Safeguarding National Environmental Regulation in a Liberalized World: Beyond the Trade Promotion Act of 2002

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Is free trade irreconcilable with sustainable development? Some environmental groups, viewing the regime of international trade and investment liberalization as an obstacle to effective environmental protection, suggest so. While many have criticized specific rules that are seen to impinge the freedom of national governments to regulate environmentally harmful practices, other theorists have gone further to examine structural factors that undermine national regulatory efforts.[2] The insight that international trade and investment may undermine national efforts to regulate private enterprise for the public good is not a new one. No less an economic thinker than Adam Smith recognized that international capital, in the presence of free trade, breaks free of the norms of national community. In order for the public good to be asserted under those circumstances, national norms must find expression in the rules that govern trade, making it less than entirely free, or else in some other embodiment of international governance.

Today, these same insights inform the debate over "trade-environment linkage." The reality of linkage was formally recognized at the 2001 ministerial meeting of the WTO in Doha, but the specific content was purposefully left vague.[3] For free traders, and particularly for developing countries concerned with securing and maintaining access to rich-country markets, the term connotes primarily the need to prevent environmental regulation from functioning as non-tariff barriers to restrict trade.[4] For others, trade-environment linkage refers to the effort to make trade liberalization consistent with effective environmental protection. Clearly, only this latter conception of linkage has the potential to address the concerns of environmentalists wary of trade.

For that reason, environmental linkage has become an important part of the landscape of U.S. trade liberalization: some measure of environmental protection is today a necessary component of U.S. trade deals if they are to be politically viable. This trend is most prominently exemplified by NAFTA, which when ratified in 1994 was accompanied by labor and environmental side agreements. Subsequently, this political reality was given legal force in the Trade Promotion Act of 2002. There, for the first time, Congress expressly required that U.S. trade representatives pursue various labor and environmental goals as a component part of trade liberalization negotiations.

This paper examines the Trade Promotion Act of 2002 (TPA) in light of the theoretical arguments for linking trade liberalization and international environmental protection. It asks whether the law's environmental provisions are (or can be) an answer to environmentalists who, skeptical of the prospects for true international governance, advocate restricting trade in order to safeguard the efficacy of national environmental regulation. I therefore begin with an overview of the theoretical justifications for linkage, and suggest that TPA addresses some of these concerns more fully than others. After evaluating the efficacy of TPA in practice, I offer some recommendations for achieving a trade-environment linkage that is both more robust and better tailored to the global scope of the modern regime of international trade.

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[2] HERMAN DALY, BEYOND GROWTH, 158-67 (1996).
[3] Shaheen Rafi Khan & Shahrukh Rafi Khan, *A Southern Agenda for Trade and Sustainable Development*, SDPI RESEARCH AND NEWS BULLETIN, March-Oct., 2004.
[4] *Id*.

I. The Transnational Effects of Domestic Environmental Regulation

International responses to environmental problems are necessary when the effects of those problems transcend borders. The alternative is to leave externalities uninternalized, creating environmental degradation, reducing gains from trade and lowering social welfare generally. The transnational aspect of environmental degradation is not only physical, but extends to moral, economic, and informational effects. While these various categories of cross-border effects all contribute to the need for international solutions, not all of them necessarily demand the conditioning of trade liberalization on environmental protection. Rather, the need for trade-environment linkage varies with the nature of the cross-border effects. The case for linkage is strongest when trade and investment liberalization itself constrains the ability of national governments to regulate.

It is unclear that the first two categories of transnational effects – physical and psychological or moral spillovers – meet this criterion. To the extent that trade stimulates the growth of the human economy, with concomitant specialization and consumerism, these cross-border effects are likely to increase.[5] But these effects are not exclusively the result of trade liberalization: economic growth and advances in communication technology – even without trade – have a tendency to increase these environmental spillovers. There may even be reason to expect that production for export will be more efficient, and thus less plagued by environmental waste, than production for domestic markets.[6] In the final analysis, trade and investment liberalization may increase the ability of national governments to deal effectively with these spillovers by improving communication and coordination between them.

