

POLICY BRIEF

# Creating an Inclusive and Ambitious Climate Alliance Instead of an Exclusive Climate Club

## Summary

The German federal government should push for a climate alliance that

- is **open and inclusive**;
- offers **extensive support for poorer nations** and clear perspectives for potential members;
- **incentivises countries to increase their national climate targets** so as to reap the benefits of membership;
- uses the **compatibility of a country's climate targets with the Paris Agreement as a prerequisite for membership** instead of requiring members to adopt a minimum carbon price; and
- **harmonises future carbon border adjustment systems** while integrating the EU's existing carbon mechanism.

The challenge that the global community faces today is immense. It must fight for climate justice and reach an emissions pathway that is compatible with the 1.5°C limit. Many states have yet to ratchet up their climate ambition in line with the Paris climate goals. **Leading countries fear that ambitious climate action will disadvantage domestic industry**, and they may be tempted to offshore production to countries with more relaxed emission standards. This creates a problem known as carbon leakage, i.e., when emission decreases in one country are offset by emission increases in another. To date, the only solutions to

prevent it are unilateral in nature. This is one reason why in most countries industrial decarbonisation has been sluggish at best.<sup>1</sup>

Russia's invasion of Ukraine in February 2022 marked not only a decisive turning point in European security and foreign policy. It also represented a **serious break in international energy and climate policy**. Since then, many countries have turned their attention to liberating themselves from fossil fuels and energy imports. **Multilateral forms of collaboration on net-zero decarbonisation**—especially between the world's leading markets and emitters—are more important than ever.

One of the most prominent projects launched by **Germany during its G7 presidency** has been the initiation of **an international "climate club"**. The idea builds on "Alliance for Climate, Competitiveness, and Industry", a key issues paper published in 2021 and prepared during the previous administration by the Federal Ministry of Finance, the Federal Foreign Office, the Federal Ministry for Economic Affairs and Climate Action, the Federal Ministry for the Environment, Nature Conservation, Nuclear Safety and Consumer Protection, and the Federal Ministry for Economic Cooperation and Development.<sup>2</sup> Germany decided to use its influence as the president of the G7 presidency to create an open, inclusive, and ambitious climate alliance.

The push for an international climate alliance has come at the right time. A properly designed climate alliance can make an important contribution to global emissions reduction and climate justice. It has the potential to accelerate industrial transformation around the world while creating conditions for fair competition. But the existence of a climate alliance also brings with it serious risks, and in the worst case—if it is seen as an exclusive project of the West or if it keeps out important states because of a focus on carbon prices—it can have the opposite of its intended effect. Below we describe several features that we believe such an alliance must have to avoid such risks and ensure its success.

## Recommendations for a climate alliance

The most important **goals of a climate alliance** should be to **increase global climate ambition, contribute to climate justice, and ensure conditions for fair competition** in key sectors. Germany and the other G7 states should work together with ambitious G20 states and poorer, more vulnerable states to develop a concept for achieving these goals. The alliance should be as inclusive as possible and not be based on an explicit minimum carbon price. Its purpose should not be to replace the EU Carbon Border Adjustment Mechanism (CBAM). Rather, it should build on the CBAM and similar approaches in other states. Germany's federal government should use the term "climate alliance" instead of "climate

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<sup>1</sup> See Jacques Delors Institute (2022): No More Free Lunch: Ending Free Allowances in the EU ETS to the Benefit of Innovation. Retrieval at <https://www.europejacquesdelors.eu/publications/no-more-free-lunch>. Last accessed on 14 June 2022.

<sup>2</sup> Bundesministerium der Finanzen (2021): Schritte zu einer Allianz für Klima, Wettbewerbsfähigkeit und Industrie – Eckpunkte eines kooperativen und offenen Klimaclubs. Retrieval at <https://www.bundesfinanzministerium.de/Content/DE/Downloads/eckpunkte-internationaler-klimaclub.html>. Last accessed on 14 June 2022.

club”, as the notion of a club is seen by many stakeholders as both exclusive and exclusionary.

We recommend considering three aspects in particular when forming a climate alliance.

1

The G7 should include other nations from the outset in the creation of an open and inclusive climate alliance. Furthermore, G7 countries should offer support in the form of climate partnerships and similar measures to help poorer nations with climate ambitions in achieving their targets.

