



# Reconciling Trade and Climate

## How the WTO Can Help Address Climate Change

**TRACEY EPPS and ANDREW GREEN**

**ELGAR INTERNATIONAL ECONOMIC LAW**



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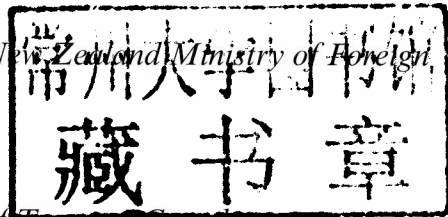
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ELGAR INTERNATIONAL ECONOMIC LAW



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## Reconciling Trade and Climate

## ELGAR INTERNATIONAL ECONOMIC LAW

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Reconciling Trade and Climate

How the WTO Can Help Address Climate Change

*Tracey Epps and Andrew Green*

# Abbreviations

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|               |   |
|---------------|---|
| AB            | Appellate Body  |
| BTA           | border tax adjustment   |
| CITES         | Convention on International Trade in Endangered Species of Wild Flora and Fauna |
| COP           | Conference of the Parties   |
| CTE           | Committee for Trade and Environment   |
| DSB           | Dispute Settlement Body   |
| DSU           | Dispute Settlement Understanding  |
| GATT          | General Agreement on Tariffs and Trade  |
| GHG           | greenhouse gas  |
| GSP           | Generalized System of Preferences   |
| LDC           | least developed country   |
| MEA           | multilateral environmental agreement  |
| MFN           | most-favoured-nation  |
| PPM           | process and production method   |
| SCM Agreement | Agreement on Subsidies and Countervailing Measures                              |
| TBT Agreement | Technical Barriers to Trade Agreement   |
| UNCTAD        | United Nations Conference on Trade and Development                              |
| UNFCCC        | United Nations Framework Convention on Climate Change                           |
| WTO           | World Trade Organization  |

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## PART I

### Introduction



# 1. Reconciling trade rules and climate policies

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## 1.1 THE PROBLEM OF TRADE AND CLIMATE CHANGE

It seems that new reports come out monthly about the urgency with which climate change must be addressed. The reports of the Intergovernmental Panel on Climate Change (IPCC) are perhaps the most famous calls to action but certainly not the only, or most extreme, ones. Climate change is already negatively affecting species and natural systems.<sup>1</sup> These reports suggest major acceleration of such effects if action is not taken. Leaders of large and small countries recently converged on Copenhagen, citing the need for policies and plans and some form of multilateral agreement to replace the Kyoto Protocol. The current debate is about how quickly action is needed and what will be most effective in reducing greenhouse gas (GHG) concentrations and the impact of climate change on the environment, including humans. Unfortunately, despite the scientific consensus and the apparent political recognition of the need to cooperate to reach a solution, action has fallen far short of what scientists claim is needed to reduce the probability of dangerous impacts on the planet and human civilization.

In this debate international trade and ‘globalization’ seem often characterized as a key source of the problem. However, we believe that this is both wrong and unhelpful – that there are important ways in which both trade and action on climate policy can work together to reduce the risks from climate change and to foster development. Most obviously perhaps, the movement of goods itself by ships, rail and truck creates GHG emissions. Moreover, the extent of economic growth and the emissions attendant on growth, such as from the production of electricity or other forms

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<sup>1</sup> IPCC, *Climate Change 2007: Synthesis Report. Contribution of Working Groups I, II and III to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change* (Geneva: IPCC, 2007) (IPCC FAR (2007)). See also International Scientific Steering Committee, *Avoiding Dangerous Climate Change: International Symposium on the Stabilization of Greenhouse Gas Concentrations* (Exeter, 2005).

of energy, are seen as the source of the rise in GHG emissions and a major obstacle to their reduction. International trade has led to increased economic growth and emissions in developed countries. Economic growth from trade by developing countries, and particularly large countries such as China and India, threatens to cause increasing emissions in the future. To the extent that World Trade Organization (WTO) rules support continued liberalization and growth of international trade, these rules have come to be seen as part of the problem.

