POLICY BRIEF – MARCH 2018

Reforming Fossil Fuel Subsidies through the Trade System

WTO: PATHS FORWARD ICTSD.ORG

Fossil fuel subsidy reform is recognised as a vital component of the transition to a sustainable future. A group of 12 countries issued a Ministerial Declaration on Fossil Fuel Subsidy Reform (WT/MIN(17)/54) on the occasion of the WTO's Eleventh Ministerial Conference in Buenos Aires in December 2017. Drawing on the knowledge and policy options generated by ICTSD and partners over recent years, this policy brief is intended to support WTO members in building on this declaration.

1. Introduction

Fossil fuel combustion is the main cause of human-induced climate change, yet governments continue to offer subsidies to the production and consumption of such fossil fuels. Global annual government spending on subsidies to fossil energy is estimated at US$333 billion by the International Monetary Fund (IMF) (Coady, Parry et al. 2015). If externalities are considered, the full costs of all fossil fuel subsidies have been valued by the IMF to amount to a staggering US$5.3 trillion. In comparison, subsidies to renewable energy amounted to US$150 billion in 2015 (IEA 2016).

Various organisations tracking the issue often present huge variations in estimates and data, something explained by the lack of a commonly accepted definition, metrics, and reporting framework (Box 1). This should not however divert attention from the fact that fossil fuel subsidies come with significant societal costs. Indeed, in addition to taking up fiscal space, fossil fuel subsidies harm the environment, reinforce inequality (Coady, Flamini, and Sears 2015), add to health hazards caused by air pollution, and slow down the energy transition. Thereby, they run counter to the shared goals of sustainable development and of combatting climate change. The need to reform and ultimately phase out these harmful subsidies is thus urgent.

Countries have recognised this and pledged in various fora to put an end to the subsidisation of fossil fuels. The G20 members vowed as early as 2009 in Pittsburgh to "rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption." Asia-Pacific Economic Cooperation (APEC) countries have since made a similar commitment, and the G7 members have agreed on 2025 as a deadline for their phase-out. In addition, the Friends of Fossil Fuel Subsidy Reform, an informal set of nine non-G20 countries, have committed to eliminate inefficient fossil fuel subsidies. Between the G20/G7, APEC, and the Friends of Fossil Fuel Subsidy Reform, more than 40 countries have already committed to phasing out fossil fuel subsidies.

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Box 1. Estimating fossil fuel subsidies

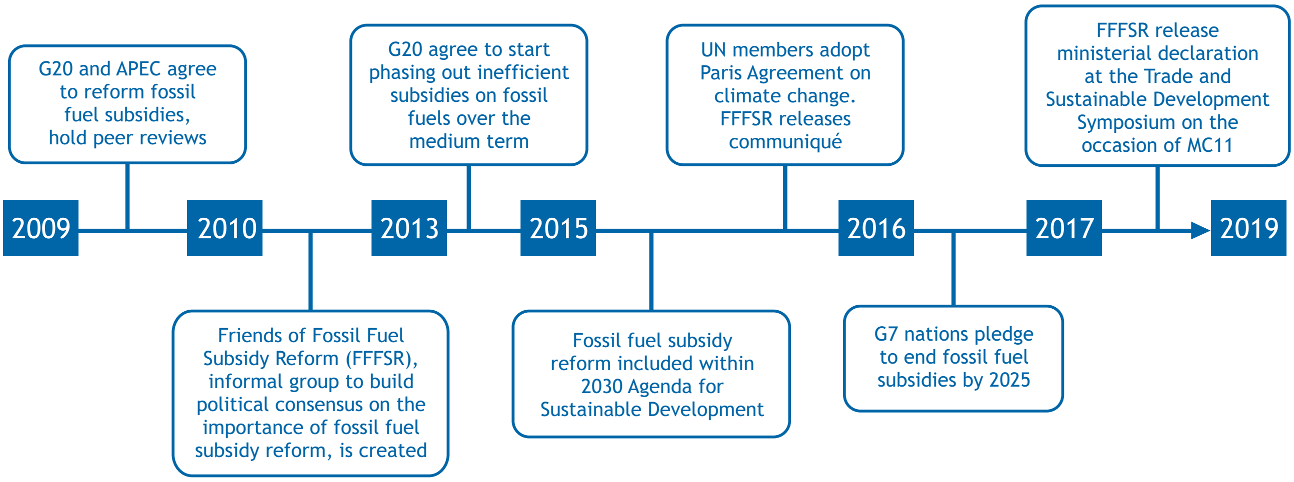
Three international organisations (International Energy Agency (IEA), IMF, Organisation for Economic Co-operation and Development (OECD)) have attempted to collect data on fossil fuel subsidies, using different methodologies (see GSI 2015).

