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The Global Regulatory Framework for Decarbonisation – 3x3 Starting Points for the Reform of Global Economic Governance

Summary

Mitigating climate change and limiting global warming to no more than 2°C require a fast and radical transformation of politics, the economy and society. Worldwide emissions of greenhouse gases need to fall to zero by 2100. Action needs to be even faster in the case of carbon dioxide (CO_2), which is primarily released in the burning of fossil fuels. According to the Intergovernmental Panel on Climate Change (IPCC), global CO_2 emissions need to reach zero by 2070 at the latest. In other words, the global economy needs to be completely "decarbonised" by then. The sustainable development goals (SDGs) of Agenda 2030 underscore the significance of this task.

The decarbonisation of our economic activity is dependent not only on the international climate regime, but also the regulatory framework for the world economy, i.e. global economic governance.

In addition to progress made in the context of the UN Framework Convention on Climate Change (UNFCCC) and the fundamental acknowledgment of all states of the need to tackle climate change in the scope of Agenda 2030 there are currently numerous initiatives that give cause for optimism – not least the commitment of the G7 states to the decarbonisation of the global economy and manifold climate actions of actors such as cities, churches and companies.

However, further reaching reforms of global economic framework conditions are necessary if a fundamental transformation is to be achieved. We therefore propose 3x3 starting points: 3 areas of action, each with 3 key aspects.

Of particular importance for the decarbonisation of the global economy are (A) adequate pricing, (B) a suitable body of regulations for international trade and investment and (C) the appropriate configuration of the financial markets.

(A) To achieve correct pricing it is necessary to (i) introduce a global carbon price, (ii) continue to remove subsidies for fossil fuels, and (iii) extend the system of payments for ecosystem services.

(B) A suitable regulatory framework for international trade and investment includes (i) climate-friendly multilateral trade rules under the aegis of the World Trade Organization (WTO), (ii) the promotion of plurilateral agreements for the liberalisation of environmental goods and services and (iii) increased focus on the right to regulate in terms of environmental aspects in bilateral and regional trade and investment agreements.

(C) In addition to the establishment of global funds such as the Green Climate Fund (GCF), the area of global financial governance has three starting points in particular: (i) regulation of financial markets, (ii) green guidelines for investment decisions and (iii) guarantee instruments for green investments.

For all reform measures there is a need to identify potential win-win constellations that offer co-benefits to as many participants as possible. In addition, attention should also be paid to trade-offs and political economy. This includes the question of which actors are in favour of the necessary measures, which resist them and why and how coalitions of change can be formed and reinforced.

To achieve the successful decarbonisation of the global economy its international regulatory framework – global economic governance – should be reformed using the following 3x3 starting points:

Price-setting for decarbonisation	Trade and investment regulations for decarbonisation	Financial markets for decarbonisation
• Introduction of a global carbon price • Removal of subsidies for fossil fuels • Expansion of payments for ecosystem services	• Reinforcement of multilateral trade rules regarding climate and the environment • Removal of trade barriers for environmental goods and services • Reinforcement of environmental aspects in free trade and investment agreements	• Reform of financial market regulations • Introduction of green guidelines for investment decisions • Provision of guarantee instruments for green investments
Source: Authors		

(A) Price-setting for decarbonisation

Higher prices for goods and services associated with high CO_2 emissions enhance the incentive to reduce emissions. Consumers will either turn to products that cause fewer emissions or reduce consumption of emissions-intensive products. This also applies for producers: in the long term, this may serve as an incentive for innovations and the development of low-emission production processes.

i. Global carbon price

One key way to influence decarbonisation is the setting of a global carbon price – either via the introduction or expansion of CO_2 taxes (price solution) or emissions trading (quantitative solution). Carbon is a very good basis for taxation, in the context of which tax evasion is difficult. As an alternative or a supplement to the price solution the quantitative solution can be pursued, whereby there is a direct political stipulation of an emissions limit and formation of the price of emissions certificates on the market (emissions trading). The revenue generated by a tax or the sale of emission certificates can be used to finance development objectives or reforms of the energy market, or to reduce other distorting forms of taxation.

With regard to the introduction of a carbon price, positive developments can be noted worldwide. Around 40 national and over 20 subnational jurisdictions have introduced a carbon price or are in the process of doing so. At the same time, the introduction of a global carbon price is not yet in reaching distance.

ii. Subsidies for fossil fuels

More than 25 states, especially in Asia, have reformed their subsidies for fossil fuels in recent years. Nevertheless, according to the International Monetary Fund (IMF) the costs caused by these subsidies, including environmental and health damage etc., currently run to around 5.3 trillion US dollars per year. These subsidies distort prices to the detriment of decarbonisation. They harm the environment, inhibit the spread of greener technologies and place a burden on national budgets.

