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## OECD ROUND TABLE ON SUSTAINABLE DEVELOPMENT

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Agenda Item 2

### TRADE LIBERALISATION AND SUSTAINABLE DEVELOPMENT

Background paper

#### *Introduction*

*OECD's work on trade liberalisation and environment aims to contribute to the achievement of sustainable development.*

At the latest session of the Commission on Sustainable Development, in April 2000, there was general agreement that "*trade is one of the best means to achieve and promote sustainable development*"<sup>1</sup>. The OECD, a major player in pursuing policy integration and the mutual supportiveness of trade and environment, remains firmly committed to move the sustainable development agenda forward.

The environmental effects of trade liberalisation have figured prominently in OECD work on trade and environment since the early 1990s<sup>2</sup>. The objective of OECD's work in this area is to promote the compatibility and mutual reinforcement of trade and environmental policies, so as to contribute to the achievement of sustainable development. The policy orientations of OECD work are those endorsed by governments in UNCED Agenda 21 and the Rio Declaration on Environment and Development. Thus, though the OECD has not focussed specifically on trade liberalisation and *sustainable development*, the latter is at the heart of the work carried out in the field of trade and environment. A chapter on "Trade, Investment and Sustainable Development" will be included in the Analytical Report on Sustainable Development, to be issued in 2001.

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1. Chairman's summary of the High-Level Segment of the eighth session of the Commission on Sustainable Development.
  2. This work has been carried out by the Joint Working Party on Trade and Environment (previously called Joint Session of Trade and Environment Experts).

The OECD has adopted a number of guidelines to promote the compatibility of trade and environmental policies and thereby contribute to the achievement of sustainable development. These guidelines focus on certain procedural aspects of the relationship between trade and environmental policies. They are intended to guide governments in the development and implementation of trade and environmental policies with potentially significant effects on each other, and to enable policy-makers to reach better informed decisions<sup>3</sup>.

### *Trade liberalisation and the environment*

***Environmental problems are the result of market and intervention failures rather than of trade liberalisation.***

Trade may have significant effects, both positive and negative, on the environment and on sustainable development. In general, however, trade is not the root cause of environmental problems, which rather reflect market and intervention failures. For example, production and export subsidies and other trade barriers can potentially worsen environmental conditions by distorting resource values, input costs and market prices.<sup>4</sup>

The removal of trade barriers can have positive and negative environmental effects as well, both for developed and developing countries. Among the positive effects of trade liberalisation on the environment are improvements of the allocation of resources, the promotion of economic growth and of general welfare – provided effective environmental policies are implemented. The negative impacts of trade liberalisation on the environment generally relate to the expansion of trade in a context of market and other intervention failures.

As expressed in the recent UNEP/IISD handbook on Environment and Trade, "*the challenge is to exploit the opportunities and reduce the threats, and in so doing, to maximise the net positive contribution that trade can make to sustainable development*".

### *How does trade liberalisation impact on the environment?*

***Trade liberalisation can have ...***

Environmental effects of trade liberalisation can be manifold. To better understand and assess them, five types of effects are identified below: scale, structural, product, technology and regulatory effects.

***...scale...***

*Scale effects* are associated with the overall level of economic activity, i.e. the macro-economic effects of trade liberalisation. By promoting economic growth, as measured by GDP, trade liberalisation can have positive scale effects by providing resources needed for environmental protection or for investment in environmental technologies. In the absence of appropriate policies to protect the environment, or

3. The procedural guidelines, adopted in 1993, address, in particular, transparency and consultation; trade and environmental examinations, reviews and follow-up; international environmental co-operation and dispute settlement.
4. Market failures occur when markets do not properly value and allocate environmental assets, leading to prices of goods and services do not reflect full environmental costs. The divergence of the apparent costs of an activity from its total cost is reflected in the loss of clean air and water and the degradation of environmental resources, e.g., the depletion of the ozone layer. Intervention failures occur when government interventions fail to correct for, create and/or further exacerbate market failures, e.g. subsidies and trade barriers leading to over-exploitation of natural resources.

where distortive domestic policies exist, the increased economic activity resulting from trade liberalisation can have negative environmental effects, such as unsustainable exploitation and use of natural resources.