- OECD estimates total support annually (2010—2014) at US$160—200 billion amongst its members plus the BRIICS (Brazil, Russian Federation, India, Indonesia, China, and South Africa).
- IEA estimates that fossil fuel subsidies in 2015 amounted to US$325 billion. This was down from US$548 billion in 2013 (5 percent of the total GDP of the 40 countries included in its analysis) due to lower fossil fuel prices and reform momentum in several countries. According to the 2013 study, a partial phase-out of these subsidies by 2020 would reduce greenhouse emissions by 360 million tonnes.
- IMF estimates that global (post-tax) subsidies amounted to US$5.3 trillion in 2015 (6.5 percent of global GDP). The pre-tax level was US$ 333 billion. According to this study, eliminating post-tax subsidies could raise government revenue by US$2.9 trillion, cut CO_2 emissions by more than 20 percent, and cut premature air pollution deaths by more than half.

The adoption of the Paris Agreement and the 2030 Agenda for Sustainable Development has added additional impetus to a timely phase-out. Article 2.1.c of the Paris Agreement expresses the aim to "[make] finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development." Likewise, Sustainable Development Goal 12 (on ensuring sustainable consumption and production patterns) calls for rationalising inefficient fossil fuel subsidies. Against this backdrop, fossil fuel subsidy reform is recognised as a vital component of the transition to a sustainable future.

It has also been suggested that the trade system, including the World Trade Organization (WTO) as well as regional and bilateral trade agreements, should play a role in restricting fossil fuel subsides. To this end, a group of 12 countries—Chile, Costa Rica, Iceland, Liechtenstein, Mexico, Republic of Moldova, New Zealand, Norway, Samoa, Switzerland, Chinese Taipei, and Uruguay—made a joint declaration on the occasion of the WTO's 11th Ministerial Conference (MC11) in Buenos Aires in December 2017, seeking to advance discussion in the WTO.[1] This policy brief is intended to support WTO members in addressing fossil fuel subsidies reform through trade disciplines and the use of trade agreements.

Figure 1. Timeline of selected action on fossil fuel subsidies



1 WTO.2017. Fossil Fuel Subsidies Reform Ministerial Statement. WT/MIN(17)/54. See also www.fffsr.org.

2. Why Reform Fossil Fuel Subsidies through the Trade System?

While commitments under the umbrella of various international fora have brought the issue of fossil fuel subsidies to the attention of the international community, there has to date been insufficient concrete action to deliver on these commitments. Although carrying through these reforms would come with a range of positive effects, they are nevertheless difficult to put in place, not least in the light of considerable vested interests, powerful industry lobbying, and fears for job-loss and increasing energy bills among voters.

With insufficient domestic action taken to curb the subsidies, countries are not well placed when it comes to holding each other accountable. This can lead to a sort of a "prisoner's dilemma," where it is difficult for individual actors to take the lead and reduce their subsidies, resulting in a situation that is suboptimal for everyone.

The trade system has a unique advantage and experience when it comes to unlocking these kinds of situations. For example, the trade system has been put to work to reduce harmful subsidies in the agriculture sector, thereby enabling members who were unable to phase out their subsidies unilaterally to gradually move towards reform.

With its binding nature, effective enforcement mechanism, and its ability to generate rewards in exchange for concessions, the WTO and indeed the broader trade system, including bilateral and regional trade agreements, could therefore make a significant contribution to international efforts to phase out fossil fuel subsidies.

A number of experts have argued that the WTO's Agreement on Subsidies and Countervailing Measures (ASCM) may be put to use for addressing fossil fuel subsidies (e.g. Horlick and Clarke 2016; Meléndez-Ortiz 2016). The ASCM was, however, not designed to address environmental issues, and only disciplines subsidies that alter competition and create distortions which—through trade—affect competitors in third countries. In addition, even though the ASCM contains extensive provisions for notification and surveillance, these have proved to be ineffective. Governments in fact have little incentive to notify their fossil fuel subsidy programmes under current rules and practice. In its current state, the ASCM therefore appears to be ill-equipped to assume the challenge of disciplining fossil fuel subsidies.