At the same time, however, climate change policies are seen as harming trade and economic growth. Climate policies may impose high costs on industry, potentially reducing the competitiveness of these industries in an increasingly integrated global economy. This concern also implicates developing countries. They worry that while developed countries grew rich through carbon-intensive economies, they themselves will be denied the ability to grow and help their citizens out of poverty by strictures on GHG emissions. These concerns about the fairness of climate policies have been obstacles to international action.

In this book, we take a more optimistic view of the connection between international trade and action on climate change. We seek to find solutions that both foster trade (and a rules-based trading system) and support the goal of tackling climate change. The theme of this book is that there are *synergies* between trade and climate policies that can lead to more efficiently addressing climate change. In fact, we see three inter-related goals that policy-makers must focus on and which, through the manner in which they reinforce each other, have the potential to increase social welfare. These goals are mitigating climate change, deterring protectionism, and furthering the development goals of developing countries.

## 1.2 CLIMATE CHANGE, PROTECTIONISM AND DEVELOPMENT

The first goal of *mitigating climate change* arises because of the nature of the causes of climate change.<sup>2</sup> The global average temperature has been rising over the past century with most of this increase ‘very likely’ due to man-made increases in GHG emissions.<sup>3</sup> The impacts of climate change depend on the size of the increase in average temperatures. The policy goal

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<sup>2</sup> See Chapter 2 for a more detailed discussion of the theory relating to mitigating climate change and fostering trade and development.

<sup>3</sup> IPCC, *supra* note 1.

of maintaining an average temperature rise of below 2 degrees Celsius has been set by scientists and is reflected in the 2009 Copenhagen Accord.<sup>4</sup>

In order to restrict temperature increases to this level, policies will have to address the key causes of GHG emissions. Climate change is a large-scale externality – a market failure in which individuals who create GHG emissions through such activities as driving cars or using electricity generated from coal obtain the benefits from the activities.<sup>5</sup> However, the costs in terms of climate change are imposed on others – largely either future generations or individuals in other countries. Governments need to choose instruments to address this market failure, such as taxes, regulations, emissions trading, or even informational remedies.

The second goal – that of *detering protectionism* – relates to the nature of trade and its connection to social welfare. Economic efficiency is maximized with liberal trade as goods are supplied by the most efficient producers regardless of where they are located. However, governments may put in place tariffs and other protectionist measures in order to placate concentrated interests such as import competing industries.<sup>6</sup> One goal of trade rules then is to reduce protectionism to the extent possible in order to maximize economic efficiency.<sup>7</sup>

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<sup>4</sup> Available online at <http://unfccc.int/resource/docs/2009/cop15/eng/o7.pdf> (date accessed: 22 January 2010). It should be noted that 193 signatories to the UN climate convention – those represented in the Alliance of Small Island States, the Least Developed Countries, and the Africa Group – all warned at the Copenhagen Conference of the Parties in December 2009 that 1.5 degrees is the absolute limit and that 2 degrees would mean hardship, mass migrations, and even death for many of their citizens. Bridges Copenhagen Update, ‘High-level Politics Meets Low Ambition: Taking Stock of COP15’ (International Centre for Trade and Sustainable Development, Geneva, 2009).

<sup>5</sup> N. Stern, *The Economics of Climate Change: The Stern Review* (Cambridge: Cambridge University Press, 2007).

<sup>6</sup> As discussed in Chapter 2, there are some potentially welfare enhancing rationales for trade barriers or measures but the general case is that trade barriers reduce economic efficiency. See Michael Trebilcock and Robert Howse, *The Regulation of International Trade*, 3rd edn (London: Routledge, 2005).

<sup>7</sup> Protectionism, as noted by Levy, tends to be seen as anything other than advocacy of free trade. Levy suggests treating protectionism as the advocacy of policies that are intended to favour domestic producers over foreign exporters. He classifies three types of protectionist measures: (1) intentional protectionism, where measures are explicitly intended to favour domestic industry over imports; (2) incidental protectionism, where measures can be justified on other grounds but also have the effect of obstructing import competition; and (3) instrumental protectionism, which describes a growing set of policies in which trade actions are used as a lever to change another country’s policies. Philip I. Levy, ‘Protectionism in the Global Economy’ (2009) *Georgetown Journal of International Affairs*.

