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Introductory Remarks

Climate change is a multi-faceted discussion: for the trading community, one of many contentious issues in the policy debate over how to deal with greenhouse gas (GHG) emissions is the appropriate role of Border Carbon Adjustments (BCAs)/Border Tax Adjustments (BTAs).[1] The role of BCAs has been analyzed in a very large policy discussion literature, as well as in a significant number of academic writings in both law and economics. One can safely summarize the state of each of these literatures as bewildering: in the legal literature there is still no consensus as to whether such measures are legal under the WTO Agreement, and while the economic literature often show that such schemes in theory at least

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[1] The term BTA specifically refers to tax measure, but the taxes could be imposed for any reason (including *e.g.* revenue collection). The term BCA instead applies to measures with a specific purpose — to reduce carbon emissions — but includes any measure imposed at the border aiming at an equalization policy treatment of the embedded carbon content of like foreign and domestic products, regardless of whether the measure takes the form of a tax or a regulation. Since we are here concerned with adjustment schemes in the context of climate policy, we will use the term BCA unless we specifically refer to tax measures.

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could have a role to play, there is doubt whether the literature addresses the concerns of critics of BCA schemes. The views concerning BCAs also differ widely in the policy areas. For instance, in November 2006 French Prime Minister de Villepin voiced his concerns with countries that will not take part in a successor to the Kyoto Protocol, expressing fear that this will lead to both competitiveness problems for European industry, and to carbon leakage. Some form of BCA was suggested to cope with these problems. However, the European Trade Commissioner Peter Mandelson discouraged effectively shelved this proposal arguing that such policies would ultimately prove counter-productive, since international cooperation was claimed to be necessary to combat climate change. In 2009 German officials even called a French proposal to target countries that would not participate in reductions of GHG a form of "eco-imperialism."[2] The purpose of this paper is to discuss the legal possibility for WTO Members to use trade remedies in the form of BTAs/BCAs against other WTO Member, without pronouncing on the policy question concerning the desirability for such schemes.

In Section 2, we take this discussion within the legal multilateral trade context: we explore the question under what conditions recourse to BTAs/BCAs is consonant with WTO law. The Section provides the relevant regulatory framework that a WTO adjudicating body must have recourse to in order to adjudicate a dispute like the one presented here. Section 3 then seeks to determine how a WTO adjudicating body would likely view BTAs/BCAs. Section 4 changes the perspective, and discusses the question of how BTAs/BCAs should be viewed. We here first briefly highlight the view of the legal doctrine, and then turn to our own proposed approach. To ease the exposition we consider a series of scenarios in which an importing country levies carbon tariffs on the exports of a country with less ambitious environmental policies. Section 5 concludes.

I. The GATT Framework

Since BTAs/BCAs are domestic instruments they must comply with Art. III GATT. Following the advent of the WTO, the original GATT (1947) has been superseded by a new instrument, the GATT 1994 which comprises not only the

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[2] Recently, similar concerns have been voiced by US policy makers. The Obama Administration has expressed willingness to join a successor to the Kyoto Protocol but has also argued that non-signatories should be punished for not joining in. As in the case of Europe though, no concrete measure has been adopted as yet (the Waxman-Markey Act was before the Senate at the moment of writing). Moreover, this is hardly an exclusively international issue: North Dakota recently voiced its concern with Minnesota's willingness to enact and apply a carbon tax, stating that it was prepared to sue, see "N.D. likely to sue Minnesota over carbon tax," *Bismarck Tribune*, December 29, 2009, *available at* <http://digg.com/environment/N_D_likely_to_sue_Minnesota_over_carbon_tax>.

original text but also all decisions by the GATT CONTRACTING PARTIES, that is, the highest organ competent to adopt decisions that bind the GATT membership. One such decision is the report of the *Working Party (WP) on Border Tax Adjustments* which discusses head on the issue of consistency of BTAs with the WTO.

1. The Mandate of the WP

The WP was requested to pronounce on the GATT-consistency of practices by the GATT contracting parties referred to as border tax adjustments. The term border tax adjustment is explained in § 4 of the final report:[3]

> ... 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).

The *destination principle* was taken over from bilateral agreements negotiated in the 1930s, such as the agreement of May 6, 1936 between the United States and France.[4]

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[3] *Border Tax Adjustments, Report of the Working Party*, December 2, 1970, GATT Doc. L/3464, BISD 18S/97.

[4] See § 10 of the Annex to the Working Party report on Border Tax Adjustment. See also Douglas Irwin, Petros C. Mavroidis & Alan O. Sykes, *The Genesis of the GATT* (2008). Economists have used more or less the same definition for the term BTA. This is, for example, how Johnson and Krauss describe border tax adjustments: "A border tax, properly interpreted, is a tax imposed when goods cross an international border, and as such must be inimical to international trade and therefore to the achievement of the economic benefits of international specialization and division of labour. A border tax adjustment, on the other hand, is an adjustment of the taxes imposed on a producer when the goods he produces cross an international border. ...Under the origin principle, a tax is imposed on the domestic production of goods, whether exported or not, and under the destination principle, the same tax is imposed on imported goods as on domestically-produced goods destined for consumption by domestic consumers, while domestically produced goods destined for consumption by foreigners enjoy a rebate of the tax. The origin principle involves no tax adjustment, but the destination principle involves a border tax adjustment to the full extent of the tax." Harry Johnson and Mel Krauss, "Border Taxes, Border Tax Adjustments, Comparative Advantage, and the Balance of Payments," *Canadian Journal of Economics*, Vol. 3, No. 4 (1970), pp. 596-597. See on this score the pioneer analysis of Grossman, Gene M. Grossman, "Border Tax Adjustments: Do they Distort Trade?," *Journal*

