

## Making climate change and trade mutually supportive

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### Introduction

A few years ago, the relations between the climate and trade communities were marked by mutual ignorance at best, and more often by deep hostility. The climate community did not want to be hindered by trade constraints. The trade community was so afraid of the damage that climate policies could do to the multilateral trade regime that it was adamantly opposed to any consideration of such concerns. Mutual destruction looked inevitable.

Now things are changing. The trade community is realizing that climate change concerns will be high on the political agenda for a long time to come. The climate community is realizing that climate policies will face fierce opposition from four-fifths of human kind if it costs too much in terms of growth and of trade, its main channel.

However, many fears and doubts still abound. The trade community remains obsessed by the host of putative conflicts raised by creative trade lawyers, forgetting that other domains of international trade law are full of conflicts that have never materialized. The climate community has not yet fully realized how easy a prey it is for protectionist interests, at great cost to climate change goals. For example, the European Commission (2009) has formulated a list of industries with "significant risk of carbon leakage" that includes sectors such as manufacturing of wines, clocks, bicycles and underwear. These quite surprising outcomes are easy to explain; one of the criteria used by the European Commission for drawing up the list is the importance of trade for the sectors examined. This criterion, driving the selection of 80 per cent of the sectors in the list, has nothing to do with climate change, but it is honey for protectionist-minded sectors.

### 1. Climate and trade communities: So many things in common

The main ingredient that is still lacking in the climate and trade debate is full recognition of the many things that the climate and trade communities have in common. First, they share a common problem – each has to deal

with a global "public good". Climate change is a public good; countries unwilling to contribute to climate change goals undermine the results of those making efforts. Freer trade is a public good; its benefits are bigger and faster to emerge if all the countries move together.

Second, the two communities have common foes as illustrated by the above mentioned European Commission list – the firms willing to slow down climate policies by using protectionism and those willing to slow down trade liberalization by using climate change excuses.

Third, they have emerging common friends – those firms willing to grasp the opportunities of delivering goods that are both cleaner (good for the climate) and cheaper (good for trade) as well as countries such as Germany or China are building up comparative advantages in environmentally-friendly goods.

Last but not least, the world climate regime has to develop in a multilateral framework, just as the trade regime did. There is one Earth, but the Copenhagen Conference has made it clear that no country is ready to surrender its sovereign rights. The world carbon price or tax is an objective that should be aimed for, but it will emerge in a future as distant as worldwide free trade.

The existence of so many fundamental similarities strongly suggests that the multilateral climate regime should not be so different from the multilateral trade regime. In the following paragraphs, it is argued that the climate community would greatly benefit from adopting the two key principles of the multilateral trade regime. It is also argued that benefits go both ways; the climate community could design some instruments that could be repatriated in the multilateral trade regime to its upmost benefit. Mutual support emerges as highly desirable.

### 2. From the trade community to the climate community

The climate community should borrow the multilateral trade regime's two key principles – "national treatment" for disciplining carbon border taxes and "most-favoured nation" for disciplining carbon tariffs.

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**(a) National treatment**

The climate community worries about carbon leakage. Arguably, carbon border taxes (CBTs) are the best instrument to fight carbon leakage; why would firms located in a country shift their dirty production to foreign countries if, once re-imported, their products would pay the country's domestic carbon taxes? If CBTs reassure the climate community, they make the trade community nervous. The trade community should be reminded that such a system has been routinely used with great success by trading partners enforcing very different rates of value added tax (VAT) during the past four decades.

Thus, there is nothing wrong with CBTs if – this “if” is crucial – they are properly enforced, as in the VAT case. This condition requires the principle of national treatment, which means that a country should impose the same domestic tax on imported goods and on similar products produced domestically. Specifically, it requires the country exporting goods to eliminate its domestic carbon taxes (if any) on exported products, while the importing country imposes its own domestic carbon taxes (if any) on imported products. Evidence from the European cap-and-trade regime suggests that carbon taxes in the dirtiest sectors would be equivalent to VAT rates of 3 per cent to 6 per cent – not insignificant numbers, but not large ones either.

In this context, it is interesting to estimate the potential impact of carbon border taxes. The table suggests three main results. First, clearly, mutual destruction is a possibility. Trade-based border taxes on imports result in massive deterioration of the situation – remarkably – of almost all the countries, to the point of putting at risk world growth; hence the willingness and/or capacity to pursue climate change policies. Second, while the impact of specific-based border taxes may be less dramatic it hurts most developing countries, ensuring political international turmoil.

