

Border Tax Adjustments for Additional  
Costs Engendered by Internal and EU  
Environmental Protection Measures:  
Implementation Options and WTO  
Admissibility

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# **Border Tax Adjustments for Additional Costs Engendered by Internal and EU Environmental Protection Measures: Implementation Options and WTO Admissibility**

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## I. Introduction

In late 2006 France proposed introducing a so-called carbon border tax into the international discussion on climate protection. After Germany's environmental minister Sigmar Gabriel endorsed this move in an interview with the newsmagazine *Spiegel*, *Financial Times Deutschland*<sup>1</sup> faulted such a tax as being not in conformity with WTO regulations. In early 2008, French President Nicolas Sarkozy, the European Trade Union Confederation (ETUC), and The Green Group in the European Parliament called for a carbon border tax on goods from countries with lax environmental regulations, with a view to protecting Europe's energy intensive industries after joining the emissions trading system. After initial discussions, the European Commission has decided to postpone until 2011 a decision regarding the introduction of a carbon border tax.

The purpose of a carbon border tax is to offset additional costs incurred by domestic manufacturers by compliance with internal environmental regulations (which imports are not subject to) – via border tax adjustments that take the form of import taxes and/or duties on imported goods. Although border tax adjustments (BTAs) could potentially be applied to numerous environmental protection measures, in view of the aforementioned proposals and the debate on climate protection currently at the centre of interest, the present report mainly discusses the application of BTAs to internal and EU climate protection instruments.

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

BTAs are intended to (a) protect domestic industries against unbalanced costs resulting from climate protection measures and eliminate competitive distortions; (b) provide an incentive for exporting countries to introduce more stringent climate protection instruments; and (c) improve the steering capacity of national and EU environmental protection measures, because, for instance, special provisions introduced with a view to furthering the competitiveness of domestic products on international markets could be repealed – as with energy taxes or emission credits.

There are different border tax adjustment systems. For example, they can offset excise taxes on consumer goods such as alcohol and cigarettes at the border. Or a BTA may be levied for environmental reasons, as is the case with the American Superfund Tax and Ozone Depleting

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<sup>1</sup> Europas Zwangsvorstellung, 20 June 2007.

Chemicals Tax. The Superfund Tax entails (among other things) an excise tax on petroleum products and certain chemicals. The tax is levied when these products are used domestically and is reimbursed when they are exported. The border tax adjustment for imported products is calculated on the basis of the tax that would have been payable if production had taken place in the US. In the interest of fulfilling its obligations under the Montreal Protocol on Substances that Deplete the Ozone Layer of 16 September 1987, the US introduced, as an excise tax, the Ozone Depleting Chemicals Tax (ODC Tax). The tax is calculated in proportion to the potential damage the relevant chemicals can cause. The BTA is applied to the import and export of the chemical itself, as well as products that contain or were manufactured with ODC, regardless of whether the substances are physically present in the relevant end product.<sup>2</sup>

Border tax adjustments can lead to trade restrictions. WTO regulations prohibit countries from taxing a specific type of imported foreign product less favourably than the counterpart like product of domestic origin but do not require that foreign products be granted more favourable conditions in this regard.

Section II of this report discusses implementation options for BTAs, as well as the problems they may engender. Section III assesses the admissibility of border adjustments under WTO law on the basis of the General Agreement on Tariffs and Trade. This discussion takes as its starting point the analysis in chapter 1 of the general acceptability of trade-related environmental measures. Crucial for border adjustments related to imports and exports are various WTO rules. The legal principle of non-discrimination, which is spelled out in greater detail by both the national treatment obligation in accordance with GATT Article III (chapter 2) and the most-favoured-nation principle in accordance with GATT Article I:1 (chapter 3), is relevant for assessing the admissibility of an environmentally motivated BTA on exports. If the principle of non-discrimination is violated, it must be determined whether the violation is justifiable according to the prerequisites set forth in GATT Article XX (chapter 4). Chapter 5 discusses the fact that inasmuch as reimbursements of domestic or European taxes on export goods are similar in nature to subsidies, GATT Article XVI and the Agreement on Subsidies and Countervailing Measures (ASCM) are relevant. Section IV contains a summary of the key points made in the report. There is no applicable case law regarding environmentally motivated BTAs. Analyses related to BTAs for energy taxes<sup>3</sup> and emissions trading<sup>4</sup> can be found in the literature.<sup>5</sup>

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<sup>2</sup> For further details see: Hoerner, Andrew, *The Role of Border Tax Adjustments in Environmental Taxation: Theory and U.S. Experience*, Working Paper, 1998, p. 11 et. seq.; Biermann et al, *Verursacherprinzip, WTO-Recht und ausgewählte Instrumente der deutschen Energiepolitik*, UBA-Text 75/03; p. 33 et. seq.

<sup>3</sup> See (among others) Biermann et. al, *Verursacherprinzip, WTO-Recht und ausgewählte Instrumente der deutschen Energiepolitik*, UBA-Text 75/03; the authors discuss the problems of WTO admissibility entailed by border tax adjustments for energy taxes.

## **II. Implementation options for BTAs for additional costs associated with domestic or EU climate protection measures**

### **1. Areas of application of BTAs**

First, it must be determined which imported products are to be subject to a BTA. There are various potential approaches to this task. For example, product properties or production methods could be the relevant criteria for a BTA. In view of the multitude of imported products and the considerable administrative effort involved, it would be efficient to focus on goods (a) whose production entails heavy environmental damage – for example, caused by high energy consumption or CO<sub>2</sub> emissions; (b) that are particularly affected by internal or European climate protection measures; and (c) are subject to international competition and/or for which there already exist special domestic arrangements to avoid competitive disadvantages. Thus, the most likely candidates for a BTA would be energy products produced using high energy inputs as well as metals, raw, basic and construction materials.

Another key issue is which criteria (if any) should be used to determine states whose products should be subject to the BTA. Moreover, it is necessary to clarify whether it should be applied equally to all countries, or whether it should be differentiated according to climate protection policies, degree of industrialization, energy efficiency, and/or CO<sub>2</sub> emissions. A state's non-accession to the Kyoto Protocol would be a questionable BTA criterion. In addition to WTO regulations which are discussed in section III (chapters 1-5) below, it must be taken into account that non-Kyoto signatories, too, may have implemented efficient climate protection measures, or, vice versa, that Kyoto signatories may not have (or not have sufficiently) implemented such instruments.

Another possibility would be to make a BTA conditional upon the climate protection objectives of exporting countries. These objectives would have to be compared with the counterpart European objectives – although this would be no easy task owing to the differing baseline conditions involved and would also necessitate making policy assessments. The question also arises as to which criteria would be applied to exporting countries that have no defined climate protection goals. For these reasons, and because climate protection goals alone are not an

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<sup>4</sup> See (among others) Ismer/Neuhoff, *Border Tax Adjustment: A feasible way to address non-participation in emission trading*, Working Paper 2004; and Ismer/Neuhoff: *Border Tax Adjustment: A feasible way to support stringent emission trading*, Working Paper 2007; the authors operate on the assumption that such trading is WTO compliant and propose relevant measurement methods. Also see: Javier de Cendra, *Can Emissions Trading Schemes be coupled with Border Tax Adjustments? An Analysis vis-à-vis WTO-Law*, RECIEL 15 (2), 2006, 131; the author operates on the assumption that a border tax adjustment for emissions trading would be WTO compliant.

<sup>5</sup> The balance of the present report mainly entails an assessment of the studies referred to in the previous footnote and the literature on WTO regulations.



accurate indication of a country's actual climate protection measures, this latter approach would likewise be inadvisable.

Instead, BTAs should be based solely on efforts at climate protection, i. e. the climate protection instruments applied by European countries and countries of origin. However, a simple parameter such as the presence or absence of a carbon tax in the country of origin would be an unduly narrow criterion and hence inadvisable. Thus, in order to calculate a BTA, the question needs to be answered, which domestic and European climate protection instruments on the one hand, and which comparable efforts in the relevant countries of origin on the other hand, should be taken into account in determining the additional burden engendered by climate protection measures and to what extent.<sup>6</sup> BTAs should be based on the extra burden incurred by climate protection that is reflected in the higher production costs of the affected European products competing with imported products (see 2. below). In order to avoid double burdens on imported products, additional costs incurred abroad resulting from compliance with climate protection instruments imposed there should be deducted from BTAs (see 3. below).

Another controversial issue that remains to be clarified is who will receive the revenue of a BTA and how this revenue is to be used. If this revenue does not flow entirely into the EU budget, it will be necessary to devise a scheme for disbursement of these funds to the EU member states. There are manifold possibilities for spending BTA revenue, ranging from financing national budgets to supporting specific domestic and foreign climate protection measures.

## **2. Burdens engendered by internal and EU climate protection instruments**

EU countries have implemented a range of climate protection instruments that can potentially engender additional costs for European products. In order to impose BTAs, it is first necessary to define and operationalize quantities for these climate protection instruments that allow for equivalent taxation of imported products.

