



# Policy Memo

**DATE:** November 20, 2015

**SUBJECT:** Designing Elements for a Robust Carbon Pricing Club

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*On October 14–16, 2015, experts and policymakers from academia, government, international organizations, and civil society gathered at the Airlie Center outside Washington, DC, to participate in the Stanley Foundation’s 56th annual Strategy for Peace Conference. This year’s conference featured autonomous roundtables where experts focused on ideas, challenges, and recommendations in four key global issue areas: Climate Change/Carbon Pricing, Human Protection from Mass Atrocity, Nuclear Security, and Global Governance.*

In the carbon pricing roundtable, experts gathered to continue a dialogue on low carbon clubs at the intersection of pricing, technology investment, and trade. This roundtable built on conversations that started at the Global Climate Policy Conference organized by Climate Strategies and the Stanley Foundation in spring 2015 in India and were continued at a workshop hosted by the Stanley Foundation, Climate Strategies, International Center for Trade and Sustainable Development and IDDRI on July 8, 2015, in Paris, which focused on the definition and role of, and interest in developing, low carbon clubs.

## **The State of Carbon Pricing Policies**

Carbon pricing policies have emerged as a powerful tool for addressing global warming. As of September 15, 2015, 39 countries and 23 regions, representing 12 percent of the world’s population, had implemented a carbon pricing policy of some kind. In 2015, over 1,000 companies reported to CDP that they had set an internal price on carbon or were planning to do so within two years,<sup>1</sup> a rapid increase compared to the 25 companies that reported implementing a carbon price in 2013. With the approach of the 21st session of the Conference of the Parties (COP21) to the United Nations Framework Convention on Climate Change (UNFCCC) in December 2015, followed closely by the 10th World Trade Organization (WTO) Ministerial, the year ahead may represent a crucial window for the expansion of carbon pricing policies and the establishment of carbon clubs.

Implementing carbon pricing policies involves navigating a number of dilemmas, including the selection of the carbon pricing policy with an implicit price (e.g., energy efficiency or product standards) or explicit price (e.g., emissions trading schemes or carbon taxes) depending on

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<sup>1</sup> CDP and We Mean Business Coalition, *Carbon Pricing Pathways: Navigating the Path to 2° C*, 2015, <https://www.cdp.net/CDPResults/carbon-pricing-pathways-2015.pdf>.

responses of from different sectors of the economy. In some instances, the necessary, or even any, price on carbon may be politically unachievable.

Creating the foundation for a successful carbon market requires (1) broadening the engagement in carbon pricing discussions to support the widespread adoption of effective carbon pricing policies; (2) establishing triggers for carbon price level increases that will transform economies and lead to large-scale decarbonization, and (3) setting principles to enable eventual market convergence on carbon price levels and compatible policies over time to ensure open markets on a global scale.<sup>2</sup> Efforts to build a global marketplace must also account for the linkages, overlaps, and potential for double counting that emerges from the parallel efforts of countries, subnational governments, and businesses.

### **Pathways for Designing a Robust Carbon Club**

The idea of creating a truly global carbon market with unified rules and formal market linkages is not realistic. Hence there are an increasing number of discussions in the research and policy communities about a club approach that can allow several carbon markets to coexist while maximizing economic and environmental benefits through cooperation. To create an effective carbon pricing club, several obstacles need to be overcome: insufficient global ambition, a lack of cohesion between disparate price policies, potential economic shocks and losses, and prices that do not rise quickly enough to cap global temperature rise at 2° C. The roundtable discussions on using carbon clubs to accelerate the transition to a low-carbon economy generated a number of key themes and strategies to address these obstacles and their less-than-ideal outcomes.

While carbon prices—the amount that must be paid for the right to emit one ton of CO<sub>2</sub> into the atmosphere—typically need to reach \$50 to \$80 per ton to trigger a shift away from fossil fuels, putting any price on carbon, regardless of the specific amount, helps to generate a signal to the market, spur discussion, prompt behavior changes, and trigger a race to the top. In British Columbia, Canada, even low levels of taxation changed people’s habits and started key conversations about climate change. These sociological benefits began at prices of approximately \$10 per ton.

Over the long term, this \$50-to-\$80 level is expected to be the price at which different carbon markets converge. Heterogeneity between different market and/or tax schemes could threaten or delay the potential for long-term or medium-term convergence between different carbon policies. Fair and transparent standards, which should be set by the club’s actors, are a crucial means of mitigating this risk.

Designing compatible carbon pricing policies could also help calm the stormy waters that heterogeneous policies could create. The goals for this kind of common carbon pricing pathway and framework will need to be determined by the club’s actors, which could include national and subnational jurisdictions.

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<sup>2</sup> Ibid..

The rules of the WTO and the UNFCCC are not likely to pose a barrier to implementing carbon clubs; to the contrary, there is room (and existing cases) within these institutions for the conversation around carbon clubs to continue.

While it may be difficult to add specific carbon pricing language to the Paris negotiating text, several other factors would characterize a successful outcome for carbon pricing in and beyond December 2015. The Paris agreement could raise the ambition to address climate change to the levels needed to catalyze effective levels of carbon pricing. The UNFCCC framework could support the creation of clear international rules for market use and exchange criteria.

