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The Permissible Reach of National Environmental Policies

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The Permissible Reach of National Environmental Policies

by

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Abstract

Trading nations exchange tariff concessions in the context of trade liberalizing rounds. Tariffs, nonetheless, are not the only instrument affecting the value of a concession. Domestic instruments affect it as well, but public order is not negotiable, and, consequently, is not scheduled. Public order is unilaterally defined, but must respect the *default rules* concerning allocation of jurisdiction which are common to all WTO Members and bind them by virtue of their appurtenance to the international community. In this paper, we focus on the interaction between trade and environment. The purpose of this study is to highlight how these rules and the GATT/WTO jointly determine the scope for unilateral environmental policies for WTO Members. In the study we examine the relevant multilateral framework dealing with this issue, as well as the relevant GATT and WTO case-law. We also briefly present the jurisdictional *default rules* in Public International Law. As a means of focusing the discussion, we consider a series of scenarios, partly building on factual aspects of cases that have already been brought before the WTO. These scenarios are intended to isolate issues of specific interest from a policy point of view. For each scenario we then seek to determine what would the outcome be, in case WTO adjudicating bodies were to explicitly take account of the *default rules* concerning allocation of jurisdiction, something which has not been done to date. Our main conclusions are two-fold: on occasion, the outcome would be different, had WTO panels observed the default rules concerning allocation of jurisdiction; more generally, the default rules can help us understand the limits of some key obligations assumed under the WTO. *Crucially, absent recourse to the default rules concerning allocation of jurisdiction, one risks understanding non-discrimination (the key GATT-obligation) as an instrument aimed to harmonize conditions of competition across markets, and not within markets, as the intent of negotiators has always been.*

JEL: F13, F18, F53

Keywords: Trade and environment, WTO

1 Introduction

The purpose of this study is to provide an overview of the *jurisdictional* aspects of the treatment of environmental policies (EP) affecting goods' trade in the World Trade Organization (WTO). The allocation of jurisdiction – that is, the allocation of the right to regulate transactions or activities – is a fundamental ingredient of law-making by sovereign states in general.¹ Jurisdiction is of particular interest in the context of unilaterally pursued EP by WTO Members. For example, there is a vivid policy discussion concerning the situations in which WTO Members have the right to pursue environmental regulation to address hazards that occur outside their sovereignty. This is effectively a question concerning jurisdiction.

WTO Members must observe Public International Law (PIL) when pursuing unilateral environmental policies, that is, both by treaties and by international custom. The main agreement of interest is of course the WTO Agreement itself, but other agreements, such as Multilateral Environmental Agreements (MEAs) could be of relevance as well. The basic principle of the GATT² and the other multilateral agreements on trade in goods in the WTO Agreement –known as Annex 1A agreements– is to allow WTO Members to unilaterally decide on their domestic policies. EPs are not treated any differently. The GATT imposes restrictions on unilaterally defined EP through, in particular, the two non-discrimination clauses – the Most-Favoured Nation (MFN) provision and the

¹ Of some interest from the point of view of the WTO Agreement is the fact that not only states have sovereignty: customs territories can have *limited* sovereignty, that is, sovereignty over a particular class of transactions. Hong Kong, China, for example, has sovereignty (also after its accession to People's Republic of China) over its international trade relations and thus, participates in the WTO as a Member.

² The GATT is the General Agreement on Tariffs and Trade, one of the agreements under the aegis of the WTO.

National Treatment (NT) provision – and also through certain other provisions. WTO Members are also bound by Customary International Law (CIL), that is, the other (besides agreements) main source of PIL, which binds states by virtue of their appurtenance to the community of nations.^{3 4} The basic principle of CIL is that states are equal partners, and that absent transfer of sovereignty to the international plane, they are free to exercise jurisdiction to their liking.⁵ This principle applies fully in the case of EP. When pursuing unilateral policies, such as EP, nonetheless, a state might encroach on the sovereignty of another nation if, for example, a transaction concerns more than one jurisdiction. CIL consists of rules and principles of general application dealing with the conduct of states, focusing on the rights and obligations of states *inter alia* in cases of jurisdictional conflict between countries. These jurisdictional rules are directly relevant for the conduct of EP.

The GATT does not include any explicit specification of the permissible jurisdictional reach of WTO Members' EP, and, in this sense, it does not explicitly address the question of which transactions a WTO Member can regulate unilaterally; it is concerned only with the issue *how* (that is, the non-discriminatory character) EP can be practised. The fact that WTO Members retain sovereignty over domestic policies, as long as such instruments are not used for

³ Public International Law covers all sources of international law, custom is one of them and a treaty is another. One can also distinguish between general and regional customs, but throughout this paper we use the term as covering both. Formally speaking, countries are also bound by derivations from general principles common to the major legal system of the world, but we disregard this source of law in what follows.

⁴ Although no specific reference to *default rules* was made, the WTO Appellate Body (AB) in its report on *US – Gasoline*, held that the WTO cannot be construed in clinical isolation from public international law (p. 17).

⁵ This is the principle of sovereign equality. States can decide however, deviations from this principle: one such agreed deviation is the introduction of *weighted voting* in the International Monetary Fund (IMF). See *infra*, our discussion of the *Lotus* jurisprudence.

protectionist purposes, permeates the GATT; there is, hence, an implicit notion of jurisdiction in the agreement. The jurisdictional rules in CIL are primarily concerned with *which* transactions or activities a country can regulate, but also with the manner in which this should be done (that is, they respond, albeit imperfectly so, to the question what is reasonable exercise of jurisdiction?). In order for unilateral EP to be lawfully pursued, they must abide by both these sets of laws.

The text of the WTO Agreement is silent on the nature of the relationship between WTO Law and the jurisdictional principles in the *defaults rules* in CIL. Litigation before the WTO has shed little, if any, light on the role of CIL (with respect to exercise of jurisdiction) in the WTO-context. Without explicitly addressing the issue, GATT/WTO case-law has implicitly embraced the principle that WTO Members have the right to regulate the conditions under which they grant market access, irrespective of adverse effects of such regulation for their trading partners. The Appellate Body (AB), for example, held that the United States (US) could lawfully condition access of shrimps to its market on the prior satisfaction of a production process unilaterally decided by the US government, notwithstanding the fact that in order to export to the US market, foreign producers had to conform to a production process which they had not decided (indeed, which they could hardly influence, and which was contrary to that decided by their own government).

Why are we concerned with jurisdictional rules concerning unilateral EPs? There are several reasons for our interest. One is our belief that, in the continuing absence of a more substantive discussion on the interaction between trade and environment, WTO Members will increasingly dispute the right of their trading

partners to regulate particular transactions, through recourse to PIL. Indeed, steps in this direction were already taken in the *US – Tuna*, and *US – Shrimp* litigations, where such arguments were made by the complainants.⁶

Second, jurisdictional rules are central for the effectiveness of any trade agreement. To demonstrate why this is the case, we will employ a highly stylized example, in which we will compare three different legal settings. Consider a world consisting of two countries that can trade. Each government has access to one type of domestic policy instrument, taxes, and to one trade instrument, tariffs. Taxes can only be levied on economic activities, such as production, sales, and consumption of goods. Tax policies are perfectly enforceable, so any tax that is levied can also be collected without administrative costs, regardless of where the activity occurs. When setting its policies, each government is only concerned with the interests of its nationals.

(i) Assume, first, that there are absolutely no jurisdictional restrictions on permissible policies. The exact tax/tariff schemes that the countries would choose in the absence of any form of policy coordination with other countries, would depend on the details of the situation. But since governments have the possibility to tax any activity occurring in this hypothetical world, they would typically find it profitable to tax foreign as well as domestic activities. What is clear is that, since the governments often disregard foreign interests when deciding on their tax schemes, the possibility of taxing foreign activities would introduce beggar-thy-neighbour-like features in the tax schemes. An agreement binding border instruments would in all likelihood have no impact at all, absent jurisdictional

⁶ As we will see, *infra*, though, panels have not reacted head on to such arguments.

rules: in this world, there would be no need to use trade instruments, since the possibility to tax foreign activities directly offers a more attractive means for beggar-thy-neighbour behaviour.

(ii) Suppose next that the agreement on tariffs is coupled with a National Treatment-like provision that restricts tax treatment of products in the domestic territory. It is hard, in general, to say whether such an agreement would have any impact at all. But the possibility would still remain to *tax activities taking place in the foreign economy*. As a result, very little, if anything, would be achieved through this agreement.

(iii) As a final case, suppose instead that the agreement on tariffs and quotas is coupled with a jurisdictional rule, prohibiting taxation of activities in the foreign country. In contrast to the previous two examples, this agreement is likely to have some impact. Note however, that the “trade part” of this agreement is immaterial, since the outcome is likely to be the same even if the bindings of the trade instruments were omitted. This will be the case, since, absent restrictions on domestic policies, the importing country can use production subsidies and consumption taxes to mimic trade barriers.⁷ In order to ensure that an agreed tariff reduction is meaningful, it must thus, at the very least, be accompanied by some form of restriction on the use of domestic policies.

The point we want to make through this abstract reasoning is that *the GATT must be supported by jurisdictional rules in order to have any impact*.

⁷ For instance, a production subsidy (which is a negative tax) and a consumption tax of equal magnitude (levied on the domestic as well as the imported product) can do a perfect job of mimicking a tariff of this magnitude.

A third reason for our interest in jurisdictional rules is our suspicion that the current allocation of jurisdiction is likely to be inefficient from an economic point of view. This suspicion stems from a combination of two factors. First, unilateral decisions are likely to take into consideration the consequences for national or government interests only. Second, the costs and benefits of regulation are likely to be unevenly spread across countries. Hence, *unilateral* decisions on EP will not appropriately balance their *global* costs and benefits. Both the trade regulation and the default rules can be seen as attempts to address the problems stemming from unilateralism. But these regimes are likely to only partially remedy the problems. Furthermore, it seems reasonable to guess *a priori* that each regime may also introduce inefficiencies due to their rigid nature, and furthermore that these inefficiencies may interact, sometimes counteracting each other, sometimes reinforcing each other. By distilling the core features of the existing legal regime, the present study may serve as a stepping stone for more detailed studies of how the current jurisdictional rules affect environmental policies, and how they should be redesigned.

Section 2 discusses in some detail the law and case-law concerning the jurisdictional ambit of unilaterally defined EP in the GATT, and Section 3 reviews the two other Annex 1A agreements of importance to this paper, namely, the *Agreement on Technical Barriers to Trade* (TBT), and the *Agreement on the Application of Sanitary and Phytosanitary Measures* (SPS). Section 4 presents the *default rules* in CIL. Sections 5-10 consider a series of stylized scenarios involving the treatment of EP under the WTO. For each scenario we first discuss what we believe a typical GATT panel – a panel that effectively disregards the *default rules* – would conclude concerning the legality of the discussed policy. We then try to

determine whether an invocation of the *default rules* would make a difference to the outcome. The hope is that these scenarios will highlight important aspects of jurisdiction in “archetype” situations with regard to EP. Section 11 summarizes our main findings, and briefly discusses some their implications.

2 The GATT Discipline on Environmental Policies

2.1 The Regulatory Framework

A central feature of the GATT is that it binds trade instruments: for instance, WTO Members have to respect the tariff concessions that they offered in the previous round; they are not allowed to use quantitative import or export restrictions; nor are they allowed to subsidize exports. The GATT leaves discretion, nonetheless, over internal (domestic) instruments to its WTO Members, although they are not *entirely* free to determine them to their liking: they must, in particular, respect the MFN provision (Art. I GATT), and the NT provision in Art. III GATT. Art. I GATT requests of each WTO Member not to treat the products originating in one WTO Member differently than the “like” products originating in any other WTO Member, both with respect to trade, as well as domestic instruments. Any trade advantage granted to the products of one WTO Member, must be accorded “immediately and unconditionally” to the “like” products originating in any other WTO Member. WTO Members must, by virtue of the legal discipline in Art. III GATT, avoid treating imported goods “so as to afford protection” to domestic “like” goods. Art. III GATT covers all fiscal instruments, as well as internal laws, regulations and requirements of non-fiscal nature that “affect” the life of imported products in a given market: a WTO

Member *can*, for example, unilaterally define its EP, but *must* apply it in a non-discriminatory manner (over all imported and domestic “like goods), to the extent that its EP affects trade in goods.⁸ The GATT is, in this sense, a “negative integration” scheme, since no common policies (EP as well) are established that all WTO Members should follow: the GATT states what is not allowed to be pursued through EP (discrimination), rather than what should be done.⁹

The GATT also contains in Art. XX GATT a loophole out of (at least formally) *any* other provision in the agreement, provided it is to achieve certain objectives included in this list. The list is exhaustive: WTO Members cannot, for example, through recourse to Art. XX GATT, address commercial externalities arising from low environmental standards in the exporting country, since such an objective does not figure in the body of Art. XX GATT. For a measure coming under the purview of this provision to be GATT-inconsistent, it must further not amount to “arbitrary or unjustifiable discrimination and/or a disguised restriction of trade”. Standing WTO case-law has made it clear that the WTO judge will review only the *means* used and not the *ends* pursued (provided of course, that the ends pursued figure in the list of Art. XX GATT).¹⁰ The test for legal consistency differs depending on the objective sought. The measure has to be “necessary” in order to achieve *some* of the listed policy objectives, and it can simply *relate to* the protection of others.

How do EP fit into this? As long as WTO Members, when pursuing EP, use a domestic instrument, their practice will come under the ambit of both Arts. I and

⁹ The only significant exception is the TRIPs.

¹⁰ For confirmation, see the very recent AB report on *Brazil – Retreaded Tyres*.

III GATT. To the extent that a trade instrument has been used, it is Art. I GATT only that is legally relevant. Note, however, that none of these provisions *explicitly* refers to EP. Importantly, the *Interpretative Note ad Art. III GATT* stipulates that domestic measures enforced at the border come under the purview of Art. III GATT (and not that of Art. XI GATT which deals with import and export quotas and does not contain a discrimination-test): thus, a sales ban which is enforced at the border and could, consequently, be mistaken for trade embargo will still be considered to be a *domestic* sales ban (and, consequently, come under the purview of Art. III GATT).¹¹ We quote:

Any internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provision of Article III.

The General Exceptions clause (Art. XX GATT) contains language that more directly address EP: Art. XX(b) GATT refers to *animal and plant life or health*, whereas Art. XX(g) GATT refers to the protection of *exhaustible natural resources*. Also, environment might possibly also come under Art. XX(a) GATT, which refers to “public morals”.

¹¹ Now, this raises this question whether it is for the GATT (in a centralized manner) or individual WTO Members to decide whether an instrument is trade or domestic. Mavroidis (2007) explains why this issue is moot.

2.2 The Jurisdictional Ambit of Unilateral Environmental Policies in Case-law

The GATT is from an economic point of view a highly “incomplete” agreement, in a number of ways. For instance, it only directly binds trade instruments, but leaves domestic instruments unbound (except for imposing the obligation not to discriminate on them). The regulation of domestic instruments is unclear because of the vagueness of notions such as “like” and “affecting”. Also, the exact nature of the loophole in Art. XX GATT is unclear. Because of this incompleteness, conflicts may arise over obligations that are implicitly or vaguely specified. As a consequence, adjudication plays an important role for the interpretation of the agreement.¹² We will in the rest of this section portray core features of the case-law treatment of the GATT disciplines on environmental policies, and in particular how it has addressed, or perhaps better, avoided to address central jurisdictional issues.

2.2.1 The GATT Case-law

(a) *US – Canadian Tuna*

This dispute, which is the closest we have gotten to discuss jurisdictional issues in the GATT/WTO dispute settlement practice, has been surprisingly overlooked in literature. The facts are as follows: Canadian authorities seized US vessels and arrested US fishermen who were fishing within the 200 miles of the Canadian coast.¹³ In response, the US government, as *per Section 205* of the *US Fishery*

¹² See the analysis along these lines, in Horn and Mavroidis (2004). For a formal explanation see Horn, Maggi and Staiger (2007).

¹³ According to customary international law, codified in the Convention on the Law of the Sea (UNCLOS III), the 200 miles-zone signals the exclusive economic zone that foreign countries cannot exploit without the consent of the coastal state having right to it.

Conservation & Management Act (1976), blocked all imports of Canadian albacore tuna into its market. Canada and the US consulted, without success and Canada submitted their dispute to a panel. Subsequently, they reached an agreement whereby the US government agreed to lift the embargo. The Canadian government, nonetheless, did not wish to suspend the panel's proceedings: in its view, the very existence of *Section 205* constituted enough of a threat that similar behaviour could be repeated in the future; it thus requested the Panel to continue its proceedings and judge whether the US measure based on *Section 205* was not GATT-inconsistent.¹⁴

The Canadian claim was that the US measure violated, *inter alia*, Art. XI GATT. The US government sought to justify its measure by invoking Art. XX(g) GATT, arguing that its measures sought to conserve an *exhaustible natural resource*. Canada did not dispute that tuna was an exhaustible natural resource, but argued that the US measures at hand had not been aiming at conserving tuna; they were rather meant to be a response to the seizure of US fishing boats by Canadian authorities, since the US government and another (un-named) state were the only two states which did not recognize the 200 miles *Exclusive Economic Zone* (EEZ) that every other nation member of the UN-system recognized as conferring exclusive economic rights to the coastal state.

On paper, it seems that this panel would unavoidably have been led to address the jurisdictional issue, that is, whether the GATT allows a country to regulate a common resource outside its border. Yet it declined to do so. It found the US

¹⁴ The Panel should have adjudicated this as an *as such* claim, that is, as a claim against the US statute itself, and not against the measure that it gave rise to, since the measure ceased to exist before the Panel was established.

measure to be in violation of Art. XX(g) GATT, since the US government had taken no accompanying measures aiming at restricting the fishing of albacore tuna by US fishermen. The Panel emphasized that its findings were meant to address the trade issue only, and that they should not be understood as an attempt to discuss the fisheries issue (which also involve a jurisdictional issue) as well:

Finally, the Panel would stress that its findings and conclusions were relevant only for the trade aspects of the matter under dispute and were not intended to have any bearing whatsoever on other aspects including those concerning questions of fishery jurisdiction. (§ 4.16)

(b) *US – Tuna (Mexico)*

In this case, the US banned imports of tuna originating in Mexico, because its production process did not conform to the US process: by not using special (purse seine) nets, Mexican fishermen were accidentally taking the life of, for US standards, an unacceptably large number of dolphins.

The jurisdictional issue here could be described as follows: through its regulation of the conditions of sale for tuna to its own market, the US government imposed a production process requirement not only on domestic fishermen, but also on Mexican fishermen. The US was hence *de facto* regulating a production process that Mexican fishermen had to comply with, if they wanted to export to the US market.

Mexico did not attack the right of the US government to regulate this transaction. It challenged the consistency of the US measure with Art. XI GATT, since the US imposed an import ban. The US government did not present any arguments to rebut the claim that Art. XI GATT had been violated; instead, it sought justification of its measures under Art. XX(b) GATT, which allows WTO Members to justify violations of the GATT, if they can demonstrate that their measure is necessary to protect human, animal, plant life or health.

The Panel did not put into question the need, as perceived by the US government, to regulate the fishing of tuna in order to save dolphins' life. The Panel rejected, nonetheless, the particular way in which the fishing regulation was done: in the Panel's view, the US government had no basis to act *unilaterally* in this context. In the Panel's thinking, were WTO Members to be allowed to act unilaterally, the result would be a world where a plethora of national regulations would make it quite onerous to trade. Hence, in this Panel's view, any unilaterally defined EP is GATT-inconsistent, precisely because it has been unilaterally (as opposed to multilaterally) defined.

(c) *US – Tuna (EEC)*

The facts of this case are strikingly similar to those in *US – Tuna (Mexico)*. The only difference was that in this case, the US measure was applied to intermediary nations that were importing only to re-export tuna fished in an environmentally-unfriendly manner. The European Community (EC) and the Netherlands (on behalf of the Netherlands Antilles) challenged the consistency of the US measure and prevailed on the same grounds as Mexico did in the case mentioned immediately *supra*.

2.2.2 The WTO Case-law

We will distinguish between cases which directly disputes over the use of EP, and cases which concern disputes over the use of domestic instruments other than EP; since, however, all domestic instruments (environmental included) come under the same legal discipline (Art. III GATT), the WTO jurisprudence under this provision is at least *potentially* relevant for environmental disputes. Four cases come under the former class: *US – Gasoline*, *US – Shrimp*, *EC – Approval and Marketing of Biotech Products*, and *Brazil – Re-treaded Tyres*.

(a) *US – Gasoline*

This case concerned a US measure which provided for different methodologies to be applied to domestic and foreign products in order to calculate the composition and emission effects of gasoline products sold in the US market. The US alleged that the rationale for the law was the protection of environment. The Panel and the AB first determined that EP come under the ambit of Art. III GATT (more recently, the panel report on *EC – Approval and Marketing of Biotech Products* confirmed this view.) They then found the measure to be inconsistent with the GATT because of its discriminatory aspect (different methodologies), and that it could not be justified through recourse to Art. XX GATT: in the AB's view, the measure at hand amounted to a disguised restriction of trade. The AB also held that the US failed to consider the costs for the complainants to comply with the regulation, and that it should have sought a bargaining solution, instead of unilaterally imposing its policies in this context.

