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DESIGNING CLIMATE CLUBS: THE FOUR MODELS, TRADE COMMITMENTS AND THE NON-DISCRIMINATION DILEMMA

Geraldo Vidigal

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Designing Climate Clubs: The Four Models, Trade Commitments and the Non-Discrimination Dilemma¹

Geraldo Vidigal*

The imminent adoption of climate-motivated trade restrictions has led to renewed interest in climate clubs (CC), by which club participants limit the application of trade restrictions to countries that fail to contribute sufficiently to emissions reduction efforts. Within the decentralized international system, small-group cooperation among climatically ambitious states may be instrumental in making climate cooperation politically feasible. In particular, decarbonizing carbon-intensive sectors may require a “club” approach. This paper analyses the main CC models being proposed, classifying them as “inducive” or “equalizing” and “exclusive” or “inclusive”. If adopted unilaterally (or “minilaterally”, by a group such as the G7), all models are likely to be contentious, either unjustifiably favoring one policy design over others or setting up arbitrary distinctions between admissible and inadmissible contributing measures. Regardless of formal legal challenges, a CC imposed without multilaterally negotiated criteria is bound to create trade tensions. A credible outcome of current proposals is a CC component within a (*de jure* or *de facto*) multilateral climate governance (MCG) system, whose residual club component operates less as an exclusive club than as a fallback element to ensure continued adherence to the governance system. To avoid pitfalls, the design of a CC must match the stated objective of decarbonizing production while allowing participants a broad measure of freedom regarding policy choices. A CC component may be permissible as a means of eliminating incentives for free riding through non-participation, as long as the MCG sets for those within the club corresponding criteria for acceptable contributing measures, established means of assessing compliance, and commensurate consequences for non-compliance.

1. Introduction

The 2021 Glasgow Climate Pact,² reaffirmed in Sharm El Sheikh by the 27th Conference of the Parties (COP27) to the United Nations Framework Convention on Climate Change (UNFCCC),³ embodies the multilateral political consensus on the need to drastically

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¹ This paper was originally prepared as a White Paper, entitled “Towards a Multilateral Climate Club?”, for presentation at the “Trade and Climate” workshop of the *Remaking the Global Trade System for a Sustainable Future* project in Talloires, France, on September 21, 2022. A subsequent version, in dialogue with existing literature and reflecting comments made by participants, is forthcoming. I thank Joel Trachtman, Dan Esty, Jan Yves Remy and other workshop participants for their comments on previous versions, and Zoé Baize for her research assistance.

² Conference of the Parties to the UNFCCC, Sharm el-Sheikh Implementation Plan, 20 November 2022.

³ Conference of the Parties serving as the meeting of the Parties to the Paris Agreement, Decision 1/CMA.3, 13 November 2021 (Glasgow Climate Pact), para. 22.

reduce global emissions of greenhouse gases (GHGs). In the Climate Pact, parties to the Paris Agreement⁴ agree that “limiting global warming to 1.5 °C requires rapid, deep and sustained reductions” to GHG emissions.⁵ Among the policy instruments to permit the fulfillment of this objective at the international level is a “climate club” (CC), an instrument originally proposed by William Nordhaus in 2015⁶ and now being considered (in substantially different form) both by the European Union (EU), in the context of its proposed Carbon Border Adjustment Measure (CBAM), and by the Group of Seven (G7), an informal intergovernmental forum gathering seven historically industrialized countries.⁷ The EU CBAM proposal, featuring a *de facto* climate club, is now all but adopted, the details having been agreed between the Council, the Commission and the Parliament in December 2022.⁸

Climate clubs have been discussed extensively in the literature.⁹ Structurally, a Climate Club involves two elements. Internally, participating countries adopt strict and costly

⁴ Paris Agreement, C.N.63.2016.TREATIES-XXVII.7.d. United Nations Framework Convention on Climate Change (adopted 29 May 1992, entered into force 21 March 1994) 1771 UNTS 107 (FCCC).

⁵ Conference of the Parties serving as the meeting of the Parties to the Paris Agreement, Decision 1/CMA.3 (Glasgow Climate Pact), para. 22.

⁶ William Nordhaus (2015), “Climate Clubs: Overcoming Free-riding in International Climate Policy” 105(4): American Economic Review 1339–1370.

⁷ G7 Statement on Climate Club, 28 June 2022, <https://www.g7germany.de/resource/blob/974430/2057926/2a7cd9f10213a481924492942dd660a1/2022-06-28-g7-climate-club-data.pdf?download=1>.

⁸ Proposal, Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism (CBAM) – Compromise text, 14 December 2022, Interinstitutional File 2021/0214(COD) (16060/22) (EU CBAM Proposal).

⁹ Nordhaus, n5 above; Robert Falkner (2016), “A Minilateral Solution for Global Climate Change? On Bargaining Efficiency, Club Benefits, and International Legitimacy”, 14 *Perspectives on Politics* 1 (2016): 87; Robert Falkner, Naghmeh Nasiritousi & Gunilla Reisch, “Climate clubs: politically feasible and desirable?” 22 *Climate Policy* (2022) 480. For a legal assessment, see Rafael Leal-Arcas, “Climate Clubs and International Trade Across the European and International Landscape” 29(3) *European Energy and Environmental Law Review* (2020) 72-88; Id, *Climate Clubs for a Sustainable Future: The Role of International Trade and Investment Law* (WoltersKluwer); Patrick Low, Gabrielle Marceau & Julia Reinaud (2012), “The Interface between the Trade and Climate Change Regimes: Scoping the Issues”, 46 *Journal of World Trade* 485. Robert Howse & Antonia Eliason (2009), “Domestic and International Strategies to Address Climate Change: An Overview of the WTO Legal Issues”, in Thomas Cottier, Olga Nartova and Sadeq Z. Bigdeli (eds), *International Trade Regulation and the Mitigation of Climate Change: World Trade Forum* (CUP), 48-94; James Bacchus (2022), *Trade Links: New Rules for a New World* (CUP).

decarbonization policies, requiring a sharp reduction in GHG emissions from their domestic industries. Externally, they impose on non-participants measures to preclude them from benefiting from non-participation. In Nordhaus's original proposal, as well as in the models currently being considered, these measures are *trade restrictions*. CC trade restrictions produce a threefold effect: (1) incentivizing countries with lagging climate policies to step up their game, so as to avoid harm to their exports, (2) avoiding so-called carbon leakage, i.e., the relocation rather than reduction of GHG emissions, expected when only some countries adopt strict decarbonization policies, and (3) mitigating the competitive disadvantage caused by strict decarbonization policies to industries of CC participants.

