Of False Conflicts and Real Challenges: Trade Agreements, Climate Clubs, and Border Adjustments

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Assessments of the relationship between trade agreements and the climate regime often focus on the potential for normative conflict. Concerns that trade commitments may prevent the adoption of measures to curb climate change, or at least that these are two regimes that “point in different directions,” are often voiced to suggest that taking climate action requires fundamentally modifying, and maybe getting rid of, current trade agreements. In this essay, we argue that allegations of conflict disregard longstanding World Trade Organization (WTO) jurisprudence on policy-justified trade measures. As a matter of principle, this alleged conflict has been essentially overcome since the 1998 Appellate Body report in United States – Shrimp. Focusing on potential conflict distracts from the real challenges and dilemmas involved in designing and implementing a global carbon regime, including through the trade instruments known as carbon border adjustment mechanisms (CBAMs and so-called “climate clubs”), for which the legal parameters provided by trade agreements may be instrumental.

Catching up with the WTO: Overcoming the “Trade Versus Environment” Framework

At the WTO, the view that trade-restrictive environmental measures are inherently at odds with WTO law was rejected early on. In United States – Shrimp, the Appellate Body disavowed key assumptions about trade agreements expressed by the first instance WTO panel. This dispute, brought by India, Malaysia, Pakistan and Thailand, concerned the application to imported shrimp of the requirement that all shrimp commercialized in the United States be harvested using turtle excluder devices in order to protect endangered sea turtles. The first instance panel, citing jurisprudence from the pre-WTO era, had reasoned that allowing a member to “[condition] access to its market for a given product upon the adoption by the exporting [m]embers of certain policies, including conservation policies,” would contradict the General Agreement on Tariffs and Trade’s (GATT) objective of “promoting economic development through trade” and threaten the integrity of the WTO system.

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Rejecting this view, the Appellate Body pointed to the explicit recognition in the WTO Agreement of “the objective of sustainable development,” and through it, of “the importance and legitimacy of environmental protection as a goal of national and international policy.” In the 1996 United States – Gasoline report, the Appellate Body had already reasoned that, rather than promoting a single liberalization objective, the GATT included multiple “purposes and objects,” some crystallized in “affirmative commitments” and some in exceptions, including the protection of legitimate “policies and interests” under Article XX.

The seemingly essential question—whether WTO rules permitted the pursuit of these objectives extraterritorially—was largely set aside. Instead of addressing it, the Appellate Body saw in the fact that protected sea turtles were found in, or migrated through, American territory, “a sufficient nexus between the migratory and endangered marine populations involved and the United States.” Once the United States addressed procedural issues and offered WTO members a negotiated arrangement for sea turtle protection, the Appellate Body rejected Malaysia’s insistence that the United States could not require compliance with its “unilaterally defined standards.” Although WTO members had a right not to be discriminated against, Malaysia did not have a “veto” over the United States’ right to pursue in good faith a legitimate objective recognized by the WTO agreements. Thus, non-discriminatory policies to pursue legitimate objectives may be permissible even when they outright prohibit the importation of products based on their mode of production.

Rational Relationship and Non-discrimination: Can Trade Requirements Be Pro-Environment?

As a matter of international trade law, CBAMs are structurally similar to the United States’ requirement for imported shrimp. As “adjustment” measures, CBAMs apply to foreign-produced products, upon importation, costs or requirements that are equivalent to those imposed on domestic products. Whether intentionally or as a result of disparate impacts on products from different countries, a CBAM or some of its aspects (such as complex reporting obligations or sanctions on non-complying countries) may contravene commitments made in the WTO and other trade agreements. If the measures are challenged, the framework for analysis developed in United States – Shrimp—one replicated in all of the subsequent jurisprudence concerning trade-restrictive measures that pursue legitimate objectives—will apply. The central point of this framework is that trade panels should in principle begin their analysis by considering whether a challenged measure violates trade commitments, but this is not where the enquiry ends. Measures that deviate from WTO commitments are not WTO-inconsistent if they are justified under a public policy exception.

