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## **THE KYOTO PROTOCOL AND THE WTO: INSTITUTIONAL EVOLUTION AND ADAPTATION**

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# THE KYOTO PROTOCOL AND THE WTO: INSTITUTIONAL EVOLUTION AND ADAPTATION

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## Overview

Questions about the interface between the multilateral climate regime embodied in the Kyoto Protocol and the multilateral trade regime embodied in the World Trade Organisation (WTO) have become especially timely since the fall of 2001. At that time, ministerial-level meetings in Marrakech and Doha agreed to advance the agendas, respectively, for the implementation of the Kyoto Protocol and for negotiations on further agreements at the WTO. There have been concerns that each of these multilateral arrangements could constrain the effectiveness of the other, and these concerns will become more salient with the entry into force of the Kyoto Protocol. There are questions about whether and how the rights and obligations of the members of the WTO and the parties to the Protocol may conflict. Of particular concern is whether provisions in the Protocol, as well as government policies and business activities undertaken in keeping with those provisions, may conflict with the WTO non-discrimination principles of national treatment and most-favoured nation treatment.

The WTO agreements that are potentially relevant to climate change issues include many of the individual Uruguay Round agreements and subsequent agreements as well. The principal elements of the Kyoto Protocol that are particularly relevant are its provisions concerning emissions trading, the Clean Development Mechanism, Joint Implementation, enforcement, and parties' policies and measures. In combination, therefore, there are numerous potential points of intersection between the elements of the Kyoto Protocol and the WTO agreements.

Previous studies have clarified many issues, as they have focused on particular aspects of the regimes' relationships. Yet, some analyses suggest that the two regimes are largely compatible and even mutually reinforcing, while others suggest that there are significant conflicts between them. Those and other studies are referenced in the 'suggestions for further reading' section at the end of the paper.<sup>1</sup>

The present paper seeks to expand on those studies by providing additional breadth and depth to understanding of the issues. The analysis gives special attention to key issues on the agenda – i.e. issues that are particularly problematic because of the likelihood of occurrence of specific conflicts and the significance of their economic and/or political consequences. The paper adopts a modified 'triage' approach, which classifies points of intersection as (a) highly problematic and clearly in need of further attention, (b) perhaps problematic but less urgent, and (c) apparently not problematic, at least at this point in time.

The principal conclusions are that:

- The missions and objectives of the two regimes are largely compatible, and their operations are potentially mutually reinforcing in several respects.

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<sup>1</sup> See especially Brack, Grubb and Windram (2000), Mueller (2002), Parker (1998), Petsonk (1999), Sampson (1999, 2001, forthcoming), Werksman (1999), Werksman and Santoro (1999), Werksman, Baumert and Dubash (2001), Wiser (1999), Zhang (1998), Zhang and Assuncao (nd).

- Some provisions of the multilateral agreements that may superficially seem at odds are not likely to become particularly problematic in practice.
- ‘Domestic policies and measures’ that governments may undertake in the context of the Protocol could pose difficult issues in the context of WTO dispute cases.
- Recent WTO agreements and dispute cases acknowledge the legitimacy of the ‘precautionary principle’ and are thus consistent with the environmental protection objectives of the Protocol.
- The relative newness of the climate regime creates opportunities for institutional adaptation, as compared with the constraints of tradition in the trade-investment regime.
- The prospect of largely independent evolutionary paths for the two regimes poses a series of issues about future international regime design and management, which may require new institutional arrangements.

In sum, the present paper thus finds that although there are some areas of interaction that are problematic, the two regimes may nevertheless co-exist in relative harmony in other respects – more like ‘neighbours’ than either ‘friends’ or ‘foes’, as Krist (2001) has suggested.

### **Diplomatic Context**

Although it is widely agreed that the relationships between the Kyoto Protocol and the WTO are important – and require further consideration – negotiations concerning them in the WTO may be precluded from the Doha round. The language of the Doha ministerial declaration is quite restrictive on this issue. Negotiations are limited to ‘the relationship between *existing* WTO rules and *specific trade obligations* set out in multilateral environmental agreements (MEAs). The negotiations shall be limited in scope to the applicability of such existing WTO rules *as among parties to the MEA in question*. The negotiations shall not prejudice the *WTO rights of any Member that is not a party to the MEA in question*’ (paragraph 31, italics added).

