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QUALIFYING THE EUROPEAN CARBON BORDER ADJUSTMENT MECHANISM

A preliminary but necessary step in assessing its WTO-legality

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Preface

This thesis is the closing piece of my studies at the Free University of Brussels. With this preface, I would like to thank the people who have supported me throughout the time of my studies and the writing of this thesis.

First and foremost, I wish to thank my mother for her unconditional support and encouragement. I would also like to thank the rest of my family, my friends and my fellow students and professors from both the Free University of Brussels and the University of Maastricht.

Finally, I would like to express my sincerest gratitude towards my promotor, Prof. dr. Kim Van der Borght. He has shown great enthusiasm for my research topic and has provided me with insightful feedback.

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Abbreviations

AB	Appellate Body
ATAA	Air Transportation Association of America
BAM	Border adjustment measure
BTA	Border tax adjustment
BTAM	Border tax adjustment measure
CARB	California Air Resources Board
CTE	Committee on Trade and Environment
ECJ	European Court of Justice
ENVI	Environment, Public Health and Food Safety
ETS	Emission trading system
EU	European Union
EU CBAM	European Carbon Border Adjustment Mechanism
EU ETS	European Emission Trading System
GATT	General Agreement on Tariffs and Trade
GHG	Greenhouse gas
INTA	International Trade
LDC	Least developed countries
MFN	Most favoured nation
MPIA	Multiparty Interim Appeal Arbitration Arrangement
NDC	Nationally determined contribution
NT	National treatment
PPM	Process and production methods
UNFCCC	United Nations Framework Convention on Climate Change
US	United States
WTO	World Trade Organisation

Introduction[1]

1. Nearly all scientists agree that climate change is happening.[2] In this context, the European Union (hereafter: EU) with the EU Green Deal, has set out to reduce greenhouse gas (hereafter: GHG) emissions by fifty-five percent by 2030 compared to the 1990 levels and to become a climate-neutral continent by 2050.[3]

2. On the 14th of July 2021, the European Commission adopted a series of legislative proposals, including the proposal for a 'Carbon Border Adjustment Mechanism' (hereafter: EU CBAM) in order to achieve these ambitious climate targets.[4]

3. This measure would directly affect trade and thus risks being incompatible with the rules imposed by the World Trade Organisation (hereafter: WTO). Many legal scholars have assessed the legality of border adjustment measures in the context of GHG emissions. However, one preliminary question is not, or only superficially, addressed in this evaluation, namely the question regarding the WTO-qualification of carbon border adjustment measures. This qualification is nonetheless important, as it determines how the WTO-compatibility test must be carried out.

4. This research will therefore focus on the preliminary step of qualifying the newly proposed EU CBAM. The first chapter of this thesis will provide a general introduction to carbon border adjustment. The international setting of climate action and the *rationale* and functioning of border adjustment measures will be explained (Chapter I). Subsequently, the current mechanism harnessed by the EU as well as the EU CBAM proposal will be analysed (Chapter II). Finally, the possible WTO-qualifications of the mechanism (Chapter III) as well as the consequences of these qualifications for the WTO-legality of the mechanism (Chapter IV), will be examined.

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[1]The information in this thesis has been updated until the 1st of May 2022.

[2]W.R.L. ANDEREGG, J.W. PRALL, J. HAROLD and S.H. SCHNEIDER, "Expert credibility in climate change", *PNAS* 2010, vol. 107, no. 27, (12107) 12107.

[3]European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions on the European Green Deal, 11 December 2019, COM(2019) 640 final (hereafter: Green Deal).

[4]European Commission, Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 14 July 2021, COM(2021) 564 final (hereafter: EU CBAM Proposal).

CHAPTER I. CARBON BORDER ADJUSTMENT

1. Setting the scene

5. There is an abundance of scientific evidence that demonstrates that global warming is real and that carbon dioxide produced by human activities is its largest contributor.[5] The greenhouse effect is mainly caused by the burning of fossil fuels, which releases carbon dioxide into the atmosphere. Carbon dioxide is one of the GHGs that traps heat into our atmosphere and thus causes global warming. Hence, scientists further agree that in order to curb the trend, emissions must be brought down.

6. Following these scientific discoveries, the public opinion has long been demanding policy action. This chapter will start with a discussion on the international and European policy responses to climate change. Understanding these policy responses is important, because the adoption of ambitious climate policies leads to a range of issues, discussed further in this chapter, which incentivise the adoption of border adjustment measures.

1.1. The International framework

7. A global problem such as climate change, requires multilateral cooperation. To this end, the United Nations Framework Convention on Climate Change (hereafter: UNFCCC) was established in 1992 as a framework for international cooperation on the issue of climate change.[6] The objective of the UNFCCC is to "*reduce greenhouse gas concentrations to a level that would prevent dangerous anthropogenic interference with the climate system*".[7] The Convention is characterised by near-universal membership.

8. The negotiations between the parties to the Convention led to the adoption of the Kyoto Protocol in 1997, which entered into force in 2005.[8] This was the first legally binding, global agreement to explicitly address climate change.[9] The treaty laid more stringent responsibilities upon industrialised countries in accordance with the UNFCCC principle of 'common but differentiated responsibilities and capabilities'. Through this principle, it is acknowledged that developing countries have, historically, contributed less to climate change and do not have the same capabilities as developed countries to address climate

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[5]W.R.L. ANDEREGG, J.W. PRALL, J. HAROLD and S.H. SCHNEIDER, "Expert credibility in climate change", *PNAS* 2010, vol. 107, no. 27, (12107) 12107; M. LYNAS, B.Z. HOULTON and S. PERRY, "Greater than 99% consensus on human caused climate change in the peer-reviewed scientific literature", *Envrion. Res. Lett.* 2021, no. 16, (1) 6.

[6]United Nations Framework Convention on Climate Change of 9 May 1992, 1771 UNTS 107 (hereafter: UNFCCC).

[7]*Ibid*., art. 2.

[8]Art. 25.1. Kyoto Protocol to the UNFCCC of 11 December 1997, 2303 UNTS 162 (hereafter: Kyoto Protocol).

[9]B. J. RICHARDSON, "Kyoto Protocol to the United Nations Framework Convention on Climate Change", *N.Z. J. ENVTL. L.* 1998, vol. 2, no. 2, (249) 249.

change.[10] Therefore, the burden in tackling the issue was allocated asymmetrically among countries.[11] For the countries listed in Annex B of the Protocol, the agreement sets an average binding GHG emission reduction target of five percent, compared to the 1990 levels.[12] Under the Protocol, the bound countries had to pursue these targets primarily through national measures, which could be freely chosen. In addition thereto, the Protocol introduced 'Flexibility Mechanisms' which were intended to reduce the costs of achieving the Kyoto emission targets.[13] The Flexibility Mechanisms were Emission Trading, the Clean Development Mechanism and Joint Implementation.[14] The Kyoto Emission Trading System was the first global scheme for emission trading. The countries listed in Annex B received a limited amount of emission units. If they emitted less than this 'cap', they could sell their surplus emission units to parties whose emissions exceeded the 'cap' imposed on them. The other two Flexibility Mechanisms allowed the countries subject to the cap to earn emission reduction credits for their participation in emissions reduction projects abroad. These credits could thus help those countries to meet their reduction targets, without reducing GHG emissions domestically.[15]

9. Penalties could be imposed in case of non-compliance with the Kyoto Protocol. However, countries could avoid sanctions by withdrawing from the agreement. This is exactly what Canada did in 2011 when it became clear that it would not meet its Kyoto targets. The potential of the Kyoto Protocol to reduce GHG emissions was further limited by the fact that the US, one of the biggest emitters in history, never even ratified the Protocol. Although number one emitter China did ratify the Protocol, it was not listed in Annex B as it was considered a developing country during the industrialisation era and thus had no mandatory emission reduction commitments.[16]

10. The Kyoto Protocol officially expired in December 2020, but already in 2015, the parties to the UNFCCC adopted the Paris Agreement.[17] The long-term goal of the agreement is to limit global warming to well below 2°C, preferably to 1.5°C, compared to pre-industrial levels.[18] Although the Paris Agreement is an equally

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[10]Preamble and art. 3.1. UNFCCC, *supra* fn. 6.
[11]K. HOLZER, *Carbon-Related Border Adjustment and WTO Law*, Cheltenham, Edward Elgar Publishing, 2014, 14 (hereafter: K. HOLZER, *Carbon*).
[12]Art. 3.1. Kyoto Protocol, *supra* fn. 8.
[13]P. BOHM, *International Greenhouse Gas Emission Trading: With Special Reference to the Kyoto Protocol,* Copenhagen, TemaNord, 1999, 18; U. WILL, *Climate Border Adjustments and WTO Law: Extending the EU Emissions Trading System to Imported Goods and Services*, Leiden, Brill Nijhoff, 2019, 15 (hereafter: U. WILL, *Climate Border Adjustments*).
[14]Art. 6, 12 and 17 Kyoto Protocol, *supra* fn. 8.
[15]*Ibid*., art. 6 and 12; S. SIMONETTI and R. DE WITT WIJNEN, "International Emissions Trading and Green Investment Schemes" in D. FREESTONE and C. STRECK, *Legal Aspects of Carbon Trading: Kyoto, Copenhagen and Beyond*, New York, OUP, 2009, 157-158.
[16]N. GRUNEWALD and I. MARTINEZ-ZARZOSO, "Did the Kyoto Protocol Fail? An evaluation of the effect of the Kyoto Protocol on CO_2 emissions", *Environment and Development Economics* 2016, no. 21, (1) 3-7; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 17.
[17]Paris Agreement of 12 December 2015, 3156 UNTS.
[18]*Ibid*., art. 2, a).