One principal climate protection instrument in the EU is emissions trading. This instrument tends to engender additional costs for the participating enterprises owing to, for instance, the need to purchase emission certificates in the event these are granted against payment, or to the necessity of having to make investments in the equipment needed to reduce carbon emissions. The exact manufacturing cost increase for specific products resulting from emissions trading is sometimes difficult to determine. In order to determine the costs engendered by emissions trading and a tax equivalent underlying the BTA, (a) the carbon emissions for each product unit in facilities participating in emissions trading would have to be determined; and (b) the values for

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<sup>6</sup> For example, in Germany the imposition of BTAs would raise the issue as to whether the entire energy tax or only the ecotax on a product (after deduction of tax reductions) should be regarded as a climate protection-related surtax.

these emissions would have to be multiplied by the relevant carbon certificate prices.<sup>7</sup> In addition, indirect impacts on production costs resulting from electricity price effects owing to emissions trading would have to be taken into account. Further study of this approach is needed.<sup>8</sup>

In the interest of promoting climate protection (as well as for fiscal reasons), the EU member states levy national taxes on energy and carbon emissions. The substantial climate protection costs for European products resulting from these taxes would have to be ascertained for a BTA. The per product costs incurred are difficult to determine since they vary according to national tax regulations as well as product-related energy consumption and/or respective carbon emissions. Energy consumption and CO<sub>2</sub> emissions differ according to the technology applied and energy source used, and this can vary from one business to another.<sup>9</sup> Moreover, energy and carbon taxes vary greatly within the EU, so that there is no uniform additional burden on imports into the European Economic Area. Hence it needs to be clarified whether additional charges should be based on regulations in the respective destination country or whether a common Community formula should be devised for them.<sup>10</sup>

In addition to taxes, there are other economic climate protection instruments such as Germany's Renewable Energy Act (EEG) and co-generation levies, which affect electricity prices. If a BTA were to allow for such measures as well, problems similar to those associated with taxes would have to be resolved. To do this, the additional power costs would have to be determined for each product, and also the reductions for specific businesses would have to be allowed for.

In addition to economic instruments, EU member states also use regulatory instruments such as plant-related threshold values and substance bans for climate protection reasons. Threshold values can engender additional costs for businesses insofar as they must either switch to more

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<sup>7</sup> These certificates are traded publically and in some cases are subject to considerable price fluctuations – a factor that raises assessment issues of its own.

<sup>8</sup> The European Commission initially considered an alternative approach whereby a Future Allowance Import Requirement (FAIR) would be incorporated into the draft Directive on the Reform of Emissions Trading. This would have required importers of products from industries that are subject to the EU emissions trading scheme to purchase emission certificates from the EU's central Community Registry System.

<sup>9</sup> Such costs are particularly difficult to determine in cases where the end product contains pre-products from various countries of origin and/or different production stages have been carried out in various countries with differing climate protection instruments.

<sup>10</sup> This issue underscores the fact that owing to the differences in internal climate protection instruments applied by the various EU member states, even like products manufactured in the EU are subject to differing additional costs. This depends on the instruments chosen by the member states and can result in competitive distortions for some products. However, since all member states are bound by their national climate protection objectives agreed on within the framework of the EU Burden Sharing, these distortions should be tolerated should they arise.

energy-efficient production technologies or from fossil fuel-based to renewable resources. Substance bans (such as for lead, hexavalent chromium, cadmium, and mercury pursuant to the RoHS directive<sup>11</sup>) engender additional costs for products that have until now contained such banned substances if manufacturers replace these with permitted and environmentally compatible substitutes whose use would be more expensive. In assessing BTAs, it will be necessary to clarify whether and how these regulatory instruments affect production costs and thus the BTA. It is difficult to determine the costs engendered by thresholds for harmful substances and to allocate these costs to individual products. To do this, it would be necessary to translate the aforementioned non-economic measures into economic parameters such as cost burdens and tax equivalents. This requires further study.

Some of the aforementioned problems could potentially be resolved through consideration of the “best available technology”, which would reduce energy consumption in the production of the products concerned to the lowest possible levels (benchmarking).<sup>12</sup> This in turn would allow for the application of regulations agreed upon at the European level such as the EU’s minimum tax rates, with a view to determining a benchmark extra burden for each product. The advantage of this approach would be that a benchmark determined in this way would constitute the lower threshold for the actual additional burden on products produced in Europe and would thus prevent imports from being placed at a competitive disadvantage. But this solution would be unsatisfactory from an environmental protection standpoint as it would reduce the BTA to a relatively low level and would provide only little incentives for foreign countries. One of the difficulties here would be posed by determining the “best available technology” and minimum energy consumption for each product. Hence, it would be advisable to limit products subject to BTAs to those for which this kind of benchmarking would be feasible. Additional research is needed in this area as well.

### **3. Prior burdens engendered by foreign climate protection instruments**

Taxes and fees as well as other burdens associated with climate protection measures in exporting countries would have to be deducted from BTAs in order to avoid double burden on imported goods. Calculating these prior burdens would pose major practical difficulties in that information would be needed related to climate protection measures of countries of origin and their effects as well as information related to the manufacturing technologies and the energy resources used for and the carbon emissions engendered by manufacturing the products in question. This approach would be fraught with difficulty, however. First, owing to the multitude of

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<sup>11</sup> Directive 2002/95/EC of the European Parliament and of the Council of 27 January 2003 on the restriction of the use of certain hazardous substances in electrical and electronic equipment, OJ L 37/19, 13.2.2003

<sup>12</sup> Also endorsed in Ismer/Neuhoff, *Border Tax Adjustment: A feasible way to address non-participation in Emission Trading*, 2004, p. 17 et. seq.; same in: *A feasible way to support stringent Emission Trading*, 2007, p. 9 et. seq.; Javier de Cendra, *RECIEL* 15 (2), 2006, 131 (143)

cases that come into play, it would be virtually impossible to achieve individual justice. And second, gathering information for individual cases would engender such high costs for the countries imposing BTAs, the EU and/or importers that the costs of such a scheme might exceed the revenues generated by it.

Instead of this approach, it might be possible to define blanket calculation parameters for BTAs such as standardized energy intensity per product and (if applicable) country of origin that would be used to determine the additional burden engendered by the climate protection instruments in such countries. This procedure would have to be structured in such a way as to ensure compliance with the principle of non-discrimination. Further study is needed in this area.

The question also arises as to whether account should be taken of measures implemented by manufacturers that voluntarily employ climate-compatible production processes even though the climate protection instruments in their countries fall short of European standards. Here it should be clarified whether manufacturers of imported goods from countries with substandard climate protection measures should be afforded the opportunity to prove that their production processes are so energy-efficient that it would not be justified to subject their products to a BTA. However, we feel that such a measure is not required under WTO regulations and would needlessly complicate the BTA framework.

### **III. WTO admissibility of BTAs for additional costs associated with internal or EU climate protection measures**

#### **1. General WTO admissibility of trade-related environmental measures**

The General Agreement on Tariffs and Trade (GATT) provides the general basis for assessing trade-related environmental measures (TREM) concerning imports and exports. The introduction of a BTA is such an import and export restricting measure.

There are two types of TREMs.<sup>13</sup> TREMs can be implemented for products that are ecologically harmful (product-related TREMs), or for products that themselves are not ecologically harmful but whose manufacturing processes are ecologically harmful (non-product-related TREMs). This distinction is based on the processes and production methods (PPMs), i. e. the manner in which goods are produced. Some PPMs affect the finished product and are called product-related PPMs, to which the aforementioned product-related TREMs refer. There are also PPMs that have no effect on the finished product (non-product-related PPMs). As non-product-related TREMs refer to ecologically *non*-harmful products which, however, are manufactured using environmentally *harmful* production methods, they refer to non-product-related PPMs.

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<sup>13</sup> Puth, Sebastian, *Der Umweltschutz im Recht der WTO*, 2005, p. 32 et. seq.

Border tax adjustments for additional costs resulting from emissions trading, compliance with plant-related threshold values, or taxes on energy and other inputs that are not physically present in end products all constitute non-product-related TREMs by virtue of the fact that these BTAs are imposed on products that themselves are ecologically non-harmful but whose production processes are ecologically harmful without having any effect on the product per se (non-product-related PPMs). By contrast, BTAs are regarded as product-related TREMs if they result from internal taxes on specific substances or ingredients in an end product and additional costs associated with substance bans. This type of BTA is imposed on products that are ecologically harmful or contain ecologically harmful substances.

Unlike product-related trade restrictions, that are in principle consistent with WTO law but subject to specific criteria<sup>14</sup> (which are to be discussed below), there is controversy regarding the WTO admissibility of non-product-related trade restrictions. Some have argued that such restrictions are not admissible under WTO law on the grounds that basing them on the non-product-related PPMs applied constitutes a major violation of the regulatory sovereignty of the country of origin, thus impeding global free trade.<sup>15</sup>

However, this view is apparently contradicted by the intention already expressed by the signatories to the GATT treaty in 1946 to the effect that both product and process costs should be eligible for BTAs. According to GATT, BTAs are admissible for taxes associated “directly or indirectly” with a product. The term “indirectly” means that BTAs should be allowable not only for taxes on products per se, but also for taxes that are incurred during the production process.<sup>16</sup> In addition, the Appellate Body<sup>17</sup> has ruled against any blanket exclusion of non-product-related trade measures.<sup>18</sup> In terms of the effect on the country of origin’s policies, there was no significant difference between importing countries’ product-related and non-product-related TREMs, i.e. no difference that would require these two types of measures to be handled differently. In both cases, in order to avoid trade restrictions, the country of origin would need to impose changes on manufacturers’ production processes via environmental regulations.<sup>19</sup>

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<sup>14</sup> Puth in Hilf/Oeter, *WTO-Recht Rechtsordnung des Welthandels*, 2005, p. 588, marginal note 25

<sup>15</sup> This is the view held by proponents of the so-called product process doctrine; see Puth, Sebastian, *WTO und Umwelt – Die Produkt-Prozess-Doktrin*, 2003, p. 64 et. seq.

