DISCUSSION PAPER

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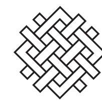

Competitiveness, Leakage and Comparability:

DISCIPLINING THE USE OF TRADE MEASURES UNDER A POST-2012 CLIMATE AGREEMENT[1]

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Summary

As the United States, the European Union and other Annex I Parties prepare legislation to cap greenhouse gas emissions post-2012, their policymakers are under increasing pressure from domestic constituencies to include trade measures as part of domestic climate policy. This Discussion Paper analyzes the trade measures contained in draft domestic climate policies emerging from the U.S. and the EU, describes the objectives of these measures, assesses how they might be imposed and discusses their implications for both a future climate agreement and the international trading system.

We find that:

- Trade measures have been included in draft climate legislation in the U.S. and considered in the EU in an effort to achieve several policy objectives: to protect domestic industry from competition ("competitiveness"), to prevent greenhouse gas polluting industries from moving overseas ("leakage") and to punish non-parties to a future climate agreement ("free-riding").
- Neither the United Nations Framework Convention on Climate Change (UNFCCC) nor the World Trade Organization (WTO) authorizes the use of trade measures as a means of protecting domestic industry from competition. The UNFCCC and WTO share a set of common principles that discourage the use of unilateral trade measures that are arbitrary, unjustifiable or disguised restrictions on trade.
- It may be possible to design trade measures that are sufficiently targeted and equitably applied to prevent emissions leakage in a way that would be consistent with WTO principles. But the UNFCCC has yet to consider whether preventing emissions leakage justifies the use of trade measures.
- Leading U.S. proposals are intended, in part, to encourage broader participation in multilateral climate negotiations. Yet as currently designed a developing country Party to a post-2012 international climate agreement that was in full compliance with its commitments under that agreement, could still face trade measures if the U.S. determined that the Party's climate policies were not "comparable" to its own.
- If such trade measures were implemented, a trade dispute would likely arise, and a WTO dispute settlement panel could be forced to choose between a result that either required the U.S. or EU to dismantle a central part of their climate legislation, and one that allowed the trade measure to stand, but in doing so undermined the UNFCCC's legitimacy as the global standard-setting body for climate policy.

This Discussion Paper suggests that it would be both reasonable and appropriate for the UNFCCC Conference of the Parties (COP) to articulate a set of principles applicable to any trade measures used to advance the Convention's objective, in order to avoid and help resolve any disputes that might arise under the WTO or elsewhere.

Trade Measures in Domestic Climate Policy

As the international community was concluding negotiations on the Kyoto Protocol in 1997, the U.S. Senate unanimously objected to U.S. participation in any agreement that did not include commitments from all major economies, claiming that it would be environmentally ineffective and put U.S. industry at a competitive disadvantage. While public support in the U.S. for action on climate change has increased considerably over the past decade, concerns remain that emission caps in developed countries in the absence of similar policies in developing countries will lead to a loss of "competitiveness" in manufacturing industries for which energy is a significant cost of production. It has been argued that this, in turn, could result in a "leakage" of emissions to countries with no or less stringent emissions limits, thus undermining the purpose of emissions limits in the U.S. or EU.

Growing political support for trade measures in the EU and U.S. is in part also due to uncertainty surrounding a future international climate agreement. Both the U.S. and Europe are looking to enact climate policy for the post-2012 period before a post-2012 international climate treaty is in place. The trade measures included in legislative drafts are seen as safeguards against a breakdown in international negotiations or in anticipation of a climate treaty that fails to include actions by major developing country economies. In currently proposed climate legislation in the U.S., for example, the U.S. administration would, after making a good-faith effort to reach an agreement, review the climate policy adopted by trading partners. Least developed countries and countries found to have taken steps to reduce emissions "comparable in effect" to those adopted in U.S. domestic legislation would be exempt from trade measures. Importers of carbon-intensive products into the U.S would be required to purchase carbon offsets equivalent to those required of domestic producers of the like products.

