Climate Policy Coherence and Border Adjustment Regulation: Clarifying the Debate

Donald Feaver, *RMIT University*
Benedict Sheehy, *RMIT University*
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Abstract: A vigorous debate surrounding the use of border adjustments as trade-related policy mechanisms to compliment national climate change policies has intensified in recent times. The debate highlights how border adjustments are not particularly well suited to respond to trade related frictions arising because of the diversity of commitments being made by countries to reduce carbon emissions. While ideally, “the greater the degree of international agreement on climate change policies, the less potential friction there should be with trade policies” this more complex challenge of harmonizing national climate policies is unlikely to occur anytime soon. In the absence of a comprehensive international agreement harmonizing national climate policies, if properly designed and used as an integral part of national climate policy measures (rather than as an ad hoc adjunct measure) border adjustments can allow nation states considerable climate policy flexibility while at the same time enabling national economies having different climate policies to be efficiently integrated to international markets.

Donald Feaver and Benedict Sheehy, Graduate School of Business and Law RMIT University, Melbourne, Australia. Contact: donald.deaver@rmit.edu.au

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1. Introduction

For the better part of a decade, an intense public debate has been underway in many countries regarding what domestic policies, if any, should be implemented to address the threat of anthropogenic climate change. Even though the science clearly shows that immediate and dramatic cuts in greenhouse gas emissions are required to avoid catastrophic climate change in the latter half of this century, there is strong resistance to domestic policies that, as some argue, will negatively impact on national economic performance. Industry and other lobby groups argue that the competitiveness of domestically produced goods will be severely undermined, both in home and export markets, by policies such as national carbon taxes or emissions trading schemes. Not surprisingly, the debate has become highly politicized. However, rather than focusing on whether it is possible to design a coherent suite of policy measures that achieve reductions in greenhouse gas emissions and minimize the negative economic impact of those policies on industry and the economy, the debate is beset by misinformation and distortion.

One aspect of the debate that suffers from such distortion concerns the role that a policy measure known as ‘border tax adjustments’ (border adjustments) can play in achieving the combined policy objectives of reducing greenhouse gas emissions and minimizing the negative economic effects of domestic climate policies. There are two compelling reasons why border adjustments are a sensible approach to mitigating the impacts of climate policy on energy intensive trade exposed (EITE) industries. First, if designed properly, border adjustments can be used to offset or adjust price differentials between domestic goods subject to national climate policies such as a carbon tax, and foreign produced goods that are not subject to similar policies in their home country of production. Second, border adjustments are attractive because their legality under the World Trade Organization (WTO) Agreements appears to be fairly

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4 Through this paper, the requirement to purchase emissions allowances under an emissions trading scheme will be treated as being equivalent to a tax within the meaning of the WTO rules. For a more detailed discussion see: Feaver, Donald, McGoldrick, Will and Victoria Wells “Is Australia’s EAP a Prohibited Export Subsidy?” 44(2) Journal of World Trade 319-348 (2010).
well settled—at least in general terms.\(^6\)

The use of border adjustments to compliment domestic climate policies, however, has sparked criticism from several quarters. Rather than being framed as a policy measure sanctioned under international trade law, border adjustments are characterized as a form of spurious protectionism in the nature of punitive tariffs.\(^7\) Such a characterization, however, exemplifies how border adjustments are poorly understood in technical terms and are being abused in a political context.\(^8\) Yet, in spite of the mischaracterization, the debate is instructive and informative. It marks something of a shift away from a traditional legal preoccupation with questions relating to their legality under international trade rules to focusing attention on several technical issues relating to their suitability within the broader context of the international climate debate. The debate is important because it not only draws attention to their potential use within a national policy context, it also raises questions regarding their viability and applicability as a regulatory response to trade frictions arising as a result of the diversity of climate policy measures implemented by different countries to reduce carbon emissions.

While ideally, “the greater the degree of international agreement on climate change policies, the less potential friction there should be with trade policies”\(^9\) this more complex challenge of harmonizing national climate policies is unlikely to occur anytime soon.\(^10\) In the absence of a comprehensive international agreement harmonizing national climate policies, if properly designed and used as an integral part of national climate policy measures (rather than as an ad hoc adjunct measure) border adjustments allow nation states considerable climate policy flexibility while at the same time enabling national economies subject to different climate policies to be efficiently integrated to international markets.

Given this context, the purpose of this paper is to examine four issues that are confusing and complicating the debate regarding the coherent use of border

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\(^{8}\) For example, see the comments of the Australian Trade Minister responding the EU proposals at: http://www.theaustralian.com.au/national-affairs/labor-fights-old-europe-over-trade/story-fn59niix-1225933590009

\(^{9}\) Low, Patrick, Marceau, G. and Julia Reinaud “The Interface Between the Trade and Climate Change Regimes: Scoping the Issue” The Graduate Institute: Centre for Trade and Economic Integration 2nd Conference- Climate Change, Trade and Competitiveness 16-18 June 2010 (2010).

\(^{10}\) Given the challenges in negotiating an agreement setting global emissions reduction targets in the period after the expiration of the Kyoto Protocol expires, it is unlikely that any multilateral agreement to harmonize domestic climate policies will be considered in the near future. See: McGoldrick, Will, Feaver, Donald and Andrew Maver “Fiduciary Duty and Climate Governance: Challenges for International Diplomacy and Law” in Coghill, Kenneth, Sampford, Charles and Tim Smith (eds) Fiduciary Duty and the Atmospheric Trust Ashgate Publishing:London (2012).
adjustments as an critical component of climate policy and its regulation. Policy coherence and regulatory coherence are related concepts that have been slowly gaining recognition in recent years. The idea of coherence in policy and regulatory contexts has been used in trade and economic policy, development policy and regulatory theory.\(^{11}\) A central proposition of coherence theory is that policy initiatives and the regulatory schemes implementing those initiatives are more likely to succeed if the regulatory measures chosen to achieve policy objectives are coherent. The corollary of regulatory success is regulatory failure.\(^{12}\) One well known form of regulatory failure is “unintended consequences.” For example, if climate policy designed to reduce carbon emissions fails to integrate economic concerns, the unintended consequence may be serious economic harm. Coherent regulatory design in this example would require effective linkages between climate policy and economic policy.\(^{13}\) In this example, a border adjustment on both imports and exports addressing the economic consequences of climate policy would allow for both climatic and economic policy objectives to be achieved—avoiding the unintended consequences, a situation referred to as regulatory coherence.\(^{14}\)

The first source of confusion stems from misunderstandings as to what border adjustments are and how they should be designed to operate to complement national climate policies. In the context of climate policy, border adjustments should be approached as a two-sided policy measure having both an import and export-side. However, most attention is directed towards their ‘import-side’. Understanding the two-sided character of the policy measure enables domestic policy-makers to fashion domestic climate policies that more coherently address concerns that are common to the separate issues of import and export competitiveness.

A second source of friction arises from confusion surrounding the notion of a ‘carbon price’. For example, in the course of the debate, it is common to hear that border adjustments are a policy measure that may be used to offset the negative economic effects of a national ‘carbon price’.\(^{15}\) Although conceptually, ‘carbon price’ and ‘carbon tax’ do bear a close relationship, the two are far from synonymous. Statements equating the two and proposing border adjustments as a solution to offset the negative economic effects of a ‘carbon price’ are both technically inaccurate, contribute to unnecessary political friction and inject a technical incoherence resulting in a breach of international obligations.

