

In: Times of India: December 8, 2009

Why “Carbon-Tax-Equalization” Tariffs are a Bad Idea

By

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There are several substantive issues dividing the developed and developing countries as we enter the final week of the Copenhagen conference on Climate Change. But none is more gratuitous than the threat posed by the US Congress, in its proposed legislation such as the Waxman-Markey bill, and in remarks by President Sarkozy and in proposals from France, that any carbon tax (or its equivalent “cap premium” in national cap and trade schemes) in the developing countries which falls below the one in the developed countries would be “equalized” or countervailed through border taxes or in other equivalent ways.

Such proposals are based on fears that have little grounding in economic analysis. They are also likely to be considered violative of the WTO rights of the developing countries on whom such tariffs would be imposed and, even if found WTO-legal in a challenge at the WTO Dispute Settlement Mechanism, will certainly provoke WTO-legal retaliation in several ways by countries that are hit with such tariffs. Besides, the implementation of such tariffs raises impossible conceptual problems in implementation. In fact, the threat of such tariffs will certainly produce “local warming” at Copenhagen and undermine the progress to a satisfactory conclusion of a new Climate Change Treaty.

At the outset, the demands are driven by a misguided sense of “fairness” and morality: that, unless others cut their emissions, we should not be asked to cut ours. If a pastor at one’s church said to his flock however that they should be virtuous only if others are, that moral restraints by oneself in the presence of licentiousness

by others should be rejected, his sermons would be popular but would draw the wrath of his superiors.

But there is also the fear of trade uncompetitiveness of one's industries if other countries do not have an identical burden: virtue practiced alone would have too high a cost. This sounds more reasonable; but the fear is not grounded in compelling economic analysis. Careful empirical analysis analysis at Brookings Institution by Warren McKibbin and Peter Wilcoxon, under the leadership of the economist Lael Brainard now with the US Treasury, have demonstrated that uncompetitiveness is a much-exaggerated fear.

Importantly, the Netherlands Bureau for Economic Policy Analysis concluded recently that raising import tariffs on imports from low-carbon-tax countries would have little impact on total carbon emissions. For example, only 6 percent of cement produced is traded internationally whereas only 8 percent of China's steel, admittedly carbon-messy, is exported. In short, the most polluting industries serve the domestic, not the export, market.

Then again, many fear that our industries will go abroad to exploit lower carbon tax burdens. But many studies show that the investment decision, as to where to locate, reflects several factors such as infrastructure, availability of raw materials and political stability.

The administration of carbon tariffs is also a complex task that will raise hackles. For example, in today's interdependent world economy, most production involves importation of components and raw materials from several sources. Calculating the carbon content of a product is therefore as arbitrary as calculating

the “local content” and source of origin in implementing preferential trade agreements and eligibility for cheaper market access: and, because it involves imposing tariffs rather than exemptions from tariffs, it will be more contentious and productive of disharmony.

What are the better alternatives to carbon-tax-equalizing tariffs? There are several. First, the use of such carbon tariffs must be effectively ruled out. This cannot be done by mere advocacy and hoping that governments will become more enlightened. This is particularly so because, if there is ambiguity about the WTO-illegality of such tariffs, the temptation to go this route will be great. So, the Copenhagen accord, when concluded, must contain a Moratorium under which no such tariffs would be levied, foregoing therefore the use of Articles II, III and XX at the WTO to do so.

Second, we need to shift to an incentive, rather than a punishment, mode. At the moment, there is ambiguity about our ability to use green subsidies. In fact, under the 1995 Subsidies and Countervailing Measures Code at the WTO, the use of green subsidies unless they are strictly across-the board is actionable. In fact, even the currently designed cap-and-trade regime in the United States, with its many exemptions for different industries and hence differential sector-specific subsidies implicit in the scheme, is actionable. We need therefore to get a waiver from the SCM Code; or we need to amend it.

Finally, we can also unite behind the proposal to free trade in environmentally friendly products and services. This market has been variously

estimated but is likely to be close to a turnover of half a trillion US dollars. Surely, this has to be a matter of high priority in any Climate Change Treaty.