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Future Climate Policy and the World Trade Organization

At the climate change conference in Bali in December 2007, countries agreed to launch a two-year process of formal negotiations on a successor pact to the Kyoto Protocol. The post-Kyoto regime is scheduled to be finalized in Copenhagen in December 2009. While it is expected to include new ambitious targets for reducing greenhouse gas emissions and to commit both developing and developed countries to take action, it may well leave many controversial issues unsolved, such as the nonparty issue,[1] the extent and binding force of obligations undertaken by both developed and developing countries, and the permissible nature of measures that one country can take to induce compliance by other countries.

At the ministerial session of the UN General Assembly in February 2008, representatives from developing countries cautioned that a new treaty to tackle climate change might hamper their efforts to achieve sustainable development. In his statement, China's special representative Yu Qingtai emphasized that any framework for future arrangements must be firmly based on the principle of "common but differentiated responsibilities" as previously established by the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol. He also stated that the effective participation of developing countries will depend

1. The main nonparty issue inherent in multilateral environmental agreements (MEAs) is the old free-rider question, which also raises a competitiveness concern. Nonparties to an MEA can enjoy the environmental benefits while making little or no contribution of their own. Under the Kyoto Protocol, a related issue was how to link a nonparty country's national emissions trading program with flexible trading mechanisms.

on financial and technological assistance from developed countries.[2]

On the other hand, developed countries such as the United States and those of the European Union have urged developing countries to be more cooperative. The clean development mechanism, one of the core mechanisms of the Kyoto Protocol, allows Annex I countries (developed countries) to meet their commitment by funding projects in non-Annex I countries (developing countries). Three key mechanisms under the Kyoto Protocol are summarized in box 4.1. Under the Kyoto Protocol, developing countries are not obligated to do more than facilitate these offset projects. However, at the carbon market conference in Copenhagen in March 2008, Yvon Slingenberg, the EU Commission's head of emissions trading, stated that the world will not reach appropriate emissions levels if developing countries play a role only as offset suppliers. He urged developing countries to gradually shift from offsetting to cap and trade. However, at the same conference, Yvo de Boer, executive secretary of the UNFCCC, pointed out that the developing world has repeatedly stated that it is not willing to adopt cap-and-trade systems.[3]

Given these huge differences—which reflect the basic disagreement between "per capita comparability" and "carbon price equivalency" discussed at the outset—the possibility of reaching clear-cut international standards and obligations seems remote for the Copenhagen conference in 2009. However, the scientific case for climate change will likely become even more persuasive over the next two years. Thus, compromise targets and time paths are likely to be agreed upon, while leaving ample room for national interpretation. Under these circumstances, we foresee that countries will enact their own unique mixes of domestic measures accompanied by import bans, border adjustments, and other mechanisms to address competitive concerns and to encourage action abroad. Already, the European Union, the United States, Canada, and Australia are well along in designing unique national systems with international measures to mitigate climate change. The next section examines how the World Trade Organization (WTO) should respond to the looming clash between climate change policies moving at different speeds.

Dispute Settlement Approach

The most obvious way to determine whether trade measures in support of greenhouse gas emissions controls are compatible with WTO agreements

2. The full statement is available at www.fmprc.gov.cn (accessed on January 12, 2009).

3. de Boer added that developing countries claim that carbon offsetting under the Kyoto clean development mechanism is the only serious money now on the table and that EU proposals would constrain the level of offset payments. For more details, see Gerard Wynn, "EU Wants Developing Nations to Do More on Climate," Reuters, March 11, 2008, www.reuters.com (accessed on January 12, 2009).

Box 4.1 Mechanisms under the Kyoto Protocol

The Kyoto Protocol adopted three major "flexibility mechanisms" for members to enlist the cooperation of other countries in applying cost-effective methods for reducing emissions or removing carbon from the atmosphere. All three mechanisms are based on the protocol's system of scoring success in meeting national targets. Under the system, Annex I countries should reduce their emissions over the five-year commitment period by the assigned amount units (AAUs—each unit equals one ton of CO_2e). Annex I countries should provide information to demonstrate that their use of the mechanisms is "supplemental to domestic action" to achieve their targets; this information is to be assessed by the Facilitative Branch of the Compliance Committee.