The mandate included any fiscal measure. Further, § 5 of the final report makes it clear that, for a measure to be considered a BTA and thus be covered by the WP report, the adjustment does not have to take place at the border, that is, at the moment a good goes through customs; it can take place at a later stage, that is, after the importation-related procedures have been completed, assuming, of course, that the rationale for its imposition is the crossing of the border. Hence, the work of the WP concerned instruments which normally come under the purview of Art. III.2 GATT. Art. III.2 GATT is not the only GATT legal provision that is relevant when it comes to operating border tax adjustments. The members of the WP agreed that five other GATT legal provisions were relevant in the examination of the GATT consistency of BTAs: Arts. I, II, VI, VII, XVI GATT. Art. II.2(a) GATT provides that:

> Nothing in this Article shall prevent any contracting party from imposing at any time on the importation of any product:
> (a) a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part.

This provision makes it clear that the trading partners can impose (domestic) taxes beyond customs duties to the extent that their taxes observe the discipline embedded in Art. III GATT. Recently, the AB, in its report on *India — Additional Import Duties*,[5] confirmed this understanding of the ambit of Art. II.2(a) in the following terms (§ 153):

> Article II:1(b) clarifies that the tariff binding in the relevant column of a Member's Schedule of Concessions provides an upper limit on the amount of OCDs and ODCs that may be imposed. Article II:2, in turn, clarifies that

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of International Economics, Vol. 10 (1980), pp. 117-128.

[5] For an economic/legal discussion of the *India — Additional Import Duties* dispute, see Paola Conconi, and Jasper Wauters, "Appellate Body Report, India — Additional and Extra-Additional Duties on Imports from the United States (WT/DS360/AB/R, adopted on 17 November 2008)," forthcoming Henrik Horn and Petros C. Mavroidis, The WTO Case Law of 2008, Cambridge University Press: Cambridge, UK (2010). There is no formal *stare decisis* (binding legal precedent) in the WTO. Adopted panel reports, nonetheless, are expected to be followed by subsequent panels dealing with the same issue since, by virtue of Art. XVI of the Agreement Establishing the WTO, they provide guidance as to the understanding of the terms of the legal provision that they were called to interpret, see Petors C. Mavroidis, "No Outsourcing of Law? WTO Law as Practiced by WTO Courts," *American Journal of International Law*, Vol. 102 (2008), pp. 421-474.

> nothing in Article II, including Article II:1(b), shall prevent a Member from imposing on the importation of a product:
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> > (i) a charge equivalent to an internal tax imposed consistently with Article III:2 in respect of a like domestic product; (ii) an anti-dumping or countervailing duty applied consistently with Article VI; or (iii) fees or other charges commensurate with the cost of services rendered. The chapeau of Article II:2, therefore, connects Articles II:1(b) and II:2(a) and indicates that the two provisions are inter-related. Article II:2(a), subject to the conditions stated therein, exempts a charge from the coverage of Article II:1(b).

Art. I GATT also comes into play because, unless respected, trading partners could afford a trade advantage by, for example, adjusting taxes for goods of a certain origin and not for others. The Working Party also had to consider Art. XVI GATT, which allows trading partners to exempt from taxation goods destined for consumption abroad without qualifying similar practices as subsidy, and Art. VI GATT because, unless otherwise specified, the lower price of a good is being exported (resulting from non-taxation) could qualify as dumping. Finally, Art. VII GATT was also relevant since a BTA should not be equated to a customs fee or formality that is covered by this provision. Recall that customs fees and formalities must be commensurate to the cost of the service rendered (as per the adopted panel report on *US — Custom User Fee*); a BTA is normally unrelated to the cost of service rendered — indeed very often no service at all is being rendered. If BTAs were to be considered as coming under the purview of Art. VII GATT, they would thus, be running afoul this provision.

The negotiators agreed that the destination principle circumscribed the taxes that could be lawfully adjusted. § 4 of the final report of the WP explains the destination principle in the following terms:

> ...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.

Taxation could thus, in principle be adjusted by both the importing and the exporting state. The next question was who should, or rather who should not perform the adjustment? The GATT contracting parties reached agreement on some measures, and did not on many others. The extent of their agreement is reflected in the following paragraph (§ 14 of the report):

> ... 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.

There was divergence of views[6] regarding the eligibility for adjustment of *taxes occultes* and some other taxes such as *property taxes*. The scarcity of complaints with respect to either of these two taxes however, persuaded negotiators to stop negotiating on them (§ 15 of the final report). Finally, there was agreement between negotiators that some taxes, such as *cascade taxes*, were eligible for adjustment, the modalities for adjusting them though were not clear (§ 16 of the final report).

The preceding analysis unambiguously supports the conclusion that the *Working Party on Border Tax Adjustments* did not manage to resolve all ambiguities and disagreements regarding tax adjustability. Disagreements between trading partners regarding similar issues continued to persist and some of them found their way into GATT/WTO adjudication. Notoriously, the United States subsequently enacted the *DISC*-, and *FSC*-legislations, both of which were condemned, the first by a GATT panel, the second by a WTO panel and the AB.[7] Nevertheless, there was agreement in the WP concerning at least some of the taxes. Note that nowhere does the report outlaw the use of BTAs for purposes of environmental protection. Hence, we can conclude that the narrowing down of the scope of Art. III GATT that took place through this report did not affect the possibility for countries to enact BTAs in order to advance environmental goals.

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[6] On the extent of disagreement, see also Matthew Genasci, "Border Tax Adjustments and Emissions Trading: the Implications of International Trade Law for Policy Design," *Carbon and Climate Law Review*, Vol. 2 (2008), pp. 33-42.