This paper examines the key Climate Club models being proposed, discusses their advisability, and explores means of addressing key political and legal challenges to their implementation. It divides climate clubs into four models, according to two whether they are "inclusive" or "exclusive" and "inducive" or "equalizing". Its main argument is that, given the variety of potential models for CC design, unless they are grounded on multilaterally negotiated criteria, distinctions between participants and non-participants can be framed as either unjustifiable (because based on policy design rather than policy effects) or arbitrary (because based on political alignment rather than policy effects). Trade restrictions that arbitrarily or unjustifiably discriminate between countries where the same relevant conditions prevails are impermissible under the rules of the World Trade Organization (WTO) and of regional trade agreements (RTAs) and are likely to be perceived as illegitimate, leading to challenges and retaliation.

Following this Introduction, Section 2 outlines the CC model originally proposed by Nordhaus and the political and legal challenges that have led to deviations from this design. Section 3 examines two proposals for climate club design: the European Union's *de facto* CC (EUCC) for countries that adopt an EU-like Emissions Trading System (ETS) and the G7's proposal of an "inclusive" CC (G7CC). Section 4 considers applicable international trade rules, with a focus on Article XX of the General Agreement on Tariffs and Trade

(GATT). Section 5 assesses the main challenges faced by the different models and considers how international legal instruments may address these challenges, embedding a limited CC into a multilateral climate governance regime. Section 6 concludes.

2. The Nordhaus Model: Challenges of an Inducive Climate Club

The concept of a climate club derives from the economic theory of clubs. Clubs are institutional mechanisms that allow multiple actors to cooperate towards a common objective, which requires contributions from all of them, by connecting the enjoyment of certain benefits to each member's contribution to the common objective.¹⁰ This concept lends itself to different institutional designs. In Nordhaus's 2015 proposal, a CC would be primarily *inducive*, organized around a binary distinction between participants and non-participants and designed to induce – one might say coerce – non-participants to join the club and apply the CC-prescribed decarbonization measures (in the case of his proposal, carbon emissions pricing). For both political and international legal reasons, the climate clubs being proposed by the EU and the G7 are *equalizing* rather than *inducive*, focusing on offsetting the competitive disadvantages imposed to domestic producers of CC participants by decarbonization and carbon pricing measures.

The focus of a Nordhaus CC is the collective action problem involved in pursuing drastic emissions reduction policies. Given the public good nature of the Earth's climate and the fact that the cost of reducing emissions falls on individual countries, "countries have an incentive to rely on the emissions reductions of others without taking proportionate domestic abatement".¹¹ To solve this, Nordhaus proposed combining two instruments. Internally, a uniform decarbonization policy for all CC participants – he proposed a price on GHG emissions, applied across the whole economy. Externally, "trade sanctions": a

¹⁰ James Buchanan describes clubs as "membership ... arrangements where 'exclusion' is possible". James M. Buchanan, "An Economic Theory of Clubs" (1964) 32(125) *Economica* 1-14, 13.

¹¹ Nordhaus, note 2 above, 1339.

flat low extra tariff, applied by all CC participants to all non-participants, regardless of the latter's carbon-reducing efforts or the carbon content of the affected exports.¹²

Both features lead to concerns, political and legal, that make implementation of the Nordhaus model elusive. As regards the internal policy, the two key proponents of a CC – the European Union and the United States – have adopted different regulatory approaches to emissions reduction. The European Union has adopted a cap-and-trade Emissions Trading Systems, currently pricing GHG emissions, for products covered by the ETS, at 50 euros per ton (a price close to the 50 dollars per ton Nordhaus concluded was optimal).¹³ In the United States, a variety of regulatory techniques coexist: several states have implemented cap-and-trade programs, such as the Regional Greenhouse Gas Initiative and the California Cap-and-Trade Program; at the federal level, however, carbon policies take the form of regulations (on products as well as production) and subsidies for the renewable energy industry and industrial decarbonization. This discrepancy makes it difficult to establish a Nordhaus CC, which is exclusive in that it requires adoption by all participants of the same domestic policies, excluding those adopting alternative policies, even if equally effective.

Externally, a Nordhaus “trade sanction”, amounting to a flat low extra tariff on all non-CC countries, is difficult to square with WTO commitments, which limit permissible trade protection to tariffs at a level negotiated at the WTO, as well as with the hundreds of RTAs in force, which mirror WTO rules and require further, often quasi-full tariff liberalization in bilateral trade.¹⁴ Extra tariffs ignoring trade obligations are likely to be

¹² Ibid.

¹³ EU Directive 2003/87/EC, 13 October 2003 (ETS Directive). Nordhaus, note 2 above, 1357. With the price of emissions set at 50 US dollars per ton emitted, Nordhaus calculated, a 5% tariff on all goods from non-participants would make it more advantageous for almost all countries to join the CC (Ibid, 1359).

¹⁴ The question of which trade commitments a carbon tariff would violate, and whether and how it could be justified, has been addressed by significant literature. For a recent assessment, see Ingo Venzke & Geraldo Vidigal (2022), “Are Unilateral Trade Measures in the Climate Crisis the End of Differentiated Responsibilities? The Case of the EU Carbon Border Adjustment Mechanism (CBAM)” 51 *Netherlands Yearbook of International Law* 187. See also Howse & Eliason, n9 above; Andrei Marcu, Michael Mehling

met with political opposition from affected countries, followed by threats of retaliation – and, possibly, actual retaliation – as well as formal dispute settlement claims.¹⁵

A flat trade sanction is also difficult to implement politically. Its (supposed) benefits would be spread across the economy, while the costs of lowering carbon emissions are highly concentrated in a few carbon-intensive industries.¹⁶ For these industries, a low uniform tariff and the prospect that other countries might join the CC does little to alleviate the short-term rise in costs and expected loss of market share, domestically and globally, to foreign competitors not similarly burdened by emissions reduction policies.

Difficulties with a Nordhaus CC mean that CCs proposed in practice diverge from his proposal in two key ways. First, they propose to be “consistent with international rules”,¹⁷

& Aaron Cosbey (2020), “Border Carbon Adjustments in the EU: Issues and Options” ERCST, Roundtable on Climate Change and Sustainable Transition <https://ssrn.com/abstract=3703387>; Alice Pirlot (2021), “Carbon Border Adjustment Measures: A Straightforward Multi-Purpose Climate Change Instrument?” 31(1): *Journal of Environmental Law* 25-52; Charles E. McLure (2011), “The GATT-Legality of Border Adjustments for Carbon Taxes and the Cost of Emissions Permits: A Riddle, Wrapped in a Mystery, Inside an Enigma” 11 *FLA. TAX L. REV.* 221; Erin Campbell & William Pizer (2021), “Border Carbon Adjustments without Full (or Any) Carbon Pricing”, *Resources for the Future*, 29 July 2021; Giulia C. Leonelli (2022), “Practical Obstacles and Structural Legal Constraints in the Adoption of ‘Defensive’ Policies: Comparing the EU Carbon Border Adjustment Mechanism and the US Proposal for a Border Carbon Adjustment” *Legal Studies* 19; Jennifer Hillman (2013), “Changing Climate for Carbon Taxes: Who’s Afraid of the WTO?” *Climate & Energy Policy Paper Series*, July 2013; Joel P. Trachtman (2017), “WTO Law Constraints on Border Tax Adjustment and Tax Credit Mechanisms to Reduce the Competitive Effects of Carbon Taxes” 70 *National Tax Journal* 469-493; Joost Pauwelyn & David Kleimann (2020), “Trade Related Aspects of a Carbon Border Adjustment Mechanism: A Legal Assessment” *European Parliament Policy Department, Directorate-General for External Policies*, PE 603.502; Matthew Porterfield (2019), “Border Adjustments for Carbon Taxes, PPMs, and the WTO” 41 *University of Pennsylvania Journal of International Law*; Pananya Larbprasertporn (2014), “The Interaction between WTO Law and the Principle of Common but Differentiated Responsibilities in the Case of Climate-Related Border Tax Adjustments” 6 *Goettingen Journal of International Law* 145-170; Goran Dominioni and Daniel Cushing Esty, “Designing Effective Border-Carbon Adjustment Mechanisms: Aligning the Global Trade and Climate Change Regimes”, 65 *Arizona Law Review* (forthcoming), available at SSRN: <https://ssrn.com/abstract=4062112>.

