

**Open Trade With the U.S.
Without Compromising Canada's Ability
to Comply With Its Kyoto Target**

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Major policy issues

- Canada's energy exports to the U.S.
- Treatment of Canadian subsidiaries of U.S. multinationals in the initial allocation of permits
- Trading between Annex B Parties and non-Annex B Parties
- The roles of Kyoto flexibility mechanism and sinks
- Shielding vulnerable sectors and invoking trade measures against non-Kyoto Parties

Canada's energy exports to the U.S.

- Increased emissions in Canada as a result of increasing energy exports to the U.S.
- Incorporate the abatement cost associated with the production of energy exported in energy pricing
- Increase the amount of cleaner energy exports to the U.S.

Canada's proposal for crediting exports of cleaner energy

- **Its potential precedent-setting effects and legal basis?**
- **Viewed as an attempt to reopen the deal**
- **Crediting exports of cleaner energy is complex undertaking**
 - very complex to establish credible counterfactual baselines
 - Should the exports of energy-efficient goods other than energy be credited???
 - countries suffering from the damages from the exports of unclean energy would demand for compensation

Treatment of Canadian subsidiaries of U.S. multinationals in the initial allocation of permits

- Potentially make use of low cost options from their operations in Canada in order to meet U.S. emissions targets
- Obligated to follow the same rules and entitled to get access to Canada's assigned amount units
 - grandfathering versus auctioning
 - differential treatments on the basis of ownership in the initial allocation of permits
 - nothing under WTOs prohibits discriminating against new emissions sources

Trading between Annex B Parties and non-Annex B Parties

- **Transferring Kyoto permits to non-Annex B Parties**
 - Kyoto Parties like Canada allowed to transfer their permits to non-Kyoto Parties like the U.S.
 - the accounting of these transferred Kyoto permits in their national registries
- **Transferring credits generated by non-Kyoto Parties to Kyoto Parties**
 - require an amendment to the Protocol, but major parties have no interest in doing so
 - implications of this unlikelihood of an amendment
 - trade between Kyoto permits and non-Kyoto credits via a clearinghouse system

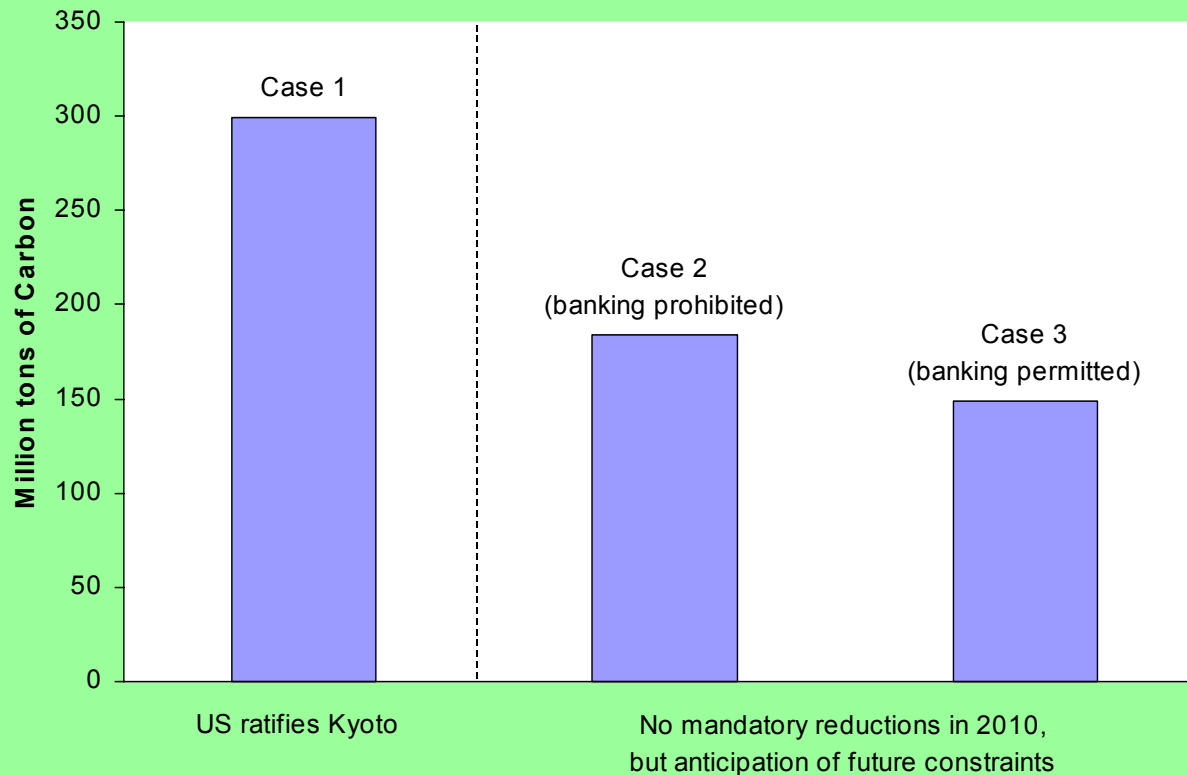
The roles of Kyoto flexibility mechanism and sinks

- **The policy context has changed substantially from the early days of climate change negotiations**
 - at Kyoto, Canada agreed to a target of 6% on the basis of U.S. parity effort at 7%
 - significant sinks credits allowed in the Marrakech Accords relax the emissions targets substantially
 - allowing the unrestricted use of Kyoto flexibility mechanisms makes much easier for the remaining Annex B Parties to meet their relaxed targets
 - these changes have converted the original Kyoto Protocol into a gradual-start agreement achievable at prices in the single digits

Why Canada likes to bear additional costs, if any, relative to the U.S. and the EU?

