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IS A COLLISION INEVITABLE?

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Moderator

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## P R O C E E D I N G S

DR. BRAINARD: All right, if everybody can grab their lunches and get seated we'll keep moving.

For our lunchtime discussion, essentially we're going to step back a little bit. We've been kind of drilling down to certain aspects of the trade and climate and competitiveness nexus.

For lunch, I thought we would have two of the most thoughtful and eminent people in this domain reflect on the challenge that we have in front of us -- from two very different perspectives.

Stu has really been at the forefront of these issues at the senior-most levels in government as a negotiator and as a policy-maker. And Jagdish, of course is one of our most eminent and thoughtful trade thinkers.

So we thought perhaps the contrast between the way that we approach these topics in the world of practice and the world of theory would be interesting.

What we're going to do is we're going to give Jagdish first and then Stu a few minutes to kind of talk a

little bit about the issues, and then we'll open it up for questions and a broader discussion.

So, I guess I could tell you who they are. But I think I've already introduced Stu, and everybody knows Jagdish, so I will not do that. I'll just hand over to Jagdish.

DR. BHAGWATI: Thank you, Lael. It's a great pleasure to be back here at Brookings. I never miss an opportunity to come here.

And particularly today. For, like everyone, I have read that Obama has turned to Brookings, inevitably, for economic advice. So if I have your ear, Lael, and you have that of Obama whom I have supported from the outset and both hope and expect to be the next President, I am only smart to be here today at your invitation!

DR. BRAINARD: (off mike)

DR. BHAGWATI: Let me start with a general comment which is relevant as background to the theme of the Conference, and then move on to some of the specifics of the interface between trade, the WTO and the

environment that many of the splendid papers at this Conference are addressing.

At the outset, we need to remember that those who work on trade (mostly academics) and those who work on the environment (mostly activists), have traditionally been at loggerheads from time to time.

Why?

One important philosophical difference which underlies a whole lot of this tension, which I think we tend to forget, is that we trade economists are typically considering and condemning governmental interventions (specifically, protectionism such as the imposition of tariffs and non-trade barriers) mainly as creating distortions and harming general welfare. On the other hand, environmentalists are typically dealing with what are best described as "missing markets" (e.g. people dump carcinogens into lakes, rivers and oceans and emit them into the atmosphere and they do not have to pay for the pollution) frequently you're missing markets on environment. They therefore see government intervention (e.g. the use of pollution-pay taxes or

the use of tradable permits) as correcting a distortion. I just thought I would remind you of this fundamental difference in the experience and lifestyle of the people on the two sides of the trade-and-environment aisle, since that underlies and explains, to some extent, the frictions we occasionally run into. Of course, trade and environment are integrally related, and that's why a lot of disputes were coming up at the GATT, the most important being, of course, the celebrated dolphin-tuna case between the United States and Mexico as the principal parties.

I will return to the important issues raised by the dolphin-tuna jurisprudence and its later reversal in the shrimp-turtle dispute, also involving the United States. But let me start with the problems raised by global warming.

Dan Drezner, in his excellent remarks, pointed out that, in the past, we have opted for short-run adjustment costs with a view to long-run gain. I don't quite know what he meant by "short-run adjustment costs," but I would simply say that an

enlightened hegemon like the United States, when going in for the GATT, certainly did not insist on the developing countries having reciprocal obligations. It simply gave away membership. It was, in fact, getting the developing countries into the GATT while gaining nothing in terms of immediate, reciprocal opening of markets.

I think the intention was to create more legitimacy for the GATT by increasing membership. Down the road, then, you would have graduation and then begin to "collect". It is what we call "extended reciprocity" or "intergenerational reciprocity".

There were no "short-run" costs a la Drezner either. After all, the developing countries at that time, in the mid-1940s, were not important markets anyway; nor were they, by and large, major exporters. They were really small players in world trade and it was only later, when they had grown, that the usual question of reciprocity would become economically relevant.

So one may ask why that argument does not work with Kyoto at the moment. Why are we not willing to play

that old GATT game? I think we have to look into that question carefully to get a sense of where the problems might be with how we approach the design of what I like to call Kyoto II..

A key problem, of course, is that there are two big players, India and China, with current and prospective emissions of CO<sub>2</sub> that are simply large for India and huge for China. We didn't have anything like that at the time the GATT was formed: the developing countries were all little players in trade, for all practical purposes. Exempting India and China from the emission obligations of a climate change treaty today is then not like exempting the developing countries from trade obligations in the 1940s.

Moreover, India and China are not willing to make any payment to get into the Kyoto club, as it were, simply because they feel -- and this is where, I think, the real crux comes in -- that they did not contribute to past damages.

Now, if you look at the past damages, we know that the accumulated fossil fuel CO<sub>2</sub> for 1850 to



2004 shows the damage attributable to India and China as less than 10 percent, while the European Union, Russia and the U.S. jointly account for nearly 70 percent. So you have basically what I've called (in a center-page Financial Times op.ed. in August 2006) a "stock" problem, the problem of "past" damage to the environment which basically, we and the EU in particular, are responsible for. And the solution to this "stock" problem in Kyoto I, which was made to bring India and China on board, was to say, "Look, because we were the ones who imposed large losses on the environment in the past, and not you, we will exempt you from any "flow" obligation for reducing the current damage, no matter how large".

Now, the problem is that, in so designing Kyoto I, we were trying to kill two birds with one stone. And, of course, that stone is not something palatable -- to mix metaphors -- to the U.S. Congress. The U.S. Senate rejected virtually unanimously the Kyoto Protocol in 1992 because they thought that India and China were going to be free riders, when in fact the free ride

was being provided because they had not been riding for almost a hundred years while we had been! I think that the general feeling instead was that these countries were being let off simply because they were developing countries, presumably on a progressive taxation ground: but progressive taxation has become increasingly a hard sell (though an Obama administration may well restore it to some respectability again).