Third, a contentious issue flows from posturing by several countries—most notably the United States and the European Union—that have either proposed legislation or are contemplating the imposition of border adjustments that selectively target

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\(^{11}\) Feaver, Donald and Benedict Sheehy “A General Theory of Coherent Regulation” (2011) available from the authors on request.

\(^{12}\) Breyer, S. Regulation and Its Reform Harvard University Press: Boston (1984). Breyer made the important observation that regulatory failure occurs where there is a mismatch between regulatory objectives and methods.

\(^{13}\) Coglianese, Cata-Backer- external policy coherence

\(^{14}\) Feaver and Sheehy, Ibid, note 11.

\(^{15}\) For example, in a recent article about carbon pricing, the authors write that “border adjustments would require steel and cement clinker importers to pay a carbon price based on Australian industry average emissions, effectively levelling the playing field.” Daley, J. and Edis, T. “The Real Cost of Carbon Pricing” Inside Story 23 September 2010 at http://inside.org.au/the-real-cost-of-carbon-pricing/ accessed 24 August 2011.
countries that have not implemented similar climate change policies. In other words, imports from countries that have not implemented a carbon tax or emissions trading scheme will be subject to some form of import border adjustment whereas imports from countries with such climate taxes or schemes will be exempt from border adjustments. Although this policy approach raises questions of fairness, particularly where countries have implemented CO₂ mitigation policies that qualify for reciprocal recognition, it points to both a poor understanding of the technical legal requirements under international law thereby introducing further incoherence.

The fourth issue relates to ambiguity arising from the lack of clear definitions, methods and approaches relating to the calculation of the magnitude of border adjustments. For example, it is unclear whether border adjustments can be used to offset costs of emissions involved in the production of the steel used in automobile manufacturing as well as the carbon emitted assembling the automobile. Alternatively, some argue that a complex chain tracing the carbon content of goods or their component inputs would need to be undertaken across borders to establish appropriate border adjustment levels. However, in spite of this discussion, it appears that this line of enquiry is moot when considered in light of the international rules.

The structure of this paper is as follows. Section 2, provides a brief overview of border adjustments and how they might be applied in conjunction with climate policies. This explanation is followed by a brief description of the international rules governing the use of border adjustments. Section 3 builds upon the operational and legal clarifications presented in Section 2 and proceeds by discussing the major aspects of the border adjustment debate that have become politically conflated as a result of confusion arising from the interchangeable use of the terms carbon price and carbon tax, rhetoric surrounding selective targeting and issues associated with the calculation of appropriate border adjustments. A summary and conclusion is presented in Section 4. The summary contains a brief discussion relating to the coherent design of climate and economic policy informed by the appropriate use of border adjustments.

2. Climate Policy and Border Adjustments

Among the many economic and political reasons why countries are reluctant to implement national climate policies, two in particular receive the most attention.

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17 As will be discussed in Section 3.3, this assertion of the need to undertake trans-border tracing is incorrect both in law and practice.

18 The question of how to calculate border adjustments is further complicated by legal constraints relating to the status of ‘product process measures’ (PPMs) under the WTO rules and discussed in greater detail in Section 2.2 of this paper.

First, critics argue and economists predict that climate policies such as carbon taxes and emissions trading schemes will have a negative impact on the competitiveness of domestically produced goods thereby reducing national economic growth and employment.\textsuperscript{20} It is alleged that in their home markets, domestic producers will lose sales to imported goods that have a price advantage because those goods are not subject to climate-related fiscal measures in their home country. Similarly, domestic producers subject to climate policy measures having fiscal effects will be competitively disadvantaged in export markets vis-à-vis other international competitors not subject to climate policy measures.\textsuperscript{21}

As a result, and secondly, it is argued that the negative impacts discussed above will motivate domestic producers to move production offshore to countries that have implemented less costly climate policies.\textsuperscript{22} A domestic producer’s decision to relocate production to a country that does not impose costs on carbon emissions is known as carbon leakage.\textsuperscript{23} That is, rather than capturing local carbon through regulation, it is leaked into the environment by transferring carbon production to countries having less stringent regulatory requirements (also known as environmental dumping).\textsuperscript{24} While a low carbon regulatory environment arguably amounts to a subsidy that arises from a country providing free waste disposal services to those producers, this contention is unlikely to be tested under WTO dispute processes.\textsuperscript{25}

Border adjustments do provide a means of integrating trade and climate policy to address concerns regarding price competitiveness and carbon leakage. However, they are not a panacea.\textsuperscript{26} They were never designed to accommodate economic social policy issues as complex and challenging as climate change.\textsuperscript{27} Rather, they were intended to fulfil a much narrower economic and policy purpose. Border adjustments were included in the GATT Agreement\textsuperscript{28} as a means of enabling countries to adjust fiscal differences between domestically produced and imported goods arising from the imposition of domestic taxes or regulations (that raise domestic product prices). In brief, border adjustments were intended to function as a linking mechanism of a structural nature that permit countries having differing domestic policies to ‘level the

\textsuperscript{20} Kee, Hiau Looi, Hong Ma and Muthukumara Mani “The Effects of Domestic Climate Change Measures on International Competitiveness” 33(6) The World Economy 820-829 (2010);


\textsuperscript{23} See footnote 1

\textsuperscript{24} Motta, Massimo and Jacques- François Thisse “Does Environmental Dumping Lead to Delocation?” 38(3-4) European Economic Review 563-576 (1994).


playing field’ by adjusting for internal fiscal policy differences at the product level either at the point of import or export without having to harmonise domestic policies.\textsuperscript{29} Having said that, if policy-makers approach the design of national climate policies that coherently manage the economic effects of those policies, a more transparent and administratively efficient outcome can be achieved using border adjustments.

\subsection*{2.1 Operational Characteristics of Border Adjustments}

When applied in the context of coherent climate policy design, it is helpful to conceive of border adjustments as being a two-sided policy mechanism rather than treating border adjustments as discrete, unrelated import taxes or export rebates (in much the same way VAT taxes\textsuperscript{30} are implemented).\textsuperscript{31} This conceptualisation, however, is at odds with the tendency of policy-makers to direct attention towards the import-side of the measures and to ignore the export-side. In addition, just as it is analytically unhelpful to conceptualize partial use of border adjustments, it is similarly unhelpful to conceptualise the use of border adjustments by one country in isolation of their use by other countries.\textsuperscript{32} A more holistic understanding of border adjustments provides a basis for coherent policy design addressing both import-side domestic competitiveness and export-side international competitiveness and carbon leakage concerns where (as will be discussed in Section 3.3, policy aspects relating to one side will have a bearing in relation to settings on the other).\textsuperscript{33}

A simplified representation of how border adjustments can be used to offset product price differences caused by a carbon tax is illustrated in Figure 1. If, for example, Country A decides to implement a national carbon tax, that tax is deemed to be an ‘origin-based tax’\textsuperscript{34} levied upon fossil fuels used in the production of domestic goods

\textsuperscript{29} The distinction between border adjustments functioning as a linking device rather than a harmonization mechanism is critical to any future negotiations concerning the need to address shortcomings in the present rules. The objectives of any discussion would need to address broader issues such as seeking agreement on the relationship between climate policy and border adjustments as well as determining common approaches to adjusting for differences in national climate policies.