## Why?

The climate alliance should **work to include any country willing to pursue ambitious climate targets**. This is because the alliance can only be truly effective if some of the world's largest emitters (US, China, India, Brazil, Indonesia, etc.) are members. Otherwise, a large portion of global trade will remain outside ambitious climate action and countries will have no incentive to join the alliance. Another reason is that **without an open approach, nations outside the alliance may regard its goals as antagonistic to their own**.

Because the impetus for the alliance has come from Germany and other G7 countries, it is important that the group make clear from the start that it is not a Western project and that it not anti-China or anti-BRICS. Both the European carbon border adjustment mechanism and the steel and aluminium agreement between the EU and the US may seem at first glance to shut out China.<sup>3</sup> But China is an indispensable partner in the fight against global warming. And in view of the global political situation—Russia's war of aggression in Ukraine, in particular—incentives are needed **for China to increase its climate ambition and forge closer climate policy ties with the EU**. Real inclusivity—which needn't involve Russia—is of vital importance today.

From the start, the alliance should offer membership to any state that shows sufficient climate ambition, even if that ambition is less than that of industrial countries. This set-up allows the benefits of cooperation and the incentives for ambitious climate policy to take their full effect. Emerging countries and **poorer nations** alike should be **eligible for membership**, though if they are to realise large-scale climate action they will also require technological and financial support. By offering help to poorer candidates, the climate alliance can enable the ambition that is needed to join the group and to create conditions for fair competition around the world. At the same time, alliance support will accelerate industrial transformation. Finally, the support contributes to global climate justice, for

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<sup>3</sup> See Dröge (2021): USA und EU: Ein Green Steel Deal? Retrievable at <https://table.media/europe/standpunkt/europa-usa-green-deal-stahlindustrie/>. Last accessed on 14 June 2022. See also Germanwatch (2021): Less confrontation, more cooperation: Increasing the acceptability of the EU Carbon Border Adjustment in Key Trading Partner Countries. Retrievable at <https://www.germanwatch.org/de/20355>. Last accessed on 14 June 2022.

without aid many poorer nations would be unable to satisfy the membership criteria for quite some time.

## How?

The alliance should **be open in principle to all countries whose national climate targets are compatible with Paris Agreement goals**. Specifically, candidate countries should have a **credible 2030 target** that is consistent with a 1.5–1.7°C pathway. The G7 should dialogue with countries in the Global South and include them in the design of the initiative.

To ensure that the interests and needs of other countries are taken account from the outset, the G7 should invite a selection of partner countries to the discussion table. These should include major emerging markets such as India, China, Indonesia, and Brazil and leading low-income countries such as Bangladesh (the chair of the V20), Senegal (chair of the group of Least-Developed Countries and the African Union), and Antigua and Barbuda (chair of the Alliance of Small Island States, AOSIS).

The G7 should help poorer nations achieve their respective climate ambitions. To that end, the **multilateral climate partnerships** such as South Africa’s Just Energy Transition Partnership are an effective instrument. They help countries increase their climate ambitions by supporting capacity development and providing financial aid. It is imperative that the G7 orient the collaborations around the development plans of the partner countries. For this, the G7 will need to intensify discussions with possible candidate countries and ensure them that the alliance is not an exclusive project of elite nations but an **important contribution to climate justice**. The support could come in various forms, e.g. through new “Fit 4 Climate Alliance” programmes initiated by development banks. Such programmes should help countries interested in joining the climate alliance raise their ambition by means of innovative financing instruments and capacity development. Given that industrial countries continue to fall short of their climate financing commitments, it is important to make sure that financial support for joining the climate alliance goes beyond previous funding commitments and that the previous commitments are fulfilled.

2

An explicit carbon price should not be a prerequisite for membership in the climate alliance. Instead, prospective members must agree to a level of climate ambition that is compatible with Paris Agreement goals.

## Why?

A **core principle of the Paris Agreement is the nationally determined contribution**, or NDC. In addition to the collective targets for climate action, climate adaptation, and climate funding, each country can decide how to reach its own climate targets. This makes sense, because depending on the national or regional context, some policy instruments are more

appropriate, expedient, feasible, or socially acceptable than others. This is especially true for carbon prices. A climate alliance should not impose a particular policy instrument on other countries or use that instrument as a criterion to distinguish between states. Moreover, **countries that are decisive for the success of the alliance**, such as the US or India, are **unlikely to introduce significant carbon prices in the foreseeable future**.<sup>4</sup> Accordingly, the creation of a climate alliance whose members must adopt a minimum carbon price is clearly at odds with the goal of inclusivity. Nevertheless, certain instruments will be necessary to secure comparable ambition across members.