The jurisdictional issue could be described as follows: the US maintained that it had the right to regulate the conditions under which gasoline products would be

sold within its territory, since, environmental externalities in the production of gasoline products abroad could affect its territory as well, assuming the said externalities were of trans-boundary nature. The US thus exercised its prescriptive jurisdiction to this effect. The complainants argued that the US legislation was discriminatory in that it was introducing two different baselines to calculate the pollution created by activities undertaken domestically, and in the foreign territory. The complainants prevailed under Art. III GATT. Neither the Panel nor the AB addressed the jurisdictional issue at all. The AB, nonetheless, emphasized the relevance of PIL for adjudication in the WTO.

(b) *US – Shrimp*

The facts in this case are strikingly similar to those in *US – Tuna (Mexico)*; the difference is that the products concerned were shrimps and sea turtles, instead of tuna and dolphins.¹⁵ The US government adopted a statute whereby, sales of shrimps in the US market were conditioned upon the prior demonstration that a particular production process had been followed, which restricted the number of sea turtles that were accidentally being caught.¹⁶

The jurisdictional issue is the same as in *US – Tuna (Mexico)*: the US government was regulating access to its territory (market) only, but imposed obligations on two sets of nationals, domestic and foreign, effectively regulating a production

¹⁵ See Howse and Neven (2007) for an economic-cum-legal of core features of this dispute, and Howse and Regan (2000), and Howse (2002), for discussion of e.g. jurisdictional aspects.

¹⁶ The US fishermen were using turtle excluding devices (TEDs), a rather cheap device that allows sea turtles to swim out, in case they are caught. Initially, the US government requested that all foreign traders wishing to sell to the US market should demonstrate that their traded shrimps were fished using TEDs. Following multilateral rulings to this effect, the US government then accepted that not only TEDs, but any device of comparable efficiency, could be legitimately employed.

process that foreigners had to observe, assuming interest to export to the US market.

The Panel and the AB reached opposite conclusions on the substance of the dispute. We will reflect only the latter, since the AB has the legal power to overturn panels' findings.¹⁷ The AB decision is a sea change when viewed against the background of the panel report on *US – Tuna (Mexico)*: in an oft-quoted passage, reproduced hereinafter, the AB held that the US government had the right to unilaterally define its EP, *provided* that it observed the statutory requirements reflected in the GATT (in this occasion, the requirements embedded in Art. XX(g) GATT, that is, that the challenged measure was relating to the conservation of exhaustible natural resources, and was applied in a non-discriminatory manner). In other words, in the absence of transfer of sovereignty to the international plane, WTO Members remained free to unilaterally regulate their market, provided that they respect the relevant GATT disciplines (§ 121):

... conditioning access to a Member's domestic market on whether exporting Members comply with, or adopt, a policy or policies unilaterally prescribed by the importing Member may, to some degree, be a common aspect of measures falling within the scope of one or another of the exceptions (a) to (j) of Article XX. Paragraphs (a) to (j) comprise measures that are recognized as exceptions to substantive obligations established in the GATT 1994, because the domestic policies embodied in such measures have been recognized as important and legitimate in character. It is not necessary to assume that requiring from exporting countries compliance with, or adoption of, certain policies (although

¹⁷ See Art. 17.13 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU).

covered in principle by one or another of the exceptions) prescribed by the importing country, renders a measure a priori incapable of justification under Article XX. Such an interpretation renders most, if not all, of the specific exceptions of Article XX inutile, a result abhorrent to the principles of interpretation we are bound to apply. (italics and emphasis in the original).

This case-law has been consistently re-produced ever since.¹⁸ As a result, it is now uncontested, as a matter of jurisprudential finding, that Art. XX GATT condones regulatory diversity.

Having established the right of the US government to regulate this transaction in a unilateral manner, the AB went on to find that, while the US measure was necessary in the sense of Art. XX GATT, it was being applied in a discriminatory manner, and, thus, violated the chapeau of this provision. Following corrective measures, the US government was eventually exonerated from all liability under the multilateral rules.

Note that the AB did not pronounce, yet again, on the permissibility of the jurisdictional reach of the US measure: in the absence of a claim, the AB did not *ex officio* examine this issue either. The reason why this issue did not come up, was probably due to the fact that the measure was allegedly designed to protect sea turtles which migrate through US waters, so US territory was in this sense directly affected by the killing of the turtles. There was some discussion to this effect in the AB report, where the AB explained its view on the “sufficient nexus” between domestic and international environment. We quote §§ 133-4:

¹⁸ See, for example, *US – Shrimp (Art. 21.5 – Malaysia)* in §§ 137 – 138.

Finally, we observe that sea turtles are highly migratory animals, passing in and out of waters subject to the rights of jurisdiction of various coastal states and the high seas. In the Panel Report, the Panel said:

... Information brought to the attention of the Panel, including documented statements from the experts, tends to *confirm the fact that sea turtles, in certain circumstances of their lives, migrate through the waters of several countries and the high sea.* ... (footnote omitted by authors, emphasis added by AB)

The sea turtle species here at stake, i.e., covered by Section 609, are all known to occur in waters over which the United States exercises jurisdiction. (footnote omitted) Of course, it is not claimed that *all* populations of these species migrate to, or traverse, at one time or another, waters subject to United States jurisdiction. Neither the appellant nor any of the appellees claims any rights of exclusive ownership over the sea turtles, at least not while they are swimming freely in their natural habitat -- the oceans. We do not pass upon the question of whether there is an implied jurisdictional limitation in Article XX(g), and if so, the nature or extent of that limitation. We note only that in the specific circumstances of the case before us, there is a sufficient nexus between the migratory and endangered marine populations involved and the United States for purposes of Article XX(g). (emphasis in original)

For all the foregoing reasons, we find that the sea turtles here involved constitute "exhaustible natural resources" for purposes of Article XX(g) of the GATT 1994..

Unfortunately, the AB did not elaborate any further and, consequently, the legal implications of this important passage are not entirely clear. One possible reading of this discussion, a reading that has been quite common in the

literature, is that the AB here effectively held that the killing of sea turtles by e.g. Malaysian fishermen of shrimp physically affected the US environment, by reducing the turtle population in the US. However, while this is perhaps the most plausible reading, it should be noted that there is no explicit statement by the AB to this effect. Also, it is not clear whether the “nexus” is a necessary condition for Art. XX GATT to be applicable.

(c) *EC – Approval and Marketing of Biotech Products*

Of interest to our paper are two issues treated by the panel: the fact that the panel report confirmed that EP come under the ambit of Art. III GATT, and the treatment of multilateral trade agreements (MEAs). With respect to the first question, the issue before the Panel was whether the EC-regime for approval of genetically modified organisms (GMOs) was consistent with a number of GATT and SPS provisions. The EC had argued that its system of approval was, *inter alia*, necessary to protect environment. The panel confirmed that EP can come under the purview of Art. III GATT.

With respect to the second question, the EC had argued that its challenged measures were fully justified by the *Cartagena Protocol on Bio-safety*, an instrument which had been ratified by 142 states. The Panel took the view that since the instrument at hand had not been ratified by all WTO Members, it was legally irrelevant for the purposes of the litigation before it. In other words, the Panel did not exclude that an MEA might be legally relevant in future litigation; for this to be the case though, it must be ratified by *all* WTO Members.

This report was not appealed, so the AB had no opportunity to pronounce on this score.¹⁹

(d) *Brazil – Re-treaded Tyres*

This is the most recent case dealing with EP. Brazil imposed an import embargo on re-treaded, but not on new tyres. The argument for the differential treatment was that re-treaded tyres have a shorter life-span than new tyres and, consequently, represent more of an environmental concern. On the other hand, the embargo on re-treaded tyres was not non-discriminatory: Brazil did accept, however, some re-treaded tyres from its MERCOSUR partners, as well as from other trading partners, following some Brazilian court decisions to this effect.

The Panel condemned Brazil since its EP did not respect the chapeau of Art. XX GATT, holding that the Brazilian measure amounted to a disguised restriction of trade (and thus, violated the requirements of the chapeau of Art. XX GATT). The AB, while modifying some of the conclusions, essentially upheld this finding. But neither the Panel, nor the AB discussed the permissibility of the jurisdictional reach of the Brazilian EP. This is less of a concern compared to other cases however, since the environmental externality that Brazil claimed to be regulating would be borne, in all likelihood, by Brazil alone.

We now turn to the cases dealing with other than EP domestic instruments.

(e) *EC – Asbestos*

¹⁹ Mavroidis (2008) however, looking at the manner in which WTO adjudicating bodies have been looking on extra-WTO law, takes a pessimistic view on this score, arguing that the overall record of the AB shows a tendency to close the door to extra-WTO law rather than to open it.

Based on scientific evidence, France enacted legislation banning sales of asbestos containing-construction material into its market. Canada challenged the consistency of the measure with Art. III GATT; in its view, asbestos-containing and asbestos-free construction material should be awarded the same regulatory treatment since they are *like* products.

The Panel agreed with Canada that the contested measure violated Art. III GATT, but exonerated it under Art. XX GATT for being necessary to protect human life. The AB overturned the Panel's findings and held that France's measures were consistent with Art. III GATT: in its view, consumers would, if presented with a choice between the two types of products, not view them as like, due to the health hazard that the asbestos-containing product gave rise to. Since the two products were unlike, there could be no violation of Art. III GATT.²⁰

The *EC – Asbestos* determination raises several difficult issues with regard to the role of consumer preferences for the definition of likeness. Without going into any detail, let us just point to a couple of these. A first issue is the notion of a "reasonable consumer", who is by construction a fictitious person who is endowed with what the AB sees as "reasonable" preferences.²¹ It goes without saying that the AB approach is a subjective exercise, in particular as long as the preferences of actual consumers are not investigated.

²⁰ See Horn and Weiler (2007a) for a critical discussion, not of the outcome of the dispute, but of the adjudicating bodies' reasoning to get there.

²¹ In many civil law countries a similar construction exists.

A second issue is the question concerning whether the perceived differences in products have to be reflected in the physical properties of the product. In this dispute, this was not an issue in the sense that the riskiness of the product was intimately associated with its physical properties. Some observers have interpreted the *EC – Asbestos* ruling to open the door to a wider interpretation whereby consumer preferences are decisive, regardless of whether the perceived differences are reflected in the physical properties of the product.²²

The *EC – Asbestos* determination also raises the question of whether consumer perceptions *as such* suffice as grounds for differential policy treatment? For instance, would products be unlike in a legal sense even if consumer perceptions are erroneous? As things stand, we do not know what the response to this question is. But our guess is that the AB would not lightheartedly accept consumer perceptions it believes are erroneous: in *EC – Asbestos* the AB did not use surveys of EC consumer perceptions of the particular product; it adopted a “reasonable consumer” perspective, inferring how such a consumer would treat the two products.²³

The jurisdictional issue in *EC – Asbestos* could be described as follows: France, by imposing the sales ban on asbestos containing construction material, regulates the *effect* of the consumption of such material in its domestic market. At the same time, it indirectly regulates the production in Canada, forcing Canadian producers to reduce or re-direct some of their production. To see that there is a jurisdictional issue involved here, note that France could have achieved the same

²² It seems likely that consumer preferences are less decisive in cases adjudicated under the SPS Agreement.

²³ It should be noted, nonetheless, that the AB did not have any empirical evidence before it. It should also be noted that it requested none.

(or at least a similar) outcome by regulating production in Canada rather than consumption in France. Since economically the outcomes are about the same, and the regulation of Canadian producers clearly involves a jurisdictional issue, so does implicitly also the regulation of consumption in France. Yet, once again, in the absence of specific claims to this effect, neither the Panel nor the AB explicitly addressed the jurisdictional issue.

(f) *EC – Tariff Preferences*

The EC provided Pakistani textiles exports with preferences additional to those granted to Indian exporters under its Generalized System of Preferences (GSP). Overruling the Panel, the AB, found nothing wrong with the EC scheme, provided that it was relying on *objective criteria*. The term *objective criteria* was not defined by the AB.²⁴ To this effect, the EC had to effect modifications in its scheme which, when challenged by India, did not provide for access to *any* developing country which would satisfy its criteria, but granted extra preferences to a closed list of beneficiaries.

Of interest to this study is the fact that the EC scheme provided Pakistan with extra preferences by following a policy that the EC had determined; Pakistan did this by enacting decrees to combat the production and trafficking of drugs. By the same token, one could imagine that the EC could grant preferences, were Pakistan (or any other beneficiary) to adopt an EP to the liking of the EC. Although the term *objective criteria* was not defined by the AB, it should cover situations which are not linked to one particular country; hence, the insistence of the AB that the EC removes the close list of beneficiaries.

²⁴ Grossman and Sykes (2005) as well deplore that the AB did not interpret any further this term.

The AB thus accepted that a WTO Member can provide preferences to another (developing) WTO Member, if the latter adopts policies that can rely on *objective criteria, irrespective* of the effect of such policies on the donor.

2.2.3 Summarizing the WTO Case-law

We could classify the cases discussed above in three different categories:

- (a) Cases where a WTO Member aims at redressing a situation that will occur in its market if importation occurs (a local consumption hazard): *EC – Asbestos, EC – Approval and Marketing of Biotech Products, Brazil – Retreaded Tyres*;
- (b) Cases where a WTO Member aims at redressing a situation that has occurred outside its territory, that is, in the territory of the exporting state, but which affects it (a trans-boundary production externality): *US – Tuna (Mexico), US – Tuna (EEC), US – Canadian Tuna, US – Shrimp, US – Gasoline*;
- (c) Cases where a WTO Member aims at redressing a situation that, *prima facie* at least, is not linked to either a production or a consumption externality: in this vein, a WTO Member aims at compensating those trading partners that adopt sound, in its view, policies by contributing (through preferential tariffs) to the costs that such policies might entail: *EC – Tariff Preferences*.

In neither of the cases presented above did the complainant raise any jurisdictional claims. In the absence of specific claims to this effect, panels did not

address this issue either: at least implicitly, they accepted that when the WTO Member was regulating access to its market, it was lawfully exercising jurisdiction. The GATT panel on *US – Canadian Tuna* took a more cautious approach on this score and, as we saw *supra*, clarified that its findings were limited to the trade issue, and that it was not aiming to prejudge at all the fisheries (jurisdictional) issue.

The paucity of claims from disputing parties concerning jurisdiction naturally raises the question whether panels could not examine the jurisdictional reach of a WTO Member's measures *ex officio*, that is, even in the absence of a specific claim to this effect? This issue is, for all practical purposes, water under the bridge. WTO panels, for a number of reasons linked to their half-legalistic, half-diplomatic nature, are not keen in addressing issues that have not been explicitly referred to them. There are good legal arguments to support the WTO panels' attitude. We deem it warranted to make a small detour to WTO case-law in order to explain the panels' attitude in this respect. In what follows, we will try to show that:

- (a) Panels have the competence to *ex officio* review which claims are properly before them;
- (b) Were they to entertain claims not properly submitted to them, panels would be violating their obligation under Art. 11 DSU, which requests of panels to make an objective assessment of only the dispute before them (the *non ultra petita* maxim).

Any adjudicating body has, of course, discretion to review *ex officio* the extent of its own competence. This means, that adjudicating bodies have competence to

verify, on their own initiative, the ambit of claims properly before them. This much has already been accepted by WTO adjudicating bodies, and is now part of the WTO legal order: the AB underscored this point in its report on *EC – Bananas*, where it held (§ 142):

We recognize that a panel request will usually be approved automatically at the DSB meeting following the meeting at which the request first appears on the DSB's agenda. As a panel request is normally not subjected to detailed scrutiny by the DSB, it is incumbent upon a panel to examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU.

In its report on *Mexico – Corn Syrup (Art. 21.5 – US)*, the AB went one step further and argued that panels *must* (as opposed to *should*) address the issue of their own competence (§ 36):

... panels have to address and dispose of certain issues of a fundamental nature, even if the parties to the dispute remain silent on those issues. In this regard, we have previously observed that [t]he vesting of jurisdiction in a panel is a fundamental prerequisite for lawful panel proceedings. For this reason, panels cannot simply ignore issues which go to the root of their jurisdiction – that is, to their authority to deal with and dispose of matters. Rather, panels must deal with such issues – if necessary, on their own motion – in order to satisfy themselves that they have authority to proceed.

The issue whether a panel is competent to adjudicate a specific dispute is eminently of legal nature. Consequently, it is subject to review by the AB. At the same time, when reviewing which claims are properly before it, a panel may eliminate a claim, but it cannot add to the claims that the complainant has submitted; this is in essence what the legal maxim *non ultra petita* amounts to. Whereas a judge is, of course, free to use its own arguments to reach a conclusion (that is, a judge is not bound by the arguments submitted by the parties to a dispute), a judge cannot make claims for either party. The AB clearly stated relevance of this principle for WTO panels in its report on *Mexico – Corn Syrup (Article 21.5 – US)*:

... as a matter of due process, and the proper exercise of the judicial function, panels are required to address issues that are put before them by the parties to a dispute. (§ 36)

By the same token, in its report on *US – Certain EC Products* the AB reversed the panel's findings on issues which had not been put properly before it. In the case at hand, the complainant had not presented any claims under Art. 23.2(a) DSU and this omission notwithstanding, the panel went on and pronounced on the consistency of the defendant's actions with the mentioned legal basis. The panel's findings in this respect were reversed (§115). In *Chile – Price Band*, the AB went one step further and held that *ultra petita* rulings constitute a violation of the panel's most fundamental duty, that is, to make an objective assessment of the matter before it (Art. 11 DSU). The only exception to *non ultra petita* is the competence of a panel (and the AB, of course) to review its own competence to adjudicate a particular dispute.

To conclude, in the absence of any claims as to the jurisdictional reach of national measures, it is only natural that WTO adjudicating bodies refrained from expressing any views on this issue.²⁵

3 The TBT/SPS Agreements

Environment-related disputes may also arise under the *Agreement on Technical Barriers to Trade* (TBT), and the *Agreement on the Application of Sanitary and Phytosanitary Measures* (SPS). These two agreements innovate compared to Art. III GATT: SPS incorporates more elaborate tests to detect protectionist intent. The SPS Agreement includes a series of proxies, such as scientific evidence, coherence in the formulation of policies, and adherence to international standards, which aim to distinguish beggar-thy-neighbour behaviour from policies genuinely aiming at protecting health/environment; the TBT Agreement adds necessity to non-discrimination. Depending on how the non-discrimination obligation is construed, the SPS Agreement outlaws beggar thy neighbour policies *in addition to* those outlawed by the GATT. It all depends on the understanding of the consistency-requirement embedded in Art. 5.5 SPS: if it is construed as covering substitutable products only, then there is no difference across the two agreements; if, conversely, it is construed *à la Australia – Salmon* to cover any

²⁵ The absence of claims regarding the jurisdictional reach is arguably due to the fact that there is an implicit understanding across trading partners to respect the *default rules* regarding jurisdictional allocation. Differences persist because the rules are unclear at the margins, as we will try to show *infra*. It is only rational that interested states aim to resolve such differences through direct negotiations, rather than submitting disputes to WTO panels with no (demonstrable) expertise on jurisdictional allocation. Such issues are the hard core of sovereignty and it is only normal that states are quite risk averse when dealing with them.

situation where there are comparable health risks, then the SPS Agreement will be exerting a de-regulatory function that the GATT does not.²⁶

In other respects, the two agreements follow the GATT-logic. Sometimes, one finds in the literature the view that the TBT and SPS Agreements are “positive integration” instruments, requesting countries to adopt certain domestic measures. In support of this claim it is frequently held that these agreements require WTO Members to adopt *international standards*. This view should be discarded: WTO Members do not have to enact international standards *irrespective* whether they want to intervene in a particular field. They will have to base their intervention on such standards, only after they have decided to intervene. This latter decision is sovereign, and not a matter of legal compulsion: WTO Members which do not want, for example, to enact legislation regarding the safety of children’s toys, do not have to adopt the relevant ISO standards.

To the extent countries adhere to international standards, the discussion concerning jurisdiction should become irrelevant, since these standards reflect international agreements. Case-law, however, has reduced some of the bite of international standards.

Pursuant to Art. 2.4 TBT, international standards or the relevant parts of them must be used as the *basis* for the adoption of *technical regulations*.²⁷ The AB in its

²⁶ Even in this situation however, a non-discrimination test is still embedded in the SPS Agreement: the ban will cover also *potential* national production; the import prohibition for foreign products amounts to a production ban for domestic products.

²⁷ Sometimes, in literature, one finds the view that the TBT and SPS Agreements are positive integration instruments. The supporters of this view point to the provisions on *international standards* to make their point. This view, however, should be discarded. WTO Members do not have to enact international standards *irrespective* whether they want to intervene in a particular field.

Report on *EC –Sardines*, explained that the terms used in Art. 2.4 TBT necessarily entail that a technical regulation should at the very least not be contradictory to the relevant *international standard*. The AB also pointed out that *all* relevant parts of an international standard, not only some of them, must form the basis of a technical regulation (§§ 248 and 250). In the same report, the AB had the opportunity to provide its understanding of the terms *ineffective or inappropriate*. In the dispute, Peru complained that the EC had deviated unjustifiably from an international standard reflecting the denomination of sardines. I provisionally cut it out, but I think our argument now is a bit short.

