## ANNEX A

**Climate Change: Competitiveness Concerns and Prospects for Engaging Developing Countries**
**Committee on Energy and Commerce, Subcommittee on Energy and Air Quality**
**Statement of William A. Reinsch, President, National Foreign Trade Council**
**March 5, 2008**

I represent the National Foreign Trade Council, the country's oldest and largest trade association devoted specifically to international trade and tax policy. Our members are primarily global companies doing business in virtually every country on earth. The NFTC supports an open, rules-based trading system, international tax policies that contribute to economic growth and job creation, and opposes unilateral economic sanctions.

In my statement I want to cover three topics: WTO compliance issues surrounding climate change proposals, the likelihood of retaliation against unilateral action either inside or outside the WTO dispute resolution process, and our preference for addressing climate change through multilateral action. The first and third topics were addressed in detail in a paper we released last December titled, "WTO – Compatibility of Four Categories of U.S. Climate Change Policy," which I commend to the Committee's attention.

In making these comments, I want to make clear that the National Foreign Trade Council is not an environmental organization and has not taken a position on the merits of specific climate change proposals. We do, however, believe strongly that any action that is taken

should be compatible with our multilateral obligations, and we will continue to evaluate new proposals against that standard as they appear.

**WTO COMPLIANCE ISSUES**

In our paper we examined four climate change bills pending in the 110th Congress from the perspective of their compatibility with WTO rules regarding national treatment, subsidies, and whether the measures proposed are more trade restrictive than necessary. We do not – and cannot – conclude definitively that a measure is "WTO-illegal." First and foremost, WTO jurisprudence tends to be case-specific. Disputes are settled based on the facts of the case presented, and they are not always regarded as precedents for future cases where the facts might well be different. Thus, although one might speculate about whether a particular measure is likely to lead to dispute resolution and then draw inferences about how such a case might be decided, it would not be correct to make a definitive statement about the "legality" of a particular measure, since that can only be determined as the result of a WTO proceeding.

Following is a brief summary of our conclusions. For more detail I would refer you to our paper.

U.S. domestic policies to address climate change can, in principle, be compatible with World Trade Organization (WTO) rules and the multilateral trading system. However, some policy tools are likely to be more trade-distorting than others and conflict with

specific WTO provisions, raising the costs and jeopardizing the long-term success of comprehensive climate change abatement programs in the United States. For example:

- Energy efficiency requirements and standards, such as the renewable fuel standard found in H.R. 6, are likely to violate GATT Article III on national treatment. In fact, similar measures adopted in the United States in the 1990s were successfully challenged in a landmark WTO dispute. By contrast, CAFE standards in H.R. 1509 appear to be more WTO-compatible.

- Government-administered eco-labeling schemes in H.R. 6 may violate the WTO Agreement on Technical Barriers to Trade for constituting measures that are "more trade-restrictive than necessary" to protect the environment, even if this objective is "legitimate."

- Subsidies for renewable energy are very likely to violate the WTO Agreement on Subsidies and Countervailing Measures. For example, loan guarantees for renewable fuels facilities in H.R. 6 are financial contributions targeting specific industries and commodity products; they may act to increase the U.S. world market share in biofuels while decreasing foreign countries' U.S. market share in conventional fuels. Any subsidy that affects the export performance of a U.S.-produced climate-friendly good is likely to be prohibited under WTO rules.

- In theory, cap-and-trade programs may be one of the most WTO-compatible policy instruments available, but in practice, such programs are accompanied by standards and regulations, eco-labeling, subsidies, and other measures that raise WTO-compatibility concerns. In addition, a particularly alarming provision in S.

> 2191 creates a reserve of emissions permits for U.S. importers of foreign goods, which is separate and additional to the national reserve. It effectively imposes a tax on imports from WTO Members who do not utilize clean production processes and methods. This is likely to violate GATT Article III on national treatment and in the absence of a multilateral agreement will almost certainly be challenged by industry-intensive developing countries where environmental standards are not as stringent as in the United States.

The last conclusion, relating to cap and trade, is the only one in our paper that has proved controversial, and I want to spend another minute on it. Our analysis of cap and trade largely tracks that found in the Committee's white paper. While the provision in S. 2191 was clearly drafted to take into account previous WTO decisions, we believe it is likely that it will be challenged – as will virtually any action the U.S. takes – and we are not confident it will ultimately pass muster.

To go into the weeds a bit, we believe there is no dispute that an international reserve allotment program on its face violates GATT Article III. Indeed, the provision in S. 2191 implicitly acknowledges that by being specifically drafted to fit into one of the permitted exceptions – Article XX(g), which relates to conservation of exhaustible natural resources.

