

The Trade-Climate Nexus and the Future of the Global Trading System

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Executive Summary

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As the multilateral trading system embodied in the World Trade Organization has become more unruly owing to China's rise, digitalization, and increasing inequality, there has been greater domestic contestation of globalization. The idea that trade policy should be about more than economic efficiency is a not a new notion but has come into full view. Trade policy is increasingly focused on how to strike the right balance among the three legs of the "Prosperity-Values-Security Triangle" and in this context the interaction between trade and climate policies has gained prominence.

The free trade of goods and services can play a constructive environmental role if the greater resources it generates are devoted to investments in climate change mitigation efforts. Yet there are critiques that unfettered free trade damages the climate if it promotes air, land, and sea travel to ship inputs and finished products.

Recently, discussions about the relationship between trade and climate have moved in a less zero-sum direction. Liberalizing trade in green goods and services, stricter environmental norms for supply chains, and promoting digital trade that has a lower carbon footprint can all play a constructive role in advancing climate goals. At the same time, measures like a carbon border adjustment mechanism to incentivize climate-friendly production by trading partners and prevent "climate leakage" could reduce the amount of international trade in the short term.

From an institutional perspective, the debate about the relation between trade and climate policies is as old as the multilateral trading system itself. According to Article XX of the General Agreement on Tariffs and Trade (GATT) from 1947, "nothing in this Agreement shall be construed to prevent adoption or enforcement by any

contracting party of measures...necessary to protect human, animal or plant life or health” or “relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.” The need to balance free trade with other objectives is a founding principle of the current trading system.

While the World Trade Organization (the GATT’s successor) has so far not been able to complete negotiations toward an Environmental Goods Agreement launched in 2014, “Trade and Environmental Sustainability Structured Discussions” (TESSD) were launched in November 2020 that among other issues address the role of fossil fuel subsidies. Moreover, in two important cases brought to its dispute settlement system, the WTO ultimately ruled that U.S. efforts to protect sea turtles and dolphins did not constitute an illegal restriction of trade, affirming the legitimacy of environmental objectives.

Beyond the WTO, Asia-Pacific Economic Cooperation (APEC), the G7, and the G20 have played a role in developing rules and norms for balancing trade and climate objectives. APEC was at the forefront of efforts to liberalize trade in environmental goods with the commitment of its 21 members in 2011 to reduce tariffs to five percent or less by 2015 and recently endorsed liberalizing trade in environmental services. At their 2021 meeting the G7 trade ministers recognized the risk of carbon leakage and agreed that countries should work collaboratively to address this risk and highlighted the importance of climate-friendly supply chains. The same year, G20 finance ministers underlined the importance of addressing subsidies.

Several bilateral and regional trade pacts—NAFTA, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the EU-Japan Economic Partnership Agreement—as well as the bipartisan U.S. Congressional “May 10th Agreement” of 2007 have also raised the prominence of environmental objectives, creating momentum in the debate about trade and climate policies.

The global trading system can draw upon a number of diverse policy options to mobilize trade to advance climate objectives. These include a carbon border adjustment mechanism (CBAM), a “Climate Club,” national security measures like the U.S. Section 232, new supply chain principles, and in the context of the World Trade Organization clarifying the role and intent of Article XX, a “Climate Waiver,” agreements on environmental goods and services, and subsidies reform.

As part of its “Green Deal,” the EU announced plans in July 2021 to introduce a CBAM by 2026, and two Members of the U.S. Congress introduced a bill in the same month that would enact a similar tax on carbon-intensive imports. While the EU would base its CBAM on the carbon price set by its Emissions Trading System, the U.S. congressional proposal would rely mostly on the costs of complying with regulations.

A Climate Club—an idea initially mooted by Nobel Laureate William Nordhaus on 2015—would be a plurilateral agreement among a critical mass of countries upholding certain high standards and with a common enforcement regime (for example, a tax) against outsiders. The German government has revived this idea, suggesting not only

the EU and the G7 but also China as members. A more coercive option would be to include climate under the national security exemption provided by measures like Section 232 of U.S. trade law.

Greater transparency of worldwide supply chains would help promote the use of climate-friendly manufacturing methods, while sectors like e-vehicles and wind power would benefit from efforts to create greater security of supply for critical minerals and reduce dependence on untrusted sources.

Within the WTO, clarifying the intent of Article XX would help reduce the likelihood of cases being brought against members' trade measures on behalf of climate goals, as would a climate waiver under which countries would be allowed an exemption from certain WTO commitments to free trade to pursue environmental objectives.

Ultimately, it is difficult to imagine countries combating climate change without some scope for measures that may restrict trade in the short term. In the absence of reformed multilateral trade rules, many countries with ambitious climate goals are likely to enact measures like a carbon border adjustment mechanism.

Yet the multilateral arena is not the only one where tensions between trade and climate are likely to play out. There are risks to the relationship between the United States and the European Union—still the main supporters of an open, rules-based trading system—if they cannot eventually align their approaches to CBAM. In the end, without U.S.-EU harmony it is hard to imagine that there will be enough goodwill between them to cooperate on creating a broader climate club of like-minded countries, pushing for a climate waiver, or updating WTO rules. The transatlantic relationship will be a test case of whether climate protectionism—however unintended—can be avoided.

I. Introduction

Over the last 10 years, the multilateral trading system embodied in the World Trade Organization has become increasingly unruly. China's rise has made the trading system more diverse ideologically, digitalization has become as much a force for anarchy as for human connection, and rising inequality in many countries has led to greater domestic contestation of globalization. The idea that trade policy should be about more than economic efficiency—not a new notion, but one that often remained implicit—has come into full view. How to strike the right balance among the three legs of what could be called the “Prosperity-Values-Security Triangle” is now an inescapable framework for thinking about the role of trade and for effective trade policymaking. The interaction between trade and climate policies has gained prominence in this context.

A. The Prosperity-Values-Security Triangle

At least since the writings of David Ricardo and Adam Smith in the 18th and 19th centuries, free trade has been put forward as a means to lift the economic fortunes of nations. But as can be seen during the debate about the removal of the Corn Laws in mid-19th century England, arguments in favor of lowering or eliminating barriers to trade—in this case, on imported grain—have often appealed to broader concerns than economic growth. The Anti-Corn Law League alternatively made the case that free trade would create greater equality among social classes, empower individual freedom, reflect God's will, or contribute to world peace (Schonhardt-Bailey, 2006).