<sup>16</sup> Hoerner, J. Andrew, *The Role of Border Tax Adjustments in Environmental Taxation*, Working Paper, 1998, p. 7

<sup>17</sup> The Appellate Body reviews the rulings and conclusions reached by the WTO’s various independent arbitration panels, which arbitrate complaints regarding violations of WTO obligations. Neither of these quasi-judicial WTO bodies hand down rulings per se, but instead issue recommendations that the higher-order Dispute Settlement Body is required to abide by.

<sup>18</sup> WTO Appellate Body, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Appellate Body dated 12 October 1998, AB-1998-4, WT/DS58/AB/R. This decision relates to a US import ban on shrimp for which fishing was harmful to sea turtles.

<sup>19</sup> See Puth’s summary of the various views on this issue in Hilf/Oeter, p. 588 et. seq.

Hence BTAs that constitute non-product-related TREMs would not automatically violate WTO regulations. The discussion below covers both kinds of trade restrictions.

## **2. The national treatment obligation pursuant to GATT Article III**

### **2.1 Scope of GATT Article III**

#### **i. Scope as compared to GATT Article II:1(b)**

Taxes imposed on imports at the border that constitute environmentally motivated border tax adjustments must be differentiated from import duties that, as internal taxes, fall within the scope of GATT Article III:2, as well as from customs duties and customs-like charges pursuant to GATT Article II:1(b). GATT Article III can be applied to border taxes insofar as the tax would essentially be imposed both on imported and domestic products that are like or in direct competition with each other. Prerequisites for a tax according to GATT Article III are that it must be imposed at the border in accordance with an intergovernmental tax adjustment agreement and is directly related to the relevant internal tax collection system.<sup>20</sup> In the case of a border adjustment involving the imposition of import taxes, this burden on imported products is levied at the border within the framework of tax adjustments between the countries affected. The border tax adjustment is directly related to additional costs engendered by domestic climate protection measures. As pointed out previously, such adjustments attributable to compliance with climate protection regulations for domestic manufacturing would be realized at the border in cases where the imported goods were not subject to these regulations or comparable ones. Hence the envisaged BTA falls within the scope of GATT Article III.

#### **ii. Scope as compared to GATT Article XI**

In addition, the scope of application of GATT Articles III and XI must be clearly differentiated. GATT Article XI applies to all import and export restrictions – and in so doing protects both foreign manufacturers *and* domestic exporters –, and covers all trade restrictions and prohibitions except customs, taxes and other charges.<sup>21</sup> Since a BTA must be classified as such an exception, it does not constitute a trade restriction within the meaning of GATT Article XI.

### **2.2 Do BTAs violate the national treatment obligation?**

The national treatment obligation pursuant to GATT Article III prohibits unequal treatment of imported goods on one hand and like products, substitutable products and directly competitive

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<sup>20</sup> Puth in Hilf/Oeter, pp. 590 and 199

<sup>21</sup> See Berrisch in Prieß/Berrisch, WTO-Handbuch, 2003, p. 115 marginal note 147, with comments on interpreting the wording of GATT Article XI(1).

products of domestic manufacturers on the other. Article III applies to all imported products and covers tax measures (pursuant to Article III:2), non-tax measures (pursuant to Article III(4)) and internal quantitative restrictions (pursuant to Article III:5 and III:7). As a tax measure, a BTA falls within the scope of GATT Article III:2, which lays out two alternative violation scenarios. GATT Article III:2, first sentence, would be violated if like products were subject to different levels of taxation or different charges (“inward directed equal treatment”). GATT Article III:2, first sentence, constitutes an absolute prohibition of discrimination and does not, unlike the second sentence of Article III:2, require that a protectionist effect of trade measures in accordance with GATT Article III:1 be established.<sup>22</sup>

The assessment process for measures pursuant to the first sentence of GATT Article III:2 comprises two stages. First it must be determined whether two products constitute “like products” within the meaning of the rule. There is no legal definition of “like product”. Two products are rarely identical, particularly when it comes to environmental quality of like products, which can vary greatly.

The following interpretational criteria elaborated by the Working Party on Border Tax Adjustments form the basis for analyzing product likeness or similarity: the properties, nature and quality of the products; the end uses of the products; consumers’ tastes and habits in respect to the products; and the customs tariff classification of the products.<sup>23</sup> Sometimes products are assessed on the basis of environmental and health factors; one example of this is a ruling of the GATT Panel to the effect that motor vehicles with low and with high fuel consumption levels fail the “likeness” criterion.<sup>24</sup> A later ruling found that health risks are not relevant for “likeness” since asbestos and asbestos-containing products are not like products in the manner of other fibres and fibre-containing products.<sup>25</sup>

In cases where like products are identified, it is then, at the second stage, determined whether the imported goods are directly or indirectly subject to higher taxes or charges, or taxes or charges that are less favourable for the importer, relative to the counterpart domestic products.

The admissibility of BTAs pursuant to the first sentence of GATT III:2 needs to be determined for additional costs resulting from advanced production processes adopted for environmental reasons, taxes on specific products, emissions trading, regulatory threshold values, and/or substance bans.

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<sup>22</sup> Bender in Hilf/Oeter, p. 187

<sup>23</sup> Report of the Working Party on Border Tax Adjustments, 2 December 1970, L/3464, II. 18

<sup>24</sup> GATT Panel, United States, Taxes on Automobiles, Report of the Panel, 29 September 1994, DS31/R

<sup>25</sup> WTO Appellate Body, European Communities, Measures Affecting Asbestos and Asbestos-containing Products, Report of the Appellate Body, 12 March 2001, WT/DS135/AB/R

### **i. Border tax adjustment for product taxes**

Product taxes are not relevant for assessing the likeness of imported and domestic products. Imported and domestic products are deemed to be physically identical insofar as the same elements are used for their manufacture, regardless of the rate of tax levied on them.

However, there is little consensus in the literature as to whether a BTA for certain indirect tax instruments would be WTO compliant in the case of internal environmental taxes on pre-products, which would constitute an indirect end-product tax only. This instrument covers prior-stage taxes on pre-products – such as ingredients – or taxes on inputs such as energy that are no longer present in the end product.

Some authors take the view that the composition and quality of the end product are the only relevant likeness criteria, so that, in particular, a compensation for tax burden differentials associated with production processes (for example energy use) would not be admissible.<sup>26</sup> This would mean that, for example, energy taxes could not be compensated for by a BTA. The decisive criterion should be that expressed by the formulation of GATT Article II:2(a) to the effect that taxes should only be imposed on “article[s] from which the imported product has been manufactured or produced in whole or in part.” This in turn means that taxes may only be levied on products that are physically present in the end product.

Other authors<sup>27</sup> take the view that WTO law does not prevent a state from implementing BTAs for taxes on inputs consumed in the production process – particularly when it comes to energy used during the production process, since this energy is not only consumed by manufacturing the end product but is also “embodied” in it.<sup>28</sup>

The Working Party on Border Tax Adjustments also acknowledged this problem and classified energy taxes as “taxes occultes.” However, the Working Party did not reach a definitive decision

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<sup>26</sup> Hauser/Ziegler, *Internationaler Handel und Umweltschutz*, Synthesebericht 2000, p. 15; Pitschas, Christian, 1995: *GATT/WTO Rules for Border Tax Adjustments and the Proposed European Directive Introducing a Tax on Carbon Dioxide Emissions and Energy*, *Georgia Journal of International and Comparative Law*, 24, p. 479 et. seq.

<sup>27</sup> Goh, Gavin, *The World Trade Organization, Kyoto and energy tax adjustments at the border*, *Journal of World Trade* 2004, p. 395 et. seq.; Pitschas, Christian, *GATT/WTO Rules for Border Tax Adjustment and the Proposed European Directive Introducing a Tax on Carbon Dioxide Emissions and Energy*, *Georgia Journal of International and Comparative Law* 24, 479, p. 490 et. seq.; Muller/Hoerner, *Using A Border Adjustment To Take The Lead on Climate Change Without Encouraging Runaway Shops*, p. 4 et. seq.; OECD Environment Directorate Centre for Tax Policy and Administration, *COM/ENV/EPOC/CTPA/CFA(2005) 41*, p. 14

<sup>28</sup> Goh, Gavin, *Journal of World Trade* 2004, p. 395 et. seq. Nonetheless, it is unclear how much (if any) energy the end product actually contains. See Schlegelmilch’s observations in *COM/ENV/EPOC/CTPA/CFA(2005) 41*, p. 14



regarding the admissibility of a BTA for such taxes<sup>29</sup> nor have the WTO Panel or Appellate Body issued a definitive ruling on this matter. For example, the Panel on the US Superfund Tax<sup>30</sup> ruled that a BTA levied on like imported products must take account of taxes on products that are used to manufacture domestic items. It remains unclear, however, whether these elements must be present in the end product.

