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Climate Policy Options and the World Trade Organization

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Abstract

This paper examines whether the climate policy options policymakers are contemplating are compatible with core principles of the world trading system set forth in the General Agreement on Tariffs and Trade (GATT), the World Trade Organization (WTO), and Appellate Body decisions. The authors argue that border measures—both import restrictive measures and export subsidies—contemplated in US climate bills and the climate policies of other countries stand a fair chance of being challenged in the WTO. Given the prospect of foreseeable conflicts with WTO rules, the authors suggest that key WTO members should attempt to negotiate a new code that delineates a large "green space" for measures that are designed to limit GHG emissions both within the member country and globally. By "green space," the authors mean policy space for climate measures that are imposed in a manner broadly consistent with core WTO principles even if a technical violation of WTO law could occur. To encourage WTO negotiating efforts along these lines, the authors recommend a time-limited "peace clause" to be adopted into climate legislation of major emitting countries. The peace clause would suspend the application of border measures or other extraterritorial controls for a defined period while WTO negotiations are under way.

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1 Introduction

The economic downturn poses daunting challenges, but Washington seems eager to take action against climate change. President Obama insists that global warming ranks among his top priorities. In the wake of the financial crisis, the Administration linked economy recovery with a low-carbon future. The American Recovery and Reinvestment Tax Act of 2009, a $787 billion stimulus package signed by President into law on February 17, 2009, provides incentives for renewable energy, energy efficiency, and smart grid and electricity transmission—about $43 billion in spending plans and about $20 billion in tax provisions.[1] President Obama's 10-year budget blueprint, released on February 26, 2009, ambitiously embraced the idea of "a Clean Energy Economy." The budget blueprint states:

"After enactment of the Budget, the Administration will work expeditiously with key stakeholders and the Congress to develop an economy-wide emissions reduction program to reduce greenhouse gas emissions approximately 14 percent below 2005 levels by 2020, and approximately 83 percent below 2005 levels by 2050. This program will be implemented through a cap-and-trade system, a policy approach that dramatically reduced acid rain at much lower costs than the traditional government regulations and mandates of the past. Through a 100 percent auction to ensure that the biggest polluters do not enjoy windfall profits, this program will fund vital investments in a clean energy future totaling $150 billion over 10 years, starting in FY 2012. The balance of the auction revenues will be returned to the people, especially vulnerable families, communities, and businesses to help the transition to a clean energy economy"[2]

During his first official foreign visit, President Obama agreed with Canadian Prime Minister Stephen Harper to launch a new clean energy initiative as a step towards a North American climate change treaty.

The Kyoto protocol expires in December 2012; a successor regime is meant to be agreed in Copenhagen or at least before 2012. Leaders have warned that international negotiations on the post-Kyoto regime will be undermined if the United States does not enact domestic legislation to reduce carbon emissions. In his remarks at the climate event held at the US Capitol on March 3, 2009, former British Prime Minister Tony Blair emphasized that the United States must show its seriousness about enacting legislation.[3] Connie Hedegaard, Danish climate and energy minister, said that the world is waiting for the United States to provide leadership.[4] Ambassador Todd Stern,

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[1] See "United States: Summary of Clean Energy And Energy Efficiency Provisions In The New Stimulus Package" by Richard M. Schwartz, Donna Mussio, David A. Zilberberg, Coleman Kennedy, David Felman and Joel Scharfstein, February 19, 2009.
Available at http://www.mondaq.com/article.asp?articleid=74760.

[2] See "A New Era of Responsibility: Renewing America's Promise," released on February 26, 2009. Office of Management and Budget. Available at:
http://www.whitehouse.gov/omb/assets/fy2010_new_era/ A_New_Era_of_Responsibility2.pdf.

[3] See "Obama must pass climate laws ahead of Copenhagen, Danish minister warns," by Suzanne Goldenberg, *Guardian*, March 4, 2009.
Available at http://www.guardian.co.uk/environment/2009/mar/04/climate-obama-denmark .

[4] See "Obama must pass climate laws ahead of Copenhagen, Danish minister warns," by Suzanne Goldenberg, *Guardian*, March 4, 2009.
Available at http://www.guardian.co.uk/environment/2009/mar/04/climate-obama-denmark .

President Obama's special envoy for climate change, stressed that nothing would give a more powerful signal to other countries than a significant and mandatory US plan enacted before Copenhagen.[5] It is not certain whether countries will sign a comprehensive post-Kyoto plan at the UN Climate Change conference in Copenhagen in December 2009, but at the Group of 20 (G-20) London Summit, held in April 2009, leaders committed to reach agreement at Copenhagen.