In Europe, the use of trade measures as part of domestic climate policy has gained traction as well. First conceived as a response to U.S. rejection of the Kyoto Protocol, trade measures are now seen as a means of preventing emissions leakage and a loss of competitiveness in the third phase (post-2012) of the EU emissions trading scheme. The European Commission has not yet proposed a specific design for its climate-related trade measures, but draft policy documents suggest similar concerns about competitiveness, leakage, and a need to assess whether producers of energy-intensive products from trading partners are on a "comparable footing."[3]

In the U.S. and Europe, trade measures are intended to achieve multiple policy objectives: addressing competitiveness, preventing leakage and punishing free-riders. This is in large part a reflection of the diversity of domestic constituencies advocating for their inclusion in domestic climate policy. Energy-intensive manufacturing firms and their employees are primarily concerned with the impact of emissions caps on their international competitiveness in an environment where different countries are moving at different speeds in imposing carbon costs on industry. Some environmental NGOs worry that capping emissions from industries in developed countries could force these industries, and their emissions, to relocate to uncapped countries.[4] And there is visible support in both the U.S. and Europe for trade measures against countries that abstain from multilateral action on climate change. Yet, as designed, these measures fall short of meeting their objectives, and if implemented, would likely be incompatible with the spirit and principles of the UNFCCC and the WTO.[5]

Trade Measures in the Context of the UNFCCC and WTO

The UNFCCC anticipates that a Party to the Convention might resort to unilateral trade measures when addressing the problems of climate change, but that such measures would need to be disciplined. Fossil fuels, energy-intensive and energy-related products are heavily traded goods, and there is a risk that, without these disciplines, climate policy could be used to disguise trade measures aimed primarily at protecting domestic industries, rather than at reducing emissions.

To avoid this, Article 3.5 of the UNFCCC provides that:

> The Parties should cooperate to promote a supportive and open international economic system that would lead to sustainable economic growth and development in all Parties, particularly developing country Parties, thus enabling them better to address the problems of climate change. *Measures taken to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade* [emphasis added].

This language draws directly from the text of the General Agreement on Tariffs and Trade, now part of the WTO[6], a free trade regime of which most UNFCCC Parties are also members. WTO rules are designed to reduce tariff and non-tariff barriers to trade and to prohibit the discriminatory use of trade measures. These rules are backed by a compulsory and binding dispute settlement system that can authorize trade sanctions against Members found in non-compliance. Article 3.5 was included in the UNFCCC to ensure, as much as possible, that trade measures taken by UNFCCC Parties to implement the Convention are consistent with free trade principles.

Since the adoption of the UNFCCC in 1992, policymakers and academics have speculated about what kinds of trade measures

a Party might put in place to advance climate change objectives, whether such measures might be challenged under the WTO's dispute settlement system, and whether these measures would be found compatible with free trade rules.[7] Recently, this speculation has been made more concrete by the inclusion of the specific trade measures in draft climate legislation in the U.S as described above.

Policymakers in Annex I (developed) countries are conscious of the constraints imposed by the WTO (and echoed in the UNFCCC) and a need to draft trade measures that do not constitute "arbitrary or unjustifiable discrimination or disguised restriction on international trade." Proponents of these measures have sought to align their design and justification with the language of WTO case law which is an important source of guidance on how to interpret WTO text. In current U.S. climate proposals, the government would distinguish between two otherwise physically identical products on the basis of the climate policy in place in the country of origin. The result of such measures is discriminatory, and most commentators, even those supporting the inclusion of these provisions in Annex I policies, have acknowledged that these would constitute a prima facie violation of WTO rules. To survive a WTO challenge, the measures would have to qualify for an environmentally related "exception."[8]