*... structural...*

*Structural effects* are associated with changes in the patterns of economic activity, i.e. the micro-economic effects of trade measures. If environmental costs are adequately internalised and distortive domestic policies removed, trade liberalisation can have positive structural effects by ensuring that all goods are produced efficiently. For example, where trade liberalisation results in the removal or reduction of supports to environmentally unsustainable activities, it will reduce environmental damage. Negative effects may occur when appropriate environmental policies do not accompany changes in patterns of economic activity, and when environmental costs and benefits are not reflected in the prices of traded goods.

*...product...*

*Product effects* are associated with trade in specific products, which can enhance or damage the environment. Trade liberalisation can have positive product effects by facilitating the transfer and sale of environmentally beneficial goods and services. Negative product effects may result from increased trade in environmentally damaging or sensitive goods, such as toxic chemicals and hazardous waste.

*...technology...*

*Technology effects* relate to changes in the way products are made, depending largely on the technology used. Positive technology effects may result when the output of pollution per unit of economic product is reduced, e.g. when liberalisation facilitates trade in environmentally friendly technologies and improves environmental management capacity through open markets and increased investment flows. Negative technology effects are produced by the transfer of environmentally unsustainable technologies, or by a lack of capacity to optimise the use of certain technologies in the receiving countries.

*...and regulatory effects...*

*Regulatory effects* are the legal and policy effects of trade liberalisation on the design and implementation of environmental regulations, standards and other measures, including voluntary approaches. These effects can be positive, where a country's ability to issue and implement effective environmental policies and regulation is maintained, or negative, where the provisions of a trade measure or agreement undermine such ability.

*Assessing the environmental effects of trade liberalisation*

*The OECD has pioneered methodologies to assess the environmental effects of trade liberalisation...*

Over the last years, several methodologies and frameworks have been developed – both at national and international levels – to assess the impact of trade on the environment and on sustainable development. Among the first methodologies are those developed by OECD in 1994<sup>5</sup>, which focus on domestic trade policies, including country policy approaches to international trade agreements, and are intended to inform policy-makers in advance of the environmental consequences of different trade policy measures.

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5. OECD Methodologies for the assessment of environmental effects of trade policies and agreements.

*... but it is difficult to distinguish these effects from those of economic growth.*

The increasing need for such assessments – and for improving and completing current methodologies – was expressed at an OECD workshop held in 1999<sup>6</sup>. The workshop also identified gaps in past assessments, such as their failure to cover the effects of services liberalisation, or the investment aspects of trade agreements. Following a request from the Joint Working Group on Trade and Environment at its May 2000 meeting, the OECD Secretariat will develop methodologies for the assessment of liberalisation of services.

Despite considerable advances in the field of environmental reviews, it remains difficult to disentangle precise causal links resulting from trade liberalisation, and then determine the correlation between the economic data and the environmental consequences. Another difficulty lies in distinguishing between the effects of trade liberalisation and those of economic growth.

*How to prevent or limit negative environmental effects of trade liberalisation: lessons drawn from recent case studies*

*Studies for different sectors highlights a number of findings such as...*

The OECD has recently examined the effects of trade liberalisation in various sectors – environmental goods and services, fossil fuels and freight transport – drawing lessons and identifying measures to prevent or limit the negative effects on the environment. The nature and scope of such environmental flanking measures will depend on the context in which trade liberalisation occurs and on whether adequate structures exist to address these potential environmental effects.

*Environmental goods and services*

*...the need for additional measures to ensure "win-win" outcomes from the liberalisation of environmental goods and services...*

Trade liberalisation in the environmental goods and services (EGS) sector can benefit both trade and the environment. It can make advanced environmental technologies more readily available, lead to increased technology transfers and expanded market opportunities, and provide incentives for the generation of technological progress, as well as economies of scale and increased efficiency<sup>7</sup>.

However, while trade liberalisation in EGS has a strong potential to produce "win-win" results for both trade and the environment, certain measures need to be put in place to ensure these environmental benefits. These include strengthening the environmental regulatory framework and the choice of policy instruments; ensuring the appropriate balance and proper timing of liberalisation for both goods and services; avoiding favouring end-of pipe technologies over cleaner technologies; and taking into account the needs of emerging economies in terms of pollution prevention and cleaner technologies, including capacity building and technology adaptation.

