TRADE AND CLIMATE CHANGE: STATE OF PLAY

A discussion paper prepared for the NZIBF
by Adrian Macey, June 2022

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FOREWORD BY PHILIP GREGAN, CHAIR, NZIBF

The members of the New Zealand International Business Forum (NZIBF) are developing greater insight and understanding about the interface between trade and climate policy. We are grateful to Adrian Macey, New Zealand's former Climate Change Ambassador and Chief Trade Negotiator, for his work preparing this background paper, which we are now pleased to share more widely.

While trade is often unfairly targeted as being at loggerheads with sustainability, trade is an important part of the solution to addressing the serious issues raised by dangerous climate change. As World Trade Organization (WTO) Director General Ngozi Okonjo-Iweala has said "*by connecting people and markets, trade helps lower costs and disseminate new environmental technologies. Trade can make resource use more efficient, reducing the strain on our ecosystems. New trade rules can help our economies become greener, cleaner, more prosperous, and more inclusive*"[1].

There has in recent years been a growing convergence between trade and climate policies. Increasingly both the WTO and United Nations Framework Convention on Climate Change (UNFCCC) are engaging in discussions with a trade dimension. Environmental provisions in bilateral and plurilateral agreements are not new, but have been increasing in detail, including in the Comprehensive and Progressive Agreement on Trans Pacific Partnership (CPTPP) and the putative NZ/UK and NZ/EU agreements. Six economies including New Zealand are leading the negotiation of an Agreement on Climate Change, Trade and Sustainability (ACCTS). At the same time several jurisdictions are developing border proposals to address the issue of "carbon leakage" whereby companies might shift production to countries with lower carbon costs or import finished products from those jurisdictions. Proposals are most advanced in the EU where in the context of the European Green Deal and in certain sectors (currently outside agri-food) a Carbon Border Adjustment Mechanism (CBAM) is being developed for implementation in 2023.

There is little doubt that there will continue to be evolution in this space, particularly as governments refine their policies to meet their nationally determined contributions (NDCs) or targets under UNFCCC. There is some risk however that some of these policies may be designed and implemented in such a way as to be more trade restrictive than necessary.

NZIBF's interest is to understand these developments in greater detail so as to be able to engage more effectively with government, business and public stakeholders. We would welcome feedback on the matters canvassed in Adrian Macey's paper.

Philip Gregan
Auckland, June 2022

[1] https://www.wto.org/english/tratop_e/envir_e/climate_intro_e.htm

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"Trade is essential to win the fight against climate change"
WTO Deputy Director General Anabel González, May 2022

Introduction

1. Links between trade and climate change are growing fast, especially since the 2015 Paris Agreement on Climate Change, which has made transitioning to low carbon a top global priority. These links serve two main purposes: facilitating the global transition and reassuring those undertaking ambitious climate action – whether countries or businesses - that they won't be left at a competitive disadvantage. Trade agreements increasingly encompass climate change. Measures such as border tax adjustments (BTAs) are currently under consideration in several countries and are being discussed internationally.

2. This background note covers the government dimension – domestic and multilateral. Trade is of course also affected by decisions by consumers and business. There are many initiatives to reduce emissions involving industry sectors – on coal, motor vehicles, investment, to name a few. Last year's climate change conference in Glasgow (COP26) saw a number of such pledges tabled. Eco-labelling schemes are proliferating, driven largely by non-state actors. Government policy on trade and climate change can make such initiatives more effective.

A Trade and climate change – the international picture

What does the climate world say about trade?

3. The core climate change treaty is the 1992 UN Framework Convention on Climate Change. Its principles are all incorporated into the Paris Agreement (2015) which created a new climate change regime. The UNFCCC states:

> **Measures taken to combat climate change, *including unilateral ones,* should not constitute a means of arbitrary and unjustifiable discrimination or a disguised restriction on international trade** (author emphasis)

4. Trade people will recognise this language as straight out of the GATT, apart from the reference to unilateral measures. So, the UNFCCC is staying that any climate change measures must not be discriminatory or protectionist, in other words that they must be compliant with the rules of the World Trade Organization (WTO).

5. “Unilateral measures” has become controversial in the climate change negotiations. Developing countries have been suspicious that the rich countries will seek to impose their climate change standards on them unjustifiably. In the lead-up to the Paris Agreement, India wanted this, and more, in the text, which would exclude any border measures being applied to developing countries:

[Developed countries] shall not resort to any form of unilateral measures against goods and services from developing country Parties on any ground related to climate change.