Last but not least, two border tax regimes have a much lower impact on trade: (a) the two-way border tax regime; and (b) the ‘no border tax’ regime. The choice between these two regimes depends largely on whether or not developed countries want to do practice what they preach. If one believes what developed countries preach, they are cutting their carbon emissions for the sake of human welfare. Their preferred choice should then be the ‘no border tax’ regime. Developed countries would accept a small decline of their exports because it minimizes the decline of the low- and middle-income developing countries’ exports. The ‘no border tax’ regime thus emerges as the preferable option from the joint points of view of climate change (the targeted CO<sub>2</sub> cut is achieved in developed countries) trade and development; this is mutual support at its best.

#### Estimated impact of alternative border tax regimes on total industrial exports

(Unit: Per cent changes)

Border tax regimes <sup>a</sup>	United States	EC	Developing countries <sup>b</sup>	Brazil	China	India
Only on imports (trade-based)	-10.1	-23.2	-14.8	1.9	-20.8	-16.0
Only on imports (specific-based)	-6.5	-6.6	-3.2	-2.5	-3.4	-3.2
Two-way tax (specific-based)	0.0	0.5	-2.0	-0.6	-1.8	-2.1
No border tax	-2.3	-2.1	-0.1	1.0	-0.9	-0.3

Source: Mattoo and others, 2009. Developed countries are assumed to reduce unilaterally their CO<sub>2</sub> emissions by 17 per cent

Note: EC = European Commission.

<sup>a</sup> Two-way border tax – elimination of the carbon tax imposed by the exporting country combined with the imposition of the carbon tax imposed by the importing country. Trade-based BT: the specific carbon tax of the *importing* country is applied on the carbon content of the *exporting* country on imports from the developing countries. Specific-based BT: the specific carbon tax of the *importing* country is applied on the carbon content of the *importing* country on imports from the developing countries and specific-based.

<sup>b</sup> Low- and middle-income developing countries.

**(b) Most-favoured nation**

Such a principle would ban the imposition of carbon tariffs on imports from only certain countries, i.e., China, India or other key emerging economies. It is crucial to distinguish between carbon tariffs and carbon border taxes; carbon tariffs do, in fact, discriminate against some countries, and they are not defined by the level of domestic carbon taxes. The most-favoured nation principle should be a pillar of the multilateral climate regime, because carbon tariffs are totally counter-productive from a climate perspective for two reasons. First, they assume that developed countries import most of their dirty products from developing countries. This is

not the case, because developing countries still export mostly goods with relatively low carbon intensity, from clothing to assembled products. Second, carbon tariffs would generate a “dual” world economy with a slowly growing trade between clean countries, and a rapidly growing trade between dirty countries – not precisely what the climate community would like to promote.

Interestingly, a trade-centred (and selfish) argument reinforces these two reasons. Assume, for example, that rich countries impose carbon tariffs on Chinese exports of dirty products (on the top of CBT). This treatment will create strong incentives among Chinese firms to upgrade as quickly as possible those products they want

to export to the rich countries. In other words, carbon tariffs will accelerate the emergence of Chinese competitors in the high-end products – exactly as voluntary export restraints and antidumping measures accelerated the technological upgrading of Japanese and Korean products from the 1970s to the 1990s. This is not exactly what the supporters of carbon tariffs are hoping for.

### 3. From the climate to the trade community

What could the climate community teach the trade community? Of course, this part is more hypothetical because the climate regime is still a blank page. Clearly, however, a sound multilateral climate regime could help the trade community with several crucial aspects.

#### (a) Better adjustment policies

The multilateral trade regime has failed to put in place sound instruments for supporting the adjustment efforts required by changing economic conditions. It relies on measures such as antidumping or safeguards, which have been amply proven to be both ineffective (they do not promote adjustment) and costly to consumers (and even to the firms triggering such measures). The same would inevitably happen if the climate community were to adopt similar instruments for addressing climate change-related adjustments.

At this stage, the climate community has the opportunity to design better instruments – be it well-targeted subsidies, public regulations or self-regulations – for addressing the adjustment problems to be met by producers of carbon-intensive products. If successful, the climate community would have provided a great service to the trade community, which could then renovate its own machinery by adopting similar instruments for trade-related adjustment problems.

#### (b) Differentiated treatment of developing countries

The climate community has already adopted the notion of “common but differentiated responsibilities” when dealing with developing and least developed countries. This notion echoes the “special and differentiated treatment” (S&DT) in the multilateral trade regime. However, S&DT can be best described as a trap for developing countries; it is not generous when truly needed, and it is generally designed in such terms that it generates perverse impacts (if any) on both the alleged beneficiaries and the developing countries excluded from its scope.

