

# The Centre for International Governance Innovation: Conference Report

## Climate Change and the Trading System

Report of a meeting in Toronto, October 26-27, 2009, organized by The Centre for International Governance Innovation and the Canadian International Council, with the support and participation of the International Institute for Sustainable Development, the International Development Research Centre, and the Centre for Trade Policy and Law.

Currently, two vitally important elements of international governance confront each other, posing complex questions about how to provide for sound action on climate change without collateral damage to the international trading system. This was the topic of a meeting in Toronto on October 26 and 27, 2009 that brought together experts from the two communities – trade experts who meet annually under CIGI's aegis and climate change specialists.<sup>1</sup>

Meeting just prior to the fifteenth conference of parties to the United Nations Framework Convention on Climate change (UNFCCC), participants at the Toronto meeting thought that it is extremely unlikely that Copenhagen will actually “seal the deal” in terms of yielding a comprehensive agreement. At best it will set the parameters for continuing negotiation, with the hope of a relatively early conclusion. In the absence of agreement on how to deal with climate change, many countries have been adopting specific actions, preparing to do so, or staking out policy or negotiating positions. By the time agreement is reached, many countries will have launched unilateral policies. These are likely to be inconsistent, given differences in policy perspectives and levels of public concern around the globe, with the European Union (EU) being the most ambitious, the United States somewhat less so, while major developing countries continue to resist binding commitments.

This spells danger for the trading system. New barriers are likely to emerge in the form of border carbon

adjustments, hard-won disciplines on subsidies may be eroded, and there will almost certainly be conflicting claims about the “carbon footprints” of competing products. If an appropriate framework for trade and climate change is not hammered out through negotiations, the pressures may spill over into the dispute settlement system.

Awareness of the challenges in dealing with the intersection of trade and climate change policies has been slow in forming. The combination of inherent uncertainties in climate change science and concerns about the costs of mitigation measures have tended to undermine political will to take effective action. At the same time, preparation to deal with the consequences for the trading system of strong climate change measures has also lagged. Significant catch-up work has been done in recent years, but the fact remains that the situation is clouded with uncertainty regarding the kinds of climate change action that will be taken, and about how these may conflict with and/or be accommodated in the trading system.

The discussion at the October meeting focussed on border carbon adjustments; on the implications of free carbon emission allowances for particular industries in cap-and-trade systems; which may run afoul of World Trade Organization (WTO) rules on subsidies; and more generally on issues relating to subsidies. Given the present uncertainties about how these features of climate change action may evolve, the group recognized the risk of mounting pressures on the WTO dispute settlement system. While the possibility of a “train wreck” in the WTO cannot be excluded, the focus of discussion at the meeting was

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<sup>1</sup> This report was prepared by Dan Ciuriak, Senior Associate, Centre for Trade Policy and Law and Bob Johnstone, Senior Advisor, Canadian International Council.



largely on the need to find ways to avert dangers so that the two important objectives can be met – dealing with climate change while preserving a sound trading system.

### Global Problems do not Respond to Unilateral Fixes: Copenhagen Must be Our Focus

Pascal Lamy, WTO Secretary-General, *WTO News*, June 26, 2009

As an integral part of the global system of production and distribution of goods and services, the trading system has its own “carbon footprint”; by helping expand economic output, trade also indirectly works to increase emissions. Since the main thrust of climate change policies is to increase the price of carbon, trade costs are impacted, with implications for the global pattern of production and consumption and thus for trade patterns.

The relative price of carbon-intensive goods and services will rise, triggering a wave of economic adjustments and spurring technological change. Trade-exposed, carbon-intensive industries such as iron and steel, chemicals, pulp and paper, cement, and aluminum and petroleum refining will face higher costs and will seek protection. Changing relative prices also creates winners: the less carbon-intensive products and factor inputs – including for example more jobs as labour substitutes for capital; but the focus of policy attention is likely to be on the losers, who will as usual clamour for trade protection.