The WTO needs to evolve to respond to the challenges of the 21st century, first and foremost the shared universal goal of sustainable development. To effectively discipline fossil fuel subsidies to that end, WTO members therefore would need to reform, amend, and complement the existing WTO infrastructure with a focus on the broader climate threat, rather than limited to trade distortions. A precedent for this class of effort at the WTO is found in ongoing negotiations aligned with Agenda 2030 mandates and geared towards the establishment of disciplines to curb subsidies that contribute to overfishing. The following section outlines a number of policy options for countries to embark on effective reform of fossil fuels through the WTO.

3. Policy Options for Reforming Fossil Fuel Subsidies through the Trade System

ICTSD has fostered an intellectual process under its E15 Initiative,[2] jointly implemented with the World Economic Forum, focused on improving the efficacy, fairness, and inclusiveness of the global system for trade and investment as well as its ability to promote sustainable development. The process has stimulated groundbreaking thinking *inter alia* on trade, climate change, and energy, and formulated a set of concrete policy options specifically on fossil fuel subsidies and trade. It has also spurred experts and organisations involved in the project to further elaborate these and other options. Since the completion of the first, expert-driven phase of the E15 project, ICTSD and several other organisations

2 http://e15initiative.org.

involved in this endeavour, including notably Climate Strategies, the Global Subsidies Initiative of the International Institute for Sustainable Development (IISD), and the Stockholm Environment Institute (SEI), have taken that work forward. The following overview summarises some of the options explored for possible approaches to reforming fossil fuel subsidies through the trade system.

The options are organised from least to most ambitious and are not necessarily mutually exclusive. While it may be politically more difficult to gain traction for the more ambitious ones, they would certainly be the most effective in curbing fossil fuel subsidies, and thus reducing pollution and greenhouse gas emissions and ultimately mitigate climate change.

3.1 Enforce existing trade rules through litigation and trade remedies

Normal trade rules apply to fossil fuel subsidies. Still, disputes over such subsidies, as well as the use of trade defence measures, have been rare. Actors interested in seeing the trade system restrict the use of fossil fuel subsidies could therefore begin by enforcing these rules. This could include making a case before a panel based on a violation of the ASCM. It could also include making use of the anti-dumping agreement to counter for example the practice of dual pricing in energy by adjusting the dumping margin (Marhold 2017).

The obvious advantage of this approach is that it would not require any rule change. A main shortcoming though is that it would only be able to adjust for trade distortions, and would hence be insufficient to compensate for the broader environmental damage caused by the subsidies curtailed.

3.2 Promote technical assistance and capacity building

Many developing countries lack the technical expertise and institutional frameworks to accomplish the complex task of phasing out fossil fuel subsidies without hurting poor people and inciting a popular backlash (Asmelash 2017). Through technical assistance and capacity building, WTO members could support these countries in identifying, measuring, and evaluating fossil fuel subsidies (Verkuijl et al. 2017). In addition, such mechanisms could also serve as a means, and even forums, for exchanging national experiences of reforming fossil fuel subsidies.

To facilitate such technical assistance and capacity building, WTO members could make use of the Enhanced Integrated Framework (EIF) for Trade-Related Assistance for the Least Developed Countries (LDCs) (Verkuijl et al. 2017). The EIF is a well-established programme through which donors can provide technical assistance and capacity building to LDCs; it is therefore well-placed to support the development of knowledge and capacity building for fossil fuel subsidy reform in LDCs.

While this option may support LDCs in better understanding their fossil fuel subsidies, it falls short of spurring action on fossil fuel subsidy reform in developing countries that are not LDCs, as well as in developed countries.

3.3 Enhance transparency and notification

Notification of fossil fuel subsidies under the ASCM is low. To enhance the transparency and visibility of fossil fuel subsidies, WTO members could mandate a full disclosure of fossil fuel subsidies under WTO rules and improve the existing WTO notification mechanism (Bacchus 2016). This could, for example, be done by establishing a shared system for notification, monitoring, and peer review.

As a first step, members could commit to using a common reporting template under the ASCM (Thöne and Dobroschke 2008). This could present information in a user-friendly format and help overcome ambiguity pertaining to differing interpretations of subsidies and other technical barriers.

