

Can't we all just get along?
An overview of the
economics of the free trade
and environment debate.

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Questions this paper addresses

- Does free trade lead to environmental degradation?
- Are there positive effects of trade on the environment? If so, what are they and how do they come about.
- What are these negative effects we keep hearing about? How do they come about?
- Have positive or negative effects been verified in the literature?
- What is the WTO stance on trade-environment issues?

Where do conflicts of interest arise?

- Where countries use trade policy to complement or enforce domestic environmental policy.
- Where countries restrict exports of natural resource based goods.
- Where countries restrict imports because of foreign production practices.
- When different countries have different environmental standards which influence trade.
- When there are cross border externalities.

Positive effects of trade on the environment

Techniques effects and foreign direct investment

- Changes in resource extraction and production technologies that lead to decline in pollution and/or reduction of environmental impact per unit of output.
- Transfer of technology to developing countries.
- Diffusion of best practices and standards.
- Institutional mimicry.

Positive effects of trade on the environment

Techniques effects and foreign direct investment

- The “pollution haven” argument has not been strongly substantiated in the literature.
- Evidence of the opposite – countries with transparent environmental programs are more successful in attracting FDI.
- Strong possibility that the “pollution haven” argument does fit specific sectors (oil and gas, mining) in the least developed countries.

Positive effects of trade on the environment

Riding the Kuznet's Curve

- Says that there is an inverted U shaped relationship between indicators of environmental degradation and income per capita.
- Implies that economic growth will eventually address environmental degradation.
- Evidence that as countries move from lower to higher levels of development, industries and overall economic activity becomes less environmentally degrading.
- Faulty association? – Literature cites statistic weaknesses and inappropriate techniques; relationship found for only a subset of indicators.

Can good environmental policy enhance gains from trade?

- Innovation can be driven by regulations leading to decreased environmental impacts.
- Regulations can create incentives for firms to reduce process inputs and waste outputs leading to efficient resource use and productivity.
- Innovation can offset environmental compliance costs leading to cleaner technologies and practices.
- This can create first mover advantage for firms.

Can good environmental policy enhance gains from trade?

- Product offsets: Not just less pollution/ resource intensive goods but better performing, higher quality, safer goods.
- Process offsets: Leads to higher productivity and higher yields (e.g. through materials savings, lower energy consumption, recycling)
- Reservations in literature: To take advantage of regulations, a firm must have substantial market power.

Negative effects of trade on the Environment

The Race to the Bottom

- Occurs when competition between high and low income countries intensifies.
- Firms search for higher returns which leads to investment in countries with the lowest environmental standards when compliance costs are least.
- Incentives for low income countries to lower standards.
- Firms can threaten to relocate causing countries with good standards to lower them to retain investments.
- Stagnation of environmental initiatives.

Negative effects of trade on the Environment

The Race to the Bottom

- Aggregate effect of slowing environmental policy progress in all competing nations.
- Composition effects: Countries begin to specialize where they have comparative advantage. This will be based on low environmental standards, so it becomes politically fatal to raise standards and lose advantage or tamper with the now burgeoning “dirty industry”.
- Inconsistent empirical evidence: In the scheme of investment and operating in developing country, environmental compliance cost is 2% or minimal.

Negative effects of trade on the Environment

Capital mobility and economies of scale

- Comes back to the pollution haven hypothesis – Capital settles in the countries with lowest standards.
- When firms compete by quantity, it is found that lowering environmental standards allow domestic firms to increase output and therefore profit share at the expense of foreign competitors.

Negative effects of trade on the Environment

Capital mobility and economies of scale

- Industries with increasing returns to scale will not relocate operations until a threshold cost of compliance is reached, then they relocate.
- Rising environmental costs are not as significant to firms as their dislike for uncertainty in policies and political regimes.
- Scale effects shift economic power towards producers especially when prices fall.
- Environmental compliance is NOT an indicator of competitiveness according to the World Bank.

