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## POLICY RESPONSES

### ENVIRONMENTAL TRADE MEASURES AND ECONOMIC COMPETITIVENESS: AN OVERVIEW OF THE ISSUES

by Steve Charnovitz

#### INTRODUCTION

This paper will outline some of the issues involved in using environmental trade measures (ETMs) for competitiveness purposes. After defining the problem, the paper will discuss various policy instruments or approaches and the GATT implications and conclude with an outlook and recommendations.

Competitiveness, as used here, is defined as the *ability of a country to produce goods and services that meet the test of international markets while its citizens earn a standard of living that is both rising and sustainable over the long run* (1). "Good" environmental policies can lead to greater competitiveness. This may occur in at least three ways. First, using less resources as inputs can enhance efficiency. Second, pollution prevention can lead to lower long-run remediation costs. Third, greater internalisation of costs can lead to more sustainable development patterns.

"Bad" environmental policies are not only bad for the environment, but they can also undermine competitiveness by overusing resources, by creating a future liability for clean-up, by permitting inefficient development, and by camouflaging protectionism. Such policies can result from improper environmental targets, improper public policy instruments, or both. This paper will not address the issue of how to identify and improve upon bad environmental policies. Instead, it will address the dilemma of *how a nation can pursue good environmental policies in a world economy where other nations do not pursue similar (or similarly good) policies.*

A nation attempting good environmental policies may find itself under two kinds of pressure. First, as a result of cost increases arising from regulation, a nation may lose exports and/or its domestic market to foreign competition. As U.S. Secretary of the Treasury Nicholas Brady pointed out, "*We must remember that in a world-wide marketplace, businesses and investors are subject to far fewer*

constraints than in the past when deciding where to locate new jobs. Superfluous regulation saps our competitive position, and must be resisted (2)." Second, as a result of these lost markets or lost investment, the government may face political pressure to lower its level of internal regulation.

Although they are not the only instrument available (and may not be the best instrument), trade measures are an instrument that can be used to relieve both the market and political pressures noted above (3). One way to use ETMs is to apply the "costs" of domestic environmental measures to imports in the same manner that they are applied to domestic production. ETMS can also be used to induce other nations to adopt better environmental policies. (This latter approach facilitates exports in addition to filtering out environmentally undesirable imports.)

## POLICY INSTRUMENTS

Five policy instruments or approaches are discussed here: (4)

1. **Tax or Regulatory Equalisation** -- The simplest approach to the inconsistency of regulatory regimes is for a nation to apply its domestic regime to imported goods. The application of a domestic product tax (e.g. on gas guzzlers) or a domestic regulation (e.g. requiring catalytic converters) to an imported product is relatively uncontroversial. What would be controversial, however, is the application to imports of a domestic tax or regulation *linked to the production process*. For example, a ban on the sale of products *made* using CFCs is unexceptional when applied to domestic products, but problematic when applied to imports. Yet if the domestic tax or regulation is not applied to such imports, they will have an undue competitive advantage.

2. **Regulation-to-Tax Neutralisation** -- A related but separate approach is to impose a tax on imports commensurate to the difference in levels between domestic and foreign regulation. For example in 1991, Senator David Boren offered a proposal to amend U.S. countervailing duty (CVD) law to neutralise the advantage enjoyed by lower regulation countries (5). Converting a regulation to an equivalent tax is easier said than done, however. There is no obvious way to determine the cost that would have been incurred by foreign manufacturers to comply with U.S. regulations. It would be unfair to project U.S. costs on other countries since their wage and price levels are probably lower. Moreover, even if one uses U.S. costs, there is no agreed upon method for calculating them. One cannot simply ask companies what their costs of compliance are. Another problem is whether to use gross or net costs. The domestic regulation may provide some direct or indirect benefit to the industry (what Claas van der Linde calls "innovation offsets").

Aside from these practical problems are some serious conceptual problems. There is little reason to think that U.S. regulations are the appropriate level for other countries (6). But if the United States enacts a Boren bill, why shouldn't every country follow suit? Would 150 different Boren-type laws around the world lead to a more coherent and healthy ecosystem? Furthermore, how can a country claim any recompense from imposing a standard on itself? Maybe Japan should levy CVDs on imports from countries that do not suffer the disadvantage of doing business in Kanji (7).

