Trade Measures for Climate Compliance: A Critical view

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Trade Measures to Ensure Compliance: The Arguments

- International trade and climate change mitigation are already linked
  - Efforts to reduce emissions will alter market prices of traded goods, causing comparative advantage in the greenhouse-gas-intensive industries to shift towards other countries – carbon leakage
  - Free trade can be injurious to efforts to reduce emissions because of the potential of leakages
  - Linking climate and trade policy holds the promise of improving the prospects for mitigating climate change
- Use of trade measures was one of the major factors behind the success of Montreal Protocol (MP)

The MP Example for Climate Change: Are we on the same page?

- The obvious differences between MP and climate change
  - Narrow vs. very broad product coverage made trade measures easier to implement
    - √ Only 8 groups of commodities covering 10 6-digit tariff lines covered by MP
  - Availability of finance and technology for implementing the commitments under the Montreal protocol
    - √ Created positive incentive for developing countries to accede to the agreement
    - √ Made obligations of the treaty including trade restrictions seem fair and therefore legitimate

Use of Trade Measures: The key propositions

- Whether the possible use of trade restriction is "fair" and "legitimate" and supported by large number of countries
- Assessment of the "fairness" and "legitimacy" of the trade restrictions
  - If trade restrictions like carbon tariffs are not likely to be WTO compatible, then is it fair and legitimate for the EU and the US to use such measures by violating their WTO commitments?
  - Remedies through the imposition of trade measures should not be worst than the malady

The Context

- Proposal to introduce "Border Tax Adjustment" (BTA) aimed at imports from countries not implementing comparable GHG (green house gas) emissions reduction policies by both European Commission and the United States
  - Addressing the risk to competitiveness of domestic industries on account of the so-called 'carbon leakage'

Proposed BTAs

- Included in the post-2012 climate change and energy package finalized by the European Commission (EC) in December 2008
  - Aims at achieving at least a 20 per cent reduction in GHG emissions from 1990 levels by 2020, raising the target to 30 per cent in the event of an international agreement (under the UNFCCC)
  - Commits other developed countries to comparable emission reductions and economically more advanced developing countries to contribute adequately according to their responsibilities and respective capabilities
- BTA proposals in the American Clean Energy and Security Act of 2009 (introduced by Senators Henry Waxman and Edward Markey)

Essentials of Proposed BTA by EC

- Basis provided by the strengthening and expanding the Emissions Trading System (EU ETS)
  - Much larger share of allowances was to be auctioned in the third phase of the ETS (2013-20) instead of being allocated for free, which is the predominant practice under the first two phases (2005-07 and 2008-12, respectively)
  - Scope of the ETS to be extended with the inclusion of a number of new sectors like aluminium and ammonia, as well as two more GHGs (nitrous oxide and perfluorocarbons) under its purview (in addition to CO_2
- "Carbon Equalization System" (CES) aims at ensuring that the Community producers in the energy-intensive, trade-exposed sectors are provided a "level playing field" *vis-à-vis those based in the* targeted countries, i.e. other developed countries and major emitting developing countries
  - Increased cost that the EU producers in these sectors would have to incur to comply with the revamped cap-and-trade system post-2012 would be effectively neutralized

The Issue

- Whether the CES would be consistent with the commitments taken by the EC at the WTO
  - WTO compatibility or otherwise of the CES is based on readings of the relevant provisions of the WTO Agreements and the rulings of the GATT/WTO dispute settlement bodies pertaining to those provisions in earlier cases

What is Border Tax Adjustment (BTA) ?

- Guided by provisions of Articles II and III of GATT
  - Article II:2(a): WTO Members are allowed to impose 'at any time on the importation of any product a charge equivalent to an internal tax imposed…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
  - Article III
    - √ Imported products shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products
    - √ No WTO Member 'shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner' that affords 'protection to domestic production'

Can EU ETS be considered as a Tax?

- According to the OECD, the term "taxes" is confined to ***compulsory***, ***unrequited payments*** to general government
  - Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments
- EU ETS are "compulsory"
  - All covered installations must hold emission allowances and failure to meet the targets would attract sanctions
- EU ETS are in the nature of 'unrequited payments'
  - Increases production costs of the covered installations
    - √ For undertaking measures for controlling emissions;
    - √ For acquiring emission allowances in case emissions exceed the allotted quotas.
  - Need to hold emission permits 'almost exclusively serves the interest of the wider community', and does not give anything specific in return to the firms
- Proposed Carbon Equalisation System (CES) may therefore be considered as carbon tax imposed on imports to compensate for the carbon cost borne by the domestic installations in EU Member States

CES "adjustable" at the border?

- Article III allows all internal taxes imposed ***directly or indirectly*** on ***like domestic products can*** be adjusted at the border
  - Ambiguity as regards the extent to which indirect taxes on inputs, incorporated or exhausted in the production process, can be adjusted at the border
- US-Superfund case provided some guidance in this regard
  - Panel considered that taxes on substances entering in the composition of the final product could be adjusted at the border
- However, it is not clear whether BTA would be allowable if the input concerned is not physically incorporated in the final product , e.g. energy consumed and carbon emitted during production

Can Products be Differentiated on the Basis of Their Carbon Contents?