Consumer preferences are also likely to change, affecting the market environment for traded goods and services. One example is the response of consumers to exhortations to buy local through the concept of “food miles” (even though the validity of this concept has been questioned due to the energy-intensive nature of food production in industrialized countries, where the buy local initiatives have been mounted).

The potential use of border measures to “level the playing field” directly raises trade issues – for example, countries that adopt carbon taxes might apply border carbon adjustments for imported goods. Jurisdictions that opt for emission cap-and-trade systems might impose obligations upon importers to acquire emission rights.

In a positive sense, trade liberalization, by removing trade barriers, can help widen the use of clean technologies and increase access to environmental goods and services, thus assisting in adaptation and mitigation efforts.

The experience in integrating multilateral environmental agreements as it has in the past with respect to environmental agreements such as the Montreal protocol on ozone, the CITES and the Basel Hazardous Waste Conventions into the rules-based trade system has been encouragingly quite positive. However, “trade and climate change” is not simply old “trade and environment” wine in new bottles. Given the complex weave of interconnections, and the scale of the impacts and costs, the development of effective climate change policies and their harmonious accommodation in trade rules pose major, perhaps unprecedented, challenges to international governance.

### Border Carbon Adjustments

Aggressive climate change measures, some participants argued, may only be politically possible if some form of relief is provided to domestic industry faced with higher costs, and with a perception of heightened

competition from suppliers in countries with weaker climate programs. The dynamic that tends to unfold involves climate change legislation being enacted (or simply announced), deleterious effects on industry are felt (or alleged), lobbying for protection ensues, and the government is pressured to either water down the

environmental protection or incorporate some form of economic protection.

A related concern is that emission-intensive production will shift to regulatory havens abroad, rendering the domestic measures ineffective (or less effective), since the targeted emissions would simply have been displaced rather than eliminated. In the climate change discussion, the displaced economic activity is referred to as “leakage.”

During the discussion, some participants argued that concerns about the impact on competitiveness in countries with more stringent emission controls are overdone. Indeed research, for instance by the World Bank and others, supports that contention. And it was noted that concerns about leakage focus largely on energy-intensive, trade-exposed industries. These industries contribute only a small fraction of national gross domestic product in most economies. Moreover, since these industries tend to produce inputs to other domestic industries, border measures will undermine effective protection for other domestic industries.

Nonetheless, given the political dynamic, most participants were of the view that such measures will almost assuredly form a significant part of the future policy landscape – whether or not they make economic sense, whether they even work in terms of hitting their intended targets. It was suggested for instance that such provisions in US legislation may be aimed at China but may actually strike Canada most severely because of the scale and breadth of its trade with the US. Or whether they would have unintended negative consequences for domestic industries by raising costs of imported production inputs.

Moreover, most participants expected such measures to be applied not only to basic commodities, where there is at least some hope of measuring the carbon content and thus accurately applying an offset, but also to complex manufactured goods, the end product of global value chains, where such a hope almost certainly will prove to be in vain.

Participants feared that any problems will squeeze out into the trading system to be adjudicated by WTO panels. Panels would be faced with significant practical problems in determining the carbon content of particular products. It was noted that the Organisation for Economic Co-operation and Development (OECD) has been doing a lot of work on carbon accounting and labelling, including at the 2009 OECD Global Forum on Trade which included several presentations bearing on this issue. But carbon labelling is still at a very early stage – the OECD has catalogued 13 schemes

and two more have surfaced since, including one in France involving a supermarket labelling program. The different methodologies which are being developed can yield radically different numbers – for example, it was noted that differences between estimates provided by two serious institutes differed in one case by a factor of six. These differences reflect the problem of life cycle analysis (a coverage question), problems of accounting for the carbon content in complex products like computers, which incorporate parts coming from around the world, and also data availability (existing data often is in private data banks and only available at exorbitant prices). This situation would pose obvious difficulties for WTO panels attempting to verify claims and counter-claims about specific border measures. Some participants were of the view that, given the likelihood that no country will trust another country’s data, there is a strong case for setting up a believable secretariat with scientists and economists to establish carbon content of goods.