Of course, such constraints in the WTO Doha round do not preclude a discussion in other fora – such as follow-up meetings to the World Summit on Sustainable Development, or in meetings in conjunction with other diplomatic processes. In one forum or another – and probably in many – representatives of governments, firms and NGOs will be confronting the issues. In any case, issues about Kyoto Protocol-WTO relationships are already being raised by individuals and by organisations, as evidenced by the growing body of studies cited in footnote 1 and in the references section. In that sense, the issues are already unofficially on the international trade-environment agenda. Even in the absence of their formal consideration in the WTO Doha round, they will be receiving increasing attention.

Within the WTO, a dispute case could prompt a formal consideration of some aspects of the relationship. Furthermore, climate change mitigation measures are already in effect at the national, sub-national and international levels. This is a reality that prompts questions about the international trade and investment implications of such extant measures as carbon taxes, emissions standards, subsidies for production technologies, labelling and certification standards for product efficiency, and markets for emission permits. It is prudent, therefore, to continue to advance understanding of the issues, as the Kyoto Protocol enters into force and as the WTO elaborates new rules during the Doha round.<sup>2</sup>

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<sup>2</sup> The issues and institutional aspects of the climate regime and trade-investment regime will evolve diplomatically as part of a wider set of issues concerning MEAs and the WTO. Taking a cue from the lexicon of acronyms about the relationship of trade measures to investment measures – i.e. Trade Related Investment

## Stated Objectives of the WTO and Kyoto Protocol

The stated objectives of the two multilateral regimes converge, and the two are officially expected to be mutually supportive.<sup>3</sup> These themes are evident in key documents for both regimes, as follows:

Article 2:3 of the *Kyoto Protocol* notes that parties should ‘strive to implement policies and measures...in such a way as to minimise adverse effects, including the adverse effects...on international trade...’

Article 3.5 of the *Framework Convention on Climate Change* (FCCC) notes that ‘The parties should cooperate to promote [an]...open international economic system’ and that ‘measures taken to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade’.

As for the WTO, in the *Doha Communiqué*, the members observe that ‘the aims of upholding and safeguarding an open and non-discriminatory multilateral trading system, and acting for the protection of the environment and the promotion of sustainable development can and must be mutually supportive’.

The beginning of the *Preamble to the Marrakesh Agreement* establishing the World Trade Organization (WTO) notes... ‘The parties to this agreement, [r]ecognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living...while allowing for the optimal use of the world’s resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development, ....’

## Potential Tangible Outcomes of Interactions

In the context of these generalised expressions of mutual support, specific activities of the two regimes offer a range of potential tangible outcomes for climate change mitigation and trade liberalisation. While some interactions of the two regimes offer the prospect of win-win outcomes, others pose the possibility of less benign outcomes. The matrix in Figure 1 depicts the full range of possible outcomes in terms of their consequences for climate change mitigation and for trade liberalisation.

Examples of win-win possibilities, represented by cell 1, include reductions of barriers to international trade and investment in goods and services related to climate change mitigation – barriers such as tariffs on windmill turbines or restrictions on foreign direct investment in (alternative) energy firms. Reduction of barriers to international business transactions in environmental goods and services is an item on the agenda of the current round of negotiations at the WTO, but it remains to be seen whether any such agreements will concern transactions that are specifically related to climate change mitigation. An example of another

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Measures (TRIMs) and Investment Related Trade Measures (IRTMs) – which have been identified in the WTO context, one can identify ‘Environment Related Trade Measures (ERTMs)’ and ‘Environment Related Investment Measures (ERIMs)’. At the same time, international environmental agreements contain numerous provisions that affect governments’ trade and investment policies and corporations’ international business practices. Thus, one can identify Trade Related Environmental Measures (TREM) and Investment Related Environmental Measures (IREM). This policy paper specifically focuses on WTO-Kyoto Protocol interfaces and thus on WTO ERTMs and ERIMs concerning climate change, and on Kyoto Protocol TREMs and IREMs.

<sup>3</sup> The preambles of international accords and communiqués from ministerial meetings do not necessarily entail precise commitments to specific tangible actions; however, they do establish a diplomatic-political context that influences subsequent negotiations and decisions.

win-win possibility would be the reduction of fossil fuel subsidies, but this is not currently on the WTO agenda.