In contrast, economic transnational effects constrain the freedom of governments to regulate economic activity in an atmosphere of liberalized trade and investment.[7] In the economic arena, the environmental policies of one country affect its neighbors via the price of traded goods and international capital flows. Polluting firms in a country with weak environmental protections face a lower cost structure, *ceteris paribus*, than their overseas competitors, and their exports enjoy a competitive advantage.[8] The competitive disadvantage

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[5] Some economists dispute the basic premise that economic growth increases environmental burdens, pointing to what is commonly called the "environmental Kuznets curve." See Thomas M. Seldon & Daqing Song, *Environmental Quality and Development: Is There a Kuznets Curve for Air Pollution Emissions*, *in* JOURNAL OF ENVIRONMENTAL ECONOMICS AND MANAGEMENT, 147-52 (1994). Those who subscribe to the Kuznets hypothesis posit that environmental externalities are forced back upon exporting firms through effective regulation, but only after a country reaches a level of economic development such that the marginal benefits of such environmental regulation compare favorably with additional polluting growth. But the empirical support for the hypothesis is weak. See Lyuba Zarsky & Kevin Gallagher, Searching for the Holy Grail?, 13 at http://www.wwf.org.uk/filelibrary/pdf/holygrail.pdf. The Kuznet's curve has been cited as evidence that the best way to preserve the environment is to spur more and more growth of the human economy. DANIEL DREZNER, U.S. TRADE STRATEGY: FREE VS. FAIR, 22 (2006). But it fails to consider that rich countries actually create *more* pollution of some types, such as carbon emissions. Moreover, pollution is only one type of environmental degradation. Rich countries certainly have the greatest impact in terms of resource consumption, both renewable and non-renewable. That rich countries use natural capital more efficiently (less degradation per dollar) does not change the fact that they cause significant environmental damage. The resources and absorptive capacity of the Earth do not vary with GDP.

[6] This argument assumes, of course, that firms bear some significant portion of the costs of this waste, which may not hold true.

[7] As noted above, this phenomenon has long been recognized. *See, e.g.*, KARL POLANYI, THE GREAT TRANSFORMATION (2001).

[8] Of course, this advantage is also enjoyed when polluting firms produce for a domestic market, as against imports from countries with stronger regulation.

experienced by such a country's trading partners is the first transnational economic effect of weak regulation.

A second economic medium for the transnational effects of regulatory choices regarding the environment is the investment decisions of corporations and portfolio investors. All else equal, a multi-national corporation has an incentive to locate production in countries lacking the regulatory mechanisms to force internalization of environmental costs, just as a portfolio investor is attracted by the profits captured by firms via cost externalization. Thus the environmental policies of one country spill over into others by their effects on capital flows.

A regime of liberalized trade and investment makes it difficult to address both categories of transnational economic spillovers – price effects and capital flow effects – because governments will inevitably face pressure from domestic exporters and current and potential investors not to impose regulation that would increase the costs of production by internalizing environmental externalities.[9] Thus, while in the static scenario a country loses competitive advantage and investment when a trading partner fails to regulate, in a dynamic scenario the country faces an altered incentive structure in its own regulatory decisions.[10]

The most politically potent manifestation of this concept is the regulatory "race to the bottom," by which countries compete for trade competitiveness and investment by lowering environmental standards.[11] But an even more likely result of the altered incentive structure faced by governments under a regime of liberalized trade and investment is regulatory chill: the failure of governments to impose regulations that they otherwise would, thus falling short of efficient internalization of environmental costs.[12] The difficulties of establishing this effect empirically are formidable, given the counterfactual nature of the inquiry. But if producers resist costly regulation, and are increasingly flexible in their decisions regarding location of production processes, it is difficult to maintain that regulatory arbitrage will not have an effect at the margins. And as global supply chains proliferate, highly natural capital-intensive stages of production can increasingly be separated out and strategically located to take advantage of differential regulation among countries. In any event, as living standards rise worldwide and the human economy places ever more strain on the natural world, natural capital is becoming increasingly scarce, and therefore more costly. These higher costs will be reflected in the cost of compliance with regulation, and will loom ever larger in the strategic planning of firms. The effect of regulatory chill will become increasingly pronounced with time.