On Capitol Hill, the debate is vigorous and several bills aiming at GHG controls have been introduced. Most prominent, the American Clean Energy and Security Act of 2009 (H.R. 2454, also known as the Waxman-Markey bill) sponsored by Representatives Henry Waxman (D-CA) and Edward Markey (D-MA) has gained the most attention. The Waxman-Markey bill, based on a cap-and trade system, was introduced to the House Energy and Commerce Committee on May 15, 2009 and passed by the Committee by a vote of 33-25 on May 21, 2009. The bill is expected to be approved by the full House this summer. While the debate on domestic GHG controls has moved forward, it still remains to be seen whether the United States will actually have domestic climate legislation in place before the Copenhagen summit in December 2009, or even before the end of 2010.

The prospect of stringent emissions controls provokes fear that heavy costs will weaken US firms, leading to the "leakage" of production and jobs to foreign firms located in countries that do not equivalently control carbon emissions, such as China and India. Not surprisingly, the economic slump has intensified the fear of losing competitiveness. A related objection is that, in the end, US controls will make no difference to climate change if emissions activity simply migrates to other countries and if US controls do not create enough "leverage" to prod China and India and other large but reluctant emitters to take action. To address both "leakage" and "leverage" concerns, the United States and other countries are contemplating provisions in their climate bills such as the allocation of free allowances, special exemptions from new controls, and border measures.

In the debate, border measures are gaining political support. While it is questionable whether border measures will bring the relief sought by vulnerable US firms,[6] border measures seem all but certain for political reasons. History shows that border adjustments were decisive in securing political acceptance of value added tax (VAT) systems. Many economists contend that, with flexible exchange rates, there is little difference between imposing a VAT at a product's origin or at a product's destination. Under the origin principle, exports pay the tax and imports do not. Under the destination principle, imports pay the tax and exports do not. In terms of economic impact after allowing for exchange rate adjustments, the principles are highly similar, if not

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5 See "US Climate Official Urges Congress To Curb Greenhouse-Gas Emissions," by Stephen Power, *Wall Street Journal*, March 3, 2009. Available at: http://online.wsj.com/article/SB123611493656622581.html?mod=googlenews_wsj).

6 For example, the United States imports carbon-intensive goods largely from Canada and the European Union—countries that emit less CO_2 than the United States. China and India, the primary targets of US trade measures, are not large suppliers of carbon-intensive exports to the United States. This implies two things: first, trade measures may not provide intended economic relief to domestic industries affected adversely by US climate change policy because US firms are competing mostly with "cleaner" countries; and second, that US trade measures may not create substantial leverage to shape the climate policies of other countries—particularly China and India. For more details, see Hufbauer, Charnovitz, and Kim (2009).

identical.[7] Yet virtually all countries that adopt VAT systems have opted for destination principle border tax adjustments (BTAs) to gain the acceptance of domestic firms. A parallel argument has surfaced in the debate over climate legislation and many US climate bills introduced in the Congress have included border measures: they limit on imports from countries that do not have comparable climate policies, and they contain some forms of relief for exports of carbon-intensive products.[8]

Whatever their ultimate effectiveness, border measures have the potential to conflict with World Trade Organization (WTO) rules. Under the WTO, countries have great flexibility in adopting environmental regulations within their territories, but the same discretion does not apply to environment-related trade measures or measures with transborder economic effects. When GHG trade measures are mixed with mechanisms designed to alleviate the burden of emission controls on domestic firms, various possible collisions could occur with WTO rules. Accordingly, such measures stand a fair chance of being challenged in the WTO. This paper examines the interaction between national measures designed to limit GHG emissions, and the operation of the world trading system.

2 Overview of Applicable World Trade Organization Rules

This section provides short summaries on core articles of the General Agreement on Tariffs and Trade (GATT) and other WTO agreements that might be cited in potential disputes over GHG trade measures under consideration. Detailed analysis of key GATT articles, WTO agreements, and the decisions of the GATT panels and WTO Appellate Body can be found in Hufbauer, Charnovitz, and Kim (2009).

GATT Article I (Most Favored Nation Treatment)

The principle of most favored nation treatment in GATT Article I holds that any advantage accorded to an imported product has to be accorded to a "like" product from any WTO member country. Article I applies to customs duties and charges, import and export formalities, and the national treatment measures covered by Article III:2 and III:4. Note, however, that if a measure is covered by GATT Article III, but is not a violation of Article III because GATT Article III:8(b) permits the payment of subsidies exclusively to domestic producers, such a measure would not come within the discipline of GATT Article I:1.

