



# Free Trade Bulletin

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## Free Trade and Tobacco: Thank You for Not Smoking (Foreign) Cigarettes

by Simon Lester

As efforts to liberalize trade have moved beyond tariffs and quotas and now cover various aspects of domestic regulation and policy, some critics have argued that trade agreements undermine domestic sovereignty. Through today's expansive trade and investment agreements, critics claim, governments are ceding regulatory space that might be necessary to protect safety and health. As a result, the critics see a conflict between the goal of free trade and investment, on the one hand, and the capacity of governments to regulate for legitimate policy reasons, on the other.

As an example, the critics point to the perceived conflict between the goal of free trade in tobacco and the capacity of governments to regulate tobacco for public health purposes. As evidence, they cite two trade and investment cases related to tobacco regulation: (1) a recent World Trade Organization decision that found a U.S. anti-smoking law—purported to be about deterring youth smoking—to violate trade rules; and (2) pending litigation on an Australian law requiring that cigarettes be sold in plain, nondescript, brown packaging, in order to deter smoking, where the complaints allege violations of trade and investment agreements (through the infringement of trademarks and on other grounds).

Partly in response to these cases, health advocates have argued that international trade and investment rules should exclude tobacco completely, or, at the least, the rules should be applied more flexibly to tobacco in order to ensure that regulation for health purposes is allowed.

This paper examines some of the perceived tensions between free trade and regulation of tobacco for health purposes and concludes that most of the concerns about trade and investment agreements undermining domestic regulation are unfounded and that special rules for tobacco are unnecessary. Free trade itself does not raise national sovereignty concerns, nor does it interfere with domestic

policymaking to any significant degree. Although there may be valid concerns about some of the more recent additions to trade and investment agreements (i.e., rules that go beyond fighting protectionism), the core of these rules constrains domestic regulation only to the extent that such regulation discriminates against imports and does not preclude legitimate domestic policymaking.

### Trade and Investment Disputes Relating to Tobacco: Protectionism vs. Legitimate Health Regulation

As with many industries, governments have protected domestic tobacco producers from foreign competition. To take a blatant example, a U.S. law that required domestic cigarette makers to use a certain amount of domestically grown tobacco was challenged successfully in the GATT in the early 1990s.<sup>1</sup> While some protectionism is obvious, other forms can be disguised or hidden and can only be seen after examining the market at issue closely. The recent *U.S.—Clove Cigarettes* case is such an example. This case involved a U.S. law that prohibits cigarettes from having any characterizing flavors other than tobacco or menthol. The logic behind the measure was that adding flavors to cigarettes makes them less harsh, and thus easier for young people to try. Of great importance for this dispute was the fact that the ban on flavored cigarettes applied to *clove* cigarettes, a type of cigarette produced mainly in Indonesia, but not to *menthol* cigarettes, which are a significant American product. Indonesia filed a complaint at the WTO. Ultimately, the WTO's Appellate Body found that even though the measure "does not expressly distinguish" between imported and domestic like products, "it operates in a manner that reflects discrimination against the group of like products imported from Indonesia." Accordingly, the Appellate Body found a violation of the "national treatment" (i.e., non-discrimination) obligation.<sup>2</sup>

In general terms, the Appellate Body's finding of violation in the *Clove Cigarettes* case is based on the notion that the exclusion of (mostly American) menthol cigarettes

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*Simon Lester is a trade policy analyst at the Cato Institute's Herbert A. Stiefel Center for Trade Policy Studies.*

from the law, while the competing (mostly Indonesian) clove cigarettes are prohibited, constitutes protectionism. Even though the statute is origin neutral on its face, and does not have explicitly different rules for imports and domestic products, there is clear evidence of the discriminatory nature of the statute. This discrimination may be disguised or hidden in purported health measures, but it can be uncovered by looking under the surface, as the Appellate Body did here.

Critics of the decision expressed concern that this ruling undermines the ability to regulate tobacco for health purposes. In reality, though, the only problem with the measure was its discriminatory nature. If the law had banned menthol as well, a move that health advocates supported, it would very likely have been found to be consistent with the rules.

Drawing a line between protectionist and nonprotectionist laws can be difficult. As the *Clove Cigarettes* case shows, some measures that are ostensibly intended for nonprotectionist ends are in fact examples of disguised protectionism. But the characterization of measures as protectionist or not is crucial for establishing appropriate trade and investment rules, and thus must be examined carefully. While *Clove Cigarettes* fell on one side of the line, other cases may fall on the other. A good example is several overlapping cases, which are in their early stages, related to Australia's laws on "plain packaging" of cigarettes. Here, the critics of trade and investment agreements may have a legitimate reason to be concerned about the impact of these agreements on domestic sovereignty.