binding treaty, it strongly differs from the Kyoto Protocol. First of all, the Agreement calls upon all nations to reduce their emissions, whereas the Kyoto Protocol mainly addressed industrialised countries. Furthermore, the Paris Agreement does not set legally binding targets, but provides a bottom-up approach whereby countries set national commitments to climate change, called 'nationally determined contributions' (hereafter: NDCs), on which they must report.[19] Every five years, countries are expected to submit an updated NDC.[20] The Agreement does not provide a mechanism to force countries to set targets in their NDCs, nor does it provide sanctions in the case of non-fulfilment of commitments. Countries only risk being 'named and shamed' in the case of non-fulfilment.[21]

1.2. European commitments

11. The EU has joined both the Kyoto Protocol and the Paris Agreement. It has achieved its GHG emission reduction targets under the Kyoto Protocol and has taken on a leading role in international climate efforts. In its NDC, submitted before the conclusion of the Paris Agreement, it committed itself to reducing GHG emissions by at least forty percent by 2030.[22] However, in 2019 the European Green Deal raised the ambitions. The EU now aims to reach at least a fifty-five percent reduction by 2030 and climate neutrality by 2050.[23] These goals were laid down in the European Climate Law, making them legally binding.[24]

12. The EU has taken a number of unilateral measures in order to achieve its emission targets, but at the heart of the EU climate change policy sits the European Emission Trading System (hereafter: EU ETS). The EU ETS is the largest emission trading system (hereafter: ETS) in the world.[25] Since the introduction of the system in 2005, emissions were reduced by approximately forty-three percent in the sectors covered by the system.[26]

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[19]*Ibid*., art. 3; M. HECHT and W. PETERS, "Border Adjustments Supplementing Nationally Determined Carbon Pricing", *Environ. Resource Econ.* 2019, no. 27, (93) 93-94.
[20]*Ibid*., art. 4, §9.
[21]F. GASPARI, "Aviation and Environmental Protection after the 2015 Paris Agreement: From Regulatory Unilateralism toward International Cooperation", *Issues in Aviation Law & Policy* 2016, vol. 15, no. 2, (347) 355.
[22]Submission to the UNFCCC by Latvia and the European Commission on Behalf of the European Union and its Member States: Intended Nationally Determined Contribution of the EU and its Member States, 6 March 2015, 1, www4.unfccc.int/sites/ndcstaging/PublishedDocuments/Austria%20First/LV-03-06-EU%20INDC.pdf.
[23]Green Deal, *supra* fn. 3.
[24]Regulation EP and Council, no. 2021/1119, 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999, *OJ. L.* 9 July 2021, 243, 1.
[25]Directive EP and Council, no. 2003/87/EC, 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC*, OJ. L.* 275, 32; Explanatory memorandum EU CBAM Proposal, *supra* fn. 4, 1.
[26]European Commission, Increasing the ambition of EU emission trading, https://ec.europa.eu/clima/eu-action/european-green-deal/delivering-european-green-deal/increasing-ambition-eu-emissions-trading_en.

1.3. US commitments

13. The United States (hereafter: US) is the world's second-largest emitter of GHG emissions.[27] Under president Biden, the country has rejoined the Paris Agreement and has committed itself in its NDC to reducing its GHG emissions by approximately fifty percent by 2030, compared to the 2005 levels.[28]

14. However, the country does not have a nationwide cap-and-trade system, similar to the EU ETS. Under the Obama administration, the House of Representatives approved the Waxman-Markey Bill, which foresaw the introduction of a federal cap-and-trade system, but the Bill never became law as it did not pass the Senate.[29] Several other bills attempted to introduce such a cap-and-trade system, but none of them were ever adopted. After failing to pass a federal cap-and-trade system, the legislative focus has shifted towards the introduction of a federal carbon tax.[30]

2. The complications of unilateral climate action

2.1. Carbon pricing

15. Under the Paris Agreement, countries eager to meet their self-defined GHG reduction targets are adopting climate policies. A particular popular policy tool in this context is carbon pricing.[31] When fossil fuels are burned, carbon dioxide is released. This negative externality, however, is not captured in the price of those fuels but is paid for by the public in the form of, for example, heatwaves and droughts. Through carbon pricing, this cost is internalised, which increases the price of fuels. Thus, the cost is shifted from the public to the polluters, which

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[27]UNEP, Emissions Gap Report 2020, xvi, figure ES.2., https://www.unep.org/emissions-gap-report-2020.

[28]US NDC, Reducing Greenhouse Gases in the United States: A 2030 Emissions Target, 1, https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/United%20States%20of%20America%20First/United%20States%20NDC%20April%2021%202021%20Final.pdf.

[29]American Clean Energy and Security Act 2009, H.R. 2452; H. VAN ASSELT and T. BREWER, "Addressing competitiveness and leakage concerns in climate policy: An analysis of border adjustment measures in het US and the EU", *Energy Policy* 2010, vol. 38, no. 1, (42) 44.

[30]L.H. GOULDER and A. SCHEIN, "Carbon Taxes v. Cap and Trade: A Critical Review", *NBER Working Paper* 2013, no. 19338, 3, https://www.nber.org/system/files/working_papers/w19338/w19338.pdf; K. HOLZER, *Carbon*, *supra* fn. 11, 51; J. WEISMAN and C. DAVENPORT, "Democrats Consider Adding Carbon Tax To Budget Bill", *New York Times* 2021, https://www.nytimes.com/2021/09/24/us/politics/carbon-tax-democrats.html.

[31]In doctrine and in this thesis, terms such as carbon pricing, carbon taxes, carbon border adjustment, high-carbon products, carbon footprint, carbon haven and carbon leakage are often used, even though the writer(s) intend(s) to refer to all GHGs that contribute to climate change and not solely to carbon dioxide (CO_2). The reason therefore, is that carbon dioxide is the largest contributor to climate change. The newly proposed European mechanism, for example, is titled 'the European Carbon Border Adjustment Mechanism', whereas the scope of the proposal also covers other GHGs, such as nitrous oxide (N_2O).

incentives them to lower emissions.[32] Hence, carbon pricing puts in place the 'polluter pays principle'. To date, around forty national and twenty-five sub-national jurisdictions have put a price on carbon.[33]

16. The two main types of carbon pricing are ETSs and carbon taxes. The most common type of ETS is the 'cap-and-trade system'.[34] A cap-and-trade system puts a cap on the total level of GHG emissions for all emitters. The cap is lowered over time which increases the cost to emit. Emitters receive emission permits that they can trade. Thus, industries with low emissions can sell their spare allowances to larger emitters. This creates a supply and demand for emission permits which establishes a market price for those emissions.[35] Carbon taxes on the other hand, as worded by the World Bank, "*directly set a price on carbon by defining a tax on GHG emissions or on the content of fossil fuels*".[36]

17. Carbon taxes provide greater price stability. Furthermore, through an adjustment of the tax rate, carbon taxes can be adjusted to changing economic conditions. However, a carbon tax, unlike an ETS, does not ensure that a certain emission target is achieved. In addition, imposing taxes is not a politically popular move.[37]

2.2. Carbon leakage and free-riding concerns

18. Although a number of countries have introduced carbon pricing policies, not all countries are contributing equally in the fight against climate change. In such a context, domestic carbon policies such as carbon pricing give rise to a range of economic, environmental and social concerns.

19. The economic concerns regard the loss of national competitiveness. As the aforementioned carbon proposals would increase costs for domestic industries, products imported from countries with no or lax carbon restrictions, so-called 'carbon havens', would gain a price advantage compared to domestic products.[38] In the short term, this could lead to a loss of market share for domestic firms. In the long term, it could give rise to the environmental problem of 'carbon leakage'. This is the phenomenon whereby domestic firms would decide to relocate their carbon-intensive production to carbon havens. This undermines domestic climate policies, as the lowering of domestic emissions is accompanied by an increase in foreign emissions. Carbon leakage does not only pose

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[32]W.R. MOOMAW and P. VERKOOIJEN, "The Future of the Paris Climate Agreement: Carbon Pricing as a Pathway to Climate Sustainability", *Fletcher F. World Aff.* 2017, vol. 41, no. 1, (69) 70-71.
[33]UNFCCC, About carbon pricing, https://unfccc.int/about-us/regional-collaboration-centres/the-ciaca-initiative/about-carbon-pricing#eq-5.
[34]K. HOLZER, *Carbon*, *supra* fn. 11, 20.
[35]W.R. MOOMAW and P. VERKOOIJEN, "The Future of the Paris Climate Agreement: Carbon Pricing as a Pathway to Climate Sustainability", *Fletcher F. World Aff.* 2017, vol. 41, no. 1, (69) 71-72.
[36]World Bank, Pricing carbon, https://www.worldbank.org/en/programs/pricing-carbon.
[37]K. HOLZER, *Carbon*, *supra* fn. 11, 21.
[38]J. PAUWELYN, "Carbon leakage measures and border tax adjustments under WTO law" in G. VAN CALSTER and D. PREVOST, *Research Handbook on Environment, Health and the WTO*, Cheltenham, Edward Elgar, 2013, 448 (hereafter: J. PAUWELYN, *Carbon leakage*).

environmental concerns but also economic and social ones as these relocations would reduce the gross domestic product and most likely lead to job losses in the country with legally binding carbon policies.[39] However, it must be noted that there is little scientific evidence that carbon leakage has indeed occurred.[40]

20. Furthermore, as clean air is a global good, countries could free ride on the efforts of others. This could not only demotivate the free-riding countries from adopting their own climate policies, but could also hamper first-movers and prevent them from taking further climate action.[41]

21. These concerns hamper climate initiatives. For example, the US refused to ratify the Kyoto Protocol because it did not require emission cuts from developing countries.[42] On the EU level, competitiveness concerns led the European Council to abandon the Commission's initial proposal for an EU tax on carbon dioxide emissions and energy.[43]

3. Addressing competitiveness concerns

3.1. International cooperation

22. The first-best solution to address the identified implications of unilateral climate initiatives, would be through a global climate agreement. A universal carbon price, for example, would eliminate competitiveness concerns and the fear of carbon leakage. However, as the choice for a bottom-up approach in the Paris Agreement illustrates, there are strong political barriers to imposing enforceable international carbon reduction commitments. As countries differ in their economic development many countries and especially the developing ones,

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[39]K. DAS, "Can Border Carbon Adjustments Be WTO-Legal?", *Manchester Journal of International Economic Law* 2011, vol. 8, no. 3, (65) 65 (hereafter: K. DAS*, WTO-legal*); S.D. LADLY, "Border carbon adjustments, WTO-law and the principle of common but differentiated responsibilities", *Int Environ Agreements* 2012, (63) 66-67 (hereafter: S.D. LADLY, *BCA, WTO-law and CBDR*).