¹⁵ In 2012, affected countries responded to the EU’s imposition of its ETS on international aviation with threats of retaliation, leading to the suspension of the policy to this day. In 2018, the United States’ imposition of (non-emissions related) tariffs on steel and aluminum was met with retaliation from nine WTO Members, as well as claims before the WTO.

¹⁶ These industries could be promised funding to offset the costs of decarbonization from the carbon tariff income. On the ensuing legal issues, see below.

¹⁷ G7 Statement, note 3 above; EU-US Joint Statement, “Steel & Aluminium”, 31 October 2021, Section 2 (“compatible with international obligations and multilateral rules, including potential rules to be jointly

thus either justifiable under a plausible interpretation of trade obligations or incorporated into these obligations. Second, rather than a uniform sanctioning tariff, they involve equalizing measures – measures that, like CBAM, offset the competitive disadvantage to the domestic industry that decarbonization policies produce. Their purpose is often described as to prevent “carbon leakage”, i.e., the risk that domestic efforts to reduce emissions “are offset by increasing emissions outside ... through relocation of production or increased imports”.¹⁸ Shifting the primary purpose of carbon border measures, from trade sanctions to equalization of competitive conditions, attracts political support from domestic industry concerned about the loss of competitiveness arising from the requirement to pay either the costs of carbon emissions or those of decarbonization.

3. The EU and G7 Proposals: Designing Equalizing Climate Clubs

a. An Exclusive Climate Club: the EU's ETS, CBAM, and Exemptions

The most clearly fleshed out proposal for a Climate Club has emerged within the European Union's proposed regulation establishing a Carbon Border Adjustment Measure. Its stated objective is to avoid carbon leakage once the European ETS, which currently includes an amount of “free allowances” (permitting cost-free emissions limited to historical levels), is tightened, imposing a significant additional cost on EU production of “emission-intensive” products, including steel, aluminum, cement, fertilizers, and hydrogen.¹⁹ The CBAM amounts to an obligation, for importers of products subject to the regulation, to purchase and surrender “CBAM certificates” corresponding to the price set domestically by the EU for these products' embedded emissions.²⁰

Under the proposed CBAM regulation, imports may be exempted from CBAM in three circumstances. First, an importer is entitled to what can be termed a “CBAM rebate” for

developed”) (https://trade.ec.europa.eu/doclib/docs/2021/october/tradoc_159890.pdf); European Commission, CBAM Regulation proposal, COM(2021) 564 final, Jul 14, 2021, p. 2 (“This measure will be designed to comply with World Trade Organization rules and other international obligations of the EU”).

¹⁸ EU CBAM Proposal, note 8 above, preamble, para. 13.

¹⁹ Ibid., preambular paragraph 29 and Art. 1(1).

²⁰ Ibid., Article 3(18) & Article 3(19).

any price already paid for embedded emissions in the country of origin of the product. Second, any free allowances awarded under the ETS lead to a proportional reduction in the CBAM duty of imported like products. Third, an exporting country is fully exempted from CBAM if it either (i) joins the EU's ETS, as European Economic Area (EEA) countries Norway, Iceland and Liechtenstein did; or (ii) sets up its own emissions trading system, mirroring the EU's ETS, and signs an agreement with the EU "fully linking" the two systems (as Switzerland does).²¹

The latter exemption creates a *de facto* "EU Climate Club" (EUCC), composed of countries – mentioned by name in an Annex to the proposed regulation – that fully accept the EU model and are thus exempted from CBAM. The EUCC thus follows the Nordhaus model in its rigidity, requiring participants (or rather, adherents) to adopt an EU-like emissions trading system and not contemplating alternative means of incentivizing decarbonization. At the same time, it diverges from the Nordhaus model in two ways. First, it does not impose a uniform low tax on all imports from non-participants but aims to impose an *equalizing charge* on a few products deemed carbon-intensive – in the original proposal, cement, electricity, fertilizers, iron and steel, aluminium,²² with an agreement in place to extend it to other products, including hydrogen.²³ According to the CBAM proposal, the mechanism it sets up seeks to apply to imported products "carbon costs equivalent to the ones that otherwise would have been borne under the EU ETS, resulting in an equivalent carbon pricing for imports and domestic products".²⁴ Second, the EUCC remains unilateral, rather than multilateral, in that it does not suggest or require adherents (i.e., states that set up their own ETS system and fully link it to the EU's system)

²¹ Ibid., Art. 2(5). The most recent version of the proposal emphasizes that the ETS must be linked to "the emission trading system of that third country or territory".

²² Ibid., Annex I.

²³ European Parliament, "Deal reached on new carbon leakage instrument to raise global climate ambition", Press Release, 13 December 2022. In the most recent proposal, CBAM has been "extended to hydrogen, indirect emissions under certain conditions, certain precursors as well as to some downstream products such as screws and bolts and similar articles of iron or steel".

²⁴ EU CBAM Proposal, note 8 above, preambular paragraph 13.

to apply their own version of CBAM against imports from third parties. Instead, the proposed CBAM regulation instructs the Commission to “address practices of circumvention” that might emerge if imports from third countries were to be routed through EUCC participants in order to avoid CBAM.²⁵

The rigidity of the EU climate border regime has been resisted by a number of WTO members. Although the United States has replaced its initial concerns with CBAM with a plan to institute its own carbon border measure,²⁶ developing country members have not adopted a similar attitude. In their meeting parallel to COP27, China, Brazil, India and South Africa (BASIC) have exhorted developed countries to avoid “Unilateral measures and discriminatory practices, such as carbon border taxes, that could result in market distortion and aggravate the trust deficit amongst Parties”.²⁷ These members argue, on the substance, that they (i) pursue decarbonization of production differently from the EU, for example through regulation of production rather than carbon pricing; or (ii) pursue their emissions reduction goals, as determined by the multilateral climate regime, by focusing on other efforts than the decarbonization of carbon-intensive production, such as halting deforestation. In terms of WTO law (explored below), the argument is that the EUCC sets up an arbitrary distinction between means of attaining decarbonization of production, accepting the means chosen by the EU to pursue decarbonization (carbon pricing) while rejecting other means outright, without considering their effectiveness for the policy objective pursued.

b. The G7 Statement – An Inclusive Climate Club?