Later, President Franklin Roosevelt's Secretary of State, Cordell Hull, defended the administration's 1934 Reciprocal Trade Agreement Act by saying:

“It was also clear from the beginning that a revival of world trade was an essential element in the maintenance of world peace. By this I do not mean, of course, that flourishing international commerce is of itself a guarantee of peaceful international relations. But I do mean that without prosperous trade among nations any foundations for enduring peace becomes precarious and is ultimately destroyed.

As with the leaders of the anti-corn law movement, Hull saw free trade as a means to enhance national security (Hull, 1943).

A further example of the broader lens through which trade policy has been viewed is the 1948 Havana Charter signed by 53 countries, which was intended to lead to the creation of an International Trade Organization.* This is not a case of claims being made for the wider benefits of free trade, but rather the related—and more contemporary—concern that trade policy cannot be isolated from other policies. Article II of the Charter makes this explicit when, referring to employment, it says:

The Members recognize that the avoidance of unemployment or underemployment, through the achievement and maintenance in each country of useful employment opportunities for those able and willing to work and of a large and steadily growing volume of production and effective demand for goods and services, is not of domestic concern alone, but is also a necessary condition for the achievement of the general purpose and the objectives set forth in Article 1, including the expansion of international trade, and thus for the well-being of all other countries (UN, 1948).

There were certainly narrow interests at play in the movement to repeal the Corn Laws (manufacturers vs. landed groups) (Kindleberger, 1975) and the Reciprocal Trade Agreements Act (U.S. grievances toward the UK's Imperial Preference) (Dingel, 2007). This does not detract from the expectation that they would have what might be called a “strategic” role in advancing broader interests or values (peace, freedom, the rule of law) at home and abroad. And although the Havana Charter could be criticized for overreaching into the affairs of national governments, it also captured the idea that trade policy does not exist in isolation, but rather in a dynamic relationship with other policies.

B. The Role of Trade in Climate: Solution or Culprit?

The interplay between trade and climate falls squarely within this historical context of trade policy serving broader goals. Rising temperatures, melting polar ice caps, and more frequent and more extreme weather events are clear evidence that global warming has become an existential threat to humanity. While energy, tax, technology, and infrastructure policies are taking the lead in reversing or at least stabilizing climate change, trade policies will be expected to contribute to this effort.

Conflicting cases can be brought to bear about the costs and benefits involved regarding the impact of trade on the climate. A traditional economic argument would

* Although the ITO was never sent to the U.S. Senate for a vote, dooming it from the start, many of its trade liberalization provisions served as the basis for the General Agreement on Tariffs and Trade, or GATT, the predecessor to the WTO.

say that the free trade of goods and services generates greater resources that can be devoted to investments in climate change mitigation efforts. In other words, when governments reduce trade barriers, either unilaterally or through trade negotiations with other countries, there is a benefit for the climate.

Others might argue that unfettered free trade is damaging to the climate because it promotes air, land, and sea travel to ship finished products, and more recently the creation of global value chains that depend on the specialized production of inputs that need to be shipped up and down the production process in a “just-in-time” manner. In other words, when governments reduce trade barriers, they may also be causing harm to the planet.

C. Squaring the Trade and Climate Circle?

In a certain sense, recent discussions about the relationship between trade and climate have moved in a more promising, less zero-sum direction that borrows from both approaches. Increasing consideration is now being given to ways that trade policy can advance climate objectives through, for example, liberalizing trade in green goods and services, stricter environmental norms for supply chains, and promoting digital trade that has a lower carbon footprint. Yet measures like a carbon border adjustment mechanism—a kind of tax on carbon intensive imports—to incentivize climate-friendly production by trading partners and prevent “climate leakage” (the movement of polluting industries to less strictly-regulated jurisdictions) could reduce the amount of international trade in the short term.

While the emphasis in this debate is understandably on how to protect the climate—a crucial goal of governments worldwide—rather than trade policy (which is one of several potential means to that end), it is also true that efforts to prevent climate change could help lend new purpose to trade policy. This state of play appears to owe itself, at least in part, to the emerging consensus that an “all of the above” approach is needed to meet the voluntary climate goals set out in the Paris Accords of the UN Framework Convention on Climate Change: top-down rules (including trade rules) will be needed, but so will bottom-up investments by government and the private sectors in technology to reduce carbon emissions as well as market-based mechanisms like the establishment of a carbon price where politically feasible.

II. The Evolution of the Trade and Climate Debate

A. The Global Context from GATT to the WTO and Beyond

It is not an exaggeration to say that the debate about the relation between trade and climate policies is as old as the multilateral trading system itself. **Article XX of the GATT**, which dates to its founding in 1947, stipulates that “nothing in this Agreement shall be construed to prevent adoption or enforcement by any contracting party of measures...necessary to protect human, animal or plant life or health” or “relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.” Much like the exemption for national security found in Article XXI, Article XX establishes that there are other objectives that need to be balanced with the commitment to free trade that was the GATT’s *raison d’être* (GATT n.d.-a).

Box 1: GATT Article XX

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 contracting party of measures:

- a. necessary to protect public morals;
- b. necessary to protect human, animal or plant life or health;***
- c. relating to the importations or exportations of gold or silver;
- d. necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies operated under paragraph 4 of Article II and Article XVII, the protection of patents, trade marks and copyrights, and the prevention of deceptive practices;
- e. relating to the products of prison labour;
- f. imposed for the protection of national treasures of artistic, historic or archaeological value;
- g. relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;***
- h. undertaken in pursuance of obligations under any intergovernmental commodity agreement which conforms to criteria submitted to the CONTRACTING PARTIES and not disapproved by them or which is itself so submitted and not so disapproved;
- i. involving restrictions on exports of domestic materials necessary to ensure essential quantities of such materials to a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a governmental stabilization plan; Provided that such restrictions shall not operate to increase the exports of or the protection afforded to such domestic industry, and shall not depart from the provisions of this Agreement relating to non-discrimination;
- j. essential to the acquisition or distribution of products in general or local short supply; Provided that any such measures shall be consistent with the principle that all contracting parties are entitled to an equitable share of the international supply of such products, and that any such measures, which are inconsistent with the other provisions of the Agreement shall be discontinued as soon as the conditions giving rise to them have ceased to exist. The CONTRACTING PARTIES shall review the need for this subparagraph not later than 30 June 1960.