[40]See e.g. European Parliament, Directorate-General for External Policies, Economic assessment of Carbon Leakage and Carbon Border Adjustment, 2020, https://data.europa.eu/doi/10.2861/02958; Vivid Economics and Ecofys, Carbon leakage prospects under Phase III of the EU ETS and beyond – report prepared for DECC, 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/318893/carbon_leakage_prospects_under_phase_III_eu_ets_beyond.pdf; Climate Action Network Europe, The lack of evidence for carbon leakage, 2014, http://www.old.caneurope.org/docman/emissions-trading-scheme/2333-eu-2030-briefing-on-lack-of-evidence-for-carbon-leakage-february-2014/file.

[41]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 28.

[42]S.Res.98, A resolution expressing the sense of the Senate regarding the conditions for the US becoming a signatory to any international agreement on greenhouse gas emissions under the UNFCCC, 105th Congress, 1997.

[43]Commission of the European Communities, Proposal for a Council Directive introducing a tax on carbon dioxide emission and energy, 30 June 1992, COM(92) 226 final; C. PITSCHAS, "GATT/WTO Rules for Border Tax Adjustment and the Proposed European Directive Introducing a Tax on Carbon Dioxide Emissions and Energy", *Georgia Journal of International and Comparative Law* 1995, vol. 24, no. 3, (479) 480-481.

would perceive setting a global carbon price as unfair.[44] The result is that climate action is mainly based on voluntary and limited commitments, and that global resources such as clean air have fallen victim to the tragedy of the commons.[45] Therefore, it has been asserted that unilateral action is needed.[46]

3.2. Unilateral non-trade-related measures

23. Such unilateral carbon action can take many forms. First of all, there are non-trade instruments to address competitiveness concerns.[47] ETSs, for example, can make emission reduction less costly by allowing companies who do not emit as much, to sell their spare emission allowances to companies with high abatement costs. The EU ETS also includes a non-trade-related mechanism to address competitiveness concerns. Under the first two phases of the EU ETS, most emission allowances were distributed for free to installations at high risk of carbon leakage. Hence, these installations were not obliged to cut emissions right away, but only to purchase allowances if they were to increase their emissions. Another non-trade-related option is the exclusion of certain energy-intensive industries from emission reduction policies or the granting of state aid to affected firms or sectors.[48] However, the latter option might affect trade and risks violating both competition law rules and the subsidy rules of the WTO.[49]

3.3. Unilateral trade-related measures

24. Trade policy can also be used to reduce global emissions. Countries could, for example, impose an import ban or other quantitative restrictions on the importation of carbon-intensive products.[50] These import restrictions can either regard foreign-emitted carbon or locally-emitted carbon. Foreign-emitted carbon is carbon emitted during the production of the goods in the exporting country. Locally-emitted carbon, by contrast, is carbon emitted during the consumption of the goods in the importing country.[51] Import restrictions on locally emitted carbon, however, do not address the competitive advantage enjoyed by the producer in the exporting country, due to the lack of carbon policies in this

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[44]K. HOLZER, *Carbon*, *supra* fn. 11, 46.
[45]J. BACCHUS, "Special Report: The Case for a WTO Climate Waiver", *Centre for International Governance Innovation* 2017, 4, https://www.cigionline.org/sites/default/files/documents/NEWEST%20Climate%20Waiver%20-%20Bacchus.pdf (hereafter: J. BACCHUS, *Climate Waiver*); A. DIAS, S. SEEUWS and A. NOSOWICZ, "EU Border Carbon Adjustments and the WTO: Hand in Hand Towards Tackling Climate Change", *Global Trade and Customs Journal* 2020, vol. 15, no. 1, (15) 15 (hereafter: A. DIAS, S. SEEUWS and A. NOSOWICZ, *Hand in Hand*).
[46]See e.g. J. BACCHUS, *Climate Waiver, supra* fn. 45, 4; C.E. MCLURE, "A Primer on the Legality of Border Adjustments for Carbon Prices: Through a GATT Darkly", *Carbon & Climate Law Review* 2011, vol. 5, no. 4, (456) 456 (hereafter: C.E. MCLURE, *Primer*).
[47]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 461.
[48]*Ibid*., 462; K. HOLZER, *Carbon*, *supra* fn. 11, 49.
[49]K. HOLZER, *Carbon*, *supra* fn. 11, 49.
[50]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 465; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 55-56.
[51]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 463.

country.[52] One of the key objectives of the EU CBAM is addressing competitiveness concerns. Hence, the focus of this thesis is on foreign-emitted carbon. However, whereas the forementioned import restrictions on foreign-emitted carbon do address competitiveness concerns, these measures risk violating trade rules.

4. Compatibility with trade rules

4.1. WTO and the environment

25. There is a strong link between trade and climate change. Worldwide trade has most certainly contributed to climate change. Climate change, *vice versa*, is expected to significantly influence trade.[53]

26. Environmental policies resulting in obstacles to trade risk violating WTO rules. These rules promote trade liberalisation and therefore limit the unilateral measures its members may adopt to tackle climate change. The most important WTO agreement for the purpose of this thesis is the General Agreement on Tariffs and Trade (GATT) which focuses on trade barriers.[54] It is acknowledged in a WTO working paper that "*the GATT rules were not drafted with climate change considerations in mind*".[55] This became clear when the GATT rules led the GATT Panel to declare illegal the US ban on tuna, caught in a manner that harmed dolphins.[56] This ruling sparked concerns among environmentalists about the compatibility of trade law and environmental action.[57] These concerns were addressed when the WTO was created, through the preamble of the Marrakesh Agreement[58], which establishes the organisation. The preamble explicitly recognises that trade expansion must take place *"in accordance with the objective of sustainable development and must seek to protect and preserve the environment*".[59] Thus, the treaty provisions must be interpreted in accordance with the objectives of sustainable development and environmental protection. In addition, during the first meeting of the General Council of the WTO in 1994, the Committee on Trade and Environment (hereafter: CTE) was created with the mandate to identify the relationship between trade and environmental measures, in order to

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[52]*Ibid*., 464.
[53]K. HOLZER, *Carbon*, *supra* fn. 11, 30.
[54]General Agreement on Tariffs and Trade of 30 October 1947, 55 UNTS 194 (hereafter: GATT).
[55]P. LOW, G. MARCEAU and J. REINAUD, "The Interface between the trade and climate change regimes: scoping the issues", *Staff Working Paper ERSD* 2011, no. 1, 14, https://www.wto.org/english/res_e/reser_e/ersd201101_e.pdf (hereafter: P. LOW, G. MARCEAU and J. REINHAUD, *Interface*).
[56]GATT Panel Report, *United States – Restrictions on Imports of Tuna,* DS29/R, 16 June 1994, unadopted, para. 6.1.
[57]J. PEEL, "Confusing Product with Process: A Critique of the Application of Product-Based Tests to Environmental Process Standards in the WTO", *New York University L.J.* 2002, vol. 10, no. 2, (217) 218-220.
[58]Marrakesh Agreement Establishing the WTO of 15 April 1994, 1876 UNTS 154 (hereafter: Marrakesh Agreement).
[59]*Ibid*., preamble.

promote sustainable growth.[60] Furthermore, although the WTO does not have an agreement that specifically deals with environmental protection, there are a number of provisions in the WTO agreements that address environmental concerns. Certain measures, for example, can be exempt from the GATT rules if they are "*necessary to protect human, animal or plant life or health*" or if they "*relate to the conservation of exhaustible natural resources […]*".[61]

27. Despite the promising preamble, the creation of the CTE and the WTO provisions addressing environmental concerns, the WTO remains a non-environmental organisation as its role is limited to trade liberalisation.

4.2. The importance of WTO-compatibility

28. As explained, competitiveness concerns can be addressed through both non-trade-related measures and through trade instruments. Linking environmental protection to trade could be appealing to climate forerunners, such as the EU, as the WTO system offers effective enforcement and sanctions.[62] This in strong contrast to the voluntary and unenforceable nature of commitments under the Paris Agreement. However, for the same reasons, it is important to design such trade-related environmental measures in a WTO-compatible manner.

