMENTAL GOODS AND SERVICES

The second trade-related approach noted above was the favouring (by tariff or subsidy or procurement regimes) of environmentally friendly goods and services against high-carbon alternatives. This, at least in principle, escapes from the highly charged national judgementalism that characterises actions taken against imports or in favour of exports to compensate for "insufficient" national climate actions. By the same token, it does nothing for national business concerns about damage to competitiveness. However, suspicions that definitions of "environmentally friendly" are being rigged to favour or protect domestic industries can quickly arise. It is partly as a result of these suspicions that progress on an agreed list of Environmental Goods and Services (EGS) has been so slow moving in the WTO Doha round. A recent important plurilateral initiative (the launch of negotiations towards an Environmental Goods Agreement, EGA) by some 40 WTO Members may lead to quicker effective action on tariff reduction. The fact that the initiative was first taken outside the WTO tends to confirm the climate community's suspicion that the WTO as an organisation is as unable to move effectively on climate issues as the UNFCCC is unable to come to binding agreements.

However, the larger problem with this approach is the economic one—particularly if it is limited to tariff reduction on specific technologies or other goods, the cost gap between low carbon and high carbon will only be partly bridged and the reasons for high carbon continuing to win in most situations will continue. And for serious inroads to be made into the conventional economic superiority of high carbon, the notion of "environmentally friendly" has to be extended to include goods and services whose purpose, primary or otherwise, is not to save or reduce carbon but whose production processes and supply chain are low carbon (and perhaps more generally sustainable) compared to some alternatives. This pitches climate objectives against the conventional WTO concept of "like products," since high-carbon and low-carbon production processes generally leave no impact on the final product itself, and (perhaps unfortunately) at present have little impact on consumer preferences.

SANCTIONS

The third approach is probably the most contentious of all—trade sanctions against countries failing to take adequate or appropriate domestic measures against GHG emissions. Merely skimming the surface of a complex and highly charged subject, it is safe to say that the justification of trade sanctions, proposed for whatever reason, tends to be problematic. The examples with which the casual observer is most familiar are probably sanctions against countries for aggression or human rights abuses under Article 41 of the UN Charter, agreed to by the UN Security Council. Trade sanctions can also be justified at the end of a WTO dispute resolution procedure. But provisions for trade sanctions do exist under multilateral environmental agreements (MEAs)—the most frequently cited example being the Montreal Protocol on ozone-depleting substances (ODS). The Montreal Protocol's particular mixture of financial aid and trade sanctions—carrots and sticks—is widely believed to be responsible for a significant part of the success of this MEA, and frequently leads the climate community to question why similar approaches cannot be made to work for GHG emissions.

Setting aside the significant issues of the multiplicity, complexity, and heterogeneity of GHG emissions in comparison to ODS, and the different pathways for financial aid by developed to developing countries for climate mitigation, the most important reason for the difference is that the parties to the Montreal Protocol agreed specifically on a regime with a trade component and the parties to the UNFCCC did not. Indeed the careful protection, within that Convention, of the existing trade regime and its norms (there is not even a provision calling for the two regimes to be mutually supportive) has already been noted.

However, from the climate community perspective, it is arguable that a climate regime without effective sanctions—Canada's painless repudiation of its Kyoto climate targets being a key milestone—has proved not to work. While the world hopes that a bottom-up system can emerge from the 2015 Paris Conference of the Parties (COP) and create a good peer-reviewed system for the delivery, if not the formation, of independent national emissions reduction targets, very few believe that acceptable global targets will be met as a consequence. Consequently the world may have to come back to sanctions at some stage in the future. This could either be in the context of a new chapter in the development of the UNFCCC or a related MEA, or in the form of independent plurilateral groups or clubs (even if supported informally by the UNFCCC) seeking to extend their reach and attain their global objective by applying sanctions against those who will not follow their preferences.

Clearly, a club or plurilateral organisations coming together not just to discriminate against external countries but also to impose trade sanctions on them, without the protection of a separate properly negotiated MEA or other instrument of international law, presumes measures that would be counter to the fundamental principles of the WTO.