The GATT environmental exception remains in the laws of the **World Trade Organization**, the GATT's successor that came into being in 1995. Moreover, in its preamble to the agreement establishing the WTO there is clear language about the balance to be struck, saying its members' "relations in the field of trade and economic endeavor should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, 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" (WTO, n.d.).

In addition, at the WTO's founding, the 1994 Marrakesh Ministerial Decision on Trade and Environment created the **Committee on Trade and Environment (CTE)** with the twin aim of identifying "the relationship between trade measures and environmental measures in order to promote sustainable development" and to "make appropriate recommendations on whether any modifications of the provisions of the multilateral trading system are required, compatible with the open, equitable and non-discriminatory nature of the system." The CTE includes a 10-point work program, some of whose items later were included in the WTO Doha Round of negotiations launched in 2001 (and still uncompleted) (WTO, n.d.-b).

The Decision emphasized that "there should not be, nor need be, any policy contradiction between upholding and safeguarding an open, non-discriminatory and equitable multilateral trading system on the one hand, and acting for the protection of the environment, and the promotion of sustainable development on the other." It has also foreshadowed a number of areas that would later become central to the debate about the relationship between trade and climate, such as updating the rules ("make appropriate recommendations on whether any modifications of the provisions of the multilateral trading system are required, compatible with the open, equitable and non-discriminatory nature of the system"), whether tariffs or taxes can be legitimate tools to promote climate goals ("the relationship between the provisions of the multilateral trading system and charges and taxes for environmental purposes"), and whether WTO members can discriminate against imports based on their production methods in order to protect the environment ("requirements for environmental purposes relating to products, including standards and technical regulations, packaging, labeling and recycling") (WTO, n.d.-c).

The **Doha Round** was the first set of multilateral trade negotiations to include an explicit reference to the environment. Moreover, in the preamble it placed the emphasis on the relationship between WTO rules and multilateral environmental agreements like the UN Framework Convention on Climate Change, on a "win-win-win" (benefiting trade, the environment, and development) approach to removing tariffs and non-tariff barriers on environmental goods and services, as well as on removing subsidies leading to environmentally harmful over-fishing (Tarasofsky and Palmer, 2006) (WTO, n.d.-d).

As it became clear the Doha Round was unlikely to find a path to conclusion, several WTO members searched for other ways to advance trade liberalization and rulemaking. Building on earlier work by the Asia-Pacific Economic Cooperation (see below) 18 WTO members decided in 2014 to launch plurilateral negotiations toward an **Environmental Goods Agreement (EGA)**. They are Australia, Canada, China, Chinese Taipei, Costa Rica, the European Union, Hong Kong (China), Iceland, Israel, Japan, Liechtenstein, New Zealand, Norway, Singapore, South Korea, Switzerland, Turkey and the United States. The EGA aimed to follow in the footsteps of two prominent plurilaterals that were successfully brought to conclusion early in the life of the WTO, the 1994 Government Procurement Agreement and the 1996 Information Technology Agreement. The EGA's ambition was to cover more than \$1 trillion worth of exports, including sectors like solar panels, gas and wind turbines, that can help combat climate change, and where tariffs were as high as 35 percent.

Although the EGA had strong support from the United States and the European Union, the talks came to a halt in November 2016 owing in part to China's negotiating position on bicycle tariffs, which was seen as inflexible and whose terms the EU could not accept (Miles, 2016).

More recently, **"Trade and Environmental Sustainability Structured Discussions" (TESSD)** were launched in November 2020 at the WTO. The impetus for these talks came from 53 countries concerned to make the WTO's work on trade and the environment more responsive to the climate crisis, to apply the lessons learned from COVID-19 about the sustainability of global value chains, and to ensure that efforts to reform WTO rules place a greater emphasis on environmental and climate goals. The results of these discussion are to be reported to the 12th WTO Ministerial Conference in Geneva at the end of November and early December 2021.

At the first meeting of the TESSD in March 2021, several countries raised fossil fuel subsidies reform as an area of focus, while others highlighted environmental goods and services, including the reduction of both tariff and non-tariff barriers to trade, as well as carbon border adjustment mechanisms (WTO, 2020).

Beyond formal negotiations like the Uruguay Round establishing the WTO or the later Doha Round, the WTO's **Dispute Settlement Body** has played a considerable role in setting out a framework for thinking about ways that trade policies can advance climate and broader environmental objectives. In particular, the decisions in two important cases before the WTO in the 1990s and 2000s have important implications for the interplay of trade and climate change. With some qualifications, the WTO affirmed that GATT Article XX's General Exceptions allow countries to restrict trade for the purpose of protecting the environment.

In the shrimp-turtle case, four Asian exporters launched a challenge in 1996 against the U.S. prohibition of imported shrimp without turtle excluder devices under Section 609 of U.S. Public Law 101-162. An initial panel ruling in 1998 decided against the United States, which had justified the practice on the basis of Article XX, finding the application

of U.S. law inconsistent with Article XI on the “General Elimination of Quantitative Restrictions,” which states that “no prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party” (GATT, n.d.).

The United States appealed the panel findings to the WTO Appellate Body, which found in its favor based on Article XX, but took issue with the way in which it implemented the measure. Once the United States altered its approach, it won a final challenge put forward by Malaysia in 2001 (USTR, 2001).

In a second litigation, the tuna-dolphin case, Mexico complained in 2008 that U.S. policies prohibiting imports of its tuna caught with nets that could also entrap dolphins were not consistent with WTO law because Mexico complied with dolphin-safe standards set out by the Inter-American Tropical Tuna Commission. It argued that the United States was in violation of several articles of the WTO’s Technical Barriers to Trade (TBT) agreement as well as Articles I and III on “most-favored nation” treatment and national treatment respectively, two foundational concepts of WTO law that seek to ensure all members are treated equally. In this case as well, the United States was initially found to be in violation but then after modifying its approach the Appellate Body ultimately decided in its favor in 2018 after Mexico’s final challenge (USTR, n.d.-a) (WTO, n.d.-c).

Beyond the GATT and later the WTO, other fora such as **Asia-Pacific Economic Cooperation APEC**, the G7, and the G20 have played a role as well in developing rules and norms for balancing trade and climate objectives. APEC was at the forefront of efforts to liberalize trade in environmental goods with the commitment of its 21 members in 2011 to reduce tariffs to five percent or less by 2015. This was a significant step as half of the top ten global exporters of environmental goods and 12 of the top 30 are APEC economies (APEC, 2016). At their June 2021 meeting, APEC trade ministers recognized that “since APEC Economic Leaders endorsed the APEC List of Environmental Goods in 2012, new environmentally friendly goods, technologies and innovations have emerged that are not covered by the original list. We are ready to take concrete steps that build on this legacy, to further APEC’s contribution to addressing the most serious environmental challenges” with a view to updating the original list. The ministers also endorsed discussions on non-tariff measures on trade in environmental goods and on liberalizing trade in environmental services (Scoop World, 2021).