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While the use of international environmental standards for CVDs would be a better approach than the use of *domestic* standards (8), the underlying problem is that there are not many international standards. If one agrees that the world economy needs such standards, there is a good tactical reason not to propose linking them to CVDs, since that would likely hinder such negotiations.

The idea of applying CVDs to social dumping goes back over 65 years. A growing number of analysts agree with the proposition that "*Just as government subsidies of a particular industry are sometimes considered unfair under the trade laws, weak and ineffectual enforcement of pollution control measures should also be included in the definition of unfair trading practices.*" (9) Last year, the negotiation of the North American Free Trade Agreement (NAFTA) led to a public debate about using environmental CVDs (10). One proposal was that CVDs be applied to parties which use lower environmental standards to attract investment (i.e., the regulatory haven problem).

3. **Subsidies** -- Another approach is the use of domestic subsidies to cover a portion of the environmental costs of regulation. Unlike the first two instruments above, this instrument can assist exports as well as shield out problematic imports. As the OECD has noted, "*Aid given for the purpose of stimulating experimentation with new pollution-control technologies and development of new pollution-abatement equipment is not necessarily incompatible with the Polluter-Pays Principle*" (11). So far, there has been little use of environmental subsidies to redress competitive imbalances. In part, this is no doubt due to the persuasiveness of the OECD. But it is probably also related to the fiscal conditions in many industrial countries.

4. **Harmonization** -- There are at least three types of harmonization. First, there can be a single standard for all countries -- either a *uniform* pollution level or uniform pollution control measures. Second, there can be a *minimum* international environmental standard, which all countries must meet but are permitted to exceed. Third, there can be policy convergence whereby countries agree to specific *common environmental policies* (e.g. the EC carbon tax) or agree to a set of common principles. For example, some principles might be full internalisation of environmental costs, the Polluter-Pays Principle, or the precautionary principle. Basically, there are two ways to induce nations to cooperate - "carrots" (e.g., financial aid or trade concessions) and "sticks" (e.g., trade prohibitions, countervailing duties, or sanctions) (12).

5. **Doing Nothing** -- In addition to these four instruments, there is also the option of doing nothing. That is, a country may decide to take no action regarding the difference between its environmental policy and the environmental policies of its trading partners. A country pursuing this strategy might believe that its domestic environmental regulation was making it better off and, therefore, that there are no net domestic costs to apply to imports.

## GATT IMPLICATIONS

This section reviews the GATT consistency of the ETMs discussed above. (For purposes of this paper, the unadopted Tuna-Dolphin report will be presumed to represent the law of the GATT (13).)

1. **Tax or Regulatory Equalisation** -- Under GATT Article III, taxes on domestic production, or on ingredients embodied in these products, can be applied to like imported products (14). Similarly, regulations on the domestic product "as such" can be applied to like imported products. But taxes (or regulations) on domestic *processes*, or on services (e.g. energy) involved in making the product, cannot be applied to like imported products. Furthermore, Article XX cannot be used to justify the application of such taxes or regulations to imports because that would involve extrajurisdictionality.

This distinction between products and processes can be critiqued on both economic and environmental grounds. As Pearson and Repetto have noted, GATT's border adjustment rule is biased against a more efficient tax on the externality (e.g. an effluent tax) in favor of a less efficient tax on the product itself (15). The GATT also appears biased from the environmental perspective. While the GATT permits a nation to ban all consumption of tuna, it does not permit it to ban only the consumption of dolphin-unsafe tuna (16).

2. **Regulation-to-Tax Neutralisation** -- Using CVDs or other taxes to neutralise regulatory policies may be inconsistent with GATT Articles I, II, III, VI, and XX. The most serious problem arises from Article I, because calibrating a tax based on the differences in foreign environmental policies constitutes a direct assault on the MFN principle (17). Some analysts believe that a low environmental standard (or the absence of one) should be countervailable under present GATT rules. Although such a situation does not meet the ordinary test for CVDs, a reasonable case could be made were a government to adopt differentially lower environmental standards for export industries. This would meet the *specificity* test for CVDs (18). Such a situation occurs with respect to labor regulations in export processing zones, but has not been alleged for environmental regulation (19).

