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The European Union's Proposed Carbon Equalization System:  
Can it be WTO Compatible?

Biswajit Dhar and Kasturi Das

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Core IV-B, Fourth Floor, India Habitat Centre  
Lodhi Road, New Delhi – 110 003 (India)  
Tel: +91-11-2468 2177/2180; Fax: +91-11-2468 2173/74  
Email: [publication@ris.org.in](mailto:publication@ris.org.in)

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# The European Union's Proposed Carbon Equalization System: Can it be WTO Compatible?

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Biswajit Dhar\*

Kasturi Das\*\*

**Abstract:** Numerous political statements by the world leaders on the urgency of reaching an ambitious climate deal in Copenhagen notwithstanding, the actual discussions at the UNFCCC (United Nations Framework Convention on Climate Change) continue to be shrouded by daunting North-South divide, dimming the hope of sealing a deal in December 2009. The negotiating climate has been further queered by the European Union (EU) and the United States (US), which have, in the recent past, made attempts to include certain unilateral trade measures in their domestic climate change regimes. Among the issues that have fuelled the debates on the climate-trade interface in the run-up to Copenhagen, perhaps the most contested one is the proposed use by developed countries of border measures on imports from countries (read 'major-emitting' developing countries) not implementing comparable GHG (green house gas) emissions reduction policies on the grounds of addressing the risk of what has been coined as 'carbon leakage'. The issue of carbon leakage has its origin in the purported apprehension in these developed countries that in the energy intensive, trade-exposed sectors, the carbon costs imposed by their domestic climate policies (e.g. carbon tax or cap-and-trade scheme) will put domestic producers at a competitive disadvantage *vis-à-vis* producers in countries not imposing similarly strict carbon constraints. It is argued that if stringent domestic climate action causes their firms to relocate to other countries with less stringent or no carbon constraint, or to lose market share to firms from countries having low emission standards, then the emission reduction achieved in countries imposing stringent measures will be offset to a great extent by an increase in emissions elsewhere. According to the developed countries, such carbon leakage could end up undermining the environmental integrity of the carbon constraining domestic policy measures. In keeping with the above arguments, law makers in both the US and the EU have proposed introduction of carbon tariffs in order to obviate the disadvantages that their domestic products may face *vis-à-vis* imports as a result of emission reduction measures being adopted by them. While the inclusion of such onerous proposals in the American Clean Energy and Security Act of 2009 (the Waxman-Markey Bill), as approved by the US House of Representatives in the end-June 2009, has generated significant furore

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\* Director-General, RIS. Email: biswajit@ris.org.in

\*\* Consultant, RIS. Email : kasturidas@ris.org.in

over the past several months, somewhat similar provisions were already included in the post-2012 climate change and energy package finalized by the EU in December 2008. It is widely argued by developing countries that such carbon tariffs on imports would be akin to protectionism in the guise of preventing global warming. Concerns have emerged among the so-called 'major-emitting developing countries' (such as, China and India), who are the main target of such measures, that these measures could act as a discriminatory market access barrier affecting their exports to the developed countries concerned in energy intensive sectors that may come under the purview of these measures. Hence, it is apprehended by them that the proposals to impose such carbon tariffs may act as an effective threat to induce them to undertake binding emission reduction commitments in the ongoing climate negotiations. It is this tacit protectionist intent allegedly underlying the proposed border measures that has triggered a huge furore among the developing countries. Another controversial issue pertaining to such carbon tariffs is whether they could be compatible with the WTO (World Trade Organization) commitments of the countries introducing such measures. This concern has found reflection not only in the post-2012 climate-energy package of the EU itself, but also in the debates on the domestic climate legislations in the EU and US. Against this backdrop, this paper makes an attempt to analyze the WTO compatibility or otherwise of the border measure proposed by the EU in its post-2012 climate-energy package. The analysis focuses on two sets of issues: (i) whether the proposed border measure could conform to the 'border tax adjustment' provisions and the Most Favoured Nation (MFN) clause of the GATT (General Agreement on Tariffs and Trade), and if not then (ii) whether the EU could justify it under the 'General Exceptions' provisions included in Article XX of the GATT that allow WTO Members, subject to certain conditions included in its *chapeau*, to deviate from their GATT obligations to serve certain legitimate policy objectives, including environmental objectives. The analysis presented in this paper indicates that the EU could face significant difficulties in establishing that the proposed border measure would be WTO-compliant. However, the devil would finally lie in the details.

## 1. THE CONTEXT

Although political leaders have tried to project global warming as a problem that the comity of nations must solve collectively, deliberations under the aegis of the UNFCCC (United Nations Framework Convention on Climate Change) has witnessed deep divisions between developed and developing countries, often reminiscent of the North-South divide of the past. As a result, the outcome of the Copenhagen Conference, the 15<sup>th</sup> meeting of the Conference of Parties of the UNFCCC (COP 15), looks to be hanging in the

balance. The negotiating pitch has been further queered by the European Union (EU) and the United States (US), which have, in the recent past, made attempts to include certain unilateral trade measures in their domestic climate change regimes. Among the issues that have fuelled the debates on the climate-trade interface in the run-up to Copenhagen, perhaps the most contested one is the proposed use by developed countries of border measures on imports from countries (read ‘major-emitting’ developing countries) not implementing comparable GHG (green house gas) emissions reduction policies on the grounds of addressing the risk of what has been coined as ‘carbon leakage’. While such a border tax adjustment, or BTA, could conceivably work in conjunction with any domestic climate change regimes, at the present juncture it has been proposed in conjunction either with a domestic carbon tax or a cap-and-trade scheme. In the case of a carbon tax, a BTA would charge imported goods the equivalent of what they would have had to pay had they been produced domestically. In the case of a cap-and-trade scheme, a BTA 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.<sup>1</sup> It is widely argued by developing countries that such BTAs on imports would be akin to protectionism in the guise of preventing global warming. Concerns have emerged among the so-called ‘major-emitting developing countries’ (such as, China and India), who are the main target of such BTAs, that these measures could act as a discriminatory market access barrier affecting their exports to the developed countries concerned in energy intensive sectors that may come under the purview of these measures. Hence, it is argued that the proposals to impose such border measures may act as an effective threat to induce them to undertake binding emission reduction commitments in the ongoing climate negotiations. It is this tacit protectionist intent allegedly underlying the proposed border measures that has triggered a huge furore among the developing countries.

The issue of carbon leakage – the ground cited by the developed countries for the proposed BTA measures on imports – has its origin in the purported apprehension in these countries that in the energy intensive, trade-exposed sectors, the carbon costs imposed by their domestic climate policies

(e.g. carbon tax or cap-and-trade scheme) will put domestic producers at a competitive disadvantage *vis-à-vis* producers in countries not imposing similarly strict carbon constraints.<sup>2</sup> It is argued that if stringent domestic climate action causes their firms to relocate to other countries with less stringent or no carbon constraint, or to lose market share to firms from countries having low emission standards, then the emission reduction achieved in countries imposing stringent measures will be offset to a great extent by an increase in emissions elsewhere. According to the developed countries, such carbon leakage could end up undermining the environmental integrity of the carbon constraining domestic policy measures. The concerns expressed by these countries related to carbon leakage are usually linked to two risks: (a) a risk of creating ‘carbon havens’ by way of attracting carbon-intensive industries in countries with less stringent carbon policies, thereby endangering the global effectiveness of carbon-constraining policies; and (b) a risk of job losses resulting from the relocation of industries to countries where climate change mitigation policies are less costly.<sup>3</sup>

In keeping with the above arguments, law makers in both the US and the EU have proposed introduction of BTA as a measure to obviate the disadvantages that their domestic products may face *vis-à-vis* imports as a result of emission reduction measures adopted by them. While the inclusion of onerous BTA proposals in the American Clean Energy and Security Act of 2009 (introduced by Senators Henry Waxman and Edward Markey, henceforth, Waxman-Markey Bill), as approved by the US House of Representatives in the end-June 2009, has generated significant furore over the past several months, somewhat similar BTA provisions were already included in the post-2012 climate change and energy package finalized by the EU in December 2008.<sup>4</sup> The EU package *inter alia* 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) committing other developed countries to comparable emission reductions and economically more advanced developing countries to contributing adequately according to their responsibilities and respective capabilities. With this aim in view, the 2008 package includes, among other things, an array of proposals towards strengthening and expanding the EU

Emissions Trading System (EU ETS)<sup>5</sup> beyond 2012 and improving its functioning. These proposals include *inter alia* the following: (i) a much larger share of allowances 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);<sup>6</sup> (ii) the 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<sub>2</sub>).

The implications of increased auctioning of emission allowances, particularly the risk of carbon leakage, dominated much of the domestic debates in the EU on the climate-energy package ever since the proposals were unveiled by the European Commission on 23 January 2008. In fact, the concerns expressed by the industry lobbies regarding these issues went on to play a significant role in the shaping up of the final version of the package that was adopted by the European Parliament on 17 December 2008.<sup>7</sup>

The climate-energy package recognizes the problem of carbon leakage as follows:

‘The Community will continue to take the lead in the negotiation of an ambitious international agreement that will achieve the objective of limiting global temperature increase to 2°C and is encouraged by the progress made in Bali (footnote omitted) towards this objective. In the event that other developed countries and other major emitters of greenhouse gases do not participate in this international agreement, this could lead to an increase in greenhouse gas emissions in third countries where industry would not be subject to comparable carbon constraints (“carbon leakage”), and at the same time could put certain energy-intensive sectors and sub-sectors in the Community which are subject to international competition at an economic disadvantage. This could undermine the environmental integrity and benefit of actions by the Community.’

The package includes two alternative strategies towards addressing the problem, namely free allocation and border measures:

‘Energy-intensive industries which are determined to be exposed to a significant risk of carbon leakage could receive a higher amount of free allocation or an effective carbon equalisation system could be introduced with a view to putting installations from the Community which are at significant risk of carbon leakage and those from third countries on a comparable footing.’

As for free allocation, it has been decided that the Community will allocate 100 per cent of allowances free of charge to sectors or sub-sectors meeting the relevant criteria. Notably, the Commission is scheduled to identify which energy intensive industry sectors or sub-sectors are likely to be subject to carbon leakage not later than 31 December 2009.<sup>8</sup> Such determination would be based on an assessment of the inability of the Community producers in a particular sector to pass on the cost of required allowances in product prices without significant loss of market share to producers from countries not taking comparable action on emissions reduction.<sup>9</sup>

On the carbon equalization system (CES), the package envisages that ‘(s)uch a system could apply requirements to importers that would be no less favourable than those applicable to installations within the EU, for example by requiring the surrender of allowances.’ This proposal apparently aims at ensuring that the Community producers in the energy-intensive, trade-exposed sectors face a level playing field *vis-à-vis* those based in the targeted countries, i.e. other developed countries and major emitting developing countries. In other words, the 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.

Importantly, the package underscores that ‘(a)ny action taken would need to be in conformity with the principles of the UNFCCC, in particular the principle of common but differentiated responsibilities and respective capabilities, taking into account the particular situation of Least Developed



Countries. *It would also need to be in conformity with the international obligations of the Community including the WTO agreement (emphasis added)*'.<sup>10</sup> In fact, there has been a wide-spread concern in the EU as to whether the proposed CES would be in compliance with its obligations at the WTO (World Trade Organization). This concern has found reflection not only in the climate-energy package, but also in statements made by various political leaders in the EU. For instance, in a speech delivered way back in December 2006, the then EU Trade Commissioner Peter Mandelson voiced his doubts about the use of this type of mechanism.<sup>11</sup> There are reasons to expect that the WTO-compatibility-related concerns may turn out to be a key determining factor behind the actual implementation or otherwise of the proposed CES.

Against this backdrop, the present paper makes an attempt to examine whether the CES would be consistent with the commitments taken by the EC<sup>12</sup> at the WTO. Given that there has never been a GATT (General Agreement on Tariffs and Trade) or WTO dispute on this issue, the analysis on the WTO compatibility or otherwise of the CES in this paper 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. It may be recalled that the doctrine of precedent does not apply in the case of GATT/WTO disputes, which implies that the findings of the earlier disputes on a particular legal provision is not binding in respect of the subsequent WTO disputes dealing with the same provision. Nevertheless, as Chimni (2002) observes, these reports form part of a growing jurisprudential *acquis* from which future panels and Appellate Bodies are not likely to depart easily.<sup>13</sup>

With this understanding, the analysis on the WTO compatibility of the proposed CES is carried out in three stages. Section 2 starts with an examination of the compatibility of the CES with the border tax adjustment (BTA) provisions of the GATT 1994, including the National Treatment (NT) obligations. Section 3 explores whether the CES could comply with the Most Favoured Nation (MFN) clause. Finally, Section 4 examines whether the CES could be justified under the General Exceptions provisions

of the GATT as enshrined in its Article XX, in case, the measure fails to comply with other substantive provisions of the GATT 1994. Section 5 concludes the paper.

## **2. CES, BORDER TAX ADJUSTMENT AND NATIONAL TREATMENT**

### **2.1 The Essentials of Border Tax Adjustment**

Through border tax adjustment (BTA) countries may impose domestic taxes and charges on imports, and exempt or reimburse them on exports. The underlying philosophy is to ensure a certain trade neutrality of domestic taxation.

In 1968, GATT Contracting Parties established a Working Party on BTAs<sup>14</sup> to examine the relevant provisions of the General Agreement, the practices of contracting parties in relation to such adjustments, as well as their possible effects on international trade. For the purpose of its examination, the Working Party used the definition of BTA applied in the OECD (Organisation for Economic Co-operation and Development) in which BTAs were 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)'.<sup>15</sup> According to the Working Party, the main articles of the GATT that had to be considered in the context of BTA on the import side were Articles II and III.

The basics of the BTA are laid out in Article II:2(a) of the GATT, which states that notwithstanding the tariff bindings specified in the schedule of concessions, 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.’ The use of this Article, however, is subject to the provisions of Article III:2, which in turn contains two sentences, requiring distinct sets of conditions to be met.<sup>16</sup> The first sentence requires that the 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* (emphasis added). The second sentence of Article III:2 requires that 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’. This provision aims at ensuring that BTA is not used for protectionist purposes.

Before delving deeper into the aforesaid legal provisions on BTA and their interpretations in the GATT/WTO *acquis*, it is important to understand whether the obligation on the domestic firms in the EU covered by the ETS to hold emission allowances up to a firm’s actual level of emissions (henceforth, ETS obligation) imposes a financial burden on the covered firms that could be akin to an ‘internal tax’ (for the purposes of a BTA as per Article II:2(a)) in purely legal terms. This is the first issue in the process of an assessment of whether the ‘burden’ borne by the domestic firms in the EU could be adjusted at the border, in accordance with the provisions of Articles II and III of the GATT 1994.

## **2.2 Are EU ETS Requirements Akin to a ‘Tax’?**

Article II:2(a) of the GATT allows WTO Members to impose a ‘charge’ on imports ‘equivalent to’ an ‘internal tax’ (imposed in respect of domestic products).<sup>17</sup> It cross-refers to Article III:2, which, in turn, talks about ‘internal taxes or other internal charges of any kind’.

The GATT panel on *EEC – Animal Feed Proteins*, however, observed that:<sup>18</sup>

‘The wording of Article II:2(a) which refers to ‘charges equivalent to internal taxes’ is different from that of Article III: 2 which refers to ‘internal taxes and other charges of any kind’, but it appeared to be the common understanding of the drafters of these articles that their scope should be the same as to the kind of measures being covered.’

The WTO panel in *India - Additional and Extra-Additional Duties on Imports from the United States* again observed that '(i)t is clear from the text of Article III:2 of the GATT 1994 that internal taxes are internal charges.'<sup>19</sup>

In view of the aforesaid renderings, the analysis here only examines whether ETS obligation is akin to a tax and does not consider the case of 'other internal charges' as a separate category.

According to the OECD, 'the term "taxes" is confined to compulsory, unrequited payments to general government.'<sup>20</sup> It is further clarified that '(t)axes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments.'<sup>21</sup> An examination of whether the OECD definition would categorise the ETS obligation as a tax requires consideration of each part of the definition: 'compulsory', 'unrequited' and 'payments'.

It is certainly compulsory for all the installations covered under the EU ETS to hold emission allowances. The binding nature of the emission caps is further reinforced by the fact that failure to meet the targets would attract sanctions.

To examine the question of 'unrequited payments', it needs to be noted that the ETS obligation increases production costs of the covered installations on two counts: for controlling emissions; and for acquiring emission allowances in case emissions exceed the allotted quotas. Now, in case all the emission permits are auctioned out, the installations are clearly required to make a payment to acquire the emission permits.<sup>22</sup> According to some analysts, since the need to hold emission permits 'almost exclusively serves the interest of the wider community',<sup>23</sup> and does not give anything specific in return to the firms (unlike in the case of a highway fee where in return for the fee the user makes use of the highway), it can easily qualify as an 'unrequited payment' which is akin to a tax. However, emission permits could 'sometimes' generate benefits for the firm holding them, since such permits are tradable and hence could potentially be sold in the secondary

market at a profit.<sup>24</sup> However, even in this case, since such prospective benefits would not necessarily be in proportion to the payments being made in auction, it may still qualify as ‘unrequited’. Examples of cases identified by the OECD, where a levy could be considered as ‘unrequited’, include, among others, the following:

‘where the government is not providing a specific service in return for the levy which it receives even though a licence may be issued to the payer (e.g. where the government grants a hunting, fishing or shooting licence which is not accompanied by the right to use a specific area of government land)’.<sup>25</sup>

The case of full auctioning of ETS permits comes close to the aforesaid example and clearly seems to be able to qualify as an ‘unrequited payment’, when such permits are being auctioned out.

In case of free allocation of permits, the amount allocated to an installation can be based on ‘grandfathering’ or a ‘benchmarking’ or a combination of the two.<sup>26</sup> Free allocation can also take into account other considerations, such as projected production levels and expected emission reduction capability.

In the EU, member countries could auction up to 5 per cent of the allowances in Phase I (2005-07) of the ETS, which has been increased to 10 per cent in Phase II (2008-12).<sup>27</sup> Even in the third phase, i.e. 2013-20, it is proposed that free allocation will continue at least partially and auctioning will only be introduced gradually in a phased manner. Hence, at least partial free allocation will continue even in the event of the EU implementing the proposed CES.<sup>28</sup>

The piquant question then is the following: can the ETS obligation be regarded as akin to a tax when allowances are handed out for free? Although in this case the covered installations would not incur any direct costs, the ETS obligation would nonetheless impose certain indirect costs. For instance, complying with the emissions cap would lead to increased resource costs as

well as regulatory costs. Moreover, in case, an installation fails to restrict itself within the allocated emissions quota, it would be required to buy extra allowances from the secondary market at the prevailing price, again incurring a cost. On the other hand, if an installation succeeds in saving some of the allowances, it can sell them out in the secondary market and earn revenue.<sup>29</sup> Hence, even though free allocation of allowances does not involve any direct payment, it does impose a financial burden or an ‘opportunity cost’ on the covered installations. Notably, the Black’s law dictionary defines tax as: ‘a monetary charge imposed by the government on persons, entities, transactions, or property to yield public revenue. Most broadly, the term embraces all governmental impositions on the person, property, privileges, occupations, and enjoyment of the people, and includes duties, imposts, and excises. Although a tax is often thought of as being pecuniary in nature, *it is not necessarily payable in money*’ (emphasis added). Given that a tax need not necessarily be payable in money, it seems plausible to argue that the ETS obligation may be regarded as akin to a tax even when all allowances are allocated for free.<sup>30</sup>

Finally, let us consider the case wherein a part of allowance quota of an installation is handed out for free and the rest is required to be bought in auction. In view of the discussions on the earlier two cases, it would not be difficult to argue that even in this case the overall financial burden imposed on the installations covered would be akin to a tax.

