

# Project Briefing

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## Key points

- The inclusion of the aviation industry in the European Union's Emissions Trading Scheme (ETS) may set a precedent for the inclusion of similar sectors in the future
- The EU limit on its market for the supply of certified emissions reductions to the Least Developed Countries from 2013 excludes other countries vulnerable to climate change that depend on tourism
- Such countries could adopt carbon optimisation taxes, or develop national or regional ETSs

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## The aviation industry, the EU's Emissions Trading Scheme and Small and Vulnerable Economies: development-friendly frameworks

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**T**he EU is the largest participant in carbon markets and largest purchaser of certified emissions reductions (CERs) from the Clean Development Mechanism (CDM) established under the Kyoto protocol. The EU has also stated that it does not consider the outcomes from the Durban Climate Conference in December 2011 (COP17) to be a new international agreement on climate change. As a result, it has decided to limit the market for CERs to the Least Developed Countries (LDCs), excluding other developing countries from 2013. This means that, for example, Small and Vulnerable Economies (SVEs) in the Caribbean region and Small Island Development States (SIDS) will be unable to supply CERs to the EU's Emissions Trading Scheme (ETS) from 2013, despite their vulnerability to climate change and their dependence on tourism and, by extension, the aviation industry for much of their income.

This increasing focus by the EU on those countries it considers to be in greatest need – the LDCs – is also shown in the reform of its generalised system of trade preferences (GSP).

However, the EU's policy on climate change seems to contradict its own trade policy, as the aviation industry has been included within the EU's ETS for the first time this year, irrespective of the country of origin. The aviation industry is the first imported service to be included in the EU ETS – a key measure to address the impact of greenhouse gas (GHG) emissions. As a result, airline companies must purchase CERs that factor in the EU's emissions reductions targets, with the costs likely to be passed on to their consumers.

This Project Briefing outlines why EU trade and climate change policy needs to adapt, given new indicators of vulnerability related to the physical and regulatory effects of climate change. This may mean recognition of the trade interests of other types of countries such as SVEs and SIDS.

### The first border carbon adjustment

The EU is still a major trading partner for developing countries, and its climate change mitigation policies could have a major impact on their trade flows. The ETS is one example of EU climate change mitigation policy, and is including a growing range of sectors. In 2013 the scheme will be expanded to include the petrochemical, ammonia and aluminium industries and additional gases. The aviation industry has been included within the ETS from 2012, with airlines having to purchase CERs for the amount of carbon emissions produced as a result of flying into the EU. The inclusion of the aviation industry in the EU's ETS is the EU's first border carbon adjustment (BCA) (see Box 1).

#### Box 1: Definitions of border carbon adjustments (BCAs)

The definitions of BCAs include:

- border taxes (as tariffs on imports and, less commonly, rebates on exports)
- mandatory emissions allowance purchase by importers, and
- embedded carbon product standards.

See: Wooders et al., 2009

In relation to trade in goods, the EU considers the use of BCAs to be legitimate for a limited number of products that are likely to be affected by carbon leakage as a result of the implementation of emissions reductions targets and their inclusion within the ETS. The European Commission continues to study the inclusion of imports to the EU ETS, although as noted by Derksen (2011) it is highly unlikely that such measures will target LDCs; no BCAs measures currently exist in relation to trade in goods.

The inclusion of the aviation industry in the EU's ETS is the first BCA to be applied to trade in services. It has already exacerbated trade frictions with large emerging economies such as China, which has barred the country's airlines from participating in the scheme. Other countries have also raised concerns and are preparing to take action, such as barring airlines from participating in the Brussels plan; filing a formal complaint at the UN's International Civil Aviation Organization; imposing levies or charges on EU airlines as a counter-measure; and abandoning negotiations with EU carriers on new routes (ICTSD, 2012).

It has been estimated that the cost of an airline ticket to the Caribbean within the scheme will increase by €8 to €10 both to and from the EU (Good, 2010). Estimates of the effects on tourism demand are, however, more varied. Bartels (2012), for example, notes that the subsequent reduction in tourism demand may be greater for price-sensitive destinations, such as Barbados, resulting in

significant reductions in GDP – an estimated 1-2% – given the island's high dependency on tourism. The discussion on the benefits of the scheme have focused on the creation of extra demand for CERs credits from the CDM from 2012.

## The exclusion of vulnerable countries

The EU decision to limit the market supply of CERs to LDCs only from 2013 will exclude SVEs, including those in the Caribbean region. This means that, with the exception of Haiti – the only LDC in the region – all source countries will be required to purchase CERs, but cannot supply them. This raises questions about the differential criteria among developing countries. And it matters because the surrender of CERs from mitigation measures adopted within the region, rather than the purchase of CERs, could help to reduce the price and demand effects from the inclusion of the aviation industry within the EU's scheme.