Contrary to the frequently prevailing opinion, subsidising fossil fuels is not an efficient way of increasing competitiveness and helping the poor. Instead, according to the World Bank these subsidies benefit the better-off in particular. However, although the removal of subsidies tends to promote equality, at the same time it leads to an increase in the price of energy and other goods, lowering the purchasing power of poorer households and slowing energy-based industrialisation processes. It is therefore essential that the savings made by the removal of subsidies are used to compensate loss of income amongst the poor, reimburse those that lose out financially and strengthen social safety nets.

iii. Payments for ecosystem services

Payments for ecosystem services (PES) are payments that, for example, compensate landowners or tenants for the non-use or preservation of carbon sinks such as forests or soil that absorb and store carbon, thus helping to limit climate change. These result-based payments can serve to create incentives to protect carbon sinks.

Over 300 PES projects already exist worldwide. The largest projects in China, Mexico, Costa Rica and the UK alone generate payments to the amount of 6.5 billion US dollars per year. PES should be used more widely in order to achieve climate-friendly pricing, especially at global level.

(B) Trade and investment regulations for decarbonisation

The currently ongoing and future negotiations of new rules for international trade and investment should also help to promote decarbonisation and tackle other environmental challenges, both within the WTO and in the scope of free trade and investment agreements.

i. Multilateral trade rules

In spite of the modest progress of recent years, the WTO remains a forum in which global rules are created and enforced. The aforementioned dismantling of subsidies for fossil fuels and other climate-damaging subsidies should therefore also be addressed within the context of the multilateral WTO negotiations. The conclusion of the Doha Round at a low level of ambition would represent an opportunity to put more important future-related issues, for example in the context of decarbonisation, on the agenda.

Thus far, environmental protection has played a backseat role in WTO rules, limited to exceptions that permit the

limitation of trade-liberalising measures where there is a proven risk of endangering "human, animal or plant life" (GATT Art. XX b). However, WTO jurisprudence shows that the exercising of these exceptions is subject to distinct limitations. Within the framework of plurilateral or bilateral and regional trade agreements a more proactive approach can now be seen, for example in the negotiations for the Environmental Goods Agreement (EGA) and the introduction of a right to regulate on environmental issues in the more recent trade negotiations of the EU and USA (see below).

At the same time, these developments also harbour risks. There is a danger that energy and emission-intensive production processes will be shifted to countries with laxer regulations (carbon leakage). This could be prevented via border adjustment measures that place tariffs or other levies on imports from countries without ambitious climate policies. However, carbon border adjustment measures are highly controversial. If they are to be introduced, then they should not be abused for the purpose of protectionism, should be compatible with WTO law and, for reasons of development policy, allow exceptions for products from less developed countries with very low emissions.

ii. Plurilateral environmental goods agreement

Since 2014 negotiations have been underway in the scope of the WTO regarding the dismantling of trade barriers for so-called environmental goods. The Environmental Goods Agreement (EGA) is being negotiated plurilaterally, currently by 14 WTO member states – with the goal of extending the results to cover all WTO member states.

Globally, environmental goods to the value of nearly 1 trillion US dollars are traded. The initial goal is to reduce tariffs on a range of environmentally-friendly products (APEC list) within the scope of the EGA. These goods can contribute to improving air and water quality, facilitating waste management and generating renewable energy. The EGA negotiations under the aegis of the WTO represent an opportunity to underpin the value of this multilateral negotiating forum. In the medium term the liberalisation of environmental services should also be tackled.

iii. Trade and investment agreements

Whilst environmental aspects have only been tentatively negotiated thus far in the scope of the WTO, numerous bilateral and regional free trade agreements (FTAs) have been concluded, some of which have comprehensive green components. The EU and USA in particular stipulate in their FTAs the obligation to not lower environmental standards, also granting the right to regulate further for the benefit of the environment. The commitment to international environmental and climate agreements, opportunities for participation of interested groups and individuals in environmental matters, transparency and enforcement mechanisms are also increasingly frequent elements of FTAs. Similarly, a trend towards more green content can also be observed in international investment agreements (IIAs). However, there are also risks, for example that developing countries are unable to meet high environmental standards or that the green clauses are abused in order to keep cheaper products from developing countries out of the market (green protectionism).

