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BORDER TAX ADJUSTMENT HOW FAR A LEGITIMATE MEANS OF POLLUTION CONTROL

Vinayak Pandey
Faculty at School of Law, Galgotias University, Greater Noida

ABSTRACT

Environmental disquiets induced countries all over the globe to adopt and effectuate stringent legislative measures. However it raised concern related to competitiveness of their industries in like products imported from countries that do not observe same environmental standards. Border tax Adjustment (BTAs) was conceptualized as a means and mechanism to overcome the apprehension of competitive disadvantage detrimental to exports generated due to adoption of environmental measures.

Border Tax Adjustment (BTAs) or Border Carbon Adjustment (BCAs) has been pushed as means to address competitiveness anxiety. A border tax adjustment was regarded as any fiscal measures which put into effect, in whole or in part, the destination principle. A BCA would charge imported goods the equivalent of what they would have had to pay had they been produced domestically, in the manner of a border tax adjustment. Such a scheme might also rebate the paid tax to exporters, ensuring that they are not disadvantaged in international markets.

Legal consistency of carbon tariffs under relevant World Trade Organization (WTO) rules is subjected to obligations provisioned under Article I:1 (MFN principle), Article III:2 (National Treatment principle) of GATT 1994. Additionally, if carbon tariffs violate any one of the two mentioned articles, legality of carbon tariffs can still be approached under Article XX of GATT 1994, under which exceptional provisions are expressly stipulated.

Keywords: Border tax Adjustment, Trade law, WTO, environment, climate protection, domestic products, import and exports, carbon emissions

INTRODUCTION

As a response to the concerns about climate change emerging from greenhouse gas emissions, countries around the world commit to reduce CO_2 emissions. However, under current United Nations Framework Convention on Climate Change's principle, which suggests "common but differentiate responsibility", some countries, particularly, developed countries concern that once they implement domestic CO_2 emissions abatement programs and internalize CO_2 emissions, competitiveness of their industries will be affected adversely by "like products" imported from countries that do not bear same or similar CO_2 emissions obligations.[1]

The developed world, which has set itself high emission targets, sees its efforts nullified by the starkly increasing emissions in these emerging developing economies. In late 2006 France government put forward the idea of introducing a carbon border tax on imports from countries that refuse to commit to the Kyoto

* Faculty at School of Law, "Galgotias University", Greater Noida, Uttar Pradesh

[1] Berstein, P.M., W.D. Montgomery, T.F. Rutherford, and G-F. Yang, 1999: Effects of Restrictions on International Permit Trading: The MS-MRT Model, The Energy Journal, Kyoto Special Issue: 221-256.

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Protocol.[1]This French initiative as per a report submitted in the French Parliament was rooted in the fact that failure to apply the Kyoto Protocol outside Europe would lead to a competitive disadvantage detrimental to the region's exports.[2]

Border Tax Adjustment (BTAs) aim to eliminate the competitive disadvantage that domestic industries would face as a result of climate protection instruments, by imposing equivalent taxes on imports. This would create a level playing field where the costs incurred by import manufacturers are on a par with those incurred by domestic producers that must comply with domestic or EU climate protection measures to which the importers are not subject. In the end, all like products within the territory of a country would be subject to the same level of burden (in keeping with the destination country principle). In addition, this would allow for reimbursement of domestic or European additional costs on non-European exports, so as to level the playing field in foreign markets in respect to the burden engendered by climate protection measures.[3]

The present study is related with the analysis of the meaning of border tax adjustment and its relation with carbon emission reduction, specially the legislative competitiveness of the adjustment and the legitimacy of the border tax adjustment under WTO rules.

MEANING

The term border tax adjustments was regarded "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)".[4]

The term "border tax adjustment" had given rise to much confusion because it implies that the adjustment necessarily takes place at the border whereas this is not the case. In fact, under certain tax systems exports never become liable to tax and so no adjustment actually takes places at the border; in addition, under certain tax systems imports are usually taxed, as is home production, by the importing country at the time they are sold by registered traders to other traders or consumers, and so the adjustment takes place after the goods cross the border. For this reason it is recommended that the term "border tax adjustments" should be replaced by "tax adjustments applied to goods entering into international trade".[5]

LEGISLATIVE COMPETITIVENESS

If the Inter Governmental Panel on Climate Change (IPCC) is to be believed and as its projections are the basis for at least some of the post 2012 discussions the Green House Gas (GHG) emissions reductions

[1]French Prime Minister's, Dominique de Villepin, speech before the interministerial committee for sustainable development 13 November 2006, found at the time at www.premier-ministre.gouv.fr/acteurs/interventions

[2] The rapporteur at the time was the present State Secretary for the environment, Nathalie Kosciusko-Morizet. The full report is available at http://www.assemblee-nationale.fr/12/pdf/rap-info/i3021- tI.pdf.