A number of countries have considered requiring that cigarettes be sold in plain packaging. Australia was the first country to adopt laws in this regard. Instead of the usual packaging, the legislation will force cigarette companies to sell their cigarettes in a logo-free drab dark brown package. As explained by the Australian Department of Health and Ageing, plain packaging will

- increase the noticeability, recall, and impact of health warning messages,
- reduce the ability of packaging to mislead consumers to believe that some products may be less harmful than others, and
- reduce the attractiveness of the tobacco product for both adults and children.<sup>3</sup>

Cigarette companies object strongly to such laws, and have brought (or convinced governments to bring) challenges in both Australian and international fora. With regard to international disputes, both trade and investment agreements have been invoked. The first case was brought by a subsidiary of the cigarette maker Philip Morris International (PMI) under the Hong Kong–Australia bilateral investment treaty. In its Notice of Claim,<sup>4</sup> filed in June of 2011, PMI put forward a number of arguments, including the claim that the law deprived it of "title to the intellectual property and goodwill" and "the commercial value of its investments in Australia." PMI argued that it is clear that there is no credible evidence that plain packaging legislation will have the claimed effect of enhanced public health.<sup>5</sup>

At around the same time that the investment claim was made, several countries raised objections in WTO Committees.<sup>6</sup> Then, in March, April, and July of 2012, dispute settlement proceedings began, as Ukraine, Honduras, and the Dominican Republic filed consultation requests.<sup>7</sup> Their key legal claims are that, as a result of the law, trademark rights are not being properly protected. With regard to "trade" arguments, the complainants alleged that the law constitutes an unnecessary obstacle to trade and is more trade restrictive than necessary to achieve the stated health objectives. They also alleged that various "discrimination" (i.e., protectionism) provisions of WTO law had been violated. However, the basis of these latter claims is unclear, as it is not obvious how the plain packaging laws treat foreign products or producers less favorably than domestic competitors.

At its core, the case against plain packaging, unlike the case of *Clove Cigarettes*, does not seem to be about protectionism. Rather, the main allegation is that the measure violates trade and investment rules that deal with issues other than protectionism, such as intellectual property and the protection of foreign investments. As a result, health advocates appear to have a point about the scope of these rules in relation to legitimate health regulation.

### **Is Tobacco Special? The Argument for Excluding Tobacco from Trade and Investment Agreements**

Cases like *Clove Cigarettes* and plain packaging have led to renewed calls by health advocates to "carve out" tobacco from trade agreements. This argument is based largely on several U.S. legal and policy documents.

During the 1980s and early 1990s, U.S. trade policy-makers worked actively to open foreign markets for U.S. cigarette exports, targeting both discriminatory measures and nondiscriminatory public health measures that had an impact on trade.<sup>8</sup> However, during the Clinton years, this policy began to change.<sup>9</sup> In 1997 Congress attached an amendment to an appropriations bill—known as the Doggett Amendment—which stated the following:

None of the funds provided by this Act shall be available to promote the sale or export of tobacco or tobacco products, or to seek the reduction or removal by any foreign country of restrictions on the marketing of tobacco or tobacco products, except for restrictions which are not applied equally to all tobacco or tobacco products of the same type.

Thus, under this provision the U.S. government will not seek to reduce or remove tobacco marketing restrictions, unless these restrictions are not applied "equally" (although the language does not mention country of origin, presumably this is the main kind of unequal treatment being targeted). This provision separates marketing restrictions that discriminate against foreign products from other, nondiscriminatory marketing restrictions. There is a clear distinction here: Protectionist measures related to tobacco are not appropriate, but nondiscriminatory measures are acceptable.

Soon after came a State Department cable along the same lines, which set out policy for all U.S. embassies

(who sometimes act on behalf of U.S. exporters). This cable provides a bit more background on the thinking of policymakers:

Given that tobacco use will be the leading cause of premature death and preventable illness early in the 21st century, there is a need to distinguish between protectionist policies and legitimate health-based actions, so as not to undermine other countries' efforts to reduce the consumption of tobacco and tobacco products and improve the health of their citizens.<sup>10</sup>

Thus, while protectionism is an appropriate target, "legitimate health-based actions" should not be discouraged.

Just before leaving office, President Clinton issued an Executive Order repeating the same guidance using slightly different language. Under this measure, the United States would not target nondiscriminatory marketing or advertising restrictions, but would still take action against discriminatory measures.<sup>11</sup> Both the Doggett Amendment and 2001 executive order remain in force.