[7] US — DISC, the GATT predecessor of US - FSC, was adjudicated during the GATT years. At stake was a US tax legislation on Domestic International Sales Corporations. In brief, a US company that would qualify as a DISC company would not be subjected to US federal income tax on its current or retained export earnings. Following a complaint by Canada and the European Community, the panel found that the US tax legislation constituted an export subsidy and was thus inconsistent with Art. XVI GATT. See *US — Tax Legislation (DISC), Report of the Panel*, November 12, 1976, GATT Doc. L/4422, BISD 23S/98, and 28S/114. See also the very thorough analysis of the case by Jackson (1978).

2. The Legal Value of the Final Report

The report of the WP on BTAs was adopted by the GATT CONTRACTING PARTIES, that is, the highest organ of the GATT and the sole competent to adopt similar acts. The legal value of such acts is addressed in GATT, as it has been amended following the successful conclusion of the Uruguay round, albeit in unclear terms: there is doubt whether the WP report is a decision by the CONTRACTING PARTIES, and thus come under the purview of Art. 1(b)(iv) GATT 1994, or whether it is part of the GATT *acquis*, and then come under the purview of Art. XVI of the Agreement Establishing the WTO. No matter how it is classified, the WP report will have legal significance. If, however, it comes under the former it should be regarded as binding on all WTO Members, whereas if it comes under the latter it should be regarding as creating legitimate expectations that WTO practice will be guided by it.

In light of the legal significance of the WP report on BTAs, it is to be expected that WTO adjudicating bodies will outlaw as GATT-inconsistent those taxes that were agreed to be treated as non-adjustable, such as payroll taxes. It could further be the case that WTO adjudicating bodies outlaw as GATT-inconsistent any other tax (not mentioned in the report of the WP) which exhibits features similar to those explicitly mentioned. Such a conclusion is warranted if adjudicating bodies were expected to view the taxes explicitly mentioned as forming an integral part of an indicative list (a rather safe assumption).

II. BTAs in Dispute: A Positive Analysis

Let us consider the case where an otherwise identical product is produced in an exporting country, with a production technology that emits more GHG emissions per unit of output compared to when the product is produced in the importing country. The importing country levies a GHG emissions tax on domestic production, and also operates a BTA scheme that taxes the imported product the same way that the domestic product is being taxed. The exporting country does not operate such a scheme. Clearly, central to the adjudicating body's determination would be to evaluate the compatibility of the BTA scheme with Art. III GATT. It would then proceed as follows:

(a) Art. III GATT does not request from WTO Members to adopt internationally efficient policies:[8] it simply imposes certain non-discrimination

[8] See in general Gene M. Grossman, Henrik Horn, Petros C. Mavroidis, and Alan O. Sykes, "National Treatment," (mimeo, 2010); Henrik Horn and Petros C. Mavroidis, "Still Hazy After All These Years," *European Journal of International Law*, Vol. 15 (2004), pp.

restrictions on the difference in taxation of imported and local products. This means that inefficient but nondiscriminatory taxation is perfectly consistent with the GATT rules. Hence, the adjudicating body will not inquire into the efficiency of the measure when evaluating the Art. III claim (the effect of the measure, in other words, is immaterial in case law);

(b) if the imported goods are like, they should be taxed equally;

(c) if the two products are unlike, they might still qualify as *directly competitive or substitutable* (DCS) products. In this case, some tax differential between the two products is permissible, if it is not applied so as to afford protection (ASATAP) to domestic production. (If the products are neither like nor DCS, the importing WTO Member can of course treat the two products in any differential manner it wants.)

Would the two products in our example be considered by the panel/AB as like? Since the concern is a fiscal instrument, the directly relevant cases are the AB reports on *Japan — Alcoholic Beverages II*, and *Korea — Alcoholic Beverages*. In these two cases the AB established that for two products to be like they must be DCS, and share the same (detailed) tariff classification.

It is consumers' perceptions that will decide whether two products are DCS: recourse to econometric indicators (cross price elasticity) is not *passage obligé*; in the AB's view recourse to elements such as consumer preferences, end uses, physical characteristics are appropriate means to define whether two goods are DCS. In short the two methods (econometric-, noneconometric indicator) are equivalent in case law. In *EC — Asbestos*,[9] adjudicated after *Japan — Alcoholic Beverages II*, the AB contributed additional understanding of likeness. This case concerned the consistency of a non-fiscal instrument (a sales ban) with Art. III.4 GATT. As such it is only indirectly relevant to border taxes. The AB did however further interpret the marketplace-test as established in the two cases mentioned above. It did not state that its interpretation of the test was confined to Art. III.4 GATT, and it could thus be expected that it will apply this approach in cases involving fiscal instruments as well. Then, what did the AB add in this case? Recall first that the EU distinguished between asbestos-containing and asbestos-free construction material, allowing the sale of the latter and banning the sale of the former. Canada complained, arguing that the two products were like and therefore differ-

39-69; and Petros C. Mavroidis, *Trade in Goods*: the GATT and the other agreements regulating trade in goods (2007).