Clean development mechanism (CDM): This mechanism enables Annex I countries to implement projects that reduce emissions in non-Annex I countries (which do not have an obligation to reduce their greenhouse gas emissions), or to absorb carbon through afforestation or reforestation activities, in return for certified emissions reductions (CERs, tCERs, and lCERs), and to assist the host countries in achieving sustainable development and contributing to the ultimate objective of the convention. The CDM is supervised by the CDM Executive Board. The challenges and issues embedded in the CDM are discussed in appendix D.

Joint implementation: Under this mechanism, an Annex I country may implement an emissions-reducing project, or a project that enhances removals by sinks in the territory of another Annex I country, and count the resulting emission reduction units (ERUs) toward meeting its own Kyoto target.

Emissions trading: This provides for Annex I countries to acquire units from other Annex I countries. These units may be in the form of AAUs and various removal units, namely ERUs, CERs, tCERs and lCERs. Further, the protocol enables a group of several Annex I countries to join together to create a market-within-a-market. Under this provision, the European Union created the Emission Trading Scheme, and each EU allowance unit is equivalent to one Kyoto AAU. Short summaries of the major carbon markets (schemes) in operation in are provided in appendix E.

Source: United Nations Framework Convention on Climate Change, http://unfccc.int (accessed on January 12, 2009).

is to let the dispute settlement process run its course. Eventually, a record of decided cases will define the contours of WTO obligations. The Appellate Body's rulings in previous cases showed considerable sympathy with environmental concerns and increased the likelihood that trade measures

that further greenhouse gas emissions controls will pass muster under WTO rules. Nevertheless, it is worth noting that the trade measures adjudicated in previous dispute cases did not have a major restrictive impact on commerce. By contrast, serious carbon emissions controls could heavily impact trade. Hence, trade disputes are likely to be more intense, and both panels and the Appellate Body may show greater concern with the ramifications of disputes for the trading system.

Moreover, in the absence of clear-cut and uniform international standards, the greenhouse gas control systems adopted by various countries will differ in major respects—both as to the severity of limitations and the details of operation. The combination of enormous costs, huge "quota rent" values, and systemic differences will generate tremendous lobbying pressure and give entrée to protectionist forces. Out of the political maelstrom, it seems certain that some countries will use domestic greenhouse gas controls, at least in part, as a rationale for curtailing imports and giving a boost to domestic firms. In 2009 economic stimulus in the United States and other countries may provide legislative vehicles for new subsidies in the name of clean energy or clean transport.

Under this scenario, many cases will be brought to the WTO, and decisions are unlikely to produce clear guidelines within a short time frame (a big WTO case can easily take at least three years to run the course of litigation through the Appellate Body and the Dispute Settlement Body). In other words, the case approach foretells a long period of uncertainty and trade frictions. As trade battles are fought, some countries may become more devoted to winning legal cases than to fighting the common enemy, climate change.

In general, we believe that relegating these matters to the WTO dispute system is not the best course. If the Appellate Body is too strict on trade-related climate measures, that could inspire greater criticism of the already-fragile WTO system. If the Appellate Body is too lenient on trade-related climate measures, by according users of unilateral measures excessive deference, that could open the door to widespread opportunistic protectionism and rent-seeking behavior. Even a middle ground is not optimal because the decisions at stake should not be made by international trade judges on the basis of the complex and ambiguous WTO jurisprudence spelled out earlier in this study. So even if the Appellate Body gets it just right under the existing framework of articles, codes, and prior decisions, and balances trade and environment in a way that we would consider reasonable, others with a different sense of balance will challenge the outcome as illegitimate. Moreover, bringing a dozen climate cases to the WTO would put great stress on its dispute settlement mechanism.