The 1994 Agreement on Subsidies and Countervailing Measures (ASCM), which applies to border adjustments on exports, is also relevant here. Whereas the 1979 ASCM only allowed countervailing measures for taxes on products that are physically detectable in exported goods, the amended 1994 Agreement stipulates that taxes that constitute indirect taxes on pre-products may be reimbursed for exports – including energy that is used or consumed during the production process.<sup>31</sup>

The foregoing observations strongly suggest that a BTA for taxes on production inputs that are not present in the end product is in principle admissible in accordance with GATT. However, in the final analysis this may be left open in cases where this BTA is justifiable according to GATT Article XX. Thus the exception stipulated in GATT Article XX would allow for the implementation of a BTA that protects internal environmental tax systems.<sup>32</sup>

Another major problem entailed by BTAs is determining the relevant monetary amounts, for which it is necessary to establish equivalence for indirect domestic taxes on the one hand, and BTAs for imported products on the other. The prohibition against higher taxes and charges for imports precludes subjecting them to even the slightest fiscal disadvantage. As pointed out in sections 2 and 3 of part II of the present report, in determining a BTA amount, the burden imposed on like products of national origin must be taken into account, and the additional costs associated with the exporting country's climate protection measures are to be factored in – in the interest of avoiding double taxation of imported products. Any tax imposed on pre-products that are used in the manufacturing process and contained in the finished product may provide a helpful guide to calculating a BTA, as that tax provides a concrete tax figure. This renders, in principle, an equivalence of the domestic product taxes and the counterpart BTA possible and makes it relatively easy to establish this equivalence. However, it is more difficult to establish input-related additional costs in cases where production input such as energy used is not present in the end product.

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<sup>29</sup> Report of the Working Party on Border Tax Adjustments, 2 December 1970, L/3464, II. 18.

<sup>30</sup> GATT Panel, United States, Taxes on Petroleum and Certain Imported Substances, Report of the Panel, 5 June 1987, L/6175-34S/136

<sup>31</sup> Agreement on Subsidies and Countervailing Measures (ASCM) 1994, Annex II (guidelines on consumption of inputs in the production process), footnote 61

<sup>32</sup> See section 4 in the present report, and Biermann et. al., p. 52

Insofar as an equivalence can be established, despite the various practical problems described above,<sup>33</sup> a BTA for additional costs resulting from specific taxes on products does not violate GATT Article III:2, regardless of whether the products in question are contained in the end product or not. But if these practical problems in establishing equivalence cannot be solved, the consequent violation of GATT Article III:2 is only justifiable on the grounds stipulated in GATT XX, according to which exceptions in respect to GATT Article III are admissible on environmental grounds.

**ii. Border tax adjustment for additional costs resulting from special - environmentally compatible – production processes**

Applying the criteria defined by the Working Party on Border Tax Adjustments<sup>34</sup> to assessments of the likeness of products manufactured using different production methods yields the following:

Application of the product-property criterion to production methods that do not affect the product results in likeness, since a product's properties are identical irrespective of whether it is made in an environmentally harmful or non-harmful manner. From the standpoint of WTO, products that are different solely with respect to their manufacturing processes and whose different production methods have no direct effect on the products themselves are like products. The end-use criterion and product-property criterion are closely related. Products manufactured in an environmentally compatible manner and other products not manufactured in this manner are intended for the same use, regardless of the manufacturing method employed.<sup>35</sup> Inasmuch as the customs tariff classification is determined by the product properties, this criterion is also an indicator of likeness. In the final analysis, consumers' tastes and habits is a criterion that allows for the differentiation of products made using various manufacturing methods. Environmentally aware consumers are attentive to production methods. Inasmuch as the three other criteria translate into likeness, and consumers' tastes and habits are not the determining factor, product likeness can be presumed to exist. In addition, product quality is the main determinant for product likeness.

GATT Article III could be deemed to have been violated if a BTA for additional costs attributable to the use of special production processes related (a) **solely** to the manner in which a product is manufactured; and (b) accorded an otherwise like product a dissimilar treatment owing to the

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<sup>33</sup> See sections 2 and 3 of part II

<sup>34</sup> Report of the Working Party on Border Tax Adjustments, 2 December 1970, L/3464, II. 18.

<sup>35</sup> Ekardt, Felix/Neumann, Nina, Liberalisierter Welthandel und Umweltschutz: Produktionsbezogene Handelsbeschränkungen und Border Tax Adjustments für umweltschädlich im Ausland hergestellte Produkte, p. 8. According to these authors, oxygen-bleached paper, for example, can be used for writing and printing, in the same manner as paper manufactured using an ozone-depleting bleaching method.

application of differing production standards.<sup>36</sup> Like products are to be treated similarly, regardless of their manufacturing process.<sup>37</sup>

And finally, the problem of calculating domestic additional burden resulting from sustainable production methods arises (see part II, sections 2 and 3). Insofar as an equivalent taxation of an imported product relative to a domestic product is not established, the consequent violation of GATT Article III:2 is only justifiable on the grounds stipulated in GATT XX.

### **iii. Border tax adjustment for additional costs resulting from threshold values and emissions trading**

Under WTO law, threshold values that may differ in the countries involved are not relevant for the likeness of imported and domestic products, insofar as the imported and domestic product have identical physical characteristics. The same holds true for emissions trading, since product likeness is unaffected by whether or not the relevant plants in the countries of origin participate in emissions trading. Imported and domestic goods containing the same materials and products are deemed like products.

The problem of determining the rate of a BTA for the imported goods discussed previously<sup>38</sup> also arises in connection with emissions trading. Owing to the practical difficulty of defining a benchmark that would allow for an equivalent taxation of imported products, there is a risk that domestic additional costs may not be completely covered by this BTA on imports; or that imported goods may be subject to higher charges than domestic goods, which would result in a violation of GATT Article III:2. This BTA would only be admissible insofar as justifiable by GATT Article XX.

### **iv. Border tax adjustment for additional costs resulting from substance bans**

The use of substitutes for substances whose domestic use is banned is relevant for product likeness assessments. If substances whose use is banned domestically for the manufacture of a product are present in the counterpart imported product, the products are deemed to be unlike because their physical properties differ. In such cases, the first sentence of GATT Article III:2 does not apply.

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<sup>36</sup> Berrisch in Prieß/Berrisch, p. 88

<sup>37</sup> See (among others) Sander/Sasti, *Freihandel und Umweltschutz, Legitimation und Grenzen grüner Handelsbeschränkungen in EU und WTO*, 2005, p. 146 et. seq. The authors do not dismiss the differences between products manufactured using different production methods out of hand, and advocate differentiating products based on their manufacturing process.

<sup>38</sup> See part II sections 2 and 3

Products that do not fall under the category of “like products” are to be assessed in accordance with GATT Article III:2, second sentence, which covers directly competitive or substitutable products. Since – in contrast to GATT Article III:2, first sentence – GATT Article III:2, second sentence expressly refers to GATT Article III:1, its likeness requirements are also relevant. This in turn means that the second sentence of GATT Article III:2 would be violated if reciprocally substitutable or directly competitive domestic and imported goods were subject to dissimilar taxation that served to protect domestic industries against competition.

Under WTO regulations, an end product that must no longer contain specific substances because these are subject to a substance ban and that is competing with products not subject to the same ban are generally regarded as substitutable products within the meaning of GATT III:2, second sentence, insofar as their physical and natural characteristics, quality, market circumstances, and consumer tastes and habits are like.

In order to avoid discrimination within the meaning of GATT III:2, second sentence, in the event of dissimilar taxation or differing fees there must be an equivalence between the additional costs attributable to substance bans and the BTA for imported products. Although the higher costs engendered by substance bans can be used as an element for BTA calculation, the problem of defining a suitable basis for such calculations arises here as well.<sup>39</sup>

Insofar as an equivalent taxation is not possible, dissimilar taxation is deemed to exist. The imposition of dissimilar taxes with a view to protecting domestic production violates the second sentence of GATT III:2.<sup>40</sup> There are problems involved with measures that solely serve purposes not related to trade, for example environmental protection, as in the present case. If competitive products exhibit different degrees of environmental compatibility based on the substances used, and if the importing country taxes the ecologically harmful (imported) product for reasons of environmental protection, this measure is deemed to discriminate against the (environmentally harmful) imported product and to be in favour of the environmentally compatible domestic product. This affects consumers’ tastes and habits in a manner that benefits the environmentally compatible product, and thus the product of domestic origin. This protectionist effect of the BTA would constitute a violation of the second sentence of GATT III:2 which in turn would only be justifiable by GATT Article XX.

### **3. Violation of the most-favoured-nation principle (GATT Article I:1)?**

According to the most-favoured-nation principle (GATT Article I), each WTO member is obligated to immediately and unconditionally grant any other WTO member any advantages that

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<sup>39</sup> See part II sections 2 and 3

<sup>40</sup> Berrisch in Prieß/Berrisch, p. 91

have been granted to any other country<sup>41</sup> (which is not required to be a WTO member) in respect to like products, services and so on. Any discrimination with respect to like or comparable products “originating in or destined for the territories of all other contracting parties” is to be avoided (“outward directed equal treatment”).