Qualifying for an environmentally related exception under the WTO requires a two-step test. First, the measure must be primarily aimed at achieving a policy objective recognized as legitimate under GATT Article XX. Protection of domestic industry from the competitiveness effects of domestic policy is *not* recognized as a legitimate policy objective under the WTO (nor is it under Article 3.5 of the UNFCCC). In order to survive a challenge, the measure would need to be related to the objective of reducing greenhouse gas emissions. This could include a) reducing the "leakage" of greenhouse gas emissions from a country where the price on carbon is high, to one where it is lower, b) encouraging the country of export to reduce its emissions, or c) bringing free-riders into an international agreement. The measure would need to be designed in the least trade restrictive manner reasonably available to the country of import. As has been argued elsewhere, it is unlikely that U.S. trade measures, as designed, would create sufficient leverage on any significant exporter of carbon-intensive goods to compel the government to undertake a comparable cap on greenhouse gases. Nor would the measures be targeted enough to incentivize individual foreign firms to adopt less carbon-intensive production processes.[9]

The second part of the Article XX test requires the importer to show the trade measure is not "arbitrary, unjustifiable or a disguised restriction on trade." The WTO dispute settlement report that has been relied upon most heavily to predict how a WTO Panel might analyze climate trade measure is the so-called "Shrimp/Turtle" dispute.[10] In the Shrimp/Turtle dispute, several Asian countries challenged a U.S. ban on shrimp imported from countries the U.S. had unilaterally determined were failing to protect sea turtles from drowning in shrimping nets in a manner essentially the same as required of U.S. shrimpers. The U.S. trade measures were eventually upheld by the WTO Appellate Body only when the U.S. adjusted its regulation to allow greater flexibility to shrimp importers. The Appellate Body found that when the U.S. shifted its standard from requiring measures essentially the same as U.S. measures to "the adoption of a program *comparable* in effectiveness," this new standard would comply with WTO disciplines. Many – though not all – trade lawyers expressing a view on this issue have concluded that the Shrimp/Turtle case opens the door for U.S. climate legislation that bases trade measures on an evaluation of the "comparability" of climate policies taken by other countries.

The most recent bills submitted to House and the Senate of US Congress share the same language, and address "comparability" as follows::

> The term "comparable action" means any greenhouse gas regulatory programs, requirements, and other measures adopted by a foreign country that, in combination, are comparable in effect to actions carried out by the United States through Federal, State and local measures to limit greenhouse gas emissions, as determined by the [International Climate Change] Commission . . .[11]

The International Climate Change Commission established under the legislation can exempt a "foreign country" from trade measures by determining that the country has taken "comparable action" during a particular calendar year under one of two tests. Under the first test for exemption, comparable action is action comparable in effect, as assessed in terms of its GHG emissions reductions in relation to US emissions reductions:

> A foreign country shall be considered to have taken comparable action if the Commission determines that the percentage change in greenhouse gas emissions in the foreign country during the relevant period is equal to or greater than the percentage change in greenhouse emissions of the United States during that period.[12]

If a foreign country fails the first test, the Commission may still determine the country has taken "comparable action" as assessed on the extent to which, during the relevant period, it has "implemented, verified, and enforced each of the following":

> (I)The deployment and use of state-of-the-art technologies in industrial processes, equipment manufacturing facilities, power generation and other energy facilities, and consumer goods (such as

automobiles and appliances), and implementation of other techniques or actions, that have the effect of limiting greenhouse gas emissions of the foreign country during the relevant period.

(II)Any regulatory programs, requirements, and other measures that the foreign country has implemented to limit greenhouse gas emissions during the relevant periods.[13]

This second test appears to assess "comparable effort" rather than comparable effect, but leaves unclear whether the benchmark for that effort will be US technology, sectoral or regulatory requirements, or some other standard.