One never-used WTO institution that could usefully come into play is the Permanent Group of Experts (PGE) for questions about subsidies. The PGE consists of five independent experts selected by the WTO's Subsidies and Countervailing Measures Committee. Upon the request of a panel,

the PGE can make an authoritative determination as to whether a measure is a prohibited export subsidy.[4] Upon the request of the committee, the PGE may be asked to issue an advisory opinion on the nature or existence of any subsidy.[5] Upon the request of a WTO member, the PGE will issue an advisory opinion on the nature of any subsidy that a member itself has or is proposing for introduction. This type of advisory opinion is supposed to remain confidential and may not be invoked in WTO dispute proceedings regarding actionable subsidies.[6]

Negotiation Approaches

Efforts have already been made to accommodate environmental controls by amending articles of the General Agreement on Tariffs and Trade (GATT) and other parts of the WTO legal text. The European Union has argued for modifications to GATT/WTO disciplines for environmental reasons, but its attempts have so far failed due to objections from many countries.[7] Within the WTO, legal text can only be amended by a consensus of members, which means that no member objects to the change. The continuing stalemate in Doha Round negotiations makes any WTO amendment for climate even less likely.

Apart from rewriting the WTO legal text, another approach would be to ask WTO members to approve a waiver to WTO obligations for a forthcoming climate agreement. A waiver, unlike a revision of the text, does not require a consensus among WTO members, but it does require approval from at least three-quarters of members.[8] Even a three-fourths requirement would make it difficult to get a waiver on a controversial subject. While waivers have been discussed for other MEAs (besides the Kyoto Protocol), none have been enacted.

The post-Kyoto regime agreed upon in Copenhagen in 2009 might propose such a waiver. For this to be likely, however, there would first need to have been broad agreement on appropriate trade measures within the post–Kyoto Protocol. In our view, reaching such agreement will be a bridge too far for the Copenhagen negotiations.

In the absence of a negotiated compact that defines WTO "green spaces" with respect to trade measures that foster greenhouse gas controls

4. Agreement on Subsidies and Countervailing Measures (ASCM) Article 4.5.

5. ASCM Article 24.3. Such a request by the committee would require consensus.

6. ASCM Article 24.4.

7. Among others who urge modification of existing WTO rules, the Public Citizen (2008) contends that the current rules do not allow enough space for domestic measures (such as cap-and-trade systems) that are designed to restrict greenhouse gas emissions.

8. In practice, waivers are approved by consensus, but voting is always possible.

worldwide, tit-for-tat retaliation and prolonged WTO litigation are likely. Faced with this prospect, countries could work together to reach agreement on trade measures that are acceptable and comply with core tenets of the WTO system (Pataki 2008, 59). The key for such a code to be practical is to enlist a critical mass of countries. By a WTO code, we mean a plurilateral agreement under Annex 4 of the WTO agreement.[9] In a plurilateral agreement, a subset of WTO members may commit to a set of rules that is binding among them and can be enforced in WTO dispute settlement. Such plurilateral agreements "do not create either obligations or rights for Members that have not accepted them."[10] Although such a code would require consensus of all WTO members to be formally added to the WTO agreement, such action could be politically possible because it would not necessarily require that all members agree to the text or substance of the code.[11]

Our proposal for a code is consistent with the policy direction given at the 2008 G-8 Summit in Hokkaido, Japan. The Declaration of Leaders Meeting of Major Economies on Energy Security and Climate Change states that the leaders will "[d]irect our trade officials responsible for WTO issues to advance with a sense of urgency their discussions on issues relevant to promoting our cooperation on climate change."[12] This statement was noteworthy in calling for normative action about climate in the WTO.

If negotiating a code as a WTO plurilateral agreement proves politically impossible, then a group of like-minded member governments could negotiate a code outside of the WTO. It might be called a Code of Good WTO Practice on Greenhouse Gas Emissions Controls. The advantage of acting outside the WTO is that nonparticipating countries could not block the negotiation of such a code. Of course, with an extra-WTO code, WTO dispute settlement would not be available for enforcement. But we do not see that as a serious disadvantage because other forms of dispute settlement could be used if needed.