- GATT/WTO jurisprudence suggests four criteria may be taken into account for determining 'likeness' of products
  - Product's properties, nature and quality, i.e. the physical properties of the products
  - Product's end-uses in a given market, i.e. the extent to which the products are capable of serving the same or similar end-uses
  - International classification of the products for tariff purposes
  - Consumers' tastes and habits, i.e. the extent to which consumers perceive and treat the products as alternative means of performing particular functions in order to satisfy a particular want or demand
- Appellate body in EC Asbestos: "any determination of 'like' products would need to take into account all the criteria, even if they provide 'conflicting indications"
- There is only a remote possibility that products may be differentiated solely on the basis of their carbon content for the purpose of the National Treatment requirements under the GATT

Violation of Article III:2 by the Proposed CES: Other Possible Reasons

- Auctioning was proposed to be ***dominant*** method of distribution of allowances
  - How to determine the tax to be applied on imports in such a situation where some of the allowances are handed out for free to a domestic firm, while the rest are required to be bought at auction?
- Partial free allocation of allowances to the domestic producers, while there is no provision for free allocation for imported products subject to BTA, may be construed as a violation of Article III:2
  - Fails to provide 'equality of competitive conditions' for imported products in relation to domestic products and fails to 'protect expectations' of the 'equal competitive relationship' between imported and domestic products

Justification of CES under GATT Article XX Exceptions

- 'General Exceptions' provisions under Article XX allow WTO Members, subject to certain conditions, to deviate from their GATT obligations to serve certain legitimate policy objectives, including those
  - Necessary to protect human, animal or plant life or health [Article XX(b)]
  - Relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption [Article XX(b)]

Extra-territoriality, PPM and Article XX

- Proposed CES would not only fall in the category of extra-territorial trade measures but would also clearly constitute a PPM-based measure

Article XX Requirements and the CES

- Use of a two-tiered test:
  - Provisional justification by reason of characterization of the measure under one of the exceptions listed out in Article XX
  - Further appraisal of the same measure under the introductory clauses of Article XX

Article XX(b) Tests and the Proposed CES

- Panel in US – Gasoline prescribed the following three-tier test for Article XX(b):
  - That the policy in respect of the measures for which the provision was invoked fell within the range of policies designed to protect human, animal or plant life or health
  - That the inconsistent measures for which the exception was being invoked were necessary to fulfil the policy objective
  - That the measures were applied in conformity with the requirements of the introductory clause of Article X

CES and Article XX(b) Tests

- Justification of the CES would not be a difficult proposition, given that the emission trading system was put in place by the EU as one of the mechanisms to implement its Kyoto commitments and that climate change is predicted to affect the basic elements of life for people around the world
  - Access to water
  - Food production,
  - Health and the environment
- CES has been proposed by the EU with the aim of addressing the risk of 'carbon leakage', i.e. the risk of relocation of GHG emitting activities from the EU to third countries not having similar carbon constraints, thereby increasing global emissions
- CES stands a high chance of being regarded as falling within the range of policies designed to protect human, animal or plant life or health
- Necessity Test
  - Whether the CES can be regarded as 'necessary' to protect human, animal or plant life or health
  - Whether CES would be able to pass the necessity test, if it is interpreted as 'least-trade restrictive', would depend on whether another alternative less-trade-restrictive measure is available that may reasonably be employed by the EU and that is either GATT-consistent
- Considering the enormous importance attached to the problem of climate change, CES may find it relatively easy to pass the necessity test.

Article XX(g) Tests

- Based on three sets of criteria
  - Whether the planet's atmosphere is an exhaustible resource
  - Whether the CES relates to the conservation of the planet's atmosphere
  - Whether the CES is made effective in conjunction with restrictions on domestic production and consumption
- Shrimp-Turtle I Appellate Body on the meaning of term 'exhaustible natural resources'
  - to be interpreted in the light of contemporary concerns of the community of nations about the protection and conservation of the environment
- Appellate Body in *US – Gasoline*
  - A measure would qualify as 'relating to the conservation of natural resources' if the measure exhibited a 'substantial relationship' with, and was not merely 'incidentally or inadvertently aimed at' the conservation of exhaustible natural resource
- Appellate Body in *US – Gasoline*
  - The term 'measures made effective in conjunction with' as a 'requirement of even-handedness in the imposition of restrictions'

Article XX Chapeau Tests

- Article XX Chapeau: Measures are not applied in a manner which would
  - constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or
  - a disguised restriction on international trade
- Appellate Body in Shrimp-Turtle I and II, and *US – Gasoline on* "arbitrary or unjustifiable discrimination between countries where the same conditions prevail"
  - Procedures must follow 'basic fairness and due process' to meet the test of "arbitrary or unjustifiable discrimination"
- Three criteria introduced by panels and the AB to determine whether a measure is a disguised restriction on international trade
  - Publicity test
  - Consideration of whether the application of a measure also amounts to arbitrary or unjustifiable discrimination
  - Examination of 'the design, architecture and revealing structure' of the measure at issue

CES and Article XX Chapeau Tests

- EU must not require the exporting countries to adopt policies towards climate change mitigation that are 'same' as those adopted by the EU
- EU should design the measure in such a manner that 'there is sufficient flexibility to take into account the specific conditions prevailing in exporting Member
- If the application of the CES fails to take into account the specific conditions prevailing in developing countries and does not pay heed to the efforts made by these countries towards adoption of 'nationally appropriate' mitigation actions, then there is a high chance that it may be regarded as 'arbitrary or unjustifiable discrimination' under Article XX *chapeau and therefore fail to* pass the *chapeau test.*

Thank you