To recap, India and China were not free-riders.

Rather, their governments were saying to the Western nations: "Look, you have done a lot of damage. You've got this "stock" liability for past emissions. And you can't just get us to accept significant 'flow' liability for current emissions while you do nothing significant on the stock side."

So, I have always felt that Kyoto I was doomed, in a way, because we really could not get going on Kyoto I, as designed, until we addressed this particular basic issue clearly and directly in a transparent manner, and foregoing the fudge that mixed up the stock and

the flow dimensions of the obligations. I think problem is going to afflict Kyoto II as well. Frankly, what we're negotiating so far shows little willingness on the part of the presently rich, developed countries to accept the notion that they must pay for past damages; and so, it would be little short of ethical nonsense for them to ask India and China to accept much larger flow obligations. Now, this unwillingness to face up to the liability for past carbon emissions is rather strange, in the sense that the United States has already accepted (as I have noted in my 2006 Financial Times article), in her domestic environmental practice, the Super Fund approach under which, for hazardous waste, liability has been assigned, in eligible industries, for past damages, even when the pollution was not regarded at the time to be harmful. We are a nation that thrives on torts, indeed my Democratic Party does also, and we cannot deny that we have actually accepted the Super Fund approach in our own environmental policy. So, in my judgment, for us to go around saying that

India and China have to accept obligations on the flow side -- which I think is perfectly appropriate -- while doing nothing like a substantial Super Fund for past carbon emissions on the stock side, is to invite condemnation as a superpower play by nations, both EU and US, which are no longer quite the superpowers that they were once. You really need to walk on two legs and not just on one leg.

I see statements all the time, from even Al Gore and Bill Clinton, about the desirability of China and India accepting flow obligations. But, unless I have missed something, neither has publicly acknowledged the need for a substantial Super Fund for our stock liability. So much for their environmentalism: self-serving for the US, not cosmopolitan and just.

Now, the same problem arises in our trade negotiations because India, and several developing nations say, "How can you have to this day sizeable trade-distorting agricultural subsidies, and then expect us to open our agricultural sector to competition from such subsidized exports by you." In fact, the Doha

Round talks collapsed in August 2008 precisely because India claimed that nearly two-thirds of its people were in the farming sector, most were subsistence farmers, and the US had only 2 million, often large, farmers with much larger subsidy support. So, India wanted a Special Safeguards Mechanism which, in my view, was excessively cautious, citing our subsidies. Remember, of course, that the US itself had introduced Special Safeguards against China; and that nothing works better to get protection than to allege, often without any basis, that the exporters are "unfairly" subsidizing exports to us! Yet, when the talks collapsed, the USTR and an obliging media, and the Congress in turn, zeroed in on India as the rejectionist culprit!

So, as we draw analogies between trade and the environment, let us remember that unless we bring to both negotiations, each extremely important, the notion that we cannot just impose on others what we want, often to our presumed advantage regardless of the others', we are likely to meet with failure.

Charles Kindleberger famously called the United States an "altruistic hegemon". I fear that it has increasingly tended in recent years to become a "selfish hegemon".

I should add that it is not just the United States that is a problem. I see little attention being paid to the stock problem in Europe either. As Senator Obama has said about Senator McCain: he is a good man; it is just that he does not get it. So, when I was in Florence recently, and Tony Blair was in the Chair and talking about what he was doing on the environment, Kishore Mahbubani, I and others from the developing countries drew his attention to the Super Fund idea. He continued through the session as if he had heard nothing! As Senator Obama would have said: Prime Minister Blair just does not get it. But unless he, Gore, Clinton and others get it, do not expect that Kyoto II can be signed and ratified by India, China, the US and EU.

Now, let me turn to the problem raised by the notion, fashionable in Congress these days, that if India and

China do not accept emissions obligations, we would impose a "border tax", better called an import duty, which is equal to the carbon tax that they are not imposing in sync with ours. This is, of course, like the idea which the French floated against the US, saying they would tax our exports to EU because we had not signed Kyoto I. This issue, of course, takes us back to the tuna-dolphin case in 1991 at the GATT. When tuna-dolphin came up, the environmentalists were terribly upset that the U.S. lost the case. At that time, I happened to be the Economic Policy Adviser to Arthur Dunkel, the Director General of GATT. And so I was consulted by the Legal Adviser, Frieder Roessler, on the ongoing case and what the position of the Secretariat should be. The focus at the time was whether specific Process and Production Methods (PPM) should be allowed to be prescribed for import eligibility I.e. could the US specify that tuna should be allowed to be imported only if purse-seine nets which also caught dolphins were not used.

Coming from the economic side, I felt that

PPMs, as a general case, should not be allowed to be so used to regulate entry of imports because they could be used to discriminate against specific suppliers while appearing facially non-discriminatory. After all, we have all been brought up in international trade on the famous apocryphal example (based however on a real case) of imported cheese being taxed by Germany if it was produced by cows grazing at 4,500 feet and above, with bells around them and under Alpine conditions. This was obviously aimed at Swiss cheese though, in principle, if Tanzania were to satisfy the conditions, Tanzanian cheese would be equally subjected to the same high tariff. The use of the PPM could then defeat the intent of non-discrimination required by the GATT. So we were coming at the PPM issue from the trade side, because the GATT was a trade institution. And we didn't really think of the environmental aspect specifically at that particular point (except that, if the issue fell under Article XX, greater leeway was permissible).



So the position we took was that the legitimation of a free use of PPMs to regulate imports would open the door to indiscriminate use of de facto discrimination in trade among different suppliers, undercutting the basic principle of non-discrimination underlying the GATT. Anybody could say the way you produce something, no matter how or why, is unacceptable! We could not see how de facto discrimination could be contained; it could proliferate hugely.