Despite this, environmental clauses contain potential that has as yet gone unused. To utilise this, FTAs and IIAs should define the scope for environmental regulation and the hierarchy of conflicting liberalisation and environmental objectives more clearly. With these prerequisites the clauses can be interpreted better with regard to the environment and protectionist measures identified more easily.

The ongoing mega-regional negotiations for the Transatlantic Trade and Investment Partnership (TTIP) in particular should be used to support the process of decarbonisation. One potential approach would be to establish incentives for green public procurement, i.e. for taking sustainability aspects into consideration when purchasing products or services. Its high share of gross national product means that public procurement can act as a key lever for environmental and climate protection. The involvement of the two trading powers USA and Europe, its sheer size and presence in political and public debate mean that TTIP has the opportunity to exercise a pioneer function in the linking of trade, environmental and climate goals.

(C) Financial markets for decarbonisation

A third area of action for the creation of climate-friendly economic framework conditions concerns the financial markets. The decarbonisation of the global economy requires the dismantling of barriers to long-term investments and more green financing, not only via the establishment of global funds such as the Green Climate Fund (GCF).

i. Financial market regulations

To make long-term investments in the decarbonisation of our economic system more attractive it is necessary to reform the international financial system. The system focuses too heavily on short-term yields and leads to chronic investment deficits for long-term and sustainable projects. The goal of financial market regulation should be to provide explicit support to low-carbon financing, thus contributing to increased investments in low-carbon projects on the part of commercial banks and institutional investors.

Current regulation means that banks and institutional investors – such as sovereign wealth funds, pension funds and insurance companies – are currently unable to invest in long-term and sustainable projects, or to do so only to a very limited extent. At the same time, these investors manage assets of several trillion US dollars and have a fundamental interest in long-term investment opportunities. In particular, if allowed to do so, insurers could act as pioneers for differentiated investment portfolios, as the

costs of climate risks are well known to them. Regulatory authorities should therefore take greater account of the risk management of the effects of climate change, as the Governor of the Bank of England, Mark Carney, has repeatedly pointed out. The forthcoming new regulations of Basel III could call for lower capital and liquidity requirements for low-carbon projects. Also in the context of Solvency II for the insurance industry exceptions for green investments are required. Decisive here will be the careful balancing of justified requirements of investor protection and sustainability. Banking stress tests and standards of due diligence for banks and other financial institutions could also include greater consideration of climate risks, thus rendering investment decisions more ecologically sustainable.

ii. Green guidelines for investment decisions

Voluntary commitments to take climate risks into account in investment decisions and promote low-carbon investments would be one way in which international financial institutions, banks and financial market actors in general could contribute to the decarbonisation of the financial sector.

In view of the lack of a realistic global carbon price, many companies and a number of development banks already employ notional, so-called shadow prices for carbon, which they include in their investment calculations. This automatically renders polluting investments more expensive, leading to the favouring of low-carbon investments. A sector-specific and ambitious shadow price for carbon would prevent competitive distortion. In addition, the consistent inclusion of climate risks in ratings, benchmarks and indices would give investors a simple means of becoming involved in financing the decarbonisation of our economy. For central banks, too, it could also be conceivable – and a few pioneers (e.g. China and Bangladesh) already exist – to implement green strategies and anchor sustainability in their mandate as a secondary objective at the least.

iii. Guarantee instruments

Surveys of investors indicate that in addition to regulatory limitations, high risks are one of the principal reasons for failing to invest in low-CO_2 projects. However, lack of information and knowledge of technology mean that the perceived risks are often much higher than the actual risks. For this reason, public donors and development-financing institutions such as development banks could become involved here, providing risk-mitigation instruments to private and institutional investors in order to motivate them to invest in green assets. Financial instruments such as structured funds, in which initial losses are borne by public shareholders, as well as guarantees can promote investment in new technologies and innovative approaches to decarbonisation. Similarly, the creation of an international investment insurance fund for green investments, paid into by both the private sector and governments, could act in a similar way to the deposit protection funds of German private banks to provide the necessary confidence among private and institutional investors.

The 3x3 starting points for a reform of global economic governance presented here would be a major step towards swifter decarbonisation of the global economy. However, in the realisation of all reform measures, care should be taken to ensure that as many as possible of those involved will benefit. A high degree of understanding of political economy is required in order to analyse who is offering resistance and for what reasons, who is in favour of the necessary measures and how coalitions of change can be achieved.

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