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# CHANGING CLIMATE FOR CARBON TAXES

Who's Afraid of the WTO?

JENNIFER HILLMAN

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# CHANGING CLIMATE FOR CARBON TAXES

## WHO'S AFRAID OF THE WTO?

CLIMATE & ENERGY POLICY PAPER SERIES

JULY 2013

Jennifer Hillman<sup>1</sup>

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# INTRODUCTION

Carbon taxes have recently become a major source of discussion in the Washington, DC policy community. Supporters contend that they offer an efficient way to simultaneously create incentives to emit less carbon dioxide and reduce the budget deficit.<sup>1</sup> Leading think tanks from both the left and the right, including Brookings, the American Enterprise Institute, and Resources for the Future, have hosted dialogues on how to structure the tax and use the revenues. Meanwhile, lawmakers have proposed two carbon tax bills during this congressional session: 1) Senators Boxer (D-CA) and Sanders (I-VT) put forward a plan to assess coal, oil, and gas producers a \$20-per-ton carbon tax<sup>2</sup>; and 2) Rep. Henry Waxman (D-CA), along with Rep. Blumenauer (D-OR) and Senators Whitehouse (D-RI) and Schatz (D-HI) released a discussion draft of a bill that would impose a fee of between \$15 and \$30 per ton on greenhouse gas emissions from power plants, factories, refineries, and other major emitters of carbon dioxide.<sup>3</sup>

Should such a carbon tax be enacted, it will in all likelihood be accompanied by measures to ensure that the U.S. industries that would be most heavily affected by the tax are not placed at a competitive disadvantage with respect to competitor producers operating in countries that have not imposed any restrictions or taxes on carbon usage. Any such efforts to “level the playing field” will raise numerous questions regarding their compatibility with U.S. international obligations, especially their

<sup>1</sup> A 2012 Congressional Research Study found, under one scenario, that a \$20 per ton carbon tax, escalating by 5.6 percent annually, could cut the projected 10-year deficit by roughly 50 percent (from \$2.3 trillion down to \$1.1 trillion). See “Carbon Tax: Deficit Reduction and Other Considerations,” CRS 7-5700, September 17, 2012.

<sup>2</sup> The Climate Protection Act of 2013, S. 332, 113<sup>th</sup> Congress, February 15, 2009.

<sup>3</sup> Broder, John M. (March 12, 2013), “Lawmakers Release Carbon Emissions Tax Plan,” *New York Times*, <http://thecaucus.blogs.nytimes.com/2013/03/12/representatives-release-carbon-emissions-tax-plan/>.

legality under agreed upon rules of the World Trade Organization (WTO) and in particular, the General Agreement on Tariffs and Trade (GATT).<sup>4</sup>

Can such a carbon tax be applied in a way that does not violate U.S. obligations under the WTO Agreements?<sup>5</sup> I believe the answer is yes, provided that policymakers carefully design such a tax, keeping in mind the basic requirements of the WTO not to discriminate in favor of domestic producers or to favor imports from certain countries over others. The key is to structure any accompanying border measure as a straightforward extension of the domestic climate policy to imports. If so designed, there should be few questions about the measure’s consistency with the WTO rules. Even if questions were raised, the United States would have strong defenses within the WTO system. And even if those defenses were somehow to fail, the United States would be able to make adjustments should some aspect of its carbon tax system be found wanting. A non-discriminatory tax enacted in good faith to address climate change should pass muster with the WTO. Therefore, the threat of WTO challenges should not deter policymakers from adopting a carbon tax system now.

<sup>4</sup> While a number of carbon reduction schemes, including a cap-and-trade or emissions trading system, could raise issues under various parts of the WTO Agreement, including in particular the Agreement on Technical Barriers to Trade, this paper focuses on the rules that would be applicable to a tax (i.e., a compulsory contribution imposed by the government for which taxpayers receive nothing identifiable in return). It is presumed that the main base of such a “carbon tax” would be the carbon dioxide emissions of fossil fuels, with the amount of the tax and its method of calculation to be determined by policymakers.

<sup>5</sup> An extensive body of literature has been created on the intersection between climate change policies and international trade rules. A thorough bibliography of that literature can be found in many of the works cited in this paper, including WTO-UNEP Report (2009), *Trade and Climate Change*, [www.wto.org](http://www.wto.org); Hufbauer, G., Charnovitz, S., and Kim, J. (2009), *Global Warming and the World Trading System*, Peterson Institute for International Economics, Washington DC.; and Houser, T. Bradley, R., Childs, B., Werksman, J., Heilmayr, R. (2008), *Leveling the Carbon Playing Field: International Competition and U.S. Climate Policy Design*, Peterson Institute for International Economics and World Resources Institute, Washington DC.

*The key is to structure any accompanying border measure as a straightforward extension of the domestic climate policy to imports.*

# 1 THE SIMPLE PATH

## Carbon Tax on U.S. Production and Use of Fossil Fuels

The United States, like all sovereign nations, is free to adopt any tax system or policy it chooses, including any that would tax the generation of power, the production of fossil fuels, and/or the major users of such power or fuels, with the amount of the tax being calibrated to the volume of carbon dioxide emitted in either the production or the burning of those fuels or the generation of power. If the United States were simply to impose its own carbon tax on U.S. power producers and/or U.S. producers of coal, oil, gasoline, natural gas, or other fuels, and even to extend it to all domestic users of fossil fuels or the power generated using those fossil fuels, there would be no potential for international trade law violations. Indeed, policymakers are free to structure such a domestic carbon tax as they see fit, including the initial amount of the tax; any change in the tax amount over time; and any methodology for assessing how much, if any, producers of downstream products such as aluminum, cement, steel, paper, chemicals, and other energy intensive industries would pay.<sup>6</sup> Complications only arise should policymakers choose to go beyond a tax applied to any or all domestic producers or users of carbon and tax or place restrictions on foreign goods or companies.