But the shrimp-turtle decision years later, by the Appellate Body, basically reversed the dolphin-tuna jurisprudence, ignoring our caution. It meant that we would now be opening the floodgates for all kinds of PPM prescriptions that would afflict anyone, on any issue (though we had also argued that the situation would be asymmetric between weaker and stronger nations as it was unlikely that the weaker nations could take on the stronger nations in this essentially arbitrary fashion: a worry that has been expressed by some prominent NGOs in the developing countries also). I was among the few who thought that this decision was

ill-judged, revealing the weakness of an Appellate body where familiarity with legal jurisprudence and practice is not a requirement for an appointment to the body. Now, I would simply say that the chickens have come home to roost against the US itself. The French plan to tax imports from the US because the US had not signed on to Kyoto I was exactly the kind of thing I had predicted. And now the US, which has among the lowest gas prices in the world, believes absurdly that, instead of being subjected to PPM restrictions itself on grounds of inadequate energy prices, it can put import taxes on such PPM grounds against India and China! And, frankly, what would then prevent India from discriminating against US exports on the ground that the US does not have a Super Fund? I could go on endlessly. This way lies chaos, just as I had argued to Roessler, and to Arthur Dunkel, during the dolphin-tuna Panel.

I think we need to be very careful about not going down that route which has been opened up by US legislation and the WTO ruling in support of it in the

shrimp-turtle case. If we go down that route, we are likely to be the losers in the end, certainly on energy and environment.

And I think we ought to tell the Congress that, look, this is a game everybody can play, and if we go down that route through more legislation aimed at using the shrimp-turtle decision, we will likely be the losers.

DR. BRAINARD: Stu.

AMBASSADOR EIZENSTAT: It's a pleasure to always be able to share a platform with Lael, and I appreciate her organizing this really important conference. And Professor Bhagwati is really the top of the class in terms of trade worldwide. And everything he says deserves an enormous amount of attention and respect. I want to reflect on two things: some general notions of where things stand following the so-called Senate debate on climate change last week; and, second, on the trade and competitiveness provisions in Boxer-Lieberman-Warner, and the political dynamic that's emerging from them, and that will get us into the next session, as well. I have to leave just a few minutes

before two, but we'll look forward to hearing about that.

First, reflections on the Senate debate, we've frankly seen spin on both sides regarding that debate.

Supporters are claiming victory based on the cloture vote Friday morning that was defeated 48 to 36, by suggesting that the 48 votes in favor of ending the debate, plus the six additional letters of support from Members who couldn't attend the vote, means there are 54 votes in support of a comprehensive global warming bill, which is more than we've had before -- and that is true. It's still not 60 votes. But I also wouldn't bank on what will happen in a real vote, and that is because 10 moderate Democrats, in a letter to Senator Boxer and Majority Leader Reid, of June 6, made it very clear that while, in general, they favored action, they would not support final passage of the Boxer substitute in its current form. They gave a whole variety of reasons, including economic impacts, and protecting the manufacturing sector, and so forth, for saying that. And that's just on the

Democratic side.

So the notion that we're going to be able to get, let alone, 67 votes for a treaty, 60 votes -- 60 votes -- to break a filibuster -- it's not 50, and it's not 51, we need 60 votes in order to break a filibuster -- is something that's a very, very tall climb. And one of the harsh lessons of last week is when people start to talk, as the Republicans -- they had very clear strategy, which the Democrats didn't -- which was gas taxes and gas taxes and gas taxes, costs and costs and costs. That's what they did and frightened everybody. The bill was pulled. And so much for the debate. So, we've got to be able to address these if we're going to have any chance of success.

On the other hand, the opponents seemed to relish the opportunity to talk about these high gas prices and tax increases, somehow tarring a cap-and-trade bill as a cap-and-tax bill that would threaten to undermine the entire economy. How ironic that at the end of the week the Republicans were eager to continue debating the bill, because they saw themselves scoring

political points, and it was the Democrats, who had insisted on the debate to begin with, who wanted to pull it off.

Looking back at the week as a whole, at the same time -- if you can sort of get over this fog -- there were perhaps a few bright spots in the midst of something I had not seen in my time in Washington, which is literally the insistence on forcing a reading of a 500-page bill, word for word. I mean, it's really quite an extraordinary step to do that. But what it did show is with a very few exceptions, people bought the science. They were now not arguing about the science, anyway.

Second, that there is a general consensus that a cap-and-trade method is a mechanism which people will support with, again, significant differences, but that that is also important.

And, third, that there is an urgency about action.

Now, those are not unimportant as we move into what will be certainly the mother of all legislative fights next year. And we're fortunate that we have two

Presidential candidates, both of whom support the notion of dealing with climate change.

Now, here are the lessons that I took from last week, in addition to the ones I've just mentioned, which is that there is at least an emerging consensus. And when one combines that with what's happening in California, with the RGGI process, the Regional Greenhouse Gas Initiative, with about a dozen mid-Atlantic and northeast states, what's happening in the business community with the creation of USCAP. I'm on the board of the Chicago Climate Exchange. We have 300 companies who will voluntarily trade 40 tons of CO<sub>2</sub> emissions this year. There is a lot of coalescence, it's a sea change in the way Washington looks at things.

Now, having said that, let me give some perhaps harsher lessons.

First, a significant gap between the position of much of the environmental community has illustrated that their support for the Boxer substitute and what is politically achievable in the near term. Now, this is

not to be negative to the environmental community, with whom I've worked very closely on forestry provisions, and who have put us largely at least where we are in terms of this emerging consensus that something has to be done.

But it is a statement of fact: if we want climate change legislation any time in the next couple of years, we will have to close the gap between what the environmental community feels is necessary, and what is politically achievable.