To sum up, the EU requirement that domestic firms hold emission allowances is most likely to qualify as an ‘internal tax or other internal charge of any kind’ as enshrined in Article III.2 of the GATT.

From the above discussion it can be surmised that the proposed carbon equalisation system (CES) may take the form of a carbon tax imposed on imports to compensate for the carbon cost borne by the domestic installations in the EU covered by the ETS. Given that the ETS obligation may be regarded as akin to a tax on domestic covered installations, it may be argued that the carbon tax to be imposed on imports would be an adjustment with respect to that tax. Alternatively, the CES may require the EU importers to take part

in the ETS alongside the domestic installations. In this case, the scenario would be a little more complicated, since both the domestic measure and the adjustment at the border would not take the explicit form of a tax. Yet, if, a domestic requirement to hold emission allowances could be qualified as, in effect, an ‘internal tax or other internal charge of any kind’ under GATT Article III:2, then so could the requirement to hold allowances for imports at the border.<sup>31</sup>

The rest of the discussion on BTA in this paper is, therefore, based on the premise that the requirements on the covered domestic installations in the EU to take part in the ETS as well as the proposed CES to be applied on imports are both akin to a tax.

Even if the requirement on the EU firms to hold allowances is akin to a carbon tax, it does not necessarily imply that this form of tax is adjustable at the border. Hence, the next question to be examined is whether this form of tax on the EU’s domestic installations belongs to the categories of taxes that are permitted to be adjusted at the border on imports as per the GATT rules. This issue is analysed in Section 2.3.

### **2.3 Product Versus Process Taxes in the Context of BTA**

Article II:2(a) of the GATT stipulates that in order to be adjustable at the border, the tax must be 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. The question is: can a carbon tax qualify under these categories of tax?

Notably, Article II:2 (a) is subject to Article III:2, which reads as follows:

‘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 [footnote omitted and emphasis added].’

Clarification regarding the eligibility of taxes for BTA was provided by the 1970 Working Party on BTA. The Working Party dwelled on the phrase ‘directly or indirectly’ as enshrined in Article III:2 and concluded that taxes directly levied on products were eligible for BTA.<sup>32</sup> While BTA is also clearly permissible for indirect taxes levied on products, there is a degree of ambiguity as regards the extent to which indirect taxes on inputs, incorporated or exhausted in the production process, can be adjusted at the border on imports. The Working Party did not reach any conclusion on this point. It merely noted that ‘there was a divergence of views with regard to the eligibility for adjustment of certain categories of tax’, such as the ‘taxes occultes’, which encompass consumption taxes on capital equipment, auxiliary materials and services used in the transportation and production of other taxable goods, as well as taxes on advertising, energy, machinery and transport. However, the Working Party did not investigate the matter further for it felt that ‘while this area of taxation was unclear, its importance - as indicated by the scarcity of complaints reported in connection with adjustments of taxes occultes- was not such as to justify further examination’.<sup>33</sup>

The case in point in this paper, however, warrants further examination of this issue, which is attempted in the discussion that follows.

First, let us consider the phrase ‘directly or indirectly’ as included in Article III:2. It has been suggested that a tax on any input to a final product or aspect of its production process may be considered to be imposed indirectly on that final product, so that Article III.2 could in principle be read so as to allow the adjustment of taxes on any input to any stage of production and distribution. A close look at the negotiating history of this provision may help in clarifying the issue better.<sup>34</sup> The records of the discussions on the drafting of the Havana Charter indicate that it was indeed the intention



of the drafters of the Charter that process as well as product charges be border adjustable. During the negotiations of the Havana Charter, the expression ‘directly or indirectly’ replaced an earlier version which referred to taxes and other internal charges ‘imposed on or in connection with like products’, because it was considered that the equivalent of the latter was difficult to translate into French. In subsequent discussions, it was stated that the word ‘indirectly’ would cover even a tax not on a product as such, but on the processing of the product.<sup>35, 36</sup>

However, even then it remains less clear whether BTA is allowable only in respect of taxes imposed on inputs physically incorporated in the final product or also on inputs that are exhausted in the production process. Article II:2(a) needs a close look in this context. It stipulates that BTA can be made with respect to ‘a charge *equivalent to* an internal tax imposed consistently with the provisions of paragraph 2 of Article III [footnote omitted] 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*’ (emphasis added). In other words, Article II.2 (a) allows WTO Members to impose adjusting charges on an imported product in respect of taxes and other internal charges imposed at a prior stage.

It is not clear whether Article II.2 (a) is intended to limit the applicability of Article III.2, so that only those taxes that are imposed on physically incorporated inputs are eligible for adjustment on the import of the ‘like’ final product, or merely to itemize one of the meanings of a tax applied ‘indirectly’ (as per Article III:2) to a product. Importantly, the equally authentic French version of Article II:2(a) refers to ‘une merchandise qui a e`te` *incorpore`e* dans i`article importe`’ (emphasis added), which seems to require that the input is physically incorporated in the imported product.<sup>37</sup>

During the negotiations of the Havana Charter, the meaning of the word ‘equivalent’ was clarified as follows: ‘(F)or example, if a [charge] is imposed on perfume because it contains alcohol, the [charge] to be imposed must take into consideration the value of the alcohol and not the value of the perfume, that is to say the value of the content and not the value of the

whole'.<sup>38</sup> This is reinforced by the findings of the *US-Superfund* case, in which the US tax was imposed on imports from Europe because they were manufactured from chemicals that would have been subject to an excise tax in the US under the Superfund Act.<sup>39</sup> The GATT panel on the *US-Superfund Case* examined whether the US tax on 'certain imported substances' (often referred to as the Superfund tax after the name of the Act imposing the tax), which taxed certain downstream imported chemicals that were derivatives of the taxable chemicals, fell under Article III. The panel observed that:

[t]he tax on certain imported substances equals in principle the 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 substances if these chemicals had been sold in the United States for use in the manufacture or production of the imported substance. In the words which the drafters of the General Agreement used in the above perfume-alcohol example: the tax is imposed on the imported substances because they are produced from chemicals subject to an excise tax in the United States and the tax rate is determined in principle in relation to the amount of these chemicals used and not in relation to the value of the imported substance. The Panel therefore concluded that, to the extent that the tax on certain imported substances was equivalent to the tax borne by like domestic substances as a result of the tax on certain chemicals the tax met the national treatment requirement of Article III:2, first sentence.<sup>40</sup>

Thus, the 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, in this particular case, whether those substances were still physically present in the final product, or they had been exhausted in the production process, and the panel made no distinction to that effect.<sup>41</sup> Thus, the jury is still out on whether BTA can be applied in respect of a tax imposed on an input, which is not physically incorporated in the final product. It would ultimately depend on how broadly any future WTO dispute panels/appellate body would interpret the relevant terms/phrases under Article II: 2(a) and Article III:2.

From the foregoing discussion it appears that, as per the GATT provisions, BTA relating to production processes would be allowable if they are applied in respect of taxes on inputs that are physically incorporated in the final product. However, it is not clear whether BTA would be allowable if the input concerned is not physically incorporated in the final product, which is indeed the case for energy consumed and carbon emitted during production. Nonetheless, in view of the fact that no definitive conclusion can be reached on this issue, we will continue to dwell on other GATT requirements relating to BTA in the following sections and examine the compatibility or otherwise of the proposed carbon equalization system (CES) in respect of each of those requirements.

## **2.4 ‘National Treatment’ Provisions of the GATT**

Even if a carbon tax were determined to be adjustable at the border that is not the end of the story. The carbon tax as well as the BTA (in the form of a CES) must also comply with the substantive requirements enshrined in Article III:2, which essentially require that imported products be treated no less favourably than ‘like domestic products’, i.e. imported products are not discriminated against. In this section, we will examine the extent to which the proposed CES stands a chance of complying with the National Treatment requirements pertaining to BTA under Article III:2 of the GATT.

### ***Article III:2 Provisions***

A close look at Article III:2 reveals that the two sentences of this provision stipulates two distinct requirements to be met:

- 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.
- 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 Article III:1.

The second sentence, when read with the principles set forth in Article III:1, requires that no contracting party shall otherwise apply internal taxes

or other internal charges to imported or domestic products in a manner so as to afford protection to domestic production.<sup>42</sup>

The meaning of the second sentence of Article III:2 is elaborated upon in the Interpretative Note to that provision, i.e. *Ad Article III, para 2*, which reads as follows:

‘A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.’

Importantly, though Article III:2, first sentence, refers to ‘like domestic products’, the second sentence, when read with *Ad Article III, para 2*, indicates that it (the second sentence of Article III:2) applies to ‘directly competitive or substitutable products’.

In *Canada - Periodicals*, the AB pointed out:

‘[T]here are two questions which need to be answered to determine whether there is a violation of Article III:2 of the GATT 1994: (a) whether imported and domestic products are like products; and (b) whether the imported products are taxed in excess of the domestic products. If the answers to both questions are affirmative, there is a violation of Article III:2, first sentence. If the answer to one question is negative, there is a need to examine further whether the measure is consistent with Article III:2, second sentence.’<sup>43</sup>

### ***2.4.1 Can Products be Differentiated on the Basis of Their Carbon-Contents?***

The question that arises in the first place is: how to determine which products are ‘like’ for the case in point? More specifically, can products be differentiated on the basis of carbon emitted during their production (henceforth referred to as ‘carbon content’)? To put it differently, for the

purpose of our analysis on National Treatment requirements, can we treat aluminium produced using coal as ‘like’ aluminium produced using natural gas, even if production of the former variety of aluminium results in higher carbon emissions compared to that of the latter?

Let us analyse this issue in the light of the GATT/WTO *acquis*. Going by this jurisprudence, the following four criteria may be taken into account in determining ‘like’ products (though the list is not a closed one):

- (a) product’s properties, nature and quality, i.e. the physical properties of the products;
- (b) the 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;
- (c) the international classification of the products for tariff purposes;
- (d) 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.

Under the first three criteria, all aluminium is likely to be regarded as ‘like products’ irrespective of differences in carbon content, due to the following reasons: (i) their physical characteristics are the same; (ii) their end-uses are also likely to be similar; and (iii) they would not normally be classified differently for import tariff purposes. Only on the basis of the last criterion, i.e. ‘consumer tastes and habits’, could there arguably be some reasons for not treating them as ‘like’, if it could be demonstrated that in view of their climate change concerns, the EU consumers do make a distinction between varieties of aluminium based on their carbon-content, while making their purchasing decisions.<sup>44</sup> However, in this context it may be recalled that going by the findings of the appellate body (AB) in *EC-Asbestos*, any determination of ‘like’ products would need to take into account all the criteria, even if they provide ‘conflicting indications’.<sup>45</sup> Hence, it may be difficult to treat products (say, aluminium) as non-‘like’ on the basis of carbon content, solely based on consumers’ tastes and habits, when all other three criteria for likeness determination are indicating them to be ‘like products’ However, it needs to be underscored here that the aforesaid four criteria are neither treaty language nor do they constitute a ‘closed list’ of

factors to be taken into account in any determination of likeness.<sup>46</sup> Moreover, any such determination would be undertaken on a case-by-case basis that would allow for ‘a fair assessment in each case of the different elements that constitute a ‘similar’ product’.<sup>47</sup> Furthermore, going by the renderings of the AB in *Japan-Alcoholic Beverages II*, it seems, the WTO dispute panels would have at least some discretion in any determination of likeness.<sup>48</sup>

On the basis of the aforesaid discussion, it may be argued that 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. Nevertheless, the ultimate determination would depend on the facts of a particular case in point and also on the discretionary decision of the WTO dispute panel/appellate body (AB) examining the case. Hence, for the purpose of our analysis, we will consider both the cases: (i) when products cannot be differentiated solely on the basis of their carbon contents; and (ii) when they can be so differentiated. For each of these two cases, we will first examine the possibility of the CES to qualify the requirements enshrined in Article III:2, first sentence and then will move on to examine the cases in the light of Article III:2, second sentence.

#### ***2.4.2 CES and Substantive Requirements under Article III:2, First Sentence***

In order to establish a violation of Article III:2, first sentence, one has to undertake a two-tiered test, in which both the following facts have to be established together:

- (i) Imported products and domestic products are like products; and that
- (ii) Imported products are taxed in excess of the domestic products.

##### **CASE 1:**

##### ***When Products Cannot be Differentiated on the Basis of Carbon-Content***

Suppose, products cannot be differentiated on the basis of carbon-content alone. In other words, all X would be treated as ‘like’ products irrespective of how much carbon is emitted in the course of its production. Now, let us

consider a hypothetical scenario in which the EU brings all domestic firms producing X under the ETS and introduces a carbon equalization system (CES) under which importers of X (in the EU) are also required to surrender emission allowances alongside domestic producers of X. As argued earlier, the ETS in this case would be akin to a carbon tax on domestically produced X and the CES would be akin to a border tax adjustment (BTA) on imported X. Given the assumption that all X would be treated as ‘like’ products, we will have to examine whether in such a scenario, imported X could be determined to be taxed ‘in excess of’ domestically produced X (which is a ‘like’ product as per our assumption here).

Now, one could contemplate a hypothetical scenario where the carbon content per unit of X, imported by the EU from a developing country, say Z, would be higher than that in domestically produced X in the EU.<sup>49</sup> It would not be very unrealistic to make this assumption since X here stands for a sector<sup>50</sup> that is covered by the EU ETS that imposes a carbon cost on its producers in the EU. Thus, it is likely to induce them to reduce the carbon content of their production. On the contrary, the developing country Z has been implicitly assumed here to impose either less stringent or no carbon cost on its producers of X as compared to the EU standards.<sup>51</sup> Hence, the carbon content per unit of X produced in country Z could be expected to be higher.<sup>52</sup>

Now, under such a hypothetical scenario, if the BTA is based on actual emission of carbon in the production process of X, then X imported from country Z could attract a higher tax (per unit of X) compared to domestically produced X in the EU. In other words, X imported from country Z could be taxed ‘in excess of’ domestically produced X in the EU. Importantly, this could be the case even if there is only ‘the smallest amount of excess’. Because, as noted by the AB in *Japan - Alcoholic Beverages II*, “even the smallest amount of excess’ is too much.”<sup>53</sup>

The aforesaid analysis is based on the assumption that the BTA is based on actual carbon emitted by the imported X (from country Z) during its production. The question is, whether it is possible to design the BTA in

such a manner that it does not constitute a violation of Article III:2, first sentence. Some commentators have suggested that an alternative basis for calculation of the carbon tax at the border (or amount of emission credits to be surrendered by imports) could be the amount of carbon that would have been emitted had the imported product been produced in the EU using the EU's 'predominant method of production' (PMP).<sup>54</sup> This is the system that was adopted in the US *Superfund* legislation for the tax on imports produced with certain chemicals. The GATT panel in this dispute did not find fault with this mechanism.<sup>55</sup> However, in the *Superfund* case this method of tax determination was applied only when actual data relevant for the tax calculation was not available for the imported products. Thus, the foreign producers having the required data at their disposal had the possibility of establishing that they actually used less of the input in question than that arrived at by calculation of the tax based on the PMP and therefore the tax charged on their products should be lower. As for the application of the PMP for all imported X under the carbon equalization system (CES), it may be argued that in case the PMP in the EU is less carbon-emitting than the production methods actually used by the relevant exporters of X from country Z (in our hypothetical case), application of the EU's PMP is likely to result in less tax burden on X imported from country Z compared to the tax burden that would have ensued, had the border tax been calculated on the basis of actual emission (by X imported from country Z). In such a scenario, imported X from country Z is not likely to be regarded as discriminated against, as per Article III:2, first sentence. However, if there exists even 'some' imported X from country Z for which the actual carbon emission is less than that corresponding to the EU's PMP, the application of this method for border tax determination purposes may constitute a violation of Article III:2, first sentence. Because, those exporters from country Z would not have the opportunity to demonstrate that their carbon emissions were lower than the standard assumed for adjustment by the EU, while domestic producers in the EU would be allowed to pay taxes according to their actual emissions.<sup>56, 57</sup>

An alternative way to introduce carbon equalization system (CES) by avoiding discrimination against imports could then be to take the lowest charges incurred by any domestic producer in the EU. Some commentators



have suggested that to make this practically feasible, the lowest charge should be estimated by assessing the quantity of GHGs that would have been emitted when all components were manufactured using the ‘best available technology in the home market’ (BATHM), i.e. in the EU.<sup>58</sup> If this approach is followed, then the most energy-inefficient imported X from country Z would have to bear a tax equal to that borne by the most energy-efficient X produced in the EU. Hence, this approach apparently stands a fair chance of being regarded as compliant with Article III:2, first sentence. Hence, it may be concluded that in a scenario where products cannot be differentiated solely on the basis of their carbon-content for the purpose of ‘like’ product determination under Article III:2, the EU may find it difficult to comply with the requirements under Article III:2, first sentence, unless the tax to be applied on imports are determined on the basis of the ‘best available technology in the home market’ (i.e. the EU).

## **CASE 2:**

### ***When Products Can be Differentiated on the Basis of Carbon-Content***

Let us now consider the case when products can *cet. par.* be differentiated on the basis of carbon-content for the purpose of ‘like’ product determination under Article III:2, first sentence. In this scenario, there would be as many varieties of a particular product (X) as there were substitutable production processes with different carbon-content. Hence, the treatment of every imported product would ideally have to be compared to that of the respective domestic product. In other words, for the purpose of determination of ‘like’ products under Article III:2, an imported X must be compared with domestically produced X in the EU having the same carbon-content. Now, let us suppose that X produced in a developing country Z would, in general, have a higher carbon content than X produced in the EU (for reasons discussed above under Case 1). Hence, when the border tax is calculated on the basis of actual carbon content, imported X from country Z would attract higher carbon tax compared to that attracted by domestically produced X in the EU. However, since in the present hypothetical scenario it is assumed that products can *cet. par.* be differentiated on the basis of carbon content, it can well be argued that high-carbon imported X is not ‘like’ low-carbon

domestically-produced X in the EU, in the first place. Hence, in this scenario, a BTA based on actual emissions by imports apparently seems to stand a better chance of qualifying under Article III:2, first sentence, compared to the scenario under Case 1.