### 3.1 Prerequisites of GATT Article I:1

In order for a measure to be deemed to have violated the most-favoured-nation treatment obligation pursuant to GATT Article I, it must fall within the scope of GATT Article I:1 and must constitute an “advantage, favour, privilege or immunity” within the meaning of GATT Article I:1.

GATT Article I:1 covers “customs duties and charges of any kind imposed on or in connection with importation or exportation.” “Charges of any kind” are taxes and fees such as import taxes or import surcharges. Import taxes that serve as countervailing measures for climate protection-related additional costs incurred by domestic production count as charges within the meaning of GATT Article I:1. Imposition of a BTA falls within the scope of GATT Article I:1.

The most-favoured-nation obligation applies in cases where a measure implemented by a state confers an advantage, favour, privilege or immunity. These terms, which are open to broad interpretation, are subsumed under the generic term “advantages,”<sup>42</sup> which also comprises exemptions from charges,<sup>43</sup> as well as to the imposition of dissimilar import tariffs.<sup>44</sup> A border tax adjustment would constitute an advantage within this meaning. Importers from countries that have already implemented climate protection measures comparable to those in the EU would be exempt from a BTA and would thus have an advantage; and conversely, products that are

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<sup>41</sup> See Berrisch in Prieß/Berrisch, p. 98 marginal note 84. This also follows from the wording of GATT Article I:1, which states 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>42</sup> Berrisch in Prieß/Berrisch, p. 99 marginal note 89 f.

<sup>43</sup> For example, the exemption granted less developed countries from payment of the merchandise processing fee imposed by the US; see GATT Panel, United States, Customs User Fee, Report of the Panel, 25 November 1987, L/6264-35S/245, marginal note 122.

<sup>44</sup> For example, the EU’s imposition of differing import customs tariffs on bananas from different countries of origin; see WTO Appellate Body, European Communities, Regime for the Importation, Sale and Distribution of Bananas, Report of the Appellate Body, 9 September 1997, WT/DS27/AB/R, marginal note 206

subject to inadequate or no climate protection measures in the relevant country of origin would be subject to the BTA. These importers would be at a disadvantage on import of their products.<sup>45</sup>

Other prerequisites for the most-favoured-nation obligation are that (a) a product that is already accorded an advantage and a product to which an advantage is to be conferred must be like or comparable products; and (b) the advantage was not conferred immediately and unconditionally.<sup>46</sup> An advantage is deemed not to have been accorded immediately and unconditionally to all like or comparable products in cases where a BTA is imposed at the cost of specific importers from selected countries.

### 3.2 Unequal treatment based on product origin?

GATT Article I prohibits unequal treatment of like products on the basis of their origin, not their properties. However, since BTAs will not relate directly to the origin of imported products, the question arises as to whether these adjustments will be tantamount to discrimination.

Criterion for imposing a border tax adjustment are climate protection measures that have or have not been implemented in the country of origin of the products concerned. However, this creates a situation where the BTA is *de facto* based on product origin, since the presence or absence of climate protection measures is a factor that is directly related to the country of origin. An importer that incurs a disadvantage in such a case would be unable to meet the mandated requirements and would be denied the advantage of a BTA exemption for this reason alone. This constitutes what GATT terms “de facto discrimination,” which is deemed to exist in cases where all products, regardless of their origin, are only formally treated similarly – but in reality only products of specific origin are accorded an advantage.<sup>47</sup> In the final analysis only products of specific origin – i.e., from countries whose climate protection measures meet European standards – can be accorded most-favoured-nation treatment. Hence a BTA would create a situation where products incur discrimination owing to their origin, which in turn would result in inadmissible unequal treatment within the meaning of GATT Article I. The WTO Panel<sup>48</sup> and Appellate Body<sup>49</sup> have both ruled that GATT Article I also applies to “de facto discrimination,” not just to disadvantages that are formally related to a product’s country of origin. The WTO dispute

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<sup>45</sup> The most-favoured-nation obligation pursuant to GATT Article I:1 also concerns measures to avert disadvantages. If a country that is actually entitled to most-favoured-nation treatment suffers a disadvantage at the hands of another country, the country put at a disadvantage can lodge a defensive claim on the basis of the most-favoured-nation-obligation. The advantages granted are to be extended to the countries receiving MFN treatment according to GATT Article 1(1)

<sup>46</sup> See part 2 for further details on likeness and comparability.

<sup>47</sup> Berrisch in Prieß/Berrisch, p. 101, marginal note 98

<sup>48</sup> WTO Panel, Canada, Certain Measures Affecting the Automotive Industry, Report of the Panel, 11 February 2000, WT/DS139/R, WT/DS142/R

<sup>49</sup> WTO Appellate Body, Canada, Certain Measures Affecting the Automotive Industry, Report of the Appellate Body 31 May 2000, WT/DS139/AB/R, WT/DS142/R

settlement *Certain Measures Affecting the Automotive Industry* related to a dispute regarding a Canadian regulation that provided for customs duty exemptions for automakers that operated factories in Canada, met specific selling criteria, and came under a special VAT scheme. Owing to the narrowness of these criteria, only a handful of automakers – among them four in the US – were granted a customs duty exemption. According to the WTO Panel and Appellate Body, that established a violation of GATT Article I, also measures that are ostensibly origin-neutral fall within the scope of the GATT most-favoured-nation obligation.<sup>50</sup>

According to these rulings, a BTA would constitute discrimination within the meaning of GATT Article I and would violate the most-favoured-nation obligation. Here as well, such a violation would only be acceptable if the requirements laid out in GATT Article XX were met.

#### **4. Exceptions to GATT Article I and III — justification according to GATT Article XX**

The aforementioned violations of GATT Articles I and III would be justifiable if the prerequisites laid down in GATT Article XX were met. WTO members are entitled to deviate from GATT rules in order to implement various policy objectives of protection. WTO members' measures that comply with the prerequisites of GATT Article XX are admissible, even if they violate GATT obligations.

Assessments of measures taken in accordance with GATT Article XX are carried out in two stages. First the measures must be deemed to meet the requirements set forth in items (a) through (j) (see section 4.1). In a second step, the measure's application modality is assessed in light of the implementation rules laid out in the introductory clause (chapeau) of Article XX (see section 4.2).

##### **4.1 Prerequisites pursuant to GATT Article XX (b) and XX (g)**

The environment as such is not mentioned as a protected value in GATT Article XX, but GATT Article XX (b) (protection of human, animal or plant life or health conservation) and Article XX (g) (conservation of exhaustible natural resources) adequately allow ecological considerations to be given their due.

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<sup>50</sup> WTO Panel, Canada, *Certain Measures Affecting the Automotive Industry*, Report of the Panel, 11 February 2000, WT/DS139/R, WT/DS142/R; WTO Appellate Body, Canada, *Certain Measures Affecting the Automotive Industry*, Report of the Appellate Body, 31 May 2000, WT/DS139/AB/R, WT/DS142/R; Bender in Hilf/Oeter, p. 179, marginal note 34 et. seq.

**i. Protected common interests or values in accordance with GATT Article XX (b)**

GATT Article XX (b) stipulates that trade-related environmental measures aimed at protecting humans, animals or plants are admissible. Hence measures implemented to meet these ends are justified.

A border tax adjustment aims to protect the environment and the world's climate in general from the global effects of environmental pollution. Hence it must be clarified whether – beyond *internal* protection of humans, plants and animals – the protected common interests or values pursuant to GATT Article XX (b) have to be interpreted extensively, meaning that also measures fall into their scope that do not directly refer to the interests or values expressly mentioned but instead relate to the conservation of *global* environmental resources such as the earth's atmosphere and the ozone layer.

It is now widely accepted that GATT Article XX (b) does in fact apply to the protection of the environment as a common interest or value, despite the fact that this is not expressly stated.<sup>51</sup> The Appellate Body has emphasized on a number of occasions<sup>52</sup> that health policy issues, environmental protection and the furtherance of sustainable development can no longer be subordinated to the objective of free trade. In addition, neither the wording nor the systematic interpretation of GATT Article XX (b) preclude implementing measures to protect global resources. In order for a trade restriction to be justified under GATT Article XX (b), it need only serve to protect humans, animals or plants. Although the clauses' wording leaves it open whether the admissibility of such measures depends on the location of the environmental resources requiring protection, this has prompted some authors to contend that no trade measures apart from those aimed at internal protection of humans, animals or plants are justified, on the grounds that otherwise they would violate the principle of territorial sovereignty and specifically the prohibition against interfering in another country's internal affairs.<sup>53</sup> Initially, the GATT Panel<sup>54</sup> rejected a justification according to GATT Article XX (b), on the grounds that internal trade restriction measures should have no extraterritorial impact and should only affect a member's own jurisdictional territory. However, the Panel later<sup>55</sup> considered trade measures

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<sup>51</sup> See (among others) Sander/Sasdi, p. 155; Berrisch in Prieß/Berrisch, p. 141 marginal note 237; Epiney, Astrid, *Welthandel und Umwelt*, DVBl. 2000, 77

<sup>52</sup> See (among others): WTO-Appellate Body, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Appellate Body, 12 October 1998, WT/DS58/AB/R

<sup>53</sup> Puth in Hilf/Oeter, p. 590 marginal note 31, with further references. In the authors' view, the right to use internal and global environmental resources falls within the scope of GATT Article XX (g).