[3] Ismer/Neuhoff, Border Tax Adjustment: A feasible way to address non-participation in emission trading, Working Paper 2004; and Ismer/Neuhoff: Border Tax Adjustment: A feasible way to support stringent emission trading, Working Paper 2007; the authors operate on the assumption that such trading is WTO compliant and propose relevant measurement methods. Also see: Javier de Cendra, Can Emissions Trading Schemes be coupled with Border Tax Adjustments? An Analysis vis-à-vis WTO-Law, RECIEL 15 (2), 2006, 131; the author operates on the assumption that a border tax adjustment for emissions trading would be WTO compliant.

[4]The GATT Report of the Working Party, Border tax adjustments, L/3464,adopted on 2 December 1970.

[5] Id., para 5; at 1.

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needed will be significant. This is particularly true in developed countries where cuts of 50–80 percent by 2050 may be necessary to avoid dangerous levels of atmospheric GHG concentration[1].

In response to that challenge, a number of countries are pursuing or considering strong domestic action to address climate change[2]. They are doing this either in anticipation of future regime obligations, as part of their obligations under the current treaties, or out of a desire to address the challenge of climate change irrespective of what might develop at the international level. In those countries, one of the key obstacles to such action is the fear that it may put their domestic industries at a disadvantage relative to producers in countries that do not take similarly strong action.

Border Carbon Adjustment (BCAs) has typically been touted as means to address competitiveness concerns[3]. While a BCA could conceivably work in conjunction with any number of domestic climate change regimes, it has been proposed to date as a companion to either a domestic carbon tax or a cap and trade scheme.

In the case of a carbon tax, a BCA would charge imported goods the equivalent of what they would have had to pay had they been produced domestically, in the manner of a border tax adjustment. Such a scheme might also rebate the paid tax to exporters, ensuring that they are not disadvantaged in international markets. In the case of a cap-and-trade scheme, a BCA would force domestic importers or foreign exporters of goods to buy emission permits based on the amount of carbon emitted in the production process, in a requirement analogous to that faced by domestic producers[4].

They might play at least two other useful roles. One is to avoid what is known as carbon leakage. That is, if strong domestic action causes firms to relocate to other countries, or to lose market share to those countries, then the emission reduction achieved at home is simply offset to some extent by an increase in emissions abroad. The fear in fact is that they will be *more* than offset, as production moves to low-standard jurisdictions. While it is closely related to competitiveness, carbon leakage is a distinct concern, focusing on the effectiveness of environmental policy. A final justification for a BCA is that it might act as an effective threat to encourage developing countries to take on hard commitments in the climate change negotiations in the manner of trade sanctions, or threats of trade sanctions[5].

Not *all* domestic producers will be subject to competitiveness impacts from foreign producers. Some, for example, may not trade their goods across borders in any significant measure. It is widely accepted that the following types of sectors are the ones that might be vulnerable:

- Those that use large amounts of energy in the production process;
- Those for which there are easy substitutes, either in the form of imports of the same good (highly traded goods), or in the form of different goods that can serve the same purpose; and

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[1] Intergovernmental Panel on Climate Change, 2007. Working Group III Contribution to the Fourth

Assessment Report of the Intergovernmental Panel on Climate Change, Climate change 2007: Mitigation of climate change. Geneva: IPCC Secretariat, at 15,available on: http://www.ipcc.ch/pdf/assessment-report/ar4/wg3/ar4-wg3-spm.pdf (visited on 10/04/2012).

[2]See "American Clean Energy and Security Act of 2009", "America's Climate Security Act", "Low Carbon Economy Act"

[3] Supra note 3.

[4] John Whalley, On the effectiveness of carbon-motivated border tax adjustments, Asia-Pacific Research and Training Network on Trade Working Paper Series, No 63, March 2009, p. 3 (www.artnetontrade.org), p. 4.