The 2022 G7 Climate Club (G7CC) seeks to address the rigidity of the EUCC. The G7 Statement proposes to establish “an open, cooperative international Climate Club,

²⁵ Ibid., Art. 27.

²⁶ Justin Worland, “John Kerry on Border Carbon Tax: The U.S. Doesn't Want to Push Others Away”, *Time* (26 July 2021).

²⁷ BASIC Ministerial joint statement at the UNFCCC’s Sharm el-Sheikh Climate Change Conference (COP27/CMP17/CMA4), 15 November 2022, para. 11.

consistent with international rules”²⁸. The stated objectives of the G7CC are “to support the effective implementation of the Paris Agreement by accelerating climate action and increasing ambition, with a particular focus on the industry sector, thereby addressing risks of carbon leakage for emission intensive goods”.

The G7CC Statement aims to set up a coordination mechanism among G7 countries so as to avoid, between them, mutual trade restrictions, legal challenges, and retaliation. To do this, the G7 proposes to develop a metric to compare the effectiveness of decarbonization policies, including “explicit carbon pricing” (i.e., the ETS) and “other carbon mitigation approaches”.²⁹ Second, the G7CC will be “inclusive in nature and open to countries that are committed to the full implementation of the Paris Agreement and the decisions thereunder, in particular the Glasgow Climate Pact, and to accelerate their action to this end”. The Statement invites non-G7 countries to “intensify discussions and consultations” with the G7 countries on the proposed club.

The G7 Statement is silent on the measures to be applied by participants to non-participants. External measures may take the form of either a charge on embedded carbon or a requirement that imported products be “low-carbon intensity”, possibly mirroring each participants’ own domestic policies. The EU’s CBAM is on track to be set up, having been agreed between the Commission, the Council and the Parliament.³⁰ Proposals are already before the US Congress to establish a US carbon tariff.³¹ And, in a US-EU Statement on Steel and Aluminum, the signatories have agreed, in what would be a *de*

²⁸ G7 Statement on Climate Club, note 3 above.

²⁹ Ibid. On carbon pricing, see James Boyce, “Carbon Pricing: Effectiveness and Equity”, 150 *Ecological Economics* (2018) 52-61; Stephano Verde and Simone Borghesi, “The International Dimension of the EU Emissions Trading System: Bringing the Pieces Together” 83 *Environ Resource Econ* (2022) 23-46; Denny Ellerman, Frank Convery & Christiam De Perthuis, *Pricing Carbon: The European Union Emissions Trading Scheme* (Cambridge University Press 2010) 9 ff.

³⁰ See note 23 above.

³¹ See 117th US Congress, S.2378 (19 July 2021) H.R.4534 (19 July 2021). See US Congressional Research Service, “Border Carbon Adjustments: Background and Recent Developments”, Report No. R47167 (22 June 2022). For an assessment, see Leonelli, note 14 above.

facto club, to “restrict market access” for steel and aluminum products “that do not meet standards for low-carbon intensity”.³²

The G7CC would thus be two steps removed from the Nordhaus CC. Like the EUCC, the G7CC would not involve a small, uniform tariff applied against non-CC participants, but the application of equalizing measures by participants against non-participants. Unlike the EUCC, it would permit participants to meet decarbonization goals in a variety of manners, designing their own domestic policies and external trade restrictions. It would thus be inclusive, in the sense of permitting a range of policies attaining the same objective, compared to the EUCC’s exclusive model, which restricts participation (i.e. non-application of CBAM) to countries that adopt essentially the same method as the EU’s ETS to promote decarbonization of production.

Table 1 summarizes the key features of the three proposed models:

Table 1 - Three Models for CC Design

| CC Design | Exclusive | Inclusive |
|-------------------|-----------------------|------------------|
| Inducive | Nordhaus Climate Club | |
| Equalizing | EU Climate Club | G7 Climate Club |

³² The Statement is broader. It proposes a club to “restrict market access for non-participants”, including countries “that do not meet conditions of market orientation and that contribute to non-market excess capacity” and those “that do not meet standards for low-carbon intensity”. The signatories commit to refrain from “non-market practices that contribute to carbon-intensive, non-market oriented capacity” in these industries. EU-US Joint Statement, “Steel & Aluminium”, 31 October 2021. See also US-UK Joint Statement, “Steel & Aluminum”, 22 March 2022. Giulia Claudia Leonelli, “Carbon Border Measures, Environmental Effectiveness and WTO Law Compatibility: Is There a Way Forward for the Steel and Aluminium Climate Club?” (2022) 21 World Trade Review 619.

4. Climate Clubs and WTO Legality: What the Current Rules Permit

a. CC Restrictions and Trade Commitments

Whether designed to emphasize inducement or equalization, CC-related restrictions on trade are likely to be tested against international trade commitments. Potentially conflicting measures include: (a) prohibiting importation of certain products from non-participants; (b) imposing tariffs above WTO/RTA commitments; (c) applying charges, taxes or restrictions in a manner that negatively impacts products from non-participants, when compared to domestic competing products; or (c) imposing on imports from non-participants charges, taxes or requirements not imposed on competing imports from CC participants.³³

A competitively neutral equalizing measure, i.e. one that is limited to applying to imported products a policy or cost imposed on domestic products, might not in principle amount to a deviation from trade commitments. Contemporary trade agreements, which reproduce, reaffirm, or are essentially modelled on WTO rules, permit the imposition on imported products of taxes or charges not in excess of those applied to domestic production, as well as of regulations affecting equally domestic and imported products.³⁴ It is possible, however, that, once the relevant carbon regime is applied in its entirety, it will in some way advantage domestic industry. This could be, for example, due to free

³³ The precise legal issues that arise depend heavily on the policy's design. For a comprehensive assessment of the key GATT obligations involved, see Ingo Venzke and Geraldo Vidigal (2022), "Are Unilateral Trade Measures in the Climate Crisis the End of Differentiated Responsibilities? The Case of the EU Carbon Border Adjustment Mechanism", 51 *Netherlands Yearbook of International Law* 187. For previous assessments, see Jennifer A. Hillman, "Changing Climate for Carbon Taxes: Who's Afraid of the WTO?" (Climate & Energy Policy Paper Series, July 2013); Joel P. Trachtman (2017), "WTO Law Constraints on Border Tax Adjustment and Tax Credit Mechanisms to Reduce the Competitive Effects of Carbon Taxes" 70 *National Tax Journal* 469-493; Joost Pauwelyn & David Kleimann (2020), "Trade Related Aspects of a Carbon Border Adjustment Mechanism: A Legal Assessment" European Parliament Policy Department, Directorate-General for External Policies, PE 603.502; Matthew Porterfield (2019), "Border Adjustments for Carbon Taxes, PPMs, and the WTO" 41 *University of Pennsylvania Journal of International Law*; Pananya Larbprasertporn (2014), "The Interaction between WTO Law and the Principle of Common but Differentiated Responsibilities in the Case of Climate-Related Border Tax Adjustments" 6 *Goettingen Journal of International Law* 145-170.