6. OECD Workshop on *Methodologies for environmental assessment of trade liberalisation agreements*, Paris, October 1999. The proceedings of the workshop have recently been published.

7. In 1996, the global environment industry was estimated at US\$ 453 billion, with OECD markets representing over 90 per cent of the total. Basic infra-structural services and waste treatment and water supply account for more than half of the total, with equipment accounting for nearly another quarter.

### *Fossil fuels*

***...the burden on the environment from current government intervention in the fossil fuel market...***

Fossil fuels continue to dominate the world energy supply and represent almost the entirety of internationally traded energy<sup>8</sup>. Governments intervene heavily in energy markets through taxation, government ownership, subsidised lending and trade barriers. Trade reforms can improve the environment, *inter alia* by exposing government-owned energy operations to competition and by rationalising inefficient and polluting coal mining operations. On the other hand, reducing fossil fuel prices that had previously been kept artificially high by government interventions might, in some cases, lead to increased stresses to the environment.

A recent simulation of liberalisation of fossil fuel markets carried out by OECD produced interesting results<sup>9</sup>. A world-wide elimination of producer and consumer price distortions may rise trade flows in fossil fuel by 4.4 per cent by 2010, and reduce carbon emissions by between 1.9 and 6.2 per cent over the next 10 years, relative to a "business as usual" scenario. All reductions would come from non-OECD countries and would result from reduced energy consumption following the removal of subsidies. Thus, reforms outside of the OECD area would be necessary to achieve the environmental benefits of less distortionary fossil fuel pricing<sup>10</sup>.

### *Freight transport*

***... and the different environmental results from freight transport reforms in the US and in Europe.***

Traditionally, transport has been highly regulated in OECD economies. The OECD has examined the effects of trade liberalisation and sectoral reforms in the transport sector in North America and Europe.

In North America, and particularly in the United States, deregulation was undertaken almost simultaneously in the rail and road sectors. This has led to improvements in operating efficiencies, service and profit levels, and to lower energy consumption and environmental impacts through new technologies and infrastructure investments.

By contrast, in Europe – where reforms of the rail and inland water sectors lagged behind those in the road sector – road haulage has dramatically increased both in absolute and in relative terms. The loss of market share of rail, inland waterways, coastal shipping and pipelines also reflected the pace and sequencing of EU liberalisation in the various transport modes. The analysis suggests that the internalisation of environmental externalities, while important, would not be sufficient to recapture market shares for the more environmentally friendly freight transport modes.

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8. Among the three fossil fuels, crude oil and petroleum products represent 75-80 per cent of international energy trade. Although coal releases the greatest emissions per heat content, due to its dominant share, crude oil is responsible for the largest share of total CO<sub>2</sub> emissions. Carbon abatement policies, including fuel switching, can also bring ancillary benefits in terms of SO<sub>x</sub> and NO<sub>x</sub> emission reductions.
  9. The simulation, run on the GREEN model, examined elimination of distortions in producer and consumer fossil fuel prices, as measured by the price gap. It distinguished between three scenarios: reform in OECD countries only; reform outside the OECD only; and world-wide reform.
  10. The "OECD-only liberalises" scenario tends to increase fossil fuel demand, as above-world market prices in Japan and Europe fall.

*Balancing trade and environment at regional and international level*

*To balance trade and environment several solutions have been proposed or implemented such as...*

The potential conflict between trade liberalisation and environmental concerns has been widely debated. At a regional level, some concrete measures have been put in place to balance trade liberalisation and environmental concerns, for example in the framework of the North American Free Trade Agreement (NAFTA) and of the Treaty establishing the European Community.

The North American Agreement on Environmental Co-operation, a side agreement to NAFTA, is intended to safeguard the environment from any negative effects of trade liberalisation under the latter. The environmental effects of NAFTA are currently being assessed and will provide the basis for judging the effectiveness of its environmental side-agreement.

The Treaty establishing the European Community, as amended, aims at ensuring that free trade within the area goes along with environmental protection. The various amendments to the EU Treaty have strengthened the environmental component of the agreement, by providing that requirements for environmental protection must be integrated into the definition and implementation of common policies and activities – which include a common commercial policy and free trade within the Community – with a view of promoting sustainable development.