\textsuperscript{31} As Biermann and Brohm note, “one way to manage the problem, as Hoerner and Muller (1997) suggest, could be to use an energy-added tax method, similar to invoice methods for value-added tax that are used in many countries throughout Europe: a tax imposed on fuels, or embodied in the electricity used in the production process, could be recorded on the invoice (like a value-added tax) that the domestic manufacturer presents after export of the product to tax authorities for rebate. To avoid unmanageable administrative burdens, one could refrain from such border adjustments when the tax is only a trivial percentage of the product price.” Biermann, Frank and Rainer Brohm “Implementing the Kyoto Protocol without the United States: The Strategic Role of Energy Tax Adjustments at the Border” 4 Climate Policy 289-302 (2005).

\textsuperscript{32} Border adjustments are frequently discussed only in relation to the import-side of the policy mechanism. For example, see: Quick, R. (2008) “Trade and Climate Change” Presentation given at UNFCCC Side Event Bonn Germany in which the author specifically mentions that border adjustments are only applied to imports without mentioning the notion of export rebates. Monjon, Stephanie, and Philippe Quirion “How to Design a Border Adjustment for the European Union Emissions Trading System?” 38(9) Energy Policy 5199-5207 (2010).

\textsuperscript{33} Biermann and Brohm, Ibid, note 31.

within Country A. Those costs are sure to be passed through to the consumer and the price of the good will increase in proportion to the energy intensity of the production process of a good. Imported goods that aren’t subject to a carbon tax in their home country will, as a consequence, have a price advantage vis-à-vis the domestic good in the absence a similar carbon tax. In theory, Country A may choose to impose a border adjustment (i.e., impose a border tax) on imported goods either based on a calculation of the imported good’s ‘carbon intensity’ or equivalent to the price effects of the carbon tax imposed on the domestic good.\textsuperscript{35} The border tax (as distinct from the origin-based carbon tax levied on the domestic producer) is deemed to be a ‘destination-based’ tax in that the imported goods are ‘destined’ for consumption within Country A.\textsuperscript{36} Stated another way, border adjustments are destination-based taxes and regulations (or rebates as discussed below) that are applied to imported goods in response to origin based taxes or policies.

Yet, that is only one half of the measure and only addresses the issue of import competitiveness. The other half of the story, which is frequently overlooked in the

\textsuperscript{35} This approach raises complex legal questions that are addressed in Section 3.4.

\textsuperscript{36} Lockwood, \textit{Ibid}, note 34.
climate policy debate, deals with the issue of export competitiveness and carbon leakage. As illustrated in Figure 1, indirect origin taxes, such as a carbon tax, imposed in Country A may be rebated back to domestic producers when a domestic product is exported (or imported products re-exported). The rebate reduces the export price enhancing the competitiveness of domestic products in international markets by removing the negative cost effects of the carbon tax. The rebate allows the export price to be as competitive in international markets as it would have been without the tax by reflecting only costs plus profits—i.e. products without tax or other policy mechanisms.\(^{37}\)

The operational aspects of border adjustments become more complex if, in a two-country trading relationship, both Country A and Country B tax carbon. The popular logic is that border adjustments will not need to be applied and goods can move freely between the two countries.\(^{38}\) However, that logic only applies if both countries have identical or similar domestic schemes (i.e., the size of the carbon tax is roughly equal). The reality is that different countries will have different climate policies having different cost impacts on domestic products. For example, European countries have implemented an emissions trading scheme whereas Australia, at the moment, envisages implementing a carbon tax. Therefore, even in the presence of domestic climate policies, some form of border adjustment will need to take place to adjust for policy differences—more specifically, where those policy differences result in different levels of taxation, those differences will have to be adjusted irrespective of whether both countries tax carbon.

A simple way to deal with climate policy differences in the absence of global climate policy harmonization is to adjust all imports and rebate all exports of products subject to a carbon tax (in the same way a VAT operates). If this occurs, exports enter international markets stripped of a carbon tax and are subsequently adjusted upon entry into the destination market. The economic rationale, according to Low et. al., can be expressed as being “if products are only taxed in their place of consumption, countries preserve the right to choose their own level of taxation and trade neutrality is maintained as all products in a given market compete on the same competitive terms (without either double taxation or advantages from a more favourable tax regime in their country of origin).”\(^{39}\) The distinction also finds some support in the economic theory that product taxes are shifted forward into consumer prices, whereas producer taxes (such as taxes on profits) are not passed on into the price of a product. Thus, on this view, producer taxes, as they do not influence product prices, do not affect the competitiveness of products and there is, therefore, no need to make adjustments for imports so as to level the economic playing field.

2.2 Legal Characteristics
It is not sufficient to explain the operational characteristics of border adjustments in isolation of the legal requirements under the WTO Agreements that discipline their


\(^{39}\) Lowe et. al. Ibid, footnote 4 at page 6.
use. In addition, it is critical to appreciate the role of the rules in shaping the design of coherent climate policy. There is a vast literature examining the legal complexities of border adjustments in detail.\footnote{40} Such an exercise is not required here. Instead, the purpose of this discussion is to highlight features of the international rules that have a bearing on the climate policy debate and the potential sources of incoherent policy outcomes which is discussed in greater detail in Section 3 below.

Border adjustments are not a recent policy innovation. As Biermann and Brohm note:

> Governments have applied border adjustments since the late 18th century, and in the 19th century, rules for the use of border adjustments were widely included in intergovernmental agreements to prevent the protectionist use of this instrument.\footnote{41}

Unlike other policy measures contained in the WTO Agreements such as the rules regulating antidumping, technical barriers to trade or rules of origin that are expressly identified and normatively articulated as discrete trade policy mechanisms that grant rights and impose obligations, border adjustments are regulatory measures that arise by implication or are ‘incidental’ to the general legal rights and obligations contained in Articles I, II and III of the GATT (in the case of import adjustments) and the WTO Agreement on Subsidies and Countervailing Measures (in the case of export rebates).\footnote{42} As such, the provisions regulating border adjustments neither grant rights nor impose obligations upon WTO Member States. Instead, they can be described as WTO sanctioned measures that explicitly acknowledge, and as a result connect, a country’s international trade rights and obligations with its internal policy sovereignty. Stated another way, border adjustments are an acknowledgement of sovereign policy rights of countries rather than the regulation of rights and obligations between WTO Member states.\footnote{43}

A GATT Working Party on Border Adjustments established in 1968 to consider a range of issues surrounding the design and use of border adjustments examined their basic characteristics in some depth. The Working Party’s Report, issued in 1970, contained, among other things, a functional definition of what constitutes a border adjustment scheme. The Working Party concluded that border adjustments are:

> any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imports sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products).\footnote{44}