The AB also addressed the question of who carries the burden of proof to show that a deviation from an *international standard* has been TBT-consistent? The AB reversed the Panel's holding concluding that, when a WTO Member does not use a relevant international standard as the basis for its technical regulation on the ground that it believes that the standard is either ineffective or inappropriate, the burden still rests with the complaining party to prove that the international standard at issue is appropriate and effective for the defendant to reach its objectives (§ 282). However, the burden of persuasion put on Peru was so low as to effectively shift the burden of the *prima facie* argumentation from Peru to the EC, that is, from the complainant to the respondent, in violation of firmly rooted principles in GATT/WTO case-law. This is very significant, since there is a considerable difference between requesting of the complainant to show that an

They will have to base their intervention on such standards, only after they have decided to intervene. This latter decision nevertheless, is sovereign, and not a matter of legal compulsion: WTO Members which do not want, for example, to enact legislation regarding the safety of children's toys, do not have to *anyway* adopt the relevant ISO standards.

international standard is effective and appropriate, and of the respondent that it is ineffective or inappropriate.^{28 29}

When it comes to unilateral interventions, WTO Members must respect obligations additional to non-discrimination, such as, necessity, coherence etc., as noted *supra*. The limited TBT/SPS case-law has with respect to jurisdictional issues followed the same approach as in GATT cases. As a result, our analysis above holds for the TBT/SPS-context as well.

To conclude, the TBT/SPS Agreements do not alter in any significant way the negative integration-character of the GATT: EP coming under their purview will be nationally defined; they will have to respect, nonetheless, requirements additional to non-discrimination. Importantly, in line with the GATT, none of these agreements discusses the jurisdictional ambit of national policies coming under their purview. We will turn to this issue now.

4. A Primer on Jurisdiction in CIL

In this Section, we provide an introduction to the treatment of territorial jurisdiction in CIL. We will not provide an exhaustive account of the origins and

²⁸ See Horn and Weiler (2007b) for a critical discussion of this and other aspects of the determination. Note, nonetheless, that Peru did not produce any evidence additional to what it had included in its complaint, and still managed to prevail.

²⁹ For a very comprehensive analysis on how international standards are being prepared and their trade relevance, see Sykes (1995).

nature of these rules, but only an introduction to some aspects that are of direct relevance to the issues at stake here, and in particular to the *default rules*.^{30 31}

4.1 The Barebones of the *DefaultRules*

The *default rules* concerning the territoriality- and the nationality-bases for prescriptive jurisdiction, can be summarized as follows:

- (a) The rules apply in situations where:
 - (i) we are neither in the realm of *universal* jurisdiction,;
 - (ii) nor has a *bargaining solution* (international agreement) been negotiated;

- (b) A state can lawfully exercise prescriptive jurisdiction³²:
 - (i) on all activities occurring in its own territory (territoriality principle);
 - (ii) over its nationals, even for acts, omissions committed outside its territory (nationality principle);

³⁰ For a fuller account, see e.g. the various contributions in Meessen (1996).

³¹ It is debatable whether the *default rules* are a source of WTO law, or simply law that WTO Members must obey anyway. No matter where one stands on this score, the end result for the purposes of our discussion is the same: the default rules circumscribe the ambit of permissible jurisdictional reach, see on this score the views of Pauwelyn (2003) on the one hand, and Trachtman (1999) and Mavroidis (2008) on the other.

³² There are other bases as well which, exceptionally, might be relevant, such as the passive protective principle, whereby a state can claim jurisdiction on activities occurring outside its jurisdiction *and* aiming at one of its nationals. Anyway, this basis is of no interest to this paper. By the same token, there is widespread acknowledgement of the *protective principle*, which enables states to exercise jurisdiction against activity occurring outside its territory aiming at its national security, and there is special jurisdiction for activities occurring aboard vessels, aircrafts and spacecrafts: none of these two bases is of direct relevance to this paper.

In case of conflict between the two bases, the territoriality-principle prevails,^{33 34}

- (c) In case there are *effects* from an activity taking place in the territory of one state in the territory of other states, or in case the effects of an activity are spread over different states, all affected states are, in principle, competent to exercise prescriptive jurisdiction (*effects doctrine*).

4.2 The Hierarchy between Territoriality and Nationality

The hierarchy between territoriality and nationality is well documented. In its often discussed *Lotus*³⁵ judgment, the *Permanent Court of International Justice* (PCIJ) said as much:

Now the first and foremost restriction imposed by international law upon a State is that –failing the existence of a permissive rule to the contrary– it may not exercise its power in any form in the territory of another State. In this sense jurisdiction is certainly territorial; it cannot be exercised by a State outside its

³³ Indeed, from early on it has been accepted that states cannot regulate in an extra-territorial manner. Viewed from this perspective the (ongoing) discussion on the nature of international law (whereby we distinguish between those that take the view that absent permissive international rules, no unilateral exercise of jurisdiction is permissible, and those who take the opposite view, that is, that international law can impose limits only to the exercise of unilateral jurisdiction) is futile. No matter what the starting point is, it will inevitably be the case, at least with respect to many transactions of interest to this paper, that more than one jurisdictions will, in principle, legitimately believe that they can exercise jurisdiction. See on this point, Dunoff (2005), and Buxbaum (2006).

³⁴ The interpretation of the term *conflict* is crucial here and there is asymmetric practice across states on this score: some will interpret it in a very strict manner and understand conflict a situation where the individual concerned cannot simultaneously comply with the legislation of two (or more) states. Others have adopted a looser standard: this is where the *comity* principle kicks in; some states will weigh their interest to regulate a particular transaction and will give in (to another state), if they judge that another state has more of an interest to regulate, *even if* the individual concerned could, in theory at least, comply with both regimes.

³⁵ France vs. Turkey, Judgment No 9, September 7, 1927, PCIJ Reports, 1928, Series A, No 10.

territory except by virtue of a permissive rule derived from international custom or from a convention.³⁶

The same principle has further been adopted early on by domestic courts. Justice Holmes, for example, proclaimed early in the 20th century:

... the general and almost universal rule is that the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done.³⁷

This does not mean that problems cannot arise in such a scenario: it could be, for example, that the punishment of an act by the state exercising jurisdiction invoking nationality is different from that of the state exercising jurisdiction on territoriality; in such cases, it could be that both states might wish to exercise jurisdiction in *cumulative* manner.

We can use the facts in *Lotus* as illustration: a Frenchman shoots from a French vessel (considered French territory) and kills a Turkish citizen on Turkish soil; the act takes place in France, its effects are felt in Turkey. The question arises who has jurisdiction in such cases? State practice first, and international courts later, have distinguished between *objective* and *subjective* territoriality: the former refers to jurisdiction for any act occurring within the national territory as circumscribed by the geographic frontiers, the effects of which are also felt

³⁶ See *Lotus, op. cit.* at pp. 18-19. On this score, see also Parrish (2007), and Bradley and Goldsmith (2006) at pp. 625ff.

³⁷ See *Am. Banana Co vs. United Fruit Co.* 213 US 347, 356-359 (1909). Recently, US courts refused to extend jurisdiction to foreigners challenging the consistency of actions by Swiss companies with US antitrust law, see *F. Hoffman La Roche Ltd. vs. Empagran SA*, 542 US 155, 164 (2004); see on this score, Klevorick and Sykes (2007).

within this territory; the latter covers cases where the effects of an act occurring *outside* the national geographic frontiers are felt *within* it (cases where there are, in other words, *trans-boundary effects*). In this latter case, jurisdiction to adjudicate the transaction is allocated to both Turkey and France.

4.3 The Effects Doctrine: no Walk in the Park

Jurisdiction based on the effects doctrine is not uncontested. We read, for example, from the US *Restatement* on Foreign Relations Law³⁸:

The effects principle is not controversial with respect to acts such as shooting or even sending libelous publications across a boundary. It is generally accepted with respect to liability for injury in the state from products made outside the state and introduced into its stream of commerce. Controversy has arisen as a result of economic regulation by the US and others, particularly through competition laws, on the basis of economic effect in their territory, when the conduct was lawful where carried out. This Restatement takes the position that a state may exercise jurisdiction based on effects in the state, when the effect or intended effect is substantial and the exercise of jurisdiction is reasonable under § 403. (emphasis added).

A threshold issue is the magnitude of the effects that suffice for the effects doctrine to be applicable. The *American Law Institute's* prominent restatement of *Foreign Relations Law of the United States* (hereinafter the *Restatement*) takes the view that, at the very least, a jurisdiction must demonstrate *substantial, direct*, and

³⁸ See, *The Restatement, op. cit.*

foreseeable effects upon its territory.³⁹ ⁴⁰ Absent such effects, countries cannot legitimately exercise jurisdiction. What exactly *substantial, direct, and foreseeable* means is unclear. The most authoritative guide to their interpretation is state practice and international courts' decisions, as well as arbitral bodies' awards on this score.

State practice provides us, alas, with incoherent responses: there are states which liberally assert jurisdiction, and states which are more conservative in this respect.⁴¹ The lack of clarity in the *default rules* is exemplified, for example, in the divergent views of Kramer (1995) and Lowenfeld (1995) regarding the manner in which the US Supreme Court addressed the jurisdictional issue in the highly contentious *Hartford Inc.* case, which provoked the disapproval of the UK government that held the view that it alone had the right to prescribe jurisdiction over this particular transaction. State practice, nevertheless, is not always inconsistent: for example, at the time the *Restatement* was written, it is true that there was no unanimity across nations as to the application of the effects doctrine in antitrust issues. The situation is different today with the application of the effects doctrine by the European Union (EU) and the US in several high-profile competition cases during the last two decades.⁴² Consensus has thus emerged regarding the acceptance of the application of the effects doctrine in a particular.

³⁹ See *Restatement of the Law Third, Foreign Relations Law of the United States* (1990) at p. 238. The *Restatement* is considered to be an authentic description of international law practice, and it is routinely cited in judgments of the highest courts around the world. It has thus exercised a *de facto* persuasive effect on courts in the United States and around the world.

⁴⁰ See *The Restatement op. cit.* at pp. 244ff.

⁴¹ For example, the United States has been often criticized for its policy in this respect both in the field of human rights, and in the field of international business transactions for asserting jurisdiction in too liberal a manner, see Lowenfeld (1995).

⁴² See the extensive analysis in Mavroidis and Neven (1999), and also Colangelo (2007).

4.4 Overlapping Jurisdictions

It stems from the above, that it is quite possible that more than one state can exercise prescriptive jurisdiction by virtue of the territoriality principle. In this case, one can envisage several outcomes.

4.4.1 Cumulative Application of Different Legal Regimes

One possibility is the cumulative application of different legal regimes. There is strictly speaking nothing *legally* wrong with assigning jurisdiction concurrently to several sovereignties.⁴³ For instance, assume that stealing is punished with five years in prison in A and seven years in B. An individual who is convicted in both jurisdictions could spend two years in B, having already spent five years in A. However, it is easy to see that assigning jurisdiction to more than one state with divergent laws, has potentially serious drawbacks: the fact that courts or administrations in two or more countries will be involved in the decision making will lead to duplication of transaction costs; more importantly probably, the outcome of the combined regulation will typically not be optimal from any country's point of view. For instance, in the example above, country A might consider the additional two years of jail term excessive. It could also be the case that the party involved cannot simultaneously comply with two decisions because they are contradictory. More generally, cumulative exercise of jurisdiction may mitigate as well as exacerbate problems stemming from unilateral decision making.

⁴³ This was largely the solution in the often discussed *Lotus* judgment by the PCIJ. (See France vs. Turkey, Judgment No 9, September 7, 1927, PCIJ Reports, 1928, Series A, No 10.)

As a consequence of its many drawbacks, the assignment of overlapping jurisdiction is discouraged in many pronouncements by courts and international institutions. A prominent example is again the *Restatement*. Cumulative application of regulations nevertheless occurs quite often in practice.

4.4.2 Comity

A second possibility is that all but one state refrain from exercising jurisdiction, a solution that is often referred to as *comity* in PIL. This is most likely the case in situations where there is agreement that one state clearly has more of an interest to regulate a particular transaction or activity than other states which could have legitimately exercised prescriptive jurisdiction as well. For instance, the *Restatement* expresses support for this option (p. 247):

When possible, the two states should consult with each other. If one state has a clearly greater interest, the other should defer, by abandoning its regulation or interpreting it or modifying it so as to eliminate the conflict...

This is what the reasonableness standard, briefly alluded to above, essentially amounts to. Since there is hierarchy between *territoriality*- and *nationality*-, reasonable exercise of prescriptive jurisdiction will be called for when the effects of an activity are 'felt' across various territories. The *Restatement* acknowledges as much:

Where regulation of transnational activity is based on its effects in the territory of the regulating state, the principle of reasonableness calls for limiting the exercise of jurisdiction so as to minimize conflict with the jurisdiction of other states, particularly with the state where the act takes place. (p. 250)

It is not easy to codify what should be considered reasonable exercise of prescriptive jurisdiction; it is, nonetheless, clear that this principle operates as a restraining factor (for some) on the exercise of jurisdiction. Under the reasonableness-standard states will, either through unilateral action (comity) or through a negotiated settlement conclude that some of them should not exercise jurisdiction over a particular transaction and let others do so.

In practice, one could imagine hundreds of scenarios where reasonable exercise of jurisdiction is called for. But rather than laying down general principles, the *Restatement* provides a comprehensive list of elements that constitute the reasonableness-standard. Consequently, a state, which, in principle, can legitimately exercise jurisdiction, might decide not to do so, based on a consideration which comprises, *but is not necessarily limited to*, the following criteria:⁴⁴

- (i) the link of the activity with another state (nationality, or territoriality, in the sense that there are *direct, substantial and foreseeable* effects with another jurisdiction);
- (ii) the importance of regulating the activity to another state;
- (iii) the existence of justified (legitimate) expectations;
- (iv) the importance of the regulation to the international system;
- (v) the manner in which such transactions have been prescribed in prior relevant state practice.

⁴⁴ See The *Restatement*, *op. cit.*, at pp. 244ff.

The *Restatement* also provides an example of what could be considered unreasonable exercise of jurisdiction:

... regulation by the United States of the labor relations of a foreign vessel that regularly calls on the United States may be unreasonable; regulation of the vessel's safety standards may not be unreasonable. (p. 246)

The intuition here seems to be that, absent respect of strict safety standards on the foreign vessel, an accident might occur in US territory, or an environmental hazard that might have an impact (on US territory as well). The link with the US territory seems less strong in case, for example, workers on the foreign vessel receive wages below the statutory minimum reserved to the corresponding job when performed on US territory by workers legally employed in the US.⁴⁵ As suggested above, a field (e.g., antitrust)-specific evaluation is warranted, since practice has developed in asymmetric manner across fields.⁴⁶

Comity happens quite rarely in practice however, because there is often disagreement as to which state should be the one designated to regulate. Take the example of an international merger between companies originating in countries A and B. Assume that 30 % of their sales are in the market of A, 25% in B, 35% in C, and 10% in D. Should C and D desist simply because companies A

⁴⁵ This is a very interesting example. We will come back to it when we discuss the applicability of our discussion here to environmental disputes.

⁴⁶ One probable explanation is that, whereas there is an emerging world-wide consensus as to what should be the criteria for antitrust intervention, this is hardly the case in other fields of regulatory activity. Most competition regimes understand the role of antitrust as the means to promote rivalry in a given market, using consumer welfare as proxy to measure whether rivalry indeed exists. This quasi-uniformity concerning the substantive criteria for antitrust intervention probably explains the world-wide acceptance of the *effects* doctrine in this field: after all, the importing state is the one that suffers (in consumer welfare terms) from say monopolistic prices of a foreign cartel.

and B are foreign? Or should C exercise jurisdiction, being the country with the largest sales? And how should the antitrust authorities of A and B behave? Should both A and B regulate this transaction? Should one of them desist, and, if yes, on what grounds should it desist? What if the new merged entity will have a monopoly in B, but no such thing in A? PIL sheds little, if any light, on this problem: there is no generally acceptable hierarchy across the various *default rules*, except for the one already mentioned, that is, that territoriality comes before nationality.

4.4.3 International Agreements (Bargaining Solutions)

The third possible solution in case of overlapping jurisdictions is an international agreement. For instance, the *Restatement* points to this option:

...When neither state has a clearly strong interest, states often attempt to eliminate the conflict so as to reduce international friction and avoid putting those who are the object of the regulations in a difficult situation. (p. 247)

When two states search for a bargaining solution to address a jurisdictional ambiguity, they can allocate jurisdiction between them to their liking, to the extent that they do not interfere with the jurisdictional space of a third state.

As Parrish (2007, pp. 29ff.) points out, there has recently been an explosion of extra-territorial cases in copyright, securities regulation, trademarks and trade names, intellectual property, corporate law and governance, bankruptcy, tax, criminal laws, civil rights, labour laws – the list is endless.⁴⁷ But the explosion of

⁴⁷ There is abundant literature on this issue. Vagts (2003), Avi-Yonah (2003), and Baumgartner (2004) provide a very adequate synthesis.

extra-territorial cases has not been accompanied by a clarification of the legal framework within which prescriptive jurisdiction should operate: the *default rules* continue to leave significant discretion to the state contemplating to exercise prescriptive jurisdiction, since we still lack rules as to which state should regulate when effects are spread over more than one territory. As a result, disputes across states as to who should be regulating a particular transaction are quite common.

4.5 The Relationship Between the *Default Rules* and the WTO Agreement

A central issue for this paper is the relationship between the WTO Agreement and the *default rules*. This is not a trivial issue, however. As noted in the Introduction, the text of the WTO Agreement is silent on the relationship, and it has not been addressed in case law either. In order to explain our own understanding of this issue, we need to take a broader perspective on the WTO Agreement.

As is often pointed out, the WTO Agreement is “incomplete” in the parlance of contract theory, in a number of ways. As a consequence of this incompleteness, the Agreement has been interpreted to include further restrictions than those explicitly stated in the text. A prime evidence of this feature is Art. XXIII.1 GATT, which specifies the legal grounds for a complaint. This provision states that

If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired as the result of
...

...the application by another contracting party of any measure, *whether or not it conflicts with the provisions of this Agreement...* (emphasis added)

As can be seen from the italicized terms, the Agreement involves commitments that go beyond what is explicitly stated in the text. This raises the question of *what* exactly is it that Members have agreed upon? This is an important question, since whatever Members have agreed upon, should fall outside the ambit of the *default rules*.

A first observation can here be drawn from the example we discussed in the Introduction: it is the *default rules* that prevent a country from imposing its tariffs or domestic instruments in foreign territory. For instance, the EC does not collect a value-added tax in the US market. If these rules did not exist it would be pointless to form the GATT. But the GATT and the *default rules* are in a sense not equally dependent on each other. While an imposition of the jurisdictional rules alone is likely to have some impact, *in order for a GATT-like agreement to have any impact, it must be supported by jurisdictional rules. More importantly, as we will try to show, for the GATT to be construed in accordance with its intended function as a negative integration agreement, it is quintessential that the default rules are observed.*

It seems relatively clear that the *default rules* are not applicable in the case of tariff bindings, since these are negotiated.⁴⁸ However, as we will see, when finer tariff classifications are made unilaterally they are probably relevant. But the agreement does not include any bindings of domestic policies, so there is more scope for *default rules* to be applicable for such measures. The question here,

⁴⁸ But, of course, Canada cannot contract the import tariffs that say exporters to the Australian market will be paying. In this sense, tariff-setting occurs within the *default rules*.

however, is *how much* the agreement can be said to cover? One could here argue along two very different lines, leading to opposite conclusions concerning the applicability of the *default rules*. We believe both of these arguments are relevant, but that they are applicable to different situations.

One line of reasoning would focus on the fact that the agreement does regulate the pursuit of domestic policies through e.g. the non-discrimination provisions. Consequently, it could be argued, there is an implicit acceptance of whatever policies Members might choose that are consistent with this explicit regulation of domestic instruments. This view is reinforced by the fact that there are a couple of explicit remedies for unfair trade advantages, in the form of duties levied in the case of dumping and subsidization. According to this line of reasoning, since there is an implicit acceptance of the consequences of letting Members unilaterally decide on their domestic policies, the *default rules* are *not* applicable. There are some important shortcomings inherent in this view, and we will be returning to this point *infra*.

A second line of reasoning instead starts from the observation that the WTO Agreement was not created in a legal vacuum, but in a situation where PIL, including the *default rules*, applied. Also, the Agreement does not contain any statement to the effect that these rules are *not* applicable. Hence, the only reasonable interpretation is that countries, when signing the Agreement, did so with the expectation that the *default rules* indeed *are* applicable.

In what follows we will argue that the first line of reasoning is applicable only in presence of what we call “commercial externalities”, while the second argumentation is relevant in situations of “physical” (and possibly “moral”)

externalities. A (negative) commercial externality arises when lax EP in the exporting country provides its exporters with a competitive advantage at the perceived expense of the importing country government. A “physical” trans-boundary externality from lax EP takes the traditional form of, say, acid rain.

The fundamental reason why these two types of externalities, which stem from the exporting country’s unilateral pursuit of EP, are treated so differently goes back to the basic *purpose of the agreement*. The GATT/WTO is an agreement regulating commercial relations between WTO Members. Hence, WTO Members should be assumed to have accepted the resulting commercial externalities from unilaterally pursued policies, to the extent these are not caught by the non-discrimination provisions. As a result, the *default rules* do not apply in case of commercial externalities. In particular, the effects doctrine cannot be invoked to give a country the right to regulate against such an effect.