<sup>6</sup> See Houser et al. (2008), p. 7 noting the U.S. Department of Energy, Energy Information Administration, manufacturing Energy Consumption Survey data, for example, that energy costs are 21.73 percent of the value of paper pulp, 31.79 percent of the value of alkalis and chlorine production, 19.19 percent of the value of nitrogenous fertilizers, 16.58 percent of the value of cement production, 11.62 percent of the value of steel, and 19.83 percent of the value of aluminum.

## Application of the Carbon Tax to Imports?

The four most frequently cited rationales for moving beyond a tax on U.S. producers and users of carbon are:<sup>7</sup>

1. Competitiveness: the need to “level the playing field” between those domestic producers subject to carbon taxes that raise their costs and those producers elsewhere who are not subject to additional carbon-related costs;<sup>8</sup>
2. Transition assistance: the need to give time or financial assistance to energy-intensive industries to help them transition to a lower carbon emissions world;<sup>9</sup>
3. Leakage avoidance: the need to discourage carbon-intensive industries from moving out of the United States to countries that do not have taxes or caps on carbon, as such moves would be both damaging to the U.S. economy and its workers, and undermine the goal of reducing greenhouse gas emissions; and

<sup>7</sup> See, for example, Werksman, J., Bradbury, J.A., and Weisher, L. (2009), “Trade Measures and Climate Change Policy: Searching for Common Ground on an Uneven Playing Field,” *World Resources Institute Working Paper*, December 2009.; and Cosbey, A., Dorege, S., Fisher, C., Reinaud, J., Stephenson, J., Weisher, L., and Wooders, P. (2012), “A Guide for the Concerned: Guidance on the Elaboration and Implementation of Border Carbon Adjustment,” Policy Report 03, *Entwined*, November 2012 (p.7).

<sup>8</sup> The United States Senate, for example, voted 95-0 in favor of the Byrd-Hagel resolution, which expressed concern that the disparity of treatment under the Kyoto Protocol between developed and developing countries, and those countries that were signing on to the Protocol and those that were not, “could result in serious harm to the United States economy, including significant job loss, trade disadvantages, increased energy and consumer costs, or any combination thereof.” S. Res. No. 98, 105<sup>th</sup> Congress (July 25, 1997).

<sup>9</sup> The studies on which industries would be most affected by requirements to reduce carbon dioxide emissions generally focus on the “trade-exposed, energy-intensive” sectors, with the agreed upon usual suspects including iron and steel, chemicals, pulp and paper, fertilizer, cement, aluminum, glass, and sometimes mining or petroleum. See Cosbey, A. (2009), *Border Carbon Adjustment: Questions and Answers (But More of the Former)*, Background Paper, IISD, October 2009.

*Complications only arise should policymakers choose to go beyond a tax applied to any or all domestic producers or users of carbon and tax or place restrictions on foreign goods or companies.*

4. Free riders: the need to encourage other countries to limit carbon emissions rather than benefiting from a system in which others tax or limit carbon usage but they do not.

rationales, particularly that of competitiveness, will motivate lawmakers to apply the carbon tax to imports as well as domestic products and producers.

Should the United States Congress enact a carbon tax, it is highly likely that one or more of these

## 2 ADDING COMPLICATIONS: EQUIVALENT TAX ON IMPORTS

The most likely form of this extension would be an equivalent tax imposed on imports, as this is the clearest way to “level the playing field” between U.S. producers and their overseas competitors. How other members of the WTO would respond to such a tax on their imports would likely depend quite significantly on how the tax was designed and whether other countries perceived that their rights under the WTO Agreements were violated.

### Internal Charge? GATT Article II versus Article III

The United States has a right under either of two potentially applicable provisions to assess a carbon-related tax or a charge on imports — called for purposes of this article a Border Tax Adjustment (BTA) — provided such a BTA does not exceed the amount of the tax imposed on similar U.S. products. If the BTA were considered a “customs duty” or a “charge imposed on or in connection with importation,” then the BTA would be subject to the restrictions of Article II of the GATT. Article II generally prohibits countries from imposing any customs duties that exceed the amounts they agreed to charge in their tariff schedule, but would allow an import duty such as a BTA that exceeds these limits if it were considered to be a “charge equivalent to an internal tax.”<sup>10</sup> If, on the other hand, the BTA were considered to be an “internal tax or internal charge” because it is paid, for example, upon resale of the product in the United States, then it would be subject to the restrictions in

Article III of the GATT.<sup>11</sup> Article III does not place any quantitative limits on “internal charges,” but contains the basic obligation that countries cannot treat imports less favorably than they treat their own domestic products.