³⁴ See Venzke & Vidigal, note 33 above.

allocation of carbon allowances to domestic producers under the EU ETS;³⁵ to subsidies offsetting the costs of decarbonization for domestic industry;³⁶ or easier certification of low-carbon production than is available for foreign producers.³⁷

Additionally, a CC will run contrary to the Most-favoured Nation obligation (GATT Art. I:1) if it advantages the industry of CC participants over that of non-participants. This is particularly likely for an CC whose participants apply differently designed decarbonization regimes, i.e. an inclusive. Art. I:1 provides that WTO members must extend, “immediately and unconditionally”, to products from all WTO members “any advantage, favour, privilege or immunity” accorded to any like product originating in or destined for any other country.

A straightforward recognition regime, conditioning importation on clearly ascertainable product characteristics (such as low carbon emissions) or universally requiring emissions-related payments, might be compatible with Art. I:1. However, a CC based on a list of self-selected participants, chosen on the basis of self-proclaimed sufficiency of their decarbonization policies and overlapping with political groupings (like the G7) would suggest a deviation from the spirit of the MFN obligation. The MFN obligation requires that, other than for explicitly permissible trade restrictions – most obviously, customs duties – producers from all WTO Members must be accorded opportunities to access other Members’ markets equivalent to those of those enjoyed by domestic

³⁵ Under the current ETS Directive, sectors “deemed to be at risk of carbon leakage” are allocated carbon “allowances free of charge” until 2030 at a level of 100% of their historic emissions. ETS Directive, note 13 above, Article 10b(1).

³⁶ These subsidies may independently violate the WTO Agreement on Subsidies and Countervailing Measures.

³⁷ WTO jurisprudence suggests a “comparable efforts” test: Members adopting a regulation with extraterritorial effects that seek to justify it under Article XX must make efforts to allow producers of other WTO Members access to relevant compliance certificates. These efforts must be comparable to the ones the Member makes to allow its own producers to demonstrate compliance with the regulation. See Appellate Body Report, *European Communities – Measures Prohibiting the Importation and Marketing of Seal Products*, WT/DS400/AB/R, adopted June 18, 2014 (*EC – Seal Products*), para. 5.336-5.337; Appellate Body Report, *US – Shrimp (Article 21.5 – Malaysia)*, para. 122.

producers of like products, as well as by producers from third countries.³⁸ Deviating from these commitments is permissible only to the extent that this is justifiable under WTO law or the relevant trade agreement.

b. Justifying Deviations from Trade Commitments: GATT Art. XX

All trade agreements modelled on WTO rules permit, under certain conditions, policies that deviate from trade commitments in the pursuit of legitimate objectives.³⁹ Under WTO law, policy justifications for trade restrictions are usually examined with reference to GATT Art. XX (“General Exceptions”), whose text is reproduced or incorporated by reference in virtually all RTAs.⁴⁰ Art. XX allows WTO members to restrict trade, on a non-discriminatory basis, to pursue legitimate objectives. Its subparagraph (g) protects policies “relating to the conservation of exhaustible natural resources”. Although no dispute has ever been brought with regard to climate measures, a clear parallel exists with the finding, by the 1996 panel in *US – Gasoline*, that “a policy to reduce the depletion of clean air [i]s a policy to conserve a natural resource”.⁴¹

Trade adjudicators have consistently used three tests to assess the legality of policy-justified trade-restrictive measures.⁴² The measure must, first, pursue a legitimate objective, set out in GATT Art. XX or another provision. Second, there must be a genuine relationship between the measure’s effects and its stated objective. In the case of Art. XX(g), the measure must objectively contribute to the protection of the relevant

³⁸ As per the jurisprudence of the Appellate Body, the existence of a legitimate regulatory distinction that could justify the detrimental impact of a measure over a Members’ competitive opportunities are to be argued under Art XX, after it has been established under Art. I:1 or III:4 that this detrimental impact exists. See Appellate Body Report, *EC – Seal Products*, para. 5.125.

³⁹ Emily Lydgate (2017), “Is it Rational and Consistent? The WTO’s Surprising Role in Shaping Domestic Public Policy” 20(3): *Journal of International Economic Law* 561-582.

⁴⁰ See the application of this by the EU-Ukraine panel. Final Report of the Arbitration Panel, *Restrictions applied by Ukraine on exports of certain wood products to the European Union*, 11 December 2020, para. 256 ff.

⁴¹ Panel Report, *United States – Standards for Reformulated and Conventional Gasoline*, adopted May 20, 1996 (WT/DS2/R).

⁴² The applicable legal tests may vary depending on the provision being applied. The central inquiry, however, is essentially the same. See in particular Appellate Body report, *EC – Seal Products*, para. 5.127 (comparing Article 2.1 of the TBT Agreement to Articles III and XX of the GATT).

exhaustible natural resource. Third, the measure must be applied without arbitrarily or unjustifiably discriminating against WTO members. In the case of Art. XX(g), this is supported by the requirement that the measure must be “made effective in conjunction with restrictions on domestic production or consumption”. Additionally, any distinction between countries (or disparate impact on their products) must be explained by a legitimate rationale, which should in principle be the same rationale that justifies the measure itself.⁴³ Finally, the measure must not constitute a disguised restriction on international trade.

The industrial production and carbon emissions targeted by CC restrictions take place outside the territory of CC participants. This does not *per se* make these restrictions unlawful. In its 1998 report in the *US – Shrimp* case, the WTO Appellate Body found that Art. XX(g) allowed restrictions on imports of shrimp caught using techniques harmful to endangered turtles (the “exhaustible natural resource”) even though the catching, and the harm to the turtles, took place in the territorial waters of exporting WTO members. This was justified due to “a sufficient nexus between the migratory and endangered marine populations involved and the United States”,⁴⁴ since the turtles migrated through United States territory. Regulations with extraterritorial effects have been considered as potentially permissible, provided that the relevant policies complied with the applicable legal requirements, in *US – Tuna*, regarding the protection of dolphins in tuna fishing taking place outside US territory,⁴⁵ and in *EC – Seals*, regarding the killing of seals outside EU territory.⁴⁶ There is little question that the harm caused by accumulated carbon emissions – or, put otherwise, the atmospheric composition and climatic stability that

⁴³ Ibid.

⁴⁴ Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, adopted November 6, 1996, WT/DS58/AB/R (*US – Shrimp*), para. 133.