In the *Shrimp-Turtle* case, the Appellate Body suggested that to qualify for this exception, the measure would have to concerned with the conservation of an "exhaustible natural resource" within the meaning of Article XX(g), it would have to relate to the

conservation of natural resources, and it would have to be "made effective in conjunction with restrictions on domestic production or consumption."

There is general agreement the proposal meets the first criterion. With respect to the second, there are good arguments on both sides. If the Appellate Body were to conclude that the measure was primarily an economic one designed to level the playing field by increasing the price of imports from countries not adopting controls on their greenhouse gas emissions, it could decide that the measure only "incidentally" focused on conservation. The third criterion would depend on implementation. For example, if the U.S. provided plentiful free allowances to domestic producers, the Appellate Body might conclude the domestic and foreign restrictions were not comparable.

Even with those uncertainties, however, the most likely basis for complaint against this proposal would be under the Chapeau of GATT Article XX. To qualify, the United States would have to show that it engaged in "serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements, and that the measure itself shows flexibility in taking into account local conditions in other countries and that its implementation does not suggest an intent to discriminate.

The Article XX Chapeau is essentially focused on how measures are implemented, which means that any final judgment on WTO compatibility cannot be reached until after the measure is in place and implementation begun. The manner in which the International Reserve Allowance program is applied may pass the Chapeau of Article XX, following

the reasoning of the *Shrimp-Turtle* case, e.g. because Title VI of S. 2191 explicitly recognizes and builds cooperatively on UNFCCC principles and international environmental efforts. However, in contrast, the provisions in question may fail to pass the Chapeau through reasoning similar to the *U.S.-Taxes on Automobiles* case. In that case, two separate accounting systems were established for importers and domestic producers of automobiles, in effect regulating imported products based on their origin of manufacture rather than on any qualities intrinsic to the automobiles. The International Reserve Allowance Program also envisions subjecting imports to regulation based on their origin of manufacture, and via a reserve of allowances "separate from, and established in addition to" the domestic reserve. As both circumstances have raised WTO compliance issues in the past, in at least one case, it is appropriate to raise the possibility that this program may be vulnerable to an unfavorable WTO decision in the future. WTO panels have been careful to observe the unique circumstances surrounding each case that has come before them. The subjective nature of judging the *manner* in which the International Reserve Allowance program will be implemented, for purposes of the Chapeau of Article XX, makes it worthy of an on-going, constructive debate, particularly for those who wish to see the program succeed in the long term.

**OTHER RETALIATORY ACTIONS**

While much of the focus of debate on the trade-related provisions of cap and trade proposals has been on WTO compliance, there is also a significant likelihood states will retaliate outside of the WTO dispute resolution process. There is no question that a program which limits imports and/or increases their price would be opposed by countries

exporting the affected products. While they might well litigate, we believe it is also likely they would take other, more direct action.

Unfortunately, there is a long history in this regard. China, for example, when confronted with a U.S. action or policy it opposes, has canceled mil-mil consultations, rejected requests for naval ship visits, blocked proposed investments, canceled or reduced the scope of buying missions, purchased major items from other countries, and taken other actions to indicate its displeasure. As you can see, these actions are not always strictly in the trade area – they often spill over into foreign policy. The classic case of this behavior was in 1983 when the United States imposed textile import quotas. The Chinese response was to stop buying wheat and other agricultural products.

While WTO rules impose some constraints on such behavior, there remain many opportunities for nontransparent retaliation – new inspection requirements, "problems" with the customs authorities, surprise audits, unexpected labor problems, and so on. This is not to argue that the United States should not act for fear of retaliation, but in a globally integrated economy, the potential pain associated with these actions could be significant, suggesting that we should certainly be aware of the possibility before we act, do our best to minimize its likelihood, and prepare an appropriate response in the event it occurs.

**MULTILATERAL ACTION AND TIMING**

Finally, I want to suggest that the approach most likely to obviate all these various problems is a multilateral one in which all relevant countries agree to take parallel steps. This would significantly reduce the possibility of either WTO litigation or direct retaliation. We would prefer that the United States devote its energy to participating in and concluding a multilateral process. If it chooses instead to lead by example through unilateral legislation, it runs the risk of the problems I have described occurring unless it were to make its legislation contingent on other nations following suit.

At the same time, the final conclusion of our paper was that international law in this area is relatively unformed, which means the advantage will go to the early actor – the first proposals implemented will more likely become the template for slower countries and will more likely become the foundation on which WTO rules will be based in the future. Thus, it is in the United States' interest to act sooner rather than later in order to increase the likelihood that our approach will ultimately be regarded as legitimate. Many observers also believe the science argues for early action, which may well be so, but there are also legal reasons for moving sooner rather than later.