GATT Article II (Tariff schedules)

GATT Article II:1(a) and (b) contain the core disciplines in the GATT on the imposition of ordinary customs duties. In addition, Article II:1(b) prohibits the imposition of newly

[7] When the profile of VAT across traded sectors is jagged—some very high rates, some very low rates—the similarity begins to fade between the impact of origin and destination BTAs. Origin BTAs will not adequately shield the highly taxed sectors from foreign competition, even after the exchange rate adjusts.

[8] These measures are akin to destination BTAs. Because carbon taxes or limits hit a few sectors fairly hard, and because countries will not all impose the same limits, the argument for destination-type BTAs is stronger.

applied charges (on items having bound tariffs) by extending the coverage to "all other duties or charges of any kind imposed "on or in connection with" importation.[9] The scope of Article II is limited, however, by Article II:2(a), which states that nothing in the article shall prevent a government from imposing on the importation of any product "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part."

GATT Article III (National Treatment)

The principle of national treatment in GATT Article III holds that an imported product is to be treated no less favorably than a like domestic product. This purpose is carried out through two principal provisions: the first sentence of Article III:2 deals with internal taxes or charges on products, and Article III:4 deals with taxes not covered by Article III:2. The Appellate Body has explained that the broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. Article III covers taxes and regulations applied both within national borders and on imported products. In decided cases, this article has been strictly applied.

GATT Article XI (General Elimination of Quantitative Restrictions)

This article prohibits the imposition of quotas, import or export licenses, or other measures on trading partners unless they fall into one of the exceptions listed in paragraph 2 of GATT Article XI.

GATT Article XX (General Exceptions)

A measure violating any provision of the GATT can be excused if it qualifies for an exception under Article XX. The Appellate Body has explained that the exceptions are "limited and conditional," and that the analysis is two-tiered. When a measure is provisionally justified under one of the specific exceptions, the panel will then determine whether the measure meets the legal standard set forth in the chapeau of Article XX [10] Relevant to climate change, the subsections of Article XX permit otherwise inconsistent trade measures if they are "necessary" to protect human, animal or plant life or health (Article XX (b)) or if they conserve exhaustible natural resources (Article XX (g)); both terms appear to cover limits on GHG emissions. While the Appellate Body's rulings in previous cases show considerable sympathy with environmental concerns, the decisions are made case-by-case; they depend on the particular facts and circumstances; and the rule of stare decisis does not strictly apply.

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[9] See the WTO Understanding on the Interpretation of Article II:1(b) of the GATT, 1994.

[10] Article XX states in part: "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:…(b) necessary to protect human, animal or plant life or health;...(g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption…." The full text of the GATT Article XX is available at: http://www.wto.org/english/docs_e/legal_e/gatt47_02_e.htm.

WTO Disciplines on Subsidies

The WTO Agreement on Subsidies and Countervailing Measures (ASCM) governs the use of subsidies. Because many climate change proposals rely upon subsidies, the ASCM comes into play. A government grant or tax exemption is clearly a "subsidy" under the ASCM, but whether the free allocation of an emission allowance is a subsidy does not have an obvious answer, and so far there has been no WTO jurisprudence on this point. Under the ASCM, a subsidy exists when a government makes a financial contribution and a benefit is conferred to the recipient firm. The free allocation of emission allowances surely is a benefit, but the key question is whether such an allocation is a financial contribution. The answer is murky since emissions allowances given away freely could be considered government permits rather than financial contributions—in other words, something akin to permission to drill for oil or construct a road. However, there are strong policy grounds for treating emission allowances as subsidies covered by the ASCM. Otherwise, in the future carbon-conscious world, governments would be able to avoid subsidy disciplines by using the "coin" of tradable emission allowances to confer aid on favored industries.

WTO Disciplines on Domestic Regulations

Another WTO agreement supervising governmental regulations is the Agreement on Technical Barriers to Trade (TBT). The scope of the TBT agreement includes both mandatory and voluntary measures. Mandatory measures are termed "technical regulations" and are defined as any measure that "lays down product characteristics or their related processes and production methods."[11] If a regulation about the energy footprint of a product is not covered by the TBT agreement, it would be covered by GATT Articles III:4 or XI. When the TBT agreement was drafted, conventional wisdom held that it covered regulations about the physical products and did not cover regulations about the way products are made. Whether that understanding would survive the text-oriented approach to interpretation now used in the WTO dispute settlement (which gives little consideration to negotiating history) remains to be seen.