The main reason for such negative effects is that the trade community has been unable to design a sound mechanism for “graduating” successful developing countries. The climate community should therefore be careful not to duplicate such a mistake; instead, if deemed necessary, it should design sound, predictable and progressive conditions of the “graduation” of developing and least developed countries.

#### (c) Negotiating techniques

A last source of inspiration that the trade community could draw from climate diplomacy concerns negotiating techniques. The climate community has already begun to negotiate on a “plurilateral” basis, that is, a core of key large countries, with a few more nations representing well-defined groups of small countries. The trade community would be well-advised to adopt similar techniques for concluding the Doha Round.

### 4. Challenges ahead

Generally speaking, the climate community should feel at ease within the broad World Trade Organization principles. If that community wants to have its own multilateral treaty, it should make sure the treaty is built on the same basic principles. Meanwhile, the trade community should grasp the opportunities to benefit from the improved disciplines that the climate community could design, in order to address the systemic current failures of the multilateral trade regime.

That said, although immensely beneficial, mutual support raises serious challenges because climate change policies raise huge difficulties in terms of implementation. The following four issues require particular care.

#### (a) Defining “similarity” or “likeness”

National treatment means that countries rely on domestic information – the one they know best. This is a highly desirable feature. However, it falls short of providing a workable definition of “similarity” between (or “likeness” of) foreign and domestic products, and production processes. Unfortunately, to say the least, the multilateral trade regime does not provide any firm guidance on this issue.

As a result, the climate community has a key role to play in shaping such a definition. It should be very careful not to be captured by definitions of “similar” that would favour vested interests to the detriment of climate change goals. This implies that similarity should be based on scientific evidence in two ways. First, such evidence should be the only criterion for defining carbon intensive sectors. This is a key step for limiting risks of protectionism. However, it is also a crucial step for the climate community because it helps to simplify the otherwise mind-boggling complexity of climate policies, and to focus on the sectors that are the true source of problems. Second, scientific evidence should be used to build “clusters” of production processes considered to have similar carbon-intensity and thus subject to the same carbon tax rate.

#### (b) Taking into account production and process methods

These two steps are critical for addressing, in a pragmatic way, the problem of production and process methods (PPMs). The logic of climate change problems

makes it inevitable that PPMs as well as products per se must be taken into consideration. Two "like" goods produced by a dirty and a clean production process are not similar from a climate perspective. This feature makes the trade community nervous. However, that community should also recognize that it implicitly takes into account production processes when it allows the imposition of different antidumping duties of "like-products" produced by different firms. The risk is thus not a matter of principles, but of sound implementation.

If these two steps are not followed, it creates the risk of denying the notion of likeness. This would hurt the trade regime. In addition, it would also harm the climate regime because it would require the impossible task of managing an enormous number of "products times processes" that are subject to a host of different carbon taxes. Developing these two steps based on scientific evidence is thus a common interest of the climate and trade communities. Doing so in a multilateral framework would make the similarity definitions even more transparent and unbiased.

### (c) How to define carbon border taxes?

The way that carbon border taxes will be defined is crucial for developing countries. Ensuring a level playing field is not a simple matter in the case of a public good because it faces two constraints: (a) from an economic perspective, past emissions have to be taken into account as well as present and future emissions; and (b) from a political perspective, the level of taxation should not harm growth too strongly if worldwide support is sought. Of the three possible ways of defining carbon border taxes, the burden on developing countries could range from one to two or even three taxes, depending on the definition chosen. Offering the best outcome from a joint climate, development and trade perspective requires the definition of border taxes in *ad valorem* terms.

### (d) Facing the unexpected

This point is based on the implicit assumption of perfect forecasts in climate change matters. This assumption is not met at the regional or local level. For example, available forecasts on more frequent and severe droughts in certain regions during the coming 20 to 50 years diverge widely, depending on the model used. An efficient way to address the problems of increased scarcity of water, and of its unequal distribution in the world is more trade between water-rich and/or water-efficient countries and the other countries – meaning the opening of their agricultural sectors (which use 70 per cent to 80 per cent of water resources) by the developed countries. In short, freer trade emerges as the cheapest source of insurance against unexpected shocks in climate change.

To conclude, rather than being afraid of each other, the climate and trade communities should realize how much they will lose if they do not cooperate, and how much they will gain if they support each other.

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