At their 2021 meeting the **G7** trade ministers devoted six paragraphs of their communiqué to trade and the environment, affirming that “the G7 has the opportunity to make trade part of the solution through coordinated action” and laid the basis for the joint use of taxes to advance climate objectives (carbon border adjustments), asserting that “as the world transitions to net zero, we acknowledge the risk of carbon leakage to decarbonisation goals, and the potential impact it could have on those

countries that have adopted rigorous approaches to reduce carbon emissions, and agree that countries should work collaboratively to address this risk.” The G7 ministers also highlighted the importance of climate-friendly supply chains, in particular sustainable approaches to forestry and agricultural products (G7, 2021).

Trade and the Environment

1. 2021 is a crucial year to accelerate international efforts to address climate change, including through the UN Climate Change Conference of the Parties (COP26). We agree that global problems such as climate change and biodiversity loss require coordinated solutions. The G7 has the opportunity to make trade part of the solution through coordinated action. We recognise that the structured discussions at the WTO on trade and environmental sustainability are an opportunity to build momentum in this regard.
2. As the world transitions to net zero, we acknowledge the risk of carbon leakage to decarbonisation goals, and the potential impact it could have on those countries that have adopted rigorous approaches to reduce carbon emissions, and agree that countries should work collaboratively to address this risk.
3. The G7 has a key role in promoting, enabling, and supporting the transition to sustainable commodities markets and supply chains, and as G7 Trade Ministers we are committed to playing our part. Deforestation is a global threat to our climate, biodiversity, food security, and livelihoods. Around 80% of global deforestation is due to change of land use for agriculture, a significant proportion of which is for the production of a specific group of internationally traded agricultural commodities.
4. We commit to work through the WTO and other fora to develop trade policy approaches that support sustainable supply chains for forest and agricultural commodities.
5. We look forward to the Forest, Agriculture and Commodity Trade (FACT) dialogue and the work of the International Tropical Timber Organization, in order to discuss a set of shared global principles as well as a common roadmap to global sustainable supply chains, helping to conserve and sustainably manage forests and other ecosystems, while promoting trade and development.
6. We commit to continue efforts with consumer and producer markets and the private sector to support sustainable supply chains that decouple agricultural production from deforestation and forest degradation. We commit to work with environment and other relevant ministries, domestically, bilaterally and in multilateral fora, including in the context of trade agreements as appropriate, to share best practices and consider any appropriate domestic actions that support this aim.

Box 2: 2021 G7 Trade Ministers Communiqué (excerpt)

As for the **G20**, the finance ministers meeting in July 2021 under the Italian presidency reinforced the importance of addressing subsidies as part of the policy mix to address climate change, declaring that it “should include a wide set of tools, such as investing in sustainable infrastructure and innovative technologies that promote decarbonisation and circular economy, and designing mechanisms to support clean energy sources, including the rationalisation and phasing-out of inefficient fossil fuel subsidies that encourage wasteful consumption and, if appropriate, the use of carbon pricing mechanisms and incentives, while providing targeted support for the poorest and the most vulnerable” (G20, 2021).

The United Nations—under whose auspices the **UN Framework Convention on Climate Change (UNFCCC)** was signed in 1992 and updated most recently by the 2015 Paris Agreement (COP21)—is not a trade policy body per se but it has played a role in the development in the interaction of trade and climate policies. One of the main ways this has occurred is through the increasing demand by the United States, the European Union, Canada, and other economies that their trade agreements include language that binds their partners to fulfilling the goals of a number of multilateral environmental agreements, including the Montreal Protocol on the ozone layer, Convention of International Trade in Endangered species (CITES), and the UN Law of the Sea.

With the coming into force of the Paris Agreement of the UNFCCC another aspect to the trade-climate nexus is taking shape. On the one hand, signatories to COP21 commit to nationally determined measures to reach the UNFCCC climate goals. They are not supposed to be imposed directly or indirectly by any external entity. On the other hand, the European Union has already introduced plans for a **Carbon Border Adjustment Measure (CBAM)** by 2026 and others are considering such a step. One of the justifications for a CBAM is that it would be one way for countries to make good on the climate goals enshrined in COP21. However, by taxing imports from countries that lack equivalent climate measures, it could be argued that the EU and others in the future are impinging on the ability of other COP21 members to pursue “nationally determined” steps. One possible way around this dilemma would be for the EU and others with a CBAM to devote some of the revenues it generates toward the \$100 billion pledge developed economies have made within the Paris Agreement to finance climate measures in least-developed countries (UNFCCC, 2021).

B. The Role of Regional and Bilateral Trade Pacts

Both the United States and the European Union have for a number of years relied on their bilateral and regional trade agreements to promote climate and broader environmental goals. One of the first such instances came with the **North American Free Trade Agreement (NAFTA)** among the United States, Canada, and Mexico, which came into effect on January 1, 1994. NAFTA was signed during the presidency of Republican George H.W. Bush. But when Democrat Bill Clinton came into office in January of 1993, he decided to negotiate two side agreements, one on labor and one on the environment. The August 1993 **“North American Agreement on Environmental Cooperation” (NAAEC)** was motivated by concerns that U.S. firms might decide to migrate their operations to Mexico, which was seen as having more lax standards in this area. It was an early example of fears about “carbon leakage” that animate current debates about the role of carbon border adjustments on imports produced with lower environmental standards. While the NAAEC was a historic step in trying to balance trade and climate concerns, its dispute settlement system has been seen as insufficient to advance environmental goals (McFadyen, 1998).

In a further example of Congressional Democrats pushing for trade policy to advance environmental objectives, the bipartisan **“May 10th Agreement”** of 2007 between Congress and the George W. Bush administration provided for enforceable language in pending free trade agreements with Peru and Panama regarding commitments in seven existing Multilateral Environment Agreements (although not the UNFCCC on climate). The parties also agreed not to “waive or derogate from existing national environmental laws in order to attract trade or investment” with a “hard law” commitment that goes beyond the “soft law” language of NAFTA. The dispute settlement provisions are also updated to allow for public submissions of complaints about non-compliance, and not just from states. The May 10th Agreement remains embedded in the approach that successive U.S. administrations have taken to negotiating trade agreements (Cosbey, 2007).

