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Environmental Tariffs Will They Be Captured by Protectionists?

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Environmental tariffs appear to be a politically necessary part of the climate change policies that are emerging in many countries. The appeal of *level playing field* arguments is seductive and difficult to dispute. Environmental policy makers, however, may be naïve, because they fail to account for the potential of trade policy mechanisms and institutions to be captured by traditional vested interests seeking economic protection. The exact structures and institutional frameworks for environmental tariffs are often left vague by environmental policy makers, making them easy targets for protectionists. Environmental tariffs appear to be particularly vulnerable to capture given the complexity of production and the embryonic stage of the science of measuring carbon intensity. The article outlines the threats to the international trading system posed by environmental tariffs and suggests cooperation between those responsible for developing environmental policy and those responsible for developing trade policy.

Keywords: capture, environmental tariffs, level playing field, protectionism, WTO

In connection with international trade policy, one often hears expressed the importance of the “level playing field”.

The meaning and implications of this goal are anything but clear. To a certain degree it may imply preserving a competitive market atmosphere for world trade

But often something more is meant by the “level playing field” idea. Even “economically competitive” actions by foreign firms are considered in some cases to be “unfair”, and thus disturb the “level playing field”. Certain categories of actions have for many decades been considered to be “unfair”, by nations and the international rules of trade. Among these are “dumping” and “subsidy” activities It is not always clear whether all the practices subsumed by trade policy experts under these categories really have a damaging impact on a world trading system, or whether they provide for uneven conditions of competition for producing firms in other nations. *Yet the goal of promoting a “level playing field” through national and international policies designed to inhibit dumping or subsidies, seems to have a powerful political appeal* [emphasis added].

John Jackson, 1992¹

The latest incarnation of *level playing field* arguments is being played out in the policy making institutions of many countries. This time the culprit in the disturbance of the *level playing field* is the absence of an internationally agreed constraint on carbon emissions. The absence of an international agreement to deal with climate change, however, does not remove the domestic political imperative to attempt to put in place policies to address the causes of global warming. As a result, some countries are moving forward with domestic policy initiatives to, among other things, reduce carbon emissions. These initiatives will impose costs on firms. As the climate change initiatives of individual countries are uncoordinated both in their level of ambition and in structure, the inevitable question arises as to their effect on the relative international competitiveness of firms subject to differing regulatory regimes. Further, some countries may choose not to put climate change policies in place or not to enforce the regulations that they do put in place. While domestic firms may grudgingly acquiesce to the imposition of carbon taxes or “cap and trade” systems, they will object vociferously if they perceive climate change–inspired increases in costs will negatively affect their relative competitiveness in the international market. Policy makers often cannot easily ignore such objections. If policies to lower carbon emissions make the playing field uneven, then policies to return to it to a level surface will be advocated. Environmental tariffs – border taxes – are being widely considered. Taxes would be applied to imports from countries that have less strict carbon

reduction policies or that do not adequately enforce those policies. Border taxes are easy to understand and have considerable political appeal.

