

## GLOBAL ECONOMIC GOVERNANCE INITIATIVE

# Policy Space for Jobs and Clean Energy

## Trade, Investment Rules, and Local Content Requirements in Renewable Energy Policies

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In an effort to address chronic inequality, air pollution, and climate change in an integrative manner, many nations have deployed Local Content Requirements (LCRs). In the five years following the 2008 Financial Crisis, twenty such policies were put in place all over the world. These policies are justified on both economic and political grounds—by correcting market distortions that favor fossil fuel-based energy and by creating good paying jobs. The two together have the potential to make markets work better, address local air pollution and climate change, and boost employment at the same time.

LCR policies are the subject of increased scrutiny under the existing trade and investment regime, which still incentivizes fossil fuel production and sees linking policies to local content as distortionary rather than market correcting. Since 2010, there have been a total of 9 disputes initiated under the trade and investment regime on the basis of local content requirements in renewable energy policies. These challenges are rooted in both the spirit of international economic law, which overwhelmingly prefers non-discrimination in international trade, as well as the specific letter of certain provisions of WTO agreements and bilateral free trade and investment agreements.

The current exceptions in trade and investment law are not adequate enough to provide the policy space to address market distortion, climate goals, and job creation. Countries seeking to protect their LCRs have turned primarily to exceptions for government procurement practices. Although this provides an interesting window of opportunity, the Appellate Body at the WTO has consistently struck down such arguments. An isolated favorable ruling before a NAFTA tribunal that is discussed in this paper is also unlikely to produce similar results moving forward. The lack of precedent in investment arbitration may lead to investors bringing similar claims over and over again. Moreover, the high costs of such cases may cause governments to avoid the use of LCRs just to protect them-

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selves from risk.

The trade and investment regime needs to create policy space for linking jobs and clean energy in order to meet our climate change goals in a socially inclusive manner. This paper argues that there are two possibilities for the future of maintaining LCRs in renewable energy policy. First, that countries should seek innovative defenses based on the purpose for these renewable energy programs – the protection of the environment. Article XX of the GATT has provided a safe haven for countries implementing other environmental measures in the past, and countries could rely on it in this context as well. Second, that countries should innovate in their treaty reform and new negotiations. The Agreement on Subsidies and Countervailing Measures Article 8 allowed for “green-light” subsidies aimed at development and environmental protection, until it expired in 2000. This type of carve out – both in negotiating WTO reform and new trade agreements – could act to make space for a new kind of “green-light” subsidies: subsidy programs supporting renewable energy development, including those that incorporate LCRs.

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## Introduction

It is an old question, but an important one: “Can nations restrict international trade to protect the global commons?” (Dunoff 1993, 1408). In today’s context, the evidence for climate change and its negative impacts on future generations is indisputable. We are not only concerned for animal and plant extinction, but for the disappearance of entire landmasses and sources of arable land for our children and grandchildren (Janetos 2016). Worldwide, countries are acknowledging this reality and making policy changes to shift our reliance away from fossil fuels and toward renewable energy (Sutter et al. 2015). Although this slow shift will not grind to a halt our progression toward a warmer earth, it may buy us much needed time to make other changes in the ways we produce and consume energy.

There are great difficulties, however, in making policy changes that make life more challenging and more expensive now, for the benefit of future generations. National governments have the important job of representing their domestic constituencies, and all too often our immediate economic, political, social and cultural concerns crowd out planning for a sustainable future. States are also subject to international trade commitments that present external constraints on domestic policy-making through the principles of non-discrimination, free trade and a hands-off approach to governance. This means that states must somehow promote the global good of renewable energy without running afoul of either domestic constituency concerns for economic well-being or international concerns about trade protection. It is a delicate balance to say the least.

In this paper, I am concerned primarily with the constraints placed on states by the international economic legal framework and its related jurisprudence. However, the interests of domestic constituencies are also integral to understanding how governments might move within these constraints. Here I ask: is there room in the international legal framework for local content requirements and other forms of industrial policy to support renewable energy development?

## Local Content Requirements: Roles and Rules

Local content requirements (LCRs) have always played a key role in development for both economic and political reasons. Local content requirements (LCRs) are government measures that “require a certain percentage of intermediate goods used in production processes . . . to be sourced from domestic manufacturers” (Stephenson 2013). They can be found in domestic legislation promoting or regulating investment in a certain sector, as well as an eligibility requirement for government financial support or special tax benefits, to name a few. They enable countries to introduce new sectors to a state or region.

Historically, these measures were put in place to build backward and forward linkages within the local economy, encouraging an integrated industrial development. Countries also relied on them to diversify their economies, introducing new businesses and sectors into certain states or regions.