Apart from various practical challenges that may arise in basing the carbon equalization system (CES) on actual emission profile of imports, difficulties may also arise some times from the fact that Article III:2, first sentence, requires a comparison of *actual* tax burdens rather than merely of *nominal* tax burdens (emphasis added), according to the dispute panel in *Argentina - Hides and Leather*. The Panel explained the method of comparison of the tax burdens imposed on imports and on domestic like products for the purposes of Article III:1, first sentence:

‘[I]t is necessary to recall the purpose of Article III:2, first sentence, which is to ensure ‘equality of competitive conditions between imported and like domestic products’ [footnote omitted]. Accordingly, Article III:2, first sentence, is not concerned with taxes or charges as such or the policy purposes Members pursue with them, but with their economic impact on the competitive opportunities of imported and like domestic products. It follows, in our view, that *what must be compared are the tax burdens imposed on the taxed products*. We consider that Article III:2, first sentence, requires a comparison of actual tax burdens rather than merely of nominal tax burdens. Were it otherwise, Members could easily evade its disciplines. Thus, even where imported and like domestic products are subject to identical tax rates, the actual tax burden can still be heavier on imported products. This could be the case, for instance, where different methods of computing tax bases lead to a greater actual tax burden for imported products ... .. It may thus be stated, in more general terms, that a determination of whether an infringement of Article III:2, first sentence, exists must be made on the basis of an overall assessment of the actual tax burdens imposed on imported products, on the one hand, and like domestic products, on the other hand (emphasis added).’<sup>59</sup>

An ‘overall assessment of the actual tax burdens’ seems to be a more difficult test to pass than comparison of ‘nominal’ tax burdens. One cannot rule out the possibility, in some cases, of ‘actual’ tax burden on an imported X turning out to be higher than that on a domestically produced X with equal carbon content, depending on the particular circumstances of a case. Difficulty may arise particularly due to the fact that going by the rendering of the Appellate Body (AB) in *Japan - Alcoholic Beverages II*, even the smallest amount of ‘excess’ tax burden on imported X may lead to a violation of Article III:2, first sentence.<sup>60</sup> Hence, it seems that to reduce the risk of violation of Article III:2, first sentence, even in this case (when products can be differentiated on the basis of their carbon content), it may be safer on the part of the EU to base the carbon equalization system (CES) on the ‘best available technology in the home market’ (BATHM ) approach, just like under Case 1.

From the analysis of the aforesaid two hypothetical scenarios it may be deciphered that a CES based on actual emissions on imports may face difficulties in complying with the requirements of Article III:2, first sentence. A CES based on the ‘best available technology in the home market’ (BATHM) approach seems to stand a better chance to qualify this test. Now, even if the CES is found to comply with Article III:2, first sentence, it still needs to be examined whether it could comply with the second sentence of this article. Given that BATHM, in our view, would be a safer approach of applying the CES, our analysis of the Article III:2, second sentence below is based on the assumption that the CES would be based on the BATHM approach (and not on any other approach, such as actual emissions from imports).

#### ***2.4.3 CES and Requirements under Article III:2, Second Sentence***

As for Article III:2, second sentence, three separate conditions are to be satisfied at the same time in order to find a violation of this provision:

- (i) the imported products and the domestic products are ‘*directly competitive or substitutable products*’ which are in competition with each other;
- (ii) the directly competitive or substitutable imported and domestic products are ‘*not similarly taxed*’; and

- (iii) the dissimilar taxation of the directly competitive or substitutable imported and domestic products is ‘*applied ... so as to afford protection to domestic production*’<sup>61</sup>

As for ‘directly competitive or substitutable products’, this is a very broad concept - much broader in scope than the concept of ‘like’ products under Article III:2, first sentence. As noted by the Appellate Body (AB) in *Japan-Alcoholic Beverages II*, ‘(h)ow much broader that category of ‘directly competitive or substitutable products’ may be in a given case is a matter for the panel to determine based on all the relevant facts in that case.’<sup>62</sup>

A review of the negotiating history<sup>63</sup> of Article III:2, second sentence and the language of the *Ad Article III* confirms that the product categories should not be so narrowly construed as to defeat the purpose of the anti-discrimination language informing the interpretation of Article III. The Geneva session of the Preparatory Committee provided an explanation of the language of the second sentence by noting that apples and oranges could be directly competitive or substitutable. Other examples provided were domestic linseed oil and imported tung oil and domestic synthetic rubber and imported natural rubber.

As noted by the panel in *Korea - Alcoholic Beverages*, ‘...even if most power generation systems are set up to utilize either coal or fuel oil, but not both, these two products could still compete indirectly as fuels. Thus, the focus should not be exclusively on the quantitative extent of the competitive overlap, but on the methodological basis on which a panel should assess the competitive relationship...However, an assessment of whether there is a direct competitive relationship between two products or groups of products requires evidence that consumers consider or could consider the two products or groups of products as alternative ways of satisfying a particular need or taste.’<sup>64</sup>

In *Japan - Alcoholic Beverages II*, the Appellate Body (AB) agreed with the Panel’s illustrative enumeration of the factors to be considered in deciding whether two subject products are ‘directly competitive or

substitutable’; for example, the nature of the compared products, and the competitive conditions in the relevant market, in addition to their physical characteristics, common end-use, and tariff classifications.<sup>65</sup>The Appellate Body found that it was ‘not inappropriate’ to consider the competitive conditions in the relevant market, as manifested in the cross-price elasticity in particular.<sup>66</sup>

In its approach to cross-price elasticity between domestic and imported products, the Panel on *Korea - Alcoholic Beverages* emphasized the ‘quality’ or ‘nature’ of competition, rather than the ‘quantitative overlap of competition’, which was later supported by the AB in this case.<sup>67</sup>In the same case the AB considered that competition in the market place is a dynamic, evolving process and thus the concept of ‘directly competitive or substitutable’ implies that ‘the competitive relationship between products is *not* to be analyzed *exclusively* by reference to *current* consumer preferences’. Following this line of argumentation, the AB concluded that the term ‘directly competitive or substitutable’ may include the analysis of *latent* as well as *extant* demand.<sup>68</sup>

Thus the GATT/WTO jurisprudence seems to have adopted a very broad approach for the purpose of determination of which products can be considered as falling in the category of ‘directly competitive or substitutable products’. The concept of competition in the relevant market place has also been interpreted quite broadly for this purpose.

It may be recalled that Ad Article III, second sentence clarifies that, ‘(a) tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.’ Now, let us consider a hypothetical case where a highly emission-intensive product X is covered by the EU ETS and accordingly a carbon equalization system (CES) is applied on imported X on the basis of the ‘best available technology in the home market’ (BATHM) approach. Also assume that there exists another

product Y, which is much less emission-intensive and not covered by the EU ETS, implying that it does not attract a carbon tax domestically. Alternatively, one can assume that Y is covered under the ETS; however, since Y is much less emission-intensive compared to X, hence the tax on domestically produced Y would be much less compared to the tax burden imposed by the CES on the imported X. Now, let us further assume that there exist some markets where Y acts as a ‘directly competitive or substitutable’ product of X. In other words, in some relevant markets, the consumers consider or could consider Y and X as alternative ways of satisfying a particular need or taste. In such a scenario, it would turn out to be the case that Y, which is a ‘directly competitive or substitutable’ product of (imported) X is ‘not similarly taxed’ in the EU, thereby satisfying the second tier of the test to find a violation of Article III:2, second sentence.<sup>69</sup>

However, in our hypothetical case, in order to find a violation of Article III:2, second sentence, a third tier of the test has to be satisfied also. This requires it to be established that the dissimilar taxation of the ‘directly competitive or substitutable’ imported and domestic products is ‘applied ... so as to afford protection to domestic production’. According to the Appellate Body (AB) in *Japan-Alcoholic Beverages II*, such an examination requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. According to AB, it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure and its overall application to ascertain whether it is applied in a way that affords protection to domestic products. Although the aim of a measure may not be easily ascertained, as has been acknowledged by the AB, nevertheless, its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. It also pointed out that the very magnitude of the dissimilar taxation in a particular case may in itself constitute evidence of such a protective application, although most often, there will be other factors to be considered as well. The AB clarified further that in conducting this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case.<sup>70</sup>

Now, in our hypothetical case, if the carbon intensity of X is substantially higher compared to that of ‘directly competitive or substitutable’ Y, then even with the ‘best available technology in the home market’ (BATHM) approach, the tax on imported X may turn out to be so higher compared to domestically produced Y that it in itself may suffice to demonstrate a protective application.<sup>71</sup> Yet in other cases, there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied ‘so as to afford protection’.<sup>72</sup>

One may also conceive of a situation where a predominantly foreign-made highly energy intensive good directly competes with a predominantly domestically-produced less energy-intensive product. For instance, in our hypothetical case, we can conceive of a scenario where more energy-intensive X is predominantly imported by the EU, whereas relatively less energy-intensive Y is mainly produced domestically, with very little imports. Then in this case the imported product (X) may be found to be generally taxed at a higher rate compared to domestically produced ‘directly competitive or substitutable’ product (Y).<sup>73</sup> In such a scenario, the ‘structure and design’ of the measure may be regarded as such that it affords protection to domestic products.<sup>74</sup>

On the basis of the analysis of our hypothetical scenario, it may be argued that in order to satisfy the requirements enshrined in Article III:2, second sentence, the coverage of the ETS and the corresponding carbon equalization system (CES) should be determined by the EU in such a comprehensive way that it takes all possible ‘directly competitive or substitutable’ products into account. This may in itself be a difficult proposition in view of the very broad interpretation of ‘directly competitive or substitutable’ products being put forward by the GATT/WTO jurisprudence. Moreover, the ‘structure and application’ of the ETS and the corresponding CES should be designed carefully so as to avoid a finding that imported products are ‘not similarly taxed’ *vis-a-vis* domestically produced ‘directly competitive or substitutable’ products in such a way that affords protection to domestic production. Notably, in *Canada - Periodicals*, the Appellate Body (AB) stated that ‘[d]issimilar taxation of even some

imported products as compared to directly competitive or substitutable domestic products is inconsistent with the provisions of the second sentence of Article III:2.<sup>75</sup>

On the basis of the foregoing analysis, it may be deciphered that even if a CES based on the ‘best available technology in the home market’ (BATHM) approach manages to qualify under Article III:2, first sentence, there is no guarantee that it would qualify under the Article III:2, second sentence, particularly in view of the very broad interpretation of the term ‘directly competitive or substitutable products’ being put forward by the GATT/WTO jurisprudence. Whether the CES would be able to satisfy the requirements enshrined in Article III:2, second sentence would depend on the ingenuity of the EU in designing the scope and structure of the ETS and the corresponding CES in such a comprehensive and strategic manner so as not to violate these requirements.

#### ***2.4.4 Problems of the ‘Best Available Technology in the Home Market’ Approach***

As discussed above, the proposed carbon equalization system (CES) stands a better chance of qualifying under Article III:2, first sentence of the GATT 1994 when the carbon content of imports is determined on the basis of the ‘best available technology in the home market’ (BATHM) approach. However, the application of even this approach may be fraught with other practical challenges as discussed below.

In the first place, a CES based on this approach may not level the playing field entirely for the EU producers. Because, the foreign producers would, regardless of the actual technology used by them, be assumed to have produced with best available technology in the EU. Thus, an energy inefficient product from country Z would be required to pay an import tax corresponding to the carbon content of the most efficient product in the EU. Notably, discrimination against domestic producers is not incompatible with Article III:2 of the GATT. However, whether such discrimination would be politically correct for the EU to go for, is a different question altogether. The domestic industry lobbies in the EU may rather prefer other alternative



measures than CES as better ways of addressing their competitiveness concerns, such as free allocation of allowances, redistribution of ETS revenues among energy-intensive industries confronting the risk of carbon leakage, etc. Notably, 100 per cent free allocation of allowances has already been put forward by the 2008 package as an alternative way of addressing the competitiveness and carbon-leakage concerns.

It may also be noted in this context that production processes not only differ in the amount of energy required, but also in the fuel type used. This brings us to the question as to which fuel is used to produce process heat. Coal fired heat production results in about twice the CO<sub>2</sub> emissions per unit heat produced than gas fired heat production. Biomass, on the other hand, may produce close to zero emissions over the life cycle. If all these types of fuels can be used in a certain process, then non-discrimination against imports for the purpose of Article III:2 might require that the lowest CO<sub>2</sub> emitting fuel type serves as reference. However, this may reduce the amount of tax on imports to a great extent, often making the CES meaningless. Some commentators have suggested that fuels like biomass should not be taken as reference for heat production on the grounds that currently biomass is not competitive in large-scale appliances, as can be seen by subsidies paid to plants producing electricity from biomass. Likewise, they argue that renewable energy inputs into large scale industrial production processes is currently not typical.<sup>76</sup> However, whether such arguments could pass muster the legal requirements of the WTO remains an open question!

One can also think of a hypothetical scenario where some exporters in say, country Z, have access to more energy-efficient technology than the *best available technology* in the EU. In such a scenario, the use of the BATHM approach may be found to be discriminating against those exporters from country Z by not allowing them to base their tax rate on their actual emission whereas domestic producers in the EU are allowed to use their actual emission levels for determining the tax applicable to them. Notably, for the purpose of both sentences of Article III:2, discrimination against even some imports are not permitted.

### ***2.4.5 Other Possible Reasons for a Violation of Article III:2 by the Proposed CES***

There are certain other aspects in the 2008 package regarding the post-2012 regime, which if finally implemented, may not be found to be in compliance with the non-discrimination requirements enshrined in Article III:2 of the GATT 1994. For instance, although auctioning is proposed to be dominant method of distribution of allowances from 2013 onwards, this is proposed to be implemented in a phased manner. The question that arises in this context is 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? Some commentators have suggested taxing imports at the market price at which allowances are sold.<sup>77</sup> That is, if, for example, half of the allowances are allocated to each domestic firm free of charge and the second half had to be bought at a price of 100 then, as per the aforesaid suggestion, BTA should be at the rate of 100. In that case, however, the claim may be made that imports, paying 100, are discriminated against *vis-a-vis* domestic products that receive 50 per cent of allowances for free, clearly violating Article III:2 requirements. Another alternative that has been suggested to avoid this problem is to base the BTA on the average cost of the allowances.<sup>78</sup> As per this suggestion, in the aforesaid example, the price used for the adjustment at the border would be 50. However, in our view, when there is partial free allocation of allowances to the domestic producers, while there is no provision for free allocation for imported products subject to BTA, there is a high chance that this in itself may turn out to be a violation of Article III:2, irrespective of exactly how the BTA rate is determined. This may be the case on the grounds that it 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.<sup>79</sup> However, partial free allocation of allowances for imports that may avoid this problem, may be very difficult to implement in practice.

On the basis of the expansive analysis carried out in this Section, it may be concluded that there is a high possibility that the EU would find it difficult to justify its proposed carbon equalization system (CES) in the form

of a border tax adjustment (BTA) under the National Treatment provisions of the GATT 1994.

### **3. COMPLIANCE OF CES WITH MOST FAVOURED NATION CLAUSE**

In order to be WTO-compatible, the proposed CES must also comply with the Most Favoured Nation requirement enshrined in Article 1 of the GATT 1994. This principle requires that ‘...any advantage, favour, privilege or immunity’ granted by any WTO Member to any product originating in or destined for any other country (WTO Member or otherwise) ‘shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other’ WTO Members.<sup>80</sup>

In view of this requirement the EU may find it difficult to justify its proposed CES if it is applied only in respect of imports from other developed countries and major-emitters among the developing countries. It needs to be underscored that the CES has ostensibly been proposed with these select group of countries in view.<sup>81</sup>

However, to avoid violation of the MFN clause, if the EU applies the proposed CES to all imports across the board, then it would also apply on imports from countries that have their own emission reduction mechanisms in place, such as the other developed countries that have ratified the Kyoto Protocol. In such a scenario, the CES might be challenged by those countries on the grounds that as a result of the CES their exporters (to the EU) were forced to pay the price of carbon twice: once under their domestic climate-related legislations; and again upon entry into the EU. In such a scenario, it may also be argued that exporters from other countries that do not have emission reduction obligations would be getting an ‘advantage’ not accorded to the exporters of the aforesaid group of countries that have emission reduction obligations. In this context, some commentators have suggested that the other developed countries with emission reduction obligations could avoid such ‘double taxation’ by rebating any tax or costs borne by their exporters to the EU upon exportation.<sup>82</sup> However, this would not solve the violation of the MFN clause on the part of the EU.

Hence, in our view, the EU may find it difficult to justify its proposed CES if it is applied only in respect of imports from select other developed countries and a few major-emitting developing countries.

However, it needs to be underscored here that even if the proposed CES is found to be in violation of either the National Treatment and/or MFN provisions of the GATT 1994, it still stands a chance of being justified under the ‘General Exceptions’ enshrined in Article XX of the GATT. The next Section of the paper dwells on this issue.

#### **4. JUSTIFICATION OF CES UNDER GATT ARTICLE XX EXCEPTIONS**

The ‘General Exceptions’ provisions enshrined in Article XX allow WTO Members, subject to certain conditions included in its *chapeau*, to deviate from its GATT obligations to serve certain legitimate policy objectives included under the ten headings ((a) to (j)) of this article. The *chapeau* and headings (b) and (g) of Article XX that are relevant for the case in point read as follows:

“Subject to the requirement that such 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, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:

(b) necessary to protect human, animal or plant life or health;

(g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;...”

##### **4.1 Extra-territoriality, PPM and Article XX**

Before examining the justification of the CES under Article XX, a discussion on the issue of eligibility or otherwise of extra-territorial measures and measures relating to process and production methods (PPMs) under this

article is warranted in order to determine whether the CES is *a priori* eligible for qualification under it. Because, the proposed CES would not only fall in the category of extra-territorial trade measures but would also clearly constitute a PPM-based measure.

A close look at the GATT panels' reports in *Tuna-Dolphin I and II* disputes, in early 1990s, and the WTO Appellate Body (AB) Reports in *Shrimp-Turtle I and II*, roughly a decade later, clearly indicates how the GATT/WTO *acquis* have evolved within just one decade in favour of allowing extra-territorial measures and those based on PPMs. These issues are discussed briefly below.

The main question the GATT Panel in *Tuna-Dolphin I* had to examine was whether the import ban imposed by the US on certain yellowfin tuna and certain yellowfin tuna products from Mexico under its Marine Mammal Protection Act of 1972 (MMPA) was consistent with the GATT obligations of the US. The stated goal of the MMPA was that the incidental kills or serious injury of marine mammals in the course of commercial fishing be reduced to insignificant levels approaching zero. The import ban was imposed on countries that could not demonstrate tuna had been captured according to the 'dolphin-safe' standards promulgated by the MMPA.<sup>83</sup>

The GATT panel concluded, among other things, that 'a contracting party may not restrict imports of a product merely because it originates in a country with environmental policies different from its own.'<sup>84</sup> Thus, the panel refused to introduce the concept of extraterritoriality into the GATT.<sup>85</sup> It noted that were it to do so 'the General Agreement would then no longer constitute a multilateral framework for trade among all contracting parties but would provide legal security only in respect of trade between a limited number of contracting parties with identical internal regulations'.<sup>86</sup> It went on to note that 'if the contracting parties were to permit import restrictions in response to differences in environmental policies under the General Agreement, they would need to impose limits on the range of policy differences justifying such responses and to develop criteria so as to prevent abuse'.<sup>87</sup> The Panel

concluded that ‘the MMPA regulates the domestic harvesting of yellowfin tuna to reduce the incidental taking of dolphin, but that these regulations could not be regarded as being applied to tuna products as such *because they would not directly regulate the sale of tuna and could not possibly affect tuna as a product...Regulations governing the taking of dolphins incidental to the taking of tuna could not affect tuna as a product*’ [emphasis added].<sup>88</sup> As Chimni (2002) has noted, it clearly endorsed the understanding that the GATT rules cover ‘only those measures that are applied to the product as such’ and not to process and production methods (PPMs).<sup>89</sup> The GATT Panel in the subsequent *Tuna-Dolphin II* reaffirmed *Tuna-Dolphin I* in its broad understanding of Article XX(g).<sup>90</sup>

Notwithstanding the fact that the *Tuna* decisions were never adopted, their reasoning had sufficient saliency to lead the Panel in *Shrimp-Turtle I*<sup>91</sup> to reach a similar conclusion with respect to Article XX in its consideration of Section 609 of the US Public Law 101–162 relating to the Protection of Sea Turtles in Shrimp Trawl Fishing Operations enacted in 1989 pursuant to the United States Endangered Species Act of 1973 (ESA) and its implementing measures. The US issued guidelines in 1991 and 1993 for the implementation of Section 609. These guidelines were extended in scope to all countries in April 1996. This led India, Malaysia, Pakistan and Thailand to resort to the WTO to resolve the dispute with the US which followed the application of trade sanctions against their exports of shrimp. Notably, the *Shrimp-Turtle* set of cases involved a factual situation almost identical to that of the *Tuna* disputes (see Box 1 for a brief description of Shrimp-Turtle disputes). Certain findings by the dispute panels and AB in *Shrimp-Turtle I and II* assume particular significance in the context of the extra-territoriality and PPM issues. The Panel found the ban to be in violation of Article XX and noted that because it was aimed at compelling another party to change its policies, were: (i) a threat to the multilateral trading system as a whole; (ii) against the object and purpose of the WTO Agreements; and (iii) outside the scope of Article XX in their entirety.<sup>92</sup>

### **Box 1: Shrimp-Turtle I and II in Brief\***

Section 609 of the US Public Law 101–162 relating to the Protection of Sea Turtles in Shrimp Trawl Fishing Operations enacted in 1989 pursuant to the United States Endangered Species Act of 1973 (ESA) calls upon the US secretary of state, in consultation with the US secretary of commerce, inter alia, to initiate negotiations for the development of bilateral or multilateral agreements for the protection and conservation of sea turtles, in particular with governments of countries engaged in commercial fishing operations likely to have a negative impact on sea turtles. It further provides that:

‘...shrimp harvested with technology that may adversely affect certain species of sea turtles protected under US law may not be imported into the US, unless the president annually certifies to the Congress: (a) that the harvesting country concerned has a regulatory programme governing the incidental taking of such sea turtles in the course of such harvesting that is comparable to that of the US, and that the average rate of that incidental taking by the vessels of the harvesting country is comparable to the average rate of incidental taking of sea turtles by US vessels in the course of such harvesting; or (b) that the fishing environment of the harvesting country does not pose a threat of incidental taking to sea turtles in the course of such harvesting.’