Daunting as are the problems of dealing with such issues, it is sometimes argued that a case for border measures is that the threat would promote wider adoption of climate change measures, especially among the larger developing countries, thereby promoting a fairer sharing of the burden of climate change action. Most participants were highly sceptical of this argument. Quite apart from the obvious political objections to waving this stick, it was pointed out that the trade in energy-intensive, trade-exposed sectors between developing economies and the major industrialized countries which could conceivably wield sufficient market clout to cause concern will often be quite minor. It was observed that what is on the table in the United States, targeting carbon-intensive primary goods, has little leverage on China. The cost of adopting stringent climate change measures might be substantially greater than the cost of losing that particular market. The measures would not in that case elicit improved environmental measures – but they would create a bad negotiating environment.

Moreover, because border measures are likely to be sector-specific (such as the measures in US legislation that speak of “comparable quantitative measures” on a sectoral basis), they may not be practical in terms of eliciting improved environmental measures in areas where the targeted country could actually deliver. It was noted, for example, that while Brazil might be in a position to make commitments on deforestation, that would not help it avoid border measures aimed at its steel industry.

## “Free Allowances” and Trade Subsidies

In the view of some, the subsidies implicit in so-called “free allowances” potentially represent a bigger issue than border carbon adjustments. Under cap-and-trade regimes, firms that emit carbon must obtain an allowance and stay within it. Depending on the regime, the allowance might be purchased at an auction by the issuing authority or on secondary markets (which might be national or international), or they might be distributed in part for free. If free allowances can be shown to be trade-distorting, they could run afoul of the WTO Agreement on Subsidies and Countervailing Measures (SCM) and be subject to challenge as actionable subsidies. It was felt that this issue cannot be avoided because it will not be possible to get a climate change bill through the US Congress without a subsidy element in terms of free allowances.

The UN, it was noted, has been advocating the use of Article XX to provide policy space on environment. However, in the view of some, reliance on Article XX to deal with an issue as important as trade and climate change would be a very poor second best – for example, it was pointed out, Article XX has no parameters. Consideration should be given, it was suggested, to building in a green component for climate change subsidies in SCM Part IV (carve outs for adaptation, R&D, regional development etc.). Under the original WTO Agreement, the SCM had such a green component, but this was allowed to expire after five years because there was no interest in renewal. Could this provision be resurrected? As well, various ideas were suggested for how the WTO might prepare to deal with climate change related subsidies: for example, to promote transparency, a notifiable subsidies template might be prepared and a subsidy review mechanism could be considered.

Some suggested that the track record of the WTO in disciplining subsidies has not been stellar. The fundamental constraint on subsidies is transparency and public information on alternative ways to deploy those funds. However, there has been little transparency in terms of reporting measures in the WTO, which does not bode well for transparency in the climate change area. Indeed, it was suggested that it is inherent in the nature of subsidies not to seek sunlight. Subsidies are the currency of politics – information is closely guarded. The OECD has long been engaged in work on subsidies but has achieved only limited coverage.

## Asymmetry in Roles and Responsibilities of Developing and Developed Countries

One theme that emerged at various points in the discussion is the very high degree of asymmetry between developed and developing countries, and increasingly among developing countries. Countries vary enormously, not only in the structure of their economies, but also in their capacity to deal with the challenges of adaptation. This has obvious implications for what is reasonable to expect of individual countries, particularly the poorest. But while it was readily acknowledged that developing countries are not responsible for climate change, it was argued that it would be self-defeating for at least the so-called “emerging” countries not to contribute to mitigation efforts since developing countries would be the hardest hit by the fallout from climate change and have the least capacity to deal with its impacts. Thus, it was argued that there is a balancing of interests to be recognized, which starts to put obligations on developing countries.

This led into discussion of the notion of fairness in dealing with climate change. The lack of a broadly shared understanding about what is fair is part of what is holding up agreement. Fairness is ultimately in the eye of the beholder and it does matter whether whatever is done is seen to be fair by governments and by their publics.

