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Mixing Apples and Oranges: The Limitations of Trade Policy in Mitigating Climate Change

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One of the latest trends among policymakers is to combine trade policy with environmental objectives. International *trade* can facilitate the diffusion of clean energy technologies and innovations. It can also prompt economic actors to utilise resources more efficiently. But although there are several variants of combined trade and environmental policies, such instruments should not be used under the false belief that they will reduce carbon emissions globally. Trade *policy* cannot leave any stronger imprint on global carbon emissions.

As much as we would like our economies to run on energy from sustainable resources, we are barking up the wrong tree if we expect trade policy to effect such a change, or foster a larger development towards profoundly lower emissions from energy systems. Lower tariffs for green goods, border taxes and carbon footprint labelling could all have their advantages and drawbacks. Trade instruments may or may not increase the leverage in negotiations on climate issues. Realistically, however, they can only play a marginal role in tackling climate change. The rapidly growing levels of carbon emissions primarily result from the systems of energy production around the world, especially coal-fired energy.

Despite this, many people find it irresistible to add trade policy to the environmental equation. Indeed, it is costly to reduce the use of polluting energy sources, especially coal. If large parts of the energy production systems need to be replaced, the transformation will be expensive. When some countries and industries are under pressure to reduce their emissions while others are not, the former turn to trade instruments to offset the competitive effects.

Undoubtedly, the energy sector is very dependent on political decisions. Public investments, subsidies, state aid, procurement policies as well as consumer incentives influence market conditions. European industries might find themselves in disadvantageous positions as a result of public support from foreign governments to energy companies – as well as of policies in Europe that have raised energy prices. Their energy bill has run up while their competitors have access to much cheaper energy. Industries then ask for compensatory policies, especially in sectors where energy costs account for a large share of the total costs.

Ideally, countries would cooperate at the multilateral level and forge a coherent global environmental regime to reduce carbon emissions. Several international accords are currently in place. But without a clear hierarchy between them, and with profound differences between countries as to how these agreements should be changed, they remain fragmented templates. As for the WTO, it was never conceived as an environmental organisation. Nevertheless, countries agreed at the outset of the Doha Development Round to negotiate “the reduction or as appropriate elimination of tariff and non-tariff barriers to environmental goods and services”. Alternative venues are pursued amid the current

standstill, but without substantial progress. In the meantime, energy related trade disputes are emerging as an updated regulatory framework is lacking.

Negotiations in the WTO stumbled on the question of defining green products. The answer is that it depends. Many products have dual uses; a component of a power-generating wind turbine can also be a part of polluting transportation equipment. Countries also tend to act strategically and suggest preferential tariffs on products for which they have a competitive advantage as exporters, while protecting their defensive interests by avoiding sensitive products with high tariffs. An EU-U.S. proposal from 2007 on zero tariffs on certain green products did not include ethanol, for instance. Another dilemma is related to the growing importance of global supply chains. Eliminating tariffs on the final product will only have a marginal effect if tariffs on inputs and components are maintained.

And when focusing on tariffs, one misses the big picture. Trade policies need to be adapted to the functioning of modern systems of energy production if they are ever to promote the diffusion of new technologies. This is currently not the case. Trade issues are still being addressed separately, either as part of negotiations on tariffs, services or intellectual property rights, although all aspects are interlinked. Modern energy production is not simply about delivering fuels to consumers. Most advanced technical solutions are integrated systems of products and services. For instance, the installation of a windmill park involves prior analysis, investment, financial services, presence of technicians as well as training of staff and maintenance. Companies thus need stable and predictable business environments if they are to invest. Inadequate protection of investment and intellectual property rights as well as visa restrictions make companies wary of political and regulatory risks.

The limitations of trade instruments are also illustrated by the fact that domestic energy policies can alter the business environment on the energy market overnight. Currently, policymakers are not letting the grass grow under their feet when it comes to regulatory activities. Any measures to protect the environment have to comply with core WTO principles. Trade restrictions cannot be imposed in an arbitrary, discriminatory or disproportionate way. Conditional departure from these rules can be allowed if trade restrictions are proved to have a direct positive impact on a specific environmental objective. In many cases such departure from the rules is not approved however, since there is often an unclear relationship between the trade restrictions and the targeted environmental goals. In effect, environmental policies or energy regulations sometimes shield domestic companies from foreign competition in order to preserve jobs in manufacturing industries.

In the end, trade policy in its current form is not likely to have any major effect on curbing carbon emissions. Looking at things from another perspective, international trade is not necessarily going to worsen the global environment either. Transports and shipments may increase the amount of greenhouse gas emissions. But depending on the situation, aggregate pollution can be reduced thanks to trade. Imported products are often less polluting if all production-related aspects are taken into account. Research also indicates that countries with open trade regimes tend to adopt environmentally-friendly technologies more quickly. So the feared environmental race to the bottom does not seem to be taking place. For example, although exports have increased from energy-intensive industries in developing countries, these countries remain net importers of energy-intensive products. According to the World Bank, the lack of strong evidence of relocation of carbon intensive industries suggests that policies in developed countries effectively shield domestic industries.

The EU, for its part, is free to operate under the premise that the grass is greener on *this* side of the fence. But if it chooses to do so, let it be clear that trade instruments *per se* are not a means to sustainable development. Ultimately, the structures of energy production will need to be transformed as part of a comprehensive energy strategy aiming to improve the global environment.