29. The imposition of import restrictions on environmental grounds can be regarded as protectionism by certain countries. They could challenge these measures through the WTO dispute settlement system.[63] The system consists of a two-instance adjudication regime. The legal reasoning of panels can be appealed before the WTO Appellate Body (hereafter: AB). The AB has found itself in a state of paralysis since December 2019, as the Trump Administration refused to appoint new members for the Body. In response thereto, an EU-led coalition of WTO members has put in place the Multi-Party Interim Appeal Arbitration Arrangement (hereafter: MPIA) to replace the AB for the time of its paralysis.[64] The MPIA is a temporary solution and applies solely to the signatories of this agreement.[65] It only offers a partial solution for the blockage, as the US for example, which has long expressed systemic concerns with the AB, is not party to the arrangement.[66] Nevertheless, it allows for WTO dispute settlement to continue. Therefore, despite the paralysis of the AB, WTO-incompatible environmental poli-

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[60]Trade and Environment Ministerial Decision of 14 April 1994, 33 ILM 1267.
[61]Art. XX(b) and (g) GATT, *supra* fn. 54.
[62]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 3.
[63]Art. 22.2, Uruguay Round of Multilateral Trade Negotiations – Annex 2: Understanding on Rules and Procedures governing the Settlement of Disputes, *OJ. L.* 23 December 1994, 336, 1 (hereafter: DSU).
[64]Multi-Party Interim Appeal Arbitration Arrangement Pursuant to Article 25 of the DSU, 27 March 2020, https://trade.ec.europa.eu/doclib/docs/2020/march/tradoc_158685.pdf.
[65]B.M. HOEKMAN and P.C. MAVROIDIS, "To AB or Not to AB? Dispute Settlement in WTO Reform", *Journal of International Economic Law* 2020, vol. 23, no. 3, (703) 704.
[66]See e.g. United States Trade Representative: Report on the Appellate Body of the World Trade Organisation, February 2020, https://ustr.gov/sites/default/files/Report_on_the_Appellate_Body_of_the_World_Trade_Organization.pdf.

cies still risk being challenged. If a measure would be declared a WTO violation, the legislating country would receive a reasonable period to adjust the measure.[67] If parties would not be able to agree on satisfactory compensation, the claimant could receive permission to impose trade sanctions.[68]

30. Furthermore, complying with the WTO rules is of political and economic importance to the EU. The EU has the highest trade volume worldwide.[69] Violating the WTO rules could lead to political conflicts which could hamper trade liberalisation. In addition, by violating WTO obligations to achieve environmental goals, the 'climate leader' would not be setting an admirable example.[70]

31. However, as noted by Englisch and Falcao "*it is settled case law of the European Court of Justice that WTO law does not normally have direct effect in Union law and thus cannot invalidate Union legislation*".[71] Designing the EU CBAM in a WTO-compatible manner is nevertheless important as it could avoid disputes and trade sanctions, and could protect the EU's image of climate leader, even if WTO-incompatibility would not invalidate the EU CBAM.

5. Carbon border adjustment

5.1. What is border adjustment?

32. Import-border adjustment measures (hereafter: import-BAMs), are the import mirror of a domestic policy. Hence, they stand a better chance of passing the WTO-legality test than restricting measures such as bans, tariffs or quantitative restrictions, solely imposed on imports. Export-border adjustment measures (hereafter: export-BAMS), regard the non-application of domestic measures to national exports.[72]

33. These measures aim at levelling the playing field by eliminating competitive disadvantages of domestic firms. Import-BAMs do so by imposing the same costs on imported goods, as domestic production is subjected to under the domestic climate policy. These import-BAMs thus raise the price of the imported goods.

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[67]Art. 21.3. DSU, *supra* fn. 63.
[68]*Ibid*., art. 22.2.
[69]Eurostat, International trade in goods, 2022, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=International_trade_in_goods#The_three_largest_global_players_for_international_trade:_EU.2C_China_and_the_USA.
[70]J. ENGLISCH and T. FALCAO, "EU Carbon Border Adjustment and WTO Law, Part One", *Environmental Law Reporter* 2021, vol. 51, no. 10, (10857) 10858 (hereafter: J. ENGLISCH and T. FALCAO, *Part One*).
[71]ECJ 12 December 1972 (joined cases 21 to 24-72), ECLI:EU:C:1972:115, *ECR* 1972, 01219 and ECJ 23 November 1999, C-149/96, ECLI:EU:C:1999:574, *ECR* 1999, I-08396, para. 47 as referred to in J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 74, 10858.
[72]K. HOLZER, *Carbon*, *supra*. fn. 11, 63; J. PAUWELYN, *Carbon leakage*, *supra*. fn. 38, 473.

Export-BAMs do so by reimbursing the charges paid by domestic firms when they export their products.[73]

5.2. Border adjustment for carbon reduction purposes

34. Border adjustment measures can serve many purposes. They are generally used to address competitiveness concerns or raise revenue. However, recently border adjustment measures have also been used for other purposes, including environmental ones. Border adjustment has, for example, been introduced for the purpose of phasing-out ozone-depleting chemicals.[74] Nonetheless, for reasons that will be explained in the final chapter of this thesis, the legality of the use of border adjustment measures for carbon reduction purposes remains debated. Nor the trade rules themselves, nor the WTO jurisprudence explicitly deal with their legality. Most legal scholars conclude that the WTO-legality of a carbon border adjustment mechanism will depend on the exact design and implementation of the measure.

5.3. State of play

35. The momentum for carbon border adjustment measures has come. Under the bottom-up approach of the Paris Agreement, members are putting forward different climate change policies and are showing different efforts in the setting and attaining of their NDCs. This can result in carbon leakage and competitive disadvantages for climate forerunners. In this context, carbon border adjustment is seen as a tool to mitigate the impact of an asymmetrical approach to climate change.[75]

36. Carbon policies in principle cover only carbon emissions produced within the jurisdiction that operates the carbon system. For example, the EU ETS applies only to carbon emissions from production in the countries of the European Economic Area. Thus far, no country has an operational carbon border adjustment system. California is the only jurisdiction that has such a system in place for electricity imports.[76]

37. Many other jurisdictions have long been contemplating the introduction of a carbon border adjustment mechanism. Canada and Japan are exploring border adjustment mechanisms and in the US several legislative proposals for a carbon

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[73]J. BACCHUS, *Climate Waiver, supra* fn. 45, 7; K. HOLZER, Proposals on Carbon-Related Border Adjustments: Prospects for WTO Compliance", *Carbon & Climate Law Review* 2010, no. 1, (51) 54 (hereafter: K. HOLZER, *Proposals*); J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 449.
[74]K. HOLZER, *Carbon*, *supra* fn. 11, 65-66; Omnibus Budget Reconciliation Act 1990, 42 U.S.C. §1395.
[75]A. MARCU and D. DYBKA, "Status of the Border Carbon Adjustments' international developments", *ERCST* 2021, 2, https://ercst.org/wp-content/uploads/2021/08/Update-on-developments-in-the-international-jurisdictions-on-the-Border-Carbon-Adjustments.pdf.
[76]Global Warming Solutions Act of 2006, A.B. 32; European Commission, Impact Assessment Report Accompanying the document Proposal for a regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 4 March 2020, SWD(2021) 643 final (part I), 29 at fn. 53 (hereafter: Impact Assessment Report).

border adjustment mechanism have been introduced but were never implemented.[77] As already mentioned, the Commission adopted a proposal for an EU CBAM in July 2021.[78] In the same month, US Senator Chris Coons and Representative Scott Peters proposed the introduction of a border adjustment measure for US carbon-intensive imports.[79] Although the EU CBAM and the Coons-Peters bill share similar objectives, they differ in design. Whereas the EU CBAM is linked to the EU ETS, the Coons-Peters Bill proposes the imposition of an import fee on selected products, equivalent to the regulatory costs imposed on US firms by GHG emission limitations.

[77]A. PRAG, "The Climate Challenge and Trade: Would border carbon adjustments accelerate or hinder climate action?", *OECD Background Paper for the 39th Round Table on Sustainable Development* 2020, 4, https://www.oecd.org/sd-roundtable/papersandpublications/The%20Climate%20Challenge%20and%20Trade...%20background%20paper%20RTSD39.pdf (hereafter: A. PRAG, *The Climate Challenge and Trade*); European Commission, Carbon Border Adjustment mechanism: Questions and Answers, https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661 (hereafter: EU CBAM Q&A); A. MARCU and D. DYBKA, "Status of the Border Carbon Adjustments' international developments", *ERCST* 2021, https://ercst.org/wp-content/uploads/2021/08/Update-on-developments-in-the-international-jurisdictions-on-the-Border-Carbon-Adjustments.pdf; United States Trade Representative: 2021 Trade Policy Agenda and 2020 Annual Report of the President of the US on the Trade Agreements Program, 2021, 3, https://ustr.gov/sites/default/files/files/reports/2021/2021%20Trade%20Agenda/Online%20PDF%202021%20Trade%20Policy%20Agenda%20and%202020%20Annual%20Report.pdf; Canada, Supporting Canadians and Fighting COVID-19, Fall Economic Statement 2020, s 3.3.2.8, https://www.budget.gc.ca/fes-eea/2020/report-rapport/FES-EEA-eng.pdf.

[78]EU CBAM Proposal, *supra* fn. 4.

[79]Fair, Affordable, Innovative, and Resilient Transition and Competition Act 2021, S. 2378 and H.R. 4534.

Interim conclusion

38. Ever since the adoption of the Kyoto Protocol, reducing GHG emissions has become a key topic on the global political agenda. With the successor of the Kyoto Protocol, the Paris Agreement, climate action has become the product of voluntary commitments, rather than obligations. However, this did not prompt the EU to adopt a more lax approach towards climate change. The EU has not only opted to increase its emission reduction targets, it has also transposed these targets into EU law, making them legally binding. To achieve its climate targets, the EU has put in place an EU wide cap-and-trade system. The US does not have a federal cap-and-trade system, but the country has also committed itself to stringent climate targets

39. However, not all countries are contributing equally in the fight against climate change. This asymmetry puts industries in countries with carbon pricing policies at a competitive disadvantage. Furthermore, it could prompt these industries to relocate to countries that free-ride on the climate action of others, instead of adopting their own carbon policies, which could undermine and hamper domestic climate action.

40. As long as an agreement on a universal carbon price seems politically unfeasible, unilateral measures are needed to address these concerns. There are a number of ways to address climate concerns, but addressing them through trade measures can be particularly appealing to climate leaders, as the WTO system offers effective enforcement and sanctions. However, despite the preamble of the Marrakesh Agreement and the environmental provisions in the WTO agreements, designing trade-restrictive, environmental measures in a WTO-compatible manner remains a challenge. A WTO violation would not invalidate EU legislation but trade-restrictive measures could be challenged under the WTO dispute settlement system, after which trade opponents could receive permission to impose trade sanctions against the EU. In this respect, it is advantageous that the Commission has not opted for a policy measure that solely envisages imports, but for a border adjustment measure which would form the import equivalent of the EU ETS.