Box 3: *The bipartisan “May 10th Agreement” on trade and the environment*

- The Administration and Congress have agreed to incorporate a specific list of multilateral environmental agreements (MEAs) in our FTAs.
- The list includes (with abbreviated titles) the Convention on International Trade in Endangered Species (CITES), Montreal Protocol on Ozone Depleting Substances, Convention on Marine Pollution, InterAmerican Tropical Tuna Convention (IATTC), Ramsar Convention on Wetlands, International Whaling Convention (IWC), and Convention on Conservation of Antarctic Marine Living Resources (CCAMLR).
- The United States is a signatory to all of these agreements. The United States takes seriously its obligations under these MEAs. We have nothing to fear from taking on FTA commitments for these agreements as well and subjecting those commitments to the FTA dispute settlement process where trade or investment are affected.
- We have also agreed to alter the non-derogation obligation for environmental laws from a “strive to” to a “shall” obligation, with allowance for waivers permitted under law as long as it does not violate the MEA. For the United States, this obligation is limited to federal laws and should not affect our implementation of these laws.
- Finally, we have agreed that all of our FTA environmental obligations will be enforced on the same basis as the commercial provisions of our agreements – same remedies, procedures, and sanctions. Previously, our 3 environmental dispute settlement procedures focused on the use of fines, as opposed to trade sanctions, and were limited to the obligation to effectively enforce environmental laws.
- In connection with the Peru FTA, we have agreed to work with the Government of Peru on comprehensive steps to address illegal logging, including of endangered mahogany, and to restrict imports of products that are harvested and traded in violation of CITES.

Later, when Democratic President Obama’s administration was negotiating the **Trans-Pacific Partnership** among 12 Asian, North American, and South American states, it was wary of including binding language on trade and climate in the final text of the deal that was arrived at in 2015. The concern was that it could mean losing Republican support in Congress, which the White House knew it would need because the majority of Democrats were known to be opposed to TPP. Obama preferred to keep his climate efforts focused on the Paris Accords rather than create a direct relationship with trade. Although President Trump withdrew the United States from the TPP negotiations in 2017, in 2018 the 11 remaining countries went on to sign the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which essentially retained the environmental provisions of the earlier TPP.

In the 2020 **U.S.-Mexico-Canada Agreement (USMCA)**, that updates NAFTA, there is no reference to the UNFCCC, but the deal does commit the three countries to work together to prevent trafficking in timber, fish, and other wildlife, which can contribute to climate change. In what has become a leitmotiv in recent U.S. trade policy history, Congressional Democrats once again obliged a Republican President, this time Donald Trump, to strengthen these provisions before USMCA was brought to a vote.

As far as the **European Union** is concerned, it has included sustainable development clauses in its trade agreement for more than a decade with commitments relating, among others, to international environmental standards and agreements, enforcement of national environmental laws, preventing a race to the bottom by weakening environmental standards, and encouraging trade that helps fight climate change. The EU currently has such language in its trade agreements with Canada, Central America, Colombia, Ecuador, Georgia, Japan, Mercosur, Mexico, Moldova, Peru, Singapore, South Korea, Ukraine, and Vietnam (European Commission, 2020).

The EU has, in comparison with the United States, directly linked the UNFCCC and particularly the 2015 Paris Accords with its trade policy. For example, the **EU-Canada Comprehensive Economic and Trade Agreement (CETA)** signed in 2016 established a joint committee on trade, climate action, and the Paris Agreement whose purpose is “to effectively implement the Paris Agreement...with the aim of strengthening the global response to climate change and holding the increase in global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels. In this regard, the Parties are committed to progressively increase their efforts to mitigate climate change” (Government of Canada, 2018) (European Commission, 2020).

More recently, the EU and Japan—which signed an Economic Partnership Agreement that entered into force in February 2019—created an **EU-Japan Green Alliance** in May 2021, a first of its kind bilateral commitment to fighting climate change and jointly meeting the Paris Accord goal of reaching net-zero greenhouse gas emissions by 2050 (European Council, 2021). Additionally, the EU-UK Brexit deal (formally, the Trade and Cooperation Agreement signed in December 2020) has language on trade and climate that promotes cooperation on carbon pricing and emissions trading, the joint goal of climate neutrality by 2050, and a commitment not to weaken climate protections in a way that impacts trade (what is known as regulatory “non-regression”) (Papanicolaou, 2021). And while the EU-Mercosur Free Trade Agreement reached in June 2019 between the EU and the four countries of the Southern Common Market (Argentina, Brazil, Paraguay, and Uruguay) includes a reference to the two sides’ Paris commitments there has been criticism that the pact’s climate protections are insufficient, which has held up its final ratification (Blenkinsop, 2021).

III. Policy Options for Advancing Climate Goals

The idea that trade policy can help to advance climate goals has gained considerable momentum in 2021. This development is accounted for in part by the increasing conviction among governments, legislators, and observers in the United States and Europe that measures based on peer pressure like the voluntary commitments enshrined in the UNFCCC Paris Accords may not be sufficient, and that stronger incentives—for example, new global trade rules and norms, sometimes backed by enforcement in case of non-compliance—need to be included in the policy toolbox. In short, both carrots and sticks are necessary (Nordhaus, 2020). These efforts have gained particular attention through a striking coincidence: the twin announcements—in the same spirit but not coordinated in advance—on July 14th by the European Union and the Democratic leadership in the U.S. Senate in favor of introducing a “carbon border adjustment mechanism” or CBAM (the EU) or a “polluter import fee” (United States) on manufactured goods from trading partners that do not meet domestic climate-protection standards (Abnett and Twidale, 2021) (Friedman, 2021).

But some form of tax on carbon-intensive imports is not the only policy measure under discussion. In the WTO, negotiations to update rules on fossil fuel subsidies, relaunching plurilateral talks on environmental goods (perhaps extended to services), and even enacting a “climate waiver” are possible ways forward, as are new rules or norms to promote climate-friendly inputs in global value chains. A more thoroughgoing reform to WTO rules—including to clarify the role of the environmental exception—needs to be the ultimate policy objective, although getting there may take time.