⁴⁵ Panel Report, *United States – Measures Concerning the Importation, Marketing and Sale of Tuna and Tuna Products*, 7.371-7.372. This dispute was litigated under the TBT Agreement, and concerned the use of a label in US territory.

⁴⁶ The complainants appear to have largely accepted that the EU’s protection of its public morals allowed it to restrict its consumers’ consumption of products made involving the violent killing of seals anywhere. See Panel Report, *EC – Seals*, para. 7.63.

climate policies protect – has a “sufficient nexus” to the territory of every state on the planet.

c. CC-related Restrictions and Distinctions under Art. XX

Both scientific knowledge and political consensus at the international level – expressed, most recently, in the Glasgow Climate Pact – leave little doubt as to the need to restrict global GHG emissions to protect the Earth’s climate. A CC trade restriction, combined with restrictions on domestic production or consumption, will no doubt contribute to the objective of reducing GHG emissions. In *Brazil – Retreaded Tyres*, the Appellate Body concluded that even an extremely trade-restrictive measure (an import ban) is justifiable as a component contributing to the objective of a broader regulatory regime.⁴⁷ The requirement in Art. XX(g) that trade-restrictive measures be “made effective in conjunction with restrictions on domestic production or consumption” will presumably be complied with easily by states applying the internal element of the CC, thus making the CC restrictions in principle justifiable under Art. XX(g).

The main challenge, then, will be passing the chapeau test. The chapeau of Art. XX prohibits applying otherwise legitimate measures in a manner that amounts to “arbitrary or unjustifiable discrimination” or a “disguised restriction on international trade”. In practice, this means that any negative effects of the measure, seen as a whole, on the competitive opportunities of foreign products must be rationally related to legitimate objectives, and in principle to the same objective that justifies the measure.

The uniform tariff connected to a Nordhaus CC would be the most difficult to justify under the chapeau. One could argue that the incentive for countries to join the CC constitutes “a legitimate cause or rationale” for discriminating, “in the light of the

⁴⁷ See Appellate Body Report, *Brazil – Measures Affecting Imports of Retreaded Tyres*, adopted December 3, 2007, WT/DS332/AB/R (*Brazil – Retreaded Tyres*), para 154.

objectives listed in the paragraphs of Article XX".⁴⁸ However, the inducive motivation of Nordhaus trade sanctions makes them difficult to justify, especially if connected to formal CC participation rather than to the effectiveness of the contribution made by a country to climate change mitigation or to the amount of carbon in the affected products. In *US – Shrimp*, the Appellate Body grounded the unjustifiability of the US's regime for shrimp importation to its "intended and actual coercive effect on the specific policy decisions made by foreign governments".⁴⁹

The EUCC may face a similar hurdle insofar as it also conditions participation in its *de facto* CC (with automatic exemption from CBAM) to adopt the same decarbonization policy as the EU. In *US – Shrimp*, the United States regime for shrimp was found to be unjustifiably discriminatory for "requir[ing] other Members to adopt essentially the same comprehensive regulatory program" as the United States for protecting turtles, and "not allow[ing] for any inquiry into the appropriateness of the regulatory program for the conditions prevailing in those exporting countries".⁵⁰

The rigidity of the EUCC is partially mitigated by CBAM rebates, which allow producers from non-members to receive compensation for carbon payments made in the country of origin. On the other hand, this regime hurts doubly producers from countries that impose costly decarbonization requirements rather than pricing GHG emissions. Even if the outcome is a 50% reduction in their CBAM duties, this is likely to still leave these companies at a competitive disadvantage vis-à-vis those that continue to use carbon-intensive production methods and simply pay for the emissions embedded in their exports to the EU.

⁴⁸ Appellate Body Report, *Brazil – Retreaded Tyres*, para 225. See the discussion on the possibility of using tariffs to pursue non-product-related objectives in Panel Report, *United States – Tariff Measures on Certain Goods from China*, circulated September 15, 2020 (under appeal), WT/DS543/R, paras 7.177-7.178.

⁴⁹ Appellate Body Report, *US – Shrimp*, note 15 above, para 161. See also Appellate Body Report, *US – Tuna II*, para. 226.

⁵⁰ Appellate Body Report, *US – Shrimp*, note 15 above, paras 164-165. See also, regarding the TBT Agreement, Appellate Body Report, *US – Tuna II*, paras 297-298.

The G7CC purports to overcome the rigidity of the EUCC, allowing conversion between different decarbonization regimes, presumably so that similarly effective, or similarly costly, systems are considered equivalent to each other avoiding carbon-related restrictions. This, however, could pose another set of difficulties, including (i) a restriction of recognized decarbonization regimes to those that fit the models adopted by G7 countries, and lack of recognition of similarly effective but different regimes; or (ii) a restriction of recognized emissions reduction efforts to those that match efforts required from G7 countries, focused on industrial emissions rather than emissions deriving from, for example, deforestation. Put otherwise, if the different decarbonization policies of CC participants A, B and C are accepted as equivalent and exempt the products from CC participants from the CC's border measure, why shouldn't the products of countries D or E, which have their own decarbonization policies, receive similar treatment? If no rationally justifiable metric grounds the distinction between participants and non-participants, the exemption of participants from the border adjustment is *arbitrary* and thus inconsistent with the chapeau of GATT Article XX.

5. The Path Ahead: Towards Multilateral Climate Governance (with a Club Component)

a. Between Unjustifiability and Arbitrariness: the CC Justification Conundrum

Ultimately, if it came down to a formal trade dispute,⁵¹ it is possible that the WTO's historic deference to members as the primary agents for making policy decisions would allow a variety of approaches to prosper, as long as rationally justifiable, climate-related distinctions are made and applied consistently to imports from various members. Given the absence of a functioning WTO Appellate Body, it is possible that a panel report on the matter will be appealed into the void. The most pressing concern for those who seek to

⁵¹ There are reports, the Indian Department of Commerce has decided to "raise the issue of CBAM ... in all appropriate fora of the WTO". Abhishek Law, "India to raise at WTO EU's plan to levy carbon tax on imports", *The Hindu Business Line* (27 January 2023).

ensure carbon policies is not so much that a formal trade decision-making body might decide that a CC, or CC-related measures, are inconsistent with trade obligations, but that the application of the CC might be considered illegitimate by non-participants regardless – and receive a response independently of a formal trade complaint. To mitigate the risk of these responses, a CC would be advised to ensure that it does not involve unjustifiable or arbitrary discrimination – something the EU at least appears intent on doing.⁵²

As explained in the previous section, the main challenge facing CC design is that the main models being considered are likely to fail the Art. XX test, and thus to be considered unlawful and illegitimate, for different reasons. Exclusive CCs restrict participation to countries adopting a specific policy design, thus *unjustifiably* discriminating countries that adopt differently designed, but equally effective, policies. Addressing the unjustifiability challenge requires setting up an inclusive CC, like the G7CC, under which a variety of policy designs are accepted as contributing equally effectively to decarbonization.

