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**DOMESTIC CLIMATE CHANGE POLICIES
AND THE WTO**

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DISCUSSION PAPERS

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DOMESTIC CLIMATE CHANGE POLICIES AND THE WTO

Lucas Assunção and ZhongXiang Zhang *

Abstract

The Kyoto Protocol sets reduction targets to greenhouse gas emission levels in developed countries, including OECD and East European countries (the so-called Annex 1 Parties to the Climate Change Convention). The Kyoto Protocol gives Annex 1 countries considerable flexibility in the choice of domestic policies to meet their emissions commitments. Possible climate policies include carbon/energy taxes, subsidies, energy efficiency standards, eco-labels, and government procurement policies. In order to meet their Kyoto targets with minimum adverse effects on their economies, Annex 1 Party governments with differentiated legal and political systems are highly likely to pursue climate policies that may have the potential to bring them into conflict with their WTO obligations. This paper explores the potential interaction between these domestic climate policies and WTO rules. It argues that their potential conflicts can be avoided or at least minimized if WTO rules are carefully scrutinized, and efforts are made early on to ensure that the proposed climate policies comply with them. It suggests an early process of pursuing consultations between WTO members and the Parties to the Climate Change Convention and points to the need to further explore ways to enhance synergies between the trade and climate regimes.

I. INTRODUCTION

Climate change as a result of increased atmospheric concentrations of the so-called greenhouse gases is an externality. To date, such an externality has not been internalized in production processes, input costs, consumer choices and energy markets. The continuous unconstrained reliance on fossil fuels bears witness to the neglect of the climate change externality: current energy policies fail to consider the costs of stabilizing greenhouse gas concentrations in the atmosphere at a level which would prevent potential catastrophic damages (and hence future economic costs). Part of the reason for this policy failure resides in the fact that climate change has so far been treated as an isolated environmental issue, whereas climate change is essentially a cross-sectoral economic problem. Given the multitude of greenhouse gas emission sources in both developed and developing economies, policy responses will require a fundamental change in the way that energy is produced and the way it is used.

The Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC) marks the first step towards an international determination to limit emissions of greenhouse gases. It is widely regarded as an important mechanism towards correcting the climate policy failure and a major push towards the internalization of the climate change externality. The Protocol has set legally binding reduction targets and timetables on greenhouse gas emissions for Annex 1 countries (i.e. the OECD countries and countries in transition to a market economy)¹ and

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¹ The Kyoto Protocol includes a basket of six greenhouse gases: carbon dioxide (CO₂), methane (CH₄), nitrous oxide (N₂O), sulfur hexafluoride (SF₆), perfluorocarbons (PFCs), and hydrofluorocarbons (HFCs). The Protocol will become effective once it is ratified by no less than 55 per cent of the parties whose CO₂ emissions represent at least 55 per cent of the total from Annex 1 countries in the year 1990. For the latest list of ratifications, see the UNFCCC web site at www.unfccc.de.

introduced three international flexibility mechanisms, namely i) international emissions trading, ii) joint implementation, and iii) the clean development mechanism (CDM). However, the Articles defining the flexibility mechanisms carry wording that their use must be supplemental to domestic actions. This has led to the open debates on interpretations of these supplementarity provisions.² With the United States withdrawal from the Kyoto Protocol in March 2001, the European Union dropped its previous insistence on a cap on the use of flexibility mechanisms to secure the reluctant support of other Umbrella Group³ members of the Protocol at the resumed sixth Conference of the Parties to the UNFCCC, held in Bonn, July 2001. The final wording of the Bonn Agreement, reaffirmed in the Marrakech Accords, is now that “domestic action shall thus constitute a significant element of the effort made by each Party included in Annex 1 to meet its quantified emission limitation and reduction commitments”. This at least indicates that domestic climate policies will have an important role to play in meeting Annex 1 countries’ emissions commitments.