The US issued guidelines in 1991 and 1993 for the implementation of Section 609. These guidelines were extended in scope to all countries in April 1996. This led India, Malaysia, Pakistan and Thailand to resort to consultations with the US to resolve the dispute which followed the application of trade sanctions against their exports of shrimp. The consultations failed and resulted in subsequent reports by the WTO Panel and the Appellate Body. In *Shrimp Turtle I* the Panel and the Appellate Body Reports noted that the US ban on imports was not in conformity with the chapeau of Article XX of GATT (1994).

The Appellate Body in *Shrimp Turtle I* emphasised the lack of flexibility in the measures demanded by the US: it did not take into account the different situations in different countries and insisted on them undertaking the *same* implementation measures as in the US and therefore amounted to “unjustifiable discrimination”. Another key issue which the Appellate Body addressed in *Shrimp Turtle I* was the place and role of international negotiations prior to the use of trade sanctions. This issue will be discussed below in greater detail.

*Box 1 continued*

It, therefore, requested the US to bring its measure in conformity with Article XI (prohibiting the use of quantitative restrictions) of GATT (1994). On January 21, 1999, subsequent to the adoption of the Panel Report (as modified by the Appellate Body Report) by the DSB, the US agreed to comply with the rulings and recommendations within a period of 13 months. In July 1999, the US department of state issued Revised Guidelines for the Implementation of Section 609 of Public Law 101-162 Relating to the Protection of Sea Turtles in Shrimp Trawl Fishing Operations. It stated that Section 609 would not *inter alia* apply to 'shrimp harvested by trawlers using TEDs (Turtle Excluder Devices) *comparable in effectiveness* to those required in the US' (emphasis added).

It also entered into negotiations with the exporting countries to arrive at a sea turtle conservation agreement in the Indian Ocean region and enhanced its offer of technical assistance. On October 12, 2000 Malaysia requested the DSB, pursuant to Article 21.5 of the Dispute Settlement Understanding (DSU) to establish a Panel to "find that by not lifting the import prohibition and not taking the necessary measures to allow the importation of certain shrimp and shrimp products in an unrestrictive manner, the US has failed to comply with the 6 November 1998 recommendations and rulings of the Dispute Settlement Body". It further requested that "the Panel suggest that the US should lift the prohibition immediately and allow the importation of certain shrimp and shrimp products in an unrestrictive manner in order to comply with the said recommendations and rulings of the Dispute Settlement Body". Thus the Shrimp-Turtle II was initiated. Against the objections raised by Malaysia, the US claimed that the Revised Guidelines and its attempt to negotiate in good faith a multilateral arrangement for the conservation of turtles responded to all the inconsistencies identified by the Appellate Body under the chapeau of Article XX of GATT (1994) and thus its import prohibition on certain shrimp and shrimp products was justified. The Revised Guidelines, it argued, did not call for the *same* regulatory regime as in the US but a regime of *comparable effectiveness*. The report of the Panel in *Shrimp Turtle II* was submitted on 15 June, 2001. Malaysia appealed from certain issues of law and legal interpretation in the Panel Report. The Appellate Body submitted its report on 22 October, 2001 upholding the conclusions of the Panel which had turned down the requests of Malaysia.

*Note:* \* The description of the facts of *Shrimp-Turtle* disputes draws heavily on Chimni (2002), pp.134-35.



The Panel's findings and analysis were, however, emphatically rejected by the AB noting, in particular, that the Panel's line of argument effectively rendered Art. XX meaningless.<sup>93</sup> Although, the US ban was found by the AB to be in violation of Article XX, that was because it required that WTO Members to adopt essentially the 'same' programme as that of the US, which was found to constitute arbitrary discrimination for not taking into account the appropriateness of the US programme for the other Members concerned, thereby violating Article XX *chapeau*. The ban was not *a priori* invalidated on the grounds of it being extra-territorial and PPM-based in nature. When the US amended its law to require the exporting countries to put in place regulatory programmes that may not be the same as those of the US, but 'comparable in effectiveness', the panel and AB in *Shrimp-Turtle II* found the US measure to be in compliance with Article XX *chapeau*, notwithstanding the fact that it still was an extra-territorial measure based on PPM. Malaysia's argument that the US, 'by imposing a unilaterally defined standard of protection, violate(d) the sovereign right of Malaysia to determine its own sea turtles protection and conservation policy' failed to find support from the AB in *Shrimp-Turtle II*.<sup>94</sup>

The aforesaid findings thus turned the earlier findings of the *Tuna* panels on the issue of extra-territoriality on its head. As per the AB, what is required is a 'sufficient nexus'<sup>95</sup> between the implementing country and the objective of the measure concerned.<sup>96</sup>

Notably, in *Shrimp-Turtle I*, the US was permitted to protect turtle in India based on the facts that: (i) the turtle are an endangered species; and (ii) are highly migratory animals which are known to occur in the US waters. Although the AB provided no criteria for determining what might constitute a 'sufficient nexus', the example in that case, namely, the protection of turtles which travel in and out of the US waters, suggests that some degree of real and direct impact on the implementing country may suffice. If the US was permitted to protect the turtle in India that may at some point cross the US waters, it is difficult to imagine why the EU would not be permitted to protect against carbon emitted, say, in India, that certainly crosses territorial borders and is scientifically proved to be as dangerous for climate change

as carbon emitted with the EU itself. Climate change after all is a truly trans-boundary problem.<sup>97</sup> Hence, it can be argued that the CES would not *a priori* be invalidated for justification under Article XX, on the grounds of it being an extra-territorial PPM-based measure. With this understanding, we will now move into an examination of the possibilities of actual justification or otherwise of the CES under Article XX.

## **4.2 Article XX Requirements and the CES**

Examination of the carbon equalization system (CES) under Article XX will involve a two-tiered test: first, provisional justification by reason of characterization of the measure under one of the exceptions listed out in Article XX; second, further appraisal of the same measure under the introductory clauses of Article XX.<sup>98</sup>The AB, in *Shrimp-Turtle I* pointed out that under the two-tiered test, the examination under a specific heading must precede the examination under the *chapeau*.<sup>99</sup> This sequence of steps is now part of both panel and AB practice. We will follow the aforesaid sequencing for our analysis below.

### ***4.2.1 Article XX (b) Tests and the Proposed CES***

Article XX(b), as indicated above, relates to the use of environmental measures that are ‘necessary to protect human, animal or plant life or health’. The panel, in *US – Gasoline*, in a finding not reviewed by the AB, prescribed the following three-tier test for Article XX(b):

- ‘(1) [T]hat 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;
- (2) that the inconsistent measures for which the exception was being invoked were *necessary* to fulfil the policy objective; and
- (3) that the measures were applied in conformity with the requirements of the *introductory clause* of Article XX.’<sup>100</sup>

The Panel stated that in order to justify the application of Article XX(b), all the above three elements had to be satisfied. Hence, we will analyse below the case of the CES with respect to each of the aforesaid three requirements in the light of the existing GATT/WTO *acquis*.

### **Underlying Policy**

The first question is whether the policy in respect of the CES in the form of a border tax adjustment (BTA) (i.e. the measure in question) fell within the range of policies designed to protect human, animal or plant life or health. In our view, justification of the CES with this requirement would not be a difficult proposition, given that the emission trading system (ETS) was set 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. It is apprehended that hundreds of millions of people could suffer hunger, water shortages and coastal flooding as the world warms.<sup>101</sup> However, it is not the ETS that is to be justified under Article XX (b), but the CES in the form of a tax adjustment at the border.

Notably, the CES has been proposed by the EU ostensibly 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. Hence, the EU can always argue that the policy in respect of the CES is reduction of GHGs in general. In that case, given the risks posed by climate change, the policy in respect of the 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**

The second tier of examination under Article XX (b) is the so-called ‘necessity test’, i.e. whether the CES can be regarded as ‘necessary’ to protect human, animal or plant life or health. In *Thailand – Cigarettes*, the panel concluded that the term ‘necessary’ had the same meaning under paragraphs (b) and (d).<sup>102</sup> The necessity test was first defined for paragraph (d) in the *US – Section 337* case. A similar approach was followed for paragraph (b) in the *Thailand – Cigarettes* case. In these two cases, a requirement of so-called ‘least-trade restrictiveness’ was established to decide whether a measure was ‘necessary’ under Article XX(b) and (d).<sup>103, 104</sup>

In the *Korea – Various Measures on Beef* case, the AB bifurcated the necessity test as follows: (i) situations where the claim may be that a measure is indispensable, i.e. where the measure is the only available; and (ii) situations where a Member may be able to justify its measure as ‘necessary’ within the meaning of Article XX, even if there would be other measures available. For the second situation, the AB adopted the following approach:

‘A measure with a relatively slight impact upon imported products might more easily be considered as ‘necessary’ than a measure with intense or broader restrictive effects...  
... [D]etermination of whether a measure, which is not ‘indispensable’, may nevertheless be ‘necessary’ within the contemplation of Article XX(d), involves in every case *a process of weighing and balancing a series of factors* which prominently include the contribution made by the compliance measure to the enforcement of the law or regulation at issue, the importance of the common interests or values protected by that law or regulation, and the accompanying impact of the law or regulation on imports or exports (emphasis added).’

From the foregoing discussion it seems that there has been some evolution in the interpretation of the necessity test under Article XX (b) and (d) from a least-trade restrictive approach to a less-trade restrictive one, supplemented with a proportionality test (‘a process of weighing and balancing a series of factors’).<sup>105</sup>

As regards the proposed CES, whether it 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 or less inconsistent with the GATT 1994 compared to the CES. There are indeed alternative measures that seem to be available with the EU that may reasonably be employed. For instance, the 2008 package itself includes an alternative mechanism to tackle the problem of ‘carbon leakage’, namely free allocation of ETS allowances.<sup>106</sup>

Given that the CES is not an ‘indispensable’ measure, whether it can still be regarded as ‘necessary’ would depend on a process of weighing and balancing a series of factors, including the importance of the common interests protected by the measure, the contribution of the trade-restriction for the success of the protection of the interests and the impact on trade flows. It may also be recalled here that in the *EC – Asbestos* case (in which for the first time, an environmental measure passed the necessity test), the appellate body (AB) observed that ‘[t]he more vital or important [the] common interests or values’ pursued, the easier it would be to accept, as ‘necessary’, measures designed to achieve those ends.<sup>107</sup> This seems to suggest that there might be differing levels of scrutiny applicable to the analysis of the necessity test, depending on the importance of the ‘interests or values’ it served.<sup>108</sup> If that be the case, then considering the enormous importance attached to the problem of climate change in the present geo-political scenario, it may be argued that the CES may find it relatively easy to pass the necessity test.

#### ***4.2.2 Article XX(g) Tests***

An examination of the consistency or otherwise of the CES with Article XX(g) would have to be based on three sets of criteria: (i) whether the planet’s atmosphere is an exhaustible resource; (ii) whether the CES relates to the conservation of the planet’s atmosphere; and (iii) whether the CES is made effective in conjunction with restrictions on domestic production and consumption.

#### ***Planet’s Atmosphere as an Exhaustible Natural Resource***

In *Shrimp-Turtle I*, the AB, while addressing the meaning of term ‘exhaustible natural resources’, emphasized the need for a dynamic rather than a static interpretation of the term ‘exhaustible’, noting the need to interpret this term ‘in the light of contemporary concerns of the community of nations about the protection and conservation of the environment’. The AB further pointed out that while Article XX was not modified during the Uruguay Round, the preamble attached to the WTO Agreement shows the signatories to the Agreement were, in 1994, fully aware of the importance and legitimacy of environmental protection as a goal of national and international policy.<sup>109</sup>

In the light of this interpretation by the AB, some commentators have justifiably argued that ‘considering the international importance given today to the problem of climate change - and the catastrophic consequences that are linked to it for all forms of life on earth - it would be surprising if the WTO would not accept that the planet’s atmosphere (that is, the layer of gases around the earth that regulates the planet’s climate) is an “exhaustible natural resource”.’<sup>110</sup>

### ***Relating to***

The next question is whether the CES can be regarded as ‘relating to’ conservation of the planet’s atmosphere (as an exhaustible natural resource). For a while, the GATT and WTO panels held that ‘relating to’ should be interpreted as ‘primarily aimed at’.<sup>111</sup> Later the AB in *US – Gasoline* made it clear that ‘the phrase ‘primarily aimed at’ was not itself treaty language and was not designed as a simple litmus test for inclusion or exclusion from Article XX (g)’.<sup>112</sup> The AB clarified the meaning of Article XX(g) by stating that 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 resources.<sup>113</sup>

Notably, this test must be applied to the legislation as such and its general design; not so much to its specific details. As a result, in both *US – Gasoline* and *Shrimp-Turtle I*, where the test was applied, it was easily met.<sup>114</sup>

Thus, GATT/WTO *acquis* on the phrase ‘relating to’ seems to have evolved from a rather narrow interpretation of ‘primarily aimed at’, to a relatively broader one. As for the CES, it is likely to have sufficient scope to qualify at least under this broader interpretation, unless there are blatant inconsistencies or protectionist features in the EU legislation pertaining to CES. Because the CES would stand a high chance of being regarded as having a ‘substantial relationship’ with objective of combating climate change and would not merely be ‘incidentally or inadvertently aimed at’ this goal. The ‘means’ here could very well be regarded as ‘reasonably related to the ends’. The CES is not likely to be regarded as ‘disproportionately

wide in its scope and reach in relation to the policy objective' of combating climate change.<sup>115</sup>

### ***Measures made effective in conjunction with***

In *US - Gasoline*, the AB described the term 'measures made effective in conjunction with' as a 'requirement of *even-handedness* in the imposition of restrictions'.<sup>116</sup> The AB further made it clear that the 'requirement of even-handedness' embodied in Article XX(g) did not amount to a requirement of 'identity of treatment'.<sup>117</sup>

In view of the fact that the CES is likely to be brought into effect together with requirements on domestic installation in the EU to take part in the ETS, there should not be any difficulty for the CES to pass this test. More specifically, even if the legislation in some of its details were to discriminate imports as opposed to domestic products, the legislation or measure as a whole can still be found to meet this test.<sup>118</sup> This was indeed the case in *US - Gasoline*, where the AB clarified that if the exception in GATT Article XX(g) required 'identity of treatment ... it is difficult to see how inconsistency with Article III:4 [i.e. a national treatment violation] would have arisen in the first place'.<sup>119</sup>

On the basis of the aforesaid analysis, it may be concluded that the proposed CES seems to stand a high chance of qualifying under Article XX (g) test.

### **4.2.3 Article XX Chapeau Tests**

Even if the CES qualifies under headings (b) or (g) of Article XX, it still would have to fulfil the requirements enshrined in the *chapeau* of this article.<sup>120</sup> *Shrimp Turtle I* provided considerable clarity on the meaning and application of the *chapeau* and has since then operated as a reference point for its application.<sup>121</sup>

Importantly, the *chapeau* is not about the measure as such, but about its detailed operating provisions and how it is actually applied.<sup>122</sup> Moreover, under this phrase, according to the AB on *Shrimp-Turtle I*, the environmental

policy goal no longer matters; the legitimacy of the policy goal and how the legislation relates to it must be examined under paragraph, not the introductory phrase.<sup>123</sup>

The AB on *Shrimp-Turtle II*,<sup>124</sup> stated that ‘[t]here are three standards contained in the *chapeau*: first, arbitrary discrimination between countries where the same conditions prevail; second, unjustifiable discrimination between countries where the same conditions prevail; and third, a disguised restriction on international trade’.<sup>125</sup> In order for the measure not to be entitled to the justifying protection of Article XX, the existence of only one of these three standards would have to be proven.<sup>126</sup>

**Arbitrary or unjustifiable discrimination between countries where the same conditions prevail**

The AB in *Shrimp-Turtle I* provided three constitutive elements of the phrase:

‘First, the application of the measure must result in *discrimination*...Second, the discrimination must be *arbitrary* or *unjustifiable* in character...Third, this discrimination must occur *between countries where the same conditions prevail* (emphasis added).’<sup>127</sup>

With respect to the phrase ‘between countries where the same conditions prevail’, the question arose as to whether the notion of discrimination under the *chapeau* of Article XX referred to conditions in importing or exporting countries (i.e. discrimination between a foreign country or foreign countries on the one hand and the home country on the other) or only to conditions in various exporting countries. The AB in *US - Gasoline* indicated that it considered both types of discrimination to be covered by the *chapeau*:<sup>128</sup> discrimination between different exporting countries (i.e. MFN-type discrimination as was found to be the case in *Shrimp-Turtle I*) as well as discrimination between exporting countries and the importing country concerned (i.e. national treatment-type discrimination as was found to be the case in *US - Gasoline*).<sup>129</sup>



While examining if there is any violation of the phrase, arbitrary discrimination ‘between countries where the same conditions prevail’, the AB in *Shrimp-Turtle I and II* has actually taken into consideration different conditions prevailing in different countries. The AB in *Shrimp-Turtle II* noted:

‘We need only say here that, in our view, a measure should be designed in such a manner that there is sufficient flexibility to take into account the specific conditions prevailing in *any* exporting Member,...’<sup>130</sup>

The AB in *Shrimp-Turtle I* noted:

‘However, it is not acceptable, in international trade relations, for one WTO Member to use an economic embargo to require other Members to adopt essentially the same comprehensive regulatory program, to achieve a certain policy goal, as that in force within that Member’s territory, without taking into consideration different conditions which may occur in the territories of those other Members.’<sup>131</sup>

The AB further observed (in *Shrimp-Turtle I*) that discrimination results not only when countries in which the same conditions prevail are differently treated, but also when the application of the measure at issue does not allow for any inquiry into the appropriateness of the regulatory programme for the conditions prevailing in those exporting countries.