Today, countries are increasingly turning to LCRs in order to affordably build up national renewable energy sectors and meet international climate change commitments. In the 5 years following the 2008 Financial Crisis, national governments introduced 20 LCRs in the renewable energy sector, part of a larger movement in favor of such policies for industrial development (Stephenson 2013). Proponents of LCRs argue that the renewable energy market is particularly well-suited to these policies, in part because it is a relatively new industry in most countries. Often new industries are not immediately competitive internationally, but, with some support, can “catch up” within a reasonable amount of time. Countries that can’t afford to directly subsidize their domestic green energy sector might want to use LCRs to the same effect. LCRs are also touted as a way to “enlist public support” for the higher costs of renewable energy projects and simultaneously to stimulate job creation in the sector (Stephenson 2013). As Joseph Stiglitz has pointed out, if a country needs to provide subsidies and other support to “try to undermine a massive distortion in an un-level playing field, you’re going to want to appropriate as much of the gains . . . as you can . . . to ensure that as much of the benefit can go to your producing economy, *especially if you’re a developing country*” (Howse and Stiglitz 2011). The challenge of climate change in particular requires a long-term view that most governments do not have. In order to prioritize this, then, the benefits must be linked to more immediate concerns – like local jobs and economic growth (see also, Meyer 2015).

In the long term, LCRs could result in an increased global supply of renewable energy and a corresponding ability to compete with fossil fuel prices. Robert Howse has argued that for China (for example) to lack support for wind and solar power industries would be “irresponsible.” Relying on our current understanding about climate change and the supply and demand of alternative energy technologies, there are good, global environmental reasons for China to prioritize the security of renewably produced energy. “Here’s a case,” he argues, “where there is possibly a legitimate non-protectionist argument for ensuring the long-term viability of a domestic industry” (Howse and Stiglitz 2011).<sup>1</sup>

There are indications, however, that both the spirit of the international legal regime, and specific letter of some treaties, preclude the use of these key policy instruments. Since the 1940s, economists and policy-makers have been trying to distance themselves from the “Beggars thy neighbor” economic approach that was prevalent before and during the Great Depression. Protectionist measures seem to be the knee-jerk reaction of most nations whenever economic well-being is threatened, but we know from experience that that won’t solve the problem. So, we have the international economic legal framework in place to keep governments from resorting to protectionist and retaliatory trade practices. The General Agreement on Tariffs and Trade (GATT) institutionalized the principle of non-discrimination, which has become the bed-rock of our international economic community. Under this principle, codified in Article III, countries may not treat (through regulation or taxation) imported goods less favorably than their own.

By the 1990s, the scope of international trade law had expanded and national treatment was part of a larger package, promising rapid development for countries that engaged in full liberalization and further deregulation across their economic sectors. The Agreement on Trade Related Investment Measures (TRIMS) and the Agreement on Subsidies and Countervailing Measures (SCM) both became a part of the “Single Undertaking” of the WTO, which specify further what types of government regulations are prohibited. Included on that list: Local Content Requirements.

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<sup>1</sup> An important question when it comes to the role of China in the global renewable energy market, is whether making renewable energy cheaper globally is increasing aggregate demand (by increasing supply and lowering the price) or reducing demand by undercutting the political support for renewables energy elsewhere. Though the answer exceeds the scope of this paper, I hope that others considering the role of industrial policy in renewable energy will uncover empirical evidence to explore this question in depth

## Global Energy Market Distortions

There are good economic reasons for challenging that dominant paradigm. In the first place, highly integrated world markets have “accentuated many of the pervasive market distortions” in the global economy (Kumar and Gallagher 2007). These distortions work against the development goals of economic diversification, technological growth and increasing domestic production capacity, to name a few. “Market failures”, as they are called, extend beyond negative economic outcomes, often resulting in social, cultural and environmental externalities that are not immediately quantifiable (Kumar and Gallagher 2007).

### Global Energy Markets’ Natural Distortion.

Nowhere are these distortions more evident than in the global energy markets. Negative environmental externalities occur when the prices in the economy do not adequately take into consideration the environmental costs of the production or consumption of a good (Kumar & Gallagher 2007). Fossil fuels, both in their production and consumption cause irreversible damage. Current projections by the international environmental community indicate that we need to hold global warming to *below* 2 degrees Celsius by the year 2100 (Janetos 2016). In order to meet that goal, however, scientists estimate that approximately 75 percent of the fossil fuels still in the ground must remain there – and not be extracted and burned (Vaughn 2015). Continuing to rely on fossil fuel for energy has some very real (negative) consequences for our earth. Still, these external impacts are not calculated as a part of the cost of these goods. As a result, the demand for fossil fuels, has been kept artificially high. In order to compete with, and ultimately overtake, fossil fuel as our dominant energy source, governments must intervene to support the development and production of renewable energy.