Both Article II.2 and Article III.2 permit countries to impose taxes or charges on imports, provided: 1) that the BTAs are imposed on products that are “like” the domestic products that are subject to the tax in the first place; and 2) that the amount of the BTA imposed on the imported goods does not exceed the amount of the tax on the domestically produced “like” products. Because of this, the GATT consistency of the carbon tax BTA should not turn on whether the BTA is designed as a “customs duty” or as an “internal charge,” but rather on whether the BTA satisfies the two conditions contained within both Articles II.2 and III.2. It should be noted, however, that a number of scholars believe that the disciplines on “internal charges” under Article III.2 are less stringent than those on customs duties under Article II.2.<sup>12</sup>

<sup>11</sup> The criteria for distinguishing between an “import” tax or “ordinary customs duty” subject to Article II versus an “internal” tax subject to Article III was recently spelled out by the WTO’s Appellate Body in a case involving China’s regime for imposing charges on automobile parts imported into China. The Appellate Body found that the distinction turns on what triggers the obligation to pay the charge. If the obligation to pay “accrues because of an *internal* factor (e.g., because the product was *re-sold* internally or because the product was *used* internally), then it falls under Article III (para 164). If the obligation to pay the charge accrues at the moment of and by virtue of importation, then the charge would fall under Article II as an import duty (para 158). WTO Appellate Body Report, *China – Measures Affecting Imports of Automobile Parts*, WT/DS339/AB/R, adopted January 12, 2009.

<sup>12</sup> See, for example, Pauwelyn, J. (2012), “Carbon Leakage Measures and Border Tax Adjustments under WTO Law,” forthcoming in Prevost, D. and Van Calster, G. (eds.), *Research Handbook on Environment, Health, and the WTO*, Edward Elgar, 2012, [www.ssrn.com/abstract=2026879](http://www.ssrn.com/abstract=2026879). Professor Pauwelyn argues that “to attract the *more permissive* GATT Article III, carbon taxes or charges on imports” should be designed to be triggered not by importation as such, but by the sale, distribution, or use of the product once imported (emphasis added) p.24.

<sup>10</sup> Article II:2 of the GATT provides that countries are not prevented from “imposing at any time on the importation of any product . . . a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of (GATT) Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part.”

*How other members of the WTO would respond to such a tax on their imports would likely depend quite significantly on how the tax was designed and whether other countries perceived that their rights under the WTO Agreements were violated.*

*The simplest and most likely WTO-consistent path for policymakers would be to impose a carbon tax on products — both domestic and imported — at the time of their sale, distribution, or transfer.*

### Indirect versus Direct Tax

In order to pass the first test under Article II.2 or III.2, requiring the tax be applied only to like products, the country must show that: 1) the tax is imposed on a product (a so-called “indirect tax”) and not on a producer or manufacturer or their income (a “direct tax”); and 2) the imported products that are subject to the BTA are “like” the domestically produced products subject to the domestic tax. The general notion is the countries can offset (i.e., adjust at the border) taxes they charge on products — such as sales taxes, VAT taxes, and excise duties — if they are assessing similar taxes on domestically produced goods. Such taxes applied to both imports and domestic goods would simply level the competitive playing field between the imported and domestic product.<sup>13</sup> It is equally generally accepted that direct taxes on income or production, such as corporate income taxes, Social Security taxes, payroll taxes, and property taxes, cannot be offset or assessed on imports, because there is neither a way of knowing whether the producers of the imports bore similar costs in their production nor a way to allocate the direct taxes on producers to specific products.<sup>14</sup>

As such, the simplest and most likely WTO-consistent path for policymakers would be to impose a carbon tax *on products* — both domestic and imported — at the time of their sale, distribution, or transfer. The tax could be applied to any

<sup>13</sup> The WTO’s Agreement on Subsidies and Countervailing Measures (ASCM) defines “indirect taxes” as “sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes, and all taxes other than direct taxes and import charges.” GATT (January 9, 1995), *Agreement on Subsidies and Countervailing Measures*, ADP/W/383, Note by the Secretariat, footnote 58.

<sup>14</sup> See WTO-UNEP Report (2009), pp. 103. The WTO’s ASCM defines “direct taxes” as “taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of property” GATT (1995). The 1975 Working Party on Border Tax Adjustments noted that indirect taxes could be adjusted at the border while direct taxes could not; this distinction was upheld in *US-FSC*, which ruled that the United States could not rebate or otherwise adjust its direct taxes.

set of consumers, ranging from a tax on fossil fuel producers based on the carbon content of their products to a tax on all businesses and consumers based on the carbon content of the goods that they buy or sell, assessed when the goods are sold. The more that the tax is described as and calculated based on the goods themselves and the less it sounds like a tax on income or ownership, the more likely the tax is to be considered an “indirect tax.”<sup>15</sup> While the amount of the tax would reflect the amount of carbon dioxide emitted during production, because it would be assessed on the product itself, the tax should be considered an indirect tax fully eligible for border adjustment for imports.<sup>16</sup> Even if the carbon tax (and the corresponding

<sup>15</sup> The ASCM excludes from the definition of a subsidy the exemption of exported products from the payment of duties or taxes “borne by the like product when destined for domestic consumption,” thereby suggesting that the closer the tax is to a tax on the consumption of the good, the more likely it is to be considered an indirect tax that can be offset or applied at the border to imports.