Finally, under proposed legislation least developed countries and countries whose share of total global greenhouse gas emissions is below the de minimis percentage of 0.5% are excluded from a comparability test (and from trade measures).[14]

If these definitions of "comparable" require the same level of emissions reductions, or the same technological and regulatory standards from developed and developing countries, U.S. domestic legislation would be sharply at odds with current international climate negotiations. The Bali Action Plan uses the term comparable as a means of ensuring that developed countries not party to the Kyoto Protocol (e.g., the U.S.) undertake commitments that are comparable to rich countries that are Kyoto Protocol Parties (e.g., the EU). There is no equivalent language in the Bali Action Plan to ensure that developing country actions that might be agreed at Copenhagen must also be "comparable" to those of developed countries. Instead, the UNFCCC principle of "common but differentiated responsibilities" is reiterated strongly. Developing countries are expected to take "nationally appropriate mitigation actions…in the context of sustainable development, supported and enabled by technology, financing and capacity-building, in a measurable, reportable and verifiable manner".

Even if developing countries agreed to fairly aggressive actions under a post-2012 agreement, these actions could still fail the kind of comparability tests that have evolved in U.S. proposals. And as the global "price of carbon" grows, the pressure on Annex I policymakers to address disparities in the costs associated with climate policy between countries will only increase.

US proposals contain a potentially helpful, if ambiguous provision that instructs the Commission that '[a]ny determination on comparable action . . . under this paragraph shall comply with applicable international agreements."[15] This provision could be interpreted to require the Commission to exempt from trade measures any country that was a Party to and in compliance with a post-2012 climate agreement to which the US was also a Party. Excluding all Parties from trade measures could, however, blunt the effectiveness of the trade measure from addressing competitiveness or leakage.

It is possible to tailor trade measures more narrowly, and to avoid a comparability test based on countries' domestic climate policies. Alternative proposals attempt to target potential carbon price disparities directly by adjusting them at the border for all carbon-intensive products regardless of country of origin.[16] These measures focus solely on addressing emissions leakage by creating incentives for individual firms to change production methods rather than attempting to coerce governments into changing policy. Measures targeting leakage can be distinguished from those targeting competitiveness because they are designed allow a country to meet its domestic environmental objectives by imposing a carbon price at the border equivalent to that faced by a domestic producer. But this price must be imposed equitably, based on the carbon-intensity of a given firm's production methods, which means that domestic companies that are dirtier than their foreign competition would still see their competitiveness erode.

While this approach avoids the risks of one Convention Party unilaterally reviewing another's policy, proponents may still face the challenge of demonstrating to the WTO that prevention of leakage is a legitimate policy objective and that leakage would have occurred in absence of the trade measure.

The UNFCCC has never debated whether the use of unilateral trade measures to discourage "leakage" would meet the standards of Article 3.5. The common but differentiated nature of commitments under the UNFCCC and the Kyoto Protocol suggests that Parties have thus far been prepared to tolerate, for some period of time, significant differences in the costs of compliance between developed and developing countries. Common but differentiated responsibility also means that emissions leakage between Parties to the Convention will likely occur under a post-2012 agreement as carbon prices will undoubtedly differ, not only between developed and developing countries but among developed countries themselves.

The UNFCCC could well agree that an individual country has the right to guard against emissions leakage as a means of meeting its own commitments under a post-2012 agreement. There is wide range of research and views on how significant the issue of leakage is from a global perspective.[17] For some Annex I countries where industry accounts for a large share of total emissions, however, there are concerns it may be difficult to achieve significant reductions without either imposing a carbon price at the border or outsourcing pollution-intensive activities to developing countries. But as of now, the issue of preventing emissions leakage hasn't been a feature of international negotiations.

Risks of a Dispute both for Climate and Trade

This divergence between international climate negotiations and domestic climate policy developments in Annex I countries creates significant risks for both the UNFCCC and the global trading system. Trade measures currently proposed in the U.S. (and to a lesser extent Europe) are aimed at encouraging broader participation in a post-2012 climate treaty. Yet as mentioned above, these measures could end up being imposed on developing countries that are party to a post-2012 agreement rather than just free-riders who choose to stay outside the agreement. If such trade measures were challenged, as they likely would be, both the trade and the climate agreements could be undermined.