Counter-notification is another option that could help improve transparency around fossil fuel subsidies (Asmelash 2017). Article 25.10 of the ASCM provides that a member who considers that a measure of another member has not been notified as a subsidy, even though it should have been, may bring the matter to the attention of the other member. If that member then fails to promptly notify the alleged subsidy, the reporting member may bring the alleged subsidy to the notice of the WTO Committee on Subsidies and Countervailing Measures. Although counter-notifications are relatively rare, they can be used to effectively enhance the transparency of fossil fuel subsidies.

Another option to this end would be for members to agree to systematically use the Trade Policy Review Mechanism (TPRM) of the WTO to enhance the visibility and transparency of fossil fuel subsidies (Asmelash 2017). Some countries such as New Zealand repeatedly raise questions about fossil fuel subsidies in Trade Policy Reviews (TPRs); this approach could be implemented more systematically, for example by members agreeing to add a section on fossil fuel subsidies to their country review report. This would not only enhance transparency, but also serve as a means for monitoring compliance.

The United States recently introduced a proposal to enhance transparency and strengthen notification requirements under WTO Agreements.[3] WTO members could use the opportunity provided by emerging discussion in the WTO on transparency enhancement to build support for the above-mentioned options.

Boosting transparency and notification house-wide could well provide clear benefits pertaining to enhanced visibility and awareness of fossil fuel subsidisation policies and practices. It does not, however, directly contribute to fossil fuel subsidy reductions, thus serving rather as a complementary action.

3.4 Introduce pledges and follow up through reporting and review

Governments could make pledges to eliminate or reduce their fossil fuel subsidies, and agree to report progress and review each other's progress. These commitments could link into existing pledges and reporting mechanisms in other fora, particularly the G20 and APEC (Verkuijl et al. 2017).

At the outset, this approach could start as a plurilateral, voluntary initiative by a number of WTO members, which could then be reviewed by an appropriate WTO committee or under the TPRM. While pledging is not a common WTO tool, there are relevant precedents like Voluntary Export Restrictions that could be explored. The advantage of this option is that it is open to members that are not part of the limited G20 and APEC membership. Pledges to reform fossil fuel subsidies could therefore be made by a broader group of countries, and associated peer reviews may support WTO members beyond the G20 and APEC in their efforts to phase out fossil fuel subsidies.

3.5 Include references to fossil fuel subsidy reform in regional trade agreements

Governments could include specific references to fossil fuel subsidy reform in their free trade agreements. By incorporating commitments to reforming fossil fuel subsidies or to technical assistance and capacity-building measures that are targeted at fossil fuel subsidy reform, countries could drive progress on the issue outside the WTO framework.

A number of recent, innovative regional trade agreements make specific reference to climate concerns, either through broad declarations of intent in the preambles or more specific commitments, for instance in environmental chapters (Gehring et al. 2013). The inclusion of fossil fuel subsidy reform in these preambles or chapters could drive progress in reducing fossil fuel subsidies at the bilateral and plurilateral levels (Benes 2017; Espa and Rolland 2015). A notable example is the EU-Singapore Free Trade Agreement, which specifically recognises the goal of reducing subsidies for fossil fuels.

3 WTO. 2017. Procedures to Enhance Transparency and Strengthen Notification Requirements Under WTO Agreements. Communication from the United States. JOB/GC/148, JOB/CTG/10.

Advances in such agreements could pave the way for multilateral efforts by fostering progress towards reform and by acting as exploratory labs.

3.6 Place the issue of fossil fuel subsidies on the agenda of the Committee on Trade and Environment

Another option would be for WTO members to explicitly place the issue of fossil fuel subsidies on the agenda of the Committee on Trade and Environment (CTE) (Verkuijl et al. 2017). The CTE could indeed play a crucial role in raising awareness of the subsidies, their magnitude and impacts, and discuss their relation to the trade system and bridge the gaps between diverse positions on the issue. In 2017, the issue of fossil fuel subsidies and the role of the WTO was indeed brought up by New Zealand in the CTE. While some members expressed their support, others conveyed that the WTO is not the appropriate venue.[4]

3.7 Provide supplementary interpretation of, or waivers from, WTO rules

WTO members could negotiate an interpretive understanding of existing WTO rules and mechanisms, and thereby clarify their applicability to fossil fuel subsidies. Multilateral interpretations do not modify the content of existing obligations, but by clarifying them they can inform the application of the rules in the context of dispute settlement (Porges and Brewer 2013).