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\footnote{40}{See footnotes in Section 1 of this paper.}
\footnote{41}{Frank Biermann and Rainer Brohm, “Border Adjustments on Energy Taxes: A Possible Tool for European Policymakers in Implementing the Kyoto Protocol?,” 74(2) Vierteljahrshefte zur Wirtschaftsforschung/Quarterly Journal of Economic Research, DIW Berlin, German Institute for Economic Research 249-258 (2005).}
\footnote{42}{WTO Agreement on Subsidies and Countervailing Measures}
\footnote{44}{Ibid, footnote 8, para. 4}
This definition identifies key elements of the mechanism and provides a basic analytical framework. Broken into its component parts, elements of border adjustments of particular significance are: (i) it is fiscal measure, (ii) that relieves products of the fiscal consequences of domestic tax by rebating some or all of the tax paid on domestically produced products that are ‘similar’ ('like products') when those domestic goods are exported, and (iii) charging some or all of a tax on imported like product when it is imported. The significance of this definition is that it identifies:

- that the operation of the devices are based upon the destination principle of taxation.\(^{45}\)
- the central units of analysis being ‘fiscal measure’ and ‘like-product’
- the two-sided character of the devices, i.e., the import and export dimensions, of border adjustments;

Several insights can be drawn from this definition. First, it is clear that the Working Party recognized border adjustments as a two-sided policy measure. Second, the narrow technical framing of the definition reinforces the previously mentioned observation that border adjustments were never designed to address issues as large and complex such as global climate change. Nevertheless, border adjustments may yet prove to be a means by which trade policy and climate policy can be integrated more coherently.\(^{46}\) A coherent integration would be a step beyond mere complimenting policy. The relevant aspects of the rules governing the import and export sides of the policy measure are discussed below.

### 2.2.1 Import-Side Tax

The provisions regulating the use of import-side border adjustments are contained in Articles II and III of the GATT. Article II:1 states the general rule that only tariffs should be imposed at the border of importing Members.\(^{47}\) However, Article II:2 provides an exemption to the general rule in providing that:

> Nothing in this Article shall prevent any contracting party from imposing at any time on the importation of any product:

> (a) a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has

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\(^{46}\) The question of policy coherence is a complex one. The problem here is that it involves the design of coherent domestic policy as prescribed by international rules. The domestic/international coherence question, however, does not lead to country-country policy coherence. For a discussion of regulatory coherence generally, see Sheehy, B. and Feaver, D. (2010) “A Theory of Regulatory Coherence” available from the author on request.

\(^{47}\) GATT Article II:1
been manufactured or produced in whole or in part;\textsuperscript{48}

In the absence of any WTO case law clarifying Article II:2, a literal reading of Article II:2(a) permits countries to impose price-based measures (i.e., a tax) at the border \textit{in addition to but independently from tariffs}. The distinction between tariff and border adjustments is critical in respect of the climate policy debate and is discussed in more detail in section 3.1 below. In addition, the tax imposed on imported goods must satisfy a correspondence test. The ‘charge’ levied against the imported good must correspond to an equivalent charge imposed either on a ‘like domestic product’ or a charge levied upon ‘an article’ used in the manufacture or production of that good “in whole or in part”.\textsuperscript{49} The question whether an imported product is a ‘like-product’ was considered by

The GATT Working Party on Border Adjustments mentioned previously also considered how the term ‘like product’ should be interpreted in relation to border adjustments. It concluded that a fair assessment whether imported and domestic products are ‘like-products’ could only be made on a case by case basis and requires a comparison of each products’ properties, nature and quality.\textsuperscript{50} The WTO Appellate Body reaffirmed the Working Party’s definition in \textit{Japan- Taxes on Alcoholic Beverages} and also affirmed that any determination in relation to ‘like products’ must be made giving consideration of the various characteristics of products. In its summary, the Appellate Body stated that in “applying the criteria cited in \textit{Border Tax Adjustments} to the facts of any particular case, and in considering other criteria that may also be relevant in certain cases, panels can only apply their best judgment in determining whether in fact products are “like”.”\textsuperscript{51} In following and extending this reasoning in \textit{EC – Asbestos}, the Appellate Body determined that a critical factor in determining ‘likeness’ is whether an imported product “competes” with a domestic product thereby establishing a legal nexus between imported and domestic products.\textsuperscript{52}

Article II:2 also permits a charge to be levied upon ‘inputs’ used in the manufacturing process (as distinguished from a tax on a good that is an end-product of a manufacturing process). This aspect of Article II:2 is particularly important where, in the case of climate policy, carbon taxes are imposed on energy derived from fossil fuels used in the manufacturing process. Therefore, a border tax can be levied upon an

\textsuperscript{48} GATT Article II (a)


\textsuperscript{50} Report of the Working Party on \textit{Border Tax Adjustments}, BISD 18S/97, para. 18: “the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a “similar” product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is “similar”: the product's end-uses in a given market; consumers’ tastes and habits, which change from country to country; the product's properties, nature and quality.”


\textsuperscript{52} \textit{EC - Asbestos}, WT/DS135/AB/R, (12 March 2001), para. 98. The main criteria that have been used to make the relevant determination are: i) the physical characteristics of the products; ii) their end use; iii) consumer preferences (as measured by the substitutability of the products in the market); and iv) the tariff classification applied to each product.
imported product equivalent to the amount of a tax levied on the energy used in the manufacture of a domestic good. There is some question whether a carbon tax on fossil fuels used in manufacturing goods is a tax on a ‘process’ rather than a tax of a ‘like-product’ or ‘input’ used in the manufacturing process. This question is discussed in further detail in Section 2.2.2 below.

Article II:2(a) also refers to ‘paragraph 2 of Article III’. The ‘national treatment’ obligations contained in Article III:2 place restrictions on the magnitude of the ‘charge’ that can be levied against imported goods. Article III:2 provides:

The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.*

Article III:2 stipulates that an “internal tax or other internal charge of any kind” shall not be “applied, directly or indirectly” to imported products “in excess of those applied, directly or indirectly, to domestic products.”54 This provision has a range of implications that are discussed in Section 3 below. However, for the present discussion, the use of import-side border adjustments are restricted to adjusting the price of imported goods that are “like-products” to domestic goods that have been subject to an internal charge levied against those domestic products or inputs used in the manufacture of those domestic products. The amount of the adjustment applied to imported goods is limited to the amount of the internal charge levied against the domestic like-good.

2.2.2 Product v. Process Issues
Given that the WTO rules are directed at a ‘product level’ analysis of ‘likeness’, several commentators have asserted that border adjustments are not an appropriate policy mechanism to be used in conjunction with carbon taxes or the requirement to purchase emission permits. This argument is based on the GATT panel decision in United States – Restrictions on Imports of Tuna. In that case, the Panel determined that the US could not restrict tuna imports from certain countries based on the method by which the tuna was caught. Discriminating against imports based on their method of production was viewed as a violation of Article III.55

In citing the Tuna case, critics of border adjustments argue that carbon taxes are a tax on fossil fuels used in the ‘process’ of producing goods.56 They argue that because fossil fuels are spent in the manufacturing process and are not manifest in the physical

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53 GATT Article III:2
54 Ibid.
55 The case often cited in support of this proposition is the GATT Panel report on United States – Restrictions on Imports of Tuna, DS21/R, 3 September 1991. However, as explained in Section 2.2.3, that is not quite what the GATT Panel did say.
BISD 39S/155, at 5.13
characteristics of a good, a carbon tax is, in effect, a tax on a ‘process’, not a tax on a product. Hence, it is argued that imposing a border tax to offset a domestic carbon tax is not likely to be permitted under the WTO rules. However, this argument confuses notions surrounding ‘methods of production’ with the notion of ‘inputs used in the production process’ previously discussed in Section 2.2.1. Taking an even stronger position, Howse and Regan assert that “there is no real support in the text or jurisprudence of the GATT for the product/process distinction.”