The WTO is not meant to regulate physical environmental externalities, however, and therefore it cannot be argued that WTO Members have agreed to accept trans-boundary physical externalities. Consequently, in the absence of other agreements – MEAs, for instance – the *default rules* are applicable.

More to the point: the very purpose of the GATT is to harmonize conditions of competition *within* and not *across* markets: once a ticket to entry, in the form of customs duty, has been paid, imported products should be treated as if they were domestic. Indeed, there would be no trade at all if the importing state could control for differences in income-taxation, EP-regulation and what have you. To paraphrase Dunoff, this would be the death of the trade regime, albeit for a different reason: prices of all goods would be equated to that of the highest de

nominator. Trade is function of endowments and, in part, the outcome of competition across regulatory regimes as well. Societies make different choices as to the level of taxation, the level of EP, the level of antitrust enforcement etc. All such choices affect trade, even if only remotely so. By signing the GATT (and then the WTO), trading partners accepted to conduct trade on the basis of such differences. When they wanted to address some of them, they did so explicitly: the antidumping provisions are a very appropriate illustration here. This does not mean, nonetheless, that whenever there is silence, there is acceptance of the other's practices. This is precisely where the *default rules* kick in: Art. XX GATT explicitly allows WTO Members to deviate from their obligations in order to protect, *inter alia*, animal life. To do that, however, they must have jurisdiction over such animal life. Just like WTO Members cannot tax income of foreigners made abroad, they cannot, in principle, protect foreign animal life. To do that, they must show a nexus with their own jurisdiction (e.g., a change in the ecological equilibrium affects all nations). To accept the opposite would lead us to absurd results such as A taxing B nationals' income made in B. In a nutshell, unless the *default rules* have been observed, the GATT cannot function, at the very least not in accordance with its intended function, that is, as an instrument promoting trade liberalization through negative integration.

4.6 Jurisdiction and the Environment in CIL

4.6.1 Environmental Conflicts and the *Default Rules*

It is by now well accepted that states cannot, through their actions or omissions, cause environmental pollution that has an impact on other states. As Sands

(2003, 461ff.) referring to the *Case Concerning the Territorial Jurisdiction of the International Commission of the River Oder* adjudicated by the PCIJ notes:

As early as 1929, the PCIJ had held that the utilization of international rivers, including their flow, was subject to international law: the Court identified the 'community of interests in a navigable river [which] becomes the basis of a common legal right, the essential features of which are the perfect equality of all riparian states in the use of the whole course of the river and the exclusion of any preferential privilege of any one riparian in relation to the others.

This case did not directly concern environment, but the use of rivers for navigation. But in 1997, in the *Case Concerning the Gabčíkovo-Nagymaros Project*, the International Court of Justice (ICJ) re-affirmed and extended this principle to non-navigational uses:

The Court considers that Czechoslovakia, by unilaterally assuming control of a shared resource, and thereby depriving Hungary of its right to an equitable and reasonable share of the natural resources of the Danube – with the continuing effects of the diversion of these waters on the ecology of the riparian state of the Szigetköz – failed to respect the proportionality which is required by international law.⁴⁹

Probably the most eloquent expression of this principle is by the *Institut de droit international* (IDI) in its 1987 *Resolution on Transboundary Air Pollution*. Art. 2 states:⁵⁰

⁴⁹ (1997) ICJ Reports 7 at §85.

⁵⁰ The IDI is a highly prestigious, non-governmental institution aiming at promoting the understanding and implementation of public international law. Its work is often cited by international courts.

In the exercise of their sovereign right to exploit their resources pursuant to their own environmental policies, states shall be under a duty to take all appropriate and effective measures to ensure that their activities or those conducted within their jurisdiction or under their control cause no transboundary air pollution.⁵¹

It is clear that the effects doctrine may often be applicable in the case of transboundary environmental problems. For instance, taking the case of environmental pollution that is carried by a river, and applying the *direct, foreseeable and substantive*-standard as explained in the *Restatement*, we can observe that:

- (a) the effects will be *direct*, since nothing intervenes between the upstream pollution of the river and environmental damage downstream;
- (b) they will be *foreseeable*, since the direction of the flow is clear;
- (c) depending on the extent of the environmental pollution, the effects could be *substantive*.

A similar type of reasoning can often be pursued in the case of air-born pollution, or pollution through seas. In all these instances the default rules give the affected state jurisdiction over acts committed outside its territory.

4.6.2 No Universal Jurisdiction Through Violation of *Jus Cogens* in Case of Environmental Damage

PIL views certain values to be of such significance as to dominate concerns for national sovereignty – this is the notion of *jus cogens*. For some specific transactions or activities states therefore have *universal* jurisdiction. Universal

⁵¹ See 62 AIDI (1987 – II).

jurisdiction is conferred for transactions where a consensus has been reached among the members of the world community as to the higher values that are at stake. There are ongoing debates about the content of the *jus cogens*, but apart from § 33 of the *Barcelona Traction* judgment by the ICJ, and sporadic mentions in the various drafts of the *United Nations General Assembly Resolution on State Responsibility*, there is to the best of our knowledge no comprehensive “official multilateral pronouncement” on this score. It is clear that there is universal jurisdiction for responses to international crimes (e.g., piracy, terrorism), These are exceptional cases and concern specific transactions only.

There was some discussion during the drafting of the *International Law Commission (ILC) on State Responsibility*⁵² to include *massive* environmental pollution among the provisions that would call for universal jurisdiction as violations of *jus cogens*. Such reference, nevertheless, was not included in the final draft, as voted by the United Nations General Assembly. But it shows that the ILC at least contemplated that causing trans-boundary environmental externalities should not amount to a trivial breach of an international law canon. Hence, important to this study, *there is no instance of universal jurisdiction with regard to environmental hazards*.

4.7 The Analysis to Follow

In what follows we discuss a series of scenarios concerning disputes related to environmental policies that a WTO court could face, and we place particular focus on jurisdictional aspects. We examine these abstract scenarios since the

⁵² These articles were eventually adopted by the United Nations General Assembly in 2001, see UN GA A/RES/56/83 of 28 January 2002.

paucity of case-law on trade and environment makes it very hard to draw more general conclusions on how jurisdictional issues would be addressed by WTO adjudicating bodies. We do not claim that these scenarios exhaust all interesting types of disputes, but in our view they cover a number of interesting archetypical situations.

For each scenario, we will first discuss what we believe a WTO panel would have ruled, in light of current case-law. We will then seek to determine what the *default rules* would add to the panel's ruling, if taken into account properly. In Section 11 we will draw some overarching conclusions on the basis of the discussions of these scenarios.

5 Tariff Distinctions Based on Environmental Impact

In this Section, we discuss scenarios where EP are couched in the form of negotiated tariff classifications, in the sense that the importing state reserves differential tariff treatment for a product produced in an environment-friendly (EF) manner compared to the same product produced in an environmentally unfriendly (EUF) manner. In Scenario I (Section 6.1) the EP is practiced through multilaterally agreed tariff classifications, and in Scenario II (Section 6.2) the EP is practiced through unilateral tariff classification.

5.1 Unilateral Tariff Distinctions Based on Environmental Impact

Scenario I: During tariff negotiations, A makes a tariff promise to import product x at 10% import duty. Product x is classified at the 6-digit level (HS).⁵³ Subsequently, A unilaterally distinguishes its tariff promise at the 8-digit level between x produced in EUF manner, facing the 10% duty, and in an EF manner, imported at 0%. The schedule of concessions of A enters into force along with all other schedules. Subsequent to the entry into force of the schedules, B challenges the classification operated by A, arguing that EUF and EF x are like products, and that the former should also benefit from 0% import duties in A's market.

Before we discuss how a GATT panel would approach this complaint, we need to explain in sufficient detail the manner in which a tariff classification can be legally challenged before a GATT panel. The explanation is quite lengthy for two reasons: first, it might seem counter-intuitive to the non-expert that a contractual party can challenge a contractual term to which it has agreed; second, law is unclear in this respect, and case-law is far from being mature either. The three sub-sections that immediately follow are inter-linked: in 5.1.1, we explain why a tariff classification that has been included in the final product of a trade round can still be challenged, if a WTO Member takes the view that it is not GATT-consistent. In 5.1.2, we briefly explain the parameters of GATT-consistency, that is, the MFN-obligation. In 5.1.3 we briefly return to Art. XX GATT, and explain under what conditions a WTO Member can legitimately deviate from its obligations, such as MFN. We then discuss the solution to the scenario.

⁵³ The Harmonized System (HS) classification is explained infra in more detail. Briefly, it contains classifications for traded goods ranging from 2- to 6-digits; the higher the number of digits, the more specific the description is (e.g., 2 digit: vehicles; 6 digit: passenger cars).

5.1.1 The Right to Challenge Tariff Classifications Under the WTO⁵⁴

At the end of a multilateral negotiation, the WTO Secretariat will circulate the tariff promises (schedules of concessions) of each and every WTO Member to the whole WTO Membership. The latter will sign them and agree on the date of their entry into force. The fact that all schedules of concessions have been agreed and signed by all WTO Members at the end of a negotiating round does not, however, suffice to render them GATT-consistent.

Tariff concessions are made between WTO Members using the tariff classifications of the *Harmonized System* (HS) as the common language to describe traded goods. The HS classifies goods from 2-6-digits, with common descriptions of approximately 5,000 commodities at the 6-digit level.

WTO Members can unilaterally further sub-divide the HS classifications. Art. 3.3 HS reads to this effect:

Nothing in this Article shall prevent a Contracting Party from establishing, in its Customs tariff or statistical nomenclatures, subdivisions classifying goods beyond the level of the Harmonized system, provided that any such subdivision is added and coded at a level beyond that of the six-digit numerical code set out in the Annex to this Convention.

The recent AB report on *EC – Chicken Cuts* acknowledges that the HS is context, in the sense of Art. 31 of the *Vienna Convention on the Law of Treaties* (VCLT), to

⁵⁴ This sub-section is relevant for Scenario II as well. To avoid unnecessary repetition, we include all of the discussion concerning GATT-consistent scheduling of tariff concessions in one place, that is, in this sub-section.

the Agreement establishing the WTO. This means that, in case of dispute over the content of a tariff classification, GATT panels will *have to* refer to it in order to resolve the dispute.

Whereas the legality of the HS classifications up to the 6-digit level cannot be disputed, this is not necessarily the case with 8-digit- (and beyond) classifications. WTO Members might object for example, to a tariff classification at the 8-digit level which distinguishes between environmentally-friendly and – unfriendly goods. Case-law to which we turn in what immediately follows, has explained under what conditions this can be the case.

In *Spain – Un-roasted Coffee*,⁵⁵ a GATT panel outlawed a sub-classification that Spain had unilaterally introduced, where it distinguished between roasted and un-roasted coffee, subsequent to its original commitment where it had made no such distinction. Brazil claimed to have suffered trade damage as a result, and brought a complaint. The rationale for outlawing the unilateral distinction was that absent rectifications (that is, changes which do not affect the substance of the commitment made), WTO Members cannot unilaterally modify schedules that have already been agreed upon.⁵⁶ *Ex post hoc* tariff classifications are, thus, GATT-inconsistent, if they materially affect the value of the concession granted.

During the *EC – Bananas III* dispute between the EC and various banana-exporting countries, the AB went one step further and held that even agreed conditions can be judged to be GATT-inconsistent, if they do not respect the

⁵⁵ See GATT Doc. BISD 28S/102.

⁵⁶ See the analysis in Mavroidis (2007) pp. 112ff.

multilateral framework.⁵⁷ The question namely arose, whether a WTO Member can specify the conditions of import in its schedule of concessions in a discriminatory, that is, a GATT-inconsistent manner, depending on the origin of the imported good? The EC had included in its schedule of concessions a condition, according to which some WTO Members (the ACP⁵⁸ countries, and those who had concluded with the EC the so-called *Framework Agreement*), would profit from a preferential rate on bananas, whereas the remaining WTO Members would not. A series of bananas-exporting WTO Members complained, claiming that the measure at hand was inconsistent with the MFN rule. The EC in response argued, *inter alia*, that its regime was consistent with the GATT, since it had been notified to the WTO Membership, and had gone through the certification process as well, without any WTO Member raising an issue as to its legality. The question before the Panel could, thus, be phrased as follows: do WTO Members, *when scheduling their concessions*, have to observe the GATT-disciplines? Or, conversely, are legally relevant *schedules only those that have been certified, or also those that were exchanged during the negotiation-stage*?

The wording of Art. II.1b GATT⁵⁹ provides a solid *prima facie* basis in favour of accepting the EC-approach: if at all, the treatment of imported goods is *subjected* to conditions etc., included in the schedule, but nowhere does Art. II GATT

⁵⁷ We use the term EC when we discuss actual disputes and not EU, as we do elsewhere, since it is the EC that is the member of the WTO (Art. XI of the Agreement establishing the WTO).

⁵⁸ ACP stands for African, Caribbean and Pacific countries which were linked to the EC through the (then) *Lomé* and, subsequently, *Cotonou* agreements.

⁵⁹ The Panel and the AB discussed the present litigation against the background of Art. 4.1 of the Agreement on Agriculture (AG) which reflects a standard very comparable to that of Art. II.1b GATT. The fact that, as the quoted passage underscores, the AB based its findings on the *Headnote* – jurisprudence which is an Art. II GATT-jurisprudence, leaves no room for doubt that, in the eyes of the two WTO adjudicating bodies, there is absolute parallelism between Art. II.1b GATT on the one hand and Art. 4.1 AG on the other.

mention that the conditions imposed should be GATT-consistent. By virtue of the *in dubio mitius* legal principle, one would expect that a WTO adjudicating body would have found that, in the absence of explicit, unambiguous transfer of sovereignty in this respect, trading nations could conclude whatever they please: this is what contractual autonomy amounts to.^{60 61} The Panel first, and the AB then, recalling the earlier *Headnote*-jurisprudence, rejected, in their *EC – Bananas III* reports, the argument of the EC. In their view, a WTO Member can, through conditions attached to its schedule, grant other WTO Members rights but it cannot, through this means, diminish its obligations. We quote from §§ 154 of the AB report:

The market access concessions for agricultural products that were made in the Uruguay Round of multilateral trade negotiations are set out in Members' Schedules annexed to the *Marrakesh Protocol*, and are an integral part of the GATT 1994. By the terms of the *Marrakesh Protocol*, the Schedules are 'Schedules to the GATT 1994', and Article II:7 of the GATT 1994 provides that 'Schedules annexed to this Agreement are hereby made an integral part of Part I of this Agreement'. With respect to concessions contained in the Schedules annexed to the GATT 1947, the panel in *United States - Restrictions on Importation of Sugar* ('*United States - Sugar Headnote*') found that:

... Article II permits contracting parties to incorporate into their Schedules acts yielding rights under the General Agreement but not acts diminishing obligations under that Agreement.

⁶⁰ Note that the AB, like many international courts, has adhered to this principle.

⁶¹ To the extent of course, that they do not violate peremptory norms of Public International Law.

This principle is equally valid for the market access concessions and commitments for agricultural products contained in the Schedules annexed to the GATT 1994. The ordinary meaning of the term 'concessions' suggests that a Member may yield rights and grant benefits, but it cannot diminish its obligations.

Remarkably, the AB, a body with a pronounced tendency to adopt textual interpretations, this time paid lip service (if at all) to the wording of the relevant text (Art. 4.1 of the *Agreement on Agriculture*). The AB did not even summarily discuss the legal value of *Protocols of Accession* in this context, either: it refers to the *Marrakesh Protocol*, but does not even discuss the legal value of the multilateral review of annexed schedules? And, importantly, what is the legal value of the *Marrakesh Protocol* itself? Instead, it moved to dismiss the claims presented by the EC based, for all practical purposes, on the *Headnote*-jurisprudence. This jurisprudence however, provides no response to the question of why GATT schedules of concessions have to observe the GATT-disciplines, rather than sequencing the latter to the former? It provides simply an assertion: they must do that. This reasoning is not satisfactory from a legal perspective.

It is less clear whether from an economic point of view the AB's decision is desirable or not. But on the negative side is a fairly fundamental argument: if the parties to this negotiation agreed to use a finer classification scheme than provided through the HS system, then one should expect that there were mutual gains from doing this.

Arguments in support of the AB's decision would probably primarily have to be built on the added complexity of the negotiations that a finer scheme might entail. Were one to introduce a comprehensive legal review of all schedules at the

end of a negotiation, the process would be probably disproportionately burdened: in the absence of centralized control of legality in the WTO, it would be essentially incumbent upon WTO Members to check each other's schedule from a GATT-consistency perspective. Since, Art. 23.2 DSU has outlawed unilateral qualifications of illegality, one could potentially imagine dozens of panels introduced at this stage. This is not a mere theoretical possibility: recall that classification at the 8-digit, the GATT consistency of which cannot be *ex ante* guaranteed, is very much state practice today. In light of the above, it seems reasonable to defend, from a policy-perspective at least, the (implicit) thesis advocated by the AB: *the multilateral review occurring with the exchange of schedules is limited to verification of the accuracy of commitments; the multilateral review has no bearing on their legality (GATT-consistency).*

In order to see the relevance of the above for our discussion, assume, for example, that during the *Doha Round*, a WTO Member enters an 8-digit classification, whereby it distinguishes between steel products produced in a manner that respects environment and all other steel products, reserving a more favourable treatment to the former. Even if all WTO Members sign on to the *Doha Round*, and the final agreement enters into force, it would still be possible for a WTO Member producing steel products in a manner that burdens the environment, to successfully challenge the consistency of the 8-digit classification with the multilateral rules.

5.1.2 The MFN Clause

The second restriction on WTO Members ability to make environment-based tariff distinctions, come from the MFN clause. We will here briefly present some basic legal aspects of this provision.

(a) The Barebones of the MFN Clause

By acceding to the WTO, a country should, by virtue of Art. I GATT, benefit from the best possible treatment granted by incumbents to imported products with respect to, in principle, all measures affecting trade.⁶² More specifically:

- (i) with respect to, in principle, all measures which affect trade either *de jure* or *de facto*, any advantage granted to goods originating anywhere in the world;
- (ii) must be extended to the like products;
- (iii) originating in any WTO Member;
- (iv) immediately and unconditionally.

The standard of review that has been applied by WTO adjudicating bodies in Art. I GATT cases is quite favourable to the complainant since there is no need to demonstrate intent to discriminate, nor resulting trade effects. Of importance to our paper are two of the four elements of the MFN mentioned above: likeness and unconditional application. We will take them in turn.

(b) The meaning of "like"

⁶² Hence, the coverage of MFN extends beyond trade instruments; it covers domestic instruments as well. The analysis presented here is also pertinent for domestic instruments as well.

Likeness is far from being a self-interpreting concept. GATT/WTO jurisprudence has employed various criteria to establish likeness. But *tariff classification* emerges as probably the dominant criterion in the context of Art. I GATT. First, the 1978 GATT Panel Report on *EEC – Animal Feed Proteins* moved towards this criterion. In this case, the question arose as to whether, by treating different protein products in different ways, the European Community was violating its obligations. There was little doubt that the products at hand could be regarded as substitutable. The question, however, was whether substitutability was appropriate to decide likeness under Art. I GATT. The Panel decided that this should not be the case.

The Panel noted that the general most-favoured-nation treatment provided for in Article I:1 ... did not mention directly competitive or substitutable products. In this regard the Panel did not consider animal, marine and synthetic proteins to be products like those vegetable proteins covered by the measures.

The GATT Panel Report on *Japan - SPF Dimension Lumber* went a step further and provided an *explicit* acknowledgement of the relevance of tariff classification as the dominant criterion to establish likeness (§§ 5.11 – 5.12):

... if a claim of likeness was raised by a contracting party in relation to the tariff treatment of its goods on importation by some other contracting party, such a claim should be based on the classification of the latter, i.e., the importing country's tariff.

The Panel noted in this respect that 'dimension lumber' as defined by Canada was a concept extraneous to the Japanese Tariff ... nor did it belong to any

internationally accepted customs classification. The Panel concluded therefore that reliance by Canada on the concept of dimension lumber was not an appropriate basis for establishing 'likeness' of products under Article I:1 of the General Agreement.⁶³

GATT panels have also implicitly emphasized the relevance of customs classification for the purposes of defining likeness, by dismissing the relevance of certain other factors that responding Members have referred to. For example, the panel report on *Spain – Un-roasted Coffee* set aside the relevance of process-based distinctions when dealing with a complaint by Brazil to the effect that a Spanish classification of un-roasted coffee between Colombian mild, other mild, unwashed Arabica, robusta and other, which accorded to the first two categories a duty free treatment, to the last three a 7% import duty, while the duty for roasted coffee was left un-bound; this practice, the Panel found, was inconsistent with Art. I GATT. It noted (§§ 4.7 – 4.10:

The Panel examined all arguments that had been advanced during the proceedings for the justification of a different tariff treatment for various groups and types of un-roasted coffee. It noted that these arguments mainly related to organoleptic differences resulting from geographical factors, cultivation methods, the processing of the beans, and the genetic factor. The Panel did not consider that such differences were sufficient reason to allow for a different treatment. It pointed out that it was not unusual in the case of agricultural

⁶³ Note that panels dealt in both cases with goods such as protein products and dimension lumber. Such products do not come under a two- or four-digit level. Although case-law has not provided us a number, it seems safe to conclude that the higher the number of digits involved, the easier it will be to show likeness. There should be no doubt that the six-digit level provides detailed enough classifications. A similar criterion (detailed classifications) has been privileged by the AB to decide on likeness under Art. III.2 GATT in the *Japan – Alcoholic Beverages II* report.

products that the taste and aroma of the end-product would differ because of one or several of the above-mentioned factors.