[5] Carolyn Fischer and Alan K. Fox, Comparing Policies to Combat Emissions Leakage: Border Tax Adjustments versus Rebates, Resources for the Future Discussion Paper 09-02, p. 6. (www.rff.org)

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- Those for which there are no cost-effective technologies available or in the pipeline that would lower carbon intensity[1].

The extent of vulnerability will of course vary from country to country, depending on predominant production techniques and energy sources, and even from facility to facility. While this sort of research is indispensable as a basis for sound policy, it typically suffers from two weaknesses that may cause it to overstate the extent of vulnerability. For one thing, most models assume unilateral action the implementing country takes action, but no other country does. This may be a necessary simplifying assumption, but in the final event it is not realistic. For another thing, top-down general equilibrium models for assessing the impacts of domestic policies will typically understate the ability of those policies to drive technological change that might blunt competitiveness impacts in the longer term.

LEGITIMACY OF BORDER TAX ADJUSTMENT UNDER WTO RULES

Legal consistency of carbon tariffs under relevant World Trade Organization (WTO) rules is subjected to obligations provisioned under Article I:1 (MFN principle), Article III:2 (National Treatment principle) of GATT 1994. Additionally, if carbon tariffs violate any one of the two mentioned articles, legality of carbon tariffs can still be approached under Article XX of GATT 1994, under which exceptional provisions are expressly stipulated.

ARTICLE II: 2 OF THE GATT 1994

Under WTO regime, Article II:2 of GATT 1994 sets forth relevant rules on border tax adjustment. It indicates that parties are permitted to impose "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."It is found that Article II:2 of GATT 1994 regulates two types of eligible border tax adjustments. The first type is to impose tariffs on imports that are "like products" of domestically produced products. In respect of the first type, taxes are imposed based on the product itself. However, according to current researches on carbon tariffs, carbon tariffs are mostly levied in light of quantities of CO2 emissions produced during the production process. This, however, involves to the second type of eligible border tax adjustment, under which tariffs are charged in light of the article from which the imported products are manufactured or produced in whole or in part[2].

Whether or not CO2 emitted from production process can be considered as "article from which the imported product has been manufactured or produced in whole or in part" is controversial. Because it is argued that CO2 is not a physical matter used for making the imported product, and only physically incorporated articles are covered by Article II:2(a). This view actually narrows the coverage of the term "article from which the imported product was manufactured". As interactions between trade and climate change have been clearly recognized, it is very likely that WTO will employ a broad interpretation on "article from which the imported product was manufactured"[3]. It would likely to accept that CO2 emitted during the production process is an article used to manufacture imported products.

The GATT Panel's decisions in US-Taxes on Petroleum and Certain Imported Substances case[4] also might provide support for the notion. In that case, the GATT panel ratified that imposing taxes on certain chemicals as well as on imported products produced by using a substantial quantity of those chemicals was consistent

[1] OECD, 2006. "The Sectoral Competitiveness Issue – Theoretical Studies," in The Political Economy of Environmentally Related Taxes. Paris: OECD. pp. 67-87.

[2] Biermann, F. & Brohm, R., (2005). Implementing the Kyoto Protocol without the United States: The Strategic Role of Energy Tax Adjustments at the Border. Climate Policy, Vol. 4, No. 3, pp. 289–302.

[3] Ibid.

[4] United States Taxes on Petroleum and Certain Imported Substances ("Superfund"), Report of the Panel adopted on 17 June 1987, BISD 34S/136.

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with Article II:2(a). The tax on the imports was intended to equalize the charges "to amount of the tax which would have been imposed under the Superfund Act on the chemicals used as materials in the manufacture or production of the imported substance if the taxable chemicals had been sold in the United States for use in the manufacture or production of the imported substance".

NATIONAL TREATMENT PRINCIPLE

Article III:2 of the GATT 1994 provisionally requires a WTO Member to treat imports the same way as that on its domestic products. This is called "national treatment" requirement. It rules that "the products of the territory of any contracting party imported into the territory of any other contracting party 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. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1."According to WTO dispute body's previous interpretations, in terms of carbon tariff, Article III:2 might require the comparison to be made between the tax imposed on a domestic product and the tax imposed on the foreign "like product"[1].

WTO dispute settlement body's viewpoints on "like products" are the crucial point. In respect of carbon tariffs, the question is whether the same products with different CO2 emissions will not be determined as "like products". In EC-Asbestos case[2], the Appellate Body explained that the concept of "like products" refers to "the nature and extent of a competitive relationship between and among products".5 Moreover, the Appellate Body also outlined four basic factors that shall be considered: (i) physical properties, nature and quality of the products; (ii) end-uses of the product; (iii) consumers' tastes and habits; and (iv) similar tariff classification. However, as emphasized by the Appellate Body in that case, these criteria must not be regarded as legally binding or exhausted.