As one participant asked, would it be fair to let developing countries have a competitive advantage for decades? Is it fair to put China in the general class of developing countries despite the size it has attained both in terms of economic output and in emissions, a category in which it has surpassed the United States to become world leader?

The heterogeneity of interests across developing countries was emphasized. China and India, it was noted, have held to a common position on climate change but their situations are actually quite different: manufacturing accounts for a much higher share of GDP in China than in India. China’s GDP scale is three to four times that of India, and its manufacturing sector is six to eight times as large.

In Africa, meanwhile, there is a lack of access to even basic technologies that would help with mitigation and adaptation. Some feared that protection in trade rules for intellectual property rights may exacerbate this access issue. A case can be made for waivers, as were provided for medicines. However there was some doubt as to how much effect such waivers would have since the proportion of the price of climate change

technology accounted for by intellectual property protection is much smaller than in medicines, where it can account for as much as 90 percent of the price.

## The Positive Agenda: Facilitating the Diffusion of Low-Carbon Technologies

There was considerable emphasis on the importance of looking beyond the difficulties of dealing with border adjustments and other potential problems to a positive agenda of how trade can support the transition to a low carbon economy, including by liberalization of trade in relevant goods and technologies. This is of course on the Doha agenda.

The OECD has also been pushing liberalization of trade in low carbon goods for a long time. But trade liberalization plays only a small part in this area – the bigger issue is creating demand for these goods. If governments got behind the low carbon technologies, it was argued, support for trade liberalization in this area would start to become significant.

The spread of business interest in climate-friendly and low-carbon technologies is a new and interesting dimension in trade and climate change. Commercial interests can drive things forward so it is important to identify areas where progress could be made – for example, China has high tariffs on solar panels and the United States recently raised tariffs on solar panel imports through a classification change.<sup>2</sup>

It was noted that progress is often made by countries specializing in areas that are particularly important to them. Germany for example developed expertise in clean water because of its need to clean up the Rhine. Similarly, Japan acquired expertise in dealing with air pollution through its efforts to clean up Tokyo's air. The United States, meanwhile, has particular expertise in dealing with mines. Canada is investing in carbon sequestration and storage projects.

At the same time, some cautionary notes were sounded. Trade liberalization on environmental goods and services has positive elements but also carries some fiscal and economic risks for developing countries, which tend to have higher tariffs in this area.

One participant made a forceful argument concerning the potential climate change mileage from reducing or eliminating subsidies for production and use of fossil fuels. Globally, it was noted, subsidies for carbon-based

fuels have been estimated to be as much as \$500 billion. According to the IPCC, removing these subsidies alone would reduce emissions by 10 percent while freeing up money for other societal goals. At the G20 meeting in Pittsburgh, there was a resolution to phase out subsidies for fossil fuels. It was observed that this should not give rise to hopes for immediate implementation but it is not unimportant, and pressure should be kept on the G20 members to deliver on this commitment.

In considering potential measures in this area, some cautions were noted. It is tempting to shift subsidies to alternative energy forms such as solar panels, but all subsidies can raise trade issues. Further, it was argued, subsidies are often used to compensate industry for costs imposed on them, whether for climate change or for other reasons. Finally, while most fossil fuel subsidies go to oil, coal is the worst emitter. If the subsidy from oil is removed, there is a risk that the substitution would be towards coal. Notwithstanding these cautionary notes, it was suggested that consideration be given to make fossil fuel subsidies simply illegal, rather than actionable, i.e. possibly illegal under WTO rules depending on their characteristics.