### Widespread subsidization of fossil fuels further distorts energy markets.

In addition to the natural distortion of the energy market, government support exacerbates this problem. Governments actively promote fossil fuel production and consumption, in the name of equitable access to energy and energy security, through subsidies, investment policies, the tax code and other domestic laws. Research surrounding government support for the fossil fuel sector reveals that it is both ubiquitous and difficult to measure. There are essentially two broad types of subsidies “those given to producers and those given to consumers” (Temperley 2017). The WTO provides a formal definition of such subsidies as a “financial contribution by a government which confers a benefit” (SCM Art. 1.1). In addition to grants and government loans, this includes tax breaks, royalty breaks, the provision of infrastructure, and goods and services offered at below market value. It also includes measures that transfer risk through providing cheaper financing, equity, and guarantees. Despite the expansive scope of this definition, it may still leave out certain consumer subsidies, such as price controls imposed by a government energy agency.<sup>2</sup>

This difficulty in defining fossil fuel subsidies makes it also difficult to measure. There have been various efforts to quantify the amount of government support for fossil fuels and for energy more generally. However, the lack of a full accounting of such subsidies make it likely that current estimates are well below the actual numbers.<sup>3</sup> One study compiled available data and calculated approximately US\$588 billion for global fossil fuel subsidies in 2014 (Whitley and Van der Burg 2015, citing Koplow 2014). The IMF proposed another approach which tallies not only traditional government subsidies but also the costs of climate change, local air pollution, congestion, accidents, and road damage (Whitley and Van der Burg 2015, citing IMF 2015). This estimate suggested that these indirect (or “post tax”) subsidies, when added to existing numbers amount to closer to US\$5.3 *trillion*. With that level of distortion in the energy market, it is not surprising that governments would need to employ subsidies and incentive programs to build up

<sup>2</sup> Even countries offering tax breaks for fossil fuel producers have resisted the categorization of “subsidy”, as in the case of the United Kingdom (Temperley 2017, citing Mandel 2016).

<sup>3</sup> A full discussion of the various attempts at defining and quantifying fossil fuel subsidies lies beyond the scope of this paper. However, for a full description and analysis of these attempts, see Temperley 2017.

competing renewable energy industries.

Another factor highlights the inequality in treatment between renewable and traditional energy sources. At the time of this writing, “no fossil fuel subsidy has ever been challenged before the WTO dispute settlement” (Van de Graaf 2017). At the same time, there have been 9 disputes challenging local content requirements in renewable energy policies since 2010. Of those, five of them resulted in the removal of the challenged measure or some retaliatory trade practice by the complainant state, and three have yet to be determined.<sup>4</sup>

Experts debate the reason for this. It could be that countries judge the likelihood of success to be low in these types of cases due to the “challenge of establishing that a fossil fuel subsidy will have adverse effects and result in injury to other WTO members” (De Bièvre 2017). It could also be that states are just more likely to challenge measures in countries with diversified economies, which is where the majority of the renewable energy technologies are. A third option may be that countries tend to challenge new measures rather than those that have been in place a long time (Van De Graaf 2017, citing Meyer 2017).

Despite their disparate treatment, subsidies for fossil fuels and for renewables are not very different in type and structure. Indeed LCRs can be found to support both sectors, and countries tend to underreport these support measures as well (Van de Graaf 2017). In the following paragraphs I explore the specific rules under the WTO and the North American Free Trade Agreement (NAFTA) governing the use of LCRs, as well as recent jurisprudence that gives shape to these rules. In this current age of withdrawing from and renegotiating older trade agreements, I conclude by proposing some alternatives that may provide the policy space necessary for countries to shift their support for fossil fuels to renewable energy.

## The WTO Agreements: LCR Prohibition in Three Provisions

Article III of the General Agreement on Tariffs and Trade (GATT) and Article XVII of the General Agreement on Trade in Services (GATS) lay out the standard of “national treatment”: goods and services from fellow WTO members must be treated “no less favorably” than domestic goods and services. This means that taxing foreign goods much more or regulating them more restrictively than similar local products violates the rules. GATT and WTO dispute settlement panels have spilled much ink trying to determine whether two products are similar, that is, “like”, or simply unlike competitors, and whether *different* treatment really amounts to *worse* treatment. There is strong evidence, however, in recent WTO disputes, that local content requirements run afoul of the spirit of the national treatment standard by encouraging producers to prefer domestic goods over imports (see *Canada-FIT*, *India-Solar*, *US-Renewables*).

In 1994, the WTO introduced two additional agreements that speak more directly to the legality of LCRs. The Agreement on Subsidies and Countervailing Measures (SCM) lists certain subsidies as “prohibited”, including those linked to LCRs (SCM Art. 3). The Agreement on Trade-Related Investment Measures (TRIMs), in addition to incorporating the standard in GATT Article III, also contains an “Illustrative List” of prohibited measures (TRIMs Art. 2, Annex). Among them, measures requiring and incentivizing higher percentages of domestic content in production, in other words, LCRs.

There are some limitations to the scope of these prohibitions. First, GATT Article III, the TRIMs agreement and the SCM agreement each apply uniquely to trade in goods. TRIMs Article 1 expressly states that it “applies to investment measures related to trade in goods only.” The SCM agreement does not have such an explicit statement of scope, but the presence of a negotiating mandate in GATS Article XV and the on-going difficulty of defining and regulating services subsidies under the Doha Round demonstrates that the existing codified rules apply only to subsidies on domestic goods (CTS 2011).

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4 Of those 5, two were the results of domestic dispute procedures, and one was settled outside of the WTO dispute settlement process. More detail about each of these cases is provided below.