Panel of EC-Asbestos concluded that chrysotile asbestos and PCG fibres are "like products" under Article III:4 of the GATT 1994. But, after examining the four factors motioned above, the Appellate Body reversed the Panel's ruling. Particularly, it found that Panel erred in excluding the health risks associated with chrysotile asbestos fibres from its examination of the physical properties,6 because PCG fibres do not involve the same risks to health as chrysotile asbestos fibres.

Considering the negative effects on climate and human health brought by CO2 emissions, it can be seen that the Appellate Body would likely to determine that products with high contents of CO2 emissions and products with a relevant low CO2 emissions are not "like products".

Under current systems, carbon tariffs are basically levied on the basis of CO2 emissions amount emitted from production processing. Imports from developing countries usually have relatively low energy efficiencies, and emit larger CO2 during production process compared with the identical products made in developed countries. As a result, although one unit of CO2 to be charged the same price, charges based on CO2 emissions amount will result a higher tax burden on foreign producers. This might not conform to requirements of national treatment factually. However, if products associated with different CO2 emissions to be regarded as "like products", then carbon tariffs would successfully avoid being inconsistent with Article III:2 provided that foreign and domestic producers are subject to the same level of tax for a given quantity of CO2 emissions.

MOST FAVORED NATIONAL PRINCIPLE

The most favoured nation (MFN) principle regulated by Article I:1 of the GATT 1994 involves different carbon reduction commitments, which is the original motivation directly entailing carbon tariffs. Article I:1

[1] Japan – Taxes on Alcoholic Beverages, Report of the Appellate Body, adopted 1 November 1996, WT/DS8/AB/R,WT/DS10/AB/R, WT/DS11/AB/R, p. 24

[2] European Community – Measures Affecting Asbestos and Asbestos-Containing Products, Report of the Appellate Body, WT/DS135/AB/R, adopted 5 April 2001, para 168.

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elaborates that "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties".

In Indonesia-Autos case[1], the WTO panel explained that advantages "cannot be made conditional on any criteria that are not related to the imported product itself." As regards to carbon tariffs, Article I:1 will not allow WTO Members to impose carbon tariffs which discriminate among foreign producers.

Carbon tariffs are designed to impose CO2 emissions costs on products imported from countries that do not take comparable actions as the importing country. Countries with comparable CO2 emissions costs might be exempted from paying extra CO2 costs. It seems that a carbon tariff on the surface does not actually provide any benefits to producers from particularly countries. But in actual implementation, how to evaluate whether or not a importing country actually adopts a comparable CO2 scheme will be problematic and easily cause debates on different treatment among WTO Members.

ARTICLE XX (B) AND (G) OF GATT 1994

WTO dispute body has acknowledged that some extents of trade restriction may be necessary to achieve certain policy objectives as long as provisionally set conditions are satisfied. In case of not ruling a carbon tariff is in consistency either with national treatment principle or MFN principle by WTO dispute body, WTO Members could still invoke Article XX to pursue legality of their measures.

Appellate Body has divided obligations that need to be satisfied under Article XX into two steps: firstly, a complained measure has to fall into one of the specified exception provisions. Then, the measures will be scrutinized in the context of "chapeau" of Article XX to be determined finally.

GATT ARTICLE XX (B) AND (G)

In order to provisionally justify a measure under Article XX (b), the measure must be proved that it is necessary for protection of human, animal or plant life or health. In Korea-Beef case[2], the Appellate Body specifically indicated three factors on requirements of Article XX (b). Firstly, the Appellate Body will contemplate the relative importance of "common interests" or "values" that the measure at issue attempts to pursue. It argued that the more vital or important those common interests or values are, the easier the complained measure to be accepted as "necessary". The second factor that would be reviewed by the Appellate Body involves the evaluation of the extent to which the measure contributes to the realization of the intended policy objectives. The greater the contribution, the more easily a measure might pass the test and to be considered as "necessary". The last aspect that the Appellate Body mentioned in Korea-Beef case to review necessity of a challenged measure is the extent of the restriction effect to which the measure brings negatively on international trade. A measure with a relative slight impact upon imported products might more easily be considered as "necessary" than a measure with intensive or broader restrictive effects.