[9] See Henrik Horn and Joseph H.H. Weiler, "EC — Asbestos," in Henrik Horn and Petros C. Mavroidis eds., *The American Law Institute Reporters' Studies on WTO Case Law* (2007), pp. 27-53.

ential treatment was not justified. The panel had found that two products were like by referring to marketplace-criteria. In a dramatic overturning of the panel decision, the AB decided that the two products were unlike: remarkably, the AB overturned the outcome while sticking, in name at least, to the marketplace-test: in the eyes of the AB, knowing that one construction material contains asbestos and that the other one does not, and further knowing the health hazard associated with consumption of the asbestos-containing product, a "reasonable" consumer would not treat the two as like products. Since the two products are unlike, the EU was legitimized to treat them in unlike manner.[10]

Even if the products are found to be unlike, they can still be found to be DCS, and violate the discipline for such product pairs. Two products are DCS, according to the Interpretative Note ad Art. III GATT if they are in competition. Case law, *Korea — Alcoholic Beverages* being the most recent pronouncement, has underlined that this is a question of actual consumer behavior (even though the AB has also found that Art. III.2 and Art. III.4 GATT are coextensive, and its findings concerning like products are in principle applicable to the term DCS as well). Hence,

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[10] It remains to be seen whether this deferential standard of review will be confined to public health-relates cases only, as Sykes has suggested, or whether it will find wider application (see Alan O. Sykes, "The Least Restrictive Means," *University of Chicago Law Review*, Vol. 70 (2003), pp. 403-416). It is often difficult, if not impossible altogether, to establish a bright line delineating the scope of environmental protection from that of public health: in the long run, there is a presumption (at the very least) that environmental hazards affect human health. Hence, by the same reasoning as in *EC — Asbestos*, a WTO adjudicating body will ask whether a reasonable consumer would distinguish between a climate-friendly and climate-unfriendly good. One can only guess as to the outcome of such a deliberation. On the one hand, it seems politically opportune, and perhaps also legitimate (in light of the health consequences), to elevate the environment to the same hierarchical value as is bestowed public health. This would suggest a similar treatment. But there are several obstacles to doing this. First, there is an important distinction between the buyer's decision regarding asbestos-containing or asbestos-free materials, and the purchasing decision regarding products that differ in the extent of GHG emissions: in the former case, buyers may prefer to purchase asbestos-free construction material for the benefit of their own health. The AB also referred to the threat of future litigation facing industrial buyers of asbestos-containing products. In the case of climate change, such arguments could hardly be made. Each buyer's consumption of a climate-unfriendly good has negligible impact on the buyer's health — instead, the environmental impact is largely an externality. A consumer may well disregard the environmental impact of his or her purchases, and this is indeed the reason for the need to regulate. But this would not constitute a legitimate reason for imposing the measure, according to the logic of EC — Asbestos. And if the argument were to be accepted also in the case of climate change, the same argument would have to be accepted in future disputes concerning differential treatment of goods that are produced using child labor, and/or in industries using more lax labor standards, etc. In sum, it does not seem as if this would be a suitable path for an adjudicating body to tread.

applied to the scenario discussed above, to the extent that the imported climate-unfriendly good is treated sufficiently differently by consumers than the locally produced climate-friendly versions, the importing state is free to tax the former at it wishes. If not, the question will be whether the tax differential by the importing country is applied so as to afford protection to domestic production. If the tax differential is more than both *de minimis* and *substantial*[11] — which we presume it to be — then the tax scheme will be found in violation of Art. III GATT, and the importing state will have to defend its measure through recourse to Art. XX GATT.

When invoking Art. XX GATT, the importing state will probably prefer to take recourse to Art. XX(g) GATT, whereby it will be requested to demonstrate that its measure relates to the protection of an exhaustible natural resource. In *US — Gasoline*, the panel held that clean air was an exhaustible natural resource (§ 6.37). Art. XX(g) GATT includes two requirements that must be cumulatively met for a measure protecting exhaustible natural resources to be judged GATT-consistent:

> (a) it must relate to the conservation of exhaustible natural resources; and
> (b) it must be made effective in conjunction with restrictions on domestic production or consumption.

In its report on *US — Shrimp*, the AB took distance from prior practice, holding that relating to means that a measure need not primarily aim at a particular means to meet the standard set in this paragraph. Even if this were not the case, that is, even if the measure aimed at something else but still contributed to the conservation of exhaustible natural resources it could still qualify as consistent with this paragraph (§ 141). Arguably, this standard is more deferential towards the regulating WTO Member than the previously employed primarily aimed-standard, since even measures which do not primarily aim at the conservation of exhaustible natural resources can be justified through recourse to Art. XX(g) GATT, assuming that they reasonably relate to the objective stated in this provision. In its report on *US — Gasoline*, the AB explained that the requirement to demonstrate that import-restricting measures are taken in conjunction with domestic measures aimed at the conservation of exhaustible natural resources was an evenhandedness requirement. It went on to stress that there was no need for an effects-test in order to comply with Art. XX(g) GATT in this respect (pp. 20-1).

In its report on US — Shrimp the AB effectively faced the question whether Art. XX(g) GATT included a jurisdictional limit, in the sense that WTO Members could intervene to protect exhaustible natural resources only within their jurisdiction, as the latter is defined by public international law (PIL). But the AB re-

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[11] The AB coined the terms *de minimis* and *substantial* in *Chile — Alcoholic Beverages*, but has so far not explained their substantive content.

frained from addressing this question whether the US measure respected the territoriality principle. In § 133 of the report the AB stated:

> 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).

Applied to our example above, it seems as if the importing country will not find it hard to defend its BTA under Art. XX(g) GATT: clean air is an exhaustible natural resource; the carbon tax scheme described above certainly relates to its protection since a rational connection between this measure and the objective can be established; the even-handedness requirement is also respected since domestic producers must respect similar environmental standards by reason of adherence of the importing state to the *Kyoto Protocol.*

Let us finally say a few words about the likely treatment of a non-fiscal BCA. The text of Art. III.4 GATT stipulates two necessary criteria for a violation:

> (a) the imported and the domestically produced goods are *like*; and
> (b) the measure affords a less favorable treatment (LFT) to the imported good.