*Figure 1. Outcome Matrix for Climate Regime / Trade-Investment Regime Interactions*

Trade- Investment Liberalisation	Climate Change Mitigation		
	Beneficial	Neutral	Detrimental
Beneficial	1	2	3
Neutral	4	5	6
Detrimental	7	8	9

Potential conflict areas where win-lose (cell 3) outcomes can occur include disputes where there is tension between trade-discriminatory elements of climate policies that focus on differences in production methods, as contrasted with the application of the WTO non-discrimination principles to production process methods. Further, whereas the Framework Convention on Climate Change (FCCC) explicitly endorses the ‘precautionary principle’ when there is uncertainty about the scientific evidence concerning the damages from trade, the WTO has only recently and tentatively begun to subscribe to such a notion, as for instance in the Technical Barriers to Trade agreement and in some dispute case decisions. More generally, lose-lose outcomes (cell 9) could occur, for instance, if conflicts such as disputes at the WTO or issues concerning US or other countries’ non-participation in the Protocol undermine confidence in both regimes.

Unlike many other multilateral environmental agreements, there are no provisions for trade sanctions in the Protocol (cell 8). In this respect, therefore, the two regimes are at least superficially compatible in legalistic terms. However, in more fundamental political terms, restrictive trade measures could nevertheless be adopted outside the terms of the Protocol to exert pressure on governments to become a party to the Kyoto Protocol or to comply more fully with its rules (cell 7), in order to offset the competitive effects of non-participation in the Kyoto Protocol.<sup>4</sup>

**Questions about the Interfaces of the Regimes**

In order to understand the nature of specific tangible issues that might arise within such interfaces, it is of course necessary to address a variety of specific questions. Such questions include the following:

What types of international business transactions in goods, services and other business activities in the flexibility mechanisms of the Kyoto are covered by WTO agreements – and which are not?

Which WTO agreements are applicable to the climate regime – and which are not?

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<sup>4</sup> There is a principle in international law that, when there are conflicts between international agreements, subsequent agreements prevail over previous agreements. However, applications of this relatively straightforward principle can be complicated, for instance, by questions about the chronology of agreements. As for relationships between the WTO and the Kyoto Protocol, there might be such questions because the GATT preceded the FCCC, which preceded the WTO, which preceded the Kyoto Protocol. There are other legal issues as well that could pertain to conflicts between the WTO and the Kyoto Protocol. In any case, it seems likely that the legal issues would be subordinated to political considerations driven by economic and other interests.

Are there differences in the implications for the climate regime between the GATT (covering goods) and the GATS (covering services)?

Would offsetting border measures qualify as 'exceptions' according to provisions concerning non-discrimination in GATT Article XX and/or GATS Article XIV?

Are climate change measures concerning the labelling and certification of energy efficiency compatible with the WTO agreement on technical barriers?

Are firms' foreign direct investment (FDI) projects, which are central to the Protocol's Clean Development Mechanism (CDM) and Joint Implementation (JI) provisions, covered in the WTO by both the GATS and the agreement on Trade Related Investment Measures (TRIMs)?

Will CDM and JI projects under the Protocol qualify as environmental exceptions under the WTO subsidies agreement?

Are firms' projects and/or governments' policies involving carbon sequestration restricted by the WTO agriculture agreement?

What are the implications for climate-trade interactions for countries such as the United States that are not parties to the Protocol but are members of the WTO?

Are regional climate agreements affected by the WTO provisions concerning regional trade agreements?

Are climate regime issues likely to become involved in the WTO dispute settlement process?

This paper does not attempt to answer conclusively all of these questions; rather it highlights areas of particular concern and/or complexity. Almost inevitably for a subject of such broad scope, some questions remain unanswered and new ones are raised.

### **The Nature of Climate Mitigation Activities in Relationship to WTO Agreements**

Questions concerning the types of international transactions in goods, services and other business activities in the flexibility mechanisms of the Kyoto Protocol that are covered by WTO agreements can be answered only if the emission credits and other elements of the Kyoto mechanisms can be defined in the context of WTO agreements. Thus a key question is: What kinds of 'things' do the flexibility mechanisms of the Kyoto Protocol entail that might raise issues in the WTO? Are Allocated Allowance Units (AAUs), Emission Reduction Units (ERUs) and Credit Emission Reductions (CERs) goods or services or something else?