The LDC group is the only country group recognised under the WTO's Enabling Clause, which provides for differential treatment for specific country groups. The two key criteria established by WTO in relation to the recognition of country groups under the Enabling Clause are:

- that the favoured countries are recognised internationally to share a common need, and
- that the preferences offered are appropriate to satisfying this need.

**Table 1: Country classification across the Caribbean**

Country	Income classification	LDC	SID	SVE
Dominican Republic	Upper middle-income country (UMIC)		✓	✓
Trinidad and Tobago	High-income country (HIC)		✓	✓
Jamaica	UMIC		✓	✓
Bahamas, The	HIC		✓	
Guyana	Lower middle-income country (LMIC)		✓	
Haiti	Low-income country (LIC)	✓	✓	
Suriname	UMIC		✓	
Barbados	HIC		✓	✓
Belize	LMIC		✓	
St. Lucia	UMIC		✓	✓
St. Vincent and the Grenadines	UMIC		✓	✓
Antigua and Barbuda	UMIC		✓	✓
St. Kitts and Nevis	UMIC		✓	✓
Grenada	UMIC		✓	✓
Dominica	UMIC		✓	✓

Source: Data on country income classification is taken from World Bank: <http://data.worldbank.org/about/country-classifications/country-and-lending-groups>. The classification of LDC and SID is used by the UN: <http://www.un.org/special-rep/ohrls/sid/list.htm>. The category of SVE is used by the World Trade Organization within agriculture, Nationally Appropriate Mitigation Actions (NAMAs) and rules-based negotiations. We have listed any Caribbean country that falls within one or more of these groups as a SVE. See Birkbeck and Harbour (2011).

The effect of using categories beyond developed, developing and LDC could be to increase even further the formal fragmentation of the WTO negotiations process (Stevens, 2012). However, this divide is becoming increasingly apparent in other fora such as the UN Framework Convention on Climate Change (UNFCCC). This is because the needs of large emerging markets, such as China and India, in relation to climate change policy, differ from those of other developing countries such as the LDCs and SIDS. This mismatch among developing country groups is becoming increasingly apparent, with SIDS and LDCs, for example, calling for more ambitious emission reduction pledges at COP17 than the emerging economies.

The use of equivalent measures by the Caribbean region in response to the EU's decision, such as the use of a carbon optimisation tax, or the development of national or regional ETS, could mean that revenue is retained in the region to mitigate and adapt to climate change, rather than being transferred to Europe. However, the establishment of such a scheme would require the development of a framework for monitoring, reporting, verifying (MRV) and certifying emissions reductions. Any tax applied to domestic and imported products/services cannot discriminate between them if they are 'like' products/services. This raises a number of questions, such as:

- how to calculate product/service specific emissions
- how to create a criterion to differentiate 'clean' and 'dirty' products/services, possibly requiring the use of rules of origin or a specific certification system, and
- how to develop a comparison method.

## Policy implications

COP17 was supposed to deliver detailed rules to account for, report, and review countries' GHG emissions, actions and finance. But negotiators agreed neither to common accounting rules nor the establishment of a process to develop such rules. However, there is a commitment to develop a common system for the MRV of emissions reductions in order to address inconsistencies in methodologies, assumptions and accounting systems. The aim is to establish a new international agreement with legal force under the UNFCCC framework that is supposed to be negotiated by 2015 and will involve all countries: developed and developing.

This suggests that the design of equivalent measures to both mitigate climate change and counteract any negative competitiveness effects that may arise from EU policy may be required sooner rather than later. Because of their higher dependence on trade as a source of growth as a result of their small domestic markets, SVEs are bound to be affected disproportionately by the trade-related climate change measures implemented by the EU. For such countries there is an even greater need to ensure that the regulatory frameworks put in place to manage climate change are development-friendly, including at the national, regional and multilateral level.

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### Project information

This policy brief draws on research being carried out under a number of existing workstreams. These include the trade and climate change component of a larger work programme at ODI on Developing a Low Carbon Competitiveness Diagnostic for Low Income Countries, funded by the UK Department for International Development, and a research paper submitted to and presented at the Caribbean Conference on Trade Policy, Innovation Governance and Small State Competitiveness June 11-13 2012. The Conference was convened by the University of the West Indies' Shridath Ramphal Centre for International Trade Law, Policy and Services (under the auspices of the WTO/UWI Chair), the Institute for Sustainable Development and the Institute of International Relations (UWI). The author is also grateful to comments received from the participants of a workshop hosted by the Economic Affairs Division, Commonwealth Secretariat, on Climate Change Mitigating Tax Measures - Legal Implications - 26 June 2012, London.