The term *like* in this provision is coextensive with the term *DCS* in Art. III.2 GATT. Moreover, the AB in its *EC — Asbestos* case law established that the term *LFT* has symmetric meaning with the term *ASATAP.* If the two products are found to be *like*, the importing state can still exonerate the measure by demonstrating that the reason for differential treatment is not to afford protection to domestic goods. The AB made this potentially important point clear in its report on *Dominican Republic — Import and Sale of Cigarettes* (§ 98), where it held:

> The Appellate Body indicated in *Korea — Various Measures on Beef* that imported products are treated less favourably than like products if a measure modifies the conditions of competition in the relevant market to the detriment of imported products. However, the existence of a detrimental effect on a given imported product resulting from a measure **does not necessarily imply that this measure accords less favourable treatment to imports if the detrimental effect is explained by factors or circumstances unrelated to the foreign origin of the product, such as the market share of the importer in this case.** (emphasis added.)

Unfortunately, we are still in the dark as to what is necessary to demonstrate in order to absolve the burden of proof embedded in the last sentence of the quoted passage.[12] Does the invocation of an objective included in the challenged measure suffice? If not, does rational connection between the means adopted and the ends sought suffice? We are inclined to believe that a positive response to this latter question suffices for a WTO Member to be absolved of any liability under Art. III.4 GATT: otherwise, the AB would have indicated what more the respondent would have to show in order to successfully respond to a challenge of inconsistency of its practices with this provision.

Last but not least, WTO law will allow BCAs/BTAs that promote a social concern (environmental protection) and are being applied in accordance with the requirements indicated above. It will not tolerate BCAs/BTAs that are imposed solely in order to address competitiveness concerns: the first paragraph of the NT provision (Art. III.1 GATT) makes it clear that domestic instruments should not be used so as to afford protection to domestic production. As we will attempt to explain in the next Section, this objective, to which we subscribe, is better served if the approach of the WTO adjudicating bodies is modified along the lines we suggest.

Finally a couple of words on the status of an MEA under WTO rules which is at best uncertain: on the one hand, the AB seems to suggest some (unspecified) relevance of MEAs in its US — Shrimp report, where, first it invokes the *Convention on the International Trade of Endangered Species* (CITES) convention and then provides its own definition of what an exhaustible natural resource is. We are thus in the dark as to the legal relevance of CITES: is it context, or supplementary means in the VCLT sense of the terms, or is it irrelevant? On the other hand, the subsequent panel on *EC — Approval and Marketing of Biotech Products* refused to address in definitive manner this issue. Based on this, Mavroidis (2008) concludes that the status of MEAs in WTO law is at best uncertain.[13]

III. BTAs in Dispute: A Normative Analysis

The purpose of this Section is to discuss our preferred approach and show our differences with what has been exposed so far. In a nutshell, we propose that when reviewing challenges against BTAs/BCAs, panels should be constructing Art. III GATT in its legal context, that is, taking into account the default rules of public (customary) international law allocating jurisdiction. This is a matter of legal compulsion since all WTO Members, by virtue of their appurtenance to the interna-

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[12] On this issue, see Henrik Horn and Petros C. Mavroidis, "Burden of Proof in Environmental Disputes in the WTO: Legal Aspects," *European Energy and Environmental Law Review*, Vol. 18 (2009), pp. 112-140.

[13] Mavroidis, *supra* note 5, pp. 469 *et seq.*

tional community, must act in respect of the default rules. Controlling for them has two important consequences:

(a) WTO Members will have to exercise jurisdiction in *reasonable* manner. The default rules include an element of proportionality and outlaw disproportional exercise of jurisdiction. This could be particularly important in cases where countries take measures to address environmental hazards that do not affect them at all (we will provide illustrations to this effect in what follows);[14]

(b) When more than one countries can legitimately exercise jurisdiction, the default rules encourage reasonable (that is, not disproportionate) exercise of jurisdiction, and even recourse to bargaining solutions in order to avoid jurisdictional conflicts (or, even, higher transaction costs). MEAs can of course also serve as bargaining solutions to address problems that affect more than one jurisdiction.

We start this Section with an overview of the legal doctrine regarding the consistency of BCAs/BTAs with the GATT rules. This is necessary in order to show the differences between our approach and what has been said on this issue so far.

1. Legal Scholarship on BCAs/BTAs

A number of authors have focused on the issue whether tax distinctions can be based on production process methods (PPMs) that have not been incorporated in the final product, a natural focus given the nature of GHG emissions. Pauwelyn (2007) argues that a textual reading of Art. II.2(a) GATT suggests that regulatory distinctions based on non-incorporated PPMs are illegal. He correctly points to the fact that in the notorious *Superfund* dispute the panel did not explicitly pronounce on this issue. Recall that Art. II.2(a) GATT reads:

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[14] Compare with the approach of WTO adjudicating bodies as discussed in Section 3: the current construction of the WTO regulatory framework probably (depending on how much one sees in the AB report on *US — Shrimp* which discusses the nexus between the regulator and the regulated activity) does not outright disallow measures which address environmental hazards that do not affect the regulating state. If however, this is indeed the case, then how can WTO adjudicating bodies claim that they still construct GATT law so as to allow for measures that promote social values while disallowing measures motivated by competitiveness-related concerns? While we do not exclude that a WTO Member might wish to address local environmental hazards that do not affect it and still not be motivated by competitiveness concerns, the presumption is much stronger when the hazard is trans-boundary.