Article 2 of the Kyoto Protocol gives Annex 1 countries considerable flexibility in the choice of domestic policies to meet their emissions commitments. Possible climate policies include carbon/energy taxes, subsidies, energy efficiency standards, eco-labels, and government procurement policies. In order to meet their Kyoto emissions targets with minimum adverse effects on their economies, it is highly likely that Annex 1 governments with differentiated legal and political systems might pursue emission reduction policies in such a way as to unfairly favour domestic producers over foreign ones. Such differential treatments could occur in governing eligibility for, and the amount of, the subsidy, in establishing energy efficiency standards, in the determination of the category of eco-labelled products and the procedures of establishing eco-labels, in specification criteria for tenders, and in specifying condition for participating in government procurement bids. In the case where a country unilaterally imposes a carbon tax, it may adjust taxes at the border to mitigate the competitive effects of cheaper imports that are not subject to a similar level of the carbon tax in the country of origin. A measure of this sort may well raise complex questions with respect to the WTO consistency and the conditions under which border taxes can be adjusted to accommodate a loss of international competitiveness. All this clearly indicates that these domestic climate policies may have the potential to bring countries into conflict with their WTO obligations.

However, Article 3.5 of the UNFCCC states the underlying principle that “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”. It is again carefully restated in Article 2.3 of the Kyoto Protocol.⁴ Thus, the real challenge for a country being both a WTO member and a Party to the Kyoto Protocol is to pursue both the Uruguay Round and Kyoto Protocol objectives through enhancement of synergy among policies and avoidance of conflict arising from unilateral discriminatory trade measures. After all, a conflict between the trade and climate regimes, if it breaks out, helps neither trade nor the global climate.

To date, however, such desirable policy coordination between the two regimes has not been addressed in a sufficiently serious manner. This paper aims to fill this gap by discussing carbon/energy

² See Zhang (2000, 2001) for a detailed discussion on these supplementarity provisions and on the assessment of the European Union proposal for ceilings on the use of Kyoto flexibility mechanisms.

³ The Umbrella Group refers to the so-called JUSSCANNZ countries (Japan, the United States, Switzerland, Canada, Australia, Norway, New Zealand). It meets daily during the international climate change negotiations to exchange information and discuss substance/strategy on issues where there is common ground.

⁴ Article 2.3 of the Kyoto Protocol states that “The Parties included in Annex 1 shall strive to implement policies and measures under this Article in such a way as to minimize adverse effects on international trade, and social, environmental and economic impacts on other Parties, especially developing country Parties and in particular those identified in Articles 4.8 and 4.9 of UNFCCC”.

taxes, subsidies, energy efficiency standards, eco-labels, government procurement policies, and exploring the potential interaction between these domestic climate policies and WTO rules.⁵ It highlights their potential conflicts, and argues that such conflicts can be avoided or at least minimized if WTO rules are carefully scrutinized, and efforts are made early on to ensure that the proposed climate policies comply with them. It suggests an early process of pursuing consultations between WTO members and the Parties to the Climate Change Convention and points to the need of further exploring ways to enhance synergies between the trade and climate regimes.

II. SUBSIDIES

Under the Agreement on Subsidies and Countervailing Measures (the Subsidies Agreement), a subsidy is defined as a financial contribution and/or a benefit conferred by a government to its domestic industries so that a given sector can develop with (temporary) lower production costs and improve its competitiveness. More specifically, it can take the form of direct transfers, loan guarantees, fiscal incentives such as tax credits, provision of goods and services other than general infrastructure, or direct payments to a funding mechanism. In the context of combating global climate change, the possibilities for fuel substitution and technical innovation are essential to the success of Annex 1 countries meeting their national emissions targets. However, clean technologies are relatively capital and knowledge-intensive, and renewable technologies are not yet competitive with conventional technologies. Thus, it is most likely that Annex 1 governments may use either of the above subsidy options or a combination of these options to promote energy conservation, the use of renewable energy, and/or the increased adoption of less carbon-emitting technologies. By encouraging producers to take environmentally beneficial actions, such subsidies contribute positively to the environment.⁶ In the economic jargon, these subsidies “capture positive environmental externalities”, in the sense that they would promote production with lower greenhouse gas emission levels.