There frankly were elements of the environmental community -- and I would say by no means all, but there were elements -- who did not want a bill to pass this year. They said, "Let's wait until Nirvana comes next year. We'll have a supportive President. We'll have maybe five to seven more pro-environment votes coming out of the elections, the Senate elections, in 2008."

We've really got to find ways to bridge the view that somehow when 2009 comes with a new President and new Congress that all of this will change. That letter,



again, from the 10 moderate Democrats should be a very chilling factor.

It's not clear that a new administration's support of climate legislation, plus the additional seats, will be enough to pass a bill like the Boxer substitute. Despite, as I mentioned, the cloture vote, we know that there are these swing votes in both parties not ready to vote for a bill like this -- one that, by the way, I feel completely comfortable in passing. So let me make it clear where I stand.

Of course, the fact that we have a bill that was reported out of committee, debated on the Senate floor, and that Republicans didn't oppose the motion to proceed, does demonstrate real progress. Again, I think it is only time before we get legislation, given all the other things that are happening in the states and with the corporate community.

Second, the key issue that will determine success in dealing with bridging this gap is a jobs and cost issue. People accept the science, they accept the urgency, they are not willing to accept -- at this

point -- the costs and job implications until they have a better idea of how to deal with it.

The take-home lesson -- and that's what we need a much more concerted effort at building on what Brookings and the Center for American Progress and others are doing -- is to make the case for why a new low-carbon energy economy means jobs and economic opportunity for the U.S., and will improve our economic security. But at the same time, we have to recognize that there is going to be a very lengthy and very painful transition period, and cost controls are essential.

I can't guarantee this, but my instinct is that if the Bingaman proposal, which never got out of committee because Senator Domenici, he's chairman of the Senate Energy Committee, Senator Domenici, his ranking member, did not support any cap-and-trade bill. But if they had been able to get his bill out, which has a safety-valve of \$12 or \$13 a ton, you might have actually gotten, in this Congress, 60 votes.

Now, I can give you, speak an hour, on why a safety-valve is a bad idea. I'm only using that as an

example of the fact that you've got this collision between a consensus that something has to be done, and a real fright about the costs and implications -- particularly when our trading competitors, like China and India, are not going to be taking those obligations.

We've got to be able to focus on this cost-control issue in ways that make sense. Safety-valve does not necessarily fall into that category.

Third -- and I think this was something that was inherent and, indeed, explicit in Bill's paper, and I hate to say this -- we're not going to get, in any reasonable period of time, 67 votes for a treaty.

It's not there. For all the reasons that were discussed, getting two-thirds of the Senate to support a post-Kyoto treaty with binding targets that are not taken economy-wide by China and India, is not going to get us two-thirds support.

Byrd-Hagel was there. Marty was part of this, the staffing, Senator Byrd. I got a very emotional call from Senator Byrd when I was at Kyoto in the midst of

negotiations. I had known him from Carter days, and I had a great respect for him. And he called up and he said, "Stu, I want to tell you something. I have a granddaughter, and I'm from a coal state. But we need to deal with climate change." Now, remember, we're talking about over 10 years ago, when the science was much less accepted. "I accept the science," he said. "I want to deal -- even though it will be a sacrifice for my state, I want to have a negotiation that will lead to success so that my grandchild will not live in a world in which climate change takes effect. But," he said, "It's got to be fair, and we can't allow China and India to get off scot free."

Now, that's, Professor, just the reality. I mean, we can talk about all the theory. That is the reality. I'll never forget that talk, it was very, very much from the heart.

So we're not going to get 67 votes. What we need to look at is how we can get 60 votes. And I understand the enthusiasm for Congressional-Executive agreements, as someone who spent a lot of time negotiating on

behalf of the Executive, and I see the appeal.

But we've got to figure out, at least initially, how to get 60 votes, and then -- and here's my thesis, and Lieberman-Warner has this in there -- the way you create initially an international regime is not by getting a 67 vote treaty, because it's not going to happen. It is, rather, getting 60 votes for a cap-and-trade program in which there is an allowance provided, as Lieberman-Warner did, for international trading by U.S. companies to meet a percentage of their obligations by trading with countries who are part of a mandatory system so that, for example, the European trading system and the U.S. could trade with each other, and vice-versa. The deeper the market -- and, Jeff, you were part of this when we were doing the cost of Kyoto with Janet -- the deeper the trading system, the lower the compliance cost. The more countries that are trading, the cheaper it is.

So we've got to figure a way out -- and that's one of the great intellectual problems of the safety-valve.

If you put a \$10 or \$12 cap on carbon, like Senator

Bingaman would do which, again, might have passed, and then you've got the European trading system at a fair market value for carbon, how do you create a trading system in which the two can trade with each other?

And so we've got to figure out conceptually a way in which we develop this international system and rules for that trading system. It's a free trade, just like you would trade any other good, as long as the price is a world price.

And that's why, again, we need to focus on building international linkages within our trading system, and that's what the bill and the manager's package did.

It also included forestry credits as part of that, allowing up to 10 percent international forestry credits. But, basically, 15 percent of a U.S. company's obligation could have been satisfied by international trading, not just trading within the U.S.

Again, given the importance of deforestation as a source of emissions, 20 percent of global greenhouse gas emissions, and the fact that it's the dominant source of emissions in many developing countries --

indeed Indonesia and Brazil rank third and fourth as the biggest emitters when emissions from deforestation are taken into account -- a provision in U.S. legislation that allows those countries to get credit for reduced emissions, even if they don't take economy-wide obligations, is a way, Professor, of beginning to get that into the system by sectoral agreements.

Now, on the specific issue of trade and competitiveness, let me offer a few comments on the bill and last week's debate.