A final transnational effect of differential environmental regulation is informational. As Herman Daly has pointed out, the optimal scale of the human economy – measured in terms of

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[9] Many have correctly pointed out that the interests of producers and investors are far from monolithic. Dale D. Murphy, *The Business Dynamics of Global Regulatory Competition*, UNIVERSITY OF CALIFORNIA INTERNATIONAL AND AREA STUDIES. Murphy distinguishes between production process regulation and market access regulation, finding that corporations promote "competition-in-laxity" in the former but not the latter. These two phenomena, however, are not fully off-setting given that the WTO restricts increased market access regulation but not production process deregulation.

[10] Even those that are skeptical of the extent of this phenomenon concede that some government policies are constrained by the interests of producers and investors, particularly in the area of monetary policy. Others have recognized environmental regulation as just one category of policy space lost to governments – particularly developing country governments – in the face of trade and investment liberalization. *See* PUTTING DEVELOPMENT FIRST: THE IMPORTANCE OF POLICY SPACE IN THE WTO AND IFIS, (Kevin P. Gallagher ed., 2005).

[11] See, e.g., ALAN TONELSON, THE RACE TO THE BOTTOM (2002). Skeptics have indicated a lack of empirical support for the hypothesis. Brian R. Copeland & Scott Taylor, *Trade, Growth and the Environment*, THE AMERICAN ECONOMIC REVIEW, 877-908 (2002). But the path of least resistance in regulation is likely to be underenforcement, which is both difficult to measure and amply supported by anecdotal evidence from the developing world.

[12] Dale Murphy, *supra* note 9.

through-put, or consumption of natural resources and production of waste byproducts – is not determined by the allocative price mechanism.[13] Like distributional issues, the question of scale is a political one, and thus requires that governments possess adequate information regarding the costs and benefits of marginal through-put growth.

In the face of trade and investment liberalization, erstwhile national environmental problems take on a global character. When environmental services are traded, a country that goes beyond optimal levels of consumption and pollution can put off the inevitable reckoning with physical constraints.[14] The global market, by "efficiently" allocating environmental services, will ensure that countries approach ecological collapse simultaneously, rather than in succession by nationally confined, cautionary crises. Trade and investment liberalization in the face of differential environmental regulation will thus obscure the optimal scale of the human economy.[15]

In summary, weak regulation in one country, by permitting environmental externalities, produces five categories of effects on neighbors and trading partners: physical spillovers, moral/psychological spillovers, price effects, capital flow effects, and information obscurity. The last three have a particularly close logical link to trade and investment liberalization, and should therefore be the focus of efforts to institutionalize trade-environment linkage. Because further trade and investment liberalization runs the risk of continuing to undermine the ability of national governments to deal with those effects, theory dictates that liberalization be conditioned on the fashioning of adequate international solutions.

II. The Trade Promotion Act of 2002

The Trade Promotion Act of 2002, which granted trade promotion authority to the Bush Administration, also imposed binding environmental objectives on U.S. trade negotiators.[16] It includes in its general statement of purpose the goal of enhancing the international means of protecting the environment and optimizing the use of the world's resources.[17] But it declines to include such ambitious goals among the specific objectives to be required of U.S. trade negotiators. Rather, the law requires that the administration do the following in negotiating trade agreements:

- ensure that trading partners do not fail to effectively enforce their environmental laws, through a sustained or recurring course of action or inaction, in a manner affecting trade;
- strengthen the capacity of trading partners to protect the environment;
- establish consultative mechanisms to build the capacity of trading partners to protect the environment;
- reduce or eliminate government practices or policies that unduly threaten sustainable development;
- conduct environmental reviews of trade agreements; and
- promote the sale of green products and services.[18]

[13] Daly, *supra* note 2, at 48-51.
[14] For more on the physical limitations on through-put growth see NICHOLAS GEORGESCU-ROEGEN, THE ENTROPY LAW AND THE ECONOMIC PROCESS (1971).
[15] Daly, *supra* note 2, at 164-66.
[16] John Audley, *Lemons into Lemonade? Environment's New Role in U.S. Trade Policy: The Trade Act of 2002*, ENVIRONMENT, 30 (March 2003).
[17] Trade Act of 2002, Public Law 107-210, 8 August 2002, 107th Congress, 2nd session, Section 2102(a)(5).
[18] *Id*. Section 2102(b)(11).