Based on these legal instruments, during the Trans Pacific Partnership (TPP) negotiations, there have been requests that USTR "carve out" tobacco from any final agreement. In this regard, Rep. Linda Sanchez (D-CA) wrote the following in a letter to USTR Ron Kirk:

The Doggett Amendment and Executive Order 13193 forbid the use of government funds to promote the sale or export of tobacco and prohibit government agencies from seeking to reduce or remove foreign restrictions on the marketing and advertising of tobacco products. Accordingly, we ask that you carve tobacco out of the TPPA.<sup>12</sup>

She expressed two specific concerns about the inclusion of tobacco. First, she stated:

We understand that the TPPA is designed to facilitate trade by, among other things, lowering tariff rates. Lowering tariff rates promotes the sale and export of products by making products less expensive. It appears as though the TPPA includes tobacco in tariff reduction negotiations and is therefore promoting the sale and export of tobacco.

This appears to be a misreading of the relevant language, though, as targeting discriminatory measures is clearly permitted, and tariffs are a classic form of discriminatory measure. Allowing tariffs to remain would mean that protectionism is tolerated in the tobacco industry, which contradicts the other guidance in the relevant documents.

Second, she pointed to problems with TPP rules on investment and intellectual property (and makes reference to the "plain packaging" case):

The Doggett Amendment and Executive Order 13193 also forbid government agencies, includ-

ing USTR, from seeking to reduce or remove nondiscriminatory restrictions on the marketing and advertising of tobacco products. We understand that the TPPA will include strong intellectual property and investment provisions as well as an investor-state dispute settlement process, which provides a mechanism for private companies to enforce these provisions. Philip Morris International is currently relying on provisions nearly identical to those contemplated in the TPPA to challenge Uruguay's regulations on the marketing and advertising of cigarettes. Philip Morris has also argued that Australia's proposed regulations requiring "plain packaging" of cigarettes would violate investment rules.

Here, Representative Sanchez is on firmer ground, as some of the intellectual property and investment provisions cited in the plain packaging cases do go beyond nondiscrimination, and could put constraints on nondiscriminatory actions by governments.

In response to these concerns, USTR is considering new rules related to tobacco—a limited "carve-out"—in the TPP. The precise language of its draft proposal has not been released to the public, but USTR has explained three elements as follows:<sup>13</sup>

- "the unique status of tobacco products from a health and regulatory perspective" would be recognized
- tobacco products (like other products) would be subject to tariff phase-outs
- there would be language in the "general exceptions" chapter that "allows health authorities in TPP governments to adopt regulations that impose origin-neutral, science-based restrictions on specific tobacco products/classes in order to safeguard public health"<sup>14</sup>

USTR's proposal was probably designed as a compromise between the full-scale exclusion called for by some, and the industry's resistance to any change. It now appears that any decision on this issue is on hold, and a resolution will likely have to wait until after the U.S. presidential election.<sup>15</sup>

### **Is There a Conflict between Free Trade and Domestic Health Regulation?**

The disputes and negotiating debate over trade in tobacco highlight the issue of whether trade and investment agreements undermine domestic sovereignty. While the critics have some valid points, for the most part trade and investment rules focus on protectionism and do not constrain health regulation. To address their concerns, this distinction between rules on protectionism and rules on other issues can help guide the effort to find an appropriate line, to ensure that promoting free trade does not undermine health regulation.

#### *Protection for Domestic Tobacco Producers*

The arguments against protectionism are numerous and

familiar enough that they need not be listed here. Among other things, protectionism makes consumers worse off, favors well-connected companies, and causes friction between trading partners. The question arises, though, whether the tobacco industry is somehow special or unique because of the health issues involved, and thus whether protecting domestic tobacco markets may be beneficial for reasons of public health. In this regard, there are two assertions that health advocates make: (1) a protected domestic industry, either state-owned or private, may be easier to steer toward appropriate tobacco regulation policies that promote public health; and (2) free trade would lead to lower prices and thus more tobacco consumption.

On the first question, it is difficult to say with great certainty how different industry structures might affect smoking rates over the long term. What is clear, though, is that if the goal is to regulate tobacco so as to promote health, protection of domestic industry is not the best focus. There are other measures—for example, taxes, marketing restrictions, and so on—that would do a much better job of reducing smoking.

On the second question, as Representative Sanchez points out, free trade leads to lower prices as tariffs (and similar protectionist trade barriers) fall. That is certainly true, but if there is a concern about lower prices, this can be easily addressed. Tariffs are simply discriminatory taxes on imports. If higher prices are what health advocates want, tariffs could be replaced by nondiscriminatory taxes that are applied to both foreign and domestic products.

#### *Constraints on Nonprotectionist Tobacco Regulation*

Let's turn now to the argument, made by many critics of the current system, that existing trade rules that go beyond protectionism undermine national sovereignty, including the ability to regulate, and thus intrude into domestic health regulation. As the plain packaging cases discussed above indicate, there is an argument that they do (or at least that they may, as the cases have not been decided yet). Where trade and investment rules limit government actions that are not protectionist, they lead to criticism of the existing rules in a way that sometimes distracts from the core purpose of trade agreements. There may be good reasons for some of these rules, but nevertheless they do interfere with domestic policymaking, and this is a legitimate source of debate about the proper scope of trade agreements.