A. Carbon Border Adjustment Mechanisms

The carbon border adjustment mechanism put forth by the EU as part of its Green Deal, which it plans to have fully operational by 2026, and the U.S. Senate majority's idea of a polluter import fee bear some similarities to each other. Although there is considerably greater detail about the EU CBAM (European Commission, 2021), a subsequent bill proposed by Senator Chris Coons and Representative Scott Peters (both Democrats), the "FAIR Transition and Competition Act of 2021," (see Box 4) uses language akin to the EU's ("border carbon adjustment") and provides some insight into what the U.S. approach may look like (Friedman, 2021a) (Coons, 2021).

An important difference between the two approaches has to do with the way the domestic price of carbon is set, which would then be used to determine whether imports are paying a similar price. While the EU CBAM relies on its Emissions Trading System begun in 2005 (and which will be expanded to cover not only power generation, manufacturing, and aviation but also buildings and transportation (Krukowska, 2021),* the U.S. proposal—perhaps bowing to the political reality that Congress is unlikely to pass legislation instituting a carbon tax—would rely on a combination of factors including the California and Northeast regional emissions trading systems, state renewable energy standards, and the compliance costs of the federal Clean Air Act to approximate a national carbon price.**

* The UK established its own emissions trading system after leaving the EU while Canada has plans to create one as well (UK, 2020) (Nicholson, 2021).

**For example, in 2009 the American Clean Energy and Security Act (HR 2454), or Waxman-Markey bill, that would have established a U.S. emissions trading system, went down to defeat.

Box 4: *FAIR Transition and Competition Act of 2021*

Protecting jobs, building resilience, and raising international climate ambition.

International climate cooperation will be a critical component in reaching net-zero emissions by 2050, and the United States has an opportunity to reframe trade around climate values. Despite the leadership of many U.S. businesses in reducing harmful greenhouse gas emissions, they will be left at a disadvantage as trading partners consider levying carbon-related tariffs on certain goods. The FAIR Transition and Competition Act of 2021 will establish a border carbon adjustment on carbon-intensive imports to account for the cost incurred by U.S. businesses to comply with laws and regulations limiting greenhouse gas emissions. The border carbon adjustment will raise billions of dollars to support communities as they adapt to increasingly severe weather events and invest in new technologies to eliminate greenhouse gas emissions. The bill also maintains a flexible approach to evolve the policy to achieve climate goals and support U.S. workers. The FAIR Transition and Competition Act of 2021 will protect U.S. jobs, reduce reliance on foreign energy sources, and drive climate innovation and resilience here at home by: Recognizing the cost to U.S. companies to produce cleaner products and comply with U.S. laws and regulations designed to lower greenhouse gas emissions by determining a domestic environmental cost incurred by businesses. Levying a fee on imported pollution to address carbon leakage that undermines urgent climate action. The import fee will be based on the domestic environmental cost incurred and will initially cover goods that are both carbon-intensive and exposed to trade competition, including aluminum, cement, iron, steel, natural gas, petroleum, and coal. The list of goods covered by the tariff will expand as the United States improves processes for determining the carbon intensity of different types of goods. Supporting international climate cooperation by encouraging the Secretary of State and United States Trade Representative to engage with trading partners on reducing greenhouse gas emissions. Funding climate resilience, transition assistance, and emissions reductions technologies through the revenues raised. A new Resilient Communities Grant Program will provide states with resources to equitably assist vulnerable communities with climate resilience efforts. Revenues will also support the development and commercialization of emissions reductions technologies and provide resources to workers and businesses affected by the transition to a low-carbon economy.

Source: Coons, 2021.

A key consideration for both the United States and the European Union is whether their approach to carbon imports would be in conformity with WTO rules. This is a question that it is not possible to answer definitively until one or both sets of measures are brought before the WTO's dispute settlement system. In the meantime, in addition to the importance of a domestic price that is then adjusted for through a border mechanism (which is allowed under WTO rules) another issue to be borne in mind is which objectives governments might use to justify a carbon border adjustment.

In general, two distinct virtues are often attributed to CBAMs: their role in combating climate change on the one hand and the way they can level the playing field between domestic and foreign producers if the latter are not subject to the compliance costs associated with advancing climate goals. By making it more expensive to produce in a less-regulated jurisdiction, a CBAM would reduce the likelihood that U.S. or EU firms shift their production offshore. One observer, a former chair of the WTO Appellate Body, has argued that the level playing field justification could run afoul of multilateral trade rules and that governments should rely on the environmental exceptions that are covered under Article XX (Bacchus, 2021). How countries use the revenues generated from a carbon border adjustment fee could also impact their WTO legality, in particular whether they are recycled into climate mitigation and adaptation efforts (Mehling, et al., 2018).

B. A Climate Club

Taking the border adjustment approach a step further, there have also been proposals that several countries join together to form a “Climate Club”—a kind of plurilateral agreement among a critical mass of participants that would uphold certain high standards and agree to a common enforcement regime (for example, a tax) against outsiders without similar climate ambitions. The idea is considered to originate with Nobel-laureate William Nordhaus, who saw the problem this way:

“Notwithstanding great progress in scientific and economic understanding of climate change, it has proven difficult to forge international agreements because of free-riding, as seen in the defunct Kyoto Protocol. This study examines the club as a model for international climate policy. Based on economic theory and empirical modeling, it finds that without sanctions against non-participants there are no stable coalitions other than those with minimal abatement. By contrast, a regime with small trade penalties on non-participants, a Climate Club, can induce a large stable coalition with high levels of abatement” (Nordhaus, 2015).

A Climate Club would be an interim step for responding to a longer-term challenge for the multilateral trading system highlighted in a recent paper from the Organization for Economic Cooperation and Development (OECD), which is that “in the absence of an internationally agreed carbon-pricing system, there is a risk that trade partners may react by bringing WTO cases and/or imposing retaliatory tariffs on countries introducing a BCA [border carbon adjustment] if they perceive it as a protectionist measure” (OECD, 2021).

In August 2021 the German government proposed that the EU should launch such a club, presenting it as a way to “give the implementation of the Paris Agreement additional impetus at the international level.” In announcing this plan, the government mentions the United States, the G7, China, India, and “other G20 countries” as potential

members. It also makes room for a diversity of approaches, saying the “instruments used can differ from country to country. The objective of the climate club is above all to **make the different rules comparable**. The climate club members will therefore discuss ways of achieving a **uniform measurement of the CO₂ content** of products and materials” (Federal Ministry of Finance, 2021).