3 Climate Policy Options under WTO Rules

This section discusses key components of climate policy generically, and then the consistency of those climate policy options with core principles of the world trading system, as set forth in the GATT, the WTO, and Appellate Body decisions.

Border Adjustments on Imports

A border tax adjustment (BTA) on an import is the application of a charge or tax on the import aimed to match the domestic indirect taxes imposed on the like product and/or its inputs. Historically, of course, BTAs had nothing to do with environmental concerns; they were applied to level the playing field between domestically made and imported goods with respect to indirect taxes and later value added taxes (i.e., taxes on products).

11 Agreement on Technical Barriers to Trade, Article 1.2 and Annex 1, paragraph 1. The TBT agreement does not apply to sanitary or phytosanitary measures (see Article 1.5).

In the climate context, analysts have sometimes used the term "BTA" as an imprecise reference to a tax imposed at the border designed to match the economic effects of a regulation on imports. But when there is no domestic tax, but only calculated economic effects, the application of the supposedly corresponding tax or charge on imports is not a BTA. [12]

Under GATT rules, only taxes on products can be border-adjusted. Thus, taxes not applied to products are not susceptible to being border-adjusted. Whether taxes on energy consumed in making a product (sometimes called "embedded energy" or "carbon footprint" taxes) are border-adjustable on an import has not been considered in WTO dispute settlement. Annexes I and II of the ASCM may be read so as to permit the rebate of prior stage energy taxes on exports, but whether that would correspondingly allow the imposition of domestic energy taxes on imports remains unclear.

It might seem straightforward to characterize carbon taxes as product taxes and impose them at the border when goods are imported. But things are not so simple. The core problem is that a product of a given physical description—say a ton of hot-rolled steel plate—will be responsible for different amounts of CO2 emission depending on the manufacturing process. Emissions will differ from firm to firm and even within a firm. Moreover, if the border-adjustment scheme reflects carbon emissions of ancillary materials (e.g., scrap steel), the tracing challenge becomes an additional source of difficulty.

Border Adjustments on Exports

Whether the ASCM permits the rebate of energy taxes on exportation has not yet been resolved. Rebating an energy or carbon tax on exports would seem to be environmentally perverse because exportation does not undo the environmental impact of the GHG emissions. Of course, the WTO legality of a BTA does not hinge on an environmental justification.

Te only sensible rationale for a rebate of climate taxes on exports would be to avoid double carbon taxation. In other words, in a world economy where nearly all governments are taxing domestic emissions, and imposing BTAs on imports to match their domestic carbon taxes, there could be an agreement to use the destination principle for energy taxes by taxing imports but not exports. All domestic production would be taxed, but when a product is exported the tax would be rebated by the exporting country government. As noted earlier, the ASCM seems to allow the rebate or remission of prior stage energy taxes when goods are exported but it is uncertain whether the same provision extends to prior stage GHG taxes.

Another border adjustment could occur if a domestic firm purchased a GHG emission allowance to produce an exported good, and the payment was then rebated. The rebate of this emission allowance would not be a rebate of a tax because the requirement to purchase an emission allowance is a regulation, not a tax. Thus, the rebate of an emission allowance on exportation is technically not a BTA. Rebating an emission allowance could have adverse WTO implications if the allowance is viewed by

[12] Cosbey (2008) also recognized that the term "BTA" has been used imprecisely. He argued that requirements to buy into domestic cap-and-trade schemes are more like regulations than taxes, and so adjustment to those schemes cannot rightly be called a tax adjustment. To avoid confusion, he proposed to use "border carbon adjustment," a broad term that refers to any trade measure that is adopted in order to level the playing field.

the WTO as the equivalent of money. If a government pays money to a firm in connection with an export, that payment constitutes a prohibited export subsidy.

Unilateral Countervailing Duties or Sanctions

A countervailing duty (CVD) is a trade penalty applied to an imported product to offset the competitive effect of a foreign subsidy. The prerequisite to a CVD action is a subsidy that is specific to a firm or industry, and that causes material injury to the competing domestic industry producing the like product. Commentators have sometimes proposed applying CVDs on carbon-intensive imports as a "stick" against "carbon free riding."[13] The problem with this formulation is that free riding on carbon restrictions is not a subsidy, as currently defined by the ASCM, because the absence of a government regulation is not the legal equivalent to the presence of a financial contribution from that government.