These items in the Protocol's flexibility mechanisms have been variously described as involving the following: carbon and thus commodities, services such as 'decarbonisation', permits that convey property rights, financial instruments, and investment goods. At the same time, CDM and JI projects represent foreign direct investment projects, which also involve trade in goods as well as provide services. Because of ambiguities about some distinctions (e.g. the difference between goods and services) in WTO agreements, there is not yet a consensus on these basic issues of coverage.

However, if emission credits are defined as services to which the General Agreement on Trade in Services (GATS) applies, then there is a question about whether the most favoured nation (MFN) principle of non-discrimination would be violated. Limiting the trading of emission permits to Kyoto Protocol parties could violate GATS Article 1. Further, if emission trading privileges are linked to compliance with other Kyoto Protocol provisions, this could also violate the WTO MFN principle. Analogous issues about violations of MFN arise in

connection with Kyoto Protocol provisions concerning Joint Implementation (JI) and Clean Development Mechanism (CDM) projects.

All three of the so-called flexibility mechanisms of the Protocol are potentially covered by one or more WTO agreements. The GATS seems more likely than the GATT to be applicable to international emissions trading. Both the GATT and GATS as well as several other agreements – including the agriculture agreement, the subsidies agreement, and the TRIMs agreement – are potentially applicable to JI and CDM projects.

### **Border Measures as Exceptions to the GATT and GATS**

Another question that has been attracting interest concerns governments' border measures undertaken in the context of the Protocol to offset the international competitive effects of domestic carbon emission reduction measures such as carbon taxes: Would offsetting border measures qualify as allowable 'exceptions' under GATT Article XX and/or GATS Article XIV provisions concerning non-discrimination? Cases undertaken in the future in the context of the WTO dispute settlement process may provide detailed answers to this question. In the meantime, preliminary analyses suggest that the distinction between products and production process methods that has been central to GATT/WTO dispute cases in the past will be a key determinant of the fate of such climate-related measures in the WTO.

GATT Article XX provides that 'Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures: ... (b) necessary to protect human, animal or plant life or health; ...' GATT Article XX also provides in section (g) that 'measures relating to the conservation of exhaustible natural resources' are exempted.

The services agreement (GATS) also contains environment-related provisions. Although it does not have an exactly equivalent provision to GATT Article XX (g) concerning 'exhaustible natural resources', the GATS preamble and Article XIV(b) are otherwise nearly identical to the provisions of GATT Article XX. Those portions of GATS are as follows: 'Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions [cf. 'the same conditions' in GATT] prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures: ... (b) necessary to protect human, animal or plant life or health; ...'

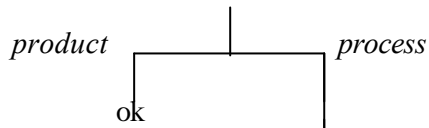
As a result of these provisions and a series of WTO dispute cases concerning potential environmental exceptions to the GATT principle of national treatment, it is possible to construct a 'logical decision tree' that represents a series of 'tests' that a measure must pass in order for it to be considered an allowable exception (see Figure 2).<sup>5</sup> There are many parallels between GATT Article XX and GATS Article XIV; indeed many of the tests in Figure 1 are identical for the two agreements. However, there are also some differences; for instance, the product-process test in step 1 for GATT is different for GATS because of course the product is a service not a good.

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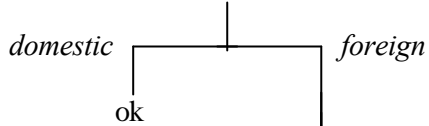
<sup>5</sup> This decision tree has been constructed partly on the basis of the verbal discussion in Sampson (forthcoming).

Figure 2. Decision Tree for Exceptions to GATT Article XX

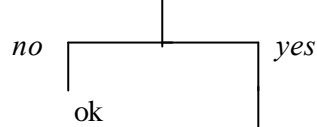
1. Is the target a product or a process?



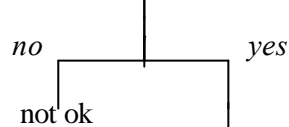
2. Is the process domestic or foreign?



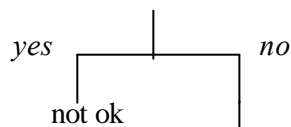
3. Does the measure discriminate against 'like products'?