Although there is no WTO case law determining whether a carbon tax is a ‘product’ or ‘process’ related tax thereby clarifying whether it may be offset using border adjustments, several related cases do shed some light on how a dispute settlement panel may be inclined to characterize a carbon tax. A tax on fossil fuels used as an ‘input’ in the production process is analogous to a tax on chemicals used as an input in the production of chemical derivative products which was the focus of analysis in the US – Superfund Tax case. In the Superfund case, the panel determined that taxes on “chemicals used as materials in the manufacture or production of the imported substances” might be taken into account when imposing border tax adjustments on imported like products. Hence, a carbon tax is not likely to be a tax on production processes and is more likely to qualify as a tax on an input used in the production of a good.

2.2.3 Export-Side Rebate
The export-side of border adjustments has received much less attention in both the debate and the literature. Although export-side border adjustments have been described as “the flip-side of the right to impose a domestic tax also on imports”, under WTO rules, there is a subtle difference between the import and export-side rules. This difference increases the suitability of border adjustments as a coherent policy measure that, if properly designed, can bring a high degree of flexibility to the types of national climate policies that can be implemented. The provisions regulating the use of export-side border adjustments are contained in Article VI:4 of the GATT 1994 Agreement as well as the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement).

The export-side adjustment takes the form of a statutorily permitted rebate of the ‘charges’ that are incurred by producers in the manufacture of goods. The rebating of domestic charges are paid to the exporter when domestic goods are exported is not considered to be a prohibited export subsidy under Article 3:1 of the SCM Agreement. The SCM Agreement provides countries the right to rebate ‘indirect’

58 Panel Report on United States – Taxes on Petroleum and Certain Imported Substances; GATT, BISD 34S/136 (June 17, 1987), at para. 2.5 and para. 5.2.4.
59 Ibid
60 Pauwelyn, Ibid, footnote 6.
61 GATT Article VI:4 and Ad Note to GATT Article XVI. See also footnote 1 and paragraphs (g) and (h) of Annex I to the Agreement on Subsidies and Countervailing Duties. The Working Party on Border Tax Adjustments (infra note 43, at para. 10) found that rules on rebates for exports and taxes on imports are equivalent: “it was agreed that GATT provisions on tax adjustment applied the principle of destination identically to imports and exports”.
62 Feaver, McGoldrick and Wells, Ibid, footnote 2. In addition see the Ad to GATT Article XVI:4 which provides that “The exemption of an exported product from duties or taxes borne by the like
domestic taxes, such as a carbon tax, paid by domestic producers of goods that are exported. A carbon tax would likely qualify as an indirect tax within the meaning of the SCM Agreement because it falls within the category of a tax that is “other than a direct tax.”

Most importantly, paragraph (g) of Annex I to SCM Agreement permits a broader range of domestic policy measures to be adjusted on export than the import-side rules permit. The import-side rules, as discussed above, do not allow countries to make fiscal adjustments relating to PPMs. By contrast, under the SCM Agreement which encompasses ‘indirect taxes’ incurred “in respect of the production and distribution of exported products”, it has been noted elsewhere that this “could arguably cover process or production-related taxes” or PPM’s. Paragraph (h) of Annex I of the SCM Agreement explicitly permits border adjustment upon exportation of a certain type of indirect tax (namely, prior stage cumulative indirect taxes) even when such taxes are “levied on inputs that are consumed in the production of the exported product” including not only “inputs physically incorporated” but also “energy, fuels and oil used in the production process”.

The operational implications of allowing a broader range of policies to fall within the scope of export-side border adjustment are subtle but extremely important in designing coherent climate policies. What appears an incongruity between the import and export side rules has the effect of permitting countries considerable flexibility in implementing and adjusting for innovative climate policies that may not conform to the more restrictive fiscally-oriented character of the import-side measures.

3. Applying Border Adjustments to Climate Change Policies

Several researchers have identified how the border adjustment debate seems to be occurring at two levels: at a product level as influenced by the focus of the rules, and at the policy level which is being dictated by the nature of the climate change problem. The debate has become sufficiently conflated between the two levels that a serious disconnect has developed between how border adjustments are politically portrayed and how they must be designed and applied to conform to international legal obligations. In accepting the proposition that border adjustments are an imperfect solution to an exceedingly complex problem, a better understanding of their
conceptual and legal characteristics provides insight into the extent they can compliment domestic climate policies. It also provides a foundation upon which some of the more contentious aspects of the border adjustment/climate change debate can be framed more precisely.

In the subsections below, several aspects of the political debate surrounding border adjustments are examined and discussed in relation to the international rules. Once the legal requirements are separated from political rhetoric, a clearer picture of the strengths and weaknesses of border adjustments as a policy measure complimenting climate policies begins to emerge.

3.1 The Unit of Analysis Problem
As mentioned above, a great deal of political friction and confusion surrounding the use of border adjustments arises when national policy-makers discuss the potential design and application of border adjustments in a manner that does not accord with WTO rules. A major source of this friction stems from what can be described as a ‘unit of analysis’ problem. The unit of analysis problem arises when opposing political agendas ignore the legal requirements and distort the purpose and application of the measure in a multitude of ways. For example, a proposed use of border measures advanced by several countries is that import-side measures should only be imposed against ‘countries’ that do not have an official and explicit carbon price.\(^\text{69}\)

The logic of this argument is flawed in several respects. As noted above, Article II of the GATT 1994 Agreement provides that border adjustments can only be imposed as a ‘charge’ equivalent to an ‘internal tax’ in respect of ‘like domestic products’. Yet, the proposition put forward above substitutes the words ‘carbon price’ and ‘countries without an explicit carbon price’ for the words ‘internal tax’ and ‘like domestic product’ contained in Article II. In making this substitution, the political version is tantamount to re-writing Article II to say that border measures will be imposed as a ‘charge equivalent to a carbon price imposed against countries without an explicit carbon price.’

There are several problems with the political version, not least of which is that border adjustments begin to resemble more a protectionist tariff than a domestic tax. First, the words ‘carbon price’ cannot be substituted for the words ‘internal tax’. The former arises, as will be explained further below, as a policy outcome whereas the latter is a policy device that generates a policy outcome. The two clearly do not fall within the same class of unit being substituted and serve different purposes. Second, although a national carbon price may correspond to a domestic carbon tax, the calculation and measurement of a national carbon price can be a complex exercise. This is because, depending on what definition of carbon price is used, carbon price may be an aggregate value that is generated from a combination of climate policy-related fiscal measures.\(^\text{70}\)

Using Article II as a point of reference, a further unit of analysis problem arises when

\(^{69}\) For the purposes of this analysis, the question whether a country has an explicit carbon price is determined by whether that country has imposed a national carbon tax or an emissions trading scheme.