Finally, economic prosperity and growth in standards of living have not been evenly distributed around the world. There is clear inequality in income and standards of living both in and across countries, with many countries' citizens living in abject poverty.<sup>8</sup> The third goal we want to emphasize is therefore the need for *further development* in order to raise standards of living around the world. The standard of living can and should be measured in a range of ways beyond mere income per capita, such as through examining whether individuals have the capabilities necessary to live lives they have reason to value.<sup>9</sup> Development cannot therefore be equated directly with economic growth or trade but economic activity is an aspect of human freedom, particularly as a means of fostering other goals (such as health and education).

Synergies between trade rules and climate change policies arise from the interactions of trade rules, economic growth and measures to address climate change. Trade rules not only provide scope for individual countries to meet their own targets for mitigating climate change but may also help governments facing domestic opposition. For example, a key concern with government action addressing climate change is that it will impose costs on domestic industry, making them uncompetitive compared with industries in countries that have not taken action. Under WTO rules, the cost of some of these measures can be imposed on imports and rebated to exports, helping to overcome domestic opposition to climate policies. There are, of course, difficulties with these measures; they are difficult to apply fairly and can harm relations with the countries facing the measures.<sup>10</sup> However, they can play some role in addressing domestic political economy concerns.

Further, trade rules attempt to ensure that countries do not put in place measures that are ostensibly aimed at addressing climate change but instead, in whole or in part, are intended to protect domestic industry at the expense of foreign producers. Countries' climate policies are in theory constrained by WTO rules from harming trade flows that may provide not only economic growth but also greater environmental benefits. For example, to the extent Brazilian ethanol is cheaper and more environmentally beneficial over its life cycle than US corn-based ethanol, WTO restrictions on protectionist measures that deny Brazilian access to US markets can aid economic growth and the effort to address climate change.<sup>11</sup>

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<sup>8</sup> Jeffrey D. Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: The Penguin Press, 2005).

<sup>9</sup> Amartya Sen, *Development as Freedom* (New York: Knopf, 1999).

<sup>10</sup> See Chapters 8 and 13.

<sup>11</sup> See, for example, Doaa Abdel Motaal, 'The Biofuels Landscape: Is There a Role for the WTO?' (2008) 42 (1) *Journal of World Trade* 61.

Trade rules therefore need not constrain efficient domestic action and may help governments to overcome political economy constraints on action. They can also address climate change by providing scope for countries to take measures to deter other countries that are not addressing climate change. Addressing climate change is an additive public good – that is, a public good that results from reducing the combined emissions of countries.<sup>12</sup> The more countries (and especially large emitters) take action, the greater the public good. However, like all public goods, parties may try to ‘free-ride’ on the actions of others. They want to benefit from other countries’ emission reductions but do not want to bear the costs of taking action themselves (for example, sacrifices in lifestyle or economic activity). Such free-riding could manifest itself as countries not joining up to climate change regimes or not complying with commitments made under such regimes. As discussed further in Chapter 3, while there are only two countries that did not ratify the Kyoto Protocol (the US and San Marino), there are many others that have no emission reduction commitments or are unlikely to meet the commitments they do have. Trade measures such as border adjustments and even import bans can reduce both non-participation and non-compliance, leading to increases in the public good. These measures can be taken unilaterally by individual countries or be part of a multilateral agreement. Regardless of their source, they can be an effective tool in reducing free-riding. Current trade rules provide scope for their use, but, as with the use of measures to address domestic political economy barriers to climate action, they raise tensions and potential fairness issues with respect to the target countries.<sup>13</sup>

Trade measures therefore can help countries meet their own domestic targets and induce others to participate in the effort to address climate change. Trade can also help overcome concerns about the impacts of climate change measures on developing countries. This theme ties in with concerns about the fairness of any attempts to address climate change. A sticking point in the international climate change negotiations has been

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<sup>12</sup> Scott Barrett, *Why Cooperate? The Incentive to Supply Global Public Goods* (Oxford: Oxford University Press, 2007). A public good is one whose benefit is shared by either the public as a whole or a sub-group thereof. It has two characteristics that are the opposite of those defining private goods: (i) it is impossible or too expensive for the supplier to exclude those who do not pay for the benefit (non-excludability); and (ii) consumption by one person does not leave less for others to consume (non-rivalrous competition). Richard D. Smith et al., *Global Public Goods for Health: Health Economics and Public Health Perspectives* (New York: Oxford University Press, 2003) at 4.