<sup>54</sup> GATT Panel, *United States, Restrictions on imports of tuna*, Report of the Panel, 3 September 1991, DS21/R-39S/155, 5.38-5.40. This ruling relates to an import ban on tuna caught with large dolphin by-catch.

<sup>55</sup> GATT Panel, *United States, Restrictions on imports of tuna*, Report of the Panel v. 16.06.1994, DS29/R, 5.11 et. seq.



justifiable that were in principle in favour of migrating fish species, and thus of any cross-border resources. In the 'shrimp-turtle' case, the Appellate Body<sup>56</sup>, too, did not expressly refuse the justification of unilateral trade measures not solely aimed at internal protection, as long as there is a nexus to sovereign territory. Moreover, the wording of GATT Article XX (b) – which makes no mention of “domestic resources” – militates in favour of the protection of foreign or common resources outside the own territory. The wording of GATT Article XX (b) does not specify the temporal, spatial and/or functional conditions to which trade protection measures for common interests or values must relate to. In addition, the fact that environmental pollution oftentimes has cross-border and global effects must also be taken into account. Particularly when it comes to environmental protection, virtually all pollution can at least potentially affect other countries, owing to the manifold interactions in and the inherent complexity of ecosystems.<sup>57</sup> The use of global environmental resources has an impact beyond the borders of the states that use such resources for production purposes. Both user and polluting countries, as well as states affected by pollution caused by this use, can determine their own environmental standards on the grounds of national sovereignty. The obligation to protect the environment exists not only in the nations' own interest: it also serves the common good of the community of nations.<sup>58</sup> At the international level, countries are obligated to (a) ensure that internal activities do not damage the environment of other countries and (b) act in a neighbour-friendly manner.<sup>59</sup> These obligations arise from Principle 2 of the 1992 Rio Declaration on Environment and Development<sup>60</sup> as well as Principle 21 of the 1972 Stockholm Declaration on the Human Environment, that has the same wording.

Trade-related environmental measures – such as BTAs – fall within the scope of the exception according to GATT Article XX (b).

In addition, GATT Article XX (b) stipulates that trade measures aimed at protecting “human, animal or plant life or health” must also be “necessary.”

A measure is deemed necessary insofar as it is appropriate to contribute to the achievement of the protection objectives.<sup>61</sup> However, such a measure fails the criterion of appropriateness in cases where these interests or values are not subject to an environmental threat. It has been

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<sup>56</sup> WTO Appellate Body, WTO Appellate Body, United States, Import Prohibition of Certain Shrimp and Shrimp Products, Report of the Appellate Body, 12 December 1998, WT/DS58/AB/R

<sup>57</sup> Epiney, DVBl. 2000, 77

<sup>58</sup> Sander/Sasdi, p. 178 f.

<sup>59</sup> Berrisch in Prieß/Berrisch, p. 144f.

<sup>60</sup> „Principle 2: States have, in accordance with the Charter of the United Nations and the principles of international law, the sovereign right to exploit their own resources pursuant to their own environmental and developmental policies, and the responsibility to ensure that activities within their jurisdiction or control do not cause damage to the environment of other States or of areas beyond the limits of national jurisdiction.”

<sup>61</sup> Puth in Hilf/Oeter, p. 592 marginal note 34

scientifically proven that protected interests or values within the meaning of GATT Article XX (b) are endangered by climate change. Such measures also meet the aforementioned criterion of appropriateness. They give exporting countries incentives to implement ambitious climate protection instruments and require exporters to manufacture in a climate-compatible manner, and they allow for ambitious internal climate protection measures without putting domestic industries at a competitive disadvantage. This in turn is consistent with such measures' objective of protecting the earth's atmosphere, the ozone layer, and "human, animal or plant life or health."

In addition to assessing its appropriateness, a trade measure must pass the GATT "least trade restrictive test."<sup>62</sup> In other words, a measure is deemed not necessary insofar as the same objective can be achieved by a measure that does not violate GATT regulations. If such a measure is not available, a measure is to be implemented that entails the least degree of inconsistency with GATT provisions.<sup>63</sup> In all cases, any alternative measure must be one that WTO members could reasonably be expected to employ, i.e. the measure must be reasonable and meaningful.

Multilateral agreements in particular are a possibility of less trade restrictive measures. Past international negotiations related to environmental and climate protection leave doubts as to whether an international agreement can be achieved and implemented successfully. Even in cases where international accords do not conflict with WTO regulations, it is doubtful whether international negotiations aimed at such agreements as an alternative measure can reasonably be expected. The problem of international negotiations seems especially grave at the level of the introductory clause (chapeau) of GATT Article XX. The Appellate Body, too, has reviewed the question of whether and under which circumstances unilateral environmental policy measures are admissible with respect to the chapeau.<sup>64</sup> For this reason we refer to section 4.2 below.

## **ii. Protected common interests and values in accordance with GATT Article XX (g)**

In addition to GATT Article XX (b), GATT Article XX (g) is relevant for trade-related environmental measures, which justifies measures aimed at conserving exhaustible natural resources.

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<sup>62</sup> This interpretation has been applied by, among others, GATT Panel, Restrictions on Importation of and Internal Taxes on Cigarettes, Report of the Panel, 5 October 1990, adopted on 7 November 1990, DS10/R-37S/200; Puth in Hilf/Oeter, p. 592 marginal note 34, objects to this narrow interpretation of necessity and advocates a broader understanding of the criterion of appropriateness.

<sup>63</sup> Berrisch in Prieß/Berrisch, p. 140 marginal note 234

<sup>64</sup> See Berrisch in Prieß/Berrisch, p. 145 and section 4.2 below

The exact territorial scope of the exception provided for in GATT Article XX (g) has not been clarified so far. The Appellate Body deliberately left open this question. According to past systematic interpretation, the justification for export restrictions aimed at preserving internal resources of the acting member was in the foreground of the 1947 GATT negotiations. However, no such restriction can be inferred from the wording of GATT Article XX (g) – which means that import restrictions aimed at protecting natural resources both within and outside the own territory fall within the scope of GATT Article XX (g).<sup>65</sup> Hence “exhaustible natural resources” pursuant to GATT Article XX (g) has to be interpreted in a broad sense, thus also with a view to the principle of sustainable development (also mentioned in the preamble to the WTO Agreement). This in turn means that the scope of protection also includes (a) non-living natural resources (such as petroleum and minerals), (b) living resources (such as plants and animals) and (c) clean air and biodiversity as a whole.<sup>66</sup> It must also be borne in mind that import restrictions are justified only insofar as they protect an acting member’s legitimate interests in the use of the natural resources affected. Apart from internal natural resources, these legitimate interests include international and global environmental resources that are not owned solely by one or more countries.

The main criterion for determining whether a trade measure is admissible under GATT Article XX (g) is whether it is a measure appropriate for the conservation of exhaustible natural resources. In order to meet this criterion, the measure in question must be related to the conservation of exhaustible natural resources, i. e., a close relationship between the measure and the objective of protection needs to be established. A border tax adjustment meets this criterion in that it constitutes a trade measure that provides an incentive for affected importers to manufacture in a more environmentally compatible manner – which in turn serves protecting exhaustible natural resources pursuant to GATT Article XX (g).

In addition, the trade measure must be applied in conjunction with restrictions on domestic production or consumption. This criterion is likewise met by a border tax adjustment. Since it is intended to offset the import-related additional costs engendered by internal or EU climate protection measures it constitutes a trade measure that is applied in conjunction with internal climate protection-related restrictions.

#### **4.2 Prerequisites of the GATT Article XX chapeau**

The purpose of the chapeau is to strike a balance between the rights and duties of WTO members. According to GATT Article XX, a trade measure is only justified in cases where it is “not applied in a manner which would constitute a means of arbitrary or unjustifiable

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<sup>65</sup> This view is widely endorsed in the literature; see Puth in Hilf/Oeter, p. 592, marginal note 35 with further references

<sup>66</sup> For various views on this issue, see Puth in Hilf/Oeter, p. 592, marginal note 35 with further reference.; Epiney, DVBl. 2000, 77 et. seq.

discrimination between countries where the same conditions prevail, or a disguised restriction on international trade.”

Border tax adjustments aim not to implement disguised restrictions on international trade but rather to protect the climate and improve the efficiency of internal and EU climate protection instruments. Border tax adjustments also aim to achieve a level playing field in European markets and offset competitive disadvantages incurred by internal industries owing to the implementation of climate protection measures. Border tax adjustments may also provide an incentive for international manufacturers to manufacture their products in a more environmentally compatible way. Border tax adjustments do not seek to restrict the freedom of international trade.