It is conceivable that in introducing subsidy incentives to domestic firms, governments will obviously attempt to foster industrial development and, at the same time, achieve reductions in present or future greenhouse gas emissions. However, if the sector where such subsidies are introduced is significantly open to foreign trade, such subsidies could potentially be challenged under WTO rules. The question is then the conditions under which such subsidies would run against WTO rules.

Article 3.1 of the Subsidies Agreement prohibits government subsidies that are contingent on export performance or use of domestic over imported products. Subsidies of this sort are prohibited regardless of whether they are applied generally or to specific industries and regardless of whether they are going to cause adverse effects to foreign competitors or not. Accordingly, subsidies made available for firms to use domestic low carbon-emitting products over foreign, high carbon-emitting

⁵ This paper focuses exclusively on the relationship between domestic climate policies and WTO rules (see also Assunção (2000)). For a discussion on the relationship between greenhouse gas emissions trading and WTO rules, see Zhang (1998), Parker (1998), Petsonk (1999), Werksman (1999).

⁶ Subsidies could also contribute negatively to the environment. The typical example is energy and transport subsidies, which are widely considered to distort trade, and in most instances to cause environmental degradation. Thus, reforming energy and transport subsidies and getting the price right to reflect their production cost and environmental externality is the win-win strategy that first needs to be pursued in mitigating carbon emissions. For example, OECD (1997c) estimates that subsidy reform could deliver 1–8 per cent CO₂ emission reductions in the energy and electricity sector and 10–15 per cent emission reductions in the transport sector while improving economic welfare.

“like products” are considered GATT-illegal. A subsidy is actionable if it is granted to certain enterprises only and if it causes injury to the domestic industry of another member or serious prejudice to the interests of another member (Article 5 of the Subsidies Agreement). Put in another way, a subsidy is actionable if it is found either *de jure* or *de facto* specific and if it causes injury or serious prejudice to the economic interests of foreign competitors.

Let us first examine the specificity requirement. Under Article 2.1(a) of the Subsidies Agreement, a subsidy is considered *de jure* specific if only “certain” enterprises are eligible. Aimed at helping reduce carbon emissions, climate change-related subsidies are most likely to be granted to few energy-intensive sectors rather than made available economy-wide. Thus, they could be challenged under the *de jure* specificity requirement of the Subsidies Agreement. If they are found to be *de jure* specific, the specificity analysis terminates. However, even if they pass the *de jure* specificity test, they could still be considered specific under the *de facto* specificity if it is found that there is a predominant use or a disproportionate use of such subsidies. For example, in the case of Dutch Flowers, a subsidy scheme nominally available to all agricultural producers was found not *de jure* specific. But the subsidies received by horticulture firms were deemed *de facto* specific because horticulture received 50 per cent of the subsidy, while accounting for only 24 per cent of Dutch agricultural production (quoted in Parker (1998)).

Because the Subsidies Agreement is intentionally vague on how the “certain enterprises” is to be interpreted, to ascertain whether a subsidy is specific in practice or not requires a case-by-case analysis. Experience shows that this is not an easy matter. However, to determine the extent of injury that a subsidy might cause is even more difficult. Under Article 15.1 of the Subsidies Agreement, determination of injury is to be based on “positive evidence and involve an objective examination of both (a) the volume of the subsidized imports and the effect of the subsidized imports on prices in the domestic market for like products and (b) the consequent impact of these imports on the domestic producers of such products” (WTO, 1995). Although in practice providing the objective investigation of adverse effects is rather complicated, it would not prevent a country home to foreign competitor’s products from initiating a WTO dispute if it estimates that the subsidy impairs its market share or discriminates against its exports. It is indeed conceivable that in key economic sectors several of the subsidy schemes currently envisaged to reduce specific industries’ greenhouse gas emissions would run against WTO rules. Potential conflict with trade rules could then become a reality and a real obstacle to successful climate change policy and compliance with the Kyoto Protocol. This risk of conflict will be higher, depending on how relevant a certain sector is for Annex 1 Party emission reductions and how significant trade flows are in that specific sector.

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