The Panel furthermore found relevant to its examination of the matter that un-roasted coffee was mainly, if not exclusively, sold in the form of blends, combining various types of coffee, and that coffee in its end-use, was universally regarded as a well-defined and single product intended for drinking.

The Panel noted that no other contracting party applied its tariff regime in respect of un-roasted, non-decaffeinated coffee in such a way that different types of coffee were subject to different tariff rates.

In light of the foregoing, the Panel *concluded* that un-roasted, non-decaffeinated coffee beans listed in the Spanish Customs Tariff ... should be considered as like products within the meaning of Article I:1. (*italics in the original*).

Having established the importance of tariff classification for determining likeness for an MFN complaint, the question arises whether *any* tariff classification can serve as criterion to decide on likeness? Recall that the harmonized tariff classification extends down to the 6-digit level. WTO Members can, nonetheless, shape their tariff bindings using 8-digit classifications. One could imagine that by introducing tariff distinctions at the 8-digit level, Members could make products that otherwise would be considered as 'like', to be viewed as 'unlike'. Importantly, they could do as much by introducing process-based distinctions: assuming for example that at the 6-digit level the item construction material is listed and goods are bound at 10% import duty, a WTO Member could introduce at the 8-digit level a distinction between asbestos-containing and asbestos-free

construction material, imposing a 10% import duty on the former and a 0% import duty on the latter. Are such distinctions GATT-consistent? The GATT panel on *Spain – Un-roasted Coffee* would have responded in the negative.⁶⁴ Is this still good law?

There are no more recent cases that squarely address this issue. The only case from which one could draw useful references is the AB report on *EC – Tariff Preferences*.⁶⁵ It seems that, if a criterion for tariff classifications that has been unilaterally employed by the classifying WTO Member has been accepted as an *objective* criterion, then 8- or more digit classifications can also serve as criteria to decide on likeness.

(c) *The meaning of “unconditionally”*

By virtue of the MFN obligation, WTO Members must extend any advantage (as understood above) *immediately* and *unconditionally* to all WTO Members. The term *immediately* seems to suggest that no time should lapse between the granting of an advantage in the first instance, and its extension to all like products originating in WTO Members. The term *unconditionally*, on the other hand, calls for an interpretation whereby no conditions should be attached when an advantage is being extended. The difference in content notwithstanding, WTO adjudicating bodies will typically review the two terms *in tandem*. The AB report on *Canada – Autos* is a good illustration of this point (§§ 75 – 86).

⁶⁴ Note that the Panel did not base its conclusions solely on classification, but on consumer preferences as well. It is difficult to ascertain which the more important concern was.

⁶⁵ For a more detailed discussion of this case, see *infra*.

With respect to the interpretation of the term *unconditionally*, the issue that has occupied panels is, to what extent only conditions *additional* to those which are necessary for the granting of an advantage in the first place, should be relevant for the interpretation of the term *unconditionally*, or, conversely, if no conditions at all should be imposed in the first instance? It seems that the latter reading should be irrelevant for the interpretation of the term *unconditionally*: if at all, such a discussion should take place in the context of the likeness-determination. Nevertheless, much of the case-law relating to the interpretation of the term *unconditionally* blurs this distinction. There is a first category of cases (panel and working party reports), which interpret the term *unconditionally* as equivalent to outlawing any conditions imposed by the importing WTO Member. These reports for all practical purposes do not compare two situations to see whether additional commitments have been imposed, for the granting of the same advantage. They outlaw the imposition of a condition irrespective of discrimination across two transactions:

- (i) the GATT Panel Report on *Belgian Family Allowances*, concerning tax exemptions for products purchased by public bodies made conditional on the existence of a certain system of family allowances to be in force in the exporting country, were found to be inconsistent with Art. I.1 GATT;
- (ii) the GATT Panel Report on *EEC – Imports of Beef* reflects the view that conditioning a duty waiver upon certification by a particular government violates the obligation to grant MFN unconditionally;
- (iii) the Working Party Report on *Accession of Hungary*⁶⁶ reflects the view that to condition a tariff treatment upon the prior acceptance of a cooperation

⁶⁶ Report adopted on 30 July 1973, see GATT Doc. BISD 20S/34.

- agreement is a violation of the requirement imposed by Art. I.1 GATT to grant MFN unconditionally;
- (iv) the WTO Panel Report on *Indonesia – Autos* found that Indonesian practices granting tax advantages to Korean companies which had entered into arrangements with Indonesian companies were inconsistent with the obligation under Art. I.1 GATT to grant MFN unconditionally;
- (v) perhaps, even more dramatically, the Panel Report on *EC – Tariff Preferences* in §§ 7.59 and 7.60 adopts an interpretation of the term *unconditionally*, whereby it becomes impossible to attach any conditions, not even when the advantage is granted in the first place:

In the Panel's view, moreover, the term 'unconditionally' in Article I:1 has a broader meaning than simply that of not requiring compensation. While the Panel acknowledges the European Communities' argument that conditionality in the context of traditional MFN clauses in bilateral treaties may relate to conditions of trade compensation for receiving MFN treatment, the Panel does not consider this to be the full meaning of 'unconditionally' under Article I:1. Rather, the Panel sees no reason not to give that term its ordinary meaning under Article I:1, that is, 'not limited by or subject to any conditions.'

Because the tariff preferences under the Drug Arrangements are accorded only on the condition that the receiving countries are experiencing a certain gravity of drug problems, these tariff preferences are not accorded 'unconditionally' to the like products originating in all other WTO Members, as required by Article I:1. The Panel therefore finds that the tariff advantages under the Drug Arrangements are not consistent with Article I:1 of GATT 1994.

There is another group of cases that do not take such an absolute approach. These reports compare two situations and essentially try to ascertain to what extent additional conditions have been imposed when extending an already granted (probably, following the fulfilment of specified conditions) advantage:

- (i) the GATT Panel Report on *EEC – Minimum Import Prices* dealt with a complaint concerning a payment deposit that the EC authorities required from all countries that could not guarantee a specified minimum import price. However, since the payment of the deposit was requested by all exporting countries falling into this category, the EC scheme was not considered to be a violation of Art. I.1 GATT;
- (ii) the WTO Panel report on *Canada – Autos* held the view that the term *unconditionally* does *not* mean that *all* conditions are prohibited. Rather, *unconditionally* refers, in the Panel’s view, to the notion that MFN treatment towards another WTO Member shall not be conditional on reciprocal conduct by that other WTO Member. Thus, conditions that are non-discriminatory across two transactions involving like goods originating in two different WTO Members do not violate Art. I GATT (§§ 10.22 and 10.24):

In our view, whether an advantage within the meaning of Article I:1 is accorded ‘unconditionally’ cannot be determined independently of an examination of whether it involves discrimination between like products of different countries.

...

In this respect, it appears to us that there is an important distinction to be made between, on the one hand, the issue of whether an advantage within the meaning of Article I:1 is subject to conditions, and, on the other, whether an advantage,

once it has been granted to the product of any country, is accorded ‘unconditionally’ to the like product of all other Members. An advantage can be granted subject to conditions without necessarily implying that it is not accorded ‘unconditionally’ to the like product of other Members. More specifically, the fact that conditions attached to such an advantage are not related to the imported product itself does not necessarily imply that such conditions are discriminatory with respect to the origin of imported products. We therefore do not believe that, as argued by Japan, the word ‘unconditionally’ in Article I:1 must be interpreted to mean that making an advantage conditional on criteria not related to the imported product itself is *per se* inconsistent with Article I:1, irrespective of whether and how such criteria relate to the origin of the imported products.

So, whereas the second group of cases understands the term *unconditionally* in *relative* terms (is A requesting from C something it did not request before from B?), the first string of cases understands the term in *absolute* terms (A cannot request *anything* from B or C when granting an advantage).

As things stand, it seems safe to take the view that no conditions at all can be legitimately placed when granting tariff advantages, a rather odd view, as we explain in more detail in Section 5.1.4. However, this is probably one area where a change in case-law would not come as complete surprise, given the evolution of case-law in other *related* areas (*EC – Tariff Preferences*; *EC – Asbestos*).

5.1.3 The general exceptions (Art. XX GATT)

Art. XX GATT contains a list of measures that can be legitimate exceptions to all GATT obligations. Case-law has consistently understood the list of measures

included in Art. XX GATT to be exhaustive.⁶⁷ The measures coming under the purview of this provision are associated with different tests for compliance. No matter which sub-paragraph has been invoked though, the WTO Member concerned must, in accordance with the *chapeau* of Art. XX GATT, make sure that its measures:

...are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail.

Art. XX GATT does not explicitly state the GATT-obligations to which it is an exception, but states that “nothing in this agreement” should prevent the imposition of the listed measures. Case-law has clarified that it is an exception not only to trade instruments, but also to domestic instruments: the AB, in its report on *Korea – Various Measures on Beef* proceeded to examine whether a Korean measure (separation of outlets) found to be inconsistent with Art. III.4 GATT, could still be justified through recourse to Art. XX(d) GATT; later, in its report on *EC – Asbestos*, the AB did not exclude the possibility that Art. XX GATT can serve as legal basis to justify measures found to be inconsistent with Art. III GATT (§ 115).

Its title (General Exceptions) leaves, in principle, little room for doubt that the various paragraphs included in this provision are *legal* exceptions to the obligations assumed under the GATT. It should consequently, in light of standing evidentiary case—law, be incumbent upon the WTO Member invoking this

⁶⁷ See, for example, the AB report on *US – Shrimp* at §157, or more recently the AB report on *Brazil – Retreaded Tyres*.

provision to carry the burden of proof to demonstrate that its measures can justifiably come under Art. XX GATT. Case-law has consistently confirmed this point.

The AB made it clear in *US – Shrimp* (§ 121), that measures are not inconsistent with Art. XX GATT merely because of their unilateral character. In the absence of transfer of sovereignty to the international plane, WTO Members remain free to unilaterally regulate, provided that they respect the relevant GATT disciplines (§ 121). This case-law has been consistently re-produced ever since. As a result, it is now uncontested as a matter of jurisprudential finding, that Art. XX GATT condones diversity.

The AB has constructed Art. XX GATT akin to a two-tier test, whereby the legal benchmark for the *substantive* conformity of a measure with Art. XX GATT is provided by the sub-paragraph invoked, whereas compliance with the *chapeau* of Art. XX GATT ensures that a measure is *applied* in a GATT-consistent manner. The AB stated as much in its Report on *US – Gasoline* (p.22). In its report on *US – Shrimp*, the AB provided the *rationale* for the two-tier approach in the following manner (§§ 119 and 120):

The sequence of steps indicated above in the analysis of a claim of justification under Article XX reflects, not inadvertence or random choice, but rather the fundamental structure and logic of Article XX. ...

The task of interpreting the chapeau so as to prevent the abuse or misuse of the specific exemptions provided for in Article XX is rendered very difficult, if

indeed it remains possible at all, where the interpreter (like the Panel in this case) has not first identified and examined the specific exception threatened with abuse.

The *chapeau* thus functions as *fixed* element that must be added to (and must be complied with) each and every sub-paragraph included in Art. XX GATT. The various sub-paragraphs of Art. XX GATT, on the other hand, reflect as briefly stated *supra*, *divergent* legal tests that serve as benchmarks in order to evaluate the consistency of a particular measure: Art. XX(b) GATT requires that measures be *necessary* to protect human health, whereas Art. XX(g) GATT requires that they must *relate to* the objective pursued. Quoting from the AB report on *US – Gasoline* (pp. 17-18):

... In enumerating the various categories of governmental acts, laws or regulations which WTO Members may carry out or promulgate in pursuit of differing legitimate state policies or interests outside the realm of trade liberalization, Article XX uses different terms in respect of different categories:

"necessary" – in paragraphs (a), (b) and (d); "essential" – in paragraph (j); "relating to"- in paragraphs (c), (e) and (g); "for the protection of" – in paragraph (f); "in pursuance of" – in paragraph (h); and "involving" – in paragraph (i).

It does not seem reasonable to suppose that the WTO Members intended to require, in respect of each and every category, the same kind or degree of connection or relationship between the measure under appraisal and the state interest or policy sought to be promoted or realized.

Finally, the WTO judge will customarily not put into question the *ends* sought by the regulating state, but simply the *means* committed to this effect. This would seem to be the natural consequence of the fact that the GATT has been constructed as a “negative integration”-type of contract. This understanding of the scope of judicial review of cases coming under the purview of Art. XX GATT has been slightly revised in recent years: first in *US – Gambling* and, more recently in *Brazil – Retreaded Tyres* (§ 143), where the AB held that when, for example, examining whether a measure is necessary to achieve a particular ends, it:

...begins with an assessment of the ‘relative importance’ of the interests or values furthered by the challenged measure, and also involves an assessment of other factors, which will usually include the contribution of the measure to the realization of the ends pursued by it and the restrictive impact of the measure on international commerce.

In practice, this means that the AB will be more deferential towards the regulating state when public health is at stake, and will exercise a more intrusive judicial review when other ends are being sought. It fell short, nonetheless, of specifying where the differences in the two tests lie. Environmental protection is closely related to public health and one might legitimately expect that the relatively speaking more deferential standard of review in the cases where public health is at stake, will be applicable also in environmental disputes. This is indeed the manner in which the AB conducted its review in *Brazil – Retreaded Tyres*, a case concerning environmental protection closely associated to public health.

Finally, we referred to the AB report on *US – Shrimp* and, more specifically, to the holding by the AB that it did not wish to prejudge the question whether there is a jurisdictional limitation in Art. XX GATT. As things stand, this is very much an open issue in WTO law: WTO Members can definitely regulate their own environment; it is uncertain if they can regulate other countries' environment as well.

It should, however, be quite easy to demonstrate that WTO Members can regulate only their own environment and not that of the others. WTO adjudicating bodies have not discussed what is, in this respect, the basis for the exercise of prescriptive jurisdiction? The basis, as this paper attempted to show, can only be the implicit agreement to respect the *default rules*. Consequently, states would be legitimately regulating their own environment, and any transaction that negatively affects it. This would mean that a WTO Member can legitimately take measures to protect, for example, its own clean air, and also react against activities by their trading partners which pollute it. The same WTO Member, however, can never regulate the environment of their trading partners.

5.1.4 A GATT panel's likely response

As we will try to argue on basis of the discussion in Sections 5.1.1 and 5.1.2, tariff classifications based on environmental standards *can* be GATT-legal. In Scenario I, B argues that the tariff scheme violates MFN since its exports of EUF x face a higher tariff than the exports from another country of EF x, and since the EUF and EF products are like products.⁶⁸ GATT/WTO case-law has not addressed

⁶⁸ The fact that A has had its schedule certified does not immunize A from legal challenges, as the AB held in *EC – Bananas III*, see Mavroidis (2007) pp. 88 – 93.

head on such cases.⁶⁹ The closest dispute we can think of is the *EC – Tariff Preferences*. In this case, India challenged the consistency of a GSP+ measure introduced by the EC, whereby the EC reserved an even better (than the preferential) treatment to imports of textiles originating in countries like Pakistan that had taken active measures to combat drugs trafficking. The AB, nevertheless, did not condemn the consistency of a GSP+ measure *per se* with the GATT rules; it condemned the challenged measure, merely because the EC had inserted a closed list of beneficiaries. Had the EC introduced an open list which relied on non-discriminatory criteria and standards, the AB would have rejected India's claim. The AB said as much in § 188 of its report:

... the Regulation contains no criteria or standards to provide a basis for distinguishing beneficiaries under the Drug Arrangements from other GSP beneficiaries. Nor did the European Communities point to any such criteria or standards anywhere else, despite the Panel's request to do so. As such, the European Communities cannot justify the Regulation under paragraph 2(a), because it does not provide a basis for establishing whether or not a developing country qualifies for preferences under the Drug Arrangements. Thus, although the European Communities claims that the Drug Arrangements are available to all developing countries that are similarly affected by the drug problem, because the Regulation does not define the criteria or standards that a developing country must meet to qualify for preferences under the Drug Arrangements, there is no basis to determine whether those criteria or standards are discriminatory or not.

⁶⁹ Recall that the *US – Tuna* and *US – Shrimp* cases dealt with alleged violations of Art. XI, and not Arts. I and/or II GATT.

In § 183, the AB uses the term *objective criteria* in lieu of *non-discriminatory criteria and standards*, without defining it any further:

What is more, the Drug Arrangements themselves do *not* set out any clear prerequisites — or objective criteria — that, if met, would allow for other developing countries that are similarly affected by the drug problem to be *included* as beneficiaries under the Drug Arrangements. (emphasis added).

It stems from the above that, had the EC based its GSP+ scheme on *objective criteria* (that were non-discriminatory) it would have escaped the sanction. This ruling seems to have some implications for what a GATT panel would conclude in a situation like Scenario I.

First, tariff classifications beyond the 6-digit level can be legal, as long as any WTO Member can benefit from the more favorable tariff treatment by fulfilling clearly specified criteria. We are led to this conclusion, since, in the AB's view, the EC violated its obligations under the GATT, not because of the criteria to distinguish between several developing countries employed – the drug policies adopted – but rather because it included a closed list of recipients in its GSP programme. This made it impossible for other Members of the WTO to profit from the GSP+ treatment, even if they adopted policies consistent with the *objective* criteria established by the EC.

Second, by not evaluating the consistency of the particular criterion – the adopted drug policies – with the WTO, the AB seems to have taken the position that Members can freely decide on the basis for a tariff distinction. *A fortiori*, an objective criterion such as a difference in the production process (a so called

PPM⁷⁰-distinction) should be regarded as a candidate for legitimate tariff classifications.⁷¹

Third, while the AB seems to be using the term *objective* as equivalent to *non-discriminatory* (this is the conclusion from the cumulative reading of §§ 183 and 188 cited above), the term *objective* nonetheless does not significantly help our understanding of the term *de facto* discrimination: it seems to exclude cases of *de jure* discrimination (such as the closed list employed by the EC), but says little about the outer boundaries of *de facto* discrimination. Should, for example, we understand that a regime conditioning GSP+ preferences in case high environmental standards have been adopted, *de facto* discriminates in favour of beneficiaries who have already adopted policies closer to this standard than the rest of the WTO Membership? Or would such a measure be accepted because it establishes an objective criterion according to which trade advantages will be granted?⁷²

⁷⁰ PPM stands for Production Process and Method. The *US – Tuna* panel report made a number of commentators take the view that PPM-based distinctions ran afoul the GATT. There is abundant literature on this point. We would like to single out some contributions though: Hudec (1998), (1998a), and (2000) had persuasively made the point that such a construction of the GATT was untenable and in direct conflict with the negative integration character of the whole edifice. Howse and Regan (2000) clarified this further, demonstrating that not only on wider policy grounds, but on simple legal grounds as well, it is not necessarily wrong to condition market access upon the prior satisfaction of regulatory conditions that amounted to PPM-requirements.

⁷¹ We are not making a policy argument here as to the appropriateness of using such measures. Policy arguments have been expressed in various places, see, for example, Bhagwati and Mavroidis (2007). Our point is strictly a legal one: *assuming* willingness to make such tariff classifications, it seems to us that the current GATT-legal framework, as completed through case-law, is no obstacle.

⁷² Following the condemnation of its policies by the AB, the EC amended its GSP+ programmes, and adopted open lists whereby every WTO Member that would accept to ratify environmental, social conventions, would automatically become a beneficiary country and profit from GSP + tariffs (see <http://europa.eu.scadplus/leg/en/lub/r11020.htm>). The consistency of the new EC GSP+ scheme with the multilateral rules has so far not been tested, however. The absence of challenge does not, however, amount to *ipso facto* consistency of the measure with the WTO.

There are arguments in favour of a cautious approach: the AB found, in *Chile – Alcoholic Beverages*, that a tax regime that conditioned the amount of tax paid on the alcoholic content of the product was in violation of the non-discrimination principle, since it conferred an advantage to the countries producing drinks of low alcoholic content and thus amounts to a *de facto* discrimination.⁷³ The AB, essentially held that such a regime favours those countries which produce lower alcoholic content-drinks. In this reading, hence, the criterion used cannot be objective probably because it does not require any change in the policy of the (potential) beneficiaries.

To conclude, although GATT/WTO case-law has not addressed the issue under consideration here head on, it seems that good arguments could be advanced in favour of the thesis that *tariff distinction based on environmental impact can be legal, and furthermore that the legality does not necessarily hinge on the existence of an environmental hazard in the importer's market.*⁷⁴

Note, however, that this case concerns *preferential* and not *ordinary* tariffs, such as those employed in our Scenario I. A crucial distinction between the two sets of instruments is that tariffs are normally negotiated while preferences are set unilaterally.⁷⁵ This distinction is less clear in Scenario I, where the distinction is introduced unilaterally, but signed off by all parties. The two situations (Scenario

⁷³ This was of course an Art. I and not an Art. III case, hence, although good arguments can be advanced in favour of a symmetric approach in Art. I GATT as well, the applicability of this approach is still very much an open issue. Horn and Mavroidis (2004) take issue with this finding. The response might change, were panels to adopt a reading of non-discrimination under Art. I similar to that adopted in Art. III GATT. This has not happened as yet.