<sup>16</sup> Because the ASCM definition of “indirect taxes” includes “all taxes other than direct taxes,” a carbon tax on products, even though it reflects a tax on inputs (energy) that are not physically incorporated into the final product should fall within the definition of an “indirect” tax, since it is not among the items specifically listed as “direct taxes” and is not in the nature of an income or wage tax. Moreover, past precedent would suggest that domestic taxes on inputs can be applied to imports as well. In both its Superfund legislation regulating hazardous chemical waste, and in reducing the amount of ozone-depleting substances that could be either produced or imported under the Montreal Protocol, the United States imposed a domestic tax on the chemicals at issue and a tax on imports of such chemicals or products containing or produced with such chemicals. Neither of these two schemes was found to violate the United States’ international trade obligations. The 1987 GATT panel report in the *US-Superfund* dispute permitted the application of the tax to imports that had used the requisite chemicals “as materials in the manufacture or production” of the imports, while the application of the tax on ozone-depleting substances was not subject to a GATT decision. GATT Panel Report, *United States-Taxes on Petroleum and Certain Imported Substances (“US - Superfund”)*, L/6175, adopted June 17, 1987, BISD 32S/136 at para 2.5 and para.5.2.4. Certainly the intent of a carbon tax — to make carbon-intensive products more expensive, thereby creating incentives to reduce carbon emission — falls within the rationale for consideration as an “indirect” tax that can be adjusted at the border. It increases the price of the goods to which it attaches. Therefore, permitting a BTA on imports maintains trade neutrality between the domestically produced and the imported goods.



BTA) were technically assessed to producers based on emissions at their production facilities rather than directly on the product when first sold, the carbon tax and BTA could be considered to be applied “indirectly” to products, in accordance with Article III:2.

However, there may be a number of policy reasons why members of Congress may prefer other forms of a carbon tax than a tax on products — ranging from taxes solely on the generation of power, to taxes on the use, transportation, or distribution of fossil fuels, to a tax on producers (rather than their products) based on overall carbon emissions at their production sites. The farther policymakers move from a tax on products or the consumption of products, the murkier it becomes as to whether a domestically applied tax can be legally assessed on imports under the GATT.<sup>17</sup>

### How Much Is the Tax?

The second test under Articles II.2 and III.3 requires the amount of the BTA to be no greater than the carbon tax applied to “like” domestic production. This test requires the careful development of a system for setting the BTA such that it does not run afoul of WTO/GATT rules. For example, if the tax were assessed based on the amount of carbon dioxide emitted in the production of a ton of steel, the U.S. government would have to establish a process to collect the information needed to determine the carbon footprint of each ton of imported steel. This could be done,

<sup>17</sup> The difficulty in determining whether domestically imposed taxes on inputs (including energy consumption) can be imposed on imports relates to a number of open questions — whether taxes on “processes” rather than “products” can be offset at the border; how broadly the WTO’s Appellate Body will interpret the key phrases in either Article II.2 (internal taxes “in respect of an *article* from which the imported product has been manufactured or produced”—and whether the interpretation of “*article*” includes energy— or Article III.2 (internal taxes . . . applied directly or *indirectly*, to like domestic products”) and whether a tax on the carbon dioxide emitted in its production can be considered an “indirect” application of a tax.

for example, by requiring imported products to be accompanied by a certification or labeling of the relevant aspects of their production process and related carbon emissions used in their production.<sup>18</sup>

The best system and one that would be least likely to raise WTO concerns would determine the carbon content of both domestically produced and imported products on a product- and plant-specific basis.<sup>19</sup> In the case of many traded manufactured products, the specific manufacturing plant, its energy source, and the process by which the product is produced substantially affect the carbon footprint of the product; the best assessments of carbon content would be at the level of a manufacturing facility. Steel, for example, produced in an electric-mini mill that gets its power from a nuclear plant would have a much smaller carbon footprint than steel produced in a blast-oxygen furnace that gets its power from a coal-fired plant. If all products — both domestic and imported — were taxed using the same methodology that reflects the amount of carbon that went into their specific production and that has, in that sense, become a part of that particular product, then application of such a BTA would be much less likely to run afoul of the WTO’s non-discrimination concerns.

However, such a system may be difficult and complicated to administer, particularly if both the

<sup>18</sup> The certification and labeling process itself would need to be one that does not place a greater administrative burden on imports than is placed on domestic producers to certify their level of carbon dioxide emissions.

<sup>19</sup> What has to be avoided in determining the domestic tax under one methodology (such as reporting of actual carbon emissions on a per ton basis from a specific plant) while determining the amount of the BTA by a different methodology (such as a universally applicable benchmark). It is just this sort of difference in methodology that was found to constitute “unjustifiable discrimination” when the United States provided individual baseline standards for U.S. gasoline producers but required imports to meet a statutory baseline. See WTO Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline* (“US – Gasoline”), WT/DS2/AB/R, adopted May 20, 1996, DSR 1996:I.

*The farther policymakers move from a tax on products or the consumption of products, the murkier it becomes as to whether a domestically applied tax can be legally assessed on imports under the GATT.*

tax and the BTA extend to indirect emissions (such as off-site generated electricity, heat or steam, or transport emissions).<sup>20</sup> Moreover, any such system would likely need an appropriate alternative means to set the carbon content of an imported good if companies, importers, or countries were unwilling or unable to provide the necessary data. The safest alternative, from a WTO law perspective, would be to assume that the carbon content of the imported product is equal to the carbon content of the like product produced by the “predominant method of production” or even the “best available technology” in the United States.<sup>21</sup> Under such a system, companies exporting less carbon intensive products than those produced by the “predominant method of production” in the United States still might be able to petition for recognition of their less carbon intensive product and thus face a smaller BTA if they could sufficiently demonstrate that the production of their particular product was less carbon-intensive.