The AB on *Shrimp-Turtle I* ruled that the ‘rigidity and inflexibility’ of the application of the measure by the US constituted ‘arbitrary discrimination’ within the meaning of the *chapeau*.<sup>132</sup> Referring to this finding the panel in *Shrimp-Turtle II* noted that there was arbitrary discrimination because the US did not take into account the conditions prevailing in the countries concerned and the appropriateness of the programme for the conditions prevailing in those countries.<sup>133</sup>

In the *US – Gasoline* case, the AB found that an unjustifiable discrimination would be one that could have been ‘foreseen’ and that was not ‘merely inadvertent or unavoidable’.<sup>134</sup>

Two criteria can be identified regarding ‘unjustifiable’ discrimination from the readings of the panel and AB reports in *Shrimp-Turtles I and II*: first, a serious effort to negotiate with the objective of concluding bilateral and multilateral agreements for the achievement of a certain policy goal; and second, the flexibility of the measure.

As part of the process of determining whether the measure had been applied in a manner that constituted a means of ‘unjustifiable discrimination’, the AB on *Shrimp-Turtle I* addressed the issue of international negotiations<sup>135</sup> and concluded that the US negotiated seriously with some Members, but not with other Members, including the appellees, that export shrimp to the US: ‘[t]he effect is plainly discriminatory and, in our view, unjustifiable’.<sup>136</sup>

As later interpreted by the panel in *Shrimp-Turtle II* and upheld by the AB,<sup>137</sup> it appears that the AB was referring to the negotiation and not the conclusion of an agreement.<sup>138</sup> Consequently, the US was obligated only to make serious good faith efforts to reach an agreement before resorting to unilateral measures.<sup>139</sup>

In *Shrimp-Turtle I*, the AB ruled that the lack of flexibility in taking into account the different situations in different countries amounted to unjustifiable discrimination.<sup>140</sup> The AB further noted that ‘[o]ther specific policies and measures that an exporting country may have adopted for the protection and conservation of sea turtles are not taken into account’. The AB concluded that discrimination results not only when countries in which the same conditions prevail are differently treated, but also when the application of the measure at issue does not allow for any inquiry into the appropriateness of the regulatory programme for the conditions prevailing in those exporting countries.<sup>141</sup>

Another aspect which the AB in *Shrimp-Turtle I* considered in determining whether the US measure at issue constituted ‘arbitrary or unjustifiable discrimination between countries where the same conditions prevail’ was the concept of ‘basic fairness and due process’. The AB noted that:

‘With respect to both types of certification, there is *no formal opportunity for an applicant country to be heard, or to respond to any arguments* that may be made against it, in the course of the certification process before a decision to grant or to deny certification is made. Moreover, *no formal written, reasoned decision*, whether of acceptance or rejection, is rendered on applications for either type of certification...No procedure for review of, or appeal from, a denial of an application is provided. The certification processes followed by the United States thus appear to be singularly *informal and casual*, and to be conducted in a manner such that these processes *could result in the negation of rights of Members*. There appears to be no way that exporting Members can be certain whether the terms of Section 609, in particular, the 1996 Guidelines, are being applied in a *fair and just manner* by the appropriate governmental agencies of the United States. It appears to us that, effectively, exporting Members applying for certification whose applications are rejected are denied *basic fairness and due process, and are discriminated against, vis-à-vis* those Members which are granted certification[emphasis added]’.<sup>142</sup>

From the foregoing renderings, it may be argued that in order to qualify the test pertaining to ‘arbitrary or unjustifiable discrimination’, the procedures for application of the proposed CES must follow ‘basic fairness and due process’. The procedures should be ‘transparent’ and ‘predictable’ and provide formal opportunities for the exporting countries concerned ‘to be heard, or to respond to any arguments’.<sup>143</sup> The EU must also engage in ‘serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements’ to address climate change, before imposing the CES. The last mentioned requirement should not be difficult to qualify with, in view of the across-the-board negotiations in the UNFCCC on climate change to which the EU is also a party. It would be all the more easy to qualify because the EU would not have to conclude actual agreements - engaging in serious, good-faith negotiations would suffice.

However, the difficulty of qualifying the ‘arbitrary or unjustifiable discrimination’ test may arise from the requirements pertaining to flexibility. The EU must not require the exporting countries to adopt policies towards climate change mitigation that are ‘same’ as those adopted by the EU. Rather, the 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’,<sup>144</sup> say China or India. The EU must take ‘into consideration different conditions which may occur’ in different exporting countries, and should ensure that the application of the measure at issue allows for an inquiry into the appropriateness of the regulatory programme for the conditions prevailing in those exporting countries. These requirements may involve consideration of the following two issues in the context of application of the proposed CES:

1. Should developing countries like China or India be expected to take similar actions on climate change mitigation as those to be undertaken by developed countries like the EU?
2. Are developing countries like China or India taking measures towards emission reduction which may not be the ‘same’ as those adopted by the EU, but are nevertheless appropriate in view of the specific conditions prevailing in those countries?

Regarding the first question, it may be argued that developing countries like China or India may not be expected to carry the same burden as developed countries, at least for three reasons. First, when looked at historically, developing countries’ contribution to the problem of climate change is significantly less compared to that of developed countries.<sup>145</sup> Second, even if some of them like China or India may depict rising trends in aggregate emissions currently, their per-capita emissions are still significantly lower than the average developed country emissions. As for India, its per capita CO<sub>2</sub> emission is merely 1.02, compared to 20.01 for the US and 9.4 for the EU. It is also well below the world average of 4.25.<sup>146</sup> Third, economic development is extremely important for developing countries like India that are still fraught with widespread poverty and economic backwardness. Maintaining a high growth rate is essential for increasing living standards of vast majority of people in these countries and

reducing their vulnerability to the impacts of climate change.<sup>147</sup> Importantly, all these imperatives of developing countries have been acknowledged by the UNFCCC. Based as it is on the core principles of ‘equity’ and ‘common but differentiated responsibilities and respective capabilities’, the Convention recognizes (in Article 4.7) that ‘economic and social development and poverty eradication are the *first and overriding priorities* of the developing country Parties [emphasis added]’. It further affirms (in Article 3.4) that ‘(t)he Parties have a *right to, and should, promote sustainable development. Policies and measures* to protect the climate system against human-induced change *should be appropriate for the specific conditions of each Party and should be integrated with national development programmes, taking into account that economic development is essential for adopting measures to address climate change* [emphasis added].’

While the ‘Bali Action Plan’ (BAP) that provides the road-map for the ongoing UNFCCC negotiations on post-2012 climate change regime, envisages quantified emission reduction for developed countries, it does not do so for developing countries. The latter are only expected to consider undertaking ‘nationally appropriate mitigation actions’ (NAMAs) in the context of sustainable development. Notably, Brazil, in a submission to the UNFCCC, has rightly pointed out that ‘(i)n a context where all must act to face the challenge of climate change, it is essential to remember that mitigation measures of developing and developed countries are different in nature, as clearly defined in the Convention, Kyoto Protocol and, more recently, in the Bali Action Plan. The UNFCCC is based on the principle of common but differentiated responsibilities, which is reflected in distinct Annex I and non-Annex I legal obligations throughout the provisions of the Convention’. This principle, according to Brazil, is a cornerstone of the regime and should guide the work of the AWG-LCA (Ad Hoc Working Group on Long-term Cooperative Action), which is mandated by the Bali COP to follow up on the BAP.

On the basis of the foregoing discussion, it may be argued that developing countries should not be expected to carry out similar actions as are taken by developed countries like the EU.

Coming to the second question, it needs to be mentioned that developing countries like China or India, despite not having any binding commitments on GHG reduction under the Kyoto Protocol, have already undertaken a range of policy measures towards GHG mitigation and plan to undertake many more. However, developing countries' endeavours on climate change are constrained in large measures by their lack of financial and technological capabilities. Importantly, recognizing these constraints, the UNFCCC have several provisions that obligate developed countries to provide support to developing countries. Article 4.3, for instance, requires developed countries to provide financial resources including for technology transfer needed by developing countries to meet their agreed full incremental costs of implementing measures. Article 4.5 further commits developed countries to take all practicable steps to facilitate and finance transfer of and access to environmentally sound technologies and know how particularly to developing countries; and requires them to support the development and enhancement of endogenous capacities and technologies of developing countries. Article 4.7 clearly states that the extent to which developing countries would implement their commitments would depend on effective implementation of developed countries' commitments on financing and technology transfer. Notwithstanding such provisions enshrined in the UNFCCC, finance and technology transfer from developed countries, including the EU, to developing countries, have so far remained far from adequate. Against this backdrop, the BAP has provided for '(e)nhanced action on technology development and transfer to support action on mitigation and adaptation' and '(e)nhanced action on the provision of financial resources and investment to support action on mitigation and adaptation and technology cooperation'. It also envisages '(n)ationally appropriate mitigation actions by developing country Parties in the context of sustainable development' to be 'supported and enabled by technology, financing and capacity-building, in a measurable, reportable and verifiable manner'.

Given the aforesaid provisions on financing and technology transfer in the UNFCCC and the importance attached to these aspects in the BAP, any determination on specific conditions prevailing in developing countries may also take into account whether the EU, as a developed country Party of

the UNFCCC, has complied with its obligations on financing and technology transfer as enshrined in the UNFCCC before applying the CES. It may be argued that such initiatives on the part of the EU could go a long way in helping developing countries undertake enhanced actions towards GHG mitigation. Importantly, the EU climate package states, in the context of the proposed CES, that ‘(a)ny action taken would need to be in conformity with the principles of the UNFCCC, in particular the principle of common but differentiated responsibilities and respective capabilities’

It may be argued on the basis of the aforesaid analysis that 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. Because, as mentioned earlier, to qualify the *chapeau* test, all the three tiers of the test (arbitrary discrimination, unjustifiable discrimination, and disguised restrictions on international trade) have to be qualified.

### **A disguised restriction on international trade**

We will now examine the third tier of the test under Article XX, *chapeau*, i.e. whether the application of the measure (CES) may be regarded as constituting ‘a disguised restriction on international trade’.

Three criteria have been progressively introduced by panels and the AB in order to determine whether a measure is a disguised restriction on international trade: (i) the publicity test,<sup>148</sup> (ii) the consideration of whether the application of a measure also amounts to arbitrary or unjustifiable discrimination,<sup>149</sup> and (iii) the examination of ‘the design, architecture and revealing structure’ of the measure at issue.<sup>150</sup>

If the other two tiers (pertaining to ‘arbitrary discrimination’ and ‘unjustifiable discrimination’) are already qualified, this final tier of the *chapeau* test (pertaining to ‘disguised restriction on international trade’) is

likely to be relatively easier to qualify, if it is publicly announced before bringing it into application and the ‘design, architecture and revealing structure’ of the CES do not indicate protectionist intents blatantly.

From the aforesaid analysis, it may be concluded that the proposed CES is likely to face significant difficulties in complying with requirements pertaining to ‘arbitrary or unjustifiable discrimination’ under Article XX chapeau. Hence, it seems that the EU may find it difficult to justify the proposed CES under Article XX exceptions, if it fails to justify it under substantive requirements of the relevant GATT provisions.

From the detailed analysis carried out in this paper, it may be concluded that the EU may face significant difficulties in justifying its proposed ‘carbon equalization system’ with the WTO rules and requirements. However, it needs to be underscored that much would depend on how the system gets implemented on the grounds, in case the EU decides to go for applying it. In other words, the devil would finally lie in the details.

## **5. CONCLUDING REMARKS**

This paper made an attempt to analyze the issue of WTO compatibility of the carbon equalization system (CES) as proposed by the EU in its 2008 climate-energy package. The focus of the analysis in the paper was on two sets of issues: (i) whether the proposed border measure could conform to the ‘border tax adjustment’ provisions and the Most Favoured Nation (MFN) clause of the GATT (General Agreement on Tariffs and Trade), and if not then (ii) whether the EU could justify it under the ‘General Exceptions’ provisions included in Article XX of the GATT that allow WTO Members, subject to certain conditions included in its *chapeau*, to deviate from their GATT obligations to serve certain legitimate policy objectives, including environmental objectives. The analysis presented in this paper indicates that the EU could face significant difficulties in establishing that the proposed CES would be WTO-compliant. Nevertheless, it needs to be underscored that no definitive conclusion can be reached on this contentious and complex issue of WTO-compatibility or otherwise of the CES unless and until such a measure gets implemented and comes under the scanner of the WTO dispute



settlement system. In any case, much would depend on the nitty-gritty of the actual designing of the measure should the EU decide to implement it. In other words, the devil would finally lie in the details.

The controversy around the carbon tariff issue has been reinforced over the recent months with the inclusion of stringent provisions in this respect in the Waxman-Markey Bill that has been cleared by the US House of Representatives in the end-June 2009. Quite in line with the EU strategies, the Bill includes two approaches to mitigating the potential impact of carbon leakage. The first is free allocation of allowances to energy-intensive, trade-exposed industries (to be identified). The second is an ‘international reserve allowance’ (IRA) scheme that essentially imposes a shadow allowance requirement on importers of energy-intensive, trade-exposed products, thereby creating a *de facto* tariff. Basically, the scheme would require importers of relevant energy-intensive products from countries with insufficient carbon policies to submit a prescribed amount of IRAs for their products to gain entry into the US. Based on the GHG emissions generated in the production process, IRAs would be submitted on a per-unit basis for each category of covered goods from a covered country.<sup>151</sup> The Bill requires that import tariffs be applied to carbon-intensive products in 2020 unless the Congress is informed by the president that border measures are not in the ‘national economic interest’ and such a presidential declaration is formally approved by the Congress. This would make BTA the rule rather than the exception.<sup>152</sup>

However, concerns are widespread even within the US regarding the use of such border measures. Some opponents of the Waxman-Markey Bill in the Senate, where the bill is expected to face greater opposition, have criticised it citing possible WTO rule violations.<sup>153</sup> In addition to uncertainties surrounding WTO compliance, there are also concerns as to how such border measures could affect US exports in case the target countries go for retaliatory measures.<sup>154</sup> It is also apprehended that such measures could even result in trade wars.<sup>155</sup> President Obama himself has sounded caution in sending out protectionist signals through such border measures and instead has expressed his preference to go for other options to address the ‘legitimate’ competitiveness concerns of the US domestic industries.<sup>156</sup>

Notably, even the ‘Clean Energy Jobs and American Power Act’ (introduced by Senators John Kerry and Barbara Boxer, henceforth Kerry-Boxer Bill) that has been approved by the Environment and Public Works Committee of the US Senate on 5 November 2009 proposes inclusion of border measures, though details are yet to be worked out.<sup>157</sup> It remains to be seen how much emphasis finally gets attached to the border measures, should the US decide to include this weapon in the final version of the climate change legislation!

Meanwhile a new round of debates has triggered within the EU by the renewed call by the French President Nicolas Sarkozy for imposing such border measures. Criticizing the Sarkozy line, Sweden, which currently holds the EU’s six-month rotating presidency, has warned that protective measures would block any progress towards a new global climate treaty in Copenhagen in December. Concerns have also been echoed by the European Commission President José Manuel Barroso, who is of the view that as the world’s biggest exporter by far, it was not in Europe’s interest to erect protectionist walls.<sup>158</sup>

From amongst the developing countries, China and India – the key targets of border carbon measures – have already voiced their opposition against such ‘green protectionism’ being contemplated by developed countries on the pretext of climate change.<sup>159</sup> They have called the US proposals for a carbon tariff unacceptable and have hinted at retaliation. They have pointed to the US per capita emissions, which are dramatically higher than the world average, as a basis for retaliating against any US efforts to place tariffs on foreign goods.<sup>160</sup>

Importantly, developing countries have recently taken up the issue at the UNFCCC also. At a meeting of the Ad Hoc Working Group on Long Term Cooperative Action (AWG-LCA) of the UNFCCC in Bonn on 12 August, India proposed the inclusion of the following paragraph in the negotiating text for the Copenhagen conference:<sup>161</sup>

‘Developed country Parties shall not resort to any form of unilateral measures including countervailing border measures, against goods and services imported from developing countries

on grounds of protection and stabilization of climate. Such unilateral measures would violate the principles and provisions of the Convention, including, in particular, those related to the principle of common but differentiated responsibilities (Article 3, Paragraph 1); trade and climate change (Article 3 paragraph 5); and the relationship between mitigation actions of developing countries and provision of financial resources and technology by developed country Parties (Article 4, Paragraphs 3 and 7).’

The Group of 77 and China – the largest developing country grouping in the UNFCCC negotiations - also called on developed countries (in the same August session) not to adopt unilateral trade-restrictive measures against developing countries. The group argued that adoption of such measures by the developed countries would be tantamount to passing on the mitigation burden by them onto developing countries, and that it would contravene the principles and provisions of the UNFCCC. The G77 and China pointed out that the measures would in particular be contravening the Convention’s principles of ‘equity’, and ‘common but differentiated responsibilities and respective capabilities’, as well as the principle enshrined in Article 3.5 that the Parties should cooperate to promote a supportive and open international economic system that would lead to sustainable economic growth and development in all Parties, particularly developing country Parties.<sup>162</sup>

Evidently, carbon tariffs will continue to remain at the centre-stage of an intense debate as developed countries find themselves under increasing pressure to undertake stricter GHG reduction targets in the post-2012 climate change regime. However, given the multi-pronged concerns, including its WTO-compatibility, looming large over such border measure, it remains to be seen whether any such measure finally gets implemented!

## Endnotes

<sup>1</sup> Cosby (2008), p.20.

<sup>2</sup> As observed by WTO-UNEP (2009):

“It should be noted, however, that studies to date find generally that the cost of compliance with an emission trading scheme is a relatively minor component of a firm’s overall costs, which include exchange-rate fluctuations, transportation costs, energy prices and differences across countries in the cost of labour. Of course, the carbon constraint in future emission trading schemes (for example, in Phase III of the EU-ETS) is expected to be more stringent, with a lower capped limit and fewer free allowances. This may therefore increase the potential impact of carbon costs on the competitiveness of a number of industrial sectors.”

<sup>3</sup> Reinaud (2008), p. 27.

<sup>4</sup> The package was proposed by the European Commission on 23 January 2008 [See EC (2008)]. A revised (watered-down) version of the package was finally adopted by the European Parliament on 17 December 2008. The package proposed a 20-20-20 targets for the EU to achieve by 2020: a 20-per cent reduction in GHG emissions from 1990 levels; increasing the share of renewables in the EU’s energy mix to 20 per cent from 8.5 per cent today; and a 20-per cent cut in energy use through improved energy efficiency.

<sup>5</sup> The EU ETS is a ‘cap and trade’ system. It caps the overall level of emissions allowed, but within that limit allows participants in the system to buy and sell allowances as they require. It requires companies to surrender allowances equivalent to their levels of CO<sub>2</sub> emissions. These allowances are the common trading ‘currency’ at the heart of the system. One allowance gives the holder the right to emit one tonne of CO<sub>2</sub>. The cap on the total number of allowances is what creates scarcity in the market. The EU ETS is the cornerstone of the EU’s strategy for fighting climate change. The ETS, was launched on 1 January 2005 as the key tool for the EU to achieve, in a cost-effective manner, its commitments under the 1997 Kyoto Protocol of the UNFCCC to reduce GHG emissions. While the first phase, 2005-07, was seen as an experimental phase of the EU ETS, the second phase, 2008-12, coincides with the first commitment period of the Kyoto protocol. From the start of 2008 the EU ETS applies not only to the 27 EU Member States but also the other three members of the European Economic Area – Norway, Iceland and Liechtenstein. It currently covers over 12,000 installations in the energy and industrial sectors which are collectively responsible for close to half of the EU’s emissions of CO<sub>2</sub> and 40 per cent of its total GHG emissions.