An alternative, or perhaps a complement to such an understanding, might be a waiver for certain clean energy policies under the ASCM, which could be made conditional upon the elimination of other policies that undermine the stated objectives, including for example fossil fuel subsidies (Howse 2013). This would provide clarity on which energy subsidies are subject to disciplines under the ASCM, including those subsidies that are given to fossil fuels and clean energy.

3.8 Change existing rules—expand the category of prohibited subsidies

To effectively discipline the use of fossil fuel subsidies through the WTO, members could expand the ASCM category of prohibited subsidies to include measures that encourage the exploration, production, and use of fossil fuels (Horlick and Clarke 2016; Marhold 2017). This option would have the advantage that prohibited subsidies, as opposed to actionable subsidies, do not need to show adverse effects on foreign industries within the sense of Article 5 of the ASCM. This would hence make it easier for WTO members to challenge fossil fuel subsidies within the WTO system.

It needs to be acknowledged that not all fossil fuel subsidies are equal, however, and a prohibition may need to include certain considerations. Some may contribute to well-defined public policy objectives. While it would still be desirable to phase them out in light of climate concerns, time-limited exceptions could be made as a transitional measure for subsidies that are, for instance, specifically targeted at poor people, or those that support reductions in energy intensity. In addition, disciplines on fossil fuel subsidies could be differentiated based on which fuel they target. Subsidies for lower emission fossil fuels could, for instance, be exempted from a full prohibition in a first phase, as they could be part of a gap solution.

3.9 Negotiate a legal framework specifically targeted at reducing fossil fuel subsidies

The existing ASCM mechanism is designed to address subsidies that distort competition, rather than subsidies that cause negative externalities, such as environmental damage. Hence, a new approach could be envisaged through which fossil fuel subsidies would be disciplined based on their effects on the climate, rather than on trade (Pereira 2017; Trachtman 2017). While necessary modifications in the ASCM could be undertaken to take account of this disparity, a separate agreement that specifically targets fossil fuel subsidies would likely be more far-reaching and enable more effective disciplines.

4 WTO. 2017. Report of the Committee on Trade and Environment. WT/CTE/24.

To this end, WTO members could negotiate a new legal framework that uses additional carbon emissions expected to be caused by fossil fuel subsidies as the threshold for their discipline (Trachtman 2017). This approach could also include a review of the specificity requirement in the ASCM that in its current form limits the scope of actionability for fossil fuel subsidies. While the specificity requirement may therefore not be desirable for such a new framework, a *de minimis* threshold of causation of additional consumption or emissions would serve the purpose of avoiding disciplines on too wide a range of government activities.

This legal framework could be pursued as a plurilateral agreement. A relatively small subset of states comprises the greatest grantors of fossil fuel subsidies. Hence, there may not be significant need or benefit derived from universality of obligation. A plurilateral agreement to which the major subsidising states adhere would therefore be efficient and effective.

3.10 Negotiate a Sustainable Energy Trade Agreement

WTO members could consider negotiating a full sectoral trade agreement on sustainable energy, which would serve to facilitate trade in and hence foster a scale up of clean energy (ICTSD 2011; Meléndez-Ortiz 2016; Meléndez-Ortiz et al. 2016). Such an agreement could provide a detailed classification of subsidies subject to the agreement, including clean as well as fossil fuel subsidies (Espa and Rolland 2015; Kennedy 2016) and could also include provisions to explicitly restrict the use of fossil fuel subsidies (Marhold 2017).

The advantage of this approach is that it would address a broad range of trade issues related to energy simultaneously, and would thereby offer attractive benefits to parties in terms of enhanced market access for clean energy technologies, increased policy space, and a clarification of rights and obligations, as opposed to some of the narrower approaches discussed above.

4. Conclusion

The trade system can make a significant contribution to reforming fossil fuel subsidies. Members could use existing WTO law to enhance the understanding and visibility of fossil fuel subsidies. This would be a good start for fossil fuel subsidy reform, as it would pave the way for future action. However, if the trade system is to effectively contribute to real reductions of fossil fuel use through subsidy reform, more ambitious steps need to be taken. While these would be politically challenging, their effectiveness would go beyond that of using existing mechanisms.