Additional flexibilities arise in the context of trade in services. The GATS Article XVII (National Treatment) commitment is limited only to “the sectors inscribed in its schedule.” This approach is known as a *positive list* approach, which means that a sector is *not bound* by the rules unless the country explicitly binds it. Contrasted with the negative list approach, it provides countries a greater chance to protect key service sectors in their economy.

A final constraint of the prohibition on LCRs can be found within the rules governing disputes. Two types of complaints are available under the WTO Dispute Settlement Understanding: one in which the defendant party has violated the text of the agreement, and one in which there has been no technical violation. In both cases, the complaining party must show that it has experienced a “nullification or impairment” of some expected benefit under the agreement. Of course, where a WTO member has violated the terms of the agreement, there is a “rebuttable presumption” of that nullification. Still, WTO members are less likely to complain in the absence of easily provable damage to their economy. Furthermore, disputes take place only between states, allowing political and diplomatic concerns to sometimes take precedence and preclude the bringing of a case. If the economic impact of the “illegal” measure is low, while the (diplomatic and financial) cost of litigation is high, states may have good reasons to leave well enough alone.

## A Broader LCR Prohibition in US Free Trade Agreements

The WTO is not the only international trade agreement to address the legality of LCRs. Parallel to the global trade regime, regional, bilateral and multilateral agreements (FTAs, for our purposes) have developed to address the specific needs of certain trade partners. These agreements are legal under Article XXIV of the GATT, which permit preferential and regional trade agreements as long as they are either fully or nearly fully liberalizing.<sup>5</sup> As a result of this rule, most FTAs contain stricter rules about trade liberalization that force broader and deeper commitments in international economic law. NAFTA is no different. Article 1106 (Performance Requirements) includes LCRs in its list of prohibited policies (see also *TPP* Art. 9.10).

In general, the limitation may seem indistinguishable from the WTO, but the context enables us to unpack the true scope and coverage of such an article. NAFTA language (repeated in all subsequent US treaties) states that “[n]o Party may impose or enforce any of the following requirements . . . in connection with the *establishment*, acquisition, expansion, management, conduct or operation of an investment” (Article 1106, emphasis added, Nikièma 2014). The apparently unassuming mention of the *establishment* of an investment extends the commitment to foreign investors even before they have entered the country and become investors, properly speaking.

Another subtle difference between the TRIMS approach and what we call “TRIMS+” approaches, typified by US trade and investment agreements, is the definition of the word “investment.” The definition of “investment” in the NAFTA is not the broadest model, though it does cover a wide variety of types of investment interests (NAFTA Article 1139, SADC Model BIT 2012). Over the years, the US has broadened and deepened this aspect of their treaties, such that investment includes “every asset that an investor owns or controls”, with a long, non-exhaustive, list of examples (*TPP* Article 9.1). The implication here is that LCRs are not only prohibited in the context of trade in goods or selected services sectors (as they are under the WTO agreements). Instead they are widely prohibited across the economy in every sector where a foreign investor is investing or *may* plan to invest.

A third contextual difference between the WTO and the NAFTA, is the different type of dispute settlement procedures available in the event of a conflict between the parties. In addition to disputes between state parties, NAFTA, and subsequent US agreements, follow the model of bilateral investment treaties,

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5 Some agreements which are not “nearly fully liberalizing” may be permitted also under the Enabling Clause, a waiver for developing and Least Developed Countries to deviate from the rules of the GATT due to their development status.

allowing private investors to sue national governments on the basis of their treaty commitments. Although the on-going debate on the legitimacy of the investor-state dispute settlement model is beyond the scope of this paper, suffice it to say that obstacles to bringing a suit under NAFTA or other US treaties are much lower. The high cost of investment arbitration is among its most critical characteristics affecting State regulatory freedom. Research has shown that even the costs of the legal defense in such a case amounts to US\$5 million. Awards in favor of the investor average around US\$75 million, but top out at over US\$1 billion (Johnson 2016). When it comes to local content requirements to promote renewable energy programs, states face the daunting likelihood of an investor-state case that will drain the public purse.

## **The Procurement Exception: Attempting to Work Around LCR Prohibitions.**

Immovable as the global trade regime seems to be on the subject of LCRs, governments have sought to by-pass those rules by way of the established government procurement exception. Since the drafting of the GATT, countries around the world have acknowledged a certain “special” treatment for government procurement practices. Nations have used this flexibility to favor domestic groups or regions that had been historically mistreated or lacking opportunities. It became a way to discriminate on a small scale that is permitted under international law.<sup>6</sup>

GATT Article III contains common language, present in many treaties: “The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale” (Article III:8). Since the TRIMS Agreement incorporates GATT Article III by reference, Article III:8 would equally apply to trade-related investment measures, as to goods trade measures more generally. The GATS provision on procurement echoes the exact same standard, only as it applies to the supply of services (GATS Article XIII).<sup>7</sup>

The NAFTA reflects a similar sentiment, if more simply stated. Article 1108(7) and 1108(8) assert that the National Treatment (1102), Most Favored Nation (1103) and Performance Requirements (1106) provisions “do not apply to procurement by a Party or a state enterprise.” Concerns about energy security and access to energy for all citizens have led to national and subnational governments keeping a tight grip on energy production and consumption. The sector is often heavily regulated, if not entirely run, by state enterprises. For that reason, the government procurement exception has taken front stage as a way for states to rebut accusations of discrimination in the energy sector.