*...environmental side agreements to regional trade agreements...*

Balancing trade and environment at the international level is more complex. Both the multilateral trading system (MTS) and that consisting of multilateral environmental agreements (MEAs) have developed largely in isolation. In addition to the divergent interests at stake, the main differences between both systems are the fragmentation of international environmental protection into numerous independent agreements, as compared to the tight package of trade agreements under the WTO; and the relative weakness of environmental monitoring and compliance mechanisms, as compared to the solidity of the MTS and its strong dispute resolution and compliance mechanisms.

In spite of wide international consensus on the importance of a harmonious relationship between MEAs the MTS, conflicts may occur. MEA-based trade restrictions could conflict with the most-favoured nation and national treatment principles, the basic elements of the MTS. A certain number of MEAs incorporate restraints on trade, either because such trade may cause environmental damage (e.g. the Basel Convention on the Control of Transfrontier Movements of Hazardous Wastes and their Disposal) or to ensure that the agreement's objectives are not undermined (e.g. the Montreal Protocol on Substances that Deplete the Ozone Layer). Potential trade issues arising from commitments under the Kyoto Protocol to the Climate Change Convention have also been identified. Although, so far, no dispute on conflicts between MEA provisions and the multilateral trading system has been brought before the competent dispute-settling bodies, the fear of potential conflict with WTO rules has been present in negotiations of several recent MEAs, and is reflected, for example, in the text of the Cartagena Protocol on Biosafety.

*...reforming the multilateral*

Several suggestions have been made to better balance the MTS and MEAs regimes. Some consider that existing safeguard clauses, in particular Article XX of the

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*trading system...*

GATT<sup>11</sup>, suffice to accommodate the implementation of MEAs provisions in the framework of multilateral trade liberalisation, and that no changes to the MTS are needed. Others have argued that, to avoid conflicts, specific measures are necessary, such as amending Article XX to add a reference to trade measures taken pursuant to MEAs. Another suggestion has been to draw up guidelines or lists of criteria that MEA-based trade measures would have to meet to be considered acceptable under WTO rules. Stronger co-operation between the WTO, UNEP and MEA secretariats has also been encouraged, and is currently being put in practice.

*...and  
strengthening the  
MEA regime.*

Finally there have been proposals to strengthen the current international environmental regime, in particular as regards monitoring and compliance, as well as dispute resolution mechanisms. Other proposals are to establish a new "international environment organisation" as a counterweight to the WTO, or to negotiate a new agreement on MEAs under the WTO, which would have similar status to other WTO agreements such as the SPS or the TBT agreements<sup>12</sup>.

### *Questions for discussion*

On this background, issues for discussion include:

- Which concrete measures should be taken to mitigate the negative environmental impacts of trade liberalisation in the sectors of environmental goods and services, fossil fuel and freight transport? What are the main practical barriers to progress?
- What measures are necessary to ensure that developing countries fully benefit from trade liberalisation?
- How useful and practicable are the suggestions made to balance the MTS and MEAs, in particular, in view of increased trade liberalisation?

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11. Art. XX of the GATT: "*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 county of measures: ... (b) necessary to protect human, animal or plant life or health... (g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.*"

12. Agreement on Sanitary and Phytosanitary Measures (SPS); Agreement on Technical Barriers to Trade (TBT).

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## RELATED DOCUMENTS

- The Environmental Effects of Trade, OECD 1994 (includes the 1993 procedural guidelines on trade and environment)
- Report on Trade and Environment to the OECD Council at Ministerial Level [OECD/GD (95) 63]
- Future liberalisation of trade in environmental goods and services: ensuring environmental protection as well as economic benefits [COM/TD/ENV (98) 37 and Annex]
- Environmental effects of liberalising trade in fossil fuels [COM/TD/ENV (98) 129]
- Environmental effects of liberalising fossil fuels trade: results from the OECD GREEN Model [COM/TD/ENV (2000) 38]
- Freight and the environment: effects of trade liberalisation and transport sector reform [OECD/GD (97) 213]
- Report on Trade and Environment [C/MIN (99)14]
- Trade measures in Multilateral Environmental Agreements, OECD 1999
- Assessing the Environmental Effects of Trade Liberalisation Agreements: Methodologies, OECD, 2000 (includes the 1994 OECD Methodologies for environmental reviews of trade policies and agreements)