⁷⁴ Of course, the validity of this conclusion depends on the meaning of the quoted phrase in the AB report on *US – Shrimp* concerning the nexus between domestic and international environment.

⁷⁵ We disregard the notion that developed countries are somehow obliged to give, or to continue awarding, preferences.

I, *EC – Preferences*) are, thus, similar: the instrument is the same (tariffs), and in both cases the description of the good is made unilaterally (the EC did not use the HS classification for textiles when conferring benefits depending on the adoption of drug-trafficking policies).

One way to discuss the applicability of the findings of the AB report on *EC – Tariff Preferences* in the MFN-context is the following: WTO Members, *might* practice two types of tariffs: MFN and preferential. We say *might*, since there is no legal obligation to treat developing countries better than developed nations. Assuming however, a WTO Member imposes a 5% import duty on imports of textiles from a developing country, while imposing 10% on imports of the like product originating in developed countries, it must, in principle, impose 5% on imports of textiles originating in any developing country. WTO Members can, nevertheless, sub-divide developing countries, and graduate their tariff preferences in accordance with *objective criteria*. This is what the AB held in its report on *EC – Tariff Preferences*.

The question then naturally arises whether WTO Members can use *objective criteria* in order to distinguish between developed countries. Recall that, according to Art. 3.3 HS:⁷⁶

Nothing in this Article shall prevent a Contracting Party from establishing, in its Customs tariff or statistical nomenclatures, subdivisions classifying goods beyond the level of the Harmonized system, provided that any such subdivision

⁷⁶ As we will see in more detail infra, the HS has been acknowledged as legal context by the AB, that is, it must be taken into account any time the consistency of a practice with a tariff classification is concerned.

is added and coded at a level beyond that of the six-digit numerical code set out in the Annex to this Convention....

Assuming thus, willingness to make such distinctions (a rather safe assumption, since many WTO Members nowadays negotiate at the 8-digit-level), how can such distinctions ever be made without *some* reference to conditions? Indeed, even at the inflexible, 6-digit-level, classifications often are linked to conditions: e.g., a 10% on chilled meat, frozen meat could be expressed as a promise to pay 10% *ad valorem*, if the imported meat is chilled or frozen.⁷⁷ At the end of the day the frontiers between *conditionality* and *likeness* are blurred: since, as we will see *infra*, process based distinctions can make two products unlike as *per* the case-law on domestic instruments, it would be highly irrational to deny that this should also be the case when recourse to trade instruments is sought. After all, WTO Members would easily circumvent the prohibition to distinguish through trade instruments, through recourse to domestic instruments.⁷⁸ What should matter is whether the exports from one state are treated worse than the like exports of another.

There are some other arguments in favour of this approach. It is, for example, perfectly legitimate for a WTO Member to condition access to its market only upon prior verification that, for example, a good's origin is the one declared in its accompanying documents. Indeed, Art. IX GATT says as much. The question is thus whether the GATT, as we know it, has taken care of all legitimate concerns

⁷⁷ Note, nonetheless, that, whereas the tariff classifications have been multilaterally negotiated and accepted, determination of objective criteria is a unilateral exercise subject only to judicial review at the WTO.

⁷⁸ Recall that process-based distinctions have been condoned in case-law in both *EC – Asbestos* and *US – Shrimp*.

that importing states might have. The advent of the *Customs Valuation Agreement* and the *Pre-shipment Inspection Agreements* is evidence enough that the original contract had not done so. The ongoing negotiation on trade facilitation is a further argument in support of this thesis. If at all, past experience is evidence that there is no reason to believe that the contract has been completed in this respect. Importing states might still be willing to condition access upon the supply of information.

5.1.5 The *Default Rules*

We have so far discussed the tariff distinctions from the point of view of the GATT, *without* taking into account the *default rules* regarding allocation of jurisdiction. Does the picture change were they to be taken into account?

It is clear that since the production occurs in B, B has jurisdiction. Whether A also has jurisdiction depends on whether the environmental hazard is trans-boundary, and if so, whether it is *direct, substantive and foreseeable*. In case it is, A can regulate, and a tariff distinction between EF- and EUF-products would be legal, assuming it is GATT-compatible in other respects. But if the hazard is self-contained in B's market, A cannot, *in the name of environmental protection*, operate such a distinction, since its own environment will not be affected.

We have, thus, identified an instance where the *default rules* would constrain an EP that would otherwise be permitted under the GATT. It occurs where a unilateral tariff distinction is made on the basis of an environmental hazard that does not affect the exporting market in any manner. The *default rules* would thus

prevent, in this case, the importing country from regulating the environment of the exporting country.

A word of caution is warranted here: we are not saying that A cannot exercise prescriptive jurisdiction in the name of *other* social values than protection of the environment; we will discuss policies based on public morals in Section 9. Here we are making a narrower finding, suggesting that incorporation of the *default rules* would lead adjudicating bodies to outlaw tariff distinctions when they are explicitly aimed to protect environment abroad only.

5.2 Multilaterally Agreed Tariff Distinctions Based on Environmental Impact

Scenario II: In the tariff negotiations, A makes a tariff promise to import *x* at 10% import duty 6-digit level. Contrary to Scenario I, A and B now also agree to a distinction at the 8-digit level between *x* produced in a EUF manner, facing the 10% duty, and in an EF manner, imported at 0%. Subsequent to the entry into force of the schedules, B challenges the classification operated by A, arguing that EUF and EF *x* are like products, and that the former should also benefit from 0% import duties in A's market.

5.2.1 A GATT Panel's Likely Response

Panels have hardly ever disturbed agreements between WTO Members.⁷⁹ Recall, nonetheless, from our analysis *supra*, that agreements across WTO Members during the negotiating-stage do not *ipso facto* confer legality to the negotiated material.⁸⁰ Hence, the panel will discuss whether the two products (EF, EUF) are like. We are, thus, in this regard effectively in the same situation as in Scenario I. In order to invoke MFN, B will have to compare the treatment of its exports of

⁷⁹ We assume for simplicity that there are no adverse effects on third countries.

⁸⁰ The *Framework Agreement* did not survive the condemnation of the EC bananas policy in *EC – Bananas III*.

EUF x in A's market to the treatment in A of some other Member's exports of EF x. The Panel will then have to determine whether the sub-classification operated by A is consistent with Art. 3.3 HS (which is the relevant legal context to the GATT). We can, of course, only speculate about the response. But were the panel to incorporate the AB case-law on *EC – Tariff Preferences*, it would find support for an affirmative provided the EF/EUF distinction is based on objective criteria.

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5.2.2 The *Default Rules*

The panel will find A at fault, only if the bargaining solution covers the environmental effect only *and* the environmental hazard is self-contained (limited to B's market).

6 Domestic EP Distinctions Absent any Trans-boundary Externality

As emphasized above, a fundamental feature of the WTO (with the exception of the TRIPs) is that most border instruments are either negotiated – as in the case of tariffs – or forbidden – as in the case of quantitative restrictions or export subsidies. Domestic instruments however, are left to the discretion of the Members. As a result, the question concerning the allocation of jurisdiction is significantly more interesting in the latter context: not only MFN, but also NT is now relevant, and there is more potential for the *default rules* to have a bite, since we are no longer in the realm of bargaining solutions. We will now investigate a

⁸¹ Compare Charnovitz (2007).

series of scenarios involving domestic instruments. In all these scenarios, the importing countries effectively allege that the exporting country is regulating environment less than it should.

Let us start the discussion by considering a rather extreme case: one where no trans-boundary effect at all from B's production of EUF x. Extreme as it is, , since this highlighting in a sharp fashion some of the limits of what can unilaterally be done:

Scenario III: B exports product y to A. B also produces EUF x, but x is not exported to A. There are no trans-boundary externalities (commercial, physical or moral) from the production of EUF x. But citing the environmental damage in B, A imposes a higher domestic tax on y than on domestically produced y. B argues that A's measures violate Art. III.2 GATT.

6.1 A GATT Panel's Likely Response

We are by assumption in a situation where the imported product and the domestic product is the same from a consumer point of view (moral effects will be considered below), and there is no regulatory need to distinguish the product either. We will discuss Art. III GATT in more detail in Section 7, let it just suffice to say here that A has no defense in such a case, against the claim that the higher tax on a like product violates Art. III.2 GATT. A will, therefore, have to invoke Art. XX GATT to defend itself. It can choose between Arts. XX(b) and XX(g) GATT: A will be arguing that its measure is necessary to protect environment or an exhaustible natural resource (such as clean air, which has been accepted to be an exhaustible natural resource by the AB in its report on *US – Reformulated Gasoline*). It is unclear whether A will prevail or not. It all depends on how we

should understand the passage in the AB report on *US –Shrimp* concerning the nexus between national and international environment to which we referred. Even if we understand this scenario to be one where this is no “nexus”, in the terminology of the AB, between A and the environment in B, it is unclear whether Art. XX(g) would help A. If the AB meant that absent such nexus the importing state cannot avail itself of the possibilities offered by Art. XX GATT, then A will lose. If the AB did not construe the nexus as a *sine qua non* for the right to regulate, but as a sufficient condition, then for what we know A may prevail.

6.2 The *Default Rules*

The scenario assumes a complete lack of trans-boundary externalities, so there is no doubt that the *default rules* would give jurisdiction to B only. Hence, if a panel took the *default rules* into account, it would start by noting that only B has jurisdiction to regulate its own environment. The panel should then observe that according to the *default rules*, A does not have jurisdiction over B’s territory, since there are no trans-boundary effects that could be leaned upon for the effects doctrine to be valid. Consequently, the panel should refute a claim for an Art. XX(b) GATT or Art. XX.(g) GATT exception. More generally, it should not be possible to use Art. XX GATT as a vehicle to employ otherwise GATT-illegal measure to encroach on other countries’ territorial jurisdiction.

7 Domestic EP Distinctions Based on Trans-boundary Pecuniary Externalities

We now turn to a series of scenarios where there are various forms of trans-boundary externalities from the lax EP pursued by the exporting country. We consider in this section a scenario where there is no trans-boundary physical environmental hazard, and where there are no moral effects involved either. In this scenario the lack of an EP in the exporting country affects the importing country, since the import price is lower (as a result of the lack of environmental policy in the exporting country). There is, hence, a pecuniary (commercial) externality stemming from the policy pursued in the exporting country. We start with this scenario, since this commercial effect will always be present, as long as B is drawing a production cost advantage from under-regulating. We will then consider in the next two sections the impact that trans-boundary physical or moral effects (stemming from under-regulation in the foreign country) can have in the discussion of this issue. Such effects would exist in addition to the commercial trans-boundary effect.

Scenario IV: In the tariff negotiations, A binds the tariff on product x. There are no externalities from the production of x directly affecting A. A imposes a higher domestic tax on EUF x, than on its EF- counterpart. A produces EF x, and B produces EUF x. B challenges A's measure, arguing that it violates Art. III.2 GATT and, that in any event, it suffered nullification and impairment as a result of A's practices (Art. XXIII.1b GATT).

7.1 Art. III GATT

The NT obligation kicks in once goods have paid their ticket to entry (import duty) to a specific market. Art. III GATT, which regulates NT, does not contain a list of specific measures that come under its purview: it exempts two (subsidies, government procurement), and indicates one (local content). For the rest, it subdivides all domestic instruments in two categories, fiscal instruments (Art. III.2 GATT), and non-fiscal instruments (Art. III.4 GATT). The over-arching purpose of Art. III GATT is that WTO Members do not use domestic measures to treat imported products so as to afford protection to domestic production.⁸² Protection must be *always* negotiated, so as to ensure that negotiators will continue to have the incentives to liberalize. Members must not undo through domestic measures the tariff promises they gave at the negotiating table.

The structure of Art. III GATT, as it applies to fiscal instruments, is as follows

- (a) If the domestic and imported products are *like*;
- (b) the latter must not be taxed *in excess* of the former.
- (c) if the domestic and imported products are *directly competitive or substitutable* (DCS);
- (d) if the two products are *not similarly taxed*;
- (e) then the dissimilar taxation must not operate *so as to afford protection* to domestic production.

Central to the scope of the NT-provision, is the adjudicating bodies' interpretation of the italicized terms. Case-law has understood like products to

⁸² See on this issue, the AB report on *Japan – Taxes on Alcoholic Beverages* at p. 16 (quoted *infra*).

be a sub-set of DCS products, in the sense that, besides being DCS, they must further share the same tariff classification (usually, at the 6-digit level). It has further clarified that it is consumers that will define whether two products are DCS. As we saw in *EC – Asbestos*, it is not necessarily the case that a consumer survey must be conducted for a panel to be persuaded about consumers' perceptions – in *EC – Asbestos* the AB inferred itself the perceptions of a reasonable consumer. Moreover, one does not need to use econometric indicators to show what consumer perceptions actually are, if seeking to quantify these: in *Korea – Alcoholic Beverages*, the AB held that two products can be shown to be DCS either through econometric- or non-econometric indicators. The latter comprise elements such as, physical characteristics, end uses, consumer reactions etc.

A WTO Member that taxes two DCS products in dissimilar manner and above a *de minimis*-threshold (which has not been identified by the AB), is *ipso facto* violating its obligations under Art. III.2 GATT. A WTO Member that taxes two DCS products in dissimilar manner but not above a *de minimis*-threshold, is not *necessarily* violating its obligations under Art. III.2 GATT: recourse to elements such as the institutional architecture of the challenged measure will be necessary in such cases; if the protective nature of the measure is thus established, then violation of Art. III.2 GATT will also be established (AB, *Chile – Alcoholic Beverages*).

Assuming two products are *like*, any difference in taxation suffices for violation of Art. III.2 GATT to be established.

With respect to non-fiscal instruments, the legal discipline is as follows:

- (a) A *measure* (law, regulation or requirement);
- (b) *affecting* internal sale, offer for sale, purchase, transportation, distribution or use;
- (c) must not afford to the imported *like product*;
- (d) *less favourable treatment*.

The italicized terms again hold the key to the understanding of the provision. The term *affecting* has been interpreted in the widest possible sense so far: there is no reported case where a measure failed this requirement. The term *like* in Art. III.4 GATT has been interpreted in similar vein as the term DCS appearing in Art. III.2 GATT. And the term *less favourable treatment* is understood to be equivalent to the term *so as to afford protection*. It is, however, far from obvious how the interpretation of this term in Art. III.2 GATT (taxation above and below the *de minimis*-threshold) can be of help in the context of Art. III.4 GATT. As already stated above, the leading case in this field (*EC – Asbestos*) did not interpret this term at all.

7.2 A GATT Panel's Likely Response

We address here the fundamental question of whether a Member is free to decide on marketing and selling conditions of foreign products into its market, when the perceived lack of regulation in the exporting market will affect the commercial terms of imports. In this scenario, we, thus, assume that A does not care about the environment in B *per se*, that is, that A does not attempt to justify its tax scheme on domestic public order (moral values). Art. III.2 GATT is applicable

since we are dealing here with a domestic tax and not an import tariff. There are here at least four legal issues that a GATT panel could have to address.

7.2.1 1st Line of Defense: A Restores Equality of Competitive Conditions

In this scenario, the exporting country invokes Art. III.2 GATT, arguing that the tax distinction between EUF and EF x is illegal, since the two products are like. Let us assume for the time being that the panel takes the view that the two products are like. A will respond that it is treating the two like products in the same manner: it is subjecting the imported product to a domestic tax for the protection of environment that it evaded in its country of origin. The response by A, in other words, is that it is not violating its obligations under Art. III.2 GATT, since all it does is to *restore the equality of competitive conditions* by taxing EUF x, since producers of EF x have taken on costs in order to avoid exposing the environment to hazards. A would thus argue that it does not afford protection to its domestic production.⁸³ This raises the fundamental question with regard to Art. III GATT concerning how to understand the notion “equality of competitive conditions in the importing market”, which adjudicating bodies have understood to be the core of the NT obligation?

It is clear that in a situation like this, production of EUF x would give a commercial advantage to producers in B, since it is not taxed while production of

⁸³ This line of reasoning has been developed in Horn and Mavroidis (2004) who take the view that it is consumers that should appreciate *likeness*, and that there should be no *a priori* presumption that government intervention that subjects two like products to a differential tax regime is *per se* GATT-inconsistent. In their view, the current case-law has made the terms *so as to afford protection to domestic production* appearing in Art. III GATT redundant. They deplore this construction, since the whole purpose of Art. III GATT is to ensure that no protection to domestic production will be afforded through recourse to domestic instruments.

EUF x is taxed in A. The question, however, is whether this choice by producers in B suffices as a ground for A to tax EUF x? More generally, how far can an importing country go in offsetting *factors that enhance the competitive advantage of imported products*? This question arises since Art. III.1 GATT refers to measures that “directly or *indirectly*” (italics added) confer an advantage to domestic products. The question is thus *how* indirect are the effects that this non-discrimination provision captures?

The Working Party on *Border Tax Adjustments* addressed some of these questions, albeit in a rather unsatisfactory manner since, at the end of the day, the GATT contracting parties could not agree on this score. But the final report issued by the Working Party was adopted by the GATT CONTRACTING PARTIES,⁸⁴ and should consequently (by virtue of Art. XVI of the *Agreement Establishing the WTO*), guide also the WTO judge. In this vein, the WTO judge should note that:

...the Working Party concluded that there was convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added. It was agreed that the TVA, regardless of its technical construction (fractioned collection), was equivalent in this respect to a tax levied directly – a retail or sales tax. Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes.⁸⁵

⁸⁴ The term CONTRACTING PARTIES (in block letters) refers to the highest organ of the GATT, the one enjoying, *inter alia*, the competence to adopt reports of panels, Working Parties etc.

⁸⁵ See the Working Party report on *Border Tax Adjustments* § 14, *op. cit.*

The term *border tax adjustment* is defined in §4 of the report:

... as any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products).⁸⁶

The GATT contracting parties took this exercise of determining the coverage of Art. III.2 GATT quite seriously: the Secretariat was asked to compile a document where it listed cases of border tax adjustments.⁸⁷ Nevertheless, beyond the noted convergence on some taxes, the GATT contracting parties did not agree any further.⁸⁸ In sum, this report endorses the *destination-principle*, that is, the right of the importing state to subject imported products to its own laws, for *some* laws only.

Following this inconclusive report, trading partners never addressed this issue again in a meaningful manner. The very rationale of Art. III GATT, however, argues against an interpretation of this provision in a manner that would make it possible for importing states to subject imported products to all their laws and

⁸⁶ The *destination* principle, as explained above was taken over from bilateral agreements negotiated in the 1930s, such as the agreement of 6 May 1936 between the United States and France, see §10 of the Annex to Working Party report on *Border Tax Adjustments*, *op. cit*

⁸⁷ See GATT Doc. L/3379 of 6 May 1970. See on this score, the excellent analysis in Démaret and Stewardson (1994).

⁸⁸ So far, GATT/WTO case-law has not dealt with cases of indirect taxes, such as payroll taxes.

regulations affecting the production process.⁸⁹ The AB acknowledged as much in *Japan – Alcoholic Beverages II*, where it held (p.16):

... The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III 'is to ensure that internal measures not be applied to imported or domestic products so as to afford protection to domestic production.' Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products.⁹⁰

So, Art. III GATT is the institutional insurance policy against circumvention of tariff promises, and nothing beyond that. That is, the term "equality of competitive conditions" should be viewed in tandem with the overarching purpose of Art. III GATT to ensure that tariff concessions will not be circumvented through e.g., domestic taxation. When contracting parties to the GATT (and now WTO Members) wanted to condemn practices conferring a trade advantage, they did so by enacting for example, the Antidumping and the Subsidies Agreements. Art. III GATT cannot thus be viewed as not as an implicit endorsement for the importing country to counteract *any* advantages that exporting firms might enjoy due to e.g. the policies pursued in their home markets. The very purpose of Art. III GATT is to act as an anti-circumvention device, and it should not be interpreted to implicitly endorse the removal of any competitive advantage that other trading nations enjoy. To repeat our previous

⁸⁹ The negotiating history of Art. III GATT lends substantial support to this understanding of the provision, see Irwin *et al.* (2008).

⁹⁰ A note by the GATT Secretariat summarizing the meetings of the *Working Party on Border Adjustments* on 18 to 20 June 1968 (GATT Doc. L/3039 of 11 July 1968) captures the same point in the following terms: "In the case of Article III, the rules were designed to safeguard tariff concessions and to prevent hidden discrimination.

statement, Art. III GATT is meant to equate conditions of competition *within* markets, not *across* markets. Where precisely we draw the line remains an open question. But it is clear that Art. III GATT was not designed as a *carte blanche* for the importing state to subject imported products to each and every regulatory requirement applicable directly or even indirectly on its own “like” products.⁹¹

What is then the implication for the likely success of a claim under Art. III GATT in the above scenario? It seems likely that a GATT panel would rule in favour of the complaining country B. Country A cannot escape an Art. III GATT-allegation by arguing, that it is removing differences in competitive conditions that stem from differences in domestic regulations across countries. Such an interpretation of Art. III GATT is also consonant with one of the underlying purposes of the GATT-edifice, which is that all protection is negotiated and not unilaterally defined.⁹²

If the panel takes the view that the two products are unlike, then its response would, of course, be that A’s EP is legal. In the present scenario, it is more probable, however, that the panel will conclude that the products are like. Assuming a reasonable consumer-test, as *per EC – Asbestos*, the panel will

⁹¹ Charnovitz (1994) takes a drastically different view. In his view, WTO Members do not exercise jurisdiction, as we suggest here, they merely regulate conditions under which imports will take place. Semantics aside, Charnovitz seems to (at least implicitly) accept that, when a country can legitimately decide on the conditions under which products will enter its market, irrespective whether such decisions affect third countries’ interests. In our view, this construction risks undoing competitive (and comparative) advantages. For instance, if an importing country can legislate that all products sold in its market must be produced with a least a certain minimum wage, the importing country could effectively shut out more labor abundant countries from selling in its market. A similar phenomenon may also arise in the context of environmental regulation. The very foundation of the GATT edifice however, was liberalization of trade that would take place in the context of regulatory diversity.