The environmental provisions of TPA were largely a response to the concerns of environmental groups about the effect of trade and investment liberalization on regulatory policy, as summarized above.[19] As some groups perceived, however, it is far from clear that the provisions of the law address the full range of concerns raised by trade and investment liberalization in the absence of international environmental standards.

While the law does address fears of a regulatory race to the bottom, it clearly stops far short of establishing binding environmental standards, and thus governments retain a substantial margin for accommodating pressures for deregulation. Even though the most likely avenue for standards-lowering – underenforcement – is addressed by the agreement, countries retain the discretion to pare back environmental protections. With the path of underenforcement partially closed-off, governments seeking to advantage their producers may be more likely to resort to open standards-lowering than they have previously. Even on questions of enforcement, governments retain substantial discretion: only sustained or recurring failures to enforce are actionable. Perhaps most importantly, the law only requires that trading partners enforce their laws when they affect trade with the United States. Treaty partners are presumably free to reduce or under-enforce environmental standards in other areas to compete for investment, as long as those particular changes do not affect trade flows to the U.S.[20]

While TPA will constrain the ability of governments to lower standards in the face of liberalized trade and investment, it fails to address the risk of regulatory chill. The processes of capacity building and consultation may enable, and even encourage, governments to strengthen their environmental protections, but agreements ratified under the TPA need not require them to do so. More than avoidance of regulatory divergence is necessary to prevent regulatory arbitrage and regulatory chill; regulatory convergence through strengthening of trading partners' environmental protections is required. Given its failure to tie liberalization to prospective strengthening of environmental protections, TPA has a relatively minor effect on the incentive structures of governments facing regulatory choices.

Perhaps the respect in which TPA falls furthest short of the theoretical ideal of trade-environmental linkage is informational. With further trade and investment liberalization, and particularly in light of the WTO's market-access rules, trade in environmental services will increase. The result is that the U.S. and its trading partners will be more able to consume beyond the constraints of their national environments, and the dependency of each, through trade, on the environmental services of the other will increase. Ecological limitations on economic activity will become less politically salient, and assessments of the optimal scale of national resource consumption will become increasingly difficult.[21] The law makes no effort to tie trade liberalization to the resolution of these difficulties, beyond general encouragement of "consultation."

Moreover, the required environmental assessments fail in several respects to adequately address this concern. Most fundamentally, the environmental reviews do not lead to significant international information sharing about environmental conditions because they focus solely on the effect of proposed agreements on U.S. environmental health.[22] Hence, future trade in environmental services and natural resources that allows the U.S. to consume beyond its

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[19] Audley, *supra* note 16, at 29; personal interview with Marcos Orellana Cruz, 26 April 2007.

[20] In practice, the trade agreements negotiated under TPA address the risk of underenforcement to attract investment, showing that negotiators in this instance have adhered to the spirit of the law. But the parties agree only to "strive to ensure" that this category of regulation is faithfully applied, in contrast to regulation affecting trade, which the agreements provide "shall" be enforced. See the U.S.-Chile Free Trade Agreement at www.ustr.gov.

[21] Daly, *supra* note 15.

[22] Kevin P. Gallagher, *The Environmental Review of the FTAA: Examining the U.S. Approach*, TRADE, EQUITY, AND DEVELOPMENT SERIES OF THE CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE, 5 (August 2003).

domestic environmental constraints will be represented as environmental gain in the reviews. Additionally, the CGE models relied on to conduct the assessments consider only the market access provisions of agreements, overlooking investment, transportation, and intellectual property effects, among others.[23] Important decisions about the optimal scale of national resource consumption are thus made more difficult by trade and investment expansion under FTA.

III. The Trade Agreements in Practice

Despite TPA's attempts to enshrine links to environmental policy in the negotiation process, specific trade agreements have a mixed record in practice. The approach of establishing linkage through the negotiating objectives of the administration is limited by the need for preserving some degree of negotiating flexibility. After all, delegating that leeway to trade negotiators, and thus avoiding micromanagement by Congress, is the principal purpose of the Trade Promotion Authority mechanism. In light of the necessary element of flexibility in the negotiating process, it is difficult for TPA to guarantee achievement of trade-environment linkage in practice.