Negative effects of trade on the Environment

The Tragedy of the Commons

- Over consumption of common pool resources leads to depletion of that resource often irreversibly.
- Each appropriator has incentive to overexploit, reducing the pool for each other appropriator.
- Situation heightened by increased trade, for developing countries which do not possess democratic institutions and process to manage this problem.
- Increased North-South trade overconsumes underpriced resources.
- Differences in property rights between high and low income countries motivates bilateral trade so circle goes on.

Negative effects of trade on the Environment

Export of Hazardous Wastes

- Increased export because of raised awareness in developed countries, increased generation and higher domestic costs of disposal coupled with lower international shipment costs because of freer trade.
- The is willingness of some developing countries to accept such wastes for “treatment” and “recycling”.
- Often firms mislabel or mislead acceptors on contents and effects of wastes.
- Developing countries do not have capacities (financial, technical, systems) to prevent and monitor.
- Preventing import/export can be deemed a trade barrier under WTO.

Negative effects of trade on the Environment

Cross Border Externalities

- Global environmental effects, often accumulative and long term. Many countries bear the burden caused by few.
- Uninternalized externalities can also lead to market failures, reduced economic efficiency, gains from trade and welfare.
- Area where combination of trade and environmental policy is justified and only multilateral negotiations can solve.
- Commercial sanctions are required.
- Successful example – Montreal Protocol

The WTO and the Environment

- 1991 the Committee on Trade and the Environment re activated.
- Driven by international concerns that trade was bad for the environment, fears of reduced competitiveness because of environ. Policies, cross border spillovers and possible protectionism.
- Direct interests are MEAs, discrimination based on production processes and the precautionary principle.

WTO Environmental Interests

- MEAs: Have imbedded trade bans, product standards, notification and labeling requirements, trade restrictions at domestic levels. Can be viewed as illegal under the WTO.
- PPMs: Trade restrictions based on how goods produced instead of quality of actual product. Troubling for business where Governments may use unfairly.
- Precautionary Principle: Complicated task to implement this in the multilateral trading system as there are many entry points for protectionist influences.

Case 1: The Shrimp-Turtle Case

- US made TEDs mandatory for shrimping.
- US bans shrimp imports from countries not using TEDs.
- WTO judged measures as discriminatory and US could only ban if necessary to conserve exhaustible natural resources of if process had repercussions to physical character of good.

Case 2: US-Mexico Tuna-Dolphin Case

- US banned imports of Mexican tuna because they did not change fishing methods to reduce dolphin kills.
- WTO considered this a quantitative restriction which should only apply to the composition of the product.
- The MMPA did not apply to composition nor could it dictate Mexican for tuna caught in foreign jurisdiction.
- WTO found the embargo unnecessarily protectionist and illegal.

Case 3: Economics of Recycling

- US law states that a minimum percent of newsprint must be recycled.
- This was detrimental to Canadian pulp and newsprint industry
- Caused Canada to lodge market access dispute at WTO.
- Danish law states that soft drink bottles must be reusable and taken back by retailers.
- EU claimed this a discriminatory practice (because two way transport was uneconomical for most)
- WTO did not dispute law but pushed for it to include metal cans also.

Summary

- There is a logical connection between trade and environment issues for the most part, and therefore in these areas policies should be harmonized.
- Positive effects can be obtained from good trade-environment policy : increased FDI, technology transfer, innovation.
- Some claims need more verification – Kuznets curve.
- Environmental policy must not be used for protectionism.

Summary

- Possible negative effects – the race to the bottom, pollution haven hypothesis, tragedy of the commons.
- Again requires quantitative data to verify.
- Some issues such as hazardous waste and cross border externalities can ONLY be solved by long term negotiations in the trade and environment arenas.
- WTO must address environment in a more focused way (TREMAs) like it has other areas (TRIPs).
- WTO must collaborate more with expert agencies on MEAs, production processes and environmental dispute mechanisms.