## How?

The common denominator that unites alliance members should **not be the adoption of a minimum carbon price**, but rather the pursuit of a **high level of climate ambition**. The alliance must bring together states that have committed themselves to implementing large-scale climate action defined not by an explicit carbon price, but rather by credible, **sector-specific targets and instruments that are compatible with Paris Agreement goals**. One possibility would be the use of **"shadow prices"**, which translate implicit carbon prices, regulations, or other instruments into explicit, internally comparable, prices. The exact membership criteria should be openly negotiated or at least coordinated with the partners. In the spirit of climate justice, it is important that the alliance works together with poorer nations to help them reach their goals.

## Proposed criteria for membership

- Prospective members of the climate alliance should have specific climate targets and policy instruments for 2030, 2040, and 2050 that are compatible with the Paris Agreement goal of keeping the global temperature rise below 2°C, and preferably below 1.5°C. Poorer nations should be eligible to receive alliance funding to meet their targets. For the time being, the most important criterion for membership should be the candidate's 2030 target. By 2027, candidates' targets for 2040 should be critical as well.
- Prospective members should have set milestones for certain sectors or periods (until planned investments are made) based on gross domestic product. The milestones can come in the form of implicit carbon shadow pricing, sector- or product-specific benchmarks for the emission intensity of production, standards for energy sources (such as green hydrogen), the use of renewable electricity, and the deployment of efficient technologies for reducing emissions. One could start with certain trade-intensive industrial sectors and over time extend the criteria for membership to other economic sectors.

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<sup>4</sup> SWP (2022): Der G7-Gipfel: Schub für die internationale Klimakooperation? Retrievable at [https://www.swp-berlin.org/publications/products/aktuell/2022A33\\_G7\\_Gipfel\\_Klimakooperation.pdf](https://www.swp-berlin.org/publications/products/aktuell/2022A33_G7_Gipfel_Klimakooperation.pdf). Last accessed 14 June 2022.

### 3

The purpose of a climate alliance should not be to take the place of the EU's CBAM. Rather, it should integrate the CBAM and the carbon border mechanisms of other countries and ensure their harmonisation in the medium to long term. Alliance members should be eligible for limited exemptions to the CBAM.

#### Why?

To accelerate industrial transformation, the EU must protect domestic industries from competitors that are not subject to implicit or explicit carbon tariffs. **To prevent carbon leakage, the EU needs to install the CBAM** by the second half of this decade.<sup>5</sup> This is the only way that European companies can survive in the green markets of the future and the only way that the EU can reach its climate targets even when faced with crisis. The CBAM can be implemented at fairly short notice and can quickly fulfil its intended function.

A central task of an **international climate alliance** is to **harmonise carbon border adjustment mechanisms across different economic areas** in the medium term. A gradual harmonisation can also guarantee longer-term protection for competition in different ambitious states. The World Trade Organization (WTO) should actively monitor negotiations to identify possible legal problems early on. Admittedly, negotiations are likely to take years because, among other reasons, most states have yet to plan border adjustment mechanisms. In other words, the alliance can lay the groundwork but some time is likely to pass before it can **guarantee conditions for fair competition**. For that, it will require a sufficient number of members with a sufficient level of ambition.

Hence, the EU and Germany's federal government should not wait for an effective alliance before pursuing the effective prevention of carbon leakage. They should **promote the CBAM as a temporary instrument solely within the confines of the EU**. Later, they can **coordinate their mechanism with the anti-carbon leakage measures of other economic areas**.

The advantage is that a climate alliance and the EU's CBAM would mutually reinforce each other. A climate alliance can mollify trading partners that regard the CBAM antagonistically and **smooth over other tensions** by offering tariff exemptions to countries that show high levels of climate ambition. Conversely, the CBAM represents a **concrete economic incentive** for states to join the alliance. Pursuing the CBAM and a climate alliance concurrently will thus accelerate the achievement of the goals of both initiatives.

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<sup>5</sup> See Germanwatch (2021), n. 4.

## How?

First, the German national government should **support the rapid implementation of the CBAM** at the EU level. In principle, its implementation is already pre-established as part of the European Green Deal, though Germany should push for a tougher version. Specifically, this means the elimination of **free EU ETS allowances** in CBAM sectors by no later than 2028. The best opportunity for making this decision is the next meeting of the Environment Council, at the end of June 2023, whose agenda includes the reform of the emissions trading system.