Most of the specific environmental negotiating objectives required by Congress appear, in some form, in the free trade agreements (FTAs) negotiated under TPA. For example, the agreement with Chile embodies several TPA provisions, including enforcement of environmental laws, an environmental review and environmental cooperation on specific cooperative projects through a Cabinet-level Environmental Affairs Council..[24]

But provision for implementation of these measures has been more problematic in other agreements. Though NAFTA's Commission for Environmental Cooperation (CEC) has been widely credited with strengthening enforcement capacity in Mexico, no CEC-like entity was created by CAFTA.[25] FTAs with Panama, Peru and Colombia did not provide for significant environmental consultation and cooperation, negating one of the few ways in which TPA might affirmatively promote regulatory convergence.[26] Nor did the administration or Congress provide any new funding for cooperation and other capacity-building activities to accompany these agreements.[27] Similar budgetary coordination problems dogged the agreement with Singapore.[28] And the United States Agency for International Development has not prioritized trade-related environmental technical assistance in its assistance programs; nor has the United States pushed the Inter-American Development Bank to do so.[29] Without funding, the promise of strengthened enforcement capacity in developing trade partners is lost.

While trade agreements do sometimes encourage efforts to improve environmental protections, only the commitment to enforce existing laws is subject to retaliatory enforcement measures..[30] Moreover, even this enforcement option is arguably weaker in the FTAs negotiated under TPA than in earlier agreements. In the U.S.-Jordan agreement, for example, the failure to enforce environmental laws could trigger retaliatory trade measures. Subsequent agreements under TPA, in contrast, provide for the application of fines in place of revocation of trade

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[23] *Id*. at 4.
[24] See the U.S.-Chile FTA, *supra* note 20.
[25] Kevin P. Gallagher, *CAFTA and the Environment*, THE PROVIDENCE JOURNAL, April 11, 2005.
[26] See Kevin Gallagher, *Greening U.S. Trade*, POLICY INNOVATIONS (April 2007), http://ase.tufts.edu/gdae/policy_research/PolicyInnovationsGallagher.pdf.
[27] *Id*.
[28] John Audley, *Evaluating Environmental Issues in the U.S.-Singapore FTA*, CEIP ISSUE BRIEF (April 2003).
[29] John Audley, *The Art of the Possible: Environment in the Free Trade Area of the Americas*, CEIP ISSUE BRIEF, 3 (Nov. 2003).
[30] Richard Dahl, *Trade, Not-So-Free Trade,* ENVIRONMENTAL HEALTH PERSPECTIVES, (Sept. 2003).

concessions. As public choice theorists have argued, there is good reason to expect that fines will be less effective than trade measures of comparable scale, because they cannot be used to mobilize domestic opposition to continuing violations in the offending country.[31] And since payment of fines is ultimately in the hands of the offending country, there is an additional risk of noncompliance that is not presented by retaliatory trade measures. This risk of noncompliance may make trade partners even less likely to undertake environmental enforcement. Whatever the reason, the environmental enforcement provisions in the bilateral and regional trade agreements approved under TPA have never been invoked. If the threat of enforcement is not credible, it will have little effect on the regulatory choices of trading partners in practice.

The purposes of trade-environment linkage are further undercut by the investment provisions of CAFTA. The agreement creates the possibility of multinational corporations suing governments before ad hoc investment tribunals for compensation for "indirect expropriation," creating a strong disincentive for environmental regulation.[32] Even if these tribunals set a high bar for finding that the regulatory costs imposed on firms constitute an expropriation, the risk of such legal action will significantly impact the cost-benefit analysis for regulatory decisions by adding adjudicative costs and heightening the political profile of investor disputes. The possibility of such lawsuits is another way for multinational firms to influence the regulatory decisions of governments, increasing the risk of regulatory chill. In sum, the environmental provisions of specific trade agreements fail to embody the full range of environmental goals of TPA.