- Does the U.S. bear any economic costs even when it faces no mandatory emissions targets?
 - several U.S. states and many U.S. large corporations are moving ahead on their own
 - only a matter of time before being required to cut their emissions on their home turf
 - energy-sector investors anticipate mandatory tighter future constraints, and thus factor this into their near-term decision
- Why Canada takes on emissions commitments in the first place?

U.S. Domestic Emission Reductions in 2010 -- the impact of anticipation of future constraints. *Source: Manne and Richels*



Additional means of mitigating competitiveness (trade) concerns

- **Shield those segments more vulnerable to global competition**
 - potential costs are felt by concentrated, often well-organized industries in comparison with widely-spread benefits
 - proper considerations of the distribution of costs among industries
 - exempt these sectors from the carbon/energy taxes or give out permits freely to these sectors in the initial allocation of permits, either totally or partially
- **Invoke trade measures against non-Kyoto Parties**

Border tax adjustments

- **Offset the international competitiveness effects**
- **Should not be in excess of taxes on “like products” manufactured and sold domestically**
- **Used in the U.S.: Superfund Tax and the Ozone-Depleting Chemicals (ODC) Tax**
- **Distinguish between energy products (e.g., coal, oil and gas) from final products (e.g., cars)**
 - formidable technical difficulties in identifying the appropriate energy/carbon contents embodied in traded products
 - Should a tax on a product based on carbon emitted in its production be regarded as a direct tax or an indirect tax?

Compatibility of using trade measures against foreign environmental practices with the GATT

- **Has not been brought much attention until the findings of Tuna/Dolphin I and Tuna/Dolphin II**
 - Tuna/Dolphin I: all trade restrictions directed against environmental harms have to be territorial
 - Tuna/Dolphin II: extra-jurisdictional application of domestic laws permitted only if aimed primarily at having a conservation or protection effect
- **Discrimination based on how product is produced has traditionally had a rough ride in the WTO**
- **BTAs not permitted for taxes or charges on production processes or non-physically incorporated inputs**
- **Recent WTO Appellate Body decisions on the Shrimp-Turtle dispute have cast doubt on these interpretations**

Significance of the WTO Appellate Body decisions on the Shrimp-Turtle dispute and their relevance to the Kyoto Protocol

- Requiring other WTO members to adopt a comparable regulatory program may not be inconsistent *per se* with the WTO obligation
- In keeping with the Vienna Convention and customary international law, deny the U.S. legal standing to challenge, for example, EU measures to enforce Kyoto
- Would trade measures be upheld if challenged by U.S. under WTO, provided that the U.S. takes a formal step to withdraw from the UNFCCC?

Conclusions (I)

- **Ways to address increased emissions in Canada as a result of increasing energy exports to U.S.**
 - incorporate the abatement cost associated with the production of energy exported in energy pricing
 - increase the amount of cleaner energy exports to U.S.
 - the political and legal uncertainties and technical complexities associated with Canada's proposal have cast the doubt on the likelihood of getting through
- **Canadian subsidiaries of U.S. multinationals are entitled to emissions permits to operate in Canada. They should not be treated less favourably than similar domestic entities in initially allocating Canada's assigned amount.**

Conclusions (II)

- **Kyoto Parties are allowed to transfer their Kyoto permits to non-Kyoto Parties like the U.S.. However, recognising credits from emissions reduction projects in non-Kyoto Parties requires amendment to the Protocol. Canada and other major Parties have no interest at all in amending the Protocol to recognize these credits and allow them to enter the Kyoto market.**
- **The combined effects of the following factors suggest that additional costs bore by Canada would appear not that high relative to the U.S. and the EU.**
 - allowing significant sinks credits
 - allowing the unrestricted use of Kyoto mechanisms
 - anticipatory behaviour on the part of U.S. investors
 - great concern about the environmental effectiveness

Conclusions (III)

- **Canada would further mitigate trade concerns by shielding those sectors more vulnerable to global competition and invoking trade measures against non-Kyoto Parties. Unless the U.S. takes a formal step to withdraw from the UNFCCC, the U.S. could lose some of the protections afforded it under WTO rules in any WTO dispute brought by Canada, the EU or other Kyoto Parties. A WTO Dispute Panel or the Appellate Body could, in keeping with the Vienna Convention and customary international law, deny the U.S. legal standing to challenge policies and measures that Canada, the EU and other like-minded countries put in place to enforce the Kyoto Protocol.**

About speaker

ZhongXiang Zhang is a professor of economics at the US Congress-funded East-West Center, Honolulu, USA; Centre for Environment and Development, Chinese Academy of Social Sciences, Beijing, China; and China Centre for Regional Economic Research, Peking University, Beijing, China. As the author of numerous articles in a wide variety of international outlets in the fields of energy and environmental economics, trade and the environment, public finance and macroeconomic modelling, he has authored the book *The Economics of Energy Policy in China: Implications for Global Climate Change* (Edward Elgar, 1997), and co-authored *International Rules for Greenhouse Gas Emissions Trading* (United Nations, 1999). Currently, he is serving on the editorial boards of seven international journals (*Climate Policy; Energy Policy; Energy and Environment; Environmental Management and Policy; Environmental Science and Policy; International Environmental Agreements: Politics, Law and Economics; International Journal of Energy, Environment and Economics*) and one Chinese journal. He has also served as an expert/consultant to many national and international organizations, including UNCTAD, UNDP, UNEP, OECD, ADB, CEC, IPCC, and WRI. He has presented research findings in more than 25 countries over the past six years. He has been included in Marquis *Who's Who in Science and Engineering* and *Who's Who in the World*. He received a BS and an MS in energy engineering and systems analysis from Tianjin University (the oldest Chinese university), and a PhD in economics from Wageningen University, The Netherlands.