In order to prevent a BTA from engendering arbitrary or unjustifiable discrimination, it must be applied indiscriminately to all WTO members that do not meet European climate protection standards that are associated with the BTA. If this is not done, importing countries would incur such discrimination. In addition, the BTA system should be designed in such a way as to allow sufficient flexibility and recognize comparable climate protection policies in the various countries from which the imported goods stem.<sup>67</sup>

In addition, it must be noted that the Appellate Body<sup>68</sup> has ruled that, according to GATT Article XX, trade restrictions are only admissible insofar as the state wishing to implement them has, without success, made efforts to negotiate an agreement regarding the measure with the states affected by it. The unique nature of extra-territorial environmental resources that are significant for two or more states entails a duty to cooperate in protecting said resources on the part of the states concerned.<sup>69</sup> In addition, it can be inferred from existing international environmental agreements that there is the necessity for all countries affected to cooperate in taking measures to protect environmental resources of global import.<sup>70</sup> Hence all states affected by global environmental problems are obligated to enter into negotiations aimed at finding solutions that are acceptable to and take account of the interests of all concerned. This in turn means that

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<sup>67</sup> For an endorsement of this view, see Cendra, *RECIEL* 15 (2) 2006, 131 (145)

<sup>68</sup> WTO Appellate Body, *United States, Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Appellate Body, 12 October 1998

<sup>69</sup> In the shrimp-turtle case, the Appellate Body ruled that any country through whose territorial waters the sea turtles pass must cooperate with a view to protecting them.

<sup>70</sup> For example, Principle 12 of the 1992 Rio Declaration on Environment and Development states as follows: “States should cooperate to promote a supportive and open international economic system that would lead to economic growth and sustainable development in all countries, to better address the problems of environmental degradation. Trade policy measures for environmental purposes should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade. Unilateral actions to deal with environmental challenges outside the jurisdiction of the importing country should be avoided. Environmental measures addressing transboundary or global environmental problems should, as far as possible, be based on an international consensus.”

unilateral trade measures on the part of the EU or Germany are justified in cases where all efforts to negotiate a comprehensive agreement have failed.<sup>71</sup>

Thus, in order for BTAs to be justified, prior to their implementation serious efforts must be made via multilateral negotiations to reach an agreement (though not necessarily to conclude one), particularly with countries that have refused so far to implement extensive climate protection measures. If this is not done, the measure would constitute unjustified discrimination within the meaning of the chapeau.

In this context, it is important to first of all determine whether existing treaties and negotiations undertaken to date suffice to fulfil the obligation to cooperate, or if further negotiations are needed. There have already been international negotiations aimed at persuading states to implement more climate protection measures and to get countries that have not ratified the Kyoto Protocol to do so. The Kyoto Protocol, which came into force on Feb 16, 2005, will expire in 2012, and the international community has not yet been able to negotiate a successor agreement. Despite the existing treaties and negotiations that have been undertaken thus far, some governments are still unwilling to implement climate protection measures. Nevertheless, achieving an international agreement is not a completely hopeless task so that yet another attempt must be made to obligate the international community to jointly set specific targets for the reduction of greenhouse gases. This is demonstrated first and foremost by current EU efforts to negotiate a new and comprehensive climate protection framework by 2009 that builds on the Kyoto Protocol, so as to avoid a hiatus when the Protocol expires. Recent climate policy initiatives from Washington, too, indicate that the American attitude toward climate protection is changing and that further international negotiations might well prove fruitful.

In the event the aforementioned negotiations fail definitely and a comprehensive climate protection agreement based on the Kyoto Protocol cannot be concluded at the 2009 Conference of the Parties in Copenhagen, we feel that the obligation to cooperate would no longer stand in the way of implementing BTAs.

## **5. Admissibility under WTO regulations and necessity of reimbursing climate protection-related additional costs for exports**

### **5.1 Necessity of reimbursement**

Since one argument in favour of border tax adjustments is to level the playing field for all “like goods” in their respective markets, it would be a logical measure to reimburse national/European exporters for climate protection-related additional costs so as to avoid placing German and other European vendors at a disadvantage in foreign markets. This export BTA would solely benefit the competitiveness of European products on international markets. However, such

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<sup>71</sup> See Puth in Hilf/Oeter, p. 594 marginal note 41

reimbursements would be inadvisable from an environmental protection standpoint since they would reduce domestic incentives for ecologically compatible manufacturing methods for export goods. The effect of this would increase in proportion to the importance of exports for a given economy or industry. Moreover, the success of German exports shows that, despite (or even because of) the high environmental standards (high in international comparison) to which German industries are subject, German businesses are competitive in foreign markets; and it further shows that additional costs engendered by environmental compliance can be offset by innovation and improved efficiency. In addition, WTO regulations indicate that a compensational export BTA would not be necessary if a BTA for imported goods were introduced. Hence, an export BTA is not required – from the standpoint of environmental protection, WTO regulations, and competition.

## **5.2 WTO admissibility of reimbursements for taxes on exported products**

Inasmuch as reimbursements of internal or European taxes on exports are similar in nature to subsidies, GATT Article VI and XVI and the Agreement on Subsidies and Countervailing Measures (ASCM, 1994) are relevant. The question arises, whether such reimbursements would constitute a subsidy within the meaning of these two agreements.

### **i. Admissibility of product tax reimbursements according to the ASCM**

Article 1 of the ASCM defines a subsidy as a benefit resulting from “a financial contribution by a government or any public body within the territory of a Member.” A benefit in this context means a pecuniary advantage accorded the recipient via this financial grant.<sup>72</sup> All reimbursements for additional costs engendered by climate protection measures would be tantamount to financial grants from Germany or the EU.

Annex I of the ASCM contains an “illustrative list of export subsidies,” which include the following: pursuant to (g), “the exemption or remission,<sup>73</sup> in respect of the production and distribution of exported products, of indirect taxes;” and pursuant to (h), the exemption or remission of prior-stage cumulative indirect taxes on goods or services used directly or indirectly in the production of exported products.<sup>74</sup> However, according to these two clauses, reimbursements of customs fees or other taxes on like products intended for domestic free circulation that do not exceed the amounts actually accrued, would not constitute an export subsidy. Trade measures that do not constitute export subsidies in accordance with ASCM Annex 1 are neither prohibited by Article 3 nor any other provision of the ASCM.<sup>75</sup>

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<sup>72</sup> Bender in Hilf/Oeter, p. 240, footnote 32

<sup>73</sup> Tax remission also includes tax reimbursement.

<sup>74</sup> See footnote 58 in Annex I of ASCM 1994

<sup>75</sup> See footnote 5 in article 3 of ASCM

Moreover, according to ASCM Annex II:I(1), "... remission ... of prior-stage cumulative indirect taxes levied on inputs that are consumed in the production of the exported product" is admissible, whereby "inputs consumed in the production process" are inputs physically incorporated as well as energy, fuels and oil and inputs used in the production process.<sup>76</sup>

Hence, we have as interim findings: according to the ASCM, taxes on (a) the inputs contained in end products; and (b) taxes on energy and fuel used in the production process must in principle be taken into account with regard to export subsidies. Under WTO regulations, such taxes can be reimbursed as long as the amount reimbursed does not exceed the amount of the actual tax.<sup>77</sup> According to the ASCM, a BTA does not constitute a subsidy as long as the amount of the adjustment is less than that of the tax.

If a BTA exceeds the actual tax, this would constitute a subsidy whose admissibility would then have to be determined. Only specific subsidies<sup>78</sup> according to ASCM Article 2 fall within the scope of the ASCM, which distinguishes between prohibited, actionable and non-actionable subsidies in parts II, III and IV respectively. Non-specific subsidies fall within the scope of non-actionable subsidies and are hence allowable in accordance with ASCM Article 1.2. According to ASCM Article 2, a subsidy is deemed *specific* insofar as it is limited to "an enterprise or industry or group of enterprises or industries" or to "certain enterprises located within a designated geographical region"; and is not granted "automatically" in accordance with "criteria or conditions" that are "clearly spelled out" in a "law, regulation, or other official document." Reimbursement of climate protection-related additional costs would not explicitly be limited to certain enterprises or industries and would rather be granted for all goods and exporters that incurred such additional costs during production. In addition, "objective criteria or conditions governing the eligibility for ... a subsidy" would have to be established, where objective criteria mean criteria of economic nature which are neutral and which do not favour certain enterprises over others.<sup>79</sup> Climate protection-related additional costs are reimbursed in order to preserve the competitiveness of German or other European export products on foreign markets. Any favouring over imported products that are on import subjected to border tax adjustments is not relevant here, since these import products are in competition with domestic products in the European single market and are subject to the very climate protection measures that the BTA is meant for in the first place.

Given objective criteria for granting a subsidy, this subsidy is not specific and thus not prohibited under the ASCM and not actionable for other WTO members (ASCM Article 1.2).

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<sup>76</sup> See footnote 61 in article II of ASCM 1994

<sup>77</sup> See Ismer/Neuhoff, p. 8; Pitschas, p. 484 et. seq., p. 497

<sup>78</sup> Defined in Article 2 of the ASCM as "specific to an enterprise or industry or group of enterprises or industries"

<sup>79</sup> See footnote 2 in Article 2.1(b) of the ASCM

**ii. ASCM admissibility of reimbursements for other climate protection-related additional costs**

Climate protection-related additional costs resulting from emissions trading, adaptation to more environmentally compatible production processes and/or compliance with plant-specific threshold values and substance bans do not constitute indirect taxes within the meaning of Annex I(g) and (h) of the ASCM. Reimbursement of these costs is not covered by the list of export subsidies according to ASCM Annex I, neither does it constitute a specific subsidy within the meaning of ASCM Article 2.<sup>80</sup> Thus, these subsidies are neither prohibited nor actionable.