IV. Making TPA Effective

Linking environmental protection with trade liberalization advances the agenda of sustainable development in important ways. Procedurally, bringing environmental interests – such as environmental ministers – to the table raises the profile and credibility of their bureaucratic domain.[33]

But under the regime of linkage established by the Trade Promotion Act of 2002, significant transnational spillovers remain unaddressed. TPA partially addresses the risk of de jure standards lowering and provides, in some cases, for consultation and capacity-building. Still, highly divergent patterns of regulation persist between the U.S. and its trading partners, creating the potential for price competition through cost externalization, regulatory arbitrage, regulatory chill, and trade in environmental services that obscures the scale of national through-put. As international economic integration continues forward, unilateral efforts to address these economic and informational transnational effects will become increasingly ineffective.

Addressing these spillovers requires some degree of internationalization of environmental standards and monitoring. TPA in its current form is a testament to the fact that consultation and capacity building is the most politically feasible approach to regulatory convergence. So the first step in reconciling TPA and the need for convergence is to ensure that such consultative mechanisms – modeled on NAFTA's Commision for Environmental Cooperation – are included in the agreements. To this end, some environmental groups have called for the trade negotiating process to be less secretive in order that civil society groups can influence their content more effectively. Keeping the status of ongoing negotiations secret does, however, serve to safeguard the flexibility of negotiators to craft innovative solutions. John Audley has suggested a compromise: expanding the Congressional Oversight Group, created

[31] Warren F. Schwartz & Alan O. Sykes, *The Economic Structure of Renegotiation and Dispute Resolution in the World Trade Organization*, 31 J. LEGAL STUD. 179, (2002).
[32] Kevin P. Gallagher, CAFTA's False Promise, AMERICAS PROGRAM POLICY BRIEF (March 2005).
[33] David Hunter, personal interview.

by TPA to monitor trade negotiators' adherence to mandated objectives, to include the heads of Congressional committees dealing with environment and labor.[34]

Equally important is for Congress to require that these efforts are accompanied by new funding. Environmental groups should encourage agencies like USAID and the multilateral banks to prioritize assistance to bolster the openings for regulatory strengthening that trade agreements provide.[35] Additionally, future grants of trade promotion authority should require more ambitious programs of environmental information sharing in place of one-time, U.S.-focused environmental reviews.

While these modifications of TPA may well be feasible, the current character of U.S. trade negotiations raises important questions about the whether the mechanism of TPA is the best way to achieve trade-environment linkage. First, the U.S. Trade Representative, like all bureaucratic entities, has its own particular institutional character and biases. Without aggressive and effective oversight, trade and investment liberalization are likely to remain the overriding priority in negotiations, with environmental safeguards trailing somewhere behind. Especially if Congress embraces the need to establish more effective mechanisms for regulatory convergence, the avenue of USTR negotiations may not be adequate.

Second, given the dependence of current U.S. trade liberalization strategy on small regional and bilateral trade agreements, and in light of the stalling of Doha, the scope of trade-environment linkage is bound to continue to lag well behind the global system of liberalized trade and investment. While it is important to link future liberalization to environmental protections, it is undeniable that the U.S. economy is already highly open to the world. The risks of economic liberalization without internationalized environmental norms are, therefore, already with us. The approach of establishing linkage through the small bilateral trade deals currently in the works, therefore, falls far short.

Moreover, addressing international environmental concerns in the forum of bilateral trade deals creates significant collective action problems, because other economies linked into the global system of trade and investment will benefit from strengthened regulation without bearing the cost.[36] Finally, even ambitious information sharing in the bilateral forum does little to address the broader informational problems surrounding trade in environmental services and the problem of scale. In a global system of trade and investment, with increasing transnational spillovers, the question of optimal scale of the human economy is a global one, requiring global coordination.

To the extent possible, therefore, Congress should complement TPA with strategies to link trade and investment liberalization to Multilateral Environmental Agreements and the establishment of multilateral – that is, global – institutions with the power to promote sustainable development on a global scale. While laudable, trade-environment linkage on a less than global scale cannot fully address the threat to the ability of governments to regulate effectively when production and commerce escape the bounds of national community.

[34] Audley, *supra* note 29.
[35] *Id*.
[36] Audley has discussed the related problem of sorting out the relationship between complicated rules of origin and environmental provisions in bilateral agreements. *Id*.