It can be argued that the EU has already attempted a form of trade sanctions in a limited but still significant context via the progressive tightening of its acceptance of Clean Development Mechanism (CDM) offset units from certain classes of countries into the EU ETS. The overt objective was, and may remain, to encourage more economically advanced developing countries to take increased mitigation action by creating an economic stick or carrot out of trade conditions for this essentially climate-related product. No action has been taken against the EU by means of WTO dispute procedures, and such action may now be improbable; but the case would have been interesting. A similar approach to conditionality is visible in the EU Aviation Directive, now sidelined at least temporarily, where special allowance would be made for countries who have taken some degree of action to reduce the climate impact of relevant international flights.

WHY PICK ON TRADE?

The long-standing reaction of the trade community to attempts to embroil trade law and policy in the resolution of the climate change issue has been to say, "Solve your own problems on the basis of your own agreed multilateral instruments, and when you have, if there are interfaces or overlaps between your regime and the trade regime, we will find means of resolving them constructively." While this is understandable, it is rendered impractical, first because an effective set of agreed international climate mitigation policies, which stand a chance of allowing the achievement of the agreed objectives, is probably as far away now as it has ever been; and second because the development of domestic politics in both developed and developing countries has revealed trade to be in principle a major source of carbon and political leakage from any aggressive mitigation regime, and thus a serious constraint on national and international mitigation plans.

So it is not as if the climate community has cast around randomly for a potential source of leverage and happened upon trade. The basic presumptions of the trade regime appear to favour the continued promotion of economic development through trade over environmental objectives that require at least some deferral of economic growth, and the premise that any restriction on international trade must be avoided if at all possible. And some WTO principles appear directly to impede actions apparently necessary to build domestic constituencies for stronger climate action. The existence of these principles casts a chilling effect over the development of climate action. If the principles are not adjusted, global climate action may depend even more on national willingness to risk or undertake economic self-sacrifice without regard to perceived fairness—a willingness that is shallow in most countries, and which may remain so until after it is too late to prevent many more decades of damaging climate change.

WHAT PRECISELY NEEDS TO CHANGE - AT LEAST IDEALLY?

On the basis of a wholly non-professional understanding of WTO instruments and jurisprudence, the following certainly seem to need to be seriously debated.

1. The ambiguities in GATT Article XX need to be removed—specifically the words "unjustifiable" and "arbitrary" in the chapeau, and the place of global climate protection in clause (b)'s "necessary to protect human, animal and plant life and health" and clause (g)'s "relating to the conservation of exhaustible natural resources."

2. The definition of o the conservation of exhaustible natural resourcesments and jurisprudence, the following certainly seem to need to be seriously debatedt regard to perceived faifootprint.

3. Subsidies and procurement practices commensurate with the promotion of domestic low-carbon energy sources and production processes should be specifically authorised in principle.

4. The principle of most-favoured nation treatment should specifically allow a derogation for distinctions based on evidence and defensible differences in national control of GHG emissions, taking into account historic responsibilities and capabilities.

5. Specific provision should be made to ensure that BAMs, including obligations to purchase emissions reductions units in a domestic or regional emissions trading scheme, are treated as legitimate national tax measures applicable to imports as well as domestic production

Even if the arguments in favour of these changes are accepted, this is self-evidently not a politically realistic prospectus for amended global trade legislation or a revised approach to trade in international climate policy. More indirect approaches, via declarations, guidelines, or the development of jurisprudence, are far more likely to work, though at the expense of long processes and uncertain outcomes when the urgency of climate action is mounting.

As emphasised at the start of this note, this list and the set of arguments on which it is based does not represent the viewpoint, demands, or objectives of any particular climate lobby, in the public or private sectors or in civil society. It deliberately ignores, merely for the purpose of starting and crystallising debate, the many important arguments from development, foreign policy, and other perspectives. But as a summary of what is going on at the back of the collective mind of the climate community when considering the relationship with trade, it probably covers a lot of ground.

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