However, in order to be effective, an inclusive CC cannot accept *any* policy design or claim to contribution. Participants must therefore establish certain acceptable metrics for decarbonization, acceptable means for attaining it, and acceptable areas in which efforts count for purposes of CC participation (for example, whether to count anti-deforestation efforts). Given the complexity of the choices involved, any set of choices is liable to be framed as *arbitrary*. Even using as a benchmark for CC participation the nationally determined contributions established by each country under the Paris Agreement⁵³ could prove problematic. Inserting a sanctioning element into the Paris Agreement would both

⁵² The Commission's earlier CBAM proposal stated: "The CBAM is a climate measure which should prevent the risk of carbon leakage and support the Union's increased ambition on climate mitigation, while ensuring WTO compatibility", while the consensual text provides that it should "support the reduction of global emissions and prevent the risk of carbon leakage, while ensuring compatibility with WTO rules". (Proposed CBAM Regulation, note 8 above, preambular paragraph 13).

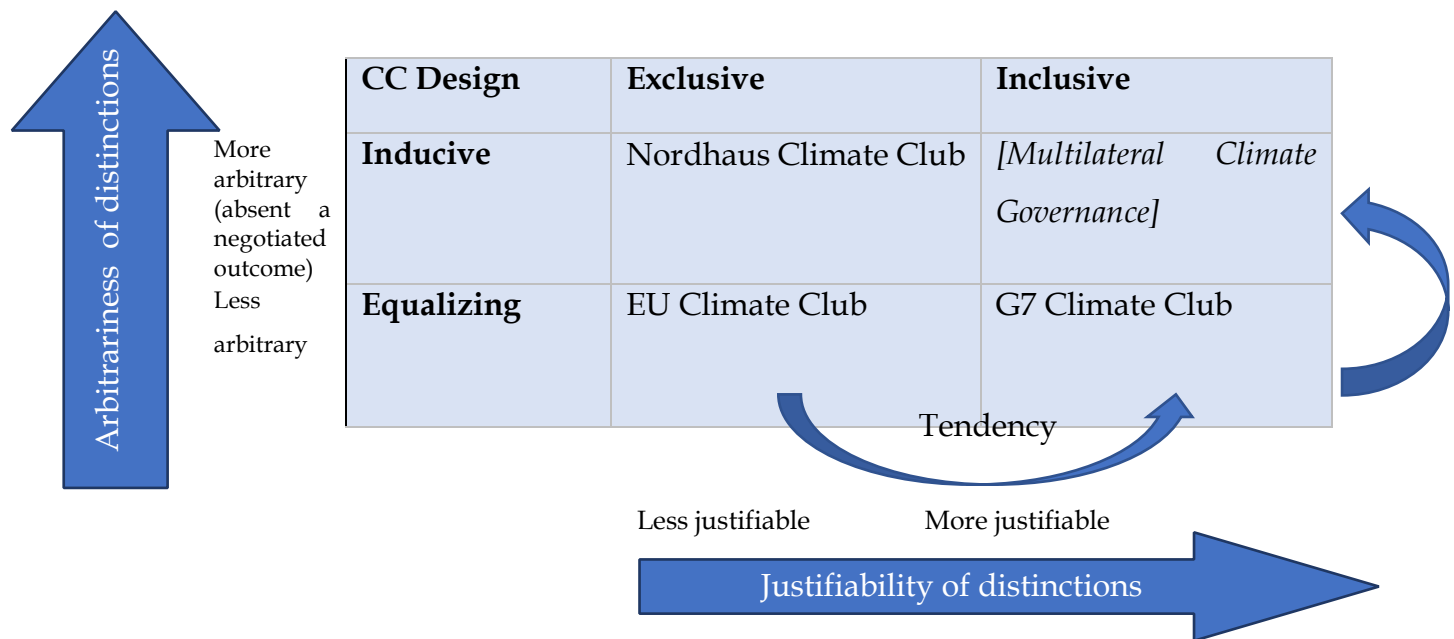
⁵³ Paris Agreement, Article 4.2.

be at odds with the model of cooperation that undergirds it, retrospectively penalizing ambitious parties and prospectively incentivizing low ambition in the establishment and updating of decarbonization targets.

The arbitrariness of an inclusive CC will seem particularly flagrant if the choices made in its design result in a group of politically aligned countries (for example, the G7) all being accepted as participants, and having their decarbonization policies deemed sufficient for exemption from trade restrictions, while other countries' efforts – by some metrics, equivalent to those of CC participants – are considered insufficient and result in trade restrictions. In other words, the less a CC requires a specific policy design from its participants, the more the variety of policy designs that are accepted as equivalent among CC participants, and the corresponding exclusion of parties, is likely to seem arbitrary.

Table 2 below summarizes the conundrum:

Table 2 – The Climate Club Justification Conundrum



b. Building a Legitimate CC: The Multilateral Avenue

To avoid the charge of arbitrariness, an inclusive climate club is likely to require a multilateral framework. A negotiating process, open to at least all WTO members, for determining the comparability of decarbonization policies, and a common mechanism, or at least common set of parameters, to measure their implementation and effects, would likely ensure both the legitimacy of ensuing measures and their WTO-compatibility. A successful negotiating process would lead to a (*de jure* or *de facto*) club component within a Multilateral Climate Governance (MCG) mechanism, providing negotiated targets and consequences for non-compliance, from which only those countries that are entirely unwilling to contribute would be excluded. Although a CC would be a component of MCG, in particular for certain hard-to-decarbonize sectors, its success is likely to depend on the provision of advantages to participants as well as on decarbonization targets that are enforced - not only *vis-à-vis* non-participants, via the club component, but also *vis-à-vis* participants.

The club component of MCG, in particular, should meet the function of a climate club as posited by Nordhaus. This function is not to allow CC participants to apply trade restrictions to non-participants, but to produce an incentive for all countries to contribute to decarbonization efforts. Thus, the ideal “climate club” is one that no longer operates as a club, because all countries adhere to its rules, resulting in the virtual non-application of trade sanctions. In other words, the purpose of CC trade sanctions is not to be applied but to modify the *status quo* of available trade relations, eliminating the option for non-participants of continuing to trade with CC participants without adopting emissions reductions policies - thus eliminating the incentive each country faces to withhold its own contribution to decarbonization and free ride on other countries’ efforts.

The purpose of eliminating the option of free riding is attained, to an extent, by the current CC proposals. The EUCC and G7CC proposals threaten to make non-participation in CC negotiations a worse outcome than participation, and penalize non-

adherence to CC requirements. If implemented in their current form, however, they would likely result in discrimination that is either unjustifiable (EUCC) or arbitrary (G7CC). In order to be inclusive without being arbitrary, a CC would need to be the outcome of a multilateral negotiation process. The outcome of this process, if it involves genuine negotiations grounded on the imperative of decarbonization, will be something akin to MCG with a residual club component.