Regardless of whether the code is negotiated inside the WTO as a plurilateral agreement or outside the WTO among like-minded countries, the code would not directly apply to countries that did not subscribe to it. So the purpose of such a code would be not to regulate the legal relation-

9. US law is ambiguous as to whether congressional approval is required for the United States to agree to such a plurilateral agreement in the WTO. The one precedent was the amendment to the Agreement on Trade-Related Aspects of Intellectual Property Rights that the Bush administration accepted for the United States without any explicit ex ante or ex post congressional approval.

10. WTO agreement, Article II:3.

11. If a particular WTO member objected to adding the code as a plurilateral agreement, that member might be induced to put aside its objections with side payments.

12. The declaration is available at www.mofa.go.jp (accessed on January 12, 2009).

ship between code members and nonmembers but rather for participating governments to agree in advance to a set of rules for trade-related climate measures in the interest of heading off disputes among those governments in the WTO. If such a code could prevent disputes coming to the WTO between the United States, European Union, Canada, Japan, and a few other countries from the Organization for Economic Cooperation and Development, that in itself would be an important accomplishment. If it could head off disputes involving China and India as well, that would be a great accomplishment.

Bringing Multilateral Environmental Norms into the World Trade Organization as Standards

In contrast to a code on trade and climate among like-minded governments, the climate regime itself could act multilaterally to create norms on trade and climate. If a forthcoming international protocol on climate contained provisions regarding trade measures, such a treaty would be considered by a WTO panel in interpreting the related WTO provisions. A key question would be whether the MEA had been agreed to by a WTO member invoking dispute settlement.[13] If the WTO member invoking dispute settlement is not a party to the MEA (e.g., the United States with respect to the Kyoto Protocol), then the WTO defendant country is probably not going to be able to use the MEA as a defense.

In recent speeches, WTO Director-General Pascal Lamy has suggested that norms agreed to in MEAs would be taken seriously at the WTO. For example, in a speech to a European Parliament Committee in May 2008, Lamy said "[a] multilateral agreement that includes all major emitters would be the best placed international instrument to guide other instruments, such as the WTO...."[14] In a speech to the Informal Trade Ministers' Dialogue on Climate Change in Bali in December 2007, Lamy said that a deal on climate change struck in the UNFCCC would "then send the WTO an appropriate signal on how its rules may best be put to the service of sustainable development; in other words, a signal on how this particular toolbox of rules [the WTO] should be employed in the fight against climate change."[15]

Building on Lamy's remarks, one can imagine that an international environmental forum could establish nonbinding principles for the use

13. Because Taiwan is not allowed to participate in MEAs, no MEA can be agreed to by all WTO members.

14. Pascal Lamy, "A Consensual International Accord on Climate Change Is Needed," Temporary Committee on Climate Change, European Parliament, May 29, 2008.

15. Pascal Lamy, "Doha Could Deliver Double-Win for Environment and Trade," Informal Trade Ministers' Dialogue on Climate Change, December 9, 2007.

of trade measures for climate change. Such principles could be used by a panel in applying Article XX. Indeed, the Appellate Body referred to extra-WTO norms in the *United States—Shrimp* case by considering the Rio Declaration on Environment and Development.[16] All else being equal, we think that a WTO panel is more likely to reject a purely unilateral measure under the Article XX chapeau than an approach stamped with some intergovernmental imprimatur of international best practices (Howse and Eliason 2008, 35). We could also imagine a multilateral climate agreement adopting binding rules regarding the use of trade measures, but this is unlikely because many countries would object to trying to write rules in an MEA that override the WTO agreement.

Given the December 2008 stalemate in WTO negotiations, it is possible that adding the issue of trade and climate could help stimulate the trade talks, with the aspiration of writing a WTO climate code. To encourage WTO negotiating efforts, US climate legislation and the legislation of other important emitting countries should contain a moratorium, to expire in January 2012, on the application of border measures or other extraterritorial controls to imported products.[17] While recognizing that negotiating a WTO code on climate will be a difficult venture, three years would seem time enough to determine whether a new WTO code can be forged that provides guidelines for countries on trade-related climate policies and heads off contentious disputes in the WTO. More details on the proposal for a WTO code are presented in chapter 5.