We're fortunate to have in the room the architects of that provision in the manager's package that was in Lieberman-Warner and, indeed, in Bingaman-Specter, and that is Marty McBroom and Andy Shoyer. And I had the pleasure of meeting with them last week. They've done a terrific paper, making a very strong case for WTO consistency, including on the environmental exceptions. I believe that we're not going to get 60 votes unless we deal with something like this. Our objective is to find some way in which we can create a WTO-consistent

model that deals with the China-India situation. I mean, one thing that I can perhaps bring to the table is just a practical, hard-headed judgment about how we get from here to there. And that is going to have to be a component.

Indeed, one of the things that I think is important to recognize is what the alternative -- what the alternative was, to that trade and competitiveness model. And that, basically, that provision in Lieberman-Warner would have set up a sort of carbon equalization system, a border adjustment, in which you somehow require people to buy emissions, importers of foreign products, from countries that aren't part of a mandatory system. That's the basic thesis. Again, this is not the place to talk about the details of the WTO compliance. There's a case that can be made that it is, a case that can be made that it's not. It's going to be a tough issue.

But let me read to you what was in the 10 Democrats', the moderate Democrats' statement about why they would oppose Boxer. And I'm just going to read the



provision on this issue on trade and competitiveness.

"The Lieberman-Warner Bill contains a mechanism to protect U.S. manufacturers from international competitors that do not face the same carbon constraints. If this mechanism," they say, "Does not work, or is found to be non-compliant with the WTO, then the program needs to be modified or suspended." And that's how drastic their -- these are 10 votes that you can't get to 60 without. You can't even get close to 60 votes without these votes.

But what was the alternative to this?

Waiting in the wings, as Marty and Andy identified when William Boyd and I met with them last week -- waiting in the wings was a steel amendment, supported by the steel industry and the steel unions, and here's what that would have done -- talking about WTO compliance issues. It would have said that China and India and developing countries have to make the same reduction in emissions as the U.S. would make -- identical.

**SPEAKER:** (off mike)

AMBASSADOR EIZENSTAT: I'm sorry -- what, Jeff?

SPEAKER: Were they specific about that? Were they specific about relative to today?

AMBASSADOR EIZENSTAT: No, in other words, relative to 1990 levels, or whatever the base level is.

SPEAKER: Specific to the U.S.

AMBASSADOR EIZENSTAT: Yes, the same ones that we would make. Whatever we adopted, whatever base year we adopted and whatever percentages, they would have to do the same.

So, I mean, that's a show-stopper if there ever was one, and maybe it would have been defeated. But I only use that as an example of the fact that that was waiting there and would have attracted a lot of support, a lot of political support.

So although there have been concerns raised about the merits of the current provision from the WTO perspective, there is a colorable argument to be made, but the bottom line is there's got to be a way in which we deal with this. There are issues. Because in the provision in the Lieberman-Warner bill, the

test for judging comparable action -- mind you, it's not the steel amendment -- you want comparable action before an importer has to purchase certain allowances to make up for the carbon differential. You're measuring non-quantitative things, qualitative measures which developing countries can take against a quantitative requirement by the U.S.

But the point is, this is something that's got to be addressed.

Now, let me deal with one other point in closing. If we accept, as I do, the political fact that any bill that hopes to pass must include some kind of China-India provision, it's very important such a provision be WTO-consistent. Maybe we can talk about energy efficiencies and other things. But it's got to somehow buy off on this argument.

We've got some time to debate the issue. We've got some time to look at it. But this is what we need to focus on.

Second, notwithstanding the politics of the issue, we need more economic analysis, more modeling of trade

flows and costs of compliance to inject real data into the debate. It's an extremely complicated intellectual undertaking, but we have some time to do the analysis and better understand what's at stake.

And then last, we are not alone. I met -- as I alluded to at the beginning of moderating the previous panel -- I met with a senior official whose name will not be mentioned here, but a senior official who is at the absolute center of the preparation of the EU's legislation, which will be introduced at the European Parliament very shortly, how to modify the European trading system and so forth.

And he said to me the following. He said, "We are under -- " -- and this DG environment talking, so you're not talking about the DG enterprise, or people who are not sympathetic. And he said, "We're under tremendous pressure from cement, from steel, from aluminum, from paper, from glass, that they're all telling us 'we're out of Europe.'" This sounds like a familiar litany, "We're out of here, and we're going to developing countries that don't have this

obligation unless we get some mitigation."

"So," he said, "We're looking at two options. Option number one is just giving them free allowances, basically, for some transition period. You just say, 'you get a wash.'" Now, of course, if you're going to meet that 20/20 goal, that is 20 percent reduction by 2020, it's got to be shifted somewhere. So presumably to utilities or whoever. But that's one option.

And the other option -- which seemed, from reading between the lines of our meeting he seemed to be leaning toward -- was a carbon equalization system, which he insists is WTO-compliant because it would be imposed, as well, on domestic manufacturing companies, but would be rebatable at the border, like the VAT -- which has gotten a pass for -- I've never been able to find a person in the U.S. who actually would own up to giving the EU that pass, and I came squarely, confronting it with the foreign sales corporation issue. But that's another story.

In any event, the fact is, the EU is seriously entertaining a very similar process to what was in

Lieberman-Warner. And here's a guy I've know for 20 years, who comes from the -- well, I'm giving away too much.

In any event, he knows a little about trade, as well. And I found it a very sobering statement, which reinforced my notion that we've really got, Professor, to put our noodles together and come up with some way in which we can convince Congress that this is not a free ride. You're absolutely right that the damages in the past are our damages, largely. No question about it. And that's why we should lead and not say "We're not even going to pass domestic cap-and-trade legislation until they act." We've got to take the lead. We've got to show we're serious.

But going forward, there is a legitimate argument on competitiveness that if they're not required to do anything going forward and we are, and they're major competitors, that there is a competitive issue here. And we've got to just face that head-on.

