

The Kyoto Protocol and the WTO

Seminar Note

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Preface

This note is based on presentations and discussion at a seminar on *The Kyoto Protocol and the WTO*, jointly organized by the Royal Institute of International Affairs (RIIA) and the International Institute for Sustainable Development (IISD) during the third WTO Ministerial Conference in Seattle.

The meeting aimed to explore the potential conflicts between climate change mitigation under the Kyoto Protocol and the system of trade rules under the WTO, and how best to avoid them. This note summarizes the main strands of the presentations and discussion at the meeting. The topics discussed here are explored in depth in RIIA's recently released book on trade and climate change.¹

IISD and RIIA would like to extend their sincere thanks to Lucas Assunção, Duncan Brack, James Cameron and Gary Sampson for their presentations; to David Runnalls for chairing the meeting; and to all of the seminar participants for their enriching discussion.

Introduction

The Kyoto Protocol to the UN Framework Convention on Climate Change (FCCC) may be the most important economic agreement penned in the 20th century. While its aims are environmental—to reduce human-induced emissions of greenhouse gases—achieving those aims will mean changing the fundamental bases of production and consumption, transport, investment and energy provision in signatory countries.

There are a number of ways in which the Protocol, or the actions that parties may take in fulfilling their objectives, might come into conflict with commitments under another body of

¹ Duncan Brack with Michael Grubb and Craig Windram, *International trade and climate change policies*, London: RIIA Energy and Environment Programme/Earthscan Publications, 1999.

international law—the World Trade Organization. These potential conflicts were the subject of most of the meeting.

Yet the aim of the meeting—and the agreed priority of the participants—was not simply to highlight such problems, but to anticipate problems to help prevent them. The Protocol itself is not yet in force, and parts of it—such as the non-compliance procedures and flexibility mechanisms—are not even spelled out. Only a handful of countries have ratified the Protocol, and some major players will have serious difficulties in doing so. Time is available to defuse the potential conflicts, none of which seem intractable given the necessary political will.

The participants discussed potential conflicts in three areas of the Kyoto Protocol: the flexibility mechanisms; policies and measures; and trade measures for compliance and enforcement. Each is summarized below, followed by a brief discussion on where to go from here.

Flexibility mechanisms

The Kyoto Protocol established three flexibility mechanisms to assist parties in meeting their targets: emissions trading (Article 17), joint implementation between Annex I countries (Article 6), and the clean development mechanism (CDM)(Article 12). None of these has yet been precisely described by the negotiations, but most of the basic ideas are clear.

Emissions trading allows Annex I parties (those parties which have committed to cutting greenhouse gas emissions) to trade emissions reductions among themselves, buying or selling credits toward their commitments. Joint implementation entails collaboration between Annex I parties on projects that will reduce carbon emissions from the baseline scenario. Such projects will earn emissions-reduction credits. The CDM will provide incentives for firms investing in emissions-reducing projects in developing countries, with credits (certified emissions reductions, or CERs) being divided between the host country and the investing firm.

Some feel the mechanisms will be the test of the Protocol's success—if they can be made to work, real progress will be made in cutting emissions. For a number of countries they were also a prerequisite for signing the agreement.

One set of issues arises from the difficulty in defining emissions-reduction units in the trade-rules system. Are emissions traders exchanging 'goods' by the WTO definition? If they are, then the exclusive right to trade them among Annex I parties may violate the WTO's most-favoured nation (MFN) principle² by discriminating against non-Annex I trading partners.

² The most-favoured nation principle prohibits members from discriminating between like goods from different WTO members.

But emissions-reductions units in fact resemble goods less than they do securities—transferable financial instruments. If they are viewed as such, then their trade is not governed by the rules of the General Agreement on Tariffs and Trade (GATT). But, as with securities, private institutions would spring up to handle trade in these new instruments. And the rules governing these trading institutions would need to conform with the General Agreement on Trade in Services (GATS), which covers measures affecting trade in services, including financial services. The GATS version of MFN would mean that providers of financial services (traders, brokers and securities exchanges) from all countries—even those not party to the Protocol—would have to be allowed to handle trades of emissions-reduction units. As long as those units are traded only between Annex I countries, there is nothing obviously wrong with this scenario.

The Protocol envisions emissions trading among countries, but the final result will probably see countries allocating their rights among their domestic industries, and letting them do much of the international trade themselves. This raises another set of issues: how will countries make the initial allocation of emission rights? Such rights are in effect valuable transferable instruments.³ If we regard their distribution as a financial contribution from government to industry, then that contribution may be considered a subsidy under the WTO's Agreement on Subsidies and Countervailing Measures (SCM).