If the intent of a proposed trade penalty is to sanction countries that are going slow on adopting climate measures, then it would violate GATT Articles I or XI or both, and would not be justified by Article XX. The justification for the import ban in the United States—Shrimp case was that the imported products from certain producers were caught in a way that led to the killing of endangered sea turtles. The Appellate Body ultimately permitted that ban, even though it was unilateral, because conditioning market access on a foreign government's adoption of a program comparable in effectiveness to the US program gave sufficient latitude to that foreign government.[14] In our view, one cannot infer from this single case that the Appellate Body would approve a trade sanction levied against a target country proceeding at a different environmental speed than the sender country. The most prominent slowpoke on the climate issue over the past 10 years has been the United States, and there was never a serious suggestion that other countries could have legally imposed trade sanctions against the United States for that reason.

In commenting on the legal status of trade sanctions, it should first be repeated that border adjustment measures are not trade sanctions. The central purpose of a border adjustment measure is to equilibrate conditions between an imported product and a domestic product. Border adjustments can be legal or illegal under WTO rules, depending on the underlying economic circumstances. One motivation for a border adjustment may be to influence the policy of another country. That is also an argument for imposing countervailing duties, namely in part to dissuade foreign governments from subsidizing. But having the motivation to influence another government does not necessarily mean that a measure amounts to a "sanction." Moreover, there are no officially agreed upon bright lines as to when a restrictive trade measure constitutes a sanction.

Finally, the WTO implications of multilaterally agreed trade sanctions against climate scofflaws have yet to be addressed. Multilaterally approved trade sanctions are virtually unknown outside of the UN Security Council and the WTO dispute system.

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13 See Ralph Nader and Toby Heaps, "We Need a Global Carbon Tax," *Wall Street Journal*, December 3, 2008, A17.

14 Appellate Body Report, *United States—Import Prohibitions of Certain Shrimp and Shrimp Products*, Recourse to Article 21.5 of the DSU by Malaysia, WT/DS58/AB/RW, adopted November 21, 2001, paragraph 144.

Although enforcement actions have been taken through multilateral environmental agreements, trade sanctions per se are not authorized.

Greenhouse Gas Performance Standards

In contrast to a carbon tax, carbon intensity standards (or carbon footprint standards) could be devised for particular sectors that could be imposed equally on both imports and domestic production.[15] If the GHGs emitted in production were to exceed the relevant performance standard, then the product could not be sold. For example, then European Commissioner for Trade Peter Mandelson suggested that environmental standards for biofuels should be the same for European and imported biofuels, and that such standards should cover changes in land use.[16] The idea of performance standards was recently put forward in a staff paper published by the US House of Representatives Energy and Commerce Committee (2008).

Although there is no WTO case law on this point, we assume that such standards would be reviewed under GATT Article III and, if necessary, under Article XX. If foreign products are treated less favorably—for example, by imputing to them artificial carbon footprint values—that would violate national treatment.

Whether a carbon performance standard would also be considered a TBT "technical regulation" and therefore subject to TBT disciplines remains an open question. In our view, panels could decide that such performance measures are covered by the TBT agreement because non-coverage would mean that the disciplines of that agreement would not apply. In other words, the definition of covered regulations in the TBT agreement—namely, regulations about "product characteristics or their related processes and production methods"[17]—could be interpreted broadly (Verrill 2008). It is true that the negotiating history of the TBT agreement would suggest an intent for narrower coverage, but in WTO jurisprudence, negotiating history takes a second place to textual and contextual analysis.

If a carbon performance standard were analyzed under the TBT agreement, a key question would be whether the national standard conformed to an international standard. If so, then the use of that standard would be "rebuttably presumed not to create an unnecessary obstacle to trade."[18] Whether such a standard could be imposed by the United States against developing countries is not clear under TBT rules, however, because the TBT agreement states that developing country WTO members should not be expected to use international standards that "are not appropriate to their development, financial and trade needs."[19] If a domestic carbon performance standard is not based on an international standard, then the domestic standard would be subject to

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15 As used here, the term "standard" means a mandatory government regulation. In other words, we follow common usage rather than the TBT agreement nomenclature that defines standards as non-mandatory provisions.

16 See Peter Mandelson, "Keeping the Crop in Hand: By Imposing Rigorous Sustainability Standards, We Can Make a Global Market in Biofuels Work," *Guardian*, April 29, 2008. Available at: www.guardian.co.uk/commentisfree/2008/apr/29/biofuels.energy (accessed January 12, 2009).