The reason that the method of determining the amount of the tax on the domestic product and the corresponding BTA is so critical goes back to one of the bedrock principles of the GATT: countries may not discriminate against imports.<sup>22</sup> Satisfying this nondiscrimination principle will require a demon-

<sup>20</sup> See Cosbey, A. et al. (2012) for a discussion of guidelines that could be used in determining how far a carbon tax and BTA could be extended and various methods for benchmarking carbon emissions.

<sup>21</sup> When the United States imposed a tax on certain chemicals (The Superfund Act of 1986), it adopted this exact system for imposing a tax on imports produced with the specified chemicals. A GATT panel ruling in a dispute over this tax did not find fault with the system of voluntary reporting backed up by use of data from the U.S. “predominant method of production” when the importer failed to provide information regarding the chemical inputs used in its production. *US – Superfund*. For a discussion of the practical difficulties of valuing carbon emissions, see WTO-UNEP (2009), pp. 101-102.

<sup>22</sup> Article III:2 prohibits discrimination in the form of charges “in excess of” those applied to like domestic products; while Article II only permits charges on imports which are “equivalent” to an internal tax.

stration that the tax on the domestic product and its corresponding BTA were determined on a fair and objective basis that relates to the specific products being taxed and not their national origin.<sup>23</sup> It also means ensuring that the amount of the BTA is not “in excess of” that applied to domestic products under Article III:2 or is “equivalent to” the charge applied to domestic products under Article II:2, even though the amount of carbon dioxide emitted during their production — and consequently the amount of the tax or BTA assessed — may differ.<sup>24</sup>

Some scholars would contend that any difference in the amount of tax assessed on domestic products compared to the BTA runs afoul of the WTO’s non-discrimination principle requiring that “like” products be treated in the same way. They would argue that a ton of aluminum produced using a low-carbon source of energy in a very efficient plant must be taxed in the same way as a ton of aluminum produced in a highly inefficient, high carbon emitting process since low-carbon aluminum is “like” high-carbon aluminum. In general, the WTO has determined whether products are “like” one another by examining their end use, consumer tastes and habits, and their physical

<sup>23</sup> Past challenges to import measures indicate that the stated intention of lawmakers, particularly statements that the purpose of a measure is to protect domestic industries, have been taken into account in determining that a measure violates Article III:2. See WTO Appellate Body Report, *Canada – Certain Measures Concerning Periodicals (Canada-Periodicals)*, WT/DS31/AB/R, adopted July 30, 1997, DSR 1991:1.

<sup>24</sup> Recent cases decided under the WTO’s Technical Barriers to Trade (TBT) Agreement may suggest that some less favorable treatment or some “detrimental effect on a given imported product” would be tolerated provided it could be explained “by factors or circumstances unrelated to the foreign origin of the product.” Appellate Body Report, *Dominican Republic – Measures Affecting the Importation and Sale of Cigarettes*, WT/DS302/AB/R, adopted May 19, 2005; Article 2.1 of TBT Agreement does not prohibit a detrimental impact on imports where “such detrimental impact on imports stems exclusively from legitimate regulatory distinctions.” *United States – Measures Affecting the Production and Sale of Clove Cigarettes*, WT/DS406/AB/R, para 174; *United States – Measures Concerning the Importation, Marketing, and Sale of Tuna and Tuna Products*, WT/DS381/AB/R, para 215.

characteristics, along with whether they compete with each other. There is a general presumption that if products compete with each other, they are “like”; if they do not, then they are unlike.

However, most WTO decisions that have found taxation systems to run afoul of the WTO’s non-discrimination rules have been based on different tax rates applied to products that have been claimed to be different (e.g., Japanese sochu versus vodka) based on a particular definition of the product. Once the WTO determined, for example, that sochu and vodka were “like” products, the lower tax on sochu (which was domestically produced) resulted in discrimination against the higher-taxed, imported vodka. Here, however, the carbon tax and the corresponding BTA would presumably be the same regardless of the definition of the product — \$20 for every ton of carbon dioxide emitted in its production. As such, the carbon tax is much more analogous to the tax found by a GATT panel not to violate Article III: the tax imposed by the United States under its Superfund Act on certain substances (used as inputs in the production process of certain chemicals), where the same tax was applied to both domestically produced products and imports if they were made using the same inputs. Moreover, there is no evidence that the imposition of a flat-rate carbon tax applied to both U.S. products and imports would run counter to the overall goal of Article III, that measures should not be applied “so as to afford protection” to domestic production, since presumably there are both more and less efficient producers of products in the United States who would be paying more and

less carbon tax depending on their level of carbon efficiency, just as in the importing countries.<sup>25</sup>

### The Alternative Path through Article XX

Should the WTO nonetheless find no room in Article II or Article III for the application of a BTA, either because the WTO determines that the BTA would treat “like” products differently by taxing, for example, high-carbon steel more than low-carbon steel or that the GATT rules do not permit border adjustments for energy or fossil fuels since those items were not physically incorporated into the imported goods themselves, then the United States would be well positioned to defend the BTA under the general exception provision of Article XX of the GATT. Article XX lays out a number of specific instances in which WTO members may be exempted from GATT rules. The two exceptions of most relevance are paragraphs (b) and (g) of Article XX, which permit WTO members to adopt policies that are inconsistent with GATT disciplines, but necessary to protect human, animal, or plant life or health (paragraph (b)), or which relate to the conservation of exhaustible natural resources (paragraph (g)). In order to justify its BTA, the United States would need to show: 1) that its carbon tax scheme along with the corresponding BTA falls under at least one of the two exceptions (either (b) or (g)) and 2) that the carbon tax/BTA system satisfies the introductory paragraph (the “chapeau”) of Article XX, which requires that the BTA not be applied in a manner that would constitute “a means