So that's why I think this is such a terrifically important conference. Again, applaud you for doing

it. And I hope that in the afternoon sessions we can begin -- as Professor Bhagwati did at the luncheon speech -- to really address this issue head-on.

(Applause)

DR. BRAINARD: Why don't we just open it up for a general discussion for a few minutes. Just put your card up if you have a comment or a question.

Jason?

DR. JASON BORDOFF: I wanted to ask both of you, but perhaps more Stu, how differently you think this question we're talking about today of competitiveness and leakage would be addressed, depending on the outcome of the election in November. We have two candidates who are on record in support of the cap-and-trade system. At least one of them also wants to waive the Federal gas tax for the summer, so it's not entirely clear they understand what a cap-and-trade system to energy prices.

But on free trade, at least the rhetoric sounds quite different from these two candidates regarding what they really think about the benefits of free trade.

Do you think it will make much difference?

AMBASSADOR EIZENSTAT: Well, that's a good question. I mean, obviously, Senator McCain has taken a more pure free-trade position than Senator Obama. But I think when it comes to this issue, I suspect there will be very little difference, because both are going to have to deal with the political reality of how you try to get 60 votes in the Senate, and deal with the China-India competitiveness issue. I mean, that's what was, in essence, the basis for Byrd-Hagel. I'm glad that it was mentioned that this was not a reaction to Kyoto. It preceded it, and it was a reaction to the Berlin Mandate.

And when I came to Kyoto as head of the U.S. delegation, I was bound by that. I mean, we had already agreed, and I remember saying, "Why do we agree with that?" And we basically had a decision to make at Kyoto.

We spent 85 percent of our time dealing with the EU and trying to convince them that we should not have to make all of the reductions in emissions from



domestic means, and that trading was absolutely essential for an efficient system. They objected to the fare-thee-well. And we ended up, at then end of the negotiation -- a half-day past the end of the negotiation, they were already building, in the Trade Center, the next exhibit that was coming up, the air-conditioning was turned off. The translators had left. And our team -- you remember the neutron bomb that was supposed to kill people and leave the buildings intact? Well, all of my team was completely planked out on the floor exhausted from 12 days of negotiations. The building was intact. None of us were. And finally the EU agreed to a language which could be interpreted both ways, but basically allowed us to have unfettered trading. Now they're relying on that 100 percent. So I think the reality is, Jason, that there's not going to be that much of a difference because this is not fundamentally a trade issue. It's an economic and cost and jobs issue.

SPEAKER: I'll just add one point which I think, if I recall, you're Stu and I'm (inaudible).

We live in a barbarian country as Isaac Berlin used to say. People address each other by their first names at their first meeting. But, I think it's, again there's a peril with trade again, which is we have decided on the fast track, right, trade promotion authority. Essentially they were going to put in labor environmental standards as part of our trade negotiations. Fortunately, we haven't really applied it to the multilateral system yet. But, you need that in order to arrive at a political consensus in your own system. But unfortunately trade involves two parties at least, right? Not just you, but also others. So if others don't agree with this particular compromise that you want to put in to get your consensus, you're getting into trouble. Now I totally agree with you as to the -- you have to have India and China. I'm also in favor of having India and China, but I think that to assume identical obligation in terms of a carbon tax, for example. Because if it emitting into a pool up there of CO<sub>2</sub>s, then there is a good economic argument saying everybody must pay the

same tax rate. But, I'm simply saying that if we do just that, or even give them a little fluctuation and say if you have less politically, you still have to do the other thing and I think we better start thinking seriously about it if we want to reach an agreement, because unless you want to follow the Bush principle of getting a coalition of the willing, you're not going to be able to really carry it through. So all I urge is that yes, it's a competitiveness thing. It's also an efficiency thing in terms of having an efficient system of taxes you pay. And I think this is really the issue I think. If you could pull it off and if you could somehow get India and China to agree without any kind of super fund or anything, any analytically correctly formulated fund -- I mean lots of people have said we must have a fund. But it's like (inaudible) must have more aid. But here is our, what I'm saying, there is an analytical basis for saying that it's a tort payment and therefore should be used. I think that ought to make it a little bit easier to (inaudible) to a country which is so, so

hell bent on torts.

SPEAKER: Let me just say one other issue which is trade (inaudible). It's a little different than the one we've been talking about. And that is one of the costs on technology transfer from developing countries is maybe their part of a sort of global bargain, is they may insist on reducing protections to intellectual property. It's sort of the energy equivalent of the pandemic issue with HIV-AIDS and so forth, where basically patents were just waived to trade, to transfer pharmaceutical drugs that were not considered affordable. And I can see a situation, Professor, where China and India will say, okay, maybe we'll play in this, but you have to transfer technology in ways that don't protect your intellectual property and we'll have another set of trade issues then we'll confront.

DR. BRAINARD: How tight is your time? Do you need to walk out? In five minutes? Okay. Why don't we do the following. Let's go around the room. Everybody can talk for 30 seconds each and then we'll

go back for the grand synthesis and each person will get 60 seconds. So, let's start with Steve and go to Arvind and go around that way.

STEVE CHARNOVITZ: Two quick questions and one per (inaudible). How important is the WTO? I mean, is it so important that we ought to have a norm that every time two rights in its climate legislation that any event that our laws (inaudible) WTO, our law is repealed or the provision is repealed? Is the WTO that important that we would want to put that kind of mechanism in our law and ask Europe to do the same? And then for Jagdish, with regard to your argument about the stock, the CO<sub>2</sub> in the atmosphere wasn't always harmful. I don't think it was harmful say in 1850. What's the principle of which one would set, use the tort analogy, when did this become a tort? And would you then propose that the United States then put money into a fund for the benefit of the whole world to make up for whenever this action really became harmful?