CHAPTER II. THE EU SYSTEM: FROM FREE ALLOWANCES TO BORDER ADJUSTMENT

1. EU CBAM Proposal

1.1. Background

41. To achieve its ambitious and legally binding climate targets discussed in the previous chapter, the EU has been exploring the option of carbon border adjustment.

42. In September 2019, the President-elect of the European Commission, Ursula von der Leyen, wrote a letter to the Commissioner for trade, Phil Hogan, in which she asked him to contribute to the design and introduction of a WTO-compatible carbon border tax.[80] Three months later, the Commission published its Communication on the European Green Deal, in which it pledged to propose a carbon border adjustment mechanism to address carbon leakage if differences in levels of ambition worldwide were to persist.[81] Subsequently, the European Parliament adopted a resolution supporting the introduction of a CBAM, provided that it would be compatible with WTO rules.[82] Finally, in July 2021, the European Commission presented its 'fit for 55 package'.[83] The package contains several proposals to update the Union's legislation in the fields of climate, energy, transport and taxation, with the purpose of achieving its fifty-five percent emission reduction target. Among these proposals is the EU CBAM proposal.

43. As required under the ordinary legislative procedure, the proposal will have to be approved by both the European Parliament and the Council of Ministers.[84] The European Parliament's Committee on the Environment, Public Health and Food Safety (hereafter: ENVI), which is the responsible committee for the EU CBAM, first submitted a range of recommendations to the European Parliament.[85] Subsequently, an agreement on the EU CBAM was reached within the Council.[86]

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[80]European Commission, Mission letter from Ursula von der Leyen, President-elect of the European Commission to Phil Hogan, Commission-designate for Trade, 10 September 2019, https://ec.europa.eu/info/sites/default/files/mission-letter-phil-hogan-2019_en.pdf.
[81]Green Deal, *supra* fn. 3, 5.
[82]European Parliament, Resolution: towards a WTO-compatible EU carbon border adjustment mechanism, 10 March 2021, 2020/2043(INI).
[83]European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions 'Fit for 55': delivering the EU's 2030 Climate Target on the way to climate neutrality, 14 July 2021, COM(2021) 550 final.
[84]Art. 294 TFEU.
[85]European Parliament, Committee on the Environment, Public Health and Food Safety, Draft Report on the proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 21 December 2021, 2021/0214(COD) (hereafter: ENVI Draft Report).
[86]Council of the European Union, Draft Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism (general approach), 15 March 2022, 2021/021(COD) (hereafter: General Approach Council).

The next step is for the European Parliament to take a position, after which it will enter into negotiations with the Council.

44. If the proposal were to be approved, as presented by the Commission, it would enter into force on the 1st of January 2023 and would become fully operational after a transitional period of three years.[87]

1.2. Rationale

45. The proposed EU CBAM is meant to serve many purposes. Most importantly, the mechanism aims to address competitiveness concerns in a world that lacks a global carbon price. As the Commission itself has indicated in its Green Deal Communication, economic concerns inspired the Commission to propose a border adjustment measure.[88] However, some countries regard carbon border adjustment as green protectionism and environmental imperialism.[89] These opponents argue, for example, that developed and developing countries should not carry the same burdens. Therefore, they find it unfair that exports of developing countries are being subjected to the regulating country's carbon pricing system.[90]

46. Naturally, the EU CBAM would also serve environmental purposes. First of all, through carbon pricing, the social cost of carbon emissions is internalised. Without the EU CBAM, the EU's climate efforts could be undermined by the relocation of carbon-intensive industries to 'carbon havens'. As explained already, the prevention of carbon leakage also implies the prevention of possible job losses that could accompany these relocations. Furthermore, an EU CBAM would incentivise countries exporting to the EU to put a price on carbon or to agree to emission cuts under an international agreement, as EU importers can deduct the carbon cost paid in their country from the cost imposed on them by the EU CBAM.[91] A final environmental purpose the EU CBAM could serve, is enabling deeper emission cuts within the EU, as domestic opposition against emission cuts would decline because of the competitiveness provision.[92]

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[87]Art. 3 and 36, §2 EU CBAM Proposal, *supra* fn. 4.
[88]Green Deal, *supra* fn. 3, 5.
[89]Konrad-Adenauer Stiftung, Expert survey on the perception of the planned EU Carbon Border Adjustment Mechanism in Asia Pacific, 2021, 3, https://www.kas.de/documents/265079/265128/EU+Carbon+Border+Adjustment+Mechanism.pdf/fed1d5a4-4424-c450-a1b9-b7dbd3616179?version=1.1&t=1615356593906; C. BAUER-BABEF, "African countries deem EU carbon border levy 'protectionist'", *EURACTIV* 2021, https://www.euractiv.com/section/energy-environment/news/developing-countries-deem-eu-carbon-border-levy-protectionist/; J. LO, "Emerging economies share 'grave concern' over EU plans for a carbon border tax", *Climate Home News* 2021, https://www.climatechangenews.com/2021/04/09/emerging-economies-share-grave-concern-eu-plans-carbon-border-tax/.
[90]K. HOLZER, *Carbon*, *supra* fn. 11, 3; A. PIRLOT, "Carbon Border Adjustment Measures: A Straightforward Multi-Purpose Climate Change Instrument?", *Journal of Environmental Law* 2021, (1) 7 (hereafter: A. PIRLOT, *CBAMs*).
[91]Art. 9, §1-2 EU CBAM Proposal, *supra* fn. 4.
[92]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 452.

47. The EU CBAM could further be used by the EU as a tool to promote its climate leadership. It could prompt other countries to follow the European lead and adopt ambitious climate commitments, in line with the Paris Agreement.[93]

48. Lastly, the introduction of the EU CBAM would generate revenues. In its impact assessment report, the Commission asserts that raising revenue is not part of the purposes pursued with the EU CBAM proposal.[94] Nonetheless, it proposes to allocate as much as seventy-five percent of the revenues generated by the mechanism to the EU's own budget.[95] These funds would mainly be used to help repay the funds raised to finance the Union's COVID-19 recovery strategy. Allocating at least a substantial part of the EU CBAM revenues to the financing of climate purposes would be more in line with the objective postulated in the Commission proposal, *i.e.* the prevention of carbon leakage, and would help strengthen the EU CBAM's credibility as a climate measure.[96] The revenues from the Californian cap-and-trade system, for example, are used to fund the state's GHG Reduction Fund and the California Climate Investments program that works towards the reduction of GHG emissions.[97] As will be explained in further detail in the final chapter of this thesis, the European Parliament's Committee on Development has already expressed its criticism regarding the proposed use of revenues of the mechanism. The Committee argues that a substantial part of the revenues generated by the mechanism should be allocated to the climate financing of developing countries.[98]

49. The purposes put forward in the proposal are of importance. The GATT Panel clarified, at least for the tax adjustment rules of the GATT, that they "*do not distinguish between taxes with different policy purposes"*.[99] Hence, whether the obligation to purchase emission allowances is imposed to generate revenues or for environmental purposes, is not relevant for determining whether the measure is eligible for border tax adjustment (hereafter: BTA).[100] Nonetheless, the emphasis on environmental purposes, rather than on the economic concern of competitive disadvantages for European firms, increases the chance of WTO-legality of the EU CBAM. As provided for in article XX of the GATT, certain climate related policy measures can be exempt from the GATT rules, provided that they are "ne*cessary to protect human, animal or plant life or health*," or if they "*relate*

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[93]EU CBAM Proposal, *supra* fn. 4, 1; Impact Assessment Report, *supra* fn. 76, 3.

[94]Impact Assessment Report, *supra* fn. 76, 15 at 4.3.

[95]European Commission, Press release - The Commission proposes the next generation of EU own resources, 22 December 2021, https://ec.europa.eu/commission/presscorner/detail/en/ip_21_7025.

[96]A. PIRLOT, *CBAMs*, *supra* fn. 90, 17-18.

[97]A.B. 398, Ch. 135, Cal. 2017.

[98]European Parliament, Committee on Development, Draft Opinion on the proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 1 February 2022, 2021/0214(COD), 3 (hereafter: Committee on Development, Draft Opinion).

[99]GATT Panel Report, *United States – Taxes on Petroleum and Certain Imported Substances*, L/6175, adopted 17 June 1987, BISD 34S/136, para. 2.4.5.

[100]J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10867.

to the conservation of exhaustible natural resources [...]".[101] In addition, from a political perspective, protecting the competitiveness of domestic firms is more likely to be considered a protectionist aim than tackling climate change.[102] The only purpose clearly put forward in the EU CBAM proposal itself, is the prevention of carbon leakage.[103] However, it is clear from the policy context that climate leadership and addressing competitiveness concerns are also important purposes of the proposed EU CBAM. Moreover, the allocation of the vast majority of the revenues generated by the mechanism to the general EU budget does not support the claim that the proposal serves first and foremost an environmental purpose.

