

# **Leveraging Trade Policy toward Sound Environmental Governance: Legal and Economic Considerations Related to the Implementation of Market-Based Environmental Policies**

**(Ways Forward for the Multilateral Trading System)**

*Organized by ENTWINED Research Consortium*

## **ABSTRACT**

Today, some of the most important environmental problems are global in scope, in which the countries bearing the consequences are not the same as those generating the damaging pollution, or the economic pressures for unsustainable resource exploitation. Global climate change is the most obvious and pressing example of such problems.

Growth in trade—and in international economic linkages through trade—provides both great opportunities and great challenges for addressing global environmental problems. Trade helps drive economic growth, improving standards of living on the one hand and exacerbating emissions on the other, as in the rapidly expanding middle-income countries such as China, India and Brazil, not to mention most developed countries. Global markets also create challenges for countries that wish and are able to tackle these environmental problems, as few care to lighten their environmental footprint while the invisible hand directs others to tread more heavily.

Among the range of tools available to policy makers, market-based instruments like emissions taxes, cap-and-trade programs, and differential fiscal policies are generally the most economically and politically efficient mechanisms for accomplishing environmental goals. By signaling that pollution is costly, they harness market forces to find the most cost-effective means of reducing emissions—at least within the regulatory jurisdiction. But since they not only induce abatement but also make polluters pay for their emissions on the margin, these instruments can lead to greater consequences for international competitiveness than traditionally less efficient regulations. When the shifting of production outside the jurisdiction also undermines the policy goal of reducing a global pollutant, then economic efficiency argues for counterbalancing measures. Still, there are legitimate questions as to when and whether trade-related measures are the most effective response, economically or politically, or the most likely to survive legal challenges under the WTO.

This session set out to explore the interaction between market-based environmental policies, international trade, and international trade law. Since nowhere are these dynamics more evident than in the development of climate change policy, it drew from examples related to the management of greenhouse gas emissions in the US and China, including the proposed use of border adjustments. The expert panellists brought to the table the different perspectives of economic instrument design, legal interpretation,

developing country contexts, and global governance. A broad-based discussion of the issues and other applications followed the presentations.

## 1. Presentations by the panellists

### (a) Jason Potts

Sustainable Markets and Responsible Trade (SMART) Programme, IISD  
*Market-Based Environmental Policy: Building WTO Compatibility*

This presentation examined market-based policies and their compatibility within WTO regulations under the GATT 1994. Market-based policies are defined as policies that leverage market forces to change the behaviour of citizens and economic actors towards improved environmental performance. The rationale for these policies is that they are economically, dynamically, and politically efficient. There are three categories of market-based policies: price-based (directly affecting price), rights-based (new markets are created by defining new property rights), and market friction (enabling the market to be more responsive to environmental concerns). These market-based policies can be applied to firms or products, which is an important fact in the context of WTO compatibility because products are traded but firms are not. Firm-based policies (incentives for firms to reduce emissions) can negatively impact competitiveness at the domestic level, while product-based market-based policies can affect the ability of importers to bring goods into a domestic market or exporters into a foreign market. Product-based policies are important to WTO policy because of their influence on processing and production methods.

In examining the GATT 1994 cornerstone obligations, the convergence of such market-based policies and WTO regulation becomes evident. Article 11, for example, prohibits quantitative restrictions on market entry; while some environmental policies, such as intensity targets, may come into conflict with this stipulation, market-based policies are generally in line with the agreement because there are no restrictions and players can continue in the market. Articles 1 and 3 focus on the equal treatment of like products but both allow for differentiation of products based on non-product related characteristics; The *Asbestos AB* decision highlighted the importance of “competitive relationships” in determining product likeness suggesting that it is possible that physically identical products which serve different markets (e.g. eco-labels) could nevertheless be considered “un-like” based on their specific competitive characteristics. Article 20, on the other hand, stipulates that discrimination can be acceptable if necessary to protect animal, human or plant life or health or for the conservation of natural resources; Art. 20 applications, however, are subject to compatibility with the Chapeau which obliges that such intervention be applied in a manner which is neither unjustified nor discriminatory and that represents the least trade-distorting of the options available. In the *Shrimp-Turtle* decisions, considerable emphasis was placed on the ability of countries implementing environmental measures to provide objective means for monitoring that producers under similar conditions are treated similarly. Market-based policies can play

an important role in meeting these requirements where they are linked to supply chain monitoring systems and use science-based evaluation methods.