What does the trade world say about climate change?

6. In a nutshell, that trade and climate change policies can contribute towards climate action while at the same time ensuring opportunities for economic growth and diversification. These words come from the WTO.

7. Long-held views by civil society that WTO rules limit countries’ ability to protect the environment are no longer valid, if indeed they ever were. WTO jurisprudence on environmental trade measures has shown that there is no obstacle to reasonable measures, providing the non-discrimination rules are respected. Further, it is clear that the Paris Agreement, with its almost universal membership and record speed of entry into force, can used in evidence in any climate-change related trade dispute.

8. Climate change is not mentioned in the main WTO instruments, but there is broad agreement that it can be covered under the various environment provisions – including, if necessary, under the exceptions in Article XX of the GATT for goods and its equivalent in the GATS for services.

Current WTO work on climate change

9. The WTO now has its own work programme on climate change and trade which starts from the idea that trade can support global action on climate change consistently with the Paris Agreement.

10. Climate change is being discussed in various WTO bodies, not only the Committee on Trade and Environment. For example, the Market Access Committee has held a discussion on BTAs. A workshop held in Geneva in 2021 went into further details.

11. The WTO website has a large section devoted to trade and climate change, including information, background and discussion papers, and useful links. This is the best single resource on the subject.

12. Climate change features in a new initiative among WTO members, the **Trade and Environmental Sustainability Structured Discussions (TESSD).** This is open to stakeholders so is an opportunity for New Zealand business to contribute. One theme is how trade-related climate measures and policies can best contribute to climate and environmental goals and commitments while being consistent with WTO rules and principles. It's an opportunity both to promote good practice in regulations and to facilitate trade.

13. The WTO Director-General, Ngozi Okonjo-Iweala, has made this work a priority. She is well aware of the sensitivities of developing countries over climate-related trade measures. She said in February 2022:

Climate-related trade policies must be framed with a just transition in mind, with transition times for developing countries to find carbon alternatives, but also the financing for them to leapfrog the dirty infrastructure stage and directly build sustainable alternatives…Some developed countries are considering "border tax adjustment measures", intended to equalize carbon costs across foreign and domestic producers. However, many developing countries fear such measures could in practice be misused as a pretext for protectionism against their exports. This could weaken global cooperation on climate change when we need to strengthen it.

The Agreement on Climate Change Trade and Sustainability (ACCTS)

14. New Zealand leads this 'coalition of the willing' initiative, begun in 2019 by a small group of small countries (currently New Zealand, Costa Rica, Fiji, Iceland, Norway and Switzerland) who would regard themselves as both trade-dependent and progressive on climate change. No major trading partner of New Zealand is yet involved.

15. The ACCTS has three main themes:

- Liberalisation of climate-friendly goods and services
- Fossil fuels subsidy reform – picking up a movement New Zealand has played a prominent part in over the last few years
- Guidance on eco-labelling, which should help governments, business and consumers

16. Other themes will be added; this will be a 'living agreement'.

17. The idea is that other countries would be invited to join once it's complete. Seven rounds of negotiations have been held so far.

B Climate change in free trade agreements

New Zealand/UK FTA

18. The NZ/UK FTA has strong provisions on the environment and climate change in its article 22. It is a mix of binding commitments and best endeavours. Article 22.6 is entirely on climate change. It refers both to the Paris Agreement and the core WTO trade in goods and services agreements - GATT and GATS. It confirms that both parties understand that the exceptions in both agreements apply to climate change measures. There is a strong presumption that neither party will challenge the other's measures. But there is a safeguard; the agreement contains a binding dispute settlement mechanism modelled on that of the WTO.

19. It recognises that each country will decide its own level of protection and its enforcement measures; parties also commit not to weaken such protection in order to increase trade. The obligations include promoting:

- the mutual supportiveness of trade, investment and climate change policies and measures
- trade and investment in climate-related goods and services
- carbon pricing as a tool for reducing greenhouse gases, and integrity in international carbon markets.

20. Climate change is also covered in Article 22.7 which New Zealand and the UK undertake to end tariffs on a list of environmental goods and services, and Article 22.8 on fossil fuels subsidy reform and the clean energy transition.

21. Under the FTA a committee on environment and climate change will update the list of tariff exempt goods and services.

22. The UK/EU FTA (Economic Cooperation Agreement) has much similar language but has stronger commitments including on carbon pricing and the 2050 climate neutrality target, reflecting the UK's greater integration into the EU economy.