## **Government Procurement Exception Challenges: the Canada – Feed-In-Tariff case.**

Since 2010, 9 disputes have been initiated on the basis of local content requirements in renewable energy policies. The first time that local content measures came before a WTO panel was in 2011. At that time Japan and the European Union brought consultations against Canada for a program Ontario had introduced to encourage investments in renewable energy. The feed-in-tariff (or FIT) program, simply paid a guaranteed rate to eligible generators of electricity produced from renewable energy sources. One eligibility requirement, among many, was the purchase of local equipment to produce renewable energy. Japan and the EU claimed that Canada had violated both the TRIMS and SCM Agreements. The policy was “so straightforward” in its violation of the WTO agreements, that Canada appealed only the finding that the government procurement exception did not apply (Meyer 2015, 1954).

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6 Today, 47 WTO members are party to the plurilateral Government Procurement Agreement, which seeks to regulate and limit the use of discriminatory measures in public procurement. Parallel negotiations are taking place to regulate procurement in services sectors, with somewhat less consensus on the scope of a proposed agreement.

7 “Articles II, XVI and XVII shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of services purchased for governmental purposes and not with a view to commercial resale or with a view to use in the supply of services for commercial sale” (GATS Article XIII).

Canada argued that the feed-in tariff program was, at its heart, a government procurement program for energy production. As in many countries, Canada's provinces regulate energy production and administer distribution. The provinces are also responsible for granting permits and licenses and overseeing the retail price of energy to consumers (Christian and Shipley 2017). The feed-in-tariff program guaranteed a price for renewable energy producers who were awarded contracts – essentially government procurement contracts (*Canada-FIT* para. 2.4). The Appellate Body, however, disagreed. Based on the wording in GATT Article III, the Appellate Body noted that the products discriminated against (equipment used to produce renewable energy), were not the same as the product procured by the government (the renewable energy itself) (*Canada-FIT* para. 5.79).

Read narrowly, GATT Article III:8 does seem to limit the carve-out to the “products purchased for governmental purposes”, which, in this case, would be the energy and not the energy producing equipment. And although this conclusion is intuitively reasonable, the outcome paved the way for numerous similar claims brought on these bases. On the heels of the *Canada-FIT* decision, both the United States and the European Union initiated domestic trade investigations into the Chinese solar industry, which resulted in countervailing duties from the US and an agreement by China to voluntarily limit exports to the EU (Bridges 2012, WSJ 2013). China likewise brought a claim in 2012 against the European Union for measures substantially similar to Ontario's FIT program (*EU-Energy* 2012), which was followed by another complaint in 2014 by Russia (*EU-Renewable Energy* 2014). The former case seems not to have moved forward, but China joined the latter case as a third party. The parties, which now include Brazil and the US, among others, expect the panel report by the end of 2017.

A year after the conclusion of *Canada-FIT*, the US brought a claim against India for the same policies (*India-Solar*). The Appellate Body concluded, on terms identical to those in the *Canada-FIT* case, that India had violated GATT Article III and the TRIMS Agreement, and that the measures did not qualify for the government procurement carve-out of Article III:8. In retaliation, India brought a case in September of 2016 against the United States for a number of state-based renewable energy programs with LCRs (*US-Renewable Energy* 2016).<sup>8</sup>

### Government Procurement Under the NAFTA: *Mesa Power v. Canada*.

As has happened in a handful of other cases, *Canada – FIT* gave birth to a parallel investor-state dispute under NAFTA – *Mesa Power v. Canada*. Mesa Power is an energy company that applied to receive a contract under Ontario's FIT program. After multiple rounds of awarding contracts Mesa failed to receive its expected allotment. Although the fact of not awarding a contract to an investor is not, in itself, a violation of any treaty commitments, Mesa asserted that the process involved violated NAFTA Articles 1102 (National Treatment), 1103 (Most Favored Nation Treatment), and 1105 (Minimum Standard of Treatment). They further claimed that the LCRs present in the FIT program violated Article 1106 (Performance Requirements) (*Mesa Power*, para. 208).

Ontario had initiated the Feed-In-Tariff program as part of its Green Energy and Green Economy Act (2009) and Green Energy Act (2009), which were part of a province-wide initiative to increase reliance on renewable energy. Around the same time, Ontario initiated negotiations with a Korean Consortium to invest in renewable energy. This resulted in the Green Energy Investment Agreement (GEIA) (2010). The GEIA's impact on Mesa Power was to effectively set aside some of the otherwise available transmission capacity so that they were never awarded a contract that they might have received in the absence of the

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8 Just prior to the *Canada-FIT* case, the US brought consultations against China for its subsidies supporting its wind power sector. That case, based on the SCM Agreement, was concluded outside of the Dispute Settlement procedures of the WTO. China agreed to remove the problematic subsidies, specifically those which contained LCRs. China also claimed that those subsidies had already been removed before the claim was brought and that the Special Fund for Wind Power Equipment manufacturing (the measures at issue) was never intended to promote domestic industry, but only to increase research and development. After all, note Chinese sources, their wind power sector is strongly competitive internationally, so why subsidize? Meanwhile, US authorities hail this as a great success (ICTSD 2011).