1.3. Commission design

50. An extension of the EU ETS to imported products concretely entails that EU importers would have to buy CBAM certificates from a national authority, of which the price reflects the price that would have been paid had the goods been produced under the EU ETS.[104] Conversely, if EU importers could prove that they have already been subject to carbon pricing in the country of production, the paid price would be fully deducted.[105]

51. It must be noted that the EU CBAM is only an import-BAM. It does not foresee export rebates, *i.e.* the reimbursement of carbon costs carried by domestic firms when they export their products to countries without equivalent carbon pricing policies. Representatives from the subjected sectors have expressed their competitiveness concerns in this regard.[106] Environmental NGO's on the other hand, argue that the inclusion of export rebates would not be coherent with the EU's climate ambitions.[107] When producers of carbon-intensive goods receive a reimbursement of the cost paid for the ETS, they are not incentivised to invest in greener production.[108] Furthermore, the inclusion of export rebates would make it more difficult to design the EU CBAM in a WTO-compatible manner.[109] It is evident from the inception impact assessment that these two reasons led the Commission to exclude export rebates from its proposal. It is stated in this document that "*The inclusion of refunds of a carbon price paid in the EU would undermine the global credibility of EU's raised climate*

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[101]Art. XX(b) and (g) GATT, *supra* fn. 54.
[102]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 95.
[103]Rec. 8 EU CBAM Proposal, *supra* fn. 4.
[104]Art. 21 EU CBAM Proposal, *supra* fn. 4; EU CBAM Q&A, *supra* fn. 77, 1.
[105]Art. 9, §1-2 EU CBAM Proposal, *supra* fn. 4.
[106]N.J. KURMAYER, "EU industry shuns carbon border levy, calls for export rebates", *EURACTIV* 2021, https://www.euractiv.com/section/energy-environment/news/eu-industry-shuns-carbon-border-levy-backs-export-rebates-instead/.
[107]Joint NGO statement on the CBAM, 13 December 2021, no. 5, https://9tj4025ol53byww26jdkao0x-wpengine.netdna-ssl.com/wp-content/uploads/Joint-NGO-statement-on-CBAM-proposal.pdf.
[108]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 91.
[109]W.H. MARUYAMA, "Climate Change and the WTO: Cap and Trade versus Carbon Tax?", *Journal of World Trade* 2011, vol. 45, no. 4, (679) 718 (hereafter: W.H. MARUYAMA, *Climate change and the WTO*).

ambitions and further risk to create frictions with major trade partners due to concerns regarding compatibility with WTO obligations".[110]

52. The carbon certificates would thus cover the carbon emitted during the production of the goods. The Commission proposal does not cover indirect emissions. Direct emissions are defined in the proposal as "*emissions from the production processes of goods over which the producer has direct control*".[111] Indirect emissions, on the other hand, are related to the activities of the producer but are not under its direct control. Emissions from electricity production, for example, would initially fall outside the scope of the mechanism.[112] In principle, the embedded emissions would be determined on the basis of the actual emissions, but default values would be used where these cannot be adequately determined.[113]

53. The EU CBAM would initially only cover imported goods of certain sectors, that the Commission determined to be at high risk of carbon leakage. The types of products covered by the EU CBAM proposal include electricity, cement, iron and steel, aluminium and fertilisers. In the future, other products in these sectors and other sectors at risk of carbon leakage could be subjected to the measure.[114] The European Parliament, for example suggests the inclusion of sectors like oil refinery, paper, glass and chemicals.[115]

54. As the EU CBAM is designed as the import equivalent of the EU ETS, the price of the CBAM certificates must closely reflect the EU ETS price. The price of EU ETS allowances is determined through auctions. The EU CBAM certificates, by contrast, would not be tradable on the secondary market. The EU ETS puts a cap on the number of allowances available to producers. The same cannot be done for the CBAM certificates available to importers, as this would constitute a quantitative restriction on importation.[116] Hence, allowing the trade of these certificates would distort the prices in the European carbon market and undermine the effectiveness and climate objective of the EU CBAM.[117] Thus, the price of the CBAM certificates would be calculated based on the weekly average auction price of EU ETS allowances. However, the proposal does foresee a system whereby importers can sell a certain amount of excess certificates to the authorities.[118]

55. Furthermore, only importers authorised by a national authority would be allowed to import the in-scope goods into the EU.[119] To receive this

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[110]Impact Assessment Report, *supra* fn. 76, 42.
[111]Art. 3(15) EU CBAM Proposal, *supra* fn. 4.
[112]*Ibid*., art. 28, §3.
[113]*Ibid*., art. 7, §2.
[114]*Ibid*., 22 and rec. 30.
[115]European Parliament, Resolution: towards a WTO-compatible EU carbon border adjustment mechanism, 10 March 2021, 2020/2043(INI), no. 12.
[116]Rec. 19 EU CBAM Proposal, *supra* fn. 4.
[117]*Ibid*., rec. 22.
[118]*Ibid*.
[119]*Ibid*., art. 4.

authorisation, importers would annually have to report on the embedded emissions of the imported goods and surrender a corresponding amount of CBAM certificates for the preceding year.[120]

56. The EU CBAM would in principle cover imports of all non-EU countries. However, the imports of certain third countries that participate in the EU ETS or have an ETS linked thereto, would be excluded from the mechanism. Hence, the countries of the European Economic Area would be excluded as they participate in the EU ETS, as well as Switzerland because its ETS is linked to the Union's.[121]

57. The EU CBAM would be phased in gradually. As mentioned, the system would initially only apply to a selected number of goods. From 2023 on, importers would have to start reporting on the embedded emissions of their goods.[122] However, they would only need to start paying a financial adjustment in 2026, when the EU CBAM becomes fully operational.[123]

58. Sanctioning non-compliance with the EU CBAM is left to the Member States, who would have to impose effective, proportionate and dissuasive sanctions. More specifically, they would have to apply penalties identical to those imposed for infringements of the EU ETS, which may be accompanied by administrative or criminal sanctions in accordance with the national legislation of the respective countries.[124]

1.4. Parliament's recommendations

59. The Committee responsible for the EU CBAM is the ENVI Committee. In December 2021, the rapporteur of the Committee, Mohammed Chahim, made available its recommendations to the European Parliament, following its first reading of the Commission's proposal. It is mentioned in the explanatory statement of the draft report that the rapporteur welcomes the overall design of the mechanism as set out in the Commission proposal and considers it a solid starting point for the legislative process.[125] Nevertheless, the report proposes a range of substantial amendments to the Commission's text. Although the focus of this thesis is on the Commission's proposal, it is important to briefly give an overview of some of the most important proposed amendments.

60. First of all, the draft report proposes to broaden the scope of the EU CBAM, as to include the organic chemicals sector.[126] It also proposes, to extend the EU CBAM to downstream products and indirect emissions in all sectors covered by the mechanism.[127]. The Committee further proposes a shorter transition period than the one foreseen in the Commission's proposal and a speedier phase out of

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[120] *Ibid*., art. 5 and 6.
[121] *Ibid*., 27; EU CBAM Q&A, *supra* fn. 77, 3.
[122] *Ibid*., art. 32 and 36, §2.
[123] *Ibid*., art. 36, §3, d).
[124] *Ibid*., rec. 24 and art. 26, §1 and §5.
[125] ENVI Draft Report, *supra* fn. 85, 80.
[126] *Ibid*., amend. 13.
[127] *Ibid*., amend. 15 and 100.

free allowances.[128] Another important amendment regards the introduction of a central CBAM authority.[129] It is argued that a decentralised system with 27 national authorities could lead to uneven implementation of the regulation and therefore could lead to forum shopping.[130] A central CBAM authority would be a more efficient, transparent and cost-effective instrument, according to the rapporteur.[131] Finally, the report suggests providing financial support to decarbonisation projects in least developed countries (hereafter: LDCs). Such financial support, in the rapporteur's view, should be at least equivalent in financial value to the revenues generated by the sale of CBAM certificates.[132]

61. One of the committees for opinion, of particular importance in the context of the WTO-compatibility of the mechanism, is the Committee on International Trade (hereafter: INTA). Unlike the ENVI Committee's report, the draft opinion of the INTA Committee's rapporteur does not foresee many substantial changes to the Commission's text.[133] The most notable proposed amendment regards the usage of revenues from the sale of CBAM certificates. The rapporteur suggests, in line with the ENVI Committee's report, to use these revenues, *inter alia*, to tackle climate change in LDCs.[134] However, the Committee has rejected the rapporteur's draft opinion.[135]

62. The final report of the European Parliament is not yet available, but these reports already give a good indication of the Parliament's position. Most importantly, the ENVI Committee's draft report suggests a more rapid introduction of the mechanism and a significant extension of its scope.

1.5. Council agreement

63. The Council adopted its 'general approach' to the Commission's proposal in March 2022.[136] The Council's agreement is mostly in line with the preliminary position of the European Parliament. With regard to CBAM governance, the Council, as rapporteur Mohammed Chahim, opted for a system of greater centralisation. The agreement replaces the national registries with an EU-level registry for im-

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[128] *Ibid*., amend. 105.
[129] *Ibid*., amend. 51.
[130] *Ibid*., amend. 82.
[131] *Ibid*., 80.
[132] *Ibid*., amend. 88.
[133] European Parliament, Committee on International Trade and Committee on Environment, Public Health and Food Safety, Draft Opinion on the proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 22 November 2021, 2021/0214(COD).
[134] *Ibid*., amend. 23.
[135] Voting results on the adoption of the draft opinion of the Committee on International Trade on the proposal for a regulation establishing a CBAM (2021/0214(COD) – Rapporteur Karin Karlsbro), 28 February 2022, https://www.europarl.europa.eu/cmsdata/245360/INTA%20voting%20session%2028%20Feb%20(final%20votes)%20-%20for%20website.pdf.
[136] General Approach Council, *supra* fn. 86.

porters.[137] In addition, the Council's agreement includes a minimum threshold which exempts import shipments with a value of less than 150 euros from the EU CBAM obligations.[138] As argued by the Council, this minimum threshold would significantly reduce administrative complexity.[139]

64. However, a number of important issues such as the use of revenues of the mechanism, the potential for export rebates and the phasing-out of free allowances, a concept that will be explained in the following section of this thesis, were not addressed and thus will still need to be reviewed by the Council at a later stage. Hence, further changes to the Commission's proposal can still be expected.

65. It can be concluded that the Council agreement is an important step towards the implementation of the mechanism, but a number of controversial topics will still need to be addressed.

2. The precursory system: free allowances

66. As explained in the first chapter, border adjustment is not the only option for addressing competitiveness concerns resulting from domestic carbon pricing policies. Some countries with carbon tax measures have for example granted tax exemptions to energy-intensive industries.[140] In the EU, competitiveness concerns were already partially addressed under the EU ETS. A system of free allocation of emission allowances to sectors considered at risk of carbon leakage has been used to soften the EU's carbon pricing rules.