⁹² This argument is supported by both the negotiating history and the practice of the GATT, as argued above.

naturally be led to conclude that, since there is no environmental hazard in the importing market *and* no public order-type of concerns, it is the end-uses of the products that would matter most in the eyes of consumers in A's market. Under the circumstances, the panel should conclude that A is violating its obligations under Art. III GATT, since the purpose of this provision is not to equate competitive conditions across, but within markets.

7.2.2 2nd Line of Defense: A Counteracts B's Subsidization Through Lax Environmental Standards

Let us now turn to a different line of defense that the importing state might raise against an Art. III.2 GATT complaint. Country A may argue that through differential taxation, *it is removing from B's producers an advantage that they have been granted by means of a regulatory subsidy* in terms of low environmental standards.⁹³ This is one of the thorniest and most under-researched areas in international trade law. The case-law is so limited and unclear here that we are reluctant to take a definitive stand on what would be the GATT panel's verdict. But there are two reports by WTO adjudicating bodies, the reasoning and the outcomes of which may suggest that B will prevail.

One of these disputes is *US – Lumber IV*, which concerned countervailing duties that the US used to offset alleged subsidies for Canadian exporters.⁹⁴ The subsidies were said to arise from favourable commercial terms for the right to

⁹³ Since the alleged subsidy is in legal terms pecuniary, the importing country would need to undertake a countervailing duty investigation, and then impose a countervailing duty, rather than make tax distinctions. But we disregard this fact in order to avoid having to introduce a separate scenario..

⁹⁴ Horn and Mavroidis (2007) discuss some of the conceptual and practical problems involved in defining a subsidy that were highlighted in this dispute. See also Sykes (2003) for a general discussion concerning the subsidies regulation.

use a publicly owned production input. Hence, the allegation did not concern a direct financial payment by the government, but rather a form of under-taxation that provided beneficiaries with a commercial advantage. In this dispute, the US countervailing duties were found to be illegal, partly since the US had not managed to establish that the terms at which the Canadian firms bought the input did not reflect commercial considerations only.

The ruling in *US – Lumber IV* points to a general problem of establishing the relevant benchmark in disputes where the alleged subsidy is in terms of a regulator stance, rather than a direct financial payment. How can the countervailing country establish the situation that would have prevailed, were it not for the subsidization? If it cannot establish this situation, it cannot compute the appropriate duties. Consequently, in our Scenario III, it would be a heavy burden for A to show that there is an under-regulation of the environment in B *for commercial reasons*. B could argue that the low environmental regulation simply reflects B's preferences, and that the regulation would be the same regardless of whether it affected a product in competition with foreign products or not.

The other dispute of relevance here is *US – FSC*, where the AB found that the US was violating the SCM Agreement because it adopted a scheme whereby it exonerated US companies from their obligation to pay taxes on export income. The fact that, for example, this was argued to be done in order to remove a competitive advantage that companies which are nationals of other WTO Members enjoy (EU Member states, for example, do not tax export income so its companies do not have to be exempted from any such obligation) was immaterial.

In a nutshell, case-law seems to confirm the impression given by the texts of the WTO agreements, that that the only subsidies that can be countervailed are effectively *pecuniary*. For the rest, WTO Members can freely choose the levels of regulation (the GATT being a negative integration contract) and see their GATT-obligations imposed on a pre-existing regulatory diversity. Consequently, A cannot justify its differential taxation on the grounds that it aims to counteract the regulatory subsidy granted by B to its producers.

7.2.3 3rd Line of Defense: Art. XX GATT Exception

Assuming the defendant invokes Art. XX(b) or Art. XX(g) GATT, our analysis in Section 6.1 applies here as well.

The issue could be slightly more complicated, if A invokes Art. XX(d) GATT as defense.⁹⁵ According to Art. XX(d) GATT, a Member is allowed to an exception for measures that are

necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement,....

Let us change slightly the example to make such a defense more plausible. The argument would be as follows: following the negotiation of tariffs, A imposes an embargo on EUF x – this would be the law referred to in the quote above. A does not invoke in its law *any* regulatory objective: A simply states that it regulates access to its market to its liking. When B complains, it will raise a challenge

⁹⁵ This defense could be raised in every scenario where the complaining party has established violation of a GATT obligation. To avoid unnecessary repetitions, we treat it in extensor only here.

under Art. XI GATT and prevail; A will defend itself arguing that the imposition of an import quota is necessary to enforce an otherwise GATT-consistent measure of general application (the domestic measure that distinguishes between EF and EUF products, allowing only the former to be sold in the domestic market). Can A get away with this defense? The most recent AB report on this score (*Korea – Various Measures on Beef*) is not a model of clarity, and consequently, it is hard to tell how helpful it can be. In this report, the AB found that a Korean measure separating outlets that sell domestic beef from those that sell imported beef could not be justified under this provision. Even though (in the AB's point of view) Korea genuinely aimed to protect consumers through this measure, the measure itself was not necessary to achieve the stated objective in that it modified conditions of competition to the detriment of imported products. This reasoning is quite clearly wrong (and this is the main reason why this report is not helpful): any WTO Member can, of course modify conditions of competition and, assuming it respects the statutory requirements of the relevant provision of the GATT (I, III, XX etc.), risk at best an NVC⁹⁶ against it. Assuming, nevertheless, that the AB sticks to this reasoning, then A loses, since the modification of conditions of competition (the embargo subsequent to the negotiations) operates against the imported product.⁹⁷

Now what if this reasoning is not followed? The outcome will then depend on the interpretation of the term "necessary". In this case, nonetheless, A will have to explain the rationale for its law. Let us assume that A states that it wants

⁹⁶ NVC stands for non-violation complaint. We discuss this type of legal complain in Section 7.2.4.

⁹⁷ There is no comparable case that was adjudicated ever since this one, so it is hard to conclude on this score. Exporters will be reluctant to negotiate tariff concession with an embargo in place (that is, if the embargo pre-dates the tariff negotiation, unless if they believe that the embargo is illegal. In this case, the importer will either refuse to negotiate or set a very high tariff.

consumers to consume only EF products. Since some of its consumers value cheaper goods higher than the protection of environment, absent regulation consumers will consume EUF products. For A, a total sales ban on EUF products, irrespective where they have been produced and where the hazard lies, is the only way to guarantee that its pro-environment policies will remain intact. Hence, the measure (trade embargo) is necessary to achieve the objective sought. Does this defense fly before a WTO panel? This is hard to predict. This could be one of the instances where there is variance in the result depending on whether one accounts or not for the *default rules*. It is not excluded that a typical GATT panel might find nothing wrong with this line of defense, since the interpretation of ‘necessary’ will be influenced by the restrictive formulation of the regulatory objective.⁹⁸

7.2.4; 4th Line of Defense: NVC

But even if A complies with MFN and NT, B could still have a legal basis for a claim against A, in that B could raise an NVC against country A. According to Art. XXIII.1(b) GATT, and Art. 26 DSU, a WTO Member can request compensation⁹⁹ for “nullification or impairment” of a benefit due to

...the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement...

In the 1990 *EEC – Oilseeds I* dispute, the panel provided its understanding of the rationale for an NVC (§§ 144 and 148):

⁹⁸ Recall our discussion about the *relative importance* of the regulatory objective in *Brazil – Retreaded Tyres*.

⁹⁹ The form of compensation could vary from monetary compensation to adjustment of the policies challenged.

The idea underlying [the provisions of Article XXIII:1(b)] is that the improved competitive opportunities that can legitimately be expected from a tariff concession can be frustrated not only by measures proscribed by the General Agreement but also by measures consistent with that Agreement. In order to encourage contracting parties to make tariff concessions they must therefore be given a right of redress when a reciprocal concession is impaired by another contracting party as a result of the application of any measure, whether or not it conflicts with the General Agreement.

...

The Panel considered that the main value of a tariff concession is that it provides an assurance of better market access through improved price competition. Contracting parties negotiate tariff concessions primarily to obtain that advantage. They must therefore be assumed to base their tariff negotiations on the expectation that the price effect of the tariff concessions will not be systematically offset. If no right of redress were given to them in such a case they would be reluctant to make tariff concessions and the General Agreement would no longer be useful as a legal framework for incorporating the results of trade negotiations.

The early cases were dealing exclusively with domestic subsidies that were being paid to domestic producers, and were undermining the value of tariff concessions previously made.¹⁰⁰

But in the report on *EC – Asbestos*, the AB had to face an argument advanced by the EC to the effect that an NVC could not be used against health-based trade-obstructing measures, justified under Art. XX GATT; in the EC view a measure could not, on the one hand, be explicitly permitted under a GATT provision,

¹⁰⁰ See Petersmann (1991), and Mavroidis (2000).

while the regulating state remains liable for any related damage to its trading partners interests. The AB dismissed this argument (§§188 and 189). Remarkably, this case-law did not limit the realm of possible applications of an NVC to say those health-based measures that have a *direct* impact on the value of concessions; it is based on the *open-ended* language employed in Art. XXIII.1b GATT. Following this jurisprudence, it seems plausible that NVCs can be raised against a variety of government measures that might have an impact on the value of negotiated concessions.

Standing case-law can be summarized as follows. For a successful NVC, the trade damage should be suffered as a result of:

- (a) a legal practice by another WTO Member; which
- (b) occurs after concessions had been agreed; and which
- (c) could not have been reasonably expected.

Various commentators have stressed the desirability for strict standards for NVCs. But there has also been some sympathy for the appropriateness of the NVC instrument expressed in the literature. Bagwell *et al.* (2002) have argued, by endorsing a contractual approach, that trading partners negotiating concessions during a round should be presumed to *morally* accept each other, otherwise why negotiate in the first place? Moral acceptance will be renewed every time a new round has been successfully concluded. Changes in policy which are not GATT-inconsistent and might affect trade could be challenged through NVCs.¹⁰¹ Bagwell *et al.* (2002) do not put into question the right of the WTO Member

¹⁰¹ Mavroidis (2004) argues along the same lines but also suggests that some degree of self-restraint is warranted: any policy affects at least indirectly and potentially trade.

granting market access to regulate the conditions under which market access will take place; they simply state that, assuming such exercise has negative effects on foreign producers, the regulating state will have to compensate. Consequently, this approach does not put into question the *destination-principle* at all.

In this *specific* case, it is highly likely that B will prevail. A is not, through this measure, protecting its environment, and, it is not raising any public order-type of concerns either. Consequently, B will find it rather easy to convince the panel when arguing that it could not have legitimately expected such an action by A, subsequent to the negotiation of the tariff concession on x.

7.3 The Default Rules

As pointed out above, since the *default rules* will only be relevant in case there is no international agreement concerning the pursuit of domestic policies, the crucial question is how to understand the WTO Agreement; it clearly goes beyond the restrictions in the text, but how far? In particular, should it be interpreted to include an acceptance of the commercial effects of unilateral policies that fulfill the non-discrimination provisions?

We believe, as argued in Section 4, that the WTO Agreement should be interpreted to implicitly also cover commercial effects of unilateral policies. Consequently, the importing country cannot lean upon the *default rules* in order to justify its EP. Hence, the verdict would not change if these results were taken into account by a GATT panel.

8. Domestic EP Distinctions Based on Physical Trans-Boundary Externalities

In all scenarios in this section, the importing country EP addresses a physical trans-boundary externality. The scenarios differ in whether there is a change in policy.

8.1 Domestic EP Introduced Before Negotiations and Maintained Thereafter

Scenario V: In the tariff negotiations, A binds the tariff on x. There are externalities from the production of x directly affecting A. In its domestic taxation, A distinguishes EF- and EUF x, imposing higher taxation of the latter. A practices the same EP before and after tariff negotiations. The EP provides for a more favourable treatment of the EF product. B has always been producing EUF products, and claims that A's environmental regulation denies it market access.

8.1.1 A GATT Panel's Likely Response

Depending on the existence of competing products, country B could argue that the tax differential violates Art. I.1 GATT and/or Art. III.2 GATT. Suppose country B invokes Art. III.2 GATT, claiming that its export of product EUF x is taxed in excess of product x when produced locally in an EF manner, despite the fact that the two products are like. Here, we would be squarely within the realm of the AB report on *EC – Asbestos*, provided that consumers would treat the imported product differently than the domestically produced product upon purchase. Assuming that an adjudicating body will keep the same standard of review irrespective of whether the difference in physical characteristics results in

public health or environmental hazard, it would find that the two products (EF x and EUF x) are unlike and consequently uphold the tax differential. Note however, that the legality of the measure would *not* depend on the trans-boundary nature of the environmental hazard. It is because *consumers are concerned with the hazard* that the products are not like. In particular, the legality of the EP would not depend on environmental protection being a legitimate policy objective.

On the other hand, if consumers would *not* distinguish between the imported and locally produced product even if knowing their different environmental impact, the two products should, by virtue of the reasoning reflected in *EC – Asbestos*, be considered like, and the differential taxes imposed would then violate Art. III.2 GATT. In such a dispute, the importing country would in all likelihood claim that its measures are consistent with Art. XX GATT. A WTO adjudicating body would most likely uphold A's claims under Art. XX(b) GATT, since A is taking a measure necessary to protect its own environment (by discouraging imports of EUF products). The question before the panel would be to what extent the particular measure that is chosen to protect the environment (the differential taxation) is a *necessary* measure: the more restrictive the formulation of the objective (environmental protection), the higher the likelihood that the panel will uphold the measure, since the court will not be putting into question the ends sought, but only the means employed to this effect: for example, if the importing state claims that it is pursuing a zero-risk scenario, it can, by virtue of WTO case-law, legitimately impose an embargo on all sales of EUF x.

8.1.2 The *Default Rules*

In this case, there is no bargaining solution, since A has not scheduled its domestic policies. The *default rules* allow A to regulate behaviour by its nationals in its territory. But under the effects doctrine, A can also regulate behaviour by foreigners to the extent that such behaviour produces direct, foreseeable, and substantive effects on its market. It is hence clear that in cases where there is an environmental hazard from consumption of the imported product (similar to what was the case in *EC – Asbestos*), or in case where there is a trans-boundary production externality, A can under the *default rules* lawfully exercise jurisdiction and decide on the marketing and selling conditions of foreign products into its market.

How would the outcome be affected if the GATT panel took into account the *default rules*? The GATT panel would almost certainly allow A jurisdiction, if nothing else, due to an Art. XX GATT defense. The imposition of the *default rules* would thus in this case not change the outcome.

8.2 Domestic EP Introduced After Negotiations

Scenario VI: In the tariff negotiations, A binds the tariff on x. B produces EUF x. There are externalities from the production of x directly affecting A. Before and during tariff negotiations A makes no distinction between EU- and EUF x, but, after tariff negotiations, A introduces a tax on EUF x, and B, who now loses sales as a result, claims that A's EP denies B market access that it could rightfully expect under the GATT.

8.2.1 A GATT Panel's Likely Response

It is by now accepted (*US – Gambling*, AB) that domestic instruments (public order) do not have to be *scheduled* during negotiating rounds, and become

integral part of the list of concessions that every WTO Member submits at the end of every successful round. This means that a WTO Member can legitimately pursue EP at *any* time, provided, of course, that it respects the non-discrimination principles (MFN and NT). A has thus the sovereign right to unilaterally change its policies and now accept only EF x into its market.

Country B could possibly invoke an NVC. The question would then be whether B can demonstrate that A's policies (which undeniably nullify its benefits under the GATT) could not have been legitimately expected. Judging from case-law, B will have an almost impossible hurdle to overcome: it will have to demonstrate that it could not legitimately expect that A would take measures to protect its own environment (since the hazard is trans-boundary in this scenario). One can safely conclude that the complaint by B will fail.

Let us just for the sake of completeness note that there are in this scenario two types of commercial externalities: B's choice of EP exposes A's producers to increased competition, and A's EP worsens the competitive position of B firms. But the possibility to legally counteract such effects has already been discussed in Section 7.

8.2.2 The *Default Rules*

According to the effects doctrine in the *default rules*, A has the right to exercise prescriptive jurisdiction, since the environmental hazard is felt within its territory. Taking these rules into account will hence not affect the outcome, as long as A is allowed the right by the GATT panel to regulate. In the opposite case, where A is effectively denied jurisdiction through a successful NVC by B,

this denial would result from the application of an international agreement, and the *default rules* would not apply. Hence, in neither situation will the default rules have any bite.

8.3 Domestic EP Introduced Before Negotiations, But Abandoned Thereafter

Scenario VII: B produces EF x. Before and during tariff negotiations A imposes higher taxation on EUF than on EF x. There are externalities from the production of x directly affecting A. After tariff negotiations A removes the tax distinction, and B loses sales as a result. B claims that A's new environmental regulation denies B market access that it could rightfully expect under the GATT.

8.3.1 A GATT Panel's Likely Response

The previous scenario concerned an unexpected introduction of an EP by the importing country. Here we consider the opposite situation, where it is the importing country's *removal* of an EP that is being challenged. Such a measure could hurt B if, for instance, B's firms have invested in a EF technology in order to get market access into A, and therefore have higher production costs than necessary to produce the EUF x.

There is, therefore, no violation of the GATT here: country A does not have to enact domestic laws to protect environment, despite its appurtenance to the WTO. A can unilaterally take the view that the environmental hazard resulting from the production/consumption of EUF x is minimal, and unilaterally decide not internalize the resulting externality through a statute. B could possibly argue a NVC, but it seems (judging from the general track record with regard to NVCs) as if the probability for it to be accepted would be rather small.

8.3.2 The *Default Rules*

A has jurisdiction to regulate, since it is adversely affected by the environmental externality. From a legal point of view, A would be perceived to have decided not to exercise jurisdiction when it abandoned the previous EP. (From an economic point of view, it exercised jurisdiction by setting a low environmental standard.) But there is no legal compulsion, under the *default rules*, for A to set a certain environmental standard. Hence, the verdict would not change if the GATT panel were to take the *default rules* into account.

8.4 Domestic Taxes Introduced to Counteract Lack of EP in Exporting Market, Even in Absence of Exports

Scenario VIII: B produces EUF x. B does not export EUF x to A. There is a trans-boundary externality from the production of EUF x. A responds by imposing a higher domestic tax on product y that B exports to its market. B raises two complaints against A: a violation complaint, arguing that A's measures violate Art. III.2 GATT, and an NVC.

8.4.1 A GATT Panel's Likely Response¹⁰²

In this scenario, B will make the Art. III.2 GATT-claim, that A is violating Art. III.2 GATT by taxing imported y higher than domestic y. A has no defense under Art. III GATT, and will move into Art. XX GATT to defend itself. It can choose between Arts. XX(b) and XX(g) GATT. A will argue that the production of EUF x pollutes its own environment, and, consequently, its measure protects an exhaustible local natural resource. Its measure certainly *relates* to the protection

¹⁰² We could have constructed the same example using a trade instrument, say a tariff. The result would have been the same.

of exhaustible natural resource, since under this test, all the WTO Member invoking Art. XX(g) GATT has to show is that its measure is appropriate to reach the objective sought: A will claim that, by reducing the export income that B enjoys, it will be forcing B to change its EP. This will be, nevertheless, a novel issue before a WTO panel: A will be claiming that, in the absence of exports of x to its market, its measure must necessarily apply on a product other than the one polluting clean air which, nonetheless, originates in the polluting country. The panel will, thus, have to decide whether to construct Art. XX(g) GATT in such a wide manner, or whether it should adopt a narrower understanding of the scope of this provision, in the sense that the environmental hazard must originate in the imported y. The text of Art. XX(g) GATT does not exclude the wider interpretation. The whole spirit of the GATT does not exclude it either: as Horn and Mavroidis (2004) argue, the quintessence of the GATT is that protection must always be negotiated. In this vein, the measure adopted by A is not a protectionist measure. A, acting in accordance with the polluter pays principle, requests from B to incur the cost of the environmental hazard it causes. Although we can only speculate about the response, there are good arguments in support of A's defense.

8.4.2 The *Default Rules*

Reliance on the *default rules* would provide A with an extra argument in the case where there is a trans-boundary environmental hazard, since A has the right to regulate this transaction in light of the physical effects in its own market.

8.5 Summarizing the Physical Trans-boundary Externality Scenarios

We have in the above concluded that in the presence of a physical trans-boundary environmental externality affecting the importing country, the GATT panel will accept the importing country's EP. If products are considered like (which is not self-evident), the importing country is likely to be given jurisdiction through Art. XX GATT. The prospect for a successful NVC by the importing country is slim. Imposition of the *default rules* is not likely to affect the outcome in any of the scenarios.