GEIA (*Mesa Power* paras. 38-42).

Since Mesa was never awarded a contract, the tribunal determined that the presence of LCRs didn't have an actual impact on Mesa's financial position, and for that reason, they didn't have jurisdiction to determine the outcome under Article 1106 (*Mesa Power*, para. 404ff). However, since the tribunal turned to the government procurement exception in the NAFTA to determine whether Canada violated Articles 1102 and 1103, the decision is not without its application to our concern about LCRs. Mesa, mimicking almost exactly the argument of the Appellate Body in the *Canada-FIT* case, argued that "there is simply no link between the discriminating treatment in question and the purposes of the procurement of electricity" (*Mesa Power*, para. 391).

In order to determine the scope of the application of the government procurement exception, the tribunal (in a 2 to 1 decision) relied initially on two previous NAFTA case: *ADF Group Inc. v. United States* and *UPS v. Government of Canada*. In both cases, the words "procurement" were interpreted broadly to include all government purchases (*Mesa Power*, para. 408 (quoting ADF para. 161)). The tribunal drew from other sources as well, including the French and Spanish versions of that article which use words that could equally be translated as "purchases", without limitation as to what the State does with those purchases. The determining factor, however, was the textual difference between the government procurement carve-out in GATT Article III:8 and that in NAFTA Article 1108. While the GATT explicitly limited the scope of the exception by referring to "products purchased for governmental purposes and not with a view to commercial resale", the NAFTA simply states that the provisions of Articles 1102, 1103 and 1106 do not apply to "procurement by a Party or State enterprise." The tribunal points out that if the Parties had intended to limit the exception further, they could have done so (and indeed did do so in Chapter 15 with language similar to that in the GATT).

All this is moot if it does not apply to the LCRs for promoting renewable energy programs. Fortunately, the tribunal did not leave us guessing. Despite the fact that the tribunal did not have jurisdiction to determine the application of Article 1106 on the LCRs, it notes, in dicta, that "its findings on Article 1108(7)(a) [government procurement carve out for National Treatment and Most Favored Nation Treatment articles] would apply equally to Article 1108(8)(b) [government procurement carve out for Performance Requirements article]. . . . Thus, even if the Tribunal had jurisdiction over the domestic content claims (quod non), the latter would in any event not survive on the merits" (*Mesa Power*, para. 466).

It would be incomplete to end here, assuming that this Tribunal has the last word on the subject. Rather the outcome, while a success for Canada, is far from a certainty going forward. Notably, the tribunal was not unanimous in its decision. The Honorable Charles N. Brower dissented, arguing first that the "broad" interpretations of "government procurement" in the *ADF* and *UPS* cases do not apply here because the facts are so completely different. Both of those cases were situations of true government procurement, not, as in this case, a situation of mere government guarantees in order to supply services and products to the general public. Brower further notes that the tribunal dismisses other references to procurement within the NAFTA (especially in Chapter 10 (Government Procurement) and the more limited definition mentioned in Chapter 15) as not relevant to the interpretation under Article 1108 (*Mesa Power* dissent 2015). This practice seems to fly in the face of the Vienna Convention on the Law of Treaties, which would have practitioners interpret words and phrases first in accordance with their uses within the same chapter, and then within the same treaty.

Another reason that the *Mesa Power* decision does not spell relief for all states facing similar litigation in the future is found in the lack of a formal system of precedent (Cate 2013). Investment arbitration tribunals are able to interpret the application of the law to the facts in new ways each time. Even dissenting opinions in one case (where the state prevails) can become the basis for a favorable investor award in

the next (Van Den Burg 2010).<sup>9</sup> This factor means that the same legal issues may be brought before an investment tribunal time after time.

## Toward a New Model

*Mesa Power v. Canada* takes us by surprise. Based on both textual and contextual differences, US treaties seem to favor the investor rather than regulating state. Here, however, the tribunal hints that the NAFTA could be interpreted to have a broader exception for states attempting to promote renewable energy development via local content restrictions. Even more importantly, all US treaties since NAFTA contain the same or similar language (cf. *DR-CAFTA* Article 10.9(3)(e), *US-Singapore* Article 15.8(3)(e), *KORUS* Article 11.8(3)(e), *TPP* Article 9.10(3)(f)). Even if the *Mesa* tribunal decision is followed, however, the lack of precedent and exorbitant costs in investment arbitration, together, fail to send a clear signal that local content requirements might be permitted under US investment chapters and treaties.