67. However, border adjustment has been proposed as an alternative for free allowances, as the latter system has demonstrated its ineffectiveness. First of all, allocating free allowances does not incentivise investment in environmentally friendly production, hence the system did not lead to progress in energy transition.[141] Furthermore, free allowances are tantamount to WTO-illegal subsidies.[142] Border adjustment, by contrast, is an acceptable practice under the WTO rules and unlike free allowances and tax exemptions, it does not fully mute the carbon price signal.[143] However, economic research shows that replacing free

[137] *Ibid.*, art. 14.
[138] *Ibid.*, art. 2, a).
[139] *Ibid.*, rec. 37, a).
[140] A. PIRLOT, *CBAMs*, *supra* fn. 90, 5.
[141] EU CBAM Q&A, *supra* fn. 77, 2; P. LAMY, G. PONS and P. LETURCQ, "A European Border Carbon Adjustment Proposal", *RELP* 2020, vol. 10, no. 1, (21) 26.
[142] P. LAMY, G. PONS and P. LETURCQ, "A European Border Carbon Adjustment Proposal", *RELP* 2020, vol. 10, no. 1, (21) 28; W.H. MARUYAMA, *Climate change and the WTO, supra* fn. 109, 718.
[143] R. ISMER and M. HAUSSNER, "Inclusion of consumption into the EU ETS: The Legal Basis under European Union Law", *RECIEL* 2016, vol. 25, no. 1, (69) 70; S. MONJON and P. QUIRION, "A border adjustment for the EU ETS: Reconciling WTO rules and capacity to tackle carbon leakage", *Climate Policy* 2011, vol. 11, no. 5, (1212) 1212; A. PIRLOT, *CBAMs*, *supra* fn. 90, 5-6.

allowances with only an import-BAM, could weaken the competitiveness of European producers in foreign markets.[144]

68. The EU ETS was introduced in 2005 and is currently in its fourth phase. During the first two phases of the EU ETS, almost all allowances were allocated for free. From phase three onwards, which started in 2013, auctioning has become the default method for allowance allocation.[145] The EU CBAM would replace the system of free allowances. Free allowances would be gradually phased out from 2026 onwards, the year that the EU CBAM becomes fully operational, and be completely phased out by 2035.[146] As explained however, the European Parliament is pushing for a speedier phase-out of free allowances.[147] To avoid violating WTO rules, it is important to ensure the equal treatment of importers and EU producers.[148] For this reason, until 2035, the EU CBAM would apply solely to the extent to which the emissions do not benefit from free allowances under the EU ETS.[149]

[144]S. EVANS, M.A. MAHLING, R.A. RITZ and P. SAMMON, "Border carbon adjustments and industrial competitiveness in a European Green Deal", *Climate Policy* 2021, vol. 21, no. 3, (307) 307.

[145]European Commission, Development of EU ETS (2005-2020), https://ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets/development-eu-ets-2005-2020_nl.

[146]EU CBAM Q&A, *supra* fn. 77.

[147]ENVI Draft Report, *supra* fn. 85, amend. 15.

[148]Art. III GATT, *supra* fn. 54.

[149]Art. 31, §1 EU CBAM Proposal, *supra* fn. 4.

Interim conclusion

69. In light of the binding EU climate targets and the implications resulting from the EU's stringent climate policy, the European Commission has proposed an EU CBAM. Although the concrete design of the mechanism is still in flux, it is clear that there is a political will for implementation.

70. The EU CBAM would mitigate the competitiveness concerns of European firms and subsequently allow deeper emission cuts in the Union, prevent carbon leakage, help the EU to promote its climate leadership, incentivise other countries to adopt similar policies and generate revenues for the EU budget. The purpose put forward in the proposal is the prevention of carbon leakage, which is conducive for its WTO-legality, as this could enable an appeal to the environmental exceptions in article XX GATT.

71. Under the EU CBAM, EU importers of the subjected sectors would have to report on the GHGs emitted during the production of the imported goods and surrender a corresponding number of CBAM certificates. These certificates can only be purchased from the national authorities of whom the authorisation is required to allow the import of the selected goods into the Union.

72. Competitiveness concerns are currently addressed through the allocation of free emission allowances to industries in sectors at high risk of carbon leakage. The EU CBAM has been proposed as a replacement for the current system, as free allowances do not incentivise investments in greener production and could be considered WTO-illegal subsidies. The Commission proposes to gradually phase-out the free allowances and simultaneously phase in the EU CBAM system to avoid the unequal treatment of importing and domestic firms.

CHAPTER III. THE QUALIFICATION QUESTION

1. Introduction

73. This thesis aims to determine how the EU CBAM should be qualified under the WTO framework. The focus of this thesis will be exclusively on import-BAMs, as the EU CBAM proposal does not foresee export rebates.

74. With regard to the form of border adjustment measures, a division can be made between border tax adjustment measures (hereafter: BTAMs) based on a domestic tax or another price-based measure and border adjustment measures, *sensu stricto*, (hereafter: BAMs) based on a domestic regulation.[150] Although both types of competitiveness provisions can serve the same purposes, their WTO-legality assessment might differ. Therefore, it is important to determine whether the EU CBAM qualifies as a BTAM or as a BAM.

1.1. BTAM of a domestic price-based measure

75. A BTAM takes the form of a price-based measure, such as a tax, charge or duty, equivalent to the domestically imposed duty, charge or tax.[151] BTAMs reflect the destination principle by imposing a tax or other charge on imported products and exempting exports from taxation. Under the destination principle, taxes are paid where products are consumed and not where they are produced. It is a universal practice that consumption taxes, such as VAT, are applied according to the destination principle.[152] The EU CBAM cost, however, is related to production, not consumption and the proposal does not foresee export rebates.

76. There are already some examples of BTAMs with environmental purposes. The *US Superfund Act*, for example, introduced BTA for a domestic excise tax on certain chemicals.[153] The measure was challenged in the GATT dispute settlement system, but the Panel found that BTAMs could be imposed on

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[150]J. DE CENDRA, "Can Emission Trading Schemes Be Coupled with Border Tax Adjustments? An Analysis vis-à-vis WTO Law", *RECIEL* 2006, vol. 15, no. 2, (131) 135 (hereafter: J. DE CENDRA, *Emission Trading Schemes*); K. HOLZER, *Proposals, supra* fn. 73, 52; K. HOLZER, *Carbon*, *supra* fn. 11, 36; S.D. LADLY, *BCA, WTO-law and CBDR, supra* fn. 39, 64-67; P. LOW, G. MARCEAU and J. REINHAUD, *Interface*, *supra* fn. 55, 488; J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 474; A. PRAG, *The Climate Challenge and Trade*, *supra* fn. 77, 10.

[151]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 474; J. PAUWELYN, "U.S. Federal Climate Policy and Competitiveness Concerns: The Limits and Options of International Trade Law", *Nicholas Institute for Environmental Solutions Working Paper* 2007, no. 07/02, 17, https://nicholasinstitute.duke.edu/sites/default/files/publications/u.s.-federal-climate-policy-and-competitiveness-concerns-the-limits-and-options-of-international-trade-law-paper.pdf (hereafter: J. PAUWELYN, *US Federal Climate Policy*).

[152]K. HOLZER, *Carbon*, *supra* fn. 11, 64.

[153]Comprehensive Environmental Response, Compensation, and Liability Act 1980, 42 U.S.C. §9601 et seq.

chemical inputs used in production processes.[154] However, in contrast to emissions, the chemical inputs were physically present in the final product. Whether BTA is also possible with respect to GHG emissions, will be further analysed in the final chapter of this thesis.

1.2. BAM of a domestic regulation

77. Domestic carbon policies however, can also take the form of a regulation. For example, the domestic measure could be a maximum carbon intensity standard or a carbon intensity labelling requirement.[155] In this case, the competitiveness provision takes the form of a BAM.

2. EU ETS dependence

78. The domestic carbon policy, of which the EU CBAM is the import mirror, is the EU ETS. Whether the EU CBAM qualifies as a BTAM or a BAM is thus dependent on the qualification of the EU ETS. More specifically, the qualification of the obligation to surrender emission allowances will be determinant. If this cap-and-trade system were to qualify as a tax or a charge, that would mean that the EU CBAM would most likely qualify as a BTAM. If the EU ETS on the contrary, would qualify as a domestic regulation, that would render the EU CBAM a BAM. Hence, the qualification of the EU ETS is crucial, as it determines how the WTO-legality assessment of the EU CBAM must be carried out.[156]

79. Furthermore, the compatibility of the EU CBAM as a whole, will depend to a large extent on the compatibility of the EU ETS with these rules.[157] The EU CBAM depends for example, on the EU ETS for emission calculation, price calculation and penalties.[158]

80. It is unclear, at least at the WTO level, whether the obligation to hold emission allowances pursuant to the EU ETS cap-and-trade system, constitutes a carbon tax or a carbon regulation.

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[154]GATT Panel Report, *United States – Taxes on Petroleum and Certain Imported Substances*, L/6175, adopted 17 June 1987, BISD 34S/136, para. 2.1 (hereafter: *US Superfund*); K. HOLZER, *Carbon*, *supra* fn. 11, 65-66.

[155]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 481.

[156]C.E. MCLURE, "The GATT-Legality of Border Adjustments for Carbon Taxes and the Cost of Emission Permits: A Riddle, Wrapped in a Mystery, inside an Enigma", *Florida Tax Rev* 2011, vol. 11, no. 4, (221) 283 (hereafter; C.E. MCLURE, *GATT-Legality*).

[157]K. HOLZER, *Carbon*, *supra* fn. 11, 102; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 111-112.

[158]Art. 21, §1, 26, §1 and 7 EU CBAM Proposal, *supra* fn. 4.

3. A qualification quest

3.1. Learning from the EU qualification

3.1.1. What's in a name?

81. On the EU level, both the EU ETS and the EU CBAM are not considered to be taxes. The EU CBAM proposal includes no references to GATT provisions, from which we can derive the propound qualification. The proposal asserts to be designed in a WTO-compatible manner but only addresses two WTO obligations, which, coincidence or not, happen to apply to both types of measures.[159] These obligations will be discussed in the following chapter. However, the fact that the Commission has opted for the terms 'border adjustment', rather than for the terms 'border tax adjustment', is already an indication that the Commission prefers not to impose 'taxes'.