9 Domestic EP Distinctions Based on Moral Trans-boundary Externalities

We turn in this section to a scenario where there is an environmental externality, which however, does not *physically* affect the importing country; it only does so *morally*. For instance, an environmental hazard in a country may threaten a plant that only grows in that country, but its disappearance would not affect the worldwide ecological equilibrium. Also, the plant lacks any economic or other value to the importing country, other than the pleasure from knowing that it exists.¹⁰³

Scenario IX: *A makes EP distinctions based on local environmental effects in B. There are no physical trans-boundary environmental externalities. B challenges the measure*

¹⁰³ We disregard for ease of presentation the possibility that the plant could possibly have some future use, or that the extinguishing the plant may upset the ecological balance to the detriment of other countries.

arguing it violates Art. III GATT. A responds that B's policies are immoral, at least in the manner that A defines morality.

9.1 A GATT Panel's Likely Response

It was pointed out in Section 4 that protection of the environment does not qualify as *jus cogens*. But it is still often argued that moral aspects of environment should serve as a legal basis for tariff discriminations. For instance, there has been considerable debate whether it is legal and desirable that WTO Members condition their treatment of imported products on the process and production methods (PPM) that are employed by exporters to their markets.¹⁰⁴ There seems to be general acceptance today of the notion that EP distinctions based on PPMs are not necessarily illegal. Indeed, as the analysis in Section 7 also showed, in case of trans-boundary physical effects, PPM-based distinctions could be legal under the GATT. And to the extent there are substantial, direct and foreseeable (negative) effects (in case no PPM-based distinctions have been entered), the importing countries would have jurisdiction also according to the *default rules*.

A more contentious question, both from a normative and a legal point of view, is whether (alleged) *moral* effects should suffice in the absence of trans-boundary physical effects, for a WTO Member to prescribe jurisdiction? The introduction of morals as a ground for policy distinctions is obviously not uncomplicated. To start with, it is easy to see that a number of questions concerning evidentiary standards would immediately arise – for instance, how should the importing

¹⁰⁴ A recent contribution is Pott (2007) who argues in favor of such EP distinctions, discusses the legality of such distinctions, and suggests ways of making them legal under the WTO. See also Howse's (2007) summary of the WTO case-law relating to PPMs.

country verify the moral effects from the environmental hazard in the exporting country? There is also a question of quantification. How strongly must governments/citizens/consumers feel about the environmental hazard in the exporting country? Does it suffice that there are a few people who feel very strongly, or must it be majority?¹⁰⁵ We will disregard these issues, however, to focus on the more fundamental issue of whether a proven, wide-spread moral sentiment can serve as a basis for an EP distinction.

The introduction of morals into the equation opens at least three possibilities for the importing country with regard to the GATT:

- (a) The first possibility is to argue that EF x and EUF x (as *per* our examples so far) are not like products. The determination by the AB in *EC – Asbestos* is often interpreted as opening a door for e.g. PPM-based distinctions, *also* in cases where there are no trans-boundary physical effects. The idea here is that this ruling emphasized the importance of consumer perceptions for likeness. If from a consumer point of view it is wrong to cause environmental harm, even if the harm does not physically affect the territory where consumers reside, then consumers would possibly treat products that cause such harm differently from other products fulfilling the same needs in other respects. The products would then *per* the reasoning in *EC – Asbestos* not be like, and there could of course not be any violation of Art. III GATT. As things stand in terms of evolution of case-

¹⁰⁵ One way to resolve the issue here would be to see what domestic law norms are being violated. Assuming, for example, that there is a constitutional command against environmental degradation, one could use this fact as proxy to measure the ‘seriousness’ with which the importing state addresses this issue. This would hardly be the case if, for example, there is mere best-endavours legislation to avoid the degradation.

- law, we are not entirely convinced that if Scenario VIII captures such a situation, that A will prevail, even if A can convincingly demonstrate that consumers view the EF and the EUF products differently¹⁰⁶;
- (b) The second possibility to bring morals into the picture *would* be to invoke Art. XX GATT, and here A could lean against not only Art. XX(b), or XX(g), but also Art. XX(a), which allows for exceptions “necessary” to protect *public* morals.¹⁰⁷
- (c) The third possibility would be for a WTO Member that totally disapproves of the moral standards of another WTO Member, to invoke Art. XIII of the *Agreement Establishing the WTO*, and, thus, block trade altogether. This is an extreme measure, but as such leaves no doubt as to the seriousness of the impact that the moral standards of the previously importing WTO Member has suffered. On the other hand, a non-invocation of Art. XIII of the *Agreement Establishing the WTO* should not be equated to *absence of moral* issues. A WTO Member can, for example, legitimately take the view that, in presence of Art. XX GATT which allows it to block trade on moral grounds, it does not need to invoke Art. XIII of the *Agreement Establishing the WTO*, especially if the practices it objects to are confined to specific sectors.

¹⁰⁶ This scenario can be questioned on the grounds that there is no reason to regulate if consumers would anyway treat products differently. Various counterarguments can be made. For instance, consumers may not be able to tell one type of product apart from another through inspection.

¹⁰⁷ We side with Charnovitz (1998) and his expansive understanding of the term public order, although not necessarily for the same reasons. We are mindful of Feddersen (1998) who explains that such view is probably not consonant with the negotiating record. Absent wide construction of Art. XX(a) GATT though, one risks constructing the GATT as an instrument for de-regulation against the clear intent of the negotiators; see Mavroidis (2007).

No matter what the legal basis is, the importing state would be blocking trade from partners with which it feels that it does not share the same moral values. There has been no case-law discussing this issue head-on so far. In light however, of the manner in which WTO adjudicating bodies have recently understood non-discrimination, one could predict that, assuming the remaining aspects of the GATT regulatory framework have been respected, a WTO panel could be tempted to condone import restrictions based on moral disagreements across WTO Members. Recall that in *EC – Tariff Preferences*, the AB made such an inroad when opening the door to conditioning tariff treatment upon the satisfaction of unilaterally-set *objective* criteria. On the other hand, there are, or at least should be, a number of very difficult evidentiary issues involved here: for instance, what if B claims that there is no difference in morals that explains the divergence between what A would like B to do, and what B actually does, but that this instead reflects differences in income levels between the two countries? Also, how should the adjudicating bodies be able to determine whether A's concern for B's environment is what drives the policy, when at the same time it gives rise to commercial advantages to A firms? We flag such arguments only to show the slippery slope that we are entering when entertaining moral issues as a legitimate defense to deviate from the agreed GATT obligations.

9.2 The *Default Rules*

It is highly unclear what effect it would have to impose the *default rules*, due to the complete lack of disputes of this nature. A somewhat mechanical application of the *default rules* would lead to the conclusion that the importing country has jurisdiction, due to the trans-boundary moral effects from the environmental

degradation in the exporting country, provided that these effects satisfy the *direct, foreseeable* and *substantive* effects-requirement.

One might argue that this approach renders the notion of *jus cogens* irrelevant: if moral effects in general serve as legitimate bases for jurisdiction, why would there then be a need to classify certain moral objectives as being important enough to serve as a legitimate ground for jurisdiction? On the other hand, the more persuasive arguments lie with the contrary opinion: in case of *jus cogens*, there is an *obligation* to intervene; in case of moral effects which do not come under the purview of *jus cogens*, there is discretion. The jury is still out on this issue.

10. EP Distinctions and MEAs

We will finally consider a couple of scenarios concerning the possibility of using trade policy to support MEAs concluded outside the WTO.

10.1 Multilaterally Sanctioned EP Distinctions to Induce Compliance with MEA

We begin by considering the fundamental question whether GATT would allow the use of EP that violate the GATT as such, if they are used to induce compliance with an MEA, in a situation where the system of sanctions have been agreed upon in the MEA.

Scenario X: A and B conclude an MEA that sanctions the use of tariff or tax increases by a member when the other member does not fulfill its obligations. A and B are also Members of the WTO. B violates the MEA, and A responds with a tariff or tax increase on B products that is sanctioned by the MEA. B complains to the GATT, arguing e.g. violation of Art. III GATT.

10.1.1 A GATT Panel's Likely Response

GATT/WTO panels have been quite reluctant to acknowledge the legal validity of MEAs concluded outside the confines of the WTO. The most recent pronouncement to this effect is by the cited panel report on *EC – Approval and Marketing of Biotech Products*, where the Panel held that, absent unanimous acceptance by all Members of the WTO, an MEA will have no legal effects within the WTO legal order. So, if A defends itself under an MEA that has been signed by *some* WTO Members only, the panel will examine the measures by A in light of the obligations that A has assumed under the GATT. In this case, our discussion of Art. III GATT (since we are dealing here with a domestic instrument), and Art. XX GATT finds application.

Let us, therefore, for the sake of the argument, assume that all Members of the WTO are also Members of the MEA. The GATT panel would then, by virtue of the case-law on *EC – Approval and Marketing of Biotech Products*, examine the legal claims in light of the rules included in the MEA. As things stand, we cannot say for sure whether the MEA will be reviewed as context, subsequent practice/agreement, other relevant rule of public international law, or, merely, supplementary means of interpretation. If the latter, recourse to it will, in all likelihood, be made to support a conclusion already reached through recourse to other rules. If interpreted as context, its impact will be decisive in the resolution of the dispute since, the panel will *have to* use the rules included in the MEA as

interpretative material to decide on the rights and obligations of the parties to the dispute. Assuming we stay in this latter scenario, the Panel will have to pronounce in favour of A, since it will use the rules embedded in the MEA as the decisive interpretative material to understand the obligations of A and B under the WTO.

10.1.2 The *Default Rules*

Assuming we are dealing with a trans-boundary environmental externality, it is irrelevant if the MEA has been signed only by A and B, or by the whole WTO Membership. If the panel were to take account of the *default rules*, it would examine the basis for A's exercise of prescriptive jurisdiction. It would thus be led to discuss the MEA, which reflects the quest of A and B for a bargaining solution, to see to what extent A's actions are consistent with the rules embedded in the MEA. Since the sanctions are agreed upon in the MEA, the *default rules* would not be applicable.

We can, thus, note that trade sanctions that have been agreed upon in an MEA could be acceptable to both a traditional type of GATT panel, and also be compatible with the *default rules*. In both cases the legality would stem from the fact that the sanctions are agreed upon in the MEA. But a contentious issue for the GATT panel would be the extent to which the MEA comprises all WTO Members.

10.2 Unilateral EP Distinctions to Induce Compliance with an MEA

Scenario XI: An MEA is concluded between A and B before a GATT negotiation round. The MEA contains no rules on compliance. A has in place an EP that yields better treatment to countries that comply with the MEA. A and B then negotiate a new tariff agreement. Subsequently, B violates the MEA. Following its EP, A then increases its taxation of imports from B. Faced with a less favourable treatment, B challenges the legality of the EP.

10.2.1 A GATT Panel's Likely Response

The membership issue discussed in the context of the previous scenario would arise again. But the EP is different here, since it is now pursued unilaterally. By assumption, there are no rules in this MEA concerning sanctions for non-compliance, so the panel would not accept the EP on the basis of the agreement in the MEA. We would then effectively be back to one of the scenarios in Sections 7-9.

10.2.2 The *Default Rules*

Due to the absence of a bargaining solution concerning the trade sanctions, the situation would also from a *default rules* perspective be back to either of the scenarios in Sections 7-9.

10.3 Unilateral EP Distinctions Based on Membership of MEA

Scenario XII: A and C conclude an MEA that B does not sign. A increases tariffs on products exported by B because B refuses to become a member of the MEA. B challenges the consistency of these measures with GATT rules.

10.3.1 A GATT Panel's Likely Response

The distinguishing feature of this scenario is the fact that B is not a member of the MEA. Hence, any reference to the MEA as being an international agreement would from the GATT panel's point of view be irrelevant, since trade restricting measures cannot be justified through recourse to an instrument that has not been accepted by the totality of the WTO Members, as per the panel report in *EC – Approval and Marketing of Biotech Products*. We would then effectively be back to one of the scenarios in Sections 7-9.

10.3.2 The *Default Rules*

Again, due to the clear absence of a bargaining solution concerning the EP, the situation would also from a *default rules* perspective be back to either of the scenarios in Sections 7-9.

11. Taking Stock of the Role of Jurisdictional Rules

Environmental hazards very often have trans-boundary effects, either by physically or morally affecting other countries, or by directly or indirectly, via EP, affecting trade flows. EP are at the same time largely pursued unilaterally. The general purpose of this study has been to shed light on the international laws regulating WTO Members' freedom to pursue such policies. The purpose has, more particularly, been to provide an overview of the allocation of jurisdiction in the context of regulation of policies affecting the environment. This allocation is important since it determines which country has the right to regulate any particular transaction.

The starting point of the paper was the observation that in order for a trade agreement to have any bite at all, it is necessary to have some form of jurisdictional restrictions on the set of activities that countries can regulate. Two sets of laws regulate WTO Members in this regard: on the one hand, the WTO Agreement explicitly regulates *how* EP can be pursued, and, implicitly, it also imposes rules on what type of environmental effects that can be addressed; WTO Members are also bound by the explicit jurisdictional *default rules* in PIL by reason of their appurtenance to the international community. These two sets of laws jointly determine the ambit of unilateral environmental policies for WTO Members. WTO panels and the AB have not pronounced on the relationship between the *default rules* and the WTO Agreement, probably because no claims to this effect have been made; they have, nevertheless, repeatedly emphasized that the WTO Agreement must be interpreted in light of the principles of PIL, for instance, by taking the *Vienna Convention on the Law of Treaties* as the legal framework for treaty interpretation.

In order to structure the discussion, we have focused on a hypothetical case where there is an environmental hazard associated with the production of an export product. This hazard can be reduced through the EP pursued by the exporting country, through actions by the importing country, or through concerted action by both the exporting and the importing countries. For this setting, we have discussed how jurisdiction is likely to be implicitly allocated by a typical GATT panel, that is, a GATT panel that disregards the *default rules*, and how explicit recourse to these rules might affect the outcome. Predicting outcome of hypothetical disputes is never an exact science, and this is perhaps even less so in the current context. The GATT/WTO case-law on environmental issues is still

meager. The situation is even more problematic when it comes to applying the *default rules*. Hence, the findings concerning the different scenarios we have investigated is by necessity highly speculative. But we will nevertheless try to distil some more general observations.

(1) A first observation concerns the relation between the WTO Agreement and the *default rules*, and follows from the construction of the two sets of law. The *modus operandi* of the regulation of goods trade in the WTO Agreement is, broadly speaking, to allow any measure that has not been explicitly forbidden. Since these restrictions have been negotiated, and the *default rules* are not applicable in cases of an internationally agreed solution, the *default rules* cannot reverse a GATT court's decision to disallow regulation. But policies that are unilaterally pursued, and legal under the WTO, fall inside the ambit of the rules.

More generally, we can thus summarize the applicability of the *default rules* as follows:

Observation 1:

- (i) *Whenever the GATT (absent default rules) outlaws the importing state's EP, this follows from a bargained solution. This is what we have in case of commercial externalities. In such cases it does not change the outcome if the default rules are taken into account;*
- (ii) *Whenever the GATT (absent default rules) does not outlaw the importing state's EP, it could be due to two reasons:*

- a. *The GATT explicitly allows the measure.¹⁰⁸ The default rules are then not applicable since there is a bargained solution.*
- b. *The GATT is silent. This is where default rules may have an impact.*

(2) A second set of observations concern the possibility to use EP to address trans-boundary externalities related to environmental hazards. In the study we have discussed three types of externalities:

(a) *Commercial externalities:* Assume first that there is only a commercial externality stemming from B's lax EP that affects A. As we saw in the discussion of Scenario III, the importing country will here find it hard to get acceptance from a GATT panel for an environmental policies-distinction using domestic instruments. The *default rules* could not help the importer either. An alternative for would be for A to use tariffs. There would be a higher likelihood that this would be accepted by a GATT panel, provided that the policy distinction is made on the basis of objective criteria, or that it is negotiated. The *default rules* would in such a case not hinder A's regulation either.

(b) *Physical externalities:* What if, as a result of B's (limited) EP, there is a physical externality on A? The possibilities for A to block trade in the name of environmental protection now look much brighter. In case it employed negotiated tariff distinctions to this effect, there would be no objection by the GATT panel, assuming that the criteria are objective, as discussed in the context of Scenario II. The discussion in Scenarios IV-V led to the conclusion that a GATT

¹⁰⁸ For instance, protection of environment is a legitimate objective as *per* Art. 2.2 TBT, and, consequently, technical regulations which pursue this objective in a TBT-consistent manner can never run afoul the multilateral rules)

panel could also be persuaded concerning the legality of the unilateral use of domestic instruments. The *default rules* would then confirm A's jurisdiction. Were the EP introduced after the conclusion of the negotiation round, an NVC could be invoked: still, the complainant would find it hard to persuade the panel that it could not legitimately expect the affected state to react against the pollution of its environment.

(c) *Moral externalities*: A substantially more difficult issue is whether the mere fact that the citizens of country A dislike the lack of EP in B – what we have called “moral” effects. Such a case was presented in Scenario VIII. It was argued there that a GATT panel might be persuaded to accept the EP, if consumers in the importing country see the product as unlike, or if the importing country makes an Art. XX claim.

What are then our conclusions from the above for the allocation of jurisdiction? The exporting country clearly always has jurisdiction, both under the WTO Agreement and the *default rules*. The question of interest is, hence, whether the importing country *also* has jurisdiction. Our results could here be summarized to say that in general, both the WTO Agreement and the *default rules* would allow the importing country jurisdiction when the trans-boundary effects of the environmental hazard are physical (or possibly – but here we are simply guessing – moral), but not when they are commercial only.

At the (substantial) risk of oversimplification, the findings could be summarized as follows:

Observation 2:

Unilateral environmental policy

EP conditioned on:	GATT panel verdict	Jurisdiction by <i>default rules</i>
Commercial ext.	Illegal	Exporter
Physical ext.	Legal	Both
Moral ext.	Legal?	Exporter?

Negotiated environmental policy

Features of policy:	GATT panel verdict	Jurisdiction by <i>default rules</i>
Objective criteria Respects membership Respects MFN, NT, HS, etc	Legal	Not applicable
Fails on one of above counts	To be judged as unilateral policy	Not applicable

(3) We also discussed the possibility for importing country to use EP in order to enforce its rights under an MEA to which it is a Member. We concluded that a GATT panel would object to the relevance of any MEA for which some WTO Members are not members. If the membership issue is not a problem, then any EP that is negotiated in the MEA would have to respect WTO rules, such as, e.g. MFN and NT, and be based on objective criteria. The *default rules* would not be applicable. Unilateral policies to support MEAs have to be viewed as any unilateral policy, both from the GATT panel's point of view, and from the perspective of the *default rules*. It thus seems as if the WTO Agreement easily conflicts with policies that are sanctioned by, or support, MEAs. We summarize this observation loosely as follows:

Observation 3

There is scope for conflict between the WTO Agreement and MEAs.

(4) We have not discussed efficiency aspects of the current regulation of EP in this study. But it seems straightforward to argue that unilaterally chosen EP are likely to be inefficient, in the sense of not fulfilling the signatories' objectives to the full extent possible, due to a combination of two facts: first, environmental regulation has to trade off environmental benefits against the costs of the regulation. The benefits and the costs of any policy are likely to be *unevenly distributed across countries*, however. Second, unilateral policy decisions concerning any type of policy are likely to, more or less, *neglect foreign interests*, and there is no strong reason to believe that matters are any different with regard to unilateral decisions concerning environmental policies.

A globally efficient EP would have to trade off gains against costs across all countries concerned. The current legal regime, at least superficially, seems to choose a very different regulatory mode. Through the GATT, it imposes restrictions on permissible EP that are totally insensitive to the international distribution of the benefits and costs of regulation, leaving countries with the right to pursue any unilateral policy as long as it does not violate the non-discrimination provisions. It is unclear whether the *default rules* improve matters from an efficiency point of view. On the one hand, they cannot override restrictions imposed by the GATT rules. On the other hand, the rules point to e.g. international agreements in case of conflict, and they also contain a reasonableness standard, which may be seen as urging countries to take trans-boundary effects into account. But these rules are in a sense softer than those

concerning e.g. the territoriality principles, and the effects doctrine, so it is unclear what value they would have.

These conclusions are not meant as a criticism of either GATT/WTO law or the *default rules* – it may be that the nature of the incomplete contracting problem is such that these laws are as reasonable as could be hoped for. Instead, our conclusion is the conventional conclusion, that there is a need to look for complementary bargaining solutions for the regulation of environmental hazards with trans-boundary effects. It seems as if the current legal regime is not likely to handle such problems in a desirable manner.

We summarize this final point as follows:

Observation 4:

The WTO Agreement does not allow for any weighting of national interests in the regulation it imposes on unilateral environmental policies. The default rules possibly go somewhat in this direction, but their prescription is unclear in this regard. An environmental agreement would likely enhance efficiency.

(5) The most important conclusion in the paper is the following. the very purpose of the GATT is to harmonize conditions of competition *within* and not *across* markets. Societies make different choices as to the level of taxation, the level of EP, the level of antitrust enforcement etc. All such choices affect trade, even if only remotely so. By signing the GATT (and then the WTO), trading partners accepted to conduct trade on the basis of such differences.

Observation 5:

Unless we account for Default Rules, we risk interpreting the GATT against its purpose, which is to serve as a negative integration scheme.

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