<sup>6</sup> Share of auctioning in total allowances distributed is proposed to be increased from less than 4 per cent in phase 2 (2008-12) of the EUETS to more than half in phase 3 (2013-20).

<sup>7</sup> The final version, which was widely criticized by the environmentalists as a ‘watered-down’ one, stipulates that for sectors that are not exposed to the risk of

carbon leakage, the level of auctioning of allowances will increase in a linear manner, quite in line with the Commission proposals; but rather than reaching 100 per cent auctioning by 2020 as proposed by the Commission, the final version envisages 70 per cent auctioning by 2020, with a view to reaching 100 per cent by 2027.

<sup>8</sup> The Commission draft (of 23 January) included the deadline of 31 June 2010 for this purpose. However, in view of the urgency demonstrated by the stakeholders the final version (of 17 December) preponed the deadline.

<sup>9</sup> As observed by WTO-UNEP (2009):

“The effects of climate change measures on the competitiveness of sectors will depend on a number of factors that relate to: (i) the specific characteristics of the sector (e.g. its trade exposure; how energy intensive or CO<sub>2</sub> emission intensive it is; its direct and indirect carbon costs;(footnote omitted) its production costs; the ability to pass on cost increases through prices; the market structure; transportation costs; its capacity to reduce emissions and/or energy consumption; the possibility to evolve towards cleaner production technologies and processes); (ii) the design of the regulation (e.g. the amount of the carbon charge; the stringency of the regulation; the availability of alleviations and exemptions; and in the case of an emission trading scheme the allocation method for allowances); and (iii) other policy considerations (e.g. energy and climate policies adopted by other countries). (footnote omitted) The influence of each of these factors may be industry specific and quite complex to determine. Two of these factors have been at the centre of discussions on the effects on competitiveness of recent emission trading schemes and of those under consideration: the ‘cost pass-through capability’ of companies, and their trade exposure.”

<sup>10</sup> The issue of conformity of such measures with the UNFCCC has recently been flagged by the developing countries, as discussed in the concluding section of this paper.

<sup>11</sup> “There is one trade policy response to climate change about which I have serious doubts. That is the idea of a specific ‘climate’ tariff on countries that have not ratified Kyoto. This would be highly problematic under current WTO rules and almost impossible to implement in practice”, he opined [see, [http://ec.europa.eu/commission\\_barroso/mandelson/speeches\\_articles/sppm136\\_en.htm](http://ec.europa.eu/commission_barroso/mandelson/speeches_articles/sppm136_en.htm)]

<sup>12</sup> For legal reasons, the European Union is known officially as the European Communities in WTO business. The EU is a WTO member in its own right as are each of its 27 member States — making 28 WTO members altogether. While the member States coordinate their position in Brussels and Geneva, the European Commission alone speaks for the EU and its members at almost all WTO meetings and in almost all WTO affairs. For this reason, in most issues, WTO materials refer to the ‘EU’, or the legally-official ‘EC’[[www.wto.org](http://www.wto.org)].

<sup>13</sup> Notably, the Appellate Body in *Japan – Alcoholic Beverages II* observed that “(a)dopted panel reports are an important part of the GATT *acquis*” and that

unadopted panel reports, despite not having any binding effects, could nevertheless serve as “useful guidance.” The AB noted: “Adopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute. However, they are not binding, except with respect to resolving the particular dispute between the parties to that dispute.” [Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* (henceforth *Japan – Alcoholic Beverages II*), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, p. 108. Also see Panel Report, *Japan – Alcoholic Beverages II*, WT/DS8/R, WT/DS10/R, WT/DS11/R, adopted 1 November 1996, as modified by Appellate Body Report WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, DSR 1996:I, 125para. 6.10]. Furthermore, in the *Shrimp-Turtle II* case, the AB pointed out that the same reasoning ‘applies to adopted Appellate Body Reports as well [Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products – Recourse to Article 21.5 of the DSU by Malaysia* (hereinafter *Shrimp-Turtle II*), WT/DS58/AB/RW, adopted 21 November 2001, DSR 2001:XIII, 6481, para. 109].

<sup>14</sup> GATT (1970).

<sup>15</sup> The Working Party noted that “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.’” “Nevertheless, the term ‘border tax adjustment’ continues to be widely used.

<sup>16</sup> Article III.2 of the GATT reads as follows:

“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 [footnote omitted].”

Paragraph 1 of Article III reads as follows:

“The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture,

processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production [footnote omitted].”

- <sup>17</sup> It may be recalled at this juncture that, the Appellate Body in *Chile – Price Band System* observed that Article II:2 sets out ‘examples’ of measures which do not qualify as either ordinary customs duties or other duties or charges within the meaning of Article II:1(b).[ Appellate Body Report, *Chile – Price Band System and Safeguard Measures Relating to Certain Agricultural Products* (henceforth *Chile – Price Band System*), WT/DS207/AB/R, adopted 23 October 2002, DSR 2002:VIII, 3045 (Corr.1, DSR 2006:XII, 5473), para. 276.] Here an issue could arise whether Article II:2 exhaustively define the universe of charges that do not inherently discriminate against, or disadvantage, imports or whether it identifies only examples of such charges.
- <sup>18</sup> GATT Panel Report, *EEC – Measures on Animal Feed Proteins* (49EEC – *Animal Feed Proteins*), L/4599, adopted 14 March 1978, BISD 25S/, para. 4.16c.
- <sup>19</sup> Panel Report, *India – Additional and Extra-Additional Duties on Imports from the United States* (henceforth *India – Additional Import Duties*), WT/DS360/R, adopted 17 November 2008, reversed by Appellate Body Report WT/DS360/AB/R, fn. 216.
- <sup>20</sup> OECD (1996), p. 14.
- <sup>21</sup> *Ibid.*
- <sup>22</sup> Auctioning involves costs at two levels: compliance costs as companies have to purchase all allowances (in case of 100 per cent auctioning); and transaction costs to prepare for and participate in the auction (Ecofys, 2006, p.21).
- <sup>23</sup> Ismer and Neuhoff (2004), p. 11.
- <sup>24</sup> However, it may not always be the case, in view of the fact that price of allowances at some future date is uncertain and might differ from the price paid in the auction.
- <sup>25</sup> OECD (1996), p.15.
- <sup>26</sup> *Grandfathered allowances* are distributed in proportion to sources’ past emissions, measured for one or several years. Grandfathering can either be a one-off allocation to existing installations (e.g. the US acid rain SO<sub>2</sub> trading programme), or be regularly updated with new emissions data. Allowances can also be distributed for free based on the average, or expected, performance for the sector as a whole (e.g. tonne of emissions per unit of output). This is generally called *benchmarking*. Benchmarking can provide either fixed allowances based on expected output or be used in a rate-based trading system, with allowances adjusted ex-post based on actual production volumes This, however, is not permitted under the EU ETS. As noted by the European Commission, in its decision about the proposed second National Allocation Plan submitted by the Netherlands,– ex post adjustments contradict the essential concept of a cap-and-trade system as conceived by the [EU ETS] Directive (see, Reinaud, 2008, pp.71 and 79. Also see, [http://ec.europa.eu/environment/climat/pdf/nl\\_nap\\_decision\\_en.pdf](http://ec.europa.eu/environment/climat/pdf/nl_nap_decision_en.pdf)).
- <sup>27</sup> Free allocation in the first and second trading periods of the EU-ETS were not designed to prevent carbon leakage, but rather to compensate to potentially stranded

assets. This is a somewhat different logic than for the third trading period as free allocation in this case would be to prevent carbon leakage [Reinaud (2008), Footnote 112, p.73].

<sup>28</sup> According to the 2008 package full auctioning should be the rule from 2013 onwards for the power sector, taking into account their ability to pass on the increased cost of CO<sub>2</sub>, and no free allocation should be given for carbon capture and storage as the incentive for this arises from allowances not being required to be surrendered in respect of emissions which are stored. Electricity generators may receive free allowances for district heating and cooling and for heat and cooling produced through high efficiency cogeneration as defined by Directive 2004/8/EC in the event that such heat produced by installations in other sectors were to be given free allocations, in order to avoid distortions of competition. For other sectors covered by the Community scheme, a transitional system should be foreseen for which free allocation in 2013 would be 80 per cent of the amount that corresponded to the percentage of the overall Community-wide emissions throughout the period 2005 to 2007 that those installations emitted as a proportion of the annual Community-wide total quantity of allowances. Thereafter, the free allocation should decrease each year by equal amounts resulting in 30 per cent free allocation in 2020, with a view to reaching no free allocation in 2027.

<sup>29</sup> Given that emission allowances have a market value, failure to abate emissions below the level of allocated allowances, even when handed-out for free, does involve an 'opportunity cost' in the form of foregone earning. Notably, reports show that even during the Phase I of ETS (2005-07), when the lion's share of allowances were 'grandfathered', and that too quite liberally, an effective carbon price emerged in the EU market that reflected the balance between supply and demand. Despite over-allocation, which clearly existed in some Member States and sectors, a significant price was paid for CO<sub>2</sub> emissions during 2005-06, which induced some emission abatement. It has further been revealed that no big industrial and financial players in the EU considered carbon to be free any longer in Europe and perceived that carbon emissions would continue to be costly in the future (See, Convery et al., 2008, p. 25).

<sup>30</sup> In the context of the present discussion, an observation made by the WTO dispute panel in *Argentina-Hides and Leather*, while examining an advance tax payments requirement that allegedly imposed a higher tax burden on imports, is worth a mention. The panel noted that the actual tax burden which arises from the prepayment requirement may take one of two forms, depending on the factual circumstances of each case. First, in situations where taxable persons have disposable working capital to finance the prepayment, they are forced, on account of the prepayment requirement, to forego interest on that working capital in the interval between the tax prepayment and its crediting. Alternatively, in situations where taxable persons do not have disposable working capital to finance the prepayment, they need to raise the necessary capital and pay interest on it in the interval between the tax prepayment and its crediting. The panel then observed that it was clear that both of these situations gave rise to a financial burden, an opportunity 'cost' in one



case and a debt financing ‘cost’ in the other. Moreover, it was readily apparent, as per the panel, that the financial burden was incidental to and directly caused by the pre-payment requirement. For these reasons, the panel was of the view that the pre-payment requirement was properly regarded as an integral part of the actual tax burden and as such, it fell squarely within the scope of Article III:2, first sentence [Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and Import of Finished Leather* (henceforth *Argentina-Hides and Leather*), WT/DS155/R and Corr.1, adopted 16 February 2001, DSR 2001:V, 1779, paras. 11.187 and 11.188].

<sup>31</sup> Pauwelyn (2007), pp.22-23.

<sup>32</sup> Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added.

<sup>33</sup> GATT (1970), para.15.

<sup>34</sup> It may be mentioned here that the negotiating history or the preparatory work of a treaty and the circumstances of its conclusion is acknowledged by Article 32 of the Vienna Convention on the Law of Treaties (1969) as a “supplementary means of interpretation” of a treaty language, particularly in the cases of ambiguities. Article 32 of the Vienna Convention reads as follows:

“Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable.”

Article 31 on “General rule of interpretation” reads as follows:

1. “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
  - (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
  - (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
  - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
  - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
  - (c) any relevant rules of international law applicable in the relations between the parties.”

4. A special meaning shall be given to a term if it is established that the parties so intended.”
- <sup>35</sup> See WTO, 1995, p. 141, referring to EPCT/A/PV/9, p. 19 and EPCT/C.II/W.5, p. 5. See also footnote 58 of the 1994 Subsidies Agreement (which contains the same language as footnote 1 of the 1979 Code) that defines ‘prior-stage’ indirect taxes as ‘those levied on goods or services used directly or indirectly in making the product’ [emphasis added].
- <sup>36</sup> This language was first introduced by the United States negotiator, Oscar B. Ryder at the London Preparatory Committee. The Brazilian delegate demanded to know what was meant by the addition of the term “or indirectly”. Mr Ryder replied that the language was to allow border adjustments on “a tax, not a tax on a product as such, but on the processing of a product, which are covered by the word ‘indirectly’ here” [see, UNESCO, 1947, p. 18].
- <sup>37</sup> Pauwelyn (2007), fn.51, p. 20.
- <sup>38</sup> EPCT/TAC/PV/26, p. 21, referred to in WTO, 1995, p. 86.
- <sup>39</sup> Brack *et al.* 2000, p.84.
- <sup>40</sup> GATT Panel Report, *United States – Taxes on Petroleum and Certain Imported Substances* (henceforth *US – Superfund*), L/6175, adopted 17 June 1987, BISD 34S/136, paras. 5.2.7-5.2.8.
- <sup>41</sup> WTO (1997).
- <sup>42</sup> Article III:1 reads as follows:
- “The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production. [footnote omitted].”
- <sup>43</sup> Appellate Body Report, *Canada – Certain Measures Concerning Periodicals* (henceforth *Canada-Periodicals*), WT/DS31/AB/R, adopted 30 July 1997, DSR 1997:I, 449, pp. 22-23.
- <sup>44</sup> There are indeed some such indications visible in the EU, where some consumers are reportedly taking into account carbon-footprints of products while making their purchase decisions. [See for instance, *African trade fears carbon footprint backlash*, available at: <http://news.bbc.co.uk/2/hi/business/6383687.stm>]
- <sup>45</sup> In *EC – Asbestos*, the Appellate Body reviewed the Panel’s approach to its “likeness” analysis, and criticized the Panel for not taking into account *all* of the relevant criteria:
- “It is our view that, having adopted an approach based on the four criteria set forth in *Border Tax Adjustments*, the Panel should have examined the evidence relating to each of those four criteria and, then, weighed *all* of that evidence, along with any other relevant evidence, in making an *overall* determination of whether the products at issue could be characterized as ‘like’. Yet, the Panel expressed a

‘conclusion’ that the products were ‘like’ after examining only the *first* of the four criteria. The Panel then repeated that conclusion under the second criterion – without further analysis – before dismissing altogether the relevance of the third criterion and also before rejecting the differing tariff classifications under the fourth criterion. In our view, it was inappropriate for the Panel to express a ‘conclusion’ after examining only one of the four criteria. By reaching a ‘conclusion’ without examining all of the criteria it had decided to examine, the Panel, in reality, expressed a conclusion after examining only some of the evidence. Yet, a determination on the ‘likeness’ of products cannot be made on the basis of a partial analysis of the evidence, after examination of just one of the criteria the Panel said it would examine. For this reason, we doubt whether the Panel’s overall approach has allowed the Panel to make a proper characterization of the ‘likeness’ of the fibres at issue.” [Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products* (henceforth, *EC – Asbestos*), WT/DS135/AB/R, adopted 5 April 2001, DSR 2001:VII, 3243, para. 109]

Further, in *EC – Asbestos*, the Appellate Body acknowledged that an analysis of the various criteria for establishing ‘likeness’ can produce ‘conflicting indications’; however, it emphasized that the fact that the analysis of a particular criterion may produce an unclear result does not relieve a panel of its duty to inquire into the relevant evidence:

“In many cases, the evidence will give conflicting indications, possibly within each of the four criteria. For instance, there may be some evidence of similar physical properties and some evidence of differing physical properties. Or the physical properties may differ completely, yet there may be strong evidence of similar end-uses and a high degree of substitutability of the products from the perspective of the consumer. A panel cannot decline to inquire into relevant evidence simply because it suspects that evidence may not be ‘clear’ or, for that matter, because the parties agree that certain evidence is not relevant. In any event, we have difficulty seeing how the Panel could conclude that an examination of consumers’ tastes and habits ‘would not provide clear results’, given that the Panel did not examine any evidence relating to this criterion.” [Appellate Body Report, *EC – Asbestos*, para. 120]

<sup>46</sup> The Appellate Body in the *EC-Asbestos* case emphasized that these criteria were not treaty language nor did they constitute a ‘closed list’:

“These general criteria, or groupings of potentially shared characteristics, provide a framework for analyzing the ‘likeness’ of particular products on a case-by-case basis. These criteria are, it is well to bear in mind, simply tools to assist in the task of sorting and examining the relevant evidence. They are neither a treaty-mandated

nor a closed list of criteria that will determine the legal characterization of products. More important, the adoption of a particular framework to aid in the examination of evidence does not dissolve the duty or the need to examine, in each case, *all* of the pertinent evidence. In addition, although each criterion addresses, in principle, a different aspect of the products involved, which should be examined separately, the different criteria are interrelated. For instance, the physical properties of a product shape and limit the end-uses to which the products can be devoted. Consumer perceptions may similarly influence – modify or even render obsolete – traditional uses of the products. Tariff classification clearly reflects the physical properties of a product.” [Appellate Body Report, *EC – Asbestos*, para. 102]

<sup>47</sup> The Appellate Body in *Japan-Alcoholic Beverages II* observed:

“[P]roblems arising from the interpretation of the term [like product] should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a “similar” product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is “similar”: the product’s end-uses in a given market; consumers’ tastes and habits, which change from country to country; the product’s properties, nature and quality.” [Appellate Body Report, *Japan-Alcoholic Beverages II*, pp. 19-20 and pp. 25-26]

<sup>48</sup> As observed by the AB: “In applying the criteria cited in *Border Tax Adjustments* to the facts of any particular case, and in considering other criteria that may also be relevant in certain cases, panels can only apply their best judgement in determining whether in fact products are ‘like’. This will always involve an unavoidable element of individual, discretionary judgement. We do not agree with the Panel’s observation in paragraph 6.22 of the Panel Report that distinguishing between ‘like products’ and ‘directly competitive or substitutable products’ under Article III:2 is ‘an arbitrary decision’. Rather, we think it is a discretionary decision that must be made in considering the various characteristics of products in individual cases.” [Appellate Body Report, *Japan-Alcoholic Beverages II*, pp.19-21]

<sup>49</sup> GHG emissions involved in the production process may vary depending on the product, the company and the country. The CO<sub>2</sub> intensity of a product (i.e. embedded CO<sub>2</sub> divided by its value) depends on the quantity of fuels used, the production process of a particular good, the energy efficiency of the production process, the type of fuels or energy used, the source of the energy (i.e. the particular energy mix used in the country of production) (WTO-UNEP, 2009, p.101).

<sup>50</sup> It needs to be mentioned here that this assumption may not hold for all the sectors covered by the EU ETS. It would also depend on the developing country under consideration and may also vary from one installation to another within a particular developing country. One can come across instances where new installations have been constructed in developing countries that tend to be more carbon-efficient than in the EU.