Furthermore, these countries continue to face an obstacle at the WTO. The *Canada-FIT* and *India-Solar* cases lay out an established interpretation of GATT Article III:8. And while Appellate Body reports do not constitute binding precedent for future disputes, their reports carry more weight within the WTO system. As the appellate body in *Japan – Alcoholic Beverages II* said, AB and panel reports “create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute” (p. 14).

## General Exceptions for Environmental Good.

Since the government procurement exception does not seem carve out adequate space for LCRs, I propose two other options to protect those policies. In the first place, a state may take refuge in innovative defenses based on GATT Article XX (General Exceptions). The GATT, the GATS and most US free trade agreements contain “general exceptions”, which override all other commitments in those agreements. GATT Article XX permits measures that would otherwise violate the agreement, but which are *necessary* to protect human animal or plant life or health (Article XX(b)), or which are *relating* to the conservation of exhaustible natural resources (Article XX(e)), among other conditions. GATS Article XIV echoes this flexibility in part, while omitting the exception for measures conserving natural resources. In US FTAs, the language from the GATT and the GATS are often incorporated by reference (*NAFTA* Art. 2101, *DR-CAFTA* Art. 21.1, *TPP* Art. 29.1). More recent treaties with the United States go a step further to specify that “measures referred to in Article XX(b) of GATT 1994 [and Article XIV(b) of the GATS] include environmental measures necessary to protect human, animal or plant life or health” (*TPP*, Article 29.1(2). 29.1(3), emphasis added).

These exceptions have not been invoked as of yet in disputes related to renewable energy or climate change. This may be linked to the extremely narrow interpretations of Article XX<sup>10</sup> under WTO jurisprudence (Hildreth 2014). There is also some debate about whether Article XX applies to the SCM, as an independent agreement.<sup>11</sup> Still, I argue that the progressively widened interpretation of “necessity” by the Appellate Body may offer a solution for countries with LCRs.

Countries have relied on General Exceptions in the broader environmental context to protect animals endangered by reckless fishing practices (*US-Shrimp/Turtles* case), and protect people from environmental hazards in their homes (*EC-Asbestos*). As mentioned in the introduction, it is not uncommon nor unreasonable for countries to link policies aimed at global public goods to industrial development and local jobs

9 This occurs very infrequently. Van Den Burg found one instance of this in a review of 150 arbitral award. The possibility of such an event, however, still supports the point that arbitral awards can have inconsistent outcomes.

10 The Appellate Body has not yet addressed the parallel analysis under GATS Article XIV.

11 See the discussion on the International Economic Law and Policy Blog (<http://worldtradelaw.typepad.com/ielpblog/2012/05/gatt-article-xx-as-an-exception-to-the-scm-agreement.html>)

(Howse and Stiglitz 2011, Meyer 2015). Indeed, it may be politically *necessary* to do so (Meyer 2015).<sup>12</sup>

A proper Article XX analysis first asks whether any of the subparagraphs ((b) or (g)) apply, and then examines whether the measure passes the preliminary paragraph or *chapeau*. The initial part of this analysis is a question of *justification* – whether the measure is in fact justified due to its necessity in relation with human, animal or plant life or health, or due to its relationship to conserving exhaustible natural resources. Historically, the “necessary” standard was a difficult hurdle to clear. GATT jurisprudence suggested that provisions that states considered “necessary” would also have to be the “least [trade] restrictive means” possible for achieving the desired result (*US-Tuna*).<sup>13</sup> In the *Korea-Beef* case (2001), however, the tide of AB opinion began to shift. The Appellate Body asserted that, in the context of Article XX, the reach of the word “‘necessary’ is not limited to that which is ‘indispensable’ or ‘of absolute necessity’ or ‘inevitable’” (*Korea-Beef* para. 161).

By 2007, the appellate body demonstrated an even greater “shift” toward deference to state policy-making. The decision in *Brazil-Retreaded Tyres* stated that “a key element of the analysis of necessity of a measure under Article XX(b)” is whether “there is a genuine relationship of ends and means between the objective pursued and the measure at issue” (para. 210). This relationship should be “weighed against its trade restrictiveness”, of course, but determining “necessity” is here rather like weighing “the relevant issues and values and underlying objectives”: an art rather than a science (para. 210).

In fact, the tribunal seemed to speak almost directly to our immediate concerns – the use of local content requirements to promote renewable energy. Many “complex public health or environmental problems may be tackled only with a comprehensive policy comprising a multiplicity of interacting measures” (para. 151). The short-term results of such policies would be difficult to isolate. Instead, the tribunal argued, “the results obtained from certain actions – for instance measures adopted in order to attenuate global warming and climate change . . . – can only be evaluated with the benefit of time” (para. 151). With that sort of deferential analysis, LCRs for renewable energy may easily pass as both “necessary” to protect human, animal or plant life or health (XX(b)) and “relating to” the conservation of exhaustible natural resources (XX(e)).