To this end, the declaration made in Buenos Aires must trigger concrete action in the trade system, ensuring that it does its bit in promptly delivering for the Sustainable Development Goals and the Paris Agreement.

Table 1. Summary of options, advantages, and limitations

Option	Advantages	Limitations	References*
Enforce existing trade rules through litigation and trade remedies	Requires no amendment of existing rules	Can only address certain fossil fuel subsidies, and of these only those which have trade distortive effects	Marhold 2017; Porges and Brewer 2013; Verkuijl et al. 2017
Promote technical assistance and capacity building	Solutions-oriented approach	Narrow focus on a group of minor emitters, hence limited climate impact	Verkuijl et al. 2017
Enhance transparency and notification	Improved transparency can give an impetus for reform	No direct impact on reform	Asmelash 2017; Bacchus 2016; Thöne and Dobroschke 2008; Verkuijl et al. 2017
Introduce pledges and follow up through reporting and review	Expands efforts made in other, restricted fora like the G20, to the full WTO membership	The voluntary nature might reduce the group of countries engaging; limited accountability	Verkuijl et al. 2017
Place fossil fuel subsidies on the agenda of the CTE	Foster a nuanced understanding of options and of individual country preferences	Does not necessarily trigger reform	Verkuijl et al. 2017
Provide supplementary interpretation of, or waivers from, WTO rules	Could foster compliance and guide dispute settlement; could constitute a "carrot" by providing additional policy space for certain clean energy subsidies in exchange for reducing fossil fuel subsidies	Requires considerable engagement by the WTO membership	Howse 2013; Porges and Brewer 2013
Expand the category of prohibited subsidies under the ASCM	Effective, far-reaching disciplines on fossil fuel subsidies	Amending the ASCM requires the endorsement of at least two thirds of the WTO membership	Horlick and Clarke 2016; Marhold 2017
Negotiate a legal framework specifically targeted at reducing fossil fuel subsidies	Effective, far-reaching disciplines on fossil fuel subsidies; can be tailor-made to the objectives at hand with necessary exemptions for development purposes; can be negotiated as a plurilateral deal that can be expanded over time	Will only apply to signatories of the agreement	Pereira 2017; Trachtman 2017
Negotiate a Sustainable Energy Trade Agreement	Comprehensive approach to address a range of issues related to energy and trade, hence reaching beyond fossil fuel subsidies; attractive as it could offer benefits in terms of market access and increased policy space for green energy while simultaneously restricting the use of fossil fuel subsidies	Will only apply to signatories of the agreement	Espa and Rolland 2015; ICTSD 2011; Meléndez-Ortiz 2016; Meléndez-Ortiz et al. 2016

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WTO: Paths Forward

WTO: Paths Forward is an ICTSD initiative that builds on the outcomes of the Eleventh Ministerial Conference in December 2017. The cycle of publications and events will provide a platform for discussion and analysis on possible options for WTO-based processes going forward and into the Twelfth Ministerial Conference in 2019. The issues selected for the initial series of policy briefs are agriculture, development, disciplines on domestic regulations in services, e-commerce, fisheries subsidies, fossil fuel subsidies, and investment facilitation.

Lead authors in the production of policy briefs under the *WTO: Paths Forward* initiative are Björn Dupong, Judith Fessehaie, Jonathan Hepburn, Rashmi Jose, Felipe Sandoval, and Alice Tipping. Editorial contributors are Christophe Bellmann, Andrew Crosby, Ingrid Sidenvall Jegou, and Ricardo Meléndez-Ortiz. Oleg Smerdov is responsible for layout and Colette Holden for proofing. Series Senior Editor and Production Manager is Fabrice Lehmann; overall Direction by Ricardo Meléndez-Ortiz.

ICTSD welcomes comments and feedback on this policy brief. These can be sent to flehmann@ictsd.ch.

About ICTSD

The International Centre for Trade and Sustainable Development (ICTSD) is an independent think-and-do-tank, engaged in the provision of information, research and analysis, and policy and multistakeholder dialogue, as a not-for-profit organisation based in Geneva, Switzerland; with offices in Beijing and Brussels, and global operations. Established in 1996, ICTSD's mission is to ensure that trade and investment policy and frameworks advance sustainable development in the global economy.

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