In particular, the UNFCCC could help facilitate the development of effective accounting standards and practices (above all to avoid double counting), enabling parties to link trading schemes or to exchange units across borders, subject to accounting rules. Focusing on the accounting dimension of the UNFCCC would be less contentious than inserting specific carbon pricing language into the Paris negotiating text and would direct much-needed attention to adjusting the UNFCCC's accounting frameworks. Rules and ideas might be drawn from carbon offset forums, the Clean Development Mechanism, and potentially, if carbon pricing clubs are viewed as cooperative initiatives, the Non-State Actor Zone for Climate Action platform. The UNFCCC includes a number of principles that allow certain parties to act while others choose not to, potentially enabling this type of agreement to proceed without being hindered by countries opposed to it.

Discussions about the WTO also found that concerns about carbon pricing policies triggering WTO intervention are largely unfounded. The WTO's rules and disciplines only cover trade in goods and services. Since emission units do not fall into either of these categories, carbon pricing does not fall into the WTO's immediate jurisdiction. The WTO's involvement would only be triggered through issues that might arise from linking carbon prices with other instruments that might entail trade competitiveness issues. In other words, fear of incompatibility between the WTO and carbon pricing clubs should not inhibit efforts to create a global framework for decarbonization.

The limits of the WTO's framework also make it unlikely that this institution could address the threat of carbon leakage and competitive distortion that might arise from carbon taxes. Recent scholarship has raised the possibility of using a WTO evaluation of competitive distortion to allow an industry operating in a country with a carbon price to complain about unfair competition from an industry operating in a country without a carbon price. (The industry operating in the country with a carbon tax would argue, in effect, that another country's lack of a carbon pricing policy amounts to an undue subsidy of industry operating in that nation.) Some participants suggested that the lack of a carbon tax was unlikely to find a strong foothold in the existing WTO framework since it is unlikely to be considered a categorical distortion or to fit the WTO's very narrow and specific definition of a subsidy. This approach would also require the WTO to set a reference price for carbon, which would likely be a complicated and difficult task outside of the organization's area of expertise.

However, there may be ways for the WTO to encourage carbon pricing policy adoption and through enhanced cooperative mechanisms that increase and facilitate technology transfer, develop coherent trade policies to help attract investment, and enable countries to reduce high tariffs to facilitate access to environmental goods and services. Other plurilateral forums, such as the Trans-Pacific

Partnership, could also provide a space for advancing carbon pricing. Existing clublike schemes, particularly in trade, offer potential templates and best practices.

### **Elements of a Carbon Pricing Club**

The roundtable discussed key elements for the institutional design of a carbon club and focused, in particular, on potential incentives, criteria for membership, enforceability of rules, and mechanisms for review.

Potential incentives for engaging in a carbon pricing club might include opportunities for technology development and transfer, access to capital, and influence over the formation of the club's rules as they relate to minimum standards and trade opportunities. Possible structures for linking carbon pricing with incentives to invest and with other trade policies should be explored in more detail.

The specific objective of a club, which could range from socializing the idea of carbon pricing to helping maintain a 2° C temperature rise, will affect the stringency of membership criteria and review and influence the club's primary activities. Clubs could also evolve gradually (with only selected elements introduced commonly by all members) or encompass a broad range of different levels of participation. For instance, a principle-based approach, where membership is based on adherence to standards that promote transparency and reduce the risk of double counting, might carry the implicit threat of transitioning to a rules-based approach should participants fail to meet these standards.

These kinds of phased or flexible criteria for membership might offer one route toward including subnational governments, businesses, and other nonstate actors. Other approaches include defining club inclusion in terms of an entity's ability and authority to set and enforce a carbon price, and creating separate but parallel tracks for different kinds of actors.

Private investment is often crucial to funding the kinds of technology development and transfer that might incentivize governments to join clubs; this could create another tool for bringing different types of actors together. Whatever the structure, strategies for encouraging transparency and avoiding double counting among the different participants will be vital. It will also be crucial to ensure efforts to form a club do not jeopardize or marginalize business and investor engagement in carbon pricing.

### **Next Steps**

The roundtable noted several steps that could help facilitate efforts to discuss and develop a robust carbon pricing club:

- (1) Exploring precedents and replicable structures for carbon pricing clubs, drawing on examples from trade and other spheres.
- (2) Mapping the existing ecosystem of efforts to support and converge carbon pricing policies.
- (3) Identifying key stakeholders and participants for future discussions.

The Paris COP21 and the 10th WTO Ministerial, also in December 2015, might offer especially valuable opportunities to convene key stakeholders and to further develop and socialize this issue.

The analysis and recommendations included in this policy memo do not necessarily reflect the view of the Stanley Foundation or any of the conference participants, but rather draw on the major strands of discussion put forward at the event. Participants neither reviewed nor approved this document. Therefore, it should not be assumed that every participant subscribes to all of its recommendations, observations, and conclusions.

*For further information, please contact Jennifer Smyser at the Stanley Foundation, 563-264-1500.*

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