**iii. Admissibility according to GATT Article VI**

In addition to the requirement that countervailing duties comply with the ASCM, WTO members are obligated to take all necessary steps to ensure that said duties are consistent with GATT Article VI:3-7 (in accordance with ASCM Article 10). The second sentence of GATT Article VI:3 defines a countervailing duty within the meaning of GATT Article VI as a “special duty levied for the purpose of offsetting any bounty or subsidy bestowed, directly, or indirectly, upon the manufacture, production or export of any merchandise.” However, in view of the fact that a BTA is not imposed in order to offset a bounty or subsidy bestowed by an exporting country, it follows that GATT Article VI does not prohibit a BTA on exports.

**iv. General obligations pursuant to GATT Article XVI:A(1)**

GATT Article XVI:A(1) stipulates that any subsidy that operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, the territory of a party, said party is required to notify the other contracting parties accordingly. GATT does not expressly define the term “subsidy” here.<sup>81</sup> A subsidy within the meaning of GATT Article XVI is deemed not to exist in cases where “the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption” is “not in excess of [the amounts] which have accrued.”<sup>82</sup> If these criteria are not met, such an exemption is deemed a subsidy. If an export BTA results in an export volume increase for such products relative to the export volume in the absence of this BTA, Germany or the EU would be required to notify a subsidy. The notification submitted to the Committee on Subsidies and Countervailing Measures (see ASCM Article 26.1) must indicate “the extent and nature of the subsidization (...), the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory, and (...) the circumstances making the subsidization necessary.”

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<sup>80</sup> See section 5.2(i)

<sup>81</sup> See Bender’s comments in this regard in Hilf/Oeter, p. 238 marginal note 6 and the reference to the *know one when I see one* criterion.

<sup>82</sup> Comments on GATT Article XVI in Annex I “Comments and complementary rules” on GATT



The second sentence of GATT Article XVI:1 stipulates that in “any case in which ... serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy” is required to consult with the member affected. WTO members are entitled to request such consultations if there is reason to believe that said member has granted subsidies which can cause “serious prejudice to the interests” of the requesting member. The purpose of such a discussion is to clarify the relevant matter and reach an amicable solution aimed at limiting or abolishing any subsidization that could seriously “prejudice the interests of any other contracting party.”

#### **v. Specific obligations related to GATT Article XVI:B export subsidies**

GATT Article XVI:B lays out requirements related to export subsidies granted by a WTO member for primary products<sup>83</sup> (GATT Article XVI:3) and other products (GATT Article XVI:4). The first sentence of GATT Article XVI:3 stipulates that subsidies on the export of primary products are to be avoided in principle and then states as follows: “If, however, a contracting party grants ... [such a] subsidy ..., it shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product.” This matter is to be examined more closely in cases where the product groups eligible for a BTA also comprise primary products.

## **IV. Summary and conclusions**

In fact, the WTO admissibility of introducing environmentally motivated border tax adjustments (BTAs) via import taxes has not yet been definitively clarified neither by the WTO Panel and the Appellate Body nor in the jurisprudential literature. In our view, however, a BTA for almost all additional costs attributable to internal environmental protection measures is admissible under WTO regulations.

### **1. Import**

In our view, clearly defined BTAs aimed at offsetting additional costs resulting from internal or EU climate protection measures to which imported products shall be subject will not violate the prohibition against non-discrimination provided for in the General Agreement on Trade and Tariffs (GATT) – neither the most-favoured-nation principle pursuant to GATT Article 1 nor the principle of non-discrimination pursuant to GATT Article III:2. Should the introduction of a BTA nevertheless violate these GATT regulations, this would be justified by GATT Article XX (b) and

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<sup>83</sup> Primary products within the meaning of GATT Article XVI:B (pursuant to the Note Ad GATT Article XVI:B) are “any product of farm, forest or fishery, or any mineral, in its natural form or which has undergone such processing as is customarily required to prepare it for marketing in substantial volume in international trade.”

XX (g), as the latter allow exceptions to GATT Articles I and III with respect to environmental protection measures.

Depending on which extra burden engendered by internal climate protection measures a BTA is intended to compensate for, this BTA is either classified as a product-related (e.g. a BTA for product taxes) or a non-product-related trade restriction (e.g. a BTA for additional costs attributable to emissions trading); in principle, both restrictions are consistent with WTO regulations in specific cases.

Border tax adjustments do not violate the principle of non-discrimination pursuant to sentence 1 of GATT Article III:2 insofar as – given like domestic and imported products – there is equivalence between the additional costs resulting from internal climate protection measures and the taxes imposed on the imported products. Differences related to production processes, emissions trading and product taxes (whether for products contained or not contained in the end product), as well as threshold values that have no impact on product properties, are irrelevant for assessing product likeness. However, calculating the BTA-related additional costs engendered by domestic climate protection measures poses practical problems. Moreover, it is necessary to obtain information in the country of origin related to climate protection measures, as well as the carbon footprint of, and amount of taxable energy consumed by, the production processes used for imported products. It is as yet unclear which products from which countries should be subject to a border tax adjustment, which European and foreign climate protection instruments should be taken into account, and which BTA rate should be imposed. In some areas, considerable research will be needed in order to clarify these issues.

No like products are deemed to exist with respect to substance bans owing to the lack of physical likeness in such cases. Thus for example, if a refrigerator or freezer uses a carbon dioxide-based refrigerant rather than fluorinated GHG used in another refrigerator or freezer, the two products would not be deemed to be like. Border tax adjustments for the additional costs thus engendered are to be assessed based on the product criteria defined in the second sentence of GATT Article III:2. If equivalent taxation is not ensured for such products, a differential taxation aimed at protecting internal industries is prohibited. However, such protection would in fact be deemed to exist if a border tax adjustment affected domestic consumption in a manner that worked to the advantage of more environmentally compatible and hence domestic products.

If border tax adjustments were not to apply to all imports, this would violate the most-favoured-nation principle of GATT Article I, which prohibits any unequal treatment of like products on the grounds of the origin of one product. According to this regulation, any advantage granted only to some member states shall be accorded all other WTO members.

In cases where border tax adjustments are *not* imposed on imports from countries whose climate protection measures already meet European standards and *are* imposed on imports from countries that have implemented only inadequate climate protection measures or none at

all, the latter products would be placed at a disadvantage. Such measures would be tantamount to discrimination based on the country of origin of such products. Hence such a border tax adjustment would engender inadmissible unequal treatment (de facto discrimination) that violates GATT Article I.

We feel that potential violations of GATT Articles I and III would be justified in accordance with GATT Articles XX (b) and XX (g). The protection allowed by the exceptions in these two clauses includes the implementation of border tax adjustments to protect the climate as a global environmental resource. In order to dispel possible concerns of encroachment upon national sovereignty and prioritize intergovernmental consultations over the implementation of trade measures, a justification requires, above all, that account be taken of the duty to cooperate ensuing from the introductory clause (chapeau) of Article XX. The chapeau stipulates that before a member implements restrictive trade measures, it must offer all states affected by these measures negotiations on comparable terms. However, under WTO regulations, concluding an agreement is not required for justifying restrictive trade measures. In view of the recent developments – particularly efforts to negotiate an international climate protection framework that builds on the Kyoto Protocol –, and the climate protection discussion in the US, further talks seem promising. Thus, negotiations should be capitalized on in order to succeed in implementing binding climate protection regulations. If such negotiations fail to reach an agreement on mandatory reduction goals or worldwide climate protection measures, we feel that under WTO regulations, the duty to cooperate on environmental protection matters would not be an obstacle to the implementation of BTAs. Border tax adjustments, should they violate the WTO principle of non-discrimination, would then be justified and hence admissible under WTO regulations.

Under existing WTO regulations it must be accepted for reasons of due care, that, in implementing BTAs, the rates levied are limited in such a way that they do not engender discrimination under any circumstances. Hence, border tax adjustments related to the internal and European burden should always be commensurate with minimum levels – like EU minimum standards –, whereas BTAs related to foreign prior burden should be based on the maximum level for each country of origin. However, if BTAs are applied in this manner, they will probably fail to fully achieve their intended purpose of offsetting additional costs.

## **2. Export**

Under WTA regulations, potential border tax adjustments on imports would not necessitate a counterpart tax on exports. Nevertheless, reimbursement of climate protection-related additional costs for exports would not be considered objectionable. Such border adjustments are neither prohibited nor actionable under the Agreement on Subsidies and Countervailing Measures of border adjustments (ASCM). According to GATT Article XVI:1, a notification obligation would apply if a BTA exceeded the actual amounts accrued internally and said BTA engendered an

export volume increase for the merchandise relative to the export volume in the absence of this BTA.

Nonetheless, reimbursements reducing the internal and European climate protection-related burden would also reduce incentives for energy-efficient production of export goods and would have an adverse effect on climate protection efforts. For this reason, such an instrument would be inadvisable from an environmental protection standpoint.