New Zealand/EU FTA

23. This in progress negotiation is certain also to result in language on climate change under the trade and sustainable development chapter, but less strong than we have with the UK. The initial scoping for this area was:

…robust provisions related to trade and environment, key areas of cooperation such as climate change, and a greater contribution of trade and investment to sustainable development in areas such as trade in climate-friendly products and technologies.

24. The two sides have agreed to provisions on cooperation on liberalisation of environmental goods and services, climate change including fossil fuel subsidy reform and on eco-labelling (under a more jargonistic heading of 'voluntary sustainability assurance schemes') – themes, it will be noted, of the ACCTS. New Zealand wants to cooperate with the EU in several climate-related areas including "emerging green technologies and climate-friendly innovations, and initiatives which promote sustainable, low-emissions development throughout the economy".

25. One area of the FTA where New Zealand will need to be vigilant is in the application of any future EU climate related trade measures to our exports (see below under BTAs). This would be best pursued through the chapter on technical barriers to trade.

C Border measures

26. By far the most prominent climate-related trade measures being discussed as part of the response to the Paris Agreement, are border tax adjustments (BTAs). BTAs can equalise the carbon price paid by imports and domestic production.

What is the rationale for BTAs?

- To reassure domestic business - a political rationale as a quid pro quo for businesses who are facing higher carbon costs at home and fear unfair competition
- Preventing carbon leakage. This is really another, and more respectable way of describing unfair competition. The concept is that if high carbon prices drive exporters out of a market their place will be taken by dirtier producers, to the detriment of the climate. Nonetheless, the empirical evidence for carbon leakage is uneven and uncertain.
- To replace free allocation under emissions trading schemes. All schemes have tended to over-allocate free allowances to emissions intensive trade exposed (EITE) sectors. This makes the more stringent targets under the Paris Agreement harder to achieve. BTAs may be a more effective way of dealing with competitiveness at risk issues.
- To encourage more ambitious climate action in other countries. The prospect of border measures will influence both states and businesses and will be an incentive against free riding. No matter how hard-line a state is on opposing border taxes, businesses will take autonomous decisions based on market prospects.

Who is looking at BTAs?

27. The EU, Canada, Japan and the US have all shown interest in BTAs**.** California already has a form of BTA on electricity at its state border. But only the EU has mapped out its regulations, as part of the Green Deal. New Zealand is keeping a watching brief on the EU regulations. At home the Government announced in its May Emissions Reduction Plan that it is working on a scheme for the cement industry as a model that could replace free allocation under the ETS as it is phased out.

BTAs are likely to be applied on a product basis: their design is key

28. While there has been some suggestion that if New Zealand's climate change response is seen as inadequate, exports as a whole could risk being penalised, any imposition of a blanket country-based BTA would pose insuperable problems of WTO conformity.

29. that can affect efficiency and fairness of BTAs (see reference 5 in Annex). It is thus important that where possible exporting countries engage with those planning such measures before they are finalised.

The EU CBAM (Carbon Border Adjustment Mechanism)

30. The EU emphasises that the CBAM, introduced in July 2021, has been designed to be WTO- compliant. EU importers will buy carbon certificates corresponding to the carbon price that would have been paid had the goods been produced under the EU's carbon pricing rules. If the goods have already been subject to a carbon price in the exporting country, that amount will be deducted.

31. The EU will transition to the border tax regime over three years from 2023. From 2023 to 2025 importers will have to report their products' embedded carbon. The border tax will begin in 2026.

32. The products initially concerned are the familiar list of emissions intensive trade exposed sectors which have benefited from free allocation under the ETS – aluminium, iron and steel, cement, fertilisers, electricity, none of which are significant New Zealand exports. It is *relatively* straightforward to apply BTAs to these products.

33. But this is only a first step: the European Parliament wants the border measure to cover all products. Any expansion to other products will be more difficult – figuring out the embodied carbon content, and what carbon price has been paid, of manufactured products in particular. And there are no signs border taxes would be applied to the agricultural products that make up most of New Zealand's exports any time soon. There is thus plenty of lead time for New Zealand to engage with the EU on the treatment of those products of most importance to our trade.

34. Initially, the calculation of the embodied carbon in a product will not include the source of the electricity used, but the EU may look at this in the future. New Zealand with its prospect of being among the first countries to achieve 100% renewable electricity, would stand to benefit.

35. The EU scheme appears, typically, administratively complex, and would impose significant compliance costs on exporters.