17 TBT agreement, Article 1.2 and Annex 1, paragraph 1.

18 TBT agreement, Articles, 2.4, 2.5.

19 TBT agreement, Article 12.4

the requirement in the TBT agreement that any application to imports "shall not be more trade-restrictive than necessary to fulfil a legitimate objective," such as protection of the environment.[20]

If a panel decides that a carbon performance standard is not a TBT measure, then it would be analyzed under Article III:4 of the GATT. The standard would violate Article III:4 if it treats the imported product less favorably than the like domestic product. Most commentators would say that a regulation based on the method of production would violate Article III, but there is no WTO jurisprudence squarely on that point. A violation of Article III would not be fatal, however, as the regulating country could invoke Article XX (b) or XX(g). Assuming that the GHG performance standard is applied to all countries (including the domestic market) in the same way, we believe that the Article XX defense would succeed.

"Food Miles" and Transport Emissions

A new idea that has emerged in recent years is to internalize the externalities from international transport into the cost of a product (Kejun, Cosbey, and Murphy 2008). For agricultural products, this idea is referred to as "food miles." In a climate context, this might mean adding a charge at the border for the GHG emissions entailed in the transportation of that product to the importing country. Once such an import comes into a country, it could then be treated the same as a domestic product with respect to internal transport-related emissions.

Certainly, any food mile charge would be a violation of GATT Article I because it is origin-specific. Moreover, food mile charges would be outside the scope of Article II:2(a), which permits border tax adjustments, because transportation is a service, not an "article." Nowhere does the GATT or the General Agreement on Trade in Services (GATS) authorize BTAs on services. Food mile charges would also be a violation of Article III because imports as a group would be treated less favorably.

Using a Multilateral Climate Agreement as a Sword against Import Restrictions

Some commentators have suggested that countries which are not listed in Annex I of the United Nations Framework Convention on Climate Change (UNFCCC) could argue that, if they are in compliance with their (minimal) obligations under the UNFCCC or the Kyoto Protocol, they can not be subject to trade restrictive measures. This is not a facetious argument. However, since the WTO Appellate Body has not given weight to obligations under other international agreements (e.g., Brazil—Tyres),[21] it is difficult to imagine that a panel would imbue greater legal significance to the lack of obligations under other international agreements. Moreover, the two existing climate MEAs do not contain explicitly stated provisions that oblige developed countries to refrain from using trade or border measures against developing countries.

In upcoming Copenhagen negotiations for the next climate protocol, developing countries might seek treaty language to forestall the use of border measures that would hamper their exports. In other words, there may be proposals that, if developing countries accept some emissions reduction commitments, then developed countries

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[20] TBT agreement, Article 2.2.

[21] Appellate Body Report, *Brazil—Measures Affecting Imports of Retreaded Tyres*, WT/DS332/AB/R, adopted December 17, 2007, paragraphs 228, 234.

would agree not to impose additional commitments through unilateral measures. A specific provision of that sort, if written into the next climate protocol, might well be given legal effect in WTO dispute settlement proceedings.

Another proposition being offered in "trade and climate" debates is that, so long as it is a non-party to the Kyoto Protocol or a successor regime, the United States should be disqualified from invoking an Article XX defense for a trade-related climate measure (Frankel 2008). Although the Appellate Body in United States—Shrimp never said that prior negotiations were a prerequisite for invoking Article XX, there is nevertheless a widespread perception that the Appellate Body did so, and one could imagine a panel finding fault with the United States for not being a party to the Kyoto Protocol or successor regime.[22] Support for that outcome could be found in the Appellate Body's statement that "good faith" is required under the Article XX chapeau. Furthermore, in United States—Shrimp, the Appellate Body took note that the United States had not ratified three environmental MEAs that loosely relate to turtle conservation.[23]

Using a Multilateral Climate Agreement to Establish Rules for Trade

It would also be possible for a new climate protocol to establish a rule that all goods in international commerce have to carry an emissions permit ("carbon passport") obtained from an international facility. The permit could be issued free for production that meets an internationally determined performance standard or could be purchased at an internationally set price. If all WTO member countries subscribe to this rule, then trade conflicts regarding the treatment of imports should not arise. If some WTO members were a party to this agreement and some refused to join, then the non-parties could complain if a party refused to allow an importation without such a permit. How a WTO panel would deal with such a case is not certain. The most likely outcome is that the panel would find that the MEA norm does not override WTO rules. Yet the possibility exists that a panel could seek to internalize the climate norm into WTO rules and apply it against non-parties because the rule is multilateral. This situation did not arise in the United States—Shrimp case because the US measure was unilateral, not multilateral.