SPEAKER: (inaudible) I think (inaudible)

doing both (inaudible) this is not a common (inaudible) -- policy (inaudible) climate changes way down somewhere perhaps is there. So it seems to me that at some point, given the fact that how important it is for the U.S. to have China and India on board, and I can't imagine that for China it's terribly different from what it is for India in terms of how they view this. Somewhere I think this issue (inaudible) to bring in and certainly you have the importance of India and China being a part of the (inaudible) it really is (inaudible) appreciate (inaudible) -- that we've (inaudible) -- U.S have to be addressed.

SPEAKER: Thank you. Rather than waiting for the appellate body to put some flesh on the bones of what Article 20 can mean for a Lieberman-Warner type provision, do you think that there is a utility in getting the climate change negotiators or the WTO negotiators as policymakers to try to elaborate on what, for example, the definition of comparable might be or under what circumstances these types of trade

measures would be viewed acceptable from the viewpoint of the international community?

SPEAKER: Yes. Some of the issues around linking international trading regimes, I think get very complicated fast. First, whether it reduces costs or not does depend on what the caps are. But the politics in each jurisdiction of negotiating the obligations between sectors and within sectors tends to be very region specific. And so once you then link to trade sectors, the debate that went on in Europe may have treated the steel industry very different than the debate in the U.S. or Canada. And once you link them, the same competitiveness issues now flow between the nations. And I think that frankly is a very big challenge and you see it even within Europe in terms of the different member state national allocation plans already. And the systems that we see under discussion in Australia, the U.S., Canada and Europe are very different in their coverage and the way they treat different sectors.

DR. BRAINARD: Martin.

MARTIN McBROOM: In addition to the great comments offered by Mr. Eizenstat, I would only add that when AP designed the proposal it made into Bingham and Spector and now in Lieberman-Warner, we did so to try to draft something that would be consistent with the operation of cap in trade and from an environmental perspective, and my instructions to Andy Shoyer across the room were to find something that would be WTO compliant. I think Mr. Eizenstat hit it head on, that what you're going to see in the future are proposals coming forth that are nothing more than trade protectionism and using climate change as a means to bring that about. And that's clearly what separated us from the Still proposal in the Senate and I think that's increasingly what you're going to see as this issue moves forward -- proposals that try to work within climate change and integrate themselves with cap in trade versus those that are just using climate change to advance a trade agenda.

SPEAKER: I think I would just say that I agree very much with Professor Bhagwati that you can



see the necessity domestically for a provision to deal with trade issues to get a piece of legislation past, but there is simply no way that that is going to force any other country to the table. And it's actually going to act as a disincentive to many other countries to actually join in a consensus. I can speak as one who's sat across the table from the United States negotiators, some of whom are in this room, and there are very few threats on both the trade and the climate change tables, I should add. And there are very few of those threats which actually act as incentives to either make concessions or be continued at the table. But, the thing that I think is even more important is: what is the incentive for India and China to actually come on board? And I think Stu Eizenstat actually made a very important point, that it's the incentive of trading and being able to -- the economic incentive which is there. It's not actually creating a fund, because I cannot imagine a situation where companies like my own would be willingly taxed here in the United States, and in other countries like Australia,

for that, the funds from that transfer to be automatically put in a fund for subsidizing our competitors in China and India. That simply is not going to happen I'm afraid. And so -- and I think if you look at the proposals for distribution of the allowance allocations that are currently in play here, is that there are lots and lots of groups within the U.S. who would be, apart from companies like my own, who would be very loathe to see the, their, them being taxed or their allowance allocations that they believe they are entitled to, actually going to, for other (inaudible) into an international fund to be administered by a group of international negotiators from a global environment organization. Again, I don't see that sort of thing really happening. So I think we do have a genuine dilemma here about what is necessary for incentives within the United States for legislation and what are the ingredients necessary to actually deliver a proper global framework. And so we've really got a lot more work to do.

**SPEAKER:** I think Stu's story of 60 voting

senator on China and India is interesting, but suppose you're working for Chinese Congress. You will see another picture. China has already adapted your full emissions standard for vehicles. That is even more stringent than California standards here. So is it -- if you are working for China, is it possible for China to give a proposal to apply imported tax for American cars. This is one case. Another case, the refrigerators and air conditioners, the energy saving standards, the (inaudible) actually is much more stringent than the U.S. These are existing products in the Chinese market. China can also say, 'Okay, for import of the U.S. air conditioner and refrigerator, we're going to tax it.' Even more complexity you (inaudible), USTR is negotiating at this proposing to the Chinese delegation in Geneva to force China to (inaudible) trade of EU has already done it before. This is totally another direction. The Chinese are arguing, 'See, we don't want to export more because of climate change.' So, now China is forced to export more. It's really complex. So what's your reaction?

Thank you very much.

DR. BRAINARD: I'm going to cut off the last few and we can either bring them forward in the next one or if they're from Jagdish, we can perhaps take a few extra minutes. But I know Stu's going to have to leave. So why don't Stu and Jagdish react to this round.

MR. EIZENSTAT: These are all very good questions. Let me just say first that, Steve, I think that it would be unfortunate and a huge burden on WTO dispute resolution process to put the whole future of our climate debate in the hands of a three-person panel. I mean this could be the end of the organization really. I mean whichever way they come out, it would be a very troubling issue and yet, you know, how else do you resolve this? And, so I think that it's something we really have to look at very seriously. I'm sorry I've got a kid coming. Hello. Yeah, I'll be there in two minutes. Okay. Thanks.

SPEAKER: This is what he used to do at the negotiations.