In many countries, environmentalists, civil society more broadly and policy makers have accepted the argument that the externalities associated with under pricing carbon are having, and are going to have, wide ranging effects on climate that have the potential to impose significant adjustment costs on the global economy. Dealing with that externality is a laudable policy goal. While the intellectual arguments pertaining to the links between environmental externalities and international trade are far from conclusive and the efficacy of environmental tariffs in achieving the goal of providing incentives to reduce carbon emissions even more tenuous, *level playing field* arguments are likely to prevail in climate change policy making – environmental tariffs in some form are likely inevitable. If that is true then how they are structured and implemented is extremely important. Environmental policy makers and trade policy makers have often been at odds in the past. This is because they do not understand each other very well. Environmental policy makers often have laudable goals and want to use trade policy measures as part of their *tool kit* (Kerr, 2001). Achieving their goal is paramount and their trade policy initiatives are focused on achieving their particular goal. On the other hand, the primary goal of those who are interested in the general-good aspects of trade policy is to protect the liberalizing aspects of the institutional structure of the international trading system. In particular, they are concerned that the institutions and mechanisms put in place for the purposes of environmental policy not be open for capture by economic protectionists. They do not want environmental trade policies to be harnessed to protectionist vested interests – providing protection against legitimately more efficient foreign competitors. Trade policy professionals have lots of examples of policies that have been captured by traditional protectionist interests – antidumping (Kerr and Loppacher, 2004) and unfair subsidies (countervailing duties) (Cullen and Kerr, 1989) come immediately to mind. Further, the Biosafety Protocol provides a direct example of an instance in which environmental trade policy making was captured (Hobbs, Hobbs and Kerr, 2005; Holtby, Kerr and Hobbs, 2007). Thus, environmental policy makers often misinterpret the objections of trade policy experts as not being in sympathy with their goals – putting the benefits of trade ahead of benefits to the environment. Trade policy experts, instead, want policies structured so that the risk of capture – and thus damage to the trading system – will be minimized.

To trade policy professionals, environmental policy makers who wish to put in place trade policies often appear naïve, failing to understand the tenacity and resourcefulness of protectionist vested interests. These professionals don't deny the

desirability of dealing with many environmental issues but are often uncomfortable with the form of trade policy initiatives put in place under the guise of environmental policy – as they are with respect to initiatives designed to deal with other policy goals related to, for example, labour standards (Bakhshi and Kerr, 2008), animal welfare (Hobbs et al., 2002), bioterrorism (Kerr, 2004), etc., that can encompass trade policy as part of their policy mix. This failure to communicate among policy makers can lead to acrimony, which can escape the confines of policy debates and spill over into broad-based concerns of civil society – the conflicts over U.S. tuna-dolphin and shrimp-turtle initiatives are examples.

One of the ways in which the potential for conflict plays out is in legislation which enshrines the use of trade policy measures as part of the means to achieve environmental policy goals but leaves the specifics of the trade policy mechanisms to be worked out later. It is the details that matter to those who evaluate trade policy, and they find it hard to support vague legislative initiatives. Protectionists have been adept at having trade regulations and implementation work to their advantage even if this was not the intent of the legislation. The environmental tariffs envisioned as part of the climate change policy mix appear likely to be the next example of this lack of transparency and precision (James, 2009).

The intellectual discussion over the appropriateness of trade policy measures as part of the package of climate change policy initiatives is being conducted at a number of levels. The broad issues surrounding the link between international trade and environment have been extensively explored by a number of authors (Copeland and Taylor, 2003; Belcher, Hobbs and Kerr, 2003), as well as, more explicitly, issues relating to climate change and trade (Gaisford, Kerr and Pancoast, 2004; Gaisford, 2010). The results related to the broader question of whether or not trade should be a concern of environmental (or climate change) policy are theoretically inconclusive, with the empirical evidence leaning toward trade being a positive influence on environmental enhancement. There appears to be little empirical support for the “pollution haven” hypothesis, whereby firms choose to locate where environmental regulations are lax, or the “race to the bottom” hypothesis, whereby governments lower (or fail to raise) environmental standards as a way to enhance competitiveness. According to Copeland and Taylor (2003, 185-186),

... before we condemn trade because it creates harmful pollution havens, we must remember that differences in pollution policy are only one of many factors that cause trade. ... [W]e identified two key assumptions behind most pollution haven models: inequality in the world distribution of income, and relative production costs determined by pollution regulations alone. We cited evidence showing large inequalities in world

distribution of income, but offered no evidence that pollution regulations were an important determinant of costs. If other factors dominate the effects of pollution policy on comparative advantage, then trade may not concentrate polluting industries in countries with weak environmental regulation.