This hypothetical is put forward to show the possibility of constructive synergism between trade and climate law. We do not, however, see the climate regime moving in this direction, because carbon passports would only address the climate effects of production for exportation, not production for domestic consumption. Production for domestic consumption is by far the bigger problem. For example, only about 6 percent of cement production is traded internationally. This explains why almost all proposals for border adjustment hinge on the entire emissions profile of a foreign country, not just its exports.

Allocating Emission Allowances to Other Countries

One idea being floated in climate talks is for an industrial country like the United States to give some free emission allowances to developing countries that are taking early action to reduce GHGs. Article 1.1(a)(1) of the ASCM is ambiguous as to whether a

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22 The United States was a major player in negotiating the Kyoto Protocol. However, the United States did not ratify the agreement, nor did it have any international law obligation to do so.

23 Appellate Body Report, *United State—Shrimp*, paragraph 171 n. 174

financial contribution by Government A can be characterized as a subsidy when A gives the money to economic actors in Government B. In any event, we are doubtful that free subsidies given to other countries would cause sufficient adverse effects to be actionable, because the ASCM Part III discipline ("Actionable Subsidies") is on the donor country (Country A in our example), not the recipient country (Country B). Moreover, the ASCM does not have a most favored nation clause, so a donor country need not give the same subsidy to every WTO member.

Output-Based Rebates

Alan H. Price (2008) from Wiley Rein LLP has proposed temporary federal government payments to certain firms equal to their cost of purchasing climate emission permits. The eligible industries would include iron, steel, aluminum, pulp/paper, bulk glass, cement, and certain chemicals. Eligibility would require that an industry be energy-intensive, produce a globally traded commodity, and face rising imports in response to higher domestic energy prices. Price recognizes that such payments would be subsidies under WTO rules, but argues that "a rebate for added costs incurred under a domestic environmental policy would be unlikely to have any demonstrable impact on international competitors."

Our view is different. As we see it, if a direct payment to domestic producers is designed to protect domestic companies from the competitive effects of higher domestic regulation, then the payment may reasonably be expected to distort trade and cause serious prejudice to other WTO members. If so, the payments would violate the ASCM prohibition against granting subsidies that cause or threaten adverse effects on other countries.

Climate Safeguards

One floating idea is that, rather than compensate US firms ex ante with free distribution of emission allowances, an ex post system should instead provide government assistance to companies upon a showing of injury from competing imports or reduced opportunities to export. This program would be distinguishable from safeguards permitted in the WTO Agreement on Safeguards. Under the Safeguards Agreement, importing country governments may respond to domestic injury by trade restrictions that entail the suspension of GATT obligations or the modification of GATT tariff concessions.[24] Although the point has not been litigated in the WTO, the Safeguard Agreement does not appear to relieve WTO members of their obligations under the ASCM. In other words, WTO law seems to insist that a safeguard be a trade restrictive measure (on an imported product) rather than a subsidy. This interpretation would be consistent with the position taken by the Appellate Body in ASCM jurisprudence, which ruled against the payment of countervailing subsidies to domestic companies that are hurt from foreign subsidies. Instead, the Appellate Body held that only countervailing duties could be used.[25] Perhaps WTO rules should be modified to permit the sort of ex post relief suggested above.

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[24] Agreement on Safeguards, Article 1 and GATT Article XIX:1.

[25]. Appellate Body Report, *United States—Continued Dumping and Subsidy Offset Act of 2000*, WT/DS217/WT/AB/R, adopted January 27, 2003, paragraphs 269–273.

Hybrid Systems

"Hybrid" measures are found not only within each approach to the competitiveness question—carbon taxes and cap-and-trade systems—but also within each country's overall policy framework to cope with climate change. Governments are legislating a mixture of subsidies (e.g., biofuels, solar, and wind power), performance standards for vehicles, and other GHG controls. Major nations find it congenial to design legislation in a way that helps domestic producers, especially "national champions." The United States is well along this path with respect to biofuels, having enacted measures that generously support ethanol production by firms like Archer-Daniels-Midland. The US domestic auto industry is likewise on the threshold of more government assistance, which almost certainly will encourage CO2 efficient engines. President Nicholas Sarkozy of France and other European leaders favor the same approach, especially in the current financial crisis.

Because of their complexity and variations from country to country, hybrid systems would need to be examined under several WTO agreements. A violation of WTO rules may arise when the measure applied to an imported product is not the same as the measure applied to a domestic product. For example, this could happen when the domestic measure to be matched is not a tax on products but rather is a regulation. In that case, the measure on imports cannot be immunized by GATT Article II:2(a), dealing with border tax adjustments. The measure would instead be reviewed under GATT Article III, and if a violation is found, a panel would inquire whether an exception is permitted by GATT Article XX. Another WTO violation could arise when a measure treats foreign countries differently depending on their climate policies. Although there are valid environmental reasons for discriminating between countries, such discrimination could run afoul of GATT Article I. If so, recourse to Article XX is possible, but measures will need to be carefully designed and applied to meet the various prerequisites of Article XX.