MR. EIZENSTAT: I think it's a very serious burden to impose on an organization that's already, you know, reaching the edge of acceptability. I mean I was really, frankly, pleased even though I was on the other side of the thing when I was Deputy Treasury Secretary. We had lost the FSC battle, the Foreign Sales Corporation battle. We tried to revive it by another piece of legislation. We lost again. Took three tries by Congress basically. But the fact is there wasn't one member, no matter how conservative, who said who the hell are they to tell us to change our tax system. There's nothing more domestic. There's nothing more in the way of sovereignty than your own tax system, but people accepted it right and left and they made the change. I'm just concerned about how much of a burden we place on them. So I think that the fact is that this is a very precious institution and we need to nurture it and make sure that we don't get it into areas where it's really not terribly comfortable. But that may be the only ultimate (inaudible). Tom, your point is a very

strong point. Any time you negotiate, if you don't see how the other side looks at, then you're not going to achieve anything. Now, if we were living in a sort of perfect world of politics, what I would prefer is to have the U.S. accept its responsibility, do a cap in trade program and make the developing world -- particularly the Chinas and Indias, the Brazils, the sort of brick-type countries -- make their obligation perhaps at least initially sectoral and allow trading within sectors. You have, for example, as you say, I don't know whether it's actually enforced, but you have on paper a stronger auto emissions system or an air conditioning. That's where the forest area comes in. It's the first real break by developing countries. They're basically saying if you will give us tradable forestry credits, we will avoid deforestation. You can measure it. You can do satellite telemetry. We won't cut our trees down if we can trade in that sector. And then you ease into economy-wide standards at a later point. That's unfortunately not where we're at politically. And so

we've got to find some way in which to square this circle. Again, maybe it is energy efficiency criteria that aren't identical. And I think, Andy and Marty, in a way your legislation allows for some flexibility. You're not requiring us. So, for example, if China said we're going to take an efficiency set of criteria rather than absolute reductions, and that could be measurable. That possibly could be your contribution. And I think, again I didn't write the -- I didn't write the legislation on this piece, but that could possibly be a comparable action that would be sufficient to convince people that China and India are going to something, but not so dramatic that it requires them to make identical reductions. So, in any event, this will lead us into the afternoon. I'll let Professor Bhagwati take over from here and I appreciate the chance to be with you.

DR. BHAGWATI: I'll just respond to one point so we don't hold up the proceedings. The question of WTO compatibility, it's not clear to me exactly how the issue is arising in this context

because given the current state of legislation, I am (inaudible) is a piece on the World Trade Review examining the French proposal and say that the current jurisprudence, particularly deriving from the Shrimp-Turtle Decision means that you can actually go ahead and do these kinds of things. There are other kinds of things you can do. So it's not possible to rule it out. So the only -- so if the U.S. decides to pass this legislation and say that according to our own judgment, you are not doing something which is symmetric to what I'm doing, I'm going to counter-waive it with a board of measure. It must be sustained by the WTO as per current jurisprudence. But the problem is the (inaudible) outcome because you can do it to me for several other reasons. Now that's where we need an agreement, I think, because you don't want to kill the WTO because of it's falling in reaching this particular type of jurisprudence. And I think that's where one needs an international agreement on this issue. And I think it is possible. But it's not possible if we don't do something about



the past. Now I think -- what's the name, I can't see it -- you raised the question like who will administer all this and so on. It doesn't have to be going into a super, super fund. The U.S. itself makes a contribution. U.S. administers it. U.S. can do it for a variety of purposes -- financing R&D into other kinds of energy, solar, whatever, alright? It can even give money to a whole lot of countries to buy environmentally efficient technology or subsidize it. Which means it will remount to our own firms because we are the ones who, in the west who are actually creating this technology. I mean that's what Arnold Schwarzenegger said, because California has both venture capital and the ideas. So he's looking forward to a tremendous revival of the California economy and this actually will create new jobs all over the place for us, not for the countries which are not producing that kind of technology, environment friendly. So, in fact, it's a kind of win-win situation for our businesses as well, but if I was suggesting a super, super fund run by (inaudible) or

somebody, I should be lined up and shot. That might be good for -- you might have reasons for doing that otherwise, but not for this purpose. So I think we can do without it.

DR. BRAINARD: Did you want to address Steve's question about sort of when a tort would have been created in terms of at what point would (inaudible)?

PROF. BHAGWATI: Yeah, that's -- I think -- this is a cumulative damage, right? I mean at some stage (inaudible) sets in and you begin to see the effects. So it's just taking a guess, I suppose one could go back about 25 years or something. But it's something I haven't worked on, but it's the principle that you want to do something. And I think the main problem that Kyoto I, and I think afraid by Kyoto II is (inaudible) or whatever Copenhagen is going to be that if we don't do something along these lines, I don't think we're going to get anywhere. I just don't see why do gigantic countries like India and China would play ball. I mean we've been telling them look

you're being hurt too. Like our President Clinton you saw the other day on the Tim Russert show, it sort of disappointed me because I thought he was really a smart guy. But he said India and China must be brought on board. The smart meaning of policy (inaudible), and he was supposed to know more about policies in (inaudible). So, and then he went on to add that the other day I read about a child falling into a river in India and the river was so polluted that the child died. And so he was talking about global warming and illustrating it with local pollution. And I said good God, is this our policy? Really? I couldn't believe it. I mean that was worse than not being able to pronounce (inaudible). I mean, he should know this. But, anyway, the point is there is this looseness that goes on and I think something would have to be done. Just telling India and China you're suffering from pollution is not going to be enough. It's simply not going to be enough because you're talking about (inaudible) basically.

**DR. BRAINARD:** Alright. Well, I think

certainly the issue of technology transfer and also of intellectual property is going to come up in this next session is my guess. So I think it's a pretty clean move from one session to another. First, please join me in thanking Jagdish for being really (inaudible). And then we're going to just quickly transition to - we are just going to move so that the next panel comes and sits up here and we're just going to go directly into the next session. And I am going to hand over my mike to Paul Blustein, who any of you on the trade side will know, who is here now at Brookings writing a book on the WTO in (inaudible) although maybe he'll add a chapter on climate after having been in this conference.

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