36. Another problem is that under its regulation, the EU will be unilaterally determining the carbon price of the imported product, unless there is a bilateral understanding on a common method and/or some form of arbitration in the case of a disagreement. A risk is a de facto forced alignment of policies with those of the EU. It is quite possible that a country might have equally stringent climate policies but a lower carbon price than that in the EU. In that case the border tax would be unfair.

37. Implementing the CBAM is likely to be more difficult than the EU would like to believe – especially vis a vis those countries that would be most affected. Some imports from China and India could face tariff increases of 15-30%. In a joint statement before the Glasgow COP, the influential BASIC countries – Brazil, South Africa, India and China – expressed "grave concern" over the prospect of trade barriers such as carbon border adjustment, which they state are discriminatory and against the principles of equity and burden-sharing in the Paris Agreement. There is thus certain to be very strong opposition and possible retaliation from major developing countries. This could take the form of withdrawal of cooperation under the Paris Agreement, which India has indeed threatened.

Conclusion: what does this mean for New Zealand business?

38. Some form of border adjustment measures will be an inevitable part of the export markets to the OECD countries as long as they are leaders in reducing emissions. They could extend to other countries, most likely those taking the most ambitious climate change action. As long as our climate change targets are comparable with those of our export markets and on track to being met, New Zealand should have little to fear and a lot to gain from well-designed carbon border adjustment mechanisms. But as mentioned above there are risks that need to be mitigated. The best way of achieving this is early engagement with government and amongst the business sector both in New Zealand and abroad.

39. At present, opportunities outweigh risks. They include:

- Fairly and widely-applied BTAs would improve New Zealand exporters' competitive position relative to less carbon-efficient producers. This could benefit exports across the board.
- There is a good opportunity for business to engage with government to encourage sensible and efficient design of any BTAs in our trading partners - starting with the EU.
- Contribute to the WTO discussions on trade and environmental sustainability in order to encourage good quality regulation.

40. The risks?

- Excessive compliance costs
- Unfair or arbitrary levies on exports
- Measures that do not sit well with New Zealand's regulatory framework.

41. Business can best secure its future interests by identifying priority areas and over the next year or so working through them with both government and business partners here and abroad. Some topics could be:

- Calculation of embedded carbon in exports
- Safeguards in the NZ/EU FTA
- Implications for free allocation under the NZ ETS
- Ensuring consistency and accuracy of eco-labelling and other 'sustainability assurance schemes'
- Identification of climate-friendly goods and services for further liberalisation.

Adrian Macey
Te Herenga Waka
Victoria University of Wellington

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About the New Zealand International Business Forum

NZIBF is a coalition of senior business leaders working together to promote New Zealand's engagement in the global economy. For more detail, see www.tradeworks.org.nz.

Annex Some useful trade and climate change references

1 WTO trade and climate change resources. Contains briefs, working papers, news and

links: https://www.wto.org/english/tratop_e/envir_e/climate_intro_e.htm

2 Speech by WTO Director General at February 2022 webinar hosted by Bangladesh on climate change policies on trade and investment:

https://www.wto.org/english/news_e/spno_e/spno22_e.htm

3 Workshop on border tax adjustments Geneva March 2021. Hosted by Canadian Permanent Mission to WTO. Useful discussions about design elements and principles of BTAs:

https://www.gyoutube.com/watch?v=MoKhZ7yxaRw

4 WTO Trade and Environmental Sustainability Structured Discussions (TESSD). Ministerial statement December 2021. Outlines the themes of the discussions for 2022.

https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/MIN21/6R2.pdf&Open=True

5 EU Q and A on their Carbon Border Adjustment Mechanism

(CBAM):

https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661

6 Independent Info and advice for businesses on the CBAM:

https://www.bcg.com/en-au/publications/2021/eu-carbon-border-tax

7 The Agreement on Climate Change Trade and Sustainability (ACCTS):

https://www.mfat.govt.nz/en/trade/free-trade-agreements/trade-and-climate/agreement-on-climate-change-trade-and-sustainability

8 NZ/UK FTA - see Chapter 22.6 on climate change:

https://www.mfat.govt.nz/assets/Trade-agreements/UK-NZ-FTA/NZ-UK-Free-Trade-Agreement.pdf

9 New Zealand review of industrial allocation under the ETS:

https://consult.environment.govt.nz/climate/reforming-industrial-allocation-in-the-nz-ets/

10 Eco-labelling: OECD work:

https://www.oecd.org/env/labelling-and-information-schemes.htm