In conclusion, market-based policies can be compatible with WTO regulation. The potential for this outcome is maximized by avoiding quantitative restrictions, limiting extra-territorial effect to cases where there is a direct “nexus” of impact on the implementing country, building on existing market-based distinctions (eco-labels), being based on international standards and other participatory processes, being based on scientific evidence, and ensuring that mechanisms have effective, accurate and fair monitoring systems. Finally, however, it is important to note that market-based policies’ compatibility with WTO regulation does not guarantee sustainability. To the extent that they are unilateral in character, they can reinforce existing inequities in international markets by providing developed country stakeholders with a competitive advantage. In order to avoid this outcome, great attention and care needs to be given to ensuring that market-based mechanisms are designed with the active participation of developing country stakeholders.

(b) Carolyn Fischer

Resources for the Future

*Market-Based Environmental Policies in a Global Context*

This presentation examined the role of market-based environmental policies in overcoming global environmental problems. Fischer defined market-based environmental policies as financial instruments or prices which signal the value of environmentally-friendly behaviour. While these policies may take on different forms (e.g. taxes on emission, cap and trade, tradable performance standards, tradable portfolio standards), what is important is that all are of the same value to all economic actors. The benefits of market-based environmental policies are similar to those of trade: cost effectiveness, efficient allocation of scarce resources, consistent price signals, and profit incentives (which also provide incentive for innovation). The problems with market-based environmental policies are also similar to those of trade: they do not always improve welfare, there is hidden information, property rights are ill-defined, missing markets do not benefit, and coverage can be incomplete. Market-based policies have more of an impact on product prices than regulation but are generally more efficient. The marginal emissions cost imposed by the policy increases the product price, which can lead to a lack of competitiveness, displacement of production to countries where there is no policy coverage, or lead to emissions leakage. In this case, another policy must be implemented to limit leakage, such as border adjustments for imports, border relief for exports, a combination of the two (full coverage), or a production rebate (which could reduce cost and provide a production incentive). Each option faces challenges within WTO trade law because import adjustments discriminate and export relief and rebates may be viewed as subsidies. There is also the issue of political cooperation and who needs to be involved in implementing these policies. It is important to note that none of these policies necessarily reduces global emissions because they are merely shifted from

one country to another. Also, the policy that might be best for one trade sensitive sector may not be for another.

Overall, we can conclude that border adjustment policies are most effective at reducing leakage but, if limited to home practices, home rebates are more effective (although they are bad for the energy sectors). Most of the traditional market-based policies are useful in allowing countries to take unilateral action but they also generally are limited in the net reductions they achieve at the global level. It is important to note that the less effective policies are at reducing emissions, the more pressure they will put on the cost of the market-based policy at home. With this said, international cooperation is essential in the reduction of global emissions, even within the context of a market-based regime (eg. Countries can't rely on market-based instruments as tools for moving "beyond" global consensus to any great degree).

(c) Mark Sanctuary

ENTWINED

*Market Based Mechanisms for Climate and Energy Policy in China*

This presentation focused on the market-based mechanisms that China is implementing on climate and energy, as well as the linkages between environmental market-based mechanisms and trade. China has implemented a national climate change programme that aims to accelerate climate-friendly energy choices, to enhance science and technology capacity, and to facilitate market-based mechanisms (MBMs) for more efficient energy production and utilization. China has introduced many new regulations over the last two years, some market-based and others more centralized. In the Chinese renewable energy law, there are a number of market-based mechanisms and trade mechanisms (e.g. lower import taxes); the Clean Development Mechanism (CDM) is one important component because China generates 35% of the world's emissions reductions and CDM projects generate \$13 billion. The Chinese government taxes CERs depending on the project type – high taxes on non-preferred project types and low taxes on preferred project types. China has an implicit price floor on CER credits, as well as foreign ownership restrictions. In order to promote renewable energy, there are reduced tariffs on renewable energy components. On the supply side of the CDM projects, there is a shift away from smaller actors to more state-owned projects. On the demand side (mainly the EU), there are many large market players coming into the game who will affect the types of projects, the technology transfer, competition, and pricing. The Chinese government is putting lots of money into enabling CDM and allowing the private sector to come into the market.

There are several challenges that confront CDM actors; the public sector needs to balance domestic and foreign interests, government intervention and market mechanisms, and national priorities with international climate cooperation. On the other side of the coin, the private sector faces regulatory barriers and relatively little incentive to invest given the risks involved. The objectives of CDM are to reduce emissions, promote sustainable development, and to support technology transfer; the Chinese government is much more

interested in the latter than it is in financial flows. The issue is that technology transfer is only limited to certain types of projects and is less of a priority for the private sector. Furthermore, in China, the market mechanism cannot work where the market does not work and thus, this policy cannot replace other development initiatives.