<sup>13</sup> See Chapters 13 and 14.

that developed countries argue that, as noted above, addressing climate change is an additive public good so all countries, including developing countries, need to take action. Developing countries, on the other hand, argue it is unfair that developed countries grew economically on the basis of GHG emissions, whereas now developing countries are being asked to constrain their own growth by the need to reduce emissions.

WTO rules, in theory at least, hamper attempts by developed countries to use climate change measures in a manner that protects their own industries at the expense of industries in developing countries. Limiting such protectionism can at a minimum ensure that any action to address climate change is taken with the least possible impact on developing countries. Further, trade rules can provide for positive measures to benefit developing countries. Developed countries can, for example, provide preferences to imports from developing countries as an incentive for developing countries to take climate change action. Such measures can be used to enhance the economic opportunities for developing countries in the context of climate change.

### 1.3 KEY INTERACTIONS

These themes, of synergies and of fairness and development, implicate the current WTO rules including both how they are drafted and how they should be interpreted. We will discuss these rules in the context of three key ways in which trade and climate change policy interact: (i) in countries' use of climate policies to address their own emissions; (ii) in countries' use of unilateral action to induce other countries to take action on climate change; and (iii) in multilateral solutions to climate change.

#### 1.3.1 Implications of Trade Rules for Domestic Climate Policy

Any domestic policy that imposes costs on or provides benefits to domestic industries, or provides some barriers to imports, raises concerns about conflicts with WTO rules, as one of the main roles of the WTO rules is to reduce unnecessary barriers to trade. These domestic policies do not have to favour domestic industry explicitly or intentionally harm foreign producers. Much of the conflict between trade rules and domestic policies will arise in the context of policies that appear neutral as between domestic and foreign producers but which other countries argue implicitly harm their producers. For example, a tax on all high emission cars, whether domestic or foreign, appears neutral but what if the rule results in the domestic cars facing a much lower average tax than imports? Depending on how



WTO rules are interpreted, governments may be limited in the policies they can adopt. The first set of issues relates to this interaction of domestic climate policies and trade rules: do trade rules constrain countries' ability to address climate change? Conversely, can trade measures help countries implement climate change policies (such as by helping overcome domestic opposition by addressing competitiveness concerns)?

### **1.3.2 Unilateral Measures to Induce Other Countries to Take Action on Climate Change**

Given that addressing climate change is a public good, countries will be concerned that if they take action, other countries will simply free-ride on their efforts and take no action themselves. Countries may therefore wish to use trade measures to either force or provide incentives to these other countries to take action. For example, countries could impose a tax on imports from countries which have not adopted climate policies. Alternatively, they could afford tariff preferences to countries that do take climate action. Trade rules will determine the scope for such unilateral action. The second set of interactions therefore relates to the extent to which unilateral trade measures can be used for this purpose. If they can, should they?

### **1.3.3 Multilateral Solutions**

The final set of issues concerns multilateral solutions. The Kyoto Protocol was an attempt to build multilateral action on climate change. However, it did not initially include any means to force countries that are not signatories to adopt the Protocol or, indeed, even to ensure parties that did adopt the Protocol meet their commitments. The enforcement mechanisms that were eventually adopted have been described as too weak to be effective.<sup>14</sup> Other multilateral environmental agreements such as the Montreal Protocol on Ozone Depleting Substances have used trade measures to back commitments or to induce non-participants to join the agreement. Such measures include bans on the trade in products from these non-parties that have been made with ozone depleting substances. This last set of issues therefore asks whether trade measures can and should be built into any post-Kyoto climate change regime.

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<sup>14</sup> Barrett, *supra* note 12, and Robert N. Stavins and Scott Barrett 'Increasing Participation and Compliance in International Climate Change Agreements' (Fondazione Eni Enrico Mattei Working Paper No. 94.2002; Kennedy School of Government Working Paper No. RWP02-031, 2002).