- <sup>51</sup> Otherwise, country Z would not have been a target of the CES in the first place.
- <sup>52</sup> Unless of course, producers in country Z ‘voluntarily’ undertake similarly stringent actions as producers in the EU would take on under a ‘mandatory’ carbon constraint! However, one can indeed come across some instances where new installations have been constructed in developing countries that tend to be more carbon-efficient than those in some developed countries. Hence, it needs to be mentioned here that this assumption may not hold for all the sectors covered by the EU ETS. It would also depend on the developing country under consideration and may also vary from one installation to another within a particular developing country.
- <sup>53</sup> The panel on *Japan - Alcoholic Beverages II* found that “[t]he phrase ‘not in excess of those applied ... to like domestic products’ should be interpreted to mean at least identical or better treatment.” Confirming this interpretation, the AB further pointed out that the first sentence of Article III:2 is not qualified (unlike the second sentence of that Article) by a *de minimis* standard. Accordingly, “even the smallest amount of ‘excess’ is too much.” [Appellate Body Report, *Japan –Alcoholic Beverages II*, p. 23].
- <sup>54</sup> See, for instance, Pauwelyn, 2007, p. 31. Also see, Hoerner and Muller, 1996, pp. 35-36.
- <sup>55</sup> The same mechanism – voluntary reporting and backup imputation based on the US predominant method of production – was adopted also in the US ozone-depleting chemicals tax.
- <sup>56</sup> It may be recalled in this context that in *Argentina - Hides and Leather*, the panel pointed out that: “Article III:2, first sentence, is applicable to each individual import transaction. It does not permit Members to balance more favourable tax treatment of imported products in some instances against less favourable tax treatment of imported products in other instances [footnote omitted]”. [ Panel Report, *Argentina - Hides and Leather*, para. 11.260]
- <sup>57</sup> The facts of the 1998 *Outokumpu Oy* case in the EU makes an interesting reading in this context. The Finnish government had imposed a tax on electricity using different rates depending on how it was generated. Finland taxed imports at a flat rate set to approximate an average of the domestic rates, because it argued that it was impossible to determine how imported electricity was produced once it had entered the distribution network. Outokumpu Oy, an electricity importer, complained that this fl at rate was a violation of the European Communities Treaty, which forbids direct and indirect discrimination against imported products. The European Court of Justice agreed and explained that Finland’s law did not give the importer the opportunity to demonstrate that its electricity was produced by a particular method in order to qualify for the rate applicable to domestic electricity produced by the same method. However, the Court also held that, provided that a tax differential was based on objective criteria and applied to domestic and foreign products alike, it was lawful for member states to tax the same or similar products differentially [*Excise duty on electricity - Rates of duty varying according to the method of producing electricity of domestic origin - Flat rate for imported electricity*, Judgment of the Court of 2 April 1998, Case C-213/96, as discussed in WTO-UNEP (2009), p.102].

- <sup>58</sup> Ismer and Neuhoff (2004), p.15.
- <sup>59</sup> Panel Report, *Argentina-Hides and Leather*, paras 11.182-11.184.
- <sup>60</sup> The panel on *Japan - Alcoholic Beverages II* found that “[t]he phrase ‘not in excess of those applied ... to like domestic products’ should be interpreted to mean at least identical or better treatment’. Confirming this interpretation, the AB further pointed out that the first sentence of Article III:2 is not qualified (unlike the second sentence of that Article) by a *de minimis* standard. Accordingly, “even the smallest amount of ‘excess’ is too much.” [Appellate Body Report, *Japan –Alcoholic Beverages II*, p. 23].
- <sup>61</sup> Appellate Body Report, *Japan – Alcoholic Beverages II*, p.24.
- <sup>62</sup> Appellate Body Report on *Japan - Alcoholic Beverages II*, p. 25.
- <sup>63</sup> It may be noted here that, Article 32 of the Vienna Convention provides that it is appropriate to refer to the negotiating history of a treaty provision in order to confirm the meaning of the terms as interpreted pursuant to the application of Article 31.
- <sup>64</sup> Panel Report, *Korea – Taxes on Alcoholic Beverages* (henceforth, *Korea - Alcoholic Beverages*), WT/DS75/R, WT/DS84/R, adopted 17 February 1999, as modified by Appellate Body Report WT/DS75/AB/R, WT/DS84/AB/R, DSR 1999:I, 44, paras. 10.37-10.40.
- <sup>65</sup> Appellate Body Report on *Japan - Alcoholic Beverages II*, p. 25.
- <sup>66</sup> The AB noted:  
“The GATT 1994 is a commercial agreement, and the WTO is concerned, after all, with markets. It does not seem inappropriate to look at competition in the relevant markets as one among a number of means of identifying the broader category of products that might be described as ‘directly competitive or substitutable.”  
Nor does it seem inappropriate to examine elasticity of substitution as one means of examining those relevant markets. The Panel did not say that cross-price elasticity of demand is “*the* decisive criterion’ for determining whether products are ‘directly competitive or substitutable’.” [Appellate Body Report, *Japan - Alcoholic Beverages II*, p. 25]
- <sup>67</sup> Upon appeal, Korea argued that through its reliance on the “nature of competition” the Panel had created a “vague and subjective element” not found in Article III:2, second sentence. The Appellate Body, however, shared the Panel’s scepticism towards reliance upon the “quantitative overlap of competition”:  
“In taking issue with the use of the term ‘nature of competition’, Korea, in effect, objects to the Panel’s sceptical attitude to quantification of the competitive relationship between imported and domestic products. For the reasons set above, we share the Panel’s reluctance to rely unduly on quantitative analyses of the competitive relationship.[footnote omitted] In our view, an approach that focused solely on the quantitative overlap of competition would, in essence, make cross-price elasticity *the* decisive criterion in determining whether products are ‘directly competitive or substitutable.’” [Appellate Body Report, *Korea - Alcoholic Beverages*,

WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999, DSR 1999:I, 3, para. 134]

<sup>68</sup> The AB noted:

“The term ‘directly competitive or substitutable’ describes a particular type of relationship between two products, one imported and the other domestic. It is evident from the wording of the term that the essence of that relationship is that the products are in competition. This much is clear both from the word ‘competitive’ which means ‘characterized by competition’, and from the word ‘substitutable’ which means ‘able to be substituted’. The context of the competitive relationship is necessarily the marketplace since this is the forum where consumers choose between different products. Competition in the market place is a dynamic, evolving process. Accordingly, the wording of the term ‘directly competitive or substitutable’ implies that the competitive relationship between products is *not* to be analyzed *exclusively* by reference to *current* consumer preferences. In our view, the word ‘substitutable’ indicates that the requisite relationship *may* exist between products that are not, at a given moment, considered by consumers to be substitutes but which are, nonetheless, *capable* of being substituted for one another.

Thus, according to the ordinary meaning of the term, products are competitive or substitutable when they are interchangeable [footnote omitted] or if they offer, as the Panel noted, ‘alternative ways of satisfying a particular need or taste’. Particularly in a market where there are regulatory barriers to trade or to competition, there may well be latent demand. [footnote omitted] The words ‘competitive or substitutable’ are qualified in the *Ad Article* by the term ‘directly’. In the context of Article III:2, second sentence, the word ‘directly’ suggests a degree of proximity in the competitive relationship between the domestic and the imported products. The word ‘directly’ does not, however, prevent a panel from considering both latent and extant demand.”[ Appellate Body Report, *Korea - Alcoholic Beverages*, para. 116]

The Appellate Body in *Korea - Alcoholic Beverages* concluded its analysis of why ‘latent’ demand had to be considered in the interpretation of ‘directly competitive or substitutable products’:

“We note, however, that actual consumer demand may be influenced by measures other than internal taxation. Thus, demand may be influenced by, *inter alia*, earlier protectionist taxation, previous import prohibitions or quantitative restrictions...[T]he term ‘directly competitive or substitutable’ does not prevent a panel from taking account of evidence of latent consumer demand as one of a range of factors to be considered when assessing the competitive relationship between imported and domestic products under Article III:2, second sentence, of the GATT 1994.”[ Appellate Body Report, *Korea - Alcoholic Beverages*, paras. 122-24]

<sup>69</sup> This may be the case provided the tax on imported X is higher than *de minimis* compared to domestically produced Y, which in our hypothetical scenario is assumed to be not taxed at all (see Appellate Body Report, *Japan - Alcoholic Beverages II*, p. 33). It may further be argued that if X is highly emission-intensive, then even with the best available technology in the home market (BATHM) approach, it may be possible to imagine a situation where the tax on imported X may indeed be found to be ‘not similarly taxed’ compared to domestically produced Y in the EU, thereby satisfying the second tier of the test under Article III:2, second sentence.

<sup>70</sup> Appellate Body Report, *Japan - Alcoholic Beverages II*, p.29. The AB noted:

“... The dissimilar taxation must be more than *de minimis*. It may be so much more that it will be clear from that very differential that the dissimilar taxation was applied ‘so as to afford protection’. In some cases, that may be enough to show a violation. In this case, the Panel concluded that it was enough. Yet in other cases, there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied ‘so as to afford protection’. In any case, the three issues that must be addressed in determining whether there is such a violation must be addressed clearly and separately in each case and on a case-by-case basis. And, in every case, a careful, objective analysis, must be done of each and all relevant facts and all the relevant circumstances in order to determine ‘the existence of protective taxation’ [footnote omitted]”. [Appellate Body Report, *Japan - Alcoholic Beverages II*, p. 33]

<sup>71</sup> It may be recalled here that in *Japan - Alcoholic Beverages II*, the Appellate Body held that the very magnitude of the tax differentials may be evidence of the protective application of a national fiscal measure. The AB noted:

“... The dissimilar taxation must be more than *de minimis*. It may be so much more that it will be clear from that very differential that the dissimilar taxation was applied ‘so as to afford protection’. In some cases, that may be enough to show a violation. In this case, the Panel concluded that it was enough.” [Appellate Body Report, *Japan - Alcoholic Beverages II*, p. 33]

<sup>72</sup> Appellate Body Report, *Japan - Alcoholic Beverages II*, p. 33.

<sup>73</sup> For support, see, Ismer and Neuhoff, 2004, p. 17.

<sup>74</sup> In *Korea - Alcoholic Beverages*, Korea appealed the Panel’s finding that the Korea tax measures were inconsistent with Article III:2, second sentence, on the ground that the Panel ignored the explanation provided by Korea of the structure of the subject Korean taxation on liquor products. The Appellate Body rejected Korea’s argument and expressed its agreement with the Panel’s approach:

“Although [the Panel] considered that the magnitude of the tax differences was sufficiently large to support a finding that the contested measures afforded protection to domestic production, the Panel also considered the structure and design of the measures. In addition, the Panel found that, in practice,” [t]here is virtually no imported soju so



the beneficiaries of this structure are almost exclusively domestic producers'. In other words, the tax operates in such a way that the lower tax brackets cover almost exclusively domestic production, whereas the higher tax brackets embrace almost exclusively imported products. In such circumstances, the reasons given by Korea as to why the tax is structured in a particular way do not call into question the conclusion that the measures are applied 'so as to afford protection to domestic production'. Likewise, the reason why there is very little imported soju in Korea does not change the pattern of application of the contested measures." [Appellate Body Report, *Korea - Alcoholic Beverages*, para. 150]

<sup>75</sup> Appellate Body Report, *Canada - Periodicals*, p. 29.

<sup>76</sup> Ismer and Neuhoff, p. 29.

<sup>77</sup> See for instance, Ismer and Neuhoff, 2004, p. 11.

<sup>78</sup> Ismer and Neuhoff (2004), p. 11.

<sup>79</sup> As pointed out by the AB in *Korea - Alcoholic Beverages*, "[t]he object and purpose of Article III is the maintenance of equality of competitive conditions for imported and domestic products."

The AB further clarified that: "The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. ... Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products. ... Moreover, it is irrelevant that the 'trade effects' of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent; Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products (emphasis added)." [Appellate Body Report, *Korea - Alcoholic Beverages*, paras. 119 and 127].

<sup>80</sup> The full provision of Article I:1 of the GATT 1994 reads as follows:

With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III,\* 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.

<sup>81</sup> It may be noted here that the 2008 package clearly links the carbon-leakage problem with these categories of countries. It states: "In the event that other developed countries and other major emitters of greenhouse gases do not participate in an

- international agreement that will achieve the objective of limiting global temperature increase to 2°C, certain energy-intensive sectors and sub-sectors in the Community subject to international competition could be exposed to the risk of carbon leakage.”
- 82 Pauwelyn (2007), p.33.
- 83 The MMPA actually consisted of two separate trade bans referred to as the ‘primary nation embargo’ which prohibited the importation of tuna from countries which had not demonstrated compliance with the MMPA standards and the secondary nation embargo, which prohibited imports of processed tuna products from countries which did not themselves ban the import of non-MMPA-compliant tuna.
- 84 GATT (1993), p. 156.
- 85 Chimni (2002), p. 136.
- 86 GATT (1993), p.199.
- 87 *ibid*, p.201.
- 88 *ibid*, p.195.
- 89 Chimni (2002), p. 136.
- 90 The GATT Panel in the *Tuna-Dolphin II* noted:
- “...Article XX provides for an exception to obligations under the General Agreement. The long-standing practice of panels has accordingly been to *interpret this provision narrowly*, in a manner that preserves the basic objectives and principles of the General Agreement. If Article XX were interpreted to permit contracting parties to deviate from the obligations of the General Agreement by taking trade measures to implement policies, including conservation policies, within their own jurisdiction, the basic objectives of the General Agreement would be maintained. *If however Article XX were interpreted to permit contracting parties to take trade measures so as to force other contracting parties to change their policies within their jurisdiction, including their conservation policies, the balance of rights and obligations among contracting parties, in particular the right of access to markets, would be seriously impaired.* Under such an interpretation the General Agreement could no longer serve as a multilateral framework for trade among contracting parties. [emphasis added]” [ILM (1994), Para 5.26]
- 91 Panel Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products* (henceforth *Shrimp-Turtle I*), WT/DS58/R and Corr.1, adopted 6 November 1998, as modified by Appellate Body Report WT/DS58/AB/R, DSR 1998:VII, 2821.
- 92 Potts (2008), p. 22.
- 93 ‘(I)t appears to us ...that conditioning access to a Member’s domestic market on whether exporting Members comply with or adopt a policy or policies unilaterally prescribed by the importing Member may, to some degree, be a common aspect of measures falling within the scope of one or another of the exceptions (a) to (j) of Article XX. Paragraphs (a) to (j) comprise measures that are recognised as exceptions to substantive obligations established in the GATT 1994, because the domestic

policies embodied in such measures have been recognised as important and legitimate in character. It is not necessary to assume that requiring from exporting countries compliance with, or adoption of, certain policies (although covered in principle by one or another of the exceptions) prescribed by the importing country, renders a measure a priori incapable of justification under Article XX. Such an interpretation renders most, if not all, of the specific exceptions of Article XX inutile, a result abhorrent to the principles of interpretation we are bound to apply [Appellate Body Report, *Shrimp-Turtle I*, WT/DS58/AB/R, adopted 6 November 1998, DSR 1998:VII, 2755, paras 106-07].

<sup>94</sup> The AB in *Shrimp-Turtle II*, while upholding the findings of the panel in this case, observed:

“In our view, there is an important difference between conditioning market access on the adoption of essentially the same programme, and conditioning market access on the adoption of a programme *comparable in effectiveness*. Authorising an importing Member to condition market access on exporting Members putting in place regulatory programmes *comparable in effectiveness* to that of the importing Member gives sufficient latitude to the exporting Member with respect to the programme it may adopt to achieve the level of effectiveness required. It allows the exporting Member to adopt a regulatory programme that is suitable to the specific conditions prevailing in its territory. As we see it, the Panel correctly reasoned and concluded that conditioning market access on the adoption of a programme *comparable in effectiveness*, allows for sufficient flexibility in the application of the measure so as to avoid “arbitrary or unjustifiable discrimination”. We, therefore, agree with the conclusion of the Panel on ‘comparable effectiveness’.” [Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products – Recourse to Article 21.5 of the DSU by Malaysia* (henceforth *Shrimp-Turtle II*), WT/DS58/AB/RW, adopted 21 November 2001, DSR 2001:XIII, 6481, para 144, emphasis in original].

<sup>95</sup> AB Report, *Shrimp-Turtle I*, para. 133.

<sup>96</sup> Potts (2008), p.35.

<sup>97</sup> For support, refer to Pauwelyn (2007), p.35.

<sup>98</sup> In the *US – Gasoline* case, the Appellate Body presented a two-tiered test under Article XX, as follows:

“In order that the justifying protection of Article XX may be extended to it, the measure at issue must not only come under one or another of the particular exceptions - paragraphs (a) to (j) - listed under Article XX; it must also satisfy the requirements imposed by the opening clauses of Article XX. The analysis is, in other words, two-tiered: first, provisional justification by reason of characterization of the

measure under [one of the exceptions]; second, further appraisal of the same measure under the introductory clauses of Article XX” [Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline* (henceforth *US – Gasoline*), WT/DS2/AB/R, adopted 20 May 1996, DSR 1996:I, 3, pp. 20-21].

<sup>99</sup> Notably, in the *Shrimp-Turtle I* case, the Appellate Body disagreed with the panel that had started its analysis with the chapeau of Article XX. The AB observed:

“The task of interpreting the chapeau so as to prevent the abuse or misuse of the specific exemptions provided for in Article XX is rendered very difficult, if indeed it remains possible at all, where the interpreter (like the Panel in this case) has not first identified and examined the specific exception threatened with abuse. The standards established in the chapeau are, moreover, necessarily broad in scope and reach (...). When applied in a particular case, the actual contours and contents of these standards will vary as the kind of measure under examination varies”. [Appellate Body Report, *Shrimp-Turtle I*, para. 120].

<sup>100</sup> Panel Report, *US – Gasoline*, para. 6.20.

<sup>101</sup> Stern (2006), p. vi.

<sup>102</sup> The panel noted:

“The Panel could see no reason why under Article XX the meaning of the term ‘necessary’ under paragraph (d) should not be the same as in paragraph (b). In both paragraphs the same term was used and the same objective intended: to allow contracting parties to impose trade restrictive measures inconsistent with the General Agreement to pursue overriding public policy goals to the extent that such inconsistencies were unavoidable. The fact that paragraph (d) applies to inconsistencies resulting from the enforcement of GATT-consistent laws and regulations while paragraph (b) applies to those resulting from health-related policies therefore did not justify a different interpretation of the term ‘necessary.’” [GATT Panel Report, *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes* (henceforth *Thailand – Cigarettes*), DS10/R, adopted 7 November 1990, BISD 37S/200, para. 74]

<sup>103</sup> “In its report on *US – Section 337*, the panel indicated that concerning Article XX (d) it needed to be determined whether a GATT-consistent alternative could have been employed: ‘It was clear to the Panel that a contracting party cannot justify a measure inconsistent with another GATT provision as ‘necessary’ in terms of Article XX (d) if *an alternative measure which it could reasonably be expected to employ and which is not inconsistent with other GATT provisions is available to it*. By the same token, in cases where a measure consistent with other GATT provisions is not reasonably available, a contracting party is bound to use, among the measures reasonably available to it, *that which entails the least degree of inconsistency with other GATT provisions* (emphasis added).” [See GATT Panel Report, *United States*

*Section 337 of the Tariff Act of 1930* (henceforth *US – Section 337*), L/6439, adopted 7 November 1989, BISD 36S/345, para. 5.26].

<sup>104</sup> The panel in the *Thailand – Cigarettes* case borrowed the ‘least-trade restrictive’ requirement from the *US – Section 337* panel report. The panel defined the test of ‘necessity’ applicable under Article XX (b) as follows: “[T]he import restrictions imposed by Thailand could be considered to be ‘necessary’ in terms of Article XX (b) only if there were no alternative measure consistent with the General Agreement, or less inconsistent with it, which Thailand could reasonably be expected to employ to achieve its health policy objectives” [GATT Panel Report, *Thailand – Cigarettes*, para. 75.]

<sup>105</sup> WTO (2002), p.16.