> Nothing in this Article shall prevent any contracting party from imposing at any time on the importation of any product:
> (a) a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part;

Pauwelyn concludes that the question whether WTO Members can adjust taxes on similar grounds (to counteract non incorporated PPMs) is at best an open issue, and should probably be given a negative response.[15] Similar thoughts have been expressed by Roessler.[16] Howse and Eliason disagree with Pauwelyn, arguing that border tax adjustments under Art. III GATT already are permissible.[17] They adopt a contextual reading of Art. II GATT and borrow from the Agreement on Subsidies and Countervailing Measures to make the point that when Art. II.2 GATT speaks of manufacturing it should be understood as encompassing the process from which the final product is derived without asking the question whether the process has been incorporated in the final product or not. Hufbauer *et al.* are not as categorical as Pauwelyn: they cast doubt on the consistency of BTAs/BCAs with WTO law but prefer to evaluate whether this is indeed the case under Art. III GATT (and, depending on the facts of the case, under the SCM Agreement).[18] Potts provides a thorough analysis of similar measures under Art. III GATT and its conclusions are generally in line with our analysis in the preceding Section.[19] The same holds for Démaret and Stweardson[20] as well as for Quick[21] who, however,

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[15] Joost Pauwelyn, *US Federal Climate Policy and Competitiveness Concerns: the Limits and Options of International Trade Law*, Working Paper, prepared by Nicholas Institute for Environmental Policy Solutions, Duke University (2007).

[16] Frieder Roessler, "Diverging Domestic Policies and Multilateral Trade Integration," in Jagdish Bhagwati and Robert E. Hudec eds., *Fair Trade and Harmonization*, Vol. 2: Legal Analysis (1996), pp. 21-56; *idem*, "Beyond the Ostensible, A Tribute to Professor Robert Hudec's Insights on the Determination of the Likeness of Products Under the National Treatment Provisions of the GATT," *Journal of World Trade*, Vol. 37 (2003), pp. 771-781.

[17] Henrik Horn and Petros C. Mavroidis, "Still Hazy After All These Years," *European Journal of International Law*, Vol. 15 (2004), pp. 39-69.

[18] Clyde Hufbauer, Steve Charnovitz, and Jisun Kim, *Global Warming and the World Trading System* (2009).

[19] Jason Potts, *The Legality of PPMs under the GATT — Challenges and Opportunities for Sustainable Trade Policy* (2008).

[20] Paul Démaret and Raoul Stewardson, "Border Tax Adjustments under GATT and EC Law and General Implications for Environmental Taxes," *Journal of World Trade*, Vol. 28 (1994), pp. 5-65.

[21] Reinhard Quick, "Border Tax Adjustment in the Context of Emission Trading: Climate

emphasizes the Art. XX GATT angle.

2. Our Approach

Our argument is broadly structured as follows:

(a) Art. II GATT deals with bound tariffs. But there are no tariff classifications included in the Harmonized System that make distinctions based on non incorporated PPMs (some classifications deal with inputs and/or their final products). It is thus only normal that Art. II.2(a) GATT refers to inputs and final products. Consequently, Art. II GATT was not intended to circumscribe the ambit of Art. III GATT;

(b) Art. III GATT contains no exhaustive list of measures WTO Members can use. The only legal instrument in the WTO outside GATT 1947 that could restrict the right of Members to use BTAs, is the WP on BTAs. As discussed above, this report reflects the agreement of the WTO Membership (since this report is integral part of GATT 1994) that some domestic instruments (*e.g.*, income taxes) cannot legitimately form the subject matter of BTAs by the importing state. But environmental BTAs have not been included in this agreement. There are hence no explicit restrictions on the use of BTAs in the WTO Agreement. This is legally significant, since the presumption in international law is that unless an international discipline has been agreed, states are free to unilaterally define preferences;

(c) The legitimacy of BTAs is, absent international agreements on BTA (for instance, in the context of a MEA), fundamentally a question of jurisdiction. The default rules allocating jurisdiction (territoriality, nationality) in public international law can substantially advance legal security. Although concurrent exercise of jurisdiction cannot be outright excluded, the default rules' principle of reasonableness in the exercise of unilateral jurisdiction (which is compulsory), as well as their reference to bargaining solutions (which are encouraged) can help avoid concurrent exercise of jurisdiction by various states which is problematic when the substantive law differs across the states exercising jurisdiction;

(d) The substantive consistency of exercised jurisdiction with the WTO rules will arise if, and only if, the measure is permissible under the default rules: in its report on India — Additional Duties, the AB held that

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Protection or Naked Protectionism?," *Global Trade and Customs Journal,* Vol. 3, No. 5 (2008), pp. 163-175.

the legal benchmark to evaluate the substantive consistency of a measure (BTA) with the WTO is provided by Art. III GATT (and, if need be, by Art. XX GATT).

Let us now turn to a more detail description of our argument. Art. III GATT requires WTO Members to not afford protection to domestic production through their domestic instruments. The GATT does not impose any common policies on WTO Members; they remain free to define their policies regulating fiscal matters, competition, public health, the environment, etc., in any manner they deem it appropriate. The GATT does not put into question the resulting regulatory diversity. Put differently, Art. III GATT is meant to equate conditions of competition within markets, not across markets. A study of the negotiating record of the NT provision points to two conclusions:[22]

(a) This provision was thought as an anti-circumvention device, that is, as a means to safeguard the value of tariff concessions that would be exchanged in the first multilateral negotiation in Geneva (1948);
(b) With the exception of specific domestic instruments that have explicitly been exempted from coverage in the body of the provision, NT was meant to cover all domestic instruments, whether of fiscal- or non fiscal nature.