Such subsidies are not automatically prohibited or actionable. To be so they first must be 'specific'—granted to a specific enterprise, industry or sector, and not generally available. Most conceivable allocations would likely go to a small group of industries, with a few getting the lion's share, and so would probably be found specific. To run afoul of the SCM, however, they must also be shown to either be export promoting, or to harm some foreign competitor. The former is unlikely. The latter might be possible, and parties to the Protocol should bear that possibility in mind when designing national systems of allocation.

Policies and measures

While some argue that the flexibility mechanisms will be the heart of a successful Protocol, others maintain that the real reductions will in fact come at the domestic level, driven by governments, as policies and measures to reduce greenhouse gas (GHG) emissions. At least four types of these policies have the potential to bring countries into conflict with their WTO obligations: carbon taxes and border-tax adjustments, standards, subsidies and government procurement. Each is briefly discussed below.

Carbon taxes and border-tax adjustment

One policy that governments might use for reducing the emissions of GHGs is a tax on the carbon emitted in the production of goods. This would raise the prices of energy-intensive

³ The value of these rights underlies the problems with the initial allocation of rights internationally as well. Allocating rights on a per-capita basis, for example, would amount to a massive transfer of wealth to populous Annex I countries (or potential future Annex I countries such as China and India) that are low emitters. While this is the most equitable solution, the less populous high-emitters (such as the U.S.) would much rather see a distribution based on existing patterns of emissions.

goods and goods whose production causes high GHG emissions, penalizing them in the marketplace, and would stimulate the substitution of less-carbon intensive forms of energy for production. The final result would be less carbon emitted.

But this hypothetical chain of events ignores international trade. If foreign goods do not face the same taxes, then a unilateral carbon tax only has the effect of giving away market share of domestic business to their foreign competitors, both at home and abroad. And, in the end, global carbon emissions may be unaffected—only the names of the emitting countries would change.

One possible solution is to team up carbon taxes with what is known as border-tax adjustment (BTA). Such a scheme would see imported goods pay a tax at the border equal to what they would have paid had they been produced domestically. And it would refund the tax paid by domestically produced goods if they were exported. There is no consensus on whether such a tax would be found legal under GATT if challenged. BTA is only allowed for taxes levied directly on the product, so indirect taxes such as payroll taxes and social security charges are not eligible. A carbon tax, though, may be a different animal.⁴

Standards

Environmental standards are another set of tools that governments might use to fulfill their Kyoto Protocol obligations. The most likely type is efficiency standards mandating, for example, that appliances use only so much energy. The result would be less energy used domestically, and fewer energy-related GHG emissions.

Countries are free to adopt whatever standards they choose under WTO rules, their level of environmental protection being a matter of social choice. There may be problems, though, if such standards are designed in such a way as to penalize foreign firms in favour of domestic ones. This may be accidental—domestic firms may happen to be best suited to take advantage of particular standards, perhaps by dint of being industry leaders in the type of technology specified. It is also possible for such standards to be constructed with the aim of favouring domestic industries. Such regulations might run afoul of the WTO's Technical Barriers to Trade Agreement.

Subsidies

Governments may decide to use subsidies as another tool to help reduce national emissions. The most probable are subsidies to promote the use of renewable energy, or to promote fuel switching to less GHG-intensive sources. Such subsidies would certainly be specific in the sense discussed above—aimed at a specific sector or industry—and thus would fall under SCM rules. The key question to bear in mind when designing such programs is, do the subsidies impair the market share of a competing foreign producer? If so, they might conflict with WTO law.

⁴ The GATT 'Superfund' case found that certain U.S. taxes on products, based on the chemicals used in their production, were eligible for BTA. See L/6175 BISD, adopted 17 June, 1987, 34S/136, 160–163.

Government procurement

Governments purchase a large amount of goods and services: 10 to 25 per cent of GDP in the OECD countries. Many will be tempted to use their purchasing power to help achieve their Kyoto Protocol obligations. They may specify, for example, that they will give some purchasing preference to goods produced using renewable energy sources.

Discrimination of this sort—based on how a product is produced—has traditionally had a rough ride in the WTO. But government procurement specifications are not governed by the same rules as are general trade measures (technical regulations), and the relevant law—the Agreement on Government Procurement—does not seem to prohibit such measures. The Agreement does require that any such specifications not be constructed in such a way as to create unnecessary barriers to trade—a phrase that has yet to be defined. And the Agreement has only been signed by a handful of countries to date, though most of them are major traders.