While the German government would like to include China in a future climate club, national security concerns surrounding China are part of the broader policy lens through which border adjustment mechanisms are viewed in the United States. As U.S. Senator Edward Markey (D-MA) put it, “the United States and the EU have to think in terms of the leadership that we can provide and the message that we have to send to China and other countries that would take advantage of the high standards that we are going to enact.” So beyond environmental and economic competitiveness considerations, a third element—national security—needs to be added to the potential justifications for a border adjustment (Friedman, 2021).

C. National Security and Section 232

A CBAM is not the only kind of tax or tariff measure that has been suggested as a potential avenue to defend against challenges presented by other countries’ unwillingness to maintain high standards for climate protection. In the case of the United States, there have been calls to use Section 232 of the 1962 Trade Expansion Act (TEA), which deals with “safeguarding national security” to combat climate change, which is seen as a threat to the vital interests of the United States (Harrell, 2020) (Meyer and Tucker, 2020).

It is worth recalling that the Kennedy administration included this language in the TEA with the particular Cold War-era challenge presented by the Soviet Union in mind. Until recently, it was used sparingly by U.S. presidents, mostly toward adversarial countries in the context of the oil crises of the 1970s. Breaking with past practice, the Trump administration in 2018 imposed tariffs on imported steel and aluminum from a range of countries—including U.S. treaty allies—on the grounds that they were a threat to U.S. national security under Section 232.

While Article XXI of the WTO does provide its own national security exception, in general WTO members have been wary about resorting to such justifications for policies that otherwise could be seen as protectionist. Not only is there a risk, through imitation, of setting off an uncontrolled proliferation of national security tariffs. It is also true that should one member challenge another over such tariffs in the WTO dispute settlement system, it would put the Geneva body in the potentially uncomfortable position of having to rule on what constitutes a threat to a country’s national security. More than one WTO member could find that to be an unacceptable encroachment on its national sovereignty.

While it is certainly convincing to argue that climate change is a national security challenge, the unilateral nature of Section 232 could make its use counterproductive. Climate change is not uniquely a security threat to the United States; the interests of allied and like-minded countries that share U.S. concerns about global warming are also at stake. But would the European Union, for example, be encouraged to cooperate with the United States on their shared climate goals if it became the target of Section 232 tariffs? And if one important focus of transatlantic cooperation will be reforms to WTO rules to create a better balance between trade and climate goals, the use of Section 232—which would test the spirit if not the letter of trade multilateralism—may not be a propitious way to begin.

D. Supply Chains

Beyond more formal trade policy efforts, whether negotiated (WTO or regional trade agreements) or more coercive (tariffs and taxes), there are also options in the realm of principles and norms that, if they gain general acceptance, can advance climate goals. One area that has gained prominence is supply chains. Unlike the kind of trade that dominated the global economy when the multilateral trading system was established after World War II—which was characterized by the exchange of finished goods—today it is estimated that up to 70 percent of manufacturing is spread across global value (or supply) chains that connect multiple production centers specializing in individual inputs (OECD, n.d.).

While the COVID-19 pandemic has drawn attention to the importance of resilient supply chains to ensure the availability of medical goods during a public health emergency, there is also increasing attention being paid to the need to manage climate risks in global production processes. There are at least three key aspects to this concern.

One is the importance of maintaining climate-friendly manufacturing methods across supply chains, which will require greater reporting and transparency about the firms that provide inputs to finished goods.

Another is managing the impact climate change itself on the manufacturing capacity within current supply chains. As President Biden’s February 2021 executive order on supply chains makes clear “the United States needs resilient, diverse, and secure supply chains to ensure our economic prosperity and national security. Pandemics and other biological threats, cyber-attacks, climate shocks and extreme weather events, terrorist attacks, geopolitical and economic competition, and other conditions can reduce critical manufacturing capacity and the availability and integrity of critical goods, products, and services” (Executive Order, 2021).

And a third is the need to ensure the availability of critical minerals that are essential for producing a range of green goods like batteries for electric vehicles or turbines for windmills. Because China is the leading supplier of a number of these critical minerals, both climate and security considerations will drive efforts to create a greater diversity (where possible) of supplying countries and firms. In a June 2021 review of its supply chain efforts, the White House pointed to this issue:

“High-capacity batteries – used in electric vehicles (EVs), for stationary storage, and for many defense applications – offer an important and growing market that can support the creation of American jobs, help meet our national security needs, and bring ambitious climate targets within reach. The rationale for supporting the U.S. supply chain now is clear: demand for EVs and energy storage is increasing, investors are increasing investment in the clean economy, and the pandemic has underscored the fragility of some U.S. supply chains” (The White House, 2021).

The European Union and Germany are also taking steps to encourage firms to adhere to certain climate norms in their production processes as they import and export across global value chains. Ahead of a European Commission proposal on corporate due diligence expected by the end of 2021, the European Parliament passed a resolution in March 2021 on the environmental and human rights aspects of supply chains. It proposes fines for companies that do not follow the guidelines (Taylor, 2021). In Germany, the parliament passed a law in June that will require firms of a certain minimum size to set up due diligence procedures with the objective of ensuring their global value chains do not include human rights and environmental abuses. If a company is found in violation of the law’s requirements it could be fined up to 2 percent of turnover (Knolle, 2021).

E. WTO: Article XX, Climate Waiver, Environmental Goods and Services, Subsidies

WTO rules that have a bearing on how countries may treat imports of carbon-intensive goods exist in a certain degree of tension with one another. On the one hand **Article XX** states that “nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures... necessary to protect human, animal or plant life or health” or “relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.” The protection of the climate falls squarely within this policy space. While the language on coupling natural resource-based restrictions on imports with similar domestic measures is significant, it does not specify what form those domestic measures may take (i.e., a carbon price vs. regulations).

On the other hand, the same Article XX leads off with language about the importance of non-discrimination:

“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...”

This points to conditions outlined in Articles I and II (most-favored nation treatment, tariff bindings), III (national treatment), as well as XI and XIII (quantitative restrictions) and potentially to a different interpretation of whether domestic measures like a border adjustment or a polluter tax are in conformity with WTO rules. Yet given how novel climate border measures are, no matter relating to them has been brought to the WTO dispute settlement system. That does not mean that the EU’s carbon border adjustment mechanism or an eventual U.S. polluter import fee would not be challenged as discriminatory under one or more WTO articles. There is ample WTO law that could be drawn upon if a member country wanted to initiate dispute settlement against either Washington or Brussels.