3. **Subsidies** --Export subsidies on manufactured goods violate the GATT Subsidies Code. An attempt was made in the Uruguay Round to treat certain domestic environmental subsidies as non-actionable, but this was dropped in the Dunkel Text at the behest of the Bush Administration. Recently, one GATT expert proposed "A modification to the definition of *actionable subsidy* to allow certain types of environment enhancing government benefits and to exempt them from countervailing duties or other trade obligations (20)."

4. **Harmonization** -- Most environmental agreements involve the coordination of *domestic* policies. For example, in the Montreal Protocol, the parties agree to reduce their consumption of CFCs. Such agreements would not conflict with the GATT. When harmonization agreements involve the coordination of *trade* policies, the commitments made in the treaty may be GATT-illegal. But so long as the agreement applies only to parties, it would supersede GATT obligations under the principles of international law. A country not participating in the agreement, however, could lodge a GATT complaint if the agreement led to trade diversion.

Some recent environmental agreements (e.g. the Montreal Protocol) raise potential GATT difficulties because they regulate trade not among parties, but between a party and a non-party. When treaties *require discrimination* against non-parties (e.g. to deal with the free rider problem), they violate GATT Article I. When action taken under a treaty are extrajurisdictional, they would fail to qualify for GATT Article XX. So far, no such dispute has been brought to the GATT.

The issue of harmonization has arisen in the GATT, but in a different context than sought by environmentalists. The Dunkel Text includes several new disciplines on the application of domestic

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health and safety standards to imported goods. It can be argued that these disciplines would press toward downward harmonization (21). Environmentalists tend to prefer upward harmonization. One difficulty in the harmonization debate is that the two sides lack a common paradigm. The environmental perspective asks whether the GATT should tolerate "dirty" trade. The trade perspective asks whether the GATT should tolerate *restrictions* on dirty trade.

5. **Doing Nothing** -- This instrument is completely GATT-legal.

## OUTLOOK AND RECOMMENDATIONS

The nexus between trade, the environment and competitiveness will continue to grow in importance. Although one might have predicted the same development 20 years ago (falsely!), the situation today is different in several respects. The most important difference is that the environment has become a key issue in a major trade negotiation -- the NAFTA (22). Whether or not more environmental provisions are added to that trilateral agreement, this "NAFTA Effect" is already changing the Uruguay Round, and will certainly influence the GATT's post-Uruguay Round agenda.

It may be true that there is little evidence that differences in environmental regulation affect the location of investment (23). But many environmental activists do not consider such lack of evidence to be a telling point, particularly when they have heard for years that new domestic regulation will undermine U.S. competitiveness.

Let me make three recommendations for policy responses:

*First, the negative impact of dissimilar environmental policies could be more easily absorbed if governments undertook more pro-competitiveness policies.* For example, incentives for greater investment, adjustment assistance for workers, aid to generic technologies, and opening up markets would cushion any blow caused by environmental frontiersmanship.

*Second, levying CVDs based on domestic standards is a bad idea (24).* Not only is the instrument harmful (taxing consumption of imports), but the institutionalisation of such an instrument by all nations would weaken the world trading system. On the other hand, levying duties based on international standards might be a useful idea (25).

*Third, the perception that the GATT is anti-environment is endangering the Uruguay Round.* Although the GATT re-established its Group on Environmental Measures and International Trade in 1991, the Group has made no tangible progress. As the matrix below shows, environmental trade issues can be divided into four boxes according to the degree of spillover and the extent of international rules. Much of the intergovernmental debate on trade and the environment has dwelled on the inappropriateness of the subject matter in Box 1. (Much of the academic analysis has also focused on this area -- what Bhagwati calls "intrinsically domestic environmental problems (26).") Instead, the

GATT Group and the OECD should first address the issues in Boxes 2-4. These are the problems that are the most difficult conceptually and politically (27).

Chart 1. Matrix of environmental issues

		Type of international rules			
		Non-general		Specific	
Degree of Spillover	Low	Salinity of a lake	1	Occupational health	2
	High	CO <sub>2</sub> Emissions	3	CFCs	4

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In conclusion, although the option of Doing Nothing raises no GATT problems and may even be the most correct economically, it seems likely that nations will utilise one of the other four alternatives instead. Since the use of these instruments can conflict with current GATT rules, consideration should be given to modifying these rules. If the GATT rules are changed, however, this should be done in a way that encourages nations to adopt regulations that will enhance productivity growth.