The question then arises as to whether special rules—that is, the “carve-out”—for tobacco are needed to prevent this interference. On this point, the issue of too much intrusion of trade and investment rules is not specific to tobacco. This is a more general problem with these agreements. As a result, rather than develop new rules for the tobacco industry, it may be worth thinking more broadly about problems arising from international economic agreements intruding into domestic regulation. Tobacco is unique in some ways, but its dangers have close parallels with many other products that cause health concerns. It is not clear that any differences between tobacco and other products merit a special regime. One of the most famous WTO dis-

putes involved a French ban on asbestos, a product even more widely cited as a health hazard than tobacco. Thus, to the extent there is a problem, having special trade rules apply to tobacco is not the solution.

#### **Conclusion**

Economics provides us with clear evidence that protectionism is an inefficient policy that makes us worse off. The tobacco industry has some unique characteristics, but the logic of basic economics does not cease to apply in this sector, and thus protection of domestic tobacco producers is no more sensible here than in other sectors. Protection for domestic producers is not a good way to reduce smoking, and there are many effective alternatives. Thus, removing protectionist barriers in the tobacco industry should remain a component of trade and investment agreements.

Using these agreements to fight protectionism should not undermine sovereignty or the ability to promote public health. An anti-protectionism rule does not interfere with domestic policymaking to any significant degree. Legitimate health regulation is still possible. At the same time, critics have raised some valid concerns about the scope of trade and investment agreements, in particular with the rules that go beyond simply fighting protectionism. While the principles involved—such as intellectual property and the protection of foreign investments—are important, it may be worth considering whether rules in these areas intrude too much into domestic policymaking. But these issues are not unique to the tobacco industry and, thus, should not lead to special rules for tobacco.

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#### **Notes**

1. GATT Panel Report, “United States Measures Affecting the Importation, Internal Sale and Use of Tobacco,” DS44/R, adopted October 4 1994, BISD 41S/131.
2. Appellate Body Report, “United States—Measures Affecting the Production and Sale of Clove Cigarettes,” WT/DS406/AB/R, adopted April 24, 2012, para. 226.
3. Department of Health and Ageing, “Plain Packaging of Tobacco Products,” <http://www.health.gov.au/internet/main/publishing.nsf/content/tobacco-plain>.
4. “Notice of Claim under the Australia / Hong Kong Agreement for the Promotion and Protection of Investments,” <http://www.dfat.gov.au/foi/downloads/dfat-foi-11-20550.pdf>.
5. *Ibid.*, para. 44.
6. See the following WTO documents: G/TBT/M/54, G/TBT/M/55, G/TBT/M/56, IP/C/M/66, IP/C/M/67, IP/C/M/69.
7. The complaints are in the following WTO documents: WT/DS434/1, WT/DS435/1, WT/DS441/1.
8. Douglas Bettcher and Ira Shapiro, “Tobacco Control in an Era of Trade Liberalisation,” *Tobacco Control* 10 (2001); Thomas Bollyky, “Forging a New Trade Policy on Tobacco,” Policy Innovation Memorandum no. 7, Council on Foreign Relations, August 2011.
9. Bollyky.
10. Department of State Cable 027439, February 14, 1998, “Tobacco: Guidance for U.S. Diplomatic Posts on Health, Trade and Commercial Issues.”
11. Executive Order 13193, January 18, 2001, “Federal Leadership on Global Tobacco Control and Prevention.”

12. The letter was a draft that was circulated among Sanchez's House colleagues, but it was never sent to Ambassador Kirk. It is available from *Inside U.S. Trade* at [http://insidetrade.com//index.php?option=com\\_iwpfile&file=jun2011/wto2011\\_2027.pdf](http://insidetrade.com//index.php?option=com_iwpfile&file=jun2011/wto2011_2027.pdf).

13. United States Trade Representative, "FACT SHEET: TPP Tobacco Proposal," <http://www.ustr.gov/about-us/press-office/fact-sheets/2012/may/tpp-tobacco-proposal>.

14. Benn McGrady of Georgetown University has uncovered a few more details on the last element. He reports that the proposal

"would supplement" the general exceptions with a new exception specific to tobacco control measures. He explains that the tobacco-specific exception "should be easier to invoke than the general exception," something that would be achieved "by using a threshold lower than a necessity test." Benn McGrady, "US Proposal on Tobacco in Trans-Pacific Partnership," <http://www.oneillinstitutetradeblog.org/us-proposal-on-tobacco-in-trans-pacific-partnership/>.

15. Inside U.S. Trade, "ASEAN Health Ministers' Tobacco Move Could Have Implications for TPP," July 19, 2012.