Although the applicable legal tests vary depending on the provision being applied, the central inquiry is essentially the same, requiring three conditions to be fulfilled. First, the measure must pursue a legitimate objective, set

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6 United States – Shrimp, Appellate Body Report, supra note 2, para. 133.
8 For the array of possible WTO obligations affected and development of other legal points made herein, see Ingo Venzke & Geraldo Vidigal, Are Trade Measures to Tackle the Climate Crisis the End of Differentiated Responsibilities? The Case of the EU Carbon Border Adjustment Mechanism (CBAM), NETH. Y.B. INT’L L. (2022).
9 See id., see also European Communities – Measures Prohibiting the Importation and Marketing of Seal Products, Appellate Body Report, WT/DS400/AB/R, WT/DS401/AB/R, para. 5.127 (May 22, 2014) (comparing Article 2.1 of the TBT Agreement to Articles III and XX of the GATT).
out in GATT Article XX or another provision. Second, there must be a genuine relationship between the measure’s effects and its stated objective. Although this relationship is often phrased in terms of “necessity,” a measure that contributes to its objectives will only be deemed unnecessary if the claimant can offer an alternative, less trade-restrictive measure capable of fulfilling the same objective to the same degree and which is reasonably available, technically and economically. Third, the measure must be applied without arbitrarily or unjustifiably discriminating against WTO members. To determine whether a distinction between (or disparate impact on) two countries is arbitrary or unjustifiable, the central question is whether the distinction (or disparate impact) can be explained by a legitimate rationale—in principle, the same rationale that justifies the measure itself.

As regards CBAMs, there is little doubt that their objective—preserving the atmosphere and, through it, life and health for humans, animals, and plants—is legitimate and urgent. It is equally clear that addressing the climate crisis requires drastically discouraging carbon emissions; and that excess carbon in the atmosphere has a “sufficient nexus” to every country, justifying each country acting on the matter. A CBAM will only fall foul of these requirements if it: (1) fails to contribute to the objective of disincentivizing carbon emissions (or a proxy objective, such as “avoiding carbon leakage”); or (2) produces discriminatory effects unconnected to the pursuit of legitimate objectives.

As discussed below, it is conceivable that, even in the absence of these requirements, countries will design their CBAMs virtuously. But it seems at least equally likely that, under pressure from domestic industry and lobbying from friendly countries, and without the constraint imposed by trade agreements, purported CBAMs will be enacted that do not “adjust” so much as outsource the costs of decarbonization. For example, policies that ostensibly restrict all carbon emissions may include exceptions, carve-outs, and temporary exclusions that, in practice, exempt from the burdens of carbon transition precisely those industries whose adaptation is most significant for this objective. Trade commitments permit other WTO members (or regional trade agreement parties) to demand that measures adopted as CBAMs make a real contribution to emissions reduction, and that they impose on domestic products equivalent costs to those imposed on foreign products. Thus, trade agreements may contribute to rather than undermine the environmental objective of CBAMs.

The Challenges of Constituting a Climate Club: Connecting Different Carbon-Restrictive Systems

The key questions regarding the lawfulness of CBAMs under trade agreements will concern the permissible grounds for discrimination or uneven impact. Under the CBAM proposal being considered by the European Union (EU),10 importers must provide carbon certificates corresponding to the price set by the EU for the carbon “embedded” in the relevant product. This price is reduced to account for “embedded emissions [] subject to a carbon price in the country of origin of the goods.”11 Imports are exempted from CBAM if the state of production either: (1) applies the EU’s own Emissions Trading System (ETS), which countries in the European Economic Area (Norway, Iceland, Liechtenstein) do; or (2) has its own emissions trading system (thus charging for carbon emissions the same way as the EU) and an agreement “fully linking” its system to the EU ETS (as Switzerland has).12 These exemptions set the basis for a so-called “climate club”: a group of countries in which each member disincentivizes domestic carbon emissions, imposes carbon barriers on imports, and exempts from these barriers other club members.