Neither the NT provision, nor the GATT more generally, include any explicit specification of the permissible jurisdictional reach of the WTO Members' domestic policies that are covered by the NT provision; the NT provision is concerned only with the issue how domestic instruments can be practiced. But the GATT is still permeated by the notion that WTO Members retain sovereignty over domestic policies, as long as such instruments are not used for protectionist purposes. Absent such an understanding the whole GATT loses its effectiveness.

To demonstrate this point, 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. Assume, first, that there are absolutely no jurisdictional restrictions on permissible policies.[23]

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[22] See Irwin *et al.*, *supra* note 4, pp. 138-143.

[23] This scenario is also discussed in Henrik Horn and Petros C. Mavroidis, "The Permissible Reach of National Environmental Policies," *Journal of World Trade*, Vol. 42 (2008), pp.

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-neighbor-like features in the tax schemes. An agreement binding border instruments would in all likelihood have no impact at all, absent jurisdictional 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-thyneighbor behavior.

Suppose next that the agreement on tariffs is coupled with a NT-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.

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.[24]

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 is based on implicit jurisdictional principles — the agreement would probably be meaningless absent adherence to these principles.

The default rules allocating jurisdiction across state actors are part and parcel of public international law.[25] There are two common bases included in the default

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1107-1178.

[24] 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 perfectly mimic a tariff of this magnitude. See also, Aaron Cosbey, *Trade and Climate Change Linkages: A Scoping Paper Produced for the Trade Ministers' Dialogue on Climate Change Issues*, Bali, Indonesia (December 8-9, 2007).

[25] In this paper we will refer alternatively to PIL and customary international law (CIL) and use them as equivalent terms for the needs of this paper: this is so, since the rules concerning allocation of jurisdiction form integral part of CIL, which itself forms integral part of PIL.

rules concerning jurisdiction: the *territoriality* principle[26] — and the *nationality* principle, which could be summarized as follows:

(1) The rules apply in situations where:
   a. we are neither in the realm of universal jurisdiction;[27]
   b. nor has a bargaining solution (international agreement) been negotiated;

(2) A state can lawfully exercise prescriptive jurisdiction:
   a. on all activities occurring in its own territory (territoriality principle);[28]
   b. over its nationals, even for acts, omissions committed outside its territory
   (nationality principle);
   c. In case of conflict[29] between the two bases, the territoriality principle prevails;

(3) 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).

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[26] 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.

[27] This basis comes into play for cases such as terrorism.

[28] 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 (in which some take the view that absent permissive international rules, no unilateral exercise of jurisdiction is permissible, and some argue that international law can impose limits only to the exercise of unilateral jurisdiction) is futile. For the type of situations that are of interest here, it will inevitably be the case that more than one jurisdiction believe it can exercise jurisdiction.

[29] The interpretation of the term conflict is crucial here. Some states interpret it strictly, understanding conflict as a situation where the individual concerned cannot simultaneously comply with the legislation of two (or more) states. Others have adopted a looser standard, leaning against the comity principle; some states will weigh the respective interests to regulate a particular transaction and will give allow another state to regulate the transaction if they judge that it has more of an interest to do so, even if the individual concerned could, in theory at least, comply with both regimes.

A crucial 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)[30] takes the view that, at the very least, a jurisdiction must demonstrate substantial, direct, and foreseeable effects upon its territory to legitimately exercise jurisdiction.

What exactly substantial, direct, and foreseeable means is unclear in general, and will necessarily depend on the case at hand. Using the example of an environmental damage in case of a river, it seems reasonable to interpret these terms as follows:

(1) the effects will be direct if nothing intervenes between the upstream pollution of the river and environmental damage downstream;
(2) they will be foreseeable if the direction of the flow is clear; and
(3) depending on the extent of the environmental pollution, the effects could be substantive.

Being part of customary international law, the meaning of the default rules should ultimately be determined by state practice, and by the decisions by international courts, as well as arbitral bodies. But state practice provides us, alas, with incoherent responses: some states liberally assert jurisdiction, and other states are more conservative.[31]

The lack of clarity in state practice with respect to reasonableness in the exercise of jurisdiction is echoed in lack of unanimity in doctrine when addressing this issue, exemplified in the divergent views of Kramer[32] and Lowenfeld[33] 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 claiming it alone had the right to prescribe jurisdiction over

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[30] See *Restatement of the Law Third, Foreign Relations Law of the United States* (1990), 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. See also *ibid.*, pp. 244 *et seq.*

[31] 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 Andreas Lowenfeld, "Conflict, Balancing of Interests, and the Exercise of Jurisdiction to Prescribe: Reflections on the Insurance Antitrust Case," *American Journal of International Law*, Vol. 89 (1995), pp. 42-53.

[32] Larry Kramer, "Extra-territorial Application of Antitrust Law after the Insurance Antitrust Case: a Reply to Professors Lowenfeld and Trimble," *American Journal of International Law*, Vol. 89 (1995), pp. 750-775.

[33] Lowenfeld, *supra* note 31.

this particular transaction.[34]

The fact that there is occasional disagreement among states when it comes to practicing restraint does not mean that the requirement for reasonable exercise of jurisdiction has subsided. Moreover, to avoid that this is the case, public international law encourages the negotiation of bargaining solutions, that is, contractual arrangements which address the jurisdictional conflict and promote a course of action that should be followed by all signatories. MEAs are very much a bargaining solution.