Nonetheless, trade is a key component of China's climate and energy objectives and China's use of MBMs has mobilized significant private sector resources. Selling CERs to Europe has provided an important boost to energy efficient projects and increased the internal rate of returns. While MBMs are efficient, they do not always address distributional concerns therefore necessitating a balance between carrot and stick approaches. In conclusion, China is taking the climate change issue seriously and market-based instruments are an important part of the equation. However, the challenges in making market-based mechanisms work in China are doubly complicated by the nascent character of the Chinese market and the need for a strong and coherent approach at the global level. Without targeted attention to these two barriers first, Chinese mechanisms are unlikely to be effective.

## **2. Questions and comments by the audience**

The discussion following the presentation revolved around two separate themes: 1. Discussion on the current position and strategy of China with respect to trade liberalization and climate change instruments 2. The relationship between WTO rules and environmentally motivated legislation more generally.

### *Chinese Trade Policy:*

In this portion of the discussion, a member of the audience whether or not there was real support from the Chinese regarding the liberalization of environmental goods—since they had observed little in the way of forthcoming proposals from the Chinese government. A panelist responded that his information was based on internal discussions, but admittedly did not represent official Chinese policy. Another member of the audience asked how the recent selling off of state-owned-enterprises within China might affect the implementation of the CDM in the coming years. A panelist responded that China the release of companies from state-ownership could allow for more efficient implementation of the CDM, but only to the extent that private ownership was promoted in a manner which encouraged competitiveness and efficiency in the free market.

### *Relationship Between WTO Trade Rules and Environmental Legislation:*

Another member of the audience noted that there was still no explicit conclusion regarding the official relationship between MEAs and the WTO. Recognizing this, the participant asked how we can hope to address the link between trade rules and environmental negotiations if there is no formal agreement on which has hierarchy over the other? A panelist noted that while there was a time when the environmental community regarded the trade regime (eg. WTO) as potential “ally” in the enforcement of

environmental rules and objectives in virtue of its special enforcement capacity, this approach has all but lost any legitimacy in light of the inability of the Parties to come to any conclusive agreement on how environmental (or other public good issues) should be met in a trade regime. In the meantime, the WTO judicial dispute resolution system (eg. The Appellate Body), has demonstrated a greater capacity in resolving the challenges faced between conflicting environmental and trade obligations through its case-by-case approach, than actual negotiators have been. The result is such that one can truly wonder whether negotiated results would actually achieve any more (or even as much) as adjudicated results already have. This point applies equally to Paragraph 30.1 of the Doha Agenda--where the best outcome is probably no outcome at all because it is hard to imagine an outcome that doesn't provide additional disincentives for countries to join MEAs.

Another participant noted the importance and potential of the use of carrots and sticks when considering an effective market-based approach to environmental regulation. On the one hand it is clear, that some countries are only likely to act on the threat of embargoes and trade bans, and with such a threat, may be willing to adopt pro-active market-based approaches. There is a need for more research on the potential linkages between command and control and market-based approaches in global environmental governance.

Another participant asked whether any of the panelists thought that it would be wise for the WTO to set a rule implementing an emissions cap on exporting products? A panelist noted that it was probably unlikely that the WTO, given its negotiating structure and framework could ever come to agreement on such a cap, even if it were to decide that this somehow fit its mandate (which itself is highly questionable).

### **3. Conclusions and ways forward**

One of the conclusions drawn from the workshop was that market-based approaches to environmental regulation do not offer a silver bullet to the solving global environmental problems. Although market-based instruments have a number of positive attributes (ability to reach beyond national jurisdictions and efficiency characteristics), their actual effectiveness for resolving specific problems depends on such a variety of factors that no conclusion can be drawn on them other than that "there untapped potential" exists.

Another conclusion drawn from the workshop was that the effective use of market-based environmental policy could only work within the context of a functioning market and that the existence of such a market could not be taken for granted in a large part of the world. Even within a well functioning market, political tides could counteract the effectiveness of market-based instruments rather quickly thus suggesting that their effective use could only reasonably be counted on within the context of a broader (environmental) governance regime.

Finally, it was concluded that while the elaboration of such a broader regime should, in principle, bear an explicit coherence with the trade system, it would not be wise to hold

such a process captive to WTO-styled negotiations which, to date, have shown little capacity to make significant advances on such matters.