The legal form of the MCG system can vary, as can the level of multilaterally agreed detail and oversight. At a minimum, an informal MCG system must involve serious negotiations on acceptable guidelines for comparing climate policies and determining their equivalence. In *US - Shrimp*, the Appellate Body found that the United States' measure was unjustifiable due to a failure to engage in "serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements for the protection and conservation of sea turtles, before enforcing the import prohibition against the shrimp exports" of certain WTO members.⁵⁴

On one end of the spectrum, the outcome of these negotiations would be an informal or *de facto* CC, with each participant applying its own version of climate-justified trade restrictions and setting up specific requirements for exemption. On the other end would be a formal climate governance body, agency or organization, involving a legitimizing document and an institutionalized coordination mechanism. In the document, a broad majority of countries would agree to parameters for determining what contribution to decarbonization is sufficient for CC participation/exemption. It could provide, among others, for the decarbonization levels that warrant an exemption from CC trade restrictions; the areas in which these targets can be met (including the extent to which emissions reduction outside of industrial production can be used); the level and type of acceptable trade restrictions derived from non-compliance; and the legitimate levels of funding for decarbonization that can be given by participants to domestic industry,

⁵⁴ Appellate Body Report, *US - Shrimp*, note 15 above, para. 166.

without itself undermining the objective of equalization and constituting illegitimate industrial protectionism.

An institutionalized coordination mechanism would prevent the MCG document from being interpreted and applied inconsistently by the various participants, which would again raise questions of unjustifiability or arbitrariness of distinctions. This coordination mechanism can involve anything from a mechanism for intergovernmental communications regarding decarbonization efforts to an international institution conducting convertibility calculations and operating as umpire in case of disagreement regarding the sufficiency of efforts. A clear source of inspiration are other non-compliance procedures and mechanisms in multilateral environmental agreements.⁵⁵ A fully-fledged MCG would likely include, or incorporate, the elements of a resource governance system, that is (i) agreement among resource users with respect to the permissible use of the common resources, (ii) a mechanism for verifying compliance with the agreed usages by individual users, and (iii) negative consequences for users that fail to comply with the relevant rules.⁵⁶

The G7 Statement goes some way towards addressing some of these issues.⁵⁷ It both invites non-G7 members to enter into negotiations for the establishment of the CC and invites a variety of institutions (“the OECD, the IMF, the World Bank, the IEA, and the

⁵⁵ See Tullio Treves et al (eds), *Non-Compliance Procedures and Mechanisms and the Effectiveness of International Environmental Agreements* (T.M.C. Asser Press 2009).

⁵⁶ Elinor Ostrom, *Governing the Commons – The Evolution of Institutions for Collective Action* (CUP 1990), 44. Ostrom mentions seven ‘design principles’: 1. Clearly defined boundaries; 2. Congruence between rules governing use of common goods and local conditions; 3. Arrangements established and managed by those affected by the rules; 4. Monitoring by the appropriators themselves or persons accountable to them; 5. A system of graduated sanctions for rule violators; 6. Accessibility to rapid, low-cost dispute resolution mechanisms; 7. Non-challenge of the institutions by external governmental authorities (Ibid, 90). While the three conditions concentrate on the use of ‘hard’ sanctions, Ostrom’s design principles involve as much ‘soft’ compliance-inducing techniques, such as transparency, accountability to other users and legitimacy derived from self-government, as ‘hard’ sanctions for outright breaches. I thank Anne van Aaken for highlighting this point. See also Christiaan Boonen, “Governing as Commons or as Global Public Goods: two Tales of Power” 13 *International Journal of the Commons* (2019) 553.

⁵⁷ G7 Statement on Climate Club, note 3 above.

WTO”) to support the initiative, welcoming in particular the recently established “Inclusive Forum on Carbon Mitigation Approaches” of the Organization for Economic Co-operation and Development (OECD). The “Inclusive Forum” title evokes the OECD’s Inclusive Framework on corporate taxation, created to facilitate implementation of the Base Erosion and Profit Shifting initiative.⁵⁸ In 2021, the Inclusive Framework led to the adoption of the OECD Statement on corporate taxation,⁵⁹ adhered to by 136 countries, allowing each country to enforce a minimum level of corporate income tax. This Statement, merely by enshrining a multilateral consensus, reverses states’ previous incentive to apply low taxation levels to multinational corporations, especially in the digital world, in order to attract them. Applying low taxation levels will now result in other countries charging the difference and receiving the relevant tax income. The EU, now covered by the OECD Statement, issued at the end of 2022 an EU Directive providing for a global minimum level of taxation for large and multinational companies.⁶⁰

The current status of global decarbonization efforts approaches that of corporate taxation prior to the OECD Statement. Just like the proposed carbon border measures compounded with climate clubs, in the area of corporate taxation the movements of various states towards the application of a digital tax, spearheaded by France, sufficiently modified the outlook for countries otherwise comfortable with the *status quo*, enough to lead them to serious negotiation over taxation of multinationals, means of calculating it, and possibilities for enforcing it, leading to the OECD process.⁶¹ The same path can be followed by attempts to enforce global emissions reduction negotiations, likely resulting in a multilateral carbon mitigation framework that operates as a “club” only against the

⁵⁸ OECD, Action Plan on Base Erosion and Profit Shifting (2013).

⁵⁹ OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 8 October 2021.

⁶⁰ EU, Council Directive 2022/2523 of 14 December 2022. on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, preambular paragraphs 1-3.

⁶¹ See James J. Nedumpara, “Skirmishes over Digital Service Taxes: The Perils and Systemic Costs of Section 301 Actions”, 13 Trade, Law & Development 63 (2021); Alice Pirlot & Henri Culot, “When International Trade Law Meets Tax Policy: The Example of Digital Services Taxes” 55 Journal of World Trade 895 (2021).

handful of states that decide to reject its operation entirely, and suffer the consequences. For those states that are within the system, the system would operate as a governance mechanism, featuring commonly agreed rules, decision-making procedures, and established measures to be taken in case of non-compliance.

6. Conclusion

A successful climate club fulfills three objectives. First, making it politically viable for CC participants to impose costly emissions reduction policies on domestic producers. Second, preventing these policies from leading to relocation rather than reduction of carbon emissions. Third, fostering the decarbonization of production in countries that would otherwise have an economic incentive not to pursue it.

A Nordhaus CC, while having the advantage of simplicity, suffers from political and legal difficulties. The EUCC and G7CC seek to address these difficulties, but raise the question of who can legitimately compare different decarbonization policies to assess their equivalence. It may be that the end result of climate club proposals, combining incentives to decarbonize with regulatory freedom, is a Multilateral Climate Club, requiring all countries to contribute to the emissions reduction effort while permitting them a choice of means for achieving it. For MCG to be perceived as legitimate, its parameters must be established through open and serious negotiations, providing parameters that are both the result of a transparent process and benefit from broad acceptance among countries.

Paradoxically, then, a successful CC will result in its trade restrictions being applied rarely. A CC will have attained its objectives if participation, and compliance with its objectives and parameters, is the most advantageous choice for each country.