Although Article 3.5 of the UNFCCC draws upon language of the General Agreement on Tariffs and Trade, the Convention does not refer or defer to the WTO as the mechanism that would have the authority to interpret this provision, or to assess the legality of trade measures that Parties put in place as part of policy aimed at meeting their commitments under the Convention. The COP, the UNFCCC's "supreme body" has the authority to "make, within its mandate, the decisions necessary to promote the effective implementation of the Convention."[18] The UNFCCC anticipated that the Parties would sign up to or develop a dispute settlement process under Article 14 of the Convention that could have resolved disputes "between any two or more Parties concerning the interpretation or application of the Convention", but no Party has taken up this option to date.

Thus, if a dispute were to arise between two Convention Parties that were also WTO Members, the WTO's compulsory dispute settlement mechanism would have to adjudicate the issue. As has been discussed, if the Party imposing trade measures argued that such barriers were justified under the environmental exceptions of Article XX, a WTO panel would be required to make an assessment of the environmental effectiveness of the measure, as well as whether the measure was being applied in a rational and justifiable manner. Given the complexity of such an assessment, the WTO would likely look to the UNFCCC for guidance on an appropriate standard for the "comparability" of actions to reduce emissions, as well as for an appropriate standard for assessing whether the trade measure constituted, under WTO and Climate law, a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade.

While this Discussion Paper does not express a view on whether the proposed U.S. and EU measures would pass such a WTO test, the analysis would be far from straightforward. Much of the political discourse around the inclusion of trade measures has been about protecting domestic industry, rather than preventing leakage, which makes such measures vulnerable as disguised protectionism. A WTO panel might be forced to choose between a result that required the U.S. to dismantle a central part of its climate legislation, and one that allowed the U.S. measure to stand, but that undermined UNFCCC's legitimacy in setting and distributing climate targets between its Parties. And given the tenuous state of the global trading system at present with the failure of the Doha round, such a determination could significantly weaken faith in the WTO itself.

Multilateral Trade Disciplines through Climate Negotiations

Given the likely inclusion of trade measures in domestic climate legislation in Annex I countries, and the prospect for challenge to such measures at the WTO, the COP should seek to clarify the meaning of Article 3.5 and establish guidelines for the use of trade measures in a way that is consistent with both the UNFCCC and the multilateral trading system. Doing so quickly would:

- Maintain a degree of multilateral discipline over the use of unilateral trade measures.
- Send a clear signal to legislators in Annex I countries that these measures, as other important dimensions of domestic climate policy, should be shaped by multilateral consultation and negotiation.
- Avoid the potential chilling effect on environmentally justifiable unilateral trade measures that would result from an implicit deference to the WTO's dispute settlement mechanism as the arbiter of comparability or effectiveness of climate policy.
- Reaffirm the view that WTO and climate principles can be mutually supportive in discouraging protectionism in the design and use of trade-related climate policy.

Recommendations for Discussion

We recommend that the UNFCCC Parties negotiate and agree in Copenhagen on an elaborated set of principles, based on Article 3.5 of the Convention, and supportive of WTO law and practice, that would discipline Parties' use of trade measures, and would help to avoid and to guide the resolution of any disputes that might arise between Parties.

At a minimum, these principles should:

- Secure the express acknowledgment of all Parties to the Copenhagen agreement that the commitments or actions that are contained in that agreement reflect the international standard for what is an appropriate and "comparable" level of effort expected of Parties during the timeframe of those commitments.

- Reaffirm that neither the UNFCCC nor the WTO supports the use of trade measures as a means of protecting domestic industry from competition and that any trade measures used to advance the implementation of the UNFCCC must be narrowly tailored to achieve a legitimate environmental objective..
- Clarify whether the use of trade measures to prevent emissions leakage between Parties is a legitimate environmental objective as part of domestic efforts to meet commitments under a Copenhagen agreement.
- Guide the use of trade measures against non-Parties or Parties not in compliance with their commitments under a Copenhagen agreement.
- Promote the exercise of diplomacy before any unilateral trade measures are resorted to.
- Require transparency, predictability and consistency in the design and application of any trade measures.
- Ensure respect for the special and differential treatment of developing country Parties based on their level of development.