11 Id. Art. 9(2).
12 Id. Art. 2(5).
One challenge with the EU’s climate club exception is that it requires other countries to adopt systems with fundamentally the same design as the EU’s. Whether the EU’s objective is to prevent carbon leakage or to reduce emissions globally, it can be attained in various ways. One of the flaws with the United States’ measures in United States – Shrimp was that they “required that other WTO members adopt essentially the same policies and enforcement practices as the United States.”13 To be WTO-compliant, this had to be changed to requiring “a programme comparable in effectiveness” to the American one, even if in the circumstances no alternative was available that was at once less costly and comparable in effectiveness.14 In United States – Tuna II (21.5), when assessing whether the discriminatory effects of a measure were justifiable, the Appellate Body phrased the key question as “whether the discrimination can be reconciled with, or is rationally related to, the policy objective” that grounded the measure.15

The same logic would apply to the permissibility of the requirement in the EU’s CBAM proposal (at least as currently designed) that, to be members of its “carbon trade club,” other states must adopt a system of monetary disincentives to emissions. If an alternative mechanism, such as the non-monetary disincentives used in the United States, is “comparable in effectiveness” to carbon pricing, requiring the use of “essentially the same” policy as the EU ETS would amount to arbitrary or unjustifiable discrimination in light of the objective of reducing carbon emissions (or preventing carbon leakage). This raises a major challenge: how to convert into monetary value these regulatory disincentives, to assess whether they fulfil the same objective of the EU’s ETS to the same degree, as the EU is allowed to demand that they do.

What of Common but Differentiated Responsibilities?

A second challenge for CBAMs is the principle of common but differentiated responsibilities (CBDR) and respective capabilities. The CBDR principle is integral to the global environmental regime and is codified, for the climate regime, in the Paris Agreement.16 It demands that countries that are, historically and presently, the highest carbon emitters, and the ones most capable of financing a transition away from emissions, contribute more to carbon reduction efforts than those with diminished contribution and capabilities. In the EU’s proposal, however, CBDR is mentioned only in passing, in the preamble, followed by an exhortation for the EU to provide technical assistance to “less developed countries.”17

The notion that WTO rules prohibit CBDR may be linked to a misinterpretation of the jurisprudence. In Brazil – Retreaded Tyres, the Appellate Body suggested that discrimination is permissible only if it is explained by the same objective that justifies the deviation from WTO obligations.18 In subsequent disputes concerning policies that aim to balance different objectives and concerns, however, the Appellate Body rephrased this to state that alignment with a measure’s main objective is “[o]ne of the most important factors” (rather than the only factor) relevant for the assessment of arbitrary or unjustifiable discrimination.19 Additionally, the non-discrimination requirement in Article XX applies “between countries where the same conditions prevail.” Between their low contribution to

17 CBAM Proposal, supra note 10, preambular para. 55.
climate change and their lack of capacity to measure and charge for carbon, most developing countries are very differently placed in their ability to measure and control emissions in production, as compared to developed economies.

Accepting the right, and perhaps the duty, to differentiate between countries as a legitimate rationale within the non-discrimination obligation raises the question of how to do so. In United States – Shrimp, the Appellate Body noted that a measure requiring action by producers within other WTO members should “take[] into consideration different conditions which may occur in the territories of those other [m]embers.”

Despite challenges in finding a formula that takes into account, as “conditions,” degrees of responsibility and capabilities, not providing any such formula seems to enforce an equality in law that contrasts with the inequality in fact between countries’ conditions.

One challenge is that the most vocal demanders of special and differentiated treatment for developing countries, such as China, India, Brazil, and South Africa, are also those with comparatively higher capacity, and, at present at least, are among the main emitters. This, however, should not be a reason to shun differentiation altogether. To the European Commission’s proposal (which avoided the matter entirely), the European Parliament’s sole proposed amendment directed at addressing disparities in development is that revenues generated by the sale of CBAM certificates should finance the de-carbonization in least-developed countries. This does not address the challenges faced by non-EU producers in complying with the same requirements imposed on EU producers, not to speak of paying the same absolute price as them for carbon emissions—meaning, for producers in the least dynamic economies, a far higher relative increase of their production costs. Rather than being competitively neutral, a CBDR-blind CBAM is likely to asymmetrically affect the competitiveness of products from the least developed economies.