<sup>25</sup> Past cases have indicated that even if products are found to be “like” one another, distinctions may be drawn in the treatment of the products without violating Article III’s national treatment requirement, provided any resulting “less favorable” treatment to imported products can be explained by factors or circumstances unrelated to the foreign origin of the product. See WTO Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products (“EC-Asbestos”)*, WT/DS135/AB/R, adopted April 5, 2001, DSR 2001: VII, 3242, para 100.; WTO Appellate Body Report, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes (“DR – Cigarettes”)*, WT/DS302/AB/R, adopted May 19, 2005, para 96.

*Should the WTO nonetheless find no room in Article II or Article III for the application of a BTA... or that the GATT rules do not permit border adjustments for energy or fossil fuels... then the United States would be well positioned to defend the BTA under the general exception provision of Article XX of the GATT.*

Past cases would suggest that demonstrating that a tax on carbon emissions assessed both domestically and at the border on imports would fit within either or both of the requirements of XX(b) or XX(g).

of arbitrary or unjustifiable discrimination between countries where the same conditions prevail” and is not “a disguised restriction on international trade.”

Past cases would suggest that demonstrating that a tax on carbon emissions assessed both domestically and at the border on imports would fit within either or both of the requirements of XX(b) (necessary to protect human, animal, or plant health) or XX(g) (relating to the conservation of an exhaustible natural resource).<sup>26</sup> Policies aimed at reducing carbon dioxide emission could well fall under XX(b) as, for example, necessary to protect human beings from the negative consequences of climate change (such as flooding or sea-level rise). Equally, they could come under XX(g) as related to the conservation of the planet’s climate, or its arable land or livable oceans, along with certain plant and

<sup>26</sup> Policies that have been found to fall within the realm of paragraphs (b) or (g) include: 1) policies aimed at reducing the consumption of cigarettes, protecting dolphins, reducing risks to human health posed by asbestos, reducing risks to human, animal, and plant life, and health arising from the accumulation of waste tires (under (b) and 2) policies aimed at the conservation of tuna, salmon, hearing, dolphins, turtles, petroleum, and clean air (under (g)). WTO Appellate Body Report, *Brazil – Measures Affecting Imports of Retreaded Tyres* (“Brazil-Retreaded Tyres”), WT/DS332/AB/R, adopted December 17, 2007; GATT Panel Report, *Thailand – Restrictions on Importations of and Internal Taxes on Cigarettes* (“Thailand Cigarettes”) DS10/R, adopted November 7, 1990, BISD 37S/200; GATT Panel Report, *United States – Restrictions on Imports of Tuna* (“US – Tuna (Mexico)”), DS21/R, September 3, 1991, unadopted, BISD 39S/155; GATT Panel Report, *United States – Prohibition of Imports of Tuna and Tuna Products from Canada* (“US – Canadian Tuna”), L5198, adopted February 22, 1982, BISD 29S/91; GATT Panel Report, *Canada – Measures Affecting Exports of Unprocessed Herring and Salmon* (Canada – Herring and Salmon), L/6268, adopted March 22, 1988, BISD 35S/ 98; GATT Panel Report, *United States – Taxes on Automobiles* (“US – Taxes on Automobiles”), DS31/ R, October 11, 1994, unadopted; *EC-Asbestos*; *US – Gasoline*; and *US – Shrimp*. When assessing whether measures fall within XX(b), the test is: 1) whether the policy for which the provision was invoked falls within the range of policies designed to protect human, animal, or plant life or health (here, within the range of those policies designed to reduce carbon dioxide and 2) whether the application of the measure (here, the carbon tax and the BTA) to imports was “necessary” (here, to prevent carbon leakage). See Appellate Body Report on *US-Gasoline*, p. 16.

animal species that might disappear as a result of global warming.<sup>27</sup>

The harder task will be proving that the BTA meets the twin requirements of the chapeau (no arbitrary or unjustifiable discrimination between countries and no disguised restrictions on trade), as very few measures have survived scrutiny under the chapeau.<sup>28</sup> Those failing measures, however, have included protectionist policies or protectionist results seeking refuge under Article XX. A carbon tax BTA, building on a policy that would probably create additional costs for U.S. companies in the short term, would likely be seen as markedly different. Congress could ensure this perception by making clear that the BTA was adopted for reasons relating to reducing carbon emissions, such as creating incentives for all producers exporting to the United States to lower their carbon emissions or preventing leakage by discouraging companies from moving outside of the United States just to avoid the domestic carbon tax. Congress could further strengthen its case by affording each company the opportunity to pay an individually determined tax that relates to their particular production process. If Congress can take these steps, then the BTA should clear the chapeau’s twin hurdles.

<sup>27</sup> See WTO-UNEP (2009), p. 108.

<sup>28</sup> Of the more than a dozen cases in which countries have invoked Article XX to justify measures that otherwise violate provisions of the GATT, only two (*EC-Asbestos* and *US-Shrimp*) (21.5) have met the Article XX “chapeau” requirements. See WTO Secretariat, *GATT/WTO Dispute Settlement Practice Relating to GATT Article XX, Paragraphs (b)(d) and (g)*, WTO Committee on Trade and Environment, WT/CTE/W/203, March 8, 2002.