\(^{70}\) There are several different definitions of carbon price- explicit, effective, shadow and implicit. It is not necessary for the purposes of this paper to incorporate the concepts of an effective of shadow carbon price into this analysis. For definitions see: CIE Comparing Effective Carbon Prices: Methodological Issues The Centre for International Economics, 2010.
arguments are made that rhetorically substitute the word ‘country’ for the words ‘like domestic product’ in Article II. A country is a high order political unit whereas a product is an economic unit of a much lower order of generality. Clearly the two are not even comparable. The object of Article II:2 is to regulate fiscal differences between products, not countries- a distinction that is discussed further in Section 4.3 below. If a country were to design border adjustments to offset a ‘carbon price’, it is highly likely that such a measure would be challenged under the WTO dispute provisions. It is also likely that a WTO Dispute Settlement panel would find against the use of the carbon price as the unit of analysis.71

3.1.1 Adjusting for Carbon Taxes or Carbon Prices?
As mentioned above, a great source of confusion in the debate is when the term ‘carbon price’ is advanced to be the unit of measure that border adjustments should offset. In addition to the legal issues it raises, carbon price is problematic in several other respects. There may be an implicit as well as explicit aspect of a carbon price. Carbon price, defined in simple terms, is the ‘cost’ of producing CO₂ emissions.72 In the absence of national climate policies that impose a cost on carbon, CO₂ emissions are nothing more than a ‘negative externality’.73 On the other hand, a carbon price is generated if a price is attached to CO₂ emissions by climate policies. An explicit carbon price arises from the imposition of a carbon tax or the implementation of an emissions trading scheme (emissions permits being a cost paid by carbon users). An implicit carbon price, on the other hand, may be generated as a result of climate change mitigation subsidies (a cost paid by government to producers to switch to lower carbon producing technologies) or other regulatory measures such as feed-in tariffs, minimum obligations for renewable generation or product labeling requirements.74 As a result, some countries may have an explicit carbon price while others that implement mitigation policies other than a carbon tax or emissions trading scheme will have an implicit national carbon price.

The distinction between explicit and implicit carbon prices has a range of policy implications affecting the design and use of border adjustments.75 Because Article II,

71 In the WTO panel report Mexico – Taxes on Soft Drinks, WT/DS308/R, 23 March 2006, paras. 8.42-45), the need for a “nexus” between the tax, the products its affects is identified. The panel found that GATT Article III:2 “requires some connection, even if indirect, between the respective taxes or other internal charges, on the one hand, and the taxed product, on the other”. This has the effect of establishing this nexus between these ‘units of analysis’ as a legal requirement.
72 The question arises as to how that cost should be calculated; i.e., in real terms as determined by the monetary costs associated with a carbon tax or should it calculated in relation to the social costs of CO₂ emissions. For example, see: Pearce, David “The Social Cost Of Carbon And Its Policy Implications” 19:3 Oxford Review of Economic Policy 362 (2003).
74 See footnote 28 above. The notion of an implicit carbon price arises where climate change mitigation policies are implemented- such as subsidies- that do not flow through to a conventionally calculated notion of a carbon price. See also; Hoeller, P. and Wallin, M. “Energy Prices, Taxes and Carbon Dioxide Emissions” Economics and Statistics Department Working Paper No. 106 OECD, Paris (1991).
75 For the purposes of this paper, the term ‘carbon price’ will be used in a reductionist sense to mean the aggregate of all domestic climate change policies and taxes that might flow from the implementation of climate change policies. For a recent example of the use of the carbon price in this way see: Convery, F., Ellerman, D. and de Perthuis, C. “The European Carbon Market in Action: Lessons from the First Trading Period” 5(2) Journal of European Environmental & Planning Law 215-231 (2008).
for example, permits only the offsetting of a ‘charge equivalent to an internal tax’, policy measures of the type that generate an implicit carbon price are not likely to fall within the scope of this requirement. A subsidy or feed-in tariffs, for example, would not qualify as ‘a charge equivalent to an internal tax’. A further complexity arises where countries implement a combination of climate policies that have the effect of generating both explicit and implicit carbon prices which, in combination, generate an ‘effective’ carbon price. While politicians seeking to address the concerns of constituents may wish to use border adjustments to offset the full effects of an effective carbon price, it is clear that the rules are more narrowly framed and only permit the offsetting of an explicit carbon price.

3.1.2 De-Constructing the Carbon Price

There is a further problem associated with the use of ‘carbon price’ as a unit of analysis in relation to border measures. As mentioned above, an explicit carbon price may be generated through a combination of climate policies that place a cost on CO$_2$ emissions. Where this is the case, because Article II:2 provides that a border adjustment is a charge equivalent to an internal tax, any border adjustment implemented to offset an explicit carbon price would have to be designed ensuring that the carbon price is disassembled into its separate fiscal components. In other words, to be consistent with Article II:2, the border adjustment of an explicit carbon price may require imposing more than one border adjusted ‘charge equivalent to an internal tax’ being levied upon imported products.

If a border adjustment is implemented in the form of a single aggregated tax to offset a carbon price generated from a combination of more than one climate policy, the measure will resemble a protectionist tariff more than a border adjustment. The reason for this is because the border adjustment would be of a magnitude that would exceed any one of the fiscal measures that it is designed to offset. Hence, because there isn’t a requisite correspondence between the border adjustment and any of the fiscal measures it is intended to offset, the border adjustment would likely be challenged under Article III paragraphs 1 and 2. Article III:1 provides that “taxes and laws affecting sale and purchase should not be applied to imported or domestic products so as to afford protection to domestic production.” As explained in EC — Asbestos, the WTO Appellate Body acknowledged that

Article III:1... ‘contains general principles’, and Article III:2, which ‘provides for specific obligations regarding internal taxes and internal charges’. Article III:1 articulates a general principle that internal measures should not be applied so as to afford protection to domestic production. This general principle informs the rest of Article III. The purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in the other paragraphs of Article III.
As such, Article III:2 provides that the “products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.” Given that a tax equivalent to the aggregate national carbon price would logically exceed any one of the domestic taxes comprising the aggregate carbon price, a border adjustment measure equivalent to the explicit carbon price would violate Article III:2.  

Finally, in the debate surrounding the use of border adjustments, it is implicitly assumed that the only indicator of effort to reduce emissions is the imposition of an explicit carbon price established through either an emissions trading scheme or a carbon tax. However, while obvious and important, an explicit price is not the only indicator. Other policies, such as subsidies, feed-in tariffs or minimum obligations for renewable generation, are also relevant. To determine the extent to which countries are establishing robust emissions policies, and hence already moving towards a low-carbon economy, all of these policies need to be considered. However, this line of enquiry falls almost entirely outside the scope of the rules examined in this paper. To the extent that they are relevant, the notion of an implicit carbon price generated by these other policies should either form the basis of any international re-negotiation of the border adjustment rules or should be avoided by countries as a potential climate policy device.

### 3.2 Selective Targeting: Ignoring the Rules

Another contentious issue associated with the use of border adjustments is exemplified by US efforts and EU proposals to ‘selectively target’ imports from countries that do not have complimentary climate policies. The rationale underlying a selective use of border adjustments is that border adjustments would only be imposed against ‘countries’ that do not have an official and explicit carbon price. Hence, as mentioned in the previous section, the proposition put forward proposes to levy measures against ‘a country’ instead of ‘products’. The proposal to selectively target countries without an explicit carbon price, as mentioned above, is tantamount to notionally re-writing of Article II by substituting the terms ‘carbon price’ and ‘internal tax’ and wholly ignoring the ‘like domestic product’ requirements. Such a re-writing of Article II suggests that border adjustments will be imposed as a “charge equivalent to a carbon price imposed against countries without an explicit carbon price”—not only something the Article II does not permit, but also a clear violation of the Article I most favoured nation obligation.