## The Institutional Setting: Is There a Governance Gap?

The institutional framework that was developed and evolved in the post-WWII period is not, it was argued, well suited to dealing with large, cross-cutting issues such as climate change. The major international institutions – the GATT/WTO, the International Monetary Fund (IMF) and the World Bank – were designed with the pressing policy objectives of the immediate postwar era in mind: dismantling trade protection; re-establishing a functioning international financial system and providing for currency stability; and providing for postwar reconstruction and later development assistance. The institutional framework was subsequently fleshed out by creating institutions specific to new issues that arose over time. While the international institutional framework thus provides a structure of international governance in particular areas, the problem, it was argued, lies in the fact that there is nothing to ensure coherence across the various regimes or effective collaboration in areas such as climate change that cut across the mandates of the existing institutions.

The WTO came in for criticism, from both trade and climate participants. It moves at a glacial pace, with negotiating rounds lasting seven to ten years to make incremental progress. Its mercantilist negotiating mode is unsuited to dealing with issues such as climate change and development. It has virtually no pro-active capacity.

<sup>2</sup> See "Solar Panel Tariff May Further Strain U.S.-China Trade" *NY Times*, September 30, 2009.

The Appellate Body, it was argued, is the only place where there is progress. Thus the WTO embodies major design flaws when dealing with the issues of today.

More generally, it was suggested, the attitude of the trade policy community when it comes to climate change (“there hasn’t been a problem yet”) is dangerously sanguine and its concentration on completing the Doha Round misplaced. Others, however, saw wrapping up the current WTO negotiations as very important on several grounds. A successful conclusion to Doha would usefully clear old issues off the agenda to allow the shift of attention to the new pressing issues. It would strengthen the WTO as an institution and, in particular, reduce the pressure on the dispute settlement mechanism which otherwise may be asked to address issues that ought properly to be dealt with by Members through negotiations. And it would allow the WTO to make a direct contribution to climate change mitigation efforts by liberalizing trade in environmental goods and services.

Some participants see the WTO’s inability to move decisively in this area as reflecting a combination of factors. The diminution of the United States’ hegemonic influence as the global economy became multi-polar, compounded by the fact that, on climate change, the United States is coming to the table with very little and is talking mostly protectionism, and by the fact that it is downplaying international law. The latter development, it was suggested, reflects the unwillingness of the Obama administration to move before Congress ratifies and thus to risk having yet another major international agreement stuck in Congressional ratification.

## Conclusion

In this meeting involving experts from the two fields – trade policy and climate change – there was no debate about whether the climate is in fact changing, that human actions bear much of the responsibility, and that governments must act. That was accepted. There might be argument about the science, for instance whether a temperature increase of more than two degrees is a precise tipping point. But whatever views participants may have had on the science of climate change, there was a clear consensus that action to deal with it must take account of implications for the trading system, and per contra that ways must be found to accommodate sensible climate action in the rules of international commerce.

The great difficulty of dealing with the potential dangers from border carbon adjustments came in for a good deal of emphasis. The majority almost certainly shared a view that it would be best to eschew them, but recognized

that they will almost certainly be part of the mix. More hopefully, there was a widespread view that the prospects of dealing with subsidies are more promising.

An important theme did emerge in the discussion of asymmetry, the great differences in wealth and capacity among countries. Whoever caused the problem, it has to be accepted that not all need contribute equally to its solution. The principle of differential treatment that is found in both the WTO and in the UN Framework Convention on Climate change has to be respected.

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## Who We Are

The Centre for International Governance Innovation is an independent, nonpartisan think tank that addresses international governance challenges. Led by a group of experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate, builds capacity, and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events, and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI's work is organized into six broad issue areas: shifting global order; environment and resources; health and social governance; international economic governance; international law, institutions and diplomacy; and global and human security. Research is spearheaded by CIGI's distinguished fellows who comprise leading economists and political scientists with rich international experience and policy expertise.

CIGI was founded in 2002 by Jim Balsillie, co-CEO of RIM (Research In Motion), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario. CIGI gratefully acknowledges the contribution of the Government of Canada to its endowment fund.

Le CIGI a été fondé en 2002 par Jim Balsillie, co-chef de la direction de RIM (Research In Motion). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario. Le CIGI exprime sa reconnaissance envers le gouvernement du Canada pour sa contribution à son Fonds de dotation.

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