Second, Germany should press to make the **CBAM** an **integral part of the climate alliance**, where it will serve as both a carrot and stick. We propose that **members of the alliance be temporarily exempted from import tariffs** for demonstrating greater climate ambition. For example, the EU could free other members from the CBAM for three years, provided they can develop adequate instruments for creating fair competition in relevant industrial sectors. The **exemption** would incentivise states to accelerate the implementation of their climate goals and raise their sector targets so they can join the climate alliance. The three-year deadline would serve to ensure an equal playing field for competition (even for member states with industrial sectors that have yet to show comparable ambition).

We propose that the exemption be rescinded for any country that fails to achieve the determined sector ambition after the three-year period. In this case, the country would remain a member of the alliance, but it would have to start paying the carbon border tariff. This approach ensures industrial competition while incentivising raised NDC ambition and accelerated industrial transformation. A possible alternative would be a stepwise decrease of the carbon border tariff based on gross domestic product (likewise for a limited period). **Poorer members would receive a larger discount** than richer ones.

It is likely that the EU will not be the only political entity to have a carbon border tariff for greenhouse gas emissions. Indeed, the UK has already announced its plans to introduce one in the future. In the medium term, therefore, **the climate alliance should work to harmonise various national and regional mechanisms**. Their coordination will make up the core work of climate alliance and has the potential to accelerate transformation and ensure fair competition. The harmonisation of the various adjustment regimes could **include, alongside the identification of carbon prices**, the recognition of regulatory laws (via shadow pricing, say). That is to say, the EU could, as part of a climate alliance, accept ambitious climate regulations as a further reason for a carbon tariff exemption or discount. Currently, the EU has no plans to pursue such a strategy.<sup>6</sup>

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<sup>6</sup> Creating equal conditions for the subsidisation of climate-friendly production are possible only for temporary periods of time. That is because of the strong disparity between companies forced into climate action by the “stick” of carbon pricing and other regulations and those motivated by the “carrot” of subsidies.

## Further Reading

In 2015, **William Nordhaus** was the first to [popularise](#) the idea of an exclusive “climate club”. In his understanding, a climate club is a group of ambitious states that adopt a collectively determined carbon price and sanction countries that do not with tariffs and other charges. A variety of papers and studies have recently appeared on the topic.

**Ottmar Edenhofer and Axel Ockenfels** [argue](#) that a carbon price is an appropriate foundation for a climate club and a solution to the problem of international cooperation. They maintain that a binding, coordinated commitment is necessary for carbon pricing, but that the current carbon price is too low.

**Agora Industry**, by contrast, is about to publish a paper contending that a carbon price is not a suitable basis for a climate club or a climate alliance.

**E3G**, in a [paper](#) from February of 2022, stresses the need for an inclusive approach. The authors recommend that extensive support be made available for poorer nations and that it should include, among other options, an international technology and investment accelerator and the possibility of incrementally joining the climate club.

In a new [paper](#), **Bruegel** likewise makes the case for the necessity of a comprehensive aid programme. In particular, it argues that revenues from the Carbon Border Adjustment Mechanism and other instruments be used for this purpose, so that the climate alliance can generate international “carbon dividends”.

The **German Institute for International and Security Affairs** (SWP) has [emphasised](#) the obstacles standing in the way of an international climate club – especially in view of Russia’s war in Ukraine and the current energy crisis – and have urged countries to dampen their expectations regarding what a climate club can deliver.

In a recent [study](#), **the German Institute for Economic Research** (DIW Berlin) warned that a cross-sectoral climate club could further polarise the international community or be seen as a parallel process running alongside the Paris Agreement. It argues instead for the employment of the sector-specific partnerships used in the G7, especially in the case of emerging countries.



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**Written by:** Anne Gläser, Christoph Bals, and David Ryfisch

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**Bonn Office**

Kaiserstr. 201

D-53113 Bonn

Tel.: +49 (0)228 / 60 492-0, Fax -19

Internet: [www.germanwatch.org](http://www.germanwatch.org)

**Berlin Office**

Stresemannstr. 72

D-10963 Berlin

Tel.: +49 (0)30 / 2888 356-0, Fax -1

Email: [info@germanwatch.org](mailto:info@germanwatch.org)

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