#### 3.2.1 The General Rule: Article I- Most Favoured Nation

Proposals to selectively target imports from countries that have not implemented climate policies that generate an explicit carbon price by means of a carbon tax are, on
their face, likely to violate GATT Article I. As a consequence, any such proposals would be considered a violation of the most favoured nation (MFN) obligation. The MFN obligation contained in Article I stipulates that “any advantage … granted by any Member to any product originating in … any other country shall be accorded immediately and unconditionally to the like product originating in … all other [WTO] Members”.

Article I:1 of the GATT, more commonly known as the most favoured nation (MFN) principle, provides that ‘any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties’. The scope of Article I:1 is further defined to include ‘all matters referred to in paragraphs 2 and 4 of Article III’.

As a core principle of the WTO regime, Article I:1 has been the subject of much scrutiny by dispute settlement panels over the decades. It has two dimensions. First is that been interpreted to mean that WTO member countries cannot impose internal measures in the form of taxes or charges that discriminate between foreign and domestic producers. More importantly for the purposes of this analysis, WTO member countries cannot impose internal taxes and charges that treat imports from different countries differently. Stated another way, Article I:1 forbids WTO member countries from discriminating between producers and their goods originating from different countries.

The general scope of Article I:1 was set out by the Appellate Body in Canada — Autos, which reviewed a Panel finding that Canadian import duty exemptions granted to motor vehicles exported from certain countries were inconsistent with Article I:1. The Appellate Body distinguished between de jure and de facto discrimination finding that both fell within the scope of the Article. In doing so, the Appellate body stated that:

In approaching this question, we observe first that the words of Article I:1 do not restrict its scope only to cases in which the failure to accord an ‘advantage’ to like products of all other Members appears on the face of the measure, or can be demonstrated on the basis of the words of the measure. Neither the words ‘de jure’ nor ‘de facto’ appear in Article I:1. Nevertheless, we observe that Article I:1 does not cover only ‘in law’, or de jure, discrimination. As several GATT panel reports confirmed, Article I:1 covers also ‘in fact’, or de facto, discrimination. Like the Panel, we cannot accept Canada’s argument that Article I:1 does not apply to measures which, on their face, are ‘origin neutral’.

Address argument that selective targeting is origin neutral and how this then relates to the granting of ‘an advantage’.

The notion of granting ‘an advantage’ is central to the issues that arise from selectively targeting on the basis of their climate policies. The Appellate Body

83 GATT 1947 (n 77) at Article I:1. The scope of Article I:1 is further defined to include ‘all matters referred to in paragraphs 2 and 4 of Article III.’
84 Ibid.
touched on the term “any advantage … granted by any Member to any product” in Canada-Autos noting that:

The words of Article I:1 refer not to some advantages granted ‘with respect to’ the subjects that fall within the defined scope of the Article, but to any advantage; not to some products, but to any product; and not to like products from some other Members, but to like products originating in or destined for all other Members.”

Further in Indonesia – Autos, the Panel explicitly held that advantages ‘cannot be made conditional on any criteri[on] that is not related to the imported product itself.’ As Veel notes, “while the mere presence of conditions attaching to the grant of some benefit may not violate Article I:1, a condition that discriminates as between different countries will violate the MFN principle. Even measures which are facially neutral between countries of origin may be found to violate Article I:1 if they result in a discriminatory impact as between countries.

The effect of a selective targeting by imposing a border adjustment upon only those imports originating from countries that have not implemented policies generating an explicit carbon price has an effect of granting an “advantage” to those countries that have implemented policies that generate an explicit carbon price. The unfairness that arises is that the policy of selective targeting does not take into account circumstances where countries may implement policies that generate an implicit carbon price. If, for example, Australia were to grant free access to products imported from Europe which are subject to CO₂ emission taxes in those countries but were to impose a border adjustment on ‘like’ Chinese products which are not subject to emissions taxes, Australia would be in violation of its Article I obligation to “immediately and unconditionally” accord MFN status to the Chinese like products.

The logic underlying the policy of selective targeting is flawed in several respects. First, the policy assumes that those countries that do not impose climate policies that generate an explicit carbon price are not taking any climate action at all. By contrast, one recent report suggest that Chinese climate policies generating an implicit carbon price has resulted in a national carbon price in China that exceeds that of most western countries. Second, the policy of selective targeting can result in absurd policy outcomes. For example, a European good produced for export should, under a properly designed scheme, be eligible for a rebate of the European climate taxes. Accordingly, the European good will enter the international market stripped of any EU carbon taxes. As a result, if Australia were to selectively target Chinese imports but grant free access to European imports, the European imports would enter and be sold in the Australian product market carbon tax free and enjoy a competitive advantage over the domestic like-goods.

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87 WTO jurisprudence has used the following four criteria to determine comparability: (1) physical characteristics of the products; (2) end-use; (3) consumer tastes and habits; (4) tariff classification (ibid., para. 101). Under all of these criteria, different types of steel depending on the energy used to produce the steel are most likely to be found comparable (they are physically the same; used for the same end-use; and not normally classified differently for import tariff purposes).
3.2.2 The Article XX Exception

In spite of legal and policy shortcomings, a strategy of selective targeting may, nonetheless be saved under the GATT rules. GATT Article XX provides a list of exceptions that permit WTO members to implement trade measures such as border adjustments that “would otherwise be inconsistent with GATT obligations.”

The ‘chapeau’ of Article XX states that, under certain circumstances, countries may adopt national policies that violate GATT obligations provided that “such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination… or a disguised restriction on international trade.”

The two paragraphs of Article XX that are most likely to provide exceptions applicable to national climate policies are paragraphs (b) and (g). Article XX (b) refers to measures “necessary to protect human, animal or plant life or health.” Article XX(g) permits the implementation of measures “relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.”

It is not clear which paragraph is most likely to apply. Condon notes that “jurisprudence on paragraph XX(g) appears to make paragraph XX(b) somewhat redundant… “. The prevailing view is that border adjustment schemes could, if designed properly, fall within the scope of either or both of these Article XX exemptions. In either case, to comply with Article XX, Howser et. al., note that a border adjustment must be “closely tailored to achieve a legitimate policy objective (such as protecting the environment) provided that the policy measure is designed in the least trade restrictive manner possible.” A broader view is taken by Trebilcock and Howse who suggest that a measure “that was even-handed between imports and domestic [products] and focussed appropriately on conservation goals, might well pass the test.” In other words, a policy clearly aimed at protecting the natural environment which may result in discrimination against imports or necessitate a border adjustment may well fall within the permitted exemptions of Article XX.

An alternative view is that a border adjustment designed to selectively target certain imports may not be as easily saved under Article XX as suggested. A review of the jurisprudence and, in particular, the legal tests that must be satisfied suggest that a selective targeting of countries would still be a violation of the GATT. For example, under Article XX(b), the test turns on whether the measure is ‘necessary’. In defining necessary in EC – Asbestos, the Appellate Body re-iterated a finding made in the earlier Korea – Beef decision that “the more vital or important the common interests

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89 Condon, Bradley (2005) GATT Article XX and Proximity of Interest: Determining the Subject Matter of Paragraphs b and g” 10 UCLA Journal of International Law and Foreign Affairs
90 GATT, Article XX(b).
91 GATT, Article XX(g).
92 Ibid.
93 Ibid, note 88.
of values pursued, the easier it would be to accept as necessary." Accordingly, the question could be phrased as whether a border adjustment scheme designed to be selective (and therefore impliedly punitive and less impliedly protectionist) is necessary? In all likelihood, given the punitive nature of the measure, the answer would be ‘no’ and the selective measure would be struck down on the grounds that a border adjustment designed in conformity with the WTO rules would achieve the same end without the discriminatory outcome.