Despite the absence of strong evidence to support the linking of environmental policy to trade policy, arguments relating to a loss of the *level playing field* and *pollution havens – carbon leakage* in the case of greenhouse gases² – appear to be those garnering the attention of environmental policy makers. They fret about jobs lost to foreign competitors through direct competition and future job losses as firms choose to locate in pollution havens (Sheldon, 2010). According to James (2009) the evidence of *the threat to competitiveness* and substantial *carbon leakage* is weak. She goes on to say,

... compelling logic has not prevented politicians from talking about using trade measures as a weapon. Carbon tariffs and other trade measures can, by their reasoning, be used as “leverage” to encourage errant countries to adopt climate change reducing measures: by dangling the carrot of increased access to markets if the trade partner adopts the “correct” policy, countries will want to reduce their emissions for the supposed benefit of all (James, 2009, 4).

Thus, it appears as if politicians, at least in the United States, have bought into the efficacy of trade sanctions³ despite evidence that they are unlikely to be effective.

The other place where environmental tariffs are being debated relates to whether they are compatible with the World Trade Organization (WTO) (Sheldon, 2010; James, 2009). One thread of the argument suggests that environmental tariffs are simply a subset of border tax adjustments,⁴ which are allowed under the WTO (Sheldon, 2010). There are a range of arguments against the idea that environmental tariffs are equivalent to border tax adjustments (James, 2009) and the question will likely require a WTO panel ruling to sort it out. If they are ruled WTO-legal under the rubric of being a form of border tax adjustment, then environmental tariffs will be accepted relatively easily. If they are not considered a subset of border tax adjustments, then other avenues to gain acceptance for environmental tariffs would have to be pursued. Governments could try to gain them a general exemption to WTO disciplines through GATT Article XX (g), which allows measures that relate to the conservation of natural resources. Again, there are arguments on each side of this question (James, 2009), and WTO panels will have to adjudicate. If Article XX (g) exemptions are required, however, each country would have to submit its particular form of environmental tariffs and co-requisite policies to a panel – for example, to gain an exemption it must be demonstrated that the tax is part of a program to

conserve natural resources and that it is the least trade distorting means to achieve the goal.

The environmental tax must be structured in such a way as to not discriminate against sources of imports, so targeting individual countries would be unlikely to withstand a WTO challenge. Further, carbon intensity is a production attribute, and the WTO rules do not allow discrimination against like products based on how they are produced, that is, on their production and processing methods (PPMs). This would mean the tax could not be structured to apply to imports with a high carbon footprint but be waived for products with a low carbon footprint. This constraint would seem to negate the intent of, for example, current U.S. legislation which would seek to reward those countries with strong environmental policies with market access and punish countries with lax environmental policies by denying or restricting market access. In short, environmental tariffs may well be subject to a wide range of challenges at the WTO. In the end, however, given the current political will to execute climate change policy in a manner that maintains, or creates, a level playing field, environmental tariffs are likely to become a fact of life – either through changes pushed through the WTO or through countries choosing to ignore WTO rulings. After all, the WTO's enforcement powers are, in reality, weak – countries are allowed to retaliate through denial of market access. There are few countries whose retaliation would have a sufficiently significant impact on the United States or the EU to have them alter their climate change policy. While acceptance of retaliation is a country's right under the WTO, it is seldom used. It has been accepted, by the EU for example, when there was strong consumer resistance to opening the market to beef produced using growth hormones and retaliation continued for a decade (Kerr and Hobbs, 2005); however, widespread ignoring of WTO commitments would likely lead to chaotic beggar-thy-neighbour retaliation and serious damage to the credibility and efficacy of the WTO. Of course, a weakening of international trade institutions would play directly into protectionist hands. One suspects that, over the intermediate run, the member states of the WTO will find a way to accommodate environmental tariffs. As Gaisford (2010, 236) suggests,

It would be difficult to escape the conclusion that there were few if any consequences for countries that engaged in political posturing rather than action in relation to their Kyoto commitments or chose to ignore or back out of their commitments entirely. This poses significant credibility issues for the Copenhagen Accord and any future agreements. In the wake of the credibility issue exposed by the Kyoto Protocol, there is a growing sense that there need to be trade-consequences for countries that do not make or follow through with commitments. To forestall a likely drift toward a free-for-all of retaliation for non-compliance and counter-retaliation, there is a

strong case to be made for World Trade Organization (WTO) oversight of trade penalties.