Reinvigorating the Doha Round

During 2008, WTO negotiators made several unsuccessful efforts to bring the Doha Round to a conclusion. The last attempt in December 2008 foundered, among other reasons, on the argument that negotiators should await the new administration of Barack Obama to see what its attitude toward the WTO and the Doha Round will be. Over the past year, some observers have suggested that 2009 offers an opportunity to breathe new life into the Doha negotiations by specifically adding climate to the negotiating agenda. No detailed proposals along these lines have surfaced, but the kernel of the idea is that synergies may be gained by linking climate negotiations to WTO negotiations. The political argument for issue linkage is somewhat elusive because major developing countries will be asked to do more than they currently want to in both arenas. However, if the Doha agenda is revised to include climate, then the negotiators would

16. Appellate Body Report, *United States—Import Prohibitions of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted on November 6, 1998, paragraphs 154, 168.

17. For similar reasons, and to facilitate talks in Copenhagen, the EU Commission has deferred consideration of border measures (see box 3.2).

have an opportunity to discuss adoption of a code along the lines of that presented in chapter 5.

As a more ambitious approach, one could imagine a renegotiation of the entire harmonized tariff system to distinguish products as to whether they are climate-friendly.[18] The Doha negotiators are already considering tariff cuts for environmental goods,[19] and those negotiations could be fine-tuned if the definition of environmental goods were to be linked to an international climate agreement.[20] The real political purchase of a revised tariff schedule would not be just the expanded tariff classifications but, more importantly, an agreement in the WTO to allow higher tariffs (above current bound levels) on goods whose production is not being accounted for under national commitments to a multilateral accord. Negotiations would also be needed in the World Customs Organization. However, there is no reason to believe that countries like China and India would go along with the WTO consensus needed to allow a comprehensive retariffication.

Another possibility for the WTO is to initiate sectoral agreements on climate that would restrict international trade in a particular commodity (e.g., steel) to countries with qualifying greenhouse gas emission limits. The use of trade-restrictive sectoral agreements (e.g., textiles and apparel) has a long history in the trading system, and one of the achievements of the Uruguay Round was the phaseout of those agreements.[21] That said, it would be possible to reintroduce a commodity approach to controlling trade for climate reasons if all WTO members agreed. This could be done by an amendment to the WTO or perhaps a WTO agreement with the International Energy Agency. In addition, one should note that GATT Article XX contains a long-dormant exception for measures "undertaken in pursuance of obligations under any intergovernmental commodity agreement that conforms to the criteria submitted to the contracting

18. For example, any climate-sensitive tariff classification could be divided into a plain and starred (*) classification, with the latter for goods produced in a climate-friendly way.

19. To our knowledge, there is no WTO-approved definition of an environmental good or service. In the most recent paper (November 2005) on the topic available on the WTO website, the designation of a good as "environmental" seems to be based on its end use rather than its production process. WTO Committee on Trade and Environment Special Session, "Synthesis of Submissions on Environmental Goods. Informal Note by the Secretariat," TN/TE/W/63 (November 17, 2005). Four more recent papers are listed on the WTO portal on this topic but carry a "JOB" designation, which means that the document is classified and not available to the public. See TN/TE/INF/4.Rev.13 (April 30, 2008, 6).

20. An agreement to reduce tariffs on environmental goods could be modeled on the WTO Information Technology Agreement.

21. The Multi-Fiber Arrangement did not have social or environmental provisions, but other trade provisions have contained social provisions regarding labor conditions (notably the Generalized System of Preferences).

parties and not disapproved by them, or which is itself submitted and not so disapproved."[22] This might allow international climate sectoral agreements, open to all WTO members, to be countenanced by the GATT.

22. GATT Article XX(h) and Ad Article XX, paragraph (h) regarding the UN Economic and Social Council resolution. The meaning of the provision was discussed in a GATT panel decision, *EEC—Import Regime for Bananas*, DS38/R, adopted on February 11, 1994 [*Bananas II*], paragraphs 165–66.