Alternatively, under Article XX(g), three criteria that must be satisfied. “First, the resource to which the measure relates must be an exhaustible natural resource. Second, the measure must relate to the conservation of the exhaustible natural resource. Third, the measure must be made effective in conjunction with restrictions with domestic production or consumption.” Although, all criteria can be satisfied in the case of carbon tariffs, their permissibility ultimately turns on the tests set out in the ‘chapeau’ of Article XX that prohibits measures that are “applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination… or a disguised restriction on international trade. The Appellate Body provided a definition of these terms in US- Reformulated Gasoline in which it stated that “the kinds of considerations pertinent in deciding whether the application of a particular measure amounts to “arbitrary or unjustifiable discrimination”, may also be taken into account in determining the presence of a "disguised restriction" on international trade. The fundamental theme is to be found in the purpose and object of avoiding abuse or illegitimate use of the exceptions to substantive rules available in Article XX.”

3.3 The Problem of Calculating the Adjustment

A further point of contention that is presented as being the most difficult in practical terms is how a ‘charge’ on imports, or rebate on exports, should be calculated and administered. The administrative challenges have not escaped the politics of the debate and critics of climate policy assert that it is impossible to implement an administratively feasible scheme that is capable of taxing (or rebating) the embedded carbon content of products. Calculating the embedded carbon content of a product requires a detailed enquiry into the CO₂ emissions generated in all aspects of the sourcing, supply, processing production marketing and transport of the product. Although critics assert that there are “no clear definitions or calculations as to the relevant… amounts that are to be used in such adjustments, or even how such calculations would be made”, a senior policy analyst within the World Customs

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100 As asserted in the Economist, ‘a carbon tariff…would be hard to implement. Customs officials would either have to assess the emissions embedded in imports, an impossibly complicated task, or make arbitrary assumptions, a recipe for a trade war’.
Organization states that the “reality is, however, that administering embodied carbon BTAs would be feasible.”

The debate is made unnecessarily complicated in two ways. First, even though two products might be considered ‘like-goods’ within the meaning of Articles II and III, their carbon content may differ substantially. For example, different producers of the same product may operate under different conditions using production methods that differ in carbon intensity. In theory, the product with the higher embedded carbon content should attract a higher tax or be accorded a larger rebate than more efficiently produced products. Since in the carbon intensity of imports originating in developing countries is frequently higher than like-goods in developed countries, it is argued that any adjustment made should be based on a calculation of the imported good’s embedded carbon content.

The problem with this approach is that it is likely to violate GATT Article II:2 which requires the border adjustment imposed on the imported good be ‘a charge equivalent to an internal tax’ levied upon the domestic like-good. The charge imposed upon the domestic good is, therefore, the reference standard against which any border adjustment must be calculated. It is evident that a border adjustment scheme could not be feasibly administered unless a trade-off between scientific accuracy and administrative expediency is made. It has been suggested elsewhere that a ‘best available technology’ (BAT) standard applied to all producers for all ‘like-products’ “would eliminate the need for estimating GHG emissions from individual plants.” Ismer and Neuhoff advocate such an approach, claiming also that it would be likely to be WTO-compliant.

The second way in which the debate is complicated is where design of the climate policy measures appears divorced from any proposed border adjustment scheme designed to support that policy. This bifurcated approach is most evident in the proposals to selectively target imports from countries having no explicit carbon pricing policy. Because the policy objective is unclear, the design of the regulatory structure will be incoherent. On the one hand, there is a policy of selective targeting which may be viewed as a punitive and coercive measure. On the other hand, there is a need to coherently compliment core climate policy through an effective, coherently designed the border adjustment. The result of the unclear policy framework is an overly complex and administratively cumbersome regulatory regime.

For example, the Lieberman-Warner Bill proposals identify four policy and administrative concerns and make a variety of suggestions to address those concerns. In the Lieberman-Warner Bill proposals, which address the cumbersome

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103 Houser et al., Ibid, note 17.
104 GATT Article II:2.
105 Although it may result in an under-estimate of GHG emissions for almost all plants, and would eliminate any incentive on firms already at BAT to further improve their emissions reduction technologies, given the wide ranges that exist in emissions intensity of the production of most products, a best available technology’ factor would most likely have to be set at a very low rate, which would render it largely ineffective in controlling leakage and reducing competitiveness concerns.
legislation emanating from unclear policy, a highly complex administration is required which appears to rival the HTS of the WTO. Importers will be required to purchase International Reserve Allowances in specified amounts on the ‘covered goods’—which themselves require a complex categorisation procedure—from countries on the ‘covered list.’ The obvious outcome of attempting to implement the proposals is an administratively complex, internationally incoherent (in the sense of compliance with WTO and BTA’s) regulatory framework which may or may not address the basic issue of carbon gas emissions.

4. Summary and Conclusions

Even though the discussion of border adjustments are only a part of the larger climate policy debate, the rhetoric and misinformation surrounding their role in complimenting climate policy makes it clear that they not well understood in some policy circles. The challenge of understanding of how border adjustments could compliment climate policy results because different issues requiring clarification arise in respect of their policy, operational and legal implications.

Rather than understanding border adjustments as a policy measure that is incidental to, or ‘tacked-on’ to a climate policy measure such as a carbon tax or an emissions trading scheme, border adjustments should be considered an essential component of a coherent integrated policy framework. The purpose of this framework is to achieve the combined policy objectives of reducing harmful CO$_2$ emissions and minimizing the negative impact of such reductions on the competitiveness of domestic goods both within and beyond domestic markets. Clearly, both the import and export sides of border adjustments need to be considered in the policy equation.

A more integrated, coherent approach to climate policy design has several interesting policy effects. Not only does such an approach encourage the development of more transparent and administratively simple climate policy measures, past experience with VAT could prove valuable. If all countries implementing climate policy were to use border adjustments in much the same way as countries with VAT’s currently use border adjustments, there would be much less need for countries to engage in the complex exercise of developing a suite of international rules to harmonize trade related aspects of climate policy.

Before a coherent suite of climate policies can be formulated, however, it is necessary to have a clear picture of what can be adjusted at the border under the WTO rules and what cannot. Confusion surrounding what is being adjusted at the border arises when the focus is shifted from a ‘charge’ imposed upon a domestic product to a ‘carbon price’. Using the carbon price as the critical unit of analysis is fraught with danger and will likely result in a policy measure being found to violate international obligations. Similarly, border adjustment policies that focus on specific ‘countries’ rather than ‘like-goods’ are likely to meet a similar fate under the WTO rules and are unlikely to be saved by relying on exemptions to the general rules.

What needs to be done at this stage is to re-orient the discussion toward coherent, comprehensive, integrated policy that addresses climate change, mindful of local variations while complying with existing WTO rules.