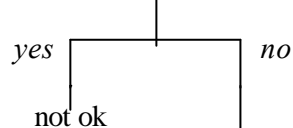
4. Is the measure 'necessary' to protect the environment?



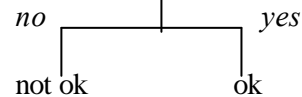
5. Does the measure constitute 'arbitrary or unjustifiable' discrimination or a 'disguised restriction' on trade?



6. Is the measure less trade restrictive than available alternatives?

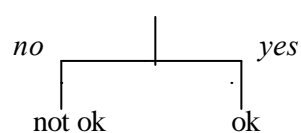


7. Are the affected lives or resources in the country imposing the barrier?



\ If 4, 5, 6 or 7, not ok /

8. Does the measure qualify for a GATT Article IX waiver?





The tests at steps 2 and 7 may be the most problematic for climate regime. As for step 7, the truly global dispersion of greenhouse gases means that the affected lives and resources are inevitably in countries other than – as well as in – the country imposing the trade barrier.<sup>6</sup>

### **Regional and Bi-lateral Arrangements**

GATT Article XXIV allows regional customs unions and free trade areas as exceptions to the most favored nation principle if several conditions are met, including that barriers to imports from outside are not higher than before the establishment of the regional arrangement. As a practical matter, such arrangements are not usually challenged, and there is no reason to expect problems for regional or bilateral climate regime schemes – whether undertaken in the context of the Kyoto Protocol or independently of it.

There are many regional and bilateral agreements concerning foreign direct investment (FDI) outside the WTO, and this is a topic needing more extensive consideration in light of their number, scope and complexity.

### **Environmental Standards in Relationship to the WTO Technical Barriers Agreement**

Another topic requiring further analysis is whether climate change measures concerning the labelling and certification of energy efficiency be compatible with the WTO Agreement on Technical Barriers (TBT).

The Kyoto Protocol provides in Article 2, paragraph 1(a)(i), for domestic energy efficiency policies and measures that will reduce greenhouse gas emissions for ‘enhancement of energy efficiency in relevant sectors of the economy’. However, because it does not explicitly specify the types of policies and measures that would be appropriate, there is uncertainty about whether the particular policies and measures that are actually adopted might conflict with WTO rules.

### **CDM and JI Projects in Relation to the WTO Subsidies Agreement**

The WTO Agreement on Subsidies and Countervailing Measures (SCMs) treats as a non-actionable subsidy government assistance to industry covering up to 20 per cent of the cost of adapting existing facilities to new environmental legislation. Non-actionable subsidies are those that cannot be challenged as a basis for undertaking countervailing duties. In Part IV, Article 8; 8.1, the agreement says:

‘The following subsidies shall be considered as non-actionable:...8.2(c) assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/or regulations which result in greater constraints and financial burden on firms, provided that the assistance:

- (i) is a one-time non-recurring measure; and
- (ii) is limited to 20 per cent of the cost of adaptation; and
- (iii) does not cover the cost of replacing and operating the assisted investment, which must be fully borne by firms; and
- (iv) is directly linked to and proportionate to a firm’s planned reduction of nuisances and pollution, and does not cover any manufacturing cost savings which may be achieved;

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<sup>6</sup> There is a simple logical issue and an analytically simple solution to this problem – namely, change the WTO phrase ‘are the’ to ‘are there’. Politically, however, such a change would probably not be easy (and perhaps not possible).

and is available to all firms which can adopt the new equipment and/or production processes’.

These provisions prompt the question of whether CDM and JI projects qualify as environmental exceptions. Answering this question is complicated by a basic difference between the Protocol and the WTO. The Protocol explicitly and directly applies to firms’ activities as well as governments’ measures, while the WTO applies directly only to the latter. Indeed, firms’ foreign direct investment (FDI) projects are central to the Protocol’s CDM and JI provisions, whereas FDI is covered only selectively in the WTO agreements, particularly in the GATS and TRIMs.

Thus, the relevance of WTO agreements to any particular CDM or JI projects will depend on whether the project involves trade and/or FDI and whether it involves goods and/or services. Some projects could of course a combination of two or more of the four possibilities that are evident.