The second aspect of the analysis is a question of *application* – whether the measure complies with the *chapeau* and is *applied* in a way that does not unduly discriminate or act as a disguised restriction on trade. As evidenced by repeated cases interpreting Article XX in GATT jurisprudence, the *chapeau* represents the truly difficult part of relying on General Exceptions. Measures that get past the “necessity” hurdle consistently fail when measured against the standard of that introductory paragraph (see *US-Shrimp/Turtles*, *Brazil-Retreaded Tyres*).

LCRs are widely out of favor throughout the WTO agreements and indeed throughout all of international economic law. While one could argue that LCRs are part of a “comprehensive policy comprising a multiplicity of interacting measures” to develop renewable energy and mitigate against climate change, their inherently discriminatory nature would be unlikely to get past the Appellate Body analysis of “arbitrary or unjustifiable discrimination” or “a disguised restriction on trade.” In fact, many such policies have the explicit (albeit, internationally illegal) purpose of discriminating against foreign products and services.

To date, the application of GATT Article XX (and GATS Article XIV) to LCRs for renewable energy is theoretical. The evolution of WTO case law on environmental protection offers some hope, however. When

<sup>12</sup> Meyer engages in an extensive analysis proposing that, for the context specific to sub-national governments, measures providing a “global public good” ought to be analyzed under a “political necessity” rubric to determine whether the measure aimed at protecting the global public good would not have passed in the absence of an LCR provision. The strengths and weaknesses of Meyer’s argument are beyond the scope of this paper. To understand his discussion in more depth, see Meyer 2015.

<sup>13</sup> For that reason, in one case, the US preferred to rely on Article XX(g) because “relating to” is ostensibly an easier standard to meet (*US-Shrimp/Turtles*).

the panel report for *US-Tuna* was released, civil society mobilized to argue for change in the way that the WTO interacted with environmental measures. The result was a substantively different approach in *US-Shrimp/Turtles*. For this reason, and because of the widespread reliance on LCRs for renewable energy programs, countries ought to continue to seek out innovative defenses for these important policies.

### Negotiating Space: options from the WTO and European Union.

The second option for protecting LCRs in renewable energy policies can be found in opportunities for treaty renegotiation and reform. This is particularly relevant in a time when even countries are eager to renegotiate or even discard older trade agreements. Thijs Van de Graaf, speaking in the context of subsidies, suggests that countries carve out renewable energy subsidies as “non-actionable” under new agreements (2017).

Article 8 of the SCM Agreement could provide another model for directly excepting renewable energy subsidies. Although it expired in 2000, Article 8 “green-lighted” subsidies for research and development, assistance to disadvantaged regions, and adaptation to new environmental requirements (Aguayo Ayala and Gallagher 2005). WTO negotiations on subsidies could give new life to the SCM Agreement by “green lighting” new subsidies supporting the development and production of renewable energy, including those with local content requirements.

Margaret Young, from Melbourne Law School, argues that the energy sector ought to learn from attempts in the fisheries sector to distinguish between subsidies with positive and negative environmental impacts. She points out that the Trans Pacific Partnership agreement, as a possible model, contains a section singling out more harmful fisheries subsidies for prohibition (Young 2017). In the same vein, countries negotiating new agreements could attempt to distinguish harmful energy subsidies, as well as LCRs, from beneficial ones, carving out space for the protection of renewable energy programs.

The EU-Singapore free trade agreement demonstrates how this could take place. Chapter Seven (Non-Tariff Barriers to Trade and Investment in Renewable Energy Generation) prioritizes “promoting, developing and increasing the generation of energy from renewable and sustainable non-fossil sources” (Art.7.1). Admittedly, the chapter does reiterate the illegality of local content requirements in the energy sector. However, it distinguishes trade and investment in the energy itself from the products used to generate it (which are bound by different rules). It also permits discriminatory measures promoting research and development, as long as they do not reach a commercial scale. On a more negative note, the rules on subsidies specifically do not apply to the coal sector, while containing hortatory language about the importance of “reduc[ing] greenhouse gas emissions” and “progressively reducing subsidies for fossil fuels” (Art. 12.7(2)(b)). We might argue that EU-Singapore provides a cautionary tale about what can happen to continue discouraging broad-based renewable energy policies, and especially those containing LCRs. At the same time, the agreement might provide a way forward – a model, if you will, for showing us how protection for renewable energy policy *could* be woven into new agreements.

## A Way Forward

For the economic diversification of developing countries, and for the political importance of linking long term global environmental goods with short term economic benefit, local content requirements will remain an essential part of national and subnational renewable energy policies. For that reason, the legality of those programs and policies will likely continue to pop up in multilateral and bilateral disputes. Under WTO law, the question of a government procurement exception has been answered. US trade and investment treaties provide us with a somewhat more uncertain future.

Still, the surprising *Mesa* outcome, along with a long line of environmentally friendly WTO cases relying on GATT Article XX, provide us with hope that these policies may someday find their place in interna-

tional law. Even more plausible, perhaps, is the possibility of carving out renewable energy policies from local content requirement rules and more general subsidies prohibitions. As governments see increasing evidence of the negative effects of climate change in their own territory, LCRs as well as other industrial policies could be welcomed back as an essential tool in a country's development policy toolkit.

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