If environmental tariffs are likely to become part of the international trade architecture, then they must be structured carefully and administrative institutions put in place to ensure that they are not open to capture by traditional protectionist interests. Protectionists crave a cloak of legitimacy (Kerr and Perdakis, 2003), and environmental tariffs could provide that cloak.

The first question to examine is when would it be appropriate to apply an environmental tariff to imports. For example, current proposed U.S. legislation – the Waxman-Markey bill – envisions blanket tariffs on imports from countries that have lesser environmental standards than the United States. Such blanket tariffs, however, are likely to create perverse incentives that inhibit investments in carbon emission technologies in exporting countries. As James (2009, 12) points out,

It should also be noted that assessing the carbon footprint of a product based on national averages will potentially work against the ostensible purpose of climate-change regulations. To the extent that efforts to produce goods more cleanly impose costs on a firm, if those efforts are not recognized by a trade partner that discriminates on a country-level basis rather than a firm-level basis, unilateral trade restrictions could in fact *discourage* the adoption of cleaner technologies. Why produce at higher cost if you cannot gain improved market access as a result?

If environmental tariffs are to be applied on a country-wide basis, then the mechanism that determines to which country they are to apply becomes important – but thus far there is little indication as to the institutional structure that is envisioned in the major countries considering environmental tariffs. One model would be for importing countries to establish, or designate, a domestic institution to independently monitor the environmental policies of 150-plus countries and recommend when tariffs should be applied – to monitor a smaller set than WTO membership would clearly be discriminatory. Of course, it would also likely be desirable to monitor some countries such as Russia, Iran and Belarus that are not WTO members. It is, however, difficult to imagine such a mechanism being totally independent from importing industries – either through indirect lobbying of politicians or directly through institutionalized complaint mechanisms. This opens the door to not only those industries truly disadvantaged by imports from countries where environmental laws are lax but also from firms that find it difficult to compete for other reasons – those seeking economic protection. The institution would then be faced with determining when complaints of injury from imports legitimately arise due to environmental cost disadvantages. This will be very difficult.

Presumably, if environmental tariffs are to be applied on a country-by-country basis, then those countries to which tariffs are to be applied will be able to see the evidence against them and to raise objections. Mechanisms for adjudication will be necessary – either domestic or international. Further, countries to which environmental tariffs are applied may choose to alter their environmental policies to come into compliance. Environmental tariffs will have to be a form of contingent protection. Thus, there must be a review and evaluation process to remove the environmental tariffs if the situation in exporting countries changes. Protectionists have proved adept at manipulating such mechanisms to delay the removal trade restrictions.⁵ The risk of country-country disputes over this and other issues is likely to lead to acrimonious international relations.

The alternative to country-wide environmental tariffs – an alternative that is likely to have considerable appeal given the damage to international relations that country-wide application may engender – is firm-level application of the tariffs. Individual firms determined to have been in receipt of a benefit that alters the playing field could have environmental tariffs applied to their imports. Instead of a major monitoring effort, complaints from disadvantaged industries would be the basis for launching an investigation that could lead to the imposition of environmental tariffs. Of course, this is the familiar contingent protection model used for the application of antidumping duties and countervailing duties. It would remove environmental tariffs from being a country-level dispute and would focus instead on the individual firm's cost. Of course, use of the environmental dumping approach would be fraught with the same difficulties as unfair pricing and unfair subsidy determinations and their co-requisite injury determinations. Dumping and countervailing duties mechanisms are widely recognized protectionist mechanisms that have little legitimacy (Kerr, 2001). The need to provide information and to mount a defence means that the mechanism itself imposes considerable, sometimes crippling, costs on accused firms, so that import-competing firms are not as interested in winning the case as they are in garnering the protection the process itself provides (Barichello, 2007). Unless carefully structured, environmental tariff mechanisms could easily be equally valuable to protectionists.