With regard to requirements put by paragraph (g), three conditions shall be satisfied. Firstly, the resource to which the measure relates must be an exhaustible natural resource. Secondly, the measure must "relate to" the conservation of the exhaustible natural resource. Lastly, the measure must be made effective in conjunction with restrictions with domestic production or consumption. In US-Gasoline case[3], the Appellate Body ruled that cleaning air is an exhaustible resource. Therefore, following above reasoning, carbon tariffs aiming at reducing CO2 emissions will be determined fall into converge of (g) on the ground of conservation of the exhaustible natural resource.

[1]Adopted 23 July 1998, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R.

[2]WT/DS161/R, WT/DS169/R, 31 July 2000.

[3] United States Standards for Reformulated and Conventional Gasoline, Report of the Appellate Body, adopted on 20 May 1996, WT/DS2/AB/R, DSR 1996:I, p. 19.

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The objective pursued by carbon tariffs is to equalize costs difference caused by reduction of CO2. As long as Members who adopt carbon tariffs keep this purpose in mind, rather than with an intention to protect domestic industries from competition, it will be sufficiently to argue that carbon tariffs are "relate to" the goal of reducing CO2 emissions, which is now treated as an important common interests to reach.

THE CHAPEAU OF ARTICLE XX

Chapeau[1] of Article XX exists as a further condition for recourse to the general exceptions. It requires a measure pursuing legality not to constitute an "arbitrary or unjustifiable discrimination between countries where the same conditions prevail" or a "disguised restriction on international trade".

Chapeau of Article XX is not just regulated against facially discriminatory measures, but also against substantively discriminatory ones.

In US-Shrimp case[2], the Appellate Body explained that although the complained measure of the United States did not break the requirement of paragraph (g), while, the action of the United States during its implementation constitute "arbitrary or unjustifiable discrimination" for following reasons: 1) it failed to engage other WTO Members in good faith negotiations for the purpose of creating an agreement for the protection of the resource; 2) the United Sates cannot force another country to adopt "essentially the same" environmental program.

As a result, carbon tariffs might be viewed as constituting "arbitrary or unjustifiable discrimination". Firstly, although carbon tariffs are collected on the basis of one unit of CO2 emissions, they actually compel other countries to adopting the same standard as that of its domestic measure, which can be considered forcing another country to adopt "essentially the same" environmental program. Secondly, the fact that domestic firms purchase allowances corresponding to their actual emissions, while importers must purchase allowances with average emissions by producers of that category of products from that country likely cannot be justified under Article XX.

In US - Gasoline case[3], the United Sates argued that it would be administratively difficult to provide individualized baseline pollution levels for all gasoline imports, and that a statutory baseline applicable to all imports should thus be permissible under Article XX. Both the Panel and the Appellate Body rejected that argument. The Appellate Body did not support administrative difficulties could be used to justify individualized treatment for domestic producers and more general treatment for foreign producers.

CONCLUSION

WTO did not decline the use of border tax adjustments on imported products, and carbon tariffs would probably be determined to be consistent with national treatment since WTO dispute settlement body might not treat a product with high CO2 emissions and that product emitting low CO2 as "like products". But, carbon tariffs still would not easily gain its legality under the WTO because of their different treatments between domestic producers and foreign producers, and among foreign producers. Requirement of "most favoured nation" treatment might be violated. Additionally, although the WTO has showing increasing efforts to grant flexibility on trade-related climate measures, defence under Article XX would not be justified easily.

So it becomes pertinent for the WTO member countries to imposing carbon tariffs with rationality. Also, given the fact that carbon tariffs are unilateral action taken by WTO members individually, they have to be dealt with cautions. Otherwise, it would not only depress international trade, but also would trigger intensive trade battles between WTO Members.

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[1] Cf. e.g. Quick/Lau (Fn. 34) at 440 ff.

[2] United States Import Prohibition of Certain Shrimp and Shrimp Products, Report to the Appelate Body, adopted on 6 November 1998, WT/DS58/AB/R, DSR 1998:VII, p. 2803 ff.

[3] Supra note 20,at 25.

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Therefore, from point of view of the WTO, it probably prefers to solve climate-related trade issues under multilateral framework. Thus, even though WTO leaves legal space for carbon tariffs, it remains a high demand on the design of carbon tariffs. Domestic measures providing carbon tariffs have to be optionally designed with cautions, bearing those rules in mind as far as possible.