Is Discrimination Politically Necessary?

A final challenge to the application of trade rules to CBAMs is the argument that the touchstone of trade agreements—the prohibition of protectionist discrimination—is itself an obstacle to climate change mitigation. Given the way domestic politics works, the argument goes, it is precisely the protectionist aspect of CBAMs that makes them politically attractive. In a globalized economy, protectionist carbon tariffs may indeed lead to decentralized global carbon pricing. If each country imposes carbon costs solely on foreign products and much of global production continues to be traded internationally, eventually a majority of production will have to pay for carbon emissions, while each government can claim to be imposing the costs of decarbonization on foreigners.

A country trying to set up unilaterally an extraterritorial carbon-pricing scheme will likely face fierce opposition. In 2012, the EU sought to charge a price for carbon emissions in aviation, covering extraterritorial emissions. In response, without referring to any legal violation in particular, twenty-three countries gathered in Moscow threatened retaliation of various kinds, demanding that the issue be negotiated at the International Civil Aviation Organization. The extraterritorial element of the charge has been suspended ever since.

Though often channeled through trade agreements, opposition to unilateral schemes does not depend on any agreement. Within a dynamic, polycentric global political system, extraterritorial policies perceived as unjustifiable by other actors are likely to be met with retaliatory action, blocking measures, and other disruptive responses. An overtly protectionist unilateral carbon border charge, without any mitigating options for carbon-reducing third

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21 Joint Statement Issued at the Conclusion of the 30th BASIC Ministerial Meeting on Climate Change Hosted by India (Apr. 8, 2021).
23 Joint Declaration of the Moscow Meeting on Inclusion of International Civil Aviation in the EU-ETS (Feb. 22, 2012).
countries and their companies, will predictably be met with similar responses, whether or not international agreements that regulate these responses are in place. An ensuing indefinite suspension of the charge would undermine not only its protectionist objective but also the objective of combating the climate crisis.

This is where the “climate club,” or “carbon club,” mechanism could make a difference. Through its “carbon club” mechanism, the EU CBAM proposal seeks to set up incentives for others to join it. Similar to the system developed to operationalize global corporate taxation agreed upon in 2021 at the Organisation for Economic Co-operation and Development, the CBAM proposal offers non-EU countries two alternatives: they may begin charging for carbon emissions, at the same price as the EU does, or they may decide not to charge for such emissions, in which case their “carbon exports” to the EU will contribute to the EU budget. From this perspective, not redistributing the proceeds of CBAM to exporting countries could be seen as a plus: it creates an incentive for these countries to actually set up a carbon pricing system themselves, instead of losing revenue to the EU.

Conclusion

Trade rules have no centralized enforcer. Trade agreements cannot determine whether the EU, or any country, is able to adopt CBAMs. What they do provide are parameters for legitimate action within a polycentric global order, preventing the escalation of policy disagreements into economic conflicts. Under their widely prevalent interpretation, these agreements require that trade measures justified on legitimate grounds indeed contribute to their stated objectives, and that discrepancies in treatment reflect discrepancies in the underlying conditions.

For those seeking to address with CBAMs the collective action problem of combatting the climate crisis, the true challenge will not be justifying CBAM permissibility in principle, but ensuring that their design does not undermine their stated objectives—either by covertly exempting politically influential industries or by engendering retaliatory measures from countries demanding their withdrawal.

If adequately designed, the climate club mechanism can be compatible with trade obligations. For this, it must be based on objective policy criteria rather than arbitrary political preferences; it must be open to (at least) all other WTO Members on the basis of the same criteria; and it must not include exceptions and carve-outs that undermine its carbon-disincentivizing objective.

A scenario of unilateral measures followed by retaliation is not only economically destructive but also means a worse outcome for the objectives pursued, as compared to one of measures grounded on agreed parameters, whose lawfulness can be verified by an adjudicator. By providing these two elements—agreed parameters and adjudication—trade agreements may in fact prove a highly useful coordination instrument for the construction of a global carbon regime.

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