Compliance and enforcement (trade measures)

The Kyoto Protocol will eventually need to have procedures for dealing with those parties that fail to meet their obligations. Article 18 calls for the first meeting of the parties to adopt a non-compliance procedure (NCP). And the sixth conference of the parties to the FCCC (November 2000 in the Hague) is expected to agree on some form of procedure, possibly fixing a penalty level per tonne of carbon emitted. But for the moment, the rules remain unwritten. The Protocol will also likely specify some use of trade measures to prevent non-parties from undermining its objectives, excluding them from certain forms of trade with the parties.

Trade measures in the Kyoto Protocol might take at least three distinct forms:

1. **Bans on trade with non-parties.** The Montreal Protocol's NCP bans parties from trading in restricted goods with non-parties. For the Kyoto Protocol, the list of goods in question is so large (anything produced with the use of GHGs) that this route seems improbable. It is likely that such a ban would be found to contravene the WTO's MFN principle (GATT Article I) if challenged, though no such challenge of an MEA has been brought to date.

2. **Trade restrictions.** Article 2 of the Protocol sets out a number of types of policies and measures that parties are encouraged to adopt to meet their obligations, including some of those discussed in the previous section. It is possible that parties will claim that they are acting under the mandate of the Protocol in enacting some of these trade-restrictive policies and measures, though none are specifically mandated.

This scenario is troubling because it is likely, and because it might precipitate a damaging clash between trade and environment objectives, were the rules and institutions no more evolved than those we have today. It is almost certain that some parties will eventually

implement policies and measures in a protectionist manner. The only question is whether another country, whether party to the Protocol or not, might complain to the WTO.⁵ Were this to happen, the defendant would probably claim it was acting within its mandated obligations under the Kyoto Protocol (though they would not be specifically mandated), and the stage would be set for a titanic clash of trade and environment rules, with fallout that would be damaging for both communities regardless of the outcome.

3. Prohibitions on emissions trading with non-complying parties, and with non-parties. The prohibition against non-parties is obviously necessary for the integrity of the emissions-trading system, and its implications for the trading system are discussed above. Unless the emissions-reduction units are defined as goods, there is not likely to be a problem. The prohibition against non-complying parties is a likely punitive element of the Protocol's NCP. While it might violate the WTO's MFN, it is unlikely a party would complain to the WTO about its application, having signed on to the procedure.

Given the interest in investment negotiations in the WTO, it is interesting to note that the draft version of the OECD's now-defunct Multilateral Agreement on Investment would have prevented countries from barring investment from non-parties or non-complying parties. If the purchase of a country's emissions-reduction units were considered akin to portfolio investment, this could have been a problem.

The way forward

The potential problems surveyed at this meeting illustrate perfectly the need for measures and institutions to bridge the trade and environmental divide. The most obvious need in this case is to resolve the question, how do the MEAs relate to the WTO? Although the WTO's Committee on Trade and Environment has spent a great deal of time on this issue, there seems to be no will among most WTO members to address the problem before it becomes concrete. This is the pragmatic trade negotiators' traditional method of operation: since there has not yet been any conflict with MEAs, there is not yet a need for action. The FCCC and the Biosafety Protocol of the Convention on Biological Diversity may change this belief.

One approach to addressing the various institutional issues might be a working group in any future WTO negotiations charged with recommending changes to the institution itself, not unlike the Uruguay Round group with a mandate to examine the functioning of the GATT system. This group would seek to maximize the WTO's contributions to sustainable development.

For their part, the environmental negotiators and domestic regulators can help avoid conflict by understanding the potential problems and constructing treaties and regulations accordingly. A number of the disciplines imposed by the WTO are potentially helpful from

⁵ Though the WTO itself has expressed its preference that MEA-related disputes between parties be addressed within the MEA, such a scenario is unlikely. The complainant would probably want to take the case to the venue that offered it the best chance of winning and enforcing its complaint—the WTO.

an environmental perspective, such as the proscription on discriminatory subsidies, for example. The issues of the trade-environment interface are not the responsibility of the WTO alone, but must also be actively addressed by the governmental environmental community.

The central message from this meeting was that there are serious potential problems in the interface between the WTO rules and the implementation of the Kyoto Protocol, but avoiding them is possible. Usually—but not always—the solutions are not complex, and time, for now, is on our side.