# 3 A FURTHER COMPLICATION: GIVING CREDIT WHERE CREDIT IS DUE?

## Tax All Like Products Alike

When imposing a BTA, policymakers may feel compelled to take into account whether the imports come from a country that has already imposed its own set of restrictions on carbon emissions — such as the European Union, Australia, or New Zealand. Steel producers in Germany, for example, already must limit their greenhouse gas emissions or purchase emissions trading permits, effectively putting a price on their emissions, while steel producers in India do not face such restrictions. The problem for the United States will be that differentiation in the BTA based on the country-of-origin of the imports would most likely result in a violation of the GATT’s “most favored nation” (MFN) principle, which requires the United States to treat imports from all WTO members the same in terms of duties or fees. Such a policy of exempting some countries but not others from the BTA would violate Article 1 of the GATT.<sup>29</sup>

If policymakers choose a *tant pis* approach, disregarding other countries policies, and apply the same BTA to all imports, then Europe and others could find a way to rebate to their own exporters the carbon tax/BTA paid to the United States for products sold in the United States. This approach raises few WTO legal issues, but may raise diplomatic hackles from those countries that took action to address climate change before the United States.

## A Second Trip Down the Road to Article XX

If policymakers do attempt to take into account the carbon policies of other countries, then the United States would need to pursue an Article XX defense, under which it would justify its viola-

tion of the most-favored-nation principle through recourse again to the GATT’s General Exceptions for measures either necessary to protect human, animal, or plant life and health (XX:(b)) or relating to the conservation of exhaustible natural resources (XX(g)). In this instance, the application of the BTA to some countries but not to others would need to be justified. As noted above, past cases suggest that a carbon tax and accompanying BTA scheme would likely fall under either or both Article XX(b) or Article XX(g), as the requisite showing that the carbon tax scheme is necessary for the protection of human, animal, or plant life or health (XX(b)) or relating to the conservation of an exhaustible natural resource (XX(g)) should be readily demonstrable.

The more problematic aspect of all the Article XX defenses has been meeting the dual requirements of the introductory paragraph (the “chapeau”): 1) that the measure is not applied in a manner that would constitute “a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail” and 2) is not a “disguised restriction on international trade.” Here, exempting those countries that have their own climate policies from the BTA would seem to fit within the first requirement of the chapeau, as the “same conditions” do not prevail when some countries have controls on carbon emissions and others do not. As such, the “discrimination” resulting from exempting some countries but not others from payment of the BTA is neither arbitrary nor unjustified; rather it would be based on an assessment of what other countries have done to regulate and reduce greenhouse gas emissions. A second type of discrimination claim might be lodged by developing and least-developed countries. They may contend that the UN Framework Convention on Climate Change (UNFCCC)’s principles of equity and “common but differentiated responsibilities” require the United States to give a break to those countries

*The problem for the United States will be that differentiation in the BTA based on the country-of-origin of the imports would most likely result in a violation of the GATT’s “most favored nation” (MFN) principle.*

<sup>29</sup> GATT Article I requires that any “advantage, favor, privilege, or immunity” granted with respect to any customs duties or charges to any product originating in one country “shall be accorded immediately and unconditionally to the like product originating in all other countries” who are members of the GATT/WTO.

that had very little carbon emissions in the past.<sup>30</sup> Exempting countries that have done less to reduce their carbon emission through reliance on equity or common but differentiated responsibilities may be harder to justify from a climate change perspective, as the exemption would not obviously be granted in furtherance of the goal of “conserving exhaustible natural resources” or “protecting human, animal, or plant life or health.” However, distinctions to lower or exempt certain poor countries from the BTA may also fall within the justifications that the “same conditions” do not prevail in those countries as they do in many of the larger exporter countries

<sup>30</sup> Article 3 of the UNFCCC provides: “The Parties should protect the climate system for the benefit of present and future generations of humankind, on the basis of equity and in accordance with their common but differentiated responsibilities and respective capabilities. Accordingly, the developed country Parties should take the lead in combating climate change and the adverse effects thereof.”

that have not adopted their own carbon emissions schemes.

With respect to the disguised restriction on trade clause, exempting some countries from a U.S. import tax does not give U.S. producers an advantage (in fact, it slightly harms them) and does not restrict trade. It simply ensures that imports pay some of the cost of carbon emissions if they are not already paying them at home. As such, provided that the decisions on which countries are entitled to exemptions or reductions in the BTA paid on their products are made in a fair and open process that objectively links the exemption to the carbon reduction policies in place in the exempted country, the exemptions should also pass muster under the “disguised restriction on trade” pillar of the chapeau.

# 4 A FINAL COMPLICATION: REBATES TO U.S. PRODUCERS ON THEIR EXPORTS

The final fork off the simple path that policy-makers could take would be to grant some form of a rebate to U.S. producers who pay the domestic carbon tax but ultimately export their products. Without such an exemption, if few countries impose their own carbon taxes or carbon reduction schemes, then U.S. exporters would be at a competitive disadvantage. Here again, the simpler the carbon tax is, the easier it would be to rebate the tax on exports consistent with the WTO rules. A straightforward carbon tax imposed on a product could be rebated as an “indirect” tax when that product is exported, provided that the amount of rebate is not more than the carbon tax paid in the first place.<sup>31</sup> Many would argue that the permission for rebating a domestically paid carbon tax once the product has been exported is broader than for