### **Carbon Sequestration in Relationship to the WTO Agriculture Agreement**

The Agreement on Agriculture exempts subsidies in the form of direct payments under environmental programmes from governments’ commitments to reduce domestic support for agricultural production. The exception, however, is subject to certain conditions, and they are quite complex and vague. They can be noted, in part, as follows:

‘Payments (a) Eligibility for ... payments [under environmental programmes] shall be determined as part of a clearly-defined government environmental or conservation programme and be dependent on the fulfilment of specific conditions related to production methods or inputs. (b) The amount of payment shall be limited to the extra costs or loss of income involved in complying with the government programmes’ (Annex II, paragraph 12).

The issue here, then is whether particular agricultural subsidies for carbon sequestration projects will meet such criteria in order to be exempt from the WTO restrictions.

### **WTO Dispute Settlement Process and Cases**

Additional questions about the Kyoto Protocol-WTO interface concern WTO disputes: Are Protocol-related disputes likely to arise in the WTO? What Protocol provisions, government policies or firm practices are the most likely to prompt WTO disputes? How are they likely to be decided? What would be the consequences for the climate and trade-investment regimes? What are the most relevant previous dispute cases, and how have they been decided? The answers to such questions will depend at least as much on the political and economic circumstances pertaining to an individual case as on the legal technicalities.

In order for a dispute case to be considered and decided in the WTO dispute settlement process, the case must pass through several stages. These often include a firm (or firms) asking their government to take the case to the WTO, after which a government decides to make a claim. The case must then go through several formal WTO stages. There must therefore be a combination of economic, political and legal factors that lead the complaining government to initiate a case.

Technical legal issues and the factual circumstances of the case are obviously central to the arguments and outcomes. But, in addition, economic interests of play a central role in the decisions of complaining firms and governments about whether to make a claim and in the decisions of responding governments (and firms) about how to approach the case. Furthermore, domestic and international political considerations also come into play as

governments (and firms) decide whether and how to pursue cases on the basis of calculations concerning political support and opposition. Once the case enters the WTO dispute process, the mixture of economic, political and legal factors changes, particularly if the case is not settled during preliminary negotiations and it becomes an item on the formal agenda of a dispute panel. Then legal issues tend to become more important.

## Conclusion

Notwithstanding the restrictions on the WTO Doha round agenda, issues about the interactions of the climate regime and the trade-investment regime are now on the de facto agenda of environmental and economic diplomacy. Linkages between the climate regime centred in the Kyoto Protocol and the trade-investment regime centred in the WTO are not likely to be formally discussed during the Doha round of negotiations; however, those issues are likely to be addressed in other forums over the next several years. Because the institutionalisation of the Kyoto Protocol is still in its formative phase and because the results of the Doha round negotiations will not be known for three or more years, the precise implications of the overlaps between the two regimes are also uncertain.

However, priorities can be established – in at least a preliminary way – for the agenda according to three categories of issues: (1) those that are most problematic; (2) those that might become problematic but are less urgent; and (3) those that do not appear at this point to be problematic.

- (1) *Interactions that are the most problematic.* Some of the rights and obligations of the parties to both the Kyoto Protocol and the WTO agreements are arguably in jeopardy and need diplomatic as well as analytic attention. In particular, the use of border measures to offset differences in the energy costs of goods is in this category.
- (2) *Interactions that are less problematic but that warrant further attention.* These include whether and how WTO disputes might arise from trade-related activities under the climate regime, environmental standards in relationship to the WTO technical barriers agreement, CDM and JI projects in relation to the WTO subsidies agreement, and carbon sequestration in relationship to the WTO agriculture agreement.
- (3) *Interactions that appear not to be problematic at this time.* Because regional trade arrangements have not generally been challenged in the WTO, regional climate arrangements are also not likely to be. Because the government procurement agreement is only a 'plurilateral' agreement not including many members of the WTO and excludes many areas from its coverage by individual country opt-outs, it also is not likely to be problematic for climate regime interactions.

In any case, both the climate regime and the trade-investment regime will undergo recurrent changes to accommodate new economic and political circumstances. It is therefore important to continue to monitor and analyse the relationships between the two regimes as they evolve. Such an effort should be undertaken not only in legal terms but also in economic and political terms in order to understand their implications for the diplomatic agendas of governments, the strategic choices of firms and the policy concerns of NGOs.

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