4 Recommendation: A New Code of Good WTO Practice on Greenhouse Gas Emissions Controls

While the post-Kyoto negotiations to be held in Copenhagen will probably result in new and ambitious targets for reducing GHG emissions, and commit both developing and developed countries to take action, national governments will likely be left to devise their own methods for meeting agreed targets. In the absence of clean-cut and uniform international standards, countries will enact their own unique mixes of domestic measures accompanied by import bans, border adjustments, and other mechanisms to address "leakage" and "leverage" concerns. 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. Consequently, many disputes are likely to land on the WTO's doorstep.

One way to determine whether the disputed trade measures in support of GHG emission controls are compatible with WTO agreements is simply to let the WTO judicial process run its course. However, we believe that relegating these matters to the WTO dispute system is not the best course for several reasons. Decisions on dispute

cases are unlikely to produce clear guidelines within a short time frame (a big WTO case can take three years to run the course of litigation through the Appellate 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 addition, 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 high stakes decisions should be made by negotiators representing national governments, not international trade judges on the basis of the complex and ambiguous WTO jurisprudence.

Instead, we suggest that key WTO members should attempt to negotiate a new code that delineates a large "green space" for measures that are designed to limit GHG emissions both within the member country and globally.[26] By a "green space" we mean a policy space for climate measures that are imposed in a manner broadly consistent with core WTO principles even if a technical violation of WTO law could occur. Measures that conform to the green space rules would not be subject to challenge in WTO dispute settlement by governments subscribing to the code. Measures to be covered by the code are following:

- Taxes or charges on the volume of carbon equivalent emissions released in association with the production of imported or exported products;
- Performance standards expressed in terms of maximum carbon equivalent emissions associated with the production of a designated quantity of the imported or exported product;
- Cap-and-trade systems that require the submission of emission permits in conjunction with imported products, or that distribute such permits in conjunction with exported products, whether the permits are distributed by government free of charge, sold at a fixed price, or auctioned;
- Comparability systems that evaluate the greenhouse gas controls of other WTO members and impose regulatory requirements on imports from, or exports to, another member country that fails to meet the prescribed standard;
- Any other greenhouse gas control measure that directly regulates or raises the landed cost of imported products, or that directly regulates or lowers the free-on-board cost of exported products; and
- Subsidies that finance research and development or physical infrastructure for the production of alternative energy sources with lower greenhouse gas emission

[26] Another idea being floated is to amend GATT articles and other parts of the WTO legal text to accommodate environmental controls. 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 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. Even a three-fourths requirement would make it difficult to get a waiver on a controversial subject.

characteristics than traditional energy sources; subsidies that finance the sequestration of greenhouse gas emissions; and subsidies for climate adaptation.

Also, to ensure comparability between imported and domestic products, like domestic products need to be defined under internationally standardized system for classifying traded products such as the Harmonized tariff system (HTS) code. Hufbauer, Charnovitz, and Kim (2009) outline possible elements of a new code in details.

The key WTO members that are big emitters (say ten countries) could negotiate a code as a plurilateral agreement under Annex 4 of the WTO agreement. 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. 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 require that all WTO members agree to the text or substance of the code.

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 the WTO. The advantage of acting outside the WTO is that non-participating 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 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 not be to regulate the legal relationship between code members and non-members, 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. Also, the new code should encourage, but not require, members to adopt GHG carbon taxes, or to auction emissions permits, as preferred GHG control measures. The reason is that to the extent the award of emissions permits becomes a commercial transaction, the room for subsidies is narrowed, and the basis of comparing emissions costs between activities and across countries is vastly improved. Given the importance of the matter, it is crucial that the code includes major emitting countries such as the United States, the European Union, Japan, China, India, and Brazil. We believe that such code is in interests of both developing and developed countries because the code would minimize risks on exports of developing countries by limiting trade measures contemplated by some developed countries, and also because the code would eliminate the risk of possible disputes over trade measures adopted by developed countries.

To encourage WTO negotiating efforts along these lines, we recommend that the United States and other important emitting countries should adopt a time-limited “peace clause” into their climate legislation. The “peace clause” would suspend the application of border measures or other extra-territorial controls for a defined period of time while WTO negotiations are underway.

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