Notes

1 For a more detailed discussion of some of the arguments in this Discussion Paper, *see*, T Houser, R Bradley, B Childs, J Werksman and R Heilmayr, Leveling the Carbon Playing Field: International Competition and US Policy Design (WRI and PIIE: 2008).

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3 The relevant language from the European Commission proposal is "Energy-intensive industries which are determined to be exposed to a significant risk of carbon leakage could receive a higher amount of free allocation or an effective carbon equalisation system could be introduced with a view to putting installations from the Community which are at significant risk of carbon leakage and those from third countries on a comparable footing. Such a system could apply requirements to importers that would be no less favourable than those applicable to installations within the EU, for example by requiring the surrender of allowances. Any action taken would need to be in conformity with the principles of the UNFCCC, in particular the principle of common but differentiated responsibilities and respective capabilities, taking into account the particular situation of Least Developed Countries. It would also need to be in conformity with the international obligations of the Community including the WTO agreement." Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community Para 20.

4 **Testimony of Environmental Defense Fund, International Brotherhood of Boilermakers, Iron Ship Builders, Blacksmiths, Forgers & Helpers, Point Carbon North America, and Holcim, Inc, Before the Committee on Finance, February 14, 2008, http://finance.senate.gov/sitepages/hearing021408.htm.**

5 For more discussion of these trade-offs, see Leveling the Carbon Playing Field, note 1.

6 1994 General Agreement on Tariffs and Trade, Article XX.

7 See, for example, S Charnowitz, Trade and Climate Change: Potential Conflicts and Synergies (Pew Center on Climate, 2003); J Pauwelyn, *US Federal Climate Policy and Competitiveness Concerns: the Limits and Options of International Trade Law.* Duke University, Nicholas Institute for Environmental Policy Solutions, NI WP 0702, April 2007

8 See, for example, A. Shoyer, Comments on WTO Consistency of International Reserve Allowance Program, paper presented at the Canadian Council on International Law, September 2008.

9 See, Leveling the Carbon Playing Field, note 1.

10 United States-Import Prohibition of Certain Shrimp and Shrimp Products, Report of the Appellate Body, WTO-Docs. WT/DS58/AB/R and WT/DS58/AB/RW.,

11 Amendment in the nature of a substitute intended to be proposed by Mrs. Boxer to S.3036, Lieberman-Warner Climate Security Act of 2008. [hereinafter Boxer-Lieberman-Warner] While Democratic leadership in the US Congress failed to gain enough support to pass this bill through the US Senate in 2008 , it will likely be taken up again in 2009. Similar language is included in all other significant legislative proposals and is seen as a necessary "price of passage" of US climate policy. See, e.g., nearly identical language in Dingell-Boucher Discussion Draft - http://energycommerce.house.gov/Climate_Change/, Part G.

12 Boxer-Lieberman-Warner, Sec 1301(4)(B)(i).

13 Id, Sec 1301(4)(B)(ii).

14 Id, Sec 1306 (b)(2). The de minimis test is based on 2 distinct determinations by the Commission, 1 of which reflects the annual average deforestation rate during a representative period for the United States and each foreign country; and 1 of which does not reflect that annual average deforestation rate.

15 Boxer-Lieberman-Warner, Sec 1301(4)(B)(iv) and 1301 (11).

16 See, for example, K Neuhoff and R Ismer, Border tax adjustment: a feasible way to support stringent emission trading, Eur J Law Econ (2007) 24:137–164.

17 For more discussion of emissions leakage, see Leveling the Carbon Playing Field, note 1.

18 The Convention also provides that "[i]n the event of a dispute between any two or more Parties concerning the interpretation or application of the Convention, the Parties concerned shall seek a settlement of the dispute through negotiation or any other peaceful means of their own choice." Article 14.