The methods that have been devised to calculate antidumping and countervailing duties are biased toward providing protection (Kerr and Loppacher, 2004).⁶ To determine the size of the environmental tariffs to apply, the carbon intensity of products and/or the production processes used to produce them must be calculated. Given that there is no internationally accepted methodology for making these calculations (James, 2009; Gaisford, 2010), ad hoc methods are likely to be put in place. Without a sound theoretical basis for the calculations, there is potential for

protectionist bias to creep in. Further, given the complexity of modern international supply chains it may be very difficult to determine the proportion of the carbon footprint that arises from the environmental laws in each country. The complex nature of this set of factors will challenge, and severely, the calculating abilities of the institutions charged with determining the size of the environmental tariffs to apply.

Thus far, the intent appears to be to apply environmental tariffs on a relative basis – according to the differences in the costs imposed by (stringent) domestic environmental regulations versus (lax) foreign environmental regulations. Current countervailing duty calculations, for example, only examine the absolute level of subsidy received by an exporter – in other words the subsidies received by import-competing domestic producers are ignored. Protectionist bias can easily creep into calculations through a proclivity to overestimate the domestic costs of environmental regulations and underestimate the cost imposed by foreign regulations.

Of course, these adversarial mechanisms for proving dumping, unfair subsidies and injury are costly to use – legal teams must be hired to present and argue cases. If protectionists have deeper pockets, then they will disproportionately reap the potential benefits from protection. Trade lawyers must be gleefully anticipating the implementation of environmental tariffs. There is much to be learned from the poorly designed and executed antidumping and countervail mechanisms, but it is not clear that the framers of environmental policy understand these deficiencies or would be willing to invest in devising superior alternatives.

Given the problems with environmental tariffs, which are a second-best or third-best policy option, at best there is some hope that further attempts at attaining a “first-best” solution will be inspired (James, 2009). It is well known that directly dealing with the source of the environmental externality is the “first-best” policy option. A strong multilateral replacement for the Kyoto Protocol could be a “first-best” option, but the failure to accomplish this in Copenhagen in late 2009 illustrates the difficulties associated with this approach. Even if such an agreement can be achieved, it may well be that it would have to incorporate environmental tariffs. As Gaisford (2010, 237) concludes,

Nevertheless, it appears to be a given that if countries agree to significant GHG reductions under the ... Accord, then trade penalties will be imposed on those that do not follow through by those that do. The only real question appears to be whether or not there will be international disciplines on such trade penalties.

Thus, it seems that environmental tariffs are likely to become part of the environmental policy architecture, either multilaterally or unilaterally, and part of the international trade architecture in the near future. Environmental policy makers will,

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in their minds, have gained a victory. It is imperative that they do not rest on their laurels – embedding environmental tariffs in the environmental and trade policy institutional architecture is only half the battle. They need to work with trade policy professionals to ensure that the mechanisms and institutions that are used to implement environmental tariffs are not open to capture by those seeking traditional economic protection. A first step would be to accept that there are those that have strong incentives to capture trade policies and use them for their nefarious purposes.

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Endnotes

1. See Jackson (1992, 17).
2. Carbon leakage relates to concerns that the expected reduction in carbon emissions will be reduced due to firms moving to pollution havens so that they will not have to reduce (or reduce as much) their carbon emissions.
3. See Kerr and Gaisford (1994) for a general discussion of the efficacy of trade sanctions.
4. Border tax adjustments – both import taxes and export subsidies – are allowed to offset the effects of a consumption or indirect tax such as a value added tax.
5. One recent example is the case of U.S. restrictions on imports of meat and animal products in the wake of the discovery of BSE – mad cow disease – in Canada. See Loppacher and Kerr (2005).
6. For example, methods that allow Japanese labour rates to be proxies for labour rates in India or Vietnam and U.S. electric power rates to be proxies for those in China; the selective use of data in zeroing; etc.