One proposal that has been put forward to reconcile trade and climate policies—and that could serve as a bridge to a time when WTO rules are updated—is a **“Climate Waiver.”** With such a waiver, which is permitted under Article IX of the WTO, countries would be allowed an exemption to certain WTO commitments to free trade for the purpose of fighting global warming. As one advocate of this measure has put it, “if carefully crafted and if scrupulously limited only to measures that meet these requirements, a WTO climate waiver will, indeed, do the most toward addressing climate change while risking the least to the multilateral trading system. A WTO climate waiver will enable the continuation of the flow of trade while also imposing a price on trade when it is fueled by the emission of carbon and other greenhouse gases” (Bacchus, 2017).

As noted in Chapter II, the **Environmental Goods Agreement** stalled in 2016. Yet there is a strong argument to make in favor of a new push to remove tariffs on green goods, since these face higher duties than other goods (Shapiro, 2020). Beyond goods, there have been recent calls to extend these talks to environmental services, which would play to the strengths of advanced economies like the United States and the European Union.

WTO rules still allow **fossil fuel subsidies** and do not create carve-outs for green subsidies that advance climate objectives. In 2017 a group of 12 WTO members first raised the issue as a priority for reform (WTO, 2017). It is estimated that government subsidies for fossil fuels are three times higher than those directed at renewable energy and that COVID-19 related support programs are biased toward fossil fuels. Already in 2019 five countries (Costa Rica, Fiji, Iceland, New Zealand, and Norway) launched the Agreement on Climate Change Trade and Stability (ACCTS) (Steenblik and Droege 2019) that puts fossil fuel reform—along with liberalization of environmental goods and services—at its core. As governments continue to subsidize their industries

to emerge from the coronavirus and to shift to a less carbon-intensive economy this issue is likely to become a priority area of the WTO work program.

Ultimately, however, it is in the interest of all WTO members to ensure that the multilateral trading system creates greater policy space for actions to preserve the climate—even if the cost is trade that is somewhat less free in the short- to medium-term. That means not just restarting the EGA and launching a new Environmental Services Agreement, or rewriting rules governing subsidies to fossil fuels and renewing energy, or even creating a climate waiver. There is also a need to clarify and strengthen Article XX as it relates to climate, thereby eliminating as much of the uncertainty as possible that surrounds how a rebooted dispute settlement system would be likely to rule on cases claiming, for example, violations of MFN and national treatment obligations. That would also reduce the need for WTO jurists to rule on whether Article XXI on national security applies to climate policy and in an ancillary way the temptation for members to rely on national laws like Section 232 of the 1962 trade act, which—even if considered legitimate as far as the climate is concerned—would best be used only rarely because of the way they can delegitimize multilateral rules.

IV. Conclusion: Avoiding Unintended Climate Protectionism

One of the most important tasks facing the United States, the European Union, and indeed the entire global economy, is updating the rules of the multilateral trading system enshrined in the World Trade Organization so they strike a better balance between free trade and preservation of the climate. While the two need not be in conflict with each other over the long term, it is challenging to imagine countries combating climate change without some scope for measures that may restrict trade in the short term.

On the one hand, while the Paris Agreement has the right objectives, it is premised on voluntary compliance according to nationally determined contributions and has no enforcement mechanisms. On the other hand, the WTO does have rules and a dispute settlement system, but these are currently not well suited to the task of promoting climate-friendly behavior among its members. The result is that, in the absence of reformed multilateral trade rules, many countries with ambitious climate goals are likely to enact measures like a carbon border adjustment mechanism, which create leverage to encourage climate laggards to green their economies. There is an important political economy aspect to this dynamic: if imports produced without high environmental standards begin to outcompete greener domestic products in home markets it will become nearly impossible to maintain voter support for policies to combat climate change.

Reform of the WTO to make it fit for an age when climate change has become an existential challenge should clearly be at the top of the global trade policy agenda. Yet the multilateral arena is not the only one where tensions between trade and climate are playing out. There are also risks to the relationship between the United States and the European Union—still the main supporters of an open, rules-based trading system—if they cannot align their approaches to carbon border adjustment. Both Washington and Brussels share the twin goal of protecting the climate and discouraging the migration of their industries to third countries with lower standards. Both are also likely to gauge the success of border measures not by how much tariff revenue they raise, or how many foreign goods are prevented from entering domestic markets, but rather by how soon the measures are phased out. That is because an early end to CBAMs would mean that U.S. and EU trading partners have established their own ambitious climate standards.

Yet the risk of conflict is real. The EU proposes to scale the imposition of a tax on imports “on account of the carbon price paid in a country of origin” (European Commission, 2021a). But the United States does not have a national carbon price and it remains unlikely that the U.S. Congress will vote to enact one soon. Instead, the version of a CBAM put forward in the Coons-Peters proposal relies on a combination of factors—the California and Northeast regional emissions trading systems, state renewable energy standards, and the compliance costs of the federal Clean Air Act—to approximate a national carbon price.

Unless the European Commission’s proposal can be modified during the legislative process so that it considers approaches to combat climate change that rely mainly on regulation, as in the United States, to be equivalent to those based on a carbon price there is a risk of considerable transatlantic trade frictions. The two sides have made some progress on alleviating bilateral tensions—for example, regarding the Boeing-Airbus subsidies or in agreeing to work together in a “U.S.-EU Trade and Technology Council.” But other irritants remain, including the national security duties imposed by the Trump administration on imports of steel and aluminum under Section 232 of the 1962 trade act, the U.S. Phase I deal with China (which arguably diverts Chinese imports away from the EU towards the United States), and the U.S. blockage of the WTO dispute settlement system’s Appellate Body.

In this uncertain context, it is not difficult to imagine how upsetting to transatlantic harmony it would be if the EU’s CBAM were to be put in place ahead of a similar U.S. effort without the two first aligning their methodologies for determining a carbon price. The result would be that although the United States and the European Union share similar climate objectives, U.S. exports could be faced with EU tariffs because of what are essentially different accounting methods.

This state of affairs would be detrimental to the transatlantic partnership. In the end, without U.S.-EU harmony on carbon border adjustment it is hard to imagine that there will be enough goodwill between them to cooperate on creating a broader climate club of like-minded countries, pushing for a climate waiver, or updating WTO rules. The transatlantic relationship will be a test case of whether climate protectionism—however unintended—can be avoided.

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