<sup>106</sup> While free allocation could be regarded as less trade-restrictive compared to CES, whether it would be consistent or less-inconsistent with the GATT is an issue that requires detailed examination. In fact WTO-compatibility of free allocation of allowances remains another open question till date.

<sup>107</sup> Appellate Body Report, *EC – Asbestos*, para. 172, referring to Appellate Body Report, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef (Korea – Various Measures on Beef)*, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, DSR 2001:I, 5, para. 162.

<sup>108</sup> WTO (2002), p.16.

<sup>109</sup> In the words of the AB in *Shrimp-Turtle I*:

The words of Article XX (g), ‘exhaustible natural resources’, were actually crafted more than 50 years ago. They must be read by a treaty interpreter in the light of contemporary concerns of the community of nations about the protection and conservation of the environment. While Article XX was not modified in the Uruguay Round, the preamble attached to the *WTO Agreement* shows that the signatories to that Agreement were, in 1994, fully aware of the importance and legitimacy of environmental protection as a goal of national and international policy. The preamble of the *WTO Agreement* - which informs not only the GATT 1994, but also the other covered agreements - explicitly acknowledges ‘the objective of *sustainable development* ...’ [Appellate Body Report, *Shrimp-Turtle I*, paras. 128-31].

<sup>110</sup> Pauwelyn (2007), p. 35.

<sup>111</sup> The first application of the ‘relating to’ clause was made in the *Canada – Salmon and Herring* case. The Panel observed that: “...while a trade measure did not have to be necessary or essential to the conservation of an exhaustible natural resource, it had to be primarily aimed at the conservation of an exhaustible natural resource to be considered as ‘relating to’ conservation within the meaning of Article XX (g).” [*Canada – Salmon and Herring*, Panel Report, para. 4.6] The panel introduced thereby the interpretation that the measure had to be ‘primarily aimed at’ and not ‘necessary or essential’. Some subsequent panel and Appellate Body reports have referred to this interpretation.

<sup>112</sup> Appellate Body Report, *US – Gasoline*, p. 17.

<sup>113</sup> In the words of the AB:

Without baselines of some kind, such scrutiny would not be possible and the Gasoline Rule’s objective of stabilizing and preventing further deterioration of the level of air pollution prevailing in 1990, would be substantially frustrated. The relationship between the baseline establishment rules and the “non-degradation” requirements of the Gasoline Rule is not negated by the inconsistency, found by the Panel, of the baseline establishment rules with the terms of Article III:4. We consider that, given that *substantial relationship*, the baseline establishment rules cannot be regarded as *merely incidentally or inadvertently aimed at* the conservation of clean air in the United States for the purposes of Article XX(g). [Appellate Body Report, *US – Gasoline*, p. 18]

<sup>114</sup> Pauwelyn (2007), p.36.

<sup>115</sup> In the *Shrimp-Turtle I* case, the AB, recalling its findings in *US – Gasoline* on the ‘relating to’ clause, further stated that: “Focusing on the design of the measure here at stake [footnote omitted], it appears to us that Section 609, cum implementing guidelines, is *not disproportionately wide in its scope and reach in relation to the policy objective of protection and conservation of sea turtle species. The means are, in principle, reasonably related to the ends. The means and ends relationship* between Section 609 and the legitimate policy of conserving an exhaustible, and, in fact, endangered species, is *observably a close and real one...* (emphasis added)”[Appellate Body Report, *Shrimp-Turtle I*, para. 141]

<sup>116</sup> The AB observed: “[T]he ordinary or natural meaning of ‘made effective’ when used in connection with a measure - a governmental act or regulation - may be seen to refer to such measure being ‘operative’, as ‘in force’, or as having ‘come into effect’. [footnote omitted] Similarly, the phrase ‘in conjunction with’ may be read quite plainly as ‘together with’ or ‘jointly with’. [footnote omitted] Taken together, the second clause of Article XX(g) appears to us to refer to governmental measures like the baseline establishment rules being promulgated or brought into effect together with restrictions on domestic production or consumption of natural resources.” [Appellate Body Report, *US – Gasoline*, p. 19].

<sup>117</sup> The AB noted:

“There is, of course, no textual basis for requiring identical treatment of domestic and imported products. Indeed, where there is identity of treatment - constituting real, not merely formal, equality of treatment - it is difficult to see how inconsistency with Article III:4 would have arisen in the first place. On the other hand, if *no* restrictions on domestically-produced like products are imposed at all, and all limitations are placed upon imported products *alone*, the measure cannot be accepted as primarily or even substantially designed for implementing conservationist goals. The measure would simply be naked discrimination for protecting locally-produced goods.”[Appellate Body Report, *US - Gasoline*, p. 21.]

- 118 Pauwelyn (2007), p. 36.
- 119 Appellate Body Report, *US – Gasoline*, p. 21.
- 120 As mentioned earlier, the chapeau requires that in order to be justified under one of the paragraphs of Article XX, measures must not be “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”. Interestingly, it may be noted here that UNFCCC also included a similar provision in its Article 3.5, which states that “...Measures taken to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade.”
- 121 The scope of the exceptions available under Article XX was spelt out by the AB in *Shrimp-Turtle I*. The AB was of the view that the language of the *chapeau* of Article XX makes it clear that each of the specific exceptions listed in the Article, in paragraph (a) to (j) is limited and conditional exception from the substantive obligations contained in the other provisions of GATT 1994. “Any measure, to qualify finally for exception, must also satisfy the requirements of the Chapeau.” This according to the Appellate Body “is a fundamental part of the rights and obligations struck by the original framers of GATT 1947”. Importantly, the AB linked the balance of rights and obligations under the chapeau of Article XX to the general principle of good faith. This principle, as the Appellate Body emphasized prohibits the abusive exercise of a state’s rights and enjoins that whenever the assertion of a right “impinges on the field covered by a treaty obligation, it must be exercised bona fide, that is to say, reasonably”. The Appellate Body further commented that an abusive exercise by a Member of its own treaty right thus results in a breach of the treaty rights of the other Members and, as well, a violation of the treaty obligation of the Member so acting.[ Appellate Body Report, *Shrimp-Turtle I*, paras.157-59]
- 122 The panel on *US – Spring Assemblies*, noted that “the Preamble of Article XX made it clear that it was the application of the measure and not the measure itself that needed to be examined [Emphasis added]”[*United States – Imports of Certain Automotive Spring Assemblies*, Panel Report adopted on 26 May 1983, BISD 30S/107, para. 56] This finding was confirmed by the Appellate Body in the *US – Gasoline* case: “[t]he chapeau by its express terms addresses, not so much the questioned measure or its specific contents as such, but rather the manner in which that measure is applied”[Appellate Body Report, *US – Gasoline*, p. 21].
- 123 Appellate Body report, *Shrimp-Turtle I*, para. 149.
- 124 Appellate Body Report, *Shrimp-Turtle II*, para. 118.
- 125 Appellate Body Report, *Shrimp-Turtle I*, para. 150.
- 126 For instance, in the *Shrimp-Turtle I* case, the Appellate Body, after finding that the measure at issue was a means of unjustifiable and arbitrary discrimination between countries where the same conditions prevail, decided that it was not necessary to examine also whether the measure was applied in a manner that constitutes a disguised restriction on international trade [Appellate Body Report, *Shrimp-Turtle I*, para. 184].

- 127 Appellate Body Report, *Shrimp-Turtle I*, para. 150.
- 128 Appellate Body Report, *US - Gasoline*, pp. 23-24.
- 129 In *Shrimp-Turtle I*, the Appellate Body confirmed its finding in *US - Gasoline* on the type of discrimination covered by the chapeau Article XX:  
In *United States - Gasoline*, we accepted the assumption of the participants in that appeal that such discrimination could occur not only between different exporting Members, but also between exporting Members and the importing Member concerned. [Appellate Body Report, *Shrimp-Turtle I*, para. 150]
- 130 AB Report, *Shrimp-Turtle II*, para 149.
- 131 AB Report, *Shrimp Turtle I*, para 155.
- 132 The AB on *Shrimp-Turtle I* ruled that the measure at issue did not meet the requirements of the *chapeau* relating to arbitrary discrimination because, through the application of the measure, the exporting members were faced with “a single, rigid and unbending requirement” to adopt *essentially the same* policies and enforcement practices as those applied to, and enforced on, domestic shrimp trawlers in the US. [Appellate Body Report, *Shrimp-Turtle I*, para. 177]
- 133 Panel Report, *Shrimp-Turtle II*, para. 5.122-5.123.
- 134 Appellate Body Report, *US – Gasoline*, p. 27.
- 135 The relevant finding of the Appellate Body Report reads as follows:  
“Another aspect of the application of Section 609 that bears heavily in any appraisal of justifiable or unjustifiable discrimination is the failure of the United States to engage the appellees, as well as other Members exporting shrimp to the United States, in serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements for the protection and conservation of sea turtles, before enforcing the import prohibition against the shrimp exports of those other Members”[Appellate Body Report, *Shrimp-Turtle I*, para. 166]
- 136 Appellate Body Report, *Shrimp-Turtle I*, para. 172.
- 137 Appellate Body Report, *Shrimp-Turtle II*, para. 134.
- 138 Panel Report, *Shrimp-Turtle II*, para. 5.63.
- 139 Panel Report, *Shrimp-Turtle II*, para. 5.67.
- 140 Appellate Body Report, *Shrimp-Turtle I*, paras. 161-64.
- 141 When the US amended the regulation requiring exporting countries to adopt a programme “comparable in effectiveness” to that of the US programme, the AB ruled that such modification allowed for sufficient flexibility in the application of the measure so as to avoid “arbitrary or unjustifiable discrimination”. The AB in *Shrimp-Turtle II* noted:  
“In our view, there is an important difference between conditioning market access on the adoption of essentially the same programme, and conditioning market access on the adoption of a programme



*comparable in effectiveness*. Authorising an importing Member to condition market access on exporting Members putting in place regulatory programmes *comparable in effectiveness* to that of the importing Member gives sufficient latitude to the exporting Member with respect to the programme it may adopt to achieve the level of effectiveness required. It allows the exporting Member to adopt a regulatory programme that is suitable to the specific conditions prevailing in its territory. As we see it, the Panel correctly reasoned and concluded that conditioning market access on the adoption of a programme *comparable in effectiveness*, allows for sufficient flexibility in the application of the measure so as to avoid ‘arbitrary or unjustifiable discrimination’. We, therefore, agree with the conclusion of the Panel on “comparable effectiveness”. (emphasis in original.)

[Appellate Body Report, *Shrimp-Turtle II*, paragraph 144.]

<sup>142</sup> Appellate Body Report, *Shrimp-Turtle I*, paras. 180-81.

<sup>143</sup> The AB on *Shrimp-Turtle I* noted that:

“With respect to both types of certification, there is *no formal opportunity for an applicant country to be heard, or to respond to any arguments* that may be made against it, in the course of the certification process before a decision to grant or to deny certification is made. Moreover, *no formal written, reasoned decision*, whether of acceptance or rejection, is rendered on applications for either type of certification...No procedure for review of, or appeal from, a denial of an application is provided. The certification processes followed by the United States thus appear to be singularly *informal and casual*, and to be conducted in a manner such that these processes *could result in the negation of rights of Members*. There appears to be no way that exporting Members can be certain whether the terms of Section 609, in particular, the 1996 Guidelines, are being applied in a *fair and just manner* by the appropriate governmental agencies of the United States. It appears to us that, effectively, exporting Members applying for certification whose applications are rejected are denied *basic fairness and due process, and are discriminated against, vis-à-vis* those Members which are granted certification” [emphasis added] [Appellate Body Report, *Shrimp-Turtle I*, paras. 180-81].

<sup>144</sup> The AB in *Shrimp-Turtle II* noted:

“We need only say here that, in our view, a measure should be designed in such a manner that there is sufficient flexibility to take into account the specific conditions prevailing in *any* exporting Member, including, of course, Malaysia. Yet this is not the same as saying that there must be specific provisions in the measure aimed at addressing specifically the particular conditions prevailing in *every individual* exporting Member. Article XX of the GATT 1994 does not require a Member

to anticipate and provide explicitly for the specific conditions prevailing and evolving in *every individual* Member.”

[Appellate Body Report, *Shrimp-Turtle II*, paragraph 149.]

<sup>145</sup> The origin of the problem lies in the rising ‘stocks’ of GHGs in the atmosphere resulting from human activity, particularly since the time of the Industrial Revolution, around 70 per cent of which have been contributed by North America and Europe alone (since 1850), while developing countries have accounted for less than one quarter only.

<sup>146</sup> Government of India (2008), Table 1.3.1, p.12.

<sup>147</sup> *ibid*, p.2.

<sup>148</sup> In the *US – Canadian Tuna* case, the panel adopted a literal interpretation of the concept of “disguised restriction on international trade” only based on a publicity test. It felt that “the United States action should not be considered to be a disguised restriction on international trade, noting that the United States prohibition of imports of tuna and tuna products from Canada had been taken as a trade measure and publicly announced as such” [GATT Panel Report, *United States – Prohibition of Imports of Tuna and Tuna Products from Canada (US – Canadian Tuna)*, L/5198, adopted 22 February 1982, BISD 29S/91, para. 4.8].

<sup>149</sup> In the *US – Gasoline* case, the AB also considered that the kinds of considerations pertinent in deciding whether the application of a particular measure amounts to ‘arbitrary or unjustifiable discrimination’ may also be taken into account in determining the presence of a ‘disguised restriction on international trade’ [Appellate Body Report, *US – Gasoline*, p. 23].

<sup>150</sup> In *EC – Asbestos*, after finding that the measure at issue met the publicity criterion, the panel examined as an additional requirement the “design, architecture and revealing structure” of the measure as it had already been introduced in *Japan – Alcoholic Beverages*[Appellate Body Report, *Japan – Alcoholic Beverages*, p. 121]. in order to discern the protective application of a measure [Panel Report, *EC – Asbestos*, para. 8.236] Similarly in the *Shrimp-Turtle II*, the panel demonstrated that the measure at issue did not constitute a disguised restriction on international trade by examining the “design, architecture and revealing structure” of the measure[Panel Report, *Shrimp-Turtle II*, para. 5.142].

<sup>151</sup> Holt and Whitney (2009), p.10.

<sup>152</sup> ICTSD (2009a).

<sup>153</sup> Senator Charles Grassley, a critic of the bill’s possible WTO violations, suggested last week that the Senate wait for an international climate agreement before taking domestic action. Grassley said this would allow the Senate to avoid negative trade effects and ensure comparable emission reduction among US trading partners (see ICTSD, 2009a).

<sup>154</sup> See for instance, the testimony of Gary N. Horlick (a leading US lawyer) before the United States Senate Committee on Finance on 8 July 2009.

<sup>155</sup> Gary Hufbauer, a Senior Fellow at the Peterson Institute for International Economics in Washington, expressed the view before a hearing of the Subcommittee on Energy

and Air Quality in March 2009 that in the absence of broad multilateral action, efforts to address competitiveness concerns and emissions leakage through the use of trade measures will have limited success. If the US imposes restrictions on imports in the name of climate change, these actions, Hufbauer warned, would likely elicit similar measures by other countries on US exports. These examples were cited by Hufbauer as reasons for the US to “make an exceptional effort to negotiate agreed international rules before blocking imports or penalising foreign GHG control measures.” According to Hufbauer, an inability to avoid the creation of unique brands of import bans, border taxes, and comparability mechanisms could result in “drawn-out trade skirmishes and even trade wars” with global cooperation in limiting emissions possibly the first casualty of a unilateral approach that ignores the basic GATT articles (see ICTSD, 2009a).

<sup>156</sup> “At a time when the economy worldwide is still deep in recession and we’ve seen a significant drop in global trade, I think we have to be very careful about sending any protectionist signals out there”, the president told reporters according to the *New York Times*. Obama recognised “a legitimate concern on the part of American businesses that they are not disadvantaged vis-a-vis their global competitors” because of higher energy costs. He noted, however, that the legislation already had various kinds of transitional assistance for energy-intensive industries even before the border tax adjustment provisions were reinserted. Furthermore, he observed that European industry faced sharper emissions curbs, and that even China - the top target of the proposed tariffs - had been moving towards a “clean energy approach”, and had already surpassed the US on fuel efficiency standards’. “I am very mindful of wanting to make sure that there’s a level playing field internationally”, Obama said. “I think there may be other ways of doing it than with a tariff approach”, he added (ICTSD, 2009b).

<sup>157</sup> Section 765 of the Bill on ‘International Trade’ states the following:

“It is the sense of the Senate that this Act will contain a trade title that will include a border measure that is consistent with our international obligations and designed to work in conjunction with provisions that allocate allowances to energy-intensive and trade-exposed industries”.

<sup>158</sup> In a speech, Sarkozy said he would put his weight behind convincing his European colleagues that the EU needs a carbon tax at its borders to safeguard the competitiveness of its industry. “I’m in favour of environmental protection but I want to keep our industry,” he said. The president said that he would not accept a system where European countries impose constraints on their industries for climate protection while allowing imports to continue from countries that do not respect the same rules. “I will lead that battle,” he said. Sarkozy has repeatedly called for such a border adjustment mechanism since negotiations over the EU’s climate and energy package, agreed last December. But Sarkozy will have a hard time convincing the 27-member bloc that border tariffs are the way to fend off unfair competition resulting from the EU’s progressive climate policies. European Commission President José Manuel Barroso echoed these warnings on 4 September. “I think it’s premature to discuss this at European level because our aim now is to convince

others - the Americans, but also the Chinese - to join us in similar types of measures”.  
<<http://www.euractiv.com/en/climate-change/sarkozy-renews-pressure-co2-border-tax/article-185387>>

<sup>159</sup> Xie Zhenhua, head of China’s Climate Change and Coordinating Committee said, “Climate change and charging carbon taxes in imports ... are two issues in two areas” and should be tackled in separate negotiating forums. “I oppose using climate change as an excuse to practice protectionism on trade,” Xie, a former Chinese environment minister, told the Carnegie Endowment for International Peace, a Washington think tank. [‘China minister rejects U.S. pollution duty idea’, Reuters, 18 March 2009, available at: <http://www.reuters.com/article/latestCrisis/idUSN18469068>]

In his visit to the US in March 2009, India’s chief climate negotiator Shyam Saran warned that “Protectionism under a green label would be a very negative development.” “What you need is really a global collaborative effort to address the issue of climate change, not something which gets linked up with issues of competitiveness,” Saran said. [“India warns against ‘green protectionism’”, 24 March 2009, available at: [http://green.yahoo.com/news/afp/20090325/sc\\_afp/usindiaclimatewarmingeconomy.html](http://green.yahoo.com/news/afp/20090325/sc_afp/usindiaclimatewarmingeconomy.html)]

A position paper released by India in the run-up to Copenhagen has pointed out that:

“(G)lobal action on Climate Change, based on the UNFCCC, is not conditional upon maintenance of trade competitiveness or level playing fields. These issues belong to global trade negotiations not to Climate Change negotiations. Introducing these new dimensions into the Climate Change discourse, would make our task more complex and difficult than it already is. Climate change negotiations should remain focussed on addressing the grave implications of Climate Change and should not impose conditionalities or additional burdens on developing countries.” [See, Government of India (2009), p.11]

<sup>160</sup> [http://www.huffingtonpost.com/jake-colvin/obama-vs-krugman-five-rea\\_b\\_287634.html](http://www.huffingtonpost.com/jake-colvin/obama-vs-krugman-five-rea_b_287634.html)

<sup>161</sup> South Centre (2009), p.4.

<sup>162</sup> South Centre (2009), p.4.

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