<sup>31</sup> See GATT Working Party (1980), *Border Tax Adjustments*, adopted December 2, 1970, L/3464, BSID 18S/97 – 109. Footnote 1 to the WTO SCM Agreement, which makes it clear the remission of taxes on domestic products when those products are exported cannot be considered a subsidy as long as the amount of the remission does not exceed the amount of the domestic tax; and item (g) of the Illustrative List of Export Subsidies contained in Annex I of the SCM Agreement, which provides that remission of taxes on exports in excess of that paid on the production and distribution of like products sold domestically constitutes an export subsidy.

the assessment of a BTA on imports.<sup>32</sup> Certainly the WTO rules on export subsidies permit a tax on domestically produced fossil fuels to be rebated when a product is exported, provided that the rebate is not larger than the actual tax levied on “like” products “when sold for domestic consumption,” and many would argue that this permission extends to taxes on energy or fuel consumption, since those taxes are levied in respect of the production of the goods.<sup>33</sup> Thus, the debate on whether to permit rebates of domestically paid carbon taxes would likely focus more on political questions than on WTO legality.

<sup>32</sup> See, Pauwelyn, J. (2007), *U.S. Federal Climate Policy and Competitiveness Concerns: The Limits and Options of International Trade Law*, Working Paper, Nicholas Institute for Environmental Policy Solutions, Duke University, pp. 44; Hoerner, J.A. and Müller, F. (1996), *Carbon Taxes for Climate Protection in a Competitive World*, a paper prepared for the Swiss Federal Office for Foreign Economic Affairs by the Environmental Tax Program of the Center for Global Change, University of Maryland College Park, pp. 47; Hoerner, A. and Muller, G. (1997), *Using A Border Adjustment To Take The Lead On Climate Change Without Encouraging Runaway Shops*; Lodefalk, M. and Storey, M. (2005), “Climate Measures and WTO Rules on Subsidies,” *Journal of World Trade* 39:1, pp. 23-44.

<sup>33</sup> Footnote 61 to Annex II of the SCM Agreement provides: “Inputs consumed in the production process are inputs physically incorporated, energy, fuels, and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product.”

*Without such an exemption, if few countries impose their own carbon taxes or carbon reduction schemes, then U.S. exporters would be at a competitive disadvantage.*

# 5 USE OF IMPORT TAX REVENUES

*A significant allocation to developing country climate efforts would help demonstrate that the United States seeks to use the BTA to combat climate change rather than protect its own industries.*

**A** final important consideration for lawmakers as they design a carbon tax scheme is how to spend the revenues generated by such a system. The most likely options include:

1. Using the revenue to reduce other taxes or the deficit.
2. Rebating the taxes to the U.S. companies most affected by the carbon tax.
3. Funding programs to support the development of low-emissions technology in the United States.
4. Helping developing countries, particularly least-developed countries, reduce their greenhouse gas emissions and adapt to climate change.

These fiscal goals are not mutually exclusive. The revenues raised through a carbon tax could be divided amongst these various ends.

Contributing a significant share of the revenues raised through the BTA toward the fourth option (helping developing countries respond to climate change) would certainly strengthen the case that

the BTA does not violate WTO law. A significant allocation to developing country climate efforts would help demonstrate that the United States seeks to use the BTA to combat climate change rather than protect its own industries. More specifically, the allocation would indicate that the carbon tax scheme and its accompanying BTA were not designed to or applied as a disguised restriction on international trade, strengthening the case that the BTA would qualify for an Article XX exemption.<sup>34</sup> Moreover, by contributing to international efforts to combat climate change, the revenues from the BTA would further demonstrate that the BTA is part of a good faith effort by the United States to achieve an international response to climate change, recognizing the wider latitude given to actions taken pursuant to international agreements or efforts to reach such agreements.<sup>35</sup>

<sup>34</sup> See, for example, *US-Shrimp (21.5)*, where the fact that the United States offered to provide technical assistance to develop the use of turtle excluder devices (TEDs) in third countries was viewed as demonstrating that the U.S. ban on shrimp imports caught without TEDs was not a disguised restriction on trade.

<sup>35</sup> The WTO Appellate Body has stated its preference that discriminatory measures be justified or taken based on international agreements, or at least as a result of good faith efforts to reach such agreements. *US-Shrimp*.



# 6 CONCLUSION

If Congress enacts a carbon tax to address climate change, streamline domestic energy policy, raise revenues, or reduce distortions in the tax system, it must be ready to address the competitiveness concerns of U.S. companies. It could do so by applying the same tax to imports coming into the United States as they apply to domestic goods in order to ensure that everyone competes on a level playing field and that everyone has the same incentive to reduce their carbon footprint. To ensure that U.S. companies are not disadvantaged when they try to export their products to foreign markets, the carbon tax could be rebated to U.S. companies whenever they export the products on which the carbon tax was assessed.

Each of these steps is permitted under the WTO rules provided: 1) that the tax is designed to fall

within the parameters of an “indirect” tax on products rather than a direct tax on the producers themselves; and 2) that any parallel taxes on imports or rebates on exports do not discriminate in favor of U.S. products. Policymakers have sufficient latitude within this framework to design and implement a carbon tax system that represents a good faith effort to reduce carbon emissions while encouraging all other countries to cut their emissions too, all while preserving the competitive position of U.S. companies. Policymakers can be bold. The WTO will recognize genuine climate change measures for what they are and is unlikely to find fault with such measures, provided they do not unfairly discriminate in favor of U.S. companies.

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