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## ENDNOTES

1. This definition is taken from Competiveness Policy Council, *Building a Competitive America*, First Annual Report to the President and Congress, 1 March 1992, at 1.
2. Remarks by Secretary of the Treasury Brady before the Columbia University School of Business, 10 December 1992, at 5.
3. As Frances Cairncross has noted, "green trade barriers may have a logic of their own. They may be the only way that one country can put real pressure on another to make sure its companies shoulder the costs they would otherwise impose on the environment." See Frances Cairncross, *Costing the Earth* (London: The Economist Books, 1991), at 251.
4. Technically, only the second instrument involves a trade policy response.
5. For a discussion of the Boren proposal, see *Trade and the Environment*, hearing before the Subcommittee on International Trade, U.S. Senate Finance Committee, Senate Hearing 102-566, 25 October 1991.
6. There is also considerable disagreement as to whether U.S. regulations are the appropriate level for the United States.
7. The Japanese language can also be viewed as an unfair advantage that makes it difficult for foreign companies to sell in the Japanese domestic market.
8. For a discussion of the difference between domestic and international standards, see Steve Charnovitz, "The Influence of International Labour Standards on the World Trading Regime: A Historical Overview", 126 *International Labour Review* (1987) at 565, 568-69.
9. Al Gore, *Earth in the Balance* (New York: Houghton Mifflin, 1992), at 343.
10. See Government of Canada, *North American Free Trade Agreement, Canadian Environmental Review*, October 1992, at 33-34.

11. "The Implementation of the Polluter-Pays Principle," adopted by the OECD Council, 1974.
12. A third method would be market-based carrots and sticks enabled by reallocating property rights to environmental resources.
13. This author believes that the analysis in the Tuna-Dolphin report is incorrect. See Steve Charnovitz, "GATT and the Environment: Examining the Issues," 4 *International Environmental Affairs*, Summer 1992, at 203.
14. Such taxes can also be rebated on exports.
15. Charles S. Pearson and Robert Repetto, "Reconciling Trade and Environment: The Next Steps," in *The Greening of World Trade* (Washington: Environmental Protection Agency, 1993).
16. The greater does not always subsume the lesser. One can ban all tuna under the GATT, but not tuna only from France.
17. Of course, the use of any CVD is a direct assault on MFN. But a CVD to influence the use of extrajurisdictional subsidies is permitted by GATT Article II:2b.
18. It might not meet the financial contribution test. But it would seem to be close to the case of countervailing against low pricing for natural resources.
19. See Steve Charnovitz, "Hidden Subsidies," *International Economic Insights*, January/February 1991, at 20.
20. John H. Jackson, "World Trade Rules and Environmental Policies: Congruence or Conflict?," 49 *Washington and Lee Law Review*, Fall 1992, at 1227, 1248.
21. For an analysis of the Dunkel text, see Steve Charnovitz, "Trade Negotiations and the Environment," 15 *International Environmental Reporter* at 144.
22. For a detailed review of the environmental provisions in NAFTA, see Steve Charnovitz, "NAFTA: An Analysis of its Environmental Provisions," 23 *Environmental Law Reporter*, February 1993, at 10067.
23. Some of these studies have been criticised for being too macro-oriented and for focusing on costs of pollution control as a percentage of total costs, rather than of value added.
24. It is curious that environmentalists, who are generally progressive, have not been able to emancipate themselves from a mercantilistic view of CVDs.

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25. A team at the Institute for International Economics recently proposed that dispute settlement panels under NAFTA be empowered to apply "green fees" to the imports of another NAFTA member. (The proposal is for taxing all imports, not just the imports linked to the environmental harm.) These green fees would be rechanneled to a NAFTA institution or returned to the target country. See Gary Clyde Hufbauer and Jeffrey J. Schott, *NAFTA An Assessment* (Washington: Institute for International Economics, 1993), at 96-97, 101.
26. See Jagdish Bhagwati, "Trade and the Environment: The False Conflict?," Bradley Lecture, 9 February 1993.
27. For an excellent discussion of a new research agenda on trade and the environment, see *Trade and Sustainable Development*, (Winnipeg: International Institute for Sustainable Development, 1992), at 63-76.

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