Recourse to default rules thus acts as a break beyond that imposed by the report of the WP on BTAs: for instance, a WTO Member will find it hard to demonstrate that its measures are necessary in order to promote environmental protection when addressing an environmental hazard that occurs outside its jurisdiction and that does not affect the environment in the Member's territory, since it will have to show direct, substantial and foreseeable effects stemming from this hazard into its market. Recall that, the WP on BTAs did not outlaw such measures. Moreover, in cases of uncertainty as to who should exercise jurisdiction, bargaining solutions (say in the form of MEA) emerge. A few remarks are pertinent:

(1) MEAs normally specify who can intervene to regulate a particular transaction coming under its purview, and thus allocates jurisdiction;
(2) The question of substantive consistency of a measure with the MEA is more delicate:
    (a) It is clear that, unless the MEA codifies customary international law, third parties do not have to abide by it, by virtue of the legal maxim *pacta tertiis nec nocent nec prosunt*. This principle has little effect though, since the importing state can anyway request from the exporter conformity with its legal system, irrespective whether the latter has been defined unilaterally or through an MEA. In other words, a WTO Member can request compliance with its laws (which mirror the MEA in which it participates) without invoking the MEA. The substantive content of the MEA would thus be *de facto* but not *de jure* relevant;
    (b) The question can legitimately be raised whether WTO Members can, through an MEA, modify the WTO contract? The straightforward response is no: amendments of the contract can take place only through the procedure established in Art. X of the Agreement Establishing the WTO. So the substantive obligations of an MEA

[34] In this vein, for example, in our 2008 paper we found diverging state practice regarding the treatment of transboundary moral externalities, leading us to conclude that the state of law on this issue is unclear.

explaining how to deal with say sea turtles by definition do not modify the GATT, since the GATT does not deal with this issue at all. An MEA, nonetheless, can encroach on the GATT if it, for example, requests that certain environmentally unfriendly goods be excluded from the markets of its signatories. Then the question will arise of whether these products are like more environmentally friendly products will arise. If the two sets of products are considered like, the differential treatment might be GATT-inconsistent. But the answer to the latter question does not depend on whether an MEA has been signed or not: WTO Members can unilaterally decide their environmental policies to this effect. An MEA, if at all, will be evidence of extra legitimacy for certain social choices (in the sense that the regulating state is not alone in thinking in this way, but one of several like minded WTO Members). In other words a panel should address the question whether such regulatory distinctions are permissible under the GATT as it has developed through case law over the years, irrespective of the invocation of an MEA. Trachtman, coming from a different angle, points to the same direction: the MEA will serve as interpretative element of an instrument coming under the purview of Art. III GATT (how do some WTO Members understand environmental protection for say GHG emissions).[35] As to whether some can decide for all, our response under point 1 above obtains here as well.

Concluding Remarks

There is increasing political pressure in several countries to complement more stringent climate policies with some form of BCA/BTA regime. This raises two obvious questions from the point of view of an international regulation of such regimes. A first question concerns their desirability. It is clear that governments may enjoy the protection they yield, if nothing else, for the same reason that they enjoy other forms of protectionism. But for an international regulation the interesting question is whether they are in some sense globally desirable?[36] The second question of interest concerns their legality under the WTO. Is it likely that a WTO adjudicating body would accept a BCA/BTA scheme as legal, and should they?

The main focus in the paper has been on the second question, whether BTAs

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[35] Joel Trachtman, "The Domain of WTO Dispute Resolution," *Harvard International Law Journal*, Vol. 40 (1999), pp. 333-377.

[36] This question is discussed in Jagdish Bhagwati and Petros C. Mavroidis, "Killing the Byrd Amendment with the Right Stone," *World Trade Review*, Vol. 3 (2004), pp. 1-9.

are lawful under the WTO. The relevant legal provision to discuss substantive consistency of a BTA/BCA with the WTO law is Art. III GATT. Unfortunately, the text of the provision is too vague to make allow a direct judgment on the legality of these schemes, and despite 60 years of case law, and a Working Party assigned the task of delimiting the legality of BTAs, it is still not clear how a WTO adjudicating body would treat a complaint. (What seems more predictable however, is that a BCA/BTA could be designed such that an Art. XX(g) exception would be granted.)

To address this unsatisfactory state of affairs concerning the ambit of Art. III GATT, we propose that when interpreting Art. III GATT, adjudicating bodies should first ask the question whether the importing state has the right to regulate. This is basically a question of the allocation of jurisdiction, and therefore takes the analysis within the four corners of the default rules allocating jurisdiction across states. As interpreted, for a state to have jurisdiction, these rules require that there are direct, foreseeable and substantial effects on the states territory. They also require that states exercise jurisdiction in reasonable manner. These restrictions are likely to significantly circumscribe the possibility of to pursue BTAs in general, but at the same time seem likely to accept climate-related BTAs. For instance, by imposing the requirement for reasonable exercise jurisdiction, the default rules reinforce the objectives sought by Art. III GATT, that is, to ensure that recourse to domestic instruments will not be made in order to address competitiveness concerns of the regulator.

An explicit reliance on the default rules would also remedy a closely related weakness in the current case law, which is the role of MEAs. The rules emphasize the desirability of bargaining solutions (such as MEAs) in situations where different principles for the allocation of jurisdiction are in conflict. Hence, to the extent that BTA schemes form part of MEAs, they would be considered legal under the WTO.

The current construction of the relevant WTO rules concerning BCAs/BTAs is, in our view, wanting in several respects. It is clear that compliance of such schemes with Art. III GATT must be ensured. But WTO case law has, nevertheless, almost completely ignored MEAs, which often discuss the modalities for permissible action through such schemes in sufficient detail; Moreover, case law has completely ignored the default rules in public international law regarding allocation of jurisdiction across states. We believe that, were WTO adjudicating bodies to control for these elements (MEAs, default rules), the outcomes of the adjudication process would become more predictable.