3.1.2. Legal basis

82. Moreover, the legal basis of both the EU ETS and the EU CBAM proposal is article 192, §1 TFEU, which mandates the Union to adopt environmental legislation.[160] If the EU CBAM were to have been a tax proposal, unanimity would have been required for its adoption. Environmental legislation, by contrast, can be adopted through the ordinary legislative procedure which only requires a qualified majority.[161]

3.1.3. Case law

83. In a case regarding the inclusion of aviation activities in the EU ETS (hereafter: the *ATAA* case), the European Court of Justice (hereafter: ECJ) concluded that the EU ETS imposed requirement to buy emission allowances is not a tax on fuel consumption.[162] First of all, a tax has a fixed rate whereas the cost of emission allowances is based on supply and demand.[163] Secondly, the financial obligation was not primarily imposed to generate revenue for the public authorities.[164] With respect to this second argument, Ulrike Will argues that the principal aim of taxes is not always to generate revenue for the government. Tobacco and alcohol taxes, for example, seek to influence citizens' behaviour.[165] Nonetheless, the Court found that the emission allowance requirement was a market-based measure and not a tax. This case, however, dealt with provisions of the Chicago Convention[166] and the EU-US Open Skies Agreement[167], and not with provisions of the GATT.

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[159]EU CBAM Proposal, *supra* fn. 4, 3 and 12.
[160]*Ibid.,* 1.
[161]Art. 294 TFEU.
[162]ECJ 21 December 2011, C-366/10, ECLI:EU:C:2011:864, *ATAA*, para 145.
[163]*Ibid*., para 142.
[164]*Ibid*., para. 143.
[165]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 119.
[166]Convention on International Civil Aviation of 7 December 1944, 15 UNTS 295.
[167]Air Transport Agreement of 30 April 2007, *OJ. L.* 25 May 2007, 134, 4.

3.1.4. Importance

84. The fact that nor the EU ETS, nor the EU CBAM, are internally considered to be taxes, does not prevent these systems from qualifying as taxes under the WTO legal order. If the economic impact of a measure is similar to that of a tax per unit of product, it could be considered a tax under the international legal order, even if the measure is domestically not considered to be a tax.[168]

85. However, the fact that the internal qualification of a measure is not decisive for its qualification under the WTO legal order, does not entail that the national qualification will be cast aside when deciding upon its WTO-qualification. European and national case law can serve as important sources of inspiration in the course of WTO dispute settlement proceedings. Article 3.2. of the Dispute Settlement Understanding stipulates that the provisions of the WTO agreements must be clarified "*in accordance with customary rules of public international law*."[169] The AB has stated in its first report that this provision "*reflects a measure of recognition that the General Agreement is not to be read in clinical isolation from public international law."*[170] Furthermore, the WTO agreements, according to the AB, must be interpreted and applied in light of *"the real world where people live, work and die".*[171] Although European and national (case) law do not form part of the 'public international legal order', they certainly form part of the 'real world'. These statements are furthermore important as they reflect the broad competences that the members of the AB have attributed themselves. These members do not consider the WTO to be a self-contained legal order.[172] Therefore, they consider themselves competent to take account of contemporary evolutions and thus, in a certain way they consider themselves competent to pre-empt global legislative developments. This judicial activism or '*gouvernement des juges'*, employed by the members of the AB, who are not even judges, explains the potential importance of non-WTO norms and cases with regard to the WTO-qualification of a measure.[173]

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[168]A. DIAS, S. SEEUWS and A. NOSOWICZ, *Hand in Hand*, *supra* fn. 45, 16.
[169]Art. 3.2. DSU, *supra* fn. 63.
[170]Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline*, 29 April 1996, WT/DS2/AB/R, adopted 20 May 1996, 17 (hereafter: *US Gasoline*).
[171]Appellate Body Report, *EC - Measures Concerning Meat and Meat Products (Hormones),* 16 January 1998, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, para. 187.
[172]J. BACCHUS, "Not in clinical isolation" in G. MARCEAU, *A History of Law and Lawyers in the GATT/WTO: The Developments of the Rule of Law in the Multilateral Trading System,* Cambridge, CUP, 2015, 509-510; G. SACERDOTI, "WTO law and the 'Fragmentation' of International Law: Specificity, integration, conflicts" in M.E. JANOW, V. DONALDSON and A. YANOVICH, *The WTO: Governance, Dispute Settlement & Developing Countries*, Huntington, Juris Publishing, 2008, 597.
[173]J.P. KELLY, "Judicial Activism at the World Trade Organisational: Development Principles of Self-Restraint", *Northwestern Journal of International Law & Business* 2002, vol. 22, no. 3, (353) 356.

3.2. Learning from the Californian cap-and-trade system

3.2.1. Introduction

86. Since the WTO-qualification cannot be conclusively derived from the legal basis of the proposal, nor from the ECJ case law, it might be interesting to analyse the Californian cap-and-trade system, which includes electricity imports.

87. After the federal government under the leadership of George Bush had failed to enact a nationwide carbon pricing policy, California developed its own climate approach.[174] In 2006, Governor Arnold Schwarzenegger signed the Global Warming Solution Act.[175] This bill delegated to the California Air Resources Board (hereafter: CARB) the responsibility to design and implement rules and regulations to reduce the state's GHG emissions. The regulations subsequently adopted by the CARB introduced the Californian cap-and-trade system. The cap established by the program covers approximately eighty percent of the state's GHG emissions. As is the case for the EU ETS allowances, allowances are tradable. A number of allowances are distributed for free, the proportion thereof is reduced over time.[176] As mentioned, the Californian system also includes electricity imports.

88. Unlike the EU CBAM, the Californian system has not generated a lot of concerns about potential trade impacts, because California mostly imports electricity from neighbouring states.[177]

3.2.2. Case law

89. There has been case law, however, on the internal qualification of the measure. The Sacramento Superior Court had to rule on the qualification of the system in the *Morning Star* case.[178] The plaintiffs in this case argued that the charges for the allowances constituted illegal taxes, because the law authorising the cap-and-trade program was not passed with the required two-third majority for the enactment of new taxes.[179] The Superior Court held that the two-third majority was not required since the charges for allowances, although they have some traditional attributes of taxes, were not taxes but the byproduct of the implementation of a regulatory program.[180] The Court gave multiple arguments

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[174]G. BANG, D.G. VICTOR and S. ANDRESEN, "California's Cap-and-Trade System: Diffusion and Lessons", *Global Environmental Politics* 2017, vol. 17, no. 3, (12) 12.
[175]Global Warming Solutions Act of 2006, A.B. 32.
[176]CARB, FAQ Cap-and-Trade Program, https://ww2.arb.ca.gov/resources/documents/faq-cap-and-trade-program#ftn22.
[177]A. PRAG, *The Climate Challenge and Trade*, *supra* fn. 77, 14; M. MEHLING, H. VAN ASSELT, K. DAS, S. DOEGE and C. VERKUIJL, "Designing Border Carbon Adjustments for Enhanced Climate Action", *Climate Strategies* 2017, 35, https://climatestrategies.org/wp-content/uploads/2017/12/CS_report-Dec-2017-4.pdf.
[178]Sacramento Superior Court (joint ruling) (US) 28 August 2013, No. 34-2012-800001313, *Morning Star Packing Co., et al. v. CARB*.
[179]*Ibid*., 5-6.
[180]*Ibid*., 21.

for this qualification. Firstly, it stated that the essence of a tax is to raise revenue, whereas the allowance requirement mainly serves regulatory purposes. Secondly, those who purchase allowances acquire a valuable benefit that is not enjoyed by others. The charges for allowances further differ from taxes, according to the Court, because purchasing them is not compulsory and because the proceeds of the system will not be used for the general support of the government, but to further regulatory purposes. [181] The California Court of Appeal affirmed that the charges for allowances do not constitute taxes.[182]

90. The Court of Appeal considered two hallmarks of a tax: (i) it is compulsory, and (ii) the taxpayer receives nothing of particular value in return for the payment.[183] The plaintiffs argued that the purchase of allowances was compulsory since businesses would have to obtain a significant number of emission allowances to continue operating in California.[184] Justice Harry E. Hull agreed with this view in his dissent opinion.[185] According to the majority of the judges however, "*the purchase of allowances is a voluntary decision driven by business judgements as to whether it is more beneficial to the company to make the purchase than to reduce emissions*".[186] They further argue that "*no entity has a vested right to pollute"*.[187] With respect to the second hallmark, the majority found that "*allowances are valuable, tradable commodities, conferring on the holder the privilege to pollute*".[188] Justice Hull also disagreed with the majority on the second hallmark. He was not convinced that the program conveys property rights as this would entail that the state 'owns' rights to pollute which it can sell to others. He does not find this construction of reasoning persuasive.[189] The dissent further argues that the regulation adopted by the CARB, explicitly states that allowances do not constitute a property right.[190] Finally, he notes that the authorisation to emit can be limited or terminated by the state at any time.[191]

91 The Appellate Court ruling was appealed to the California Supreme Court, which declined to review the lower court's decision.[192] Thus, the emission allowance requirement of the Californian cap-and-trade system does not qualify as a tax but as a regulatory scheme under the US legal order.

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[181] *Ibid*., 16.
[182] Sacramento Appellate Court (US) 6 April 2017, No. 34-2012-800001313, *Morning Star Packing Co., et al. v. CARB*, 4.
[183] *Ibid*., 5.
[184] *Ibid*., 39-40.
[185] *Ibid*., H.E. HULL, dissenting, 8-9.
[186] *Ibid*., 5.
[187] *Ibid*.
[188] *Ibid*.
[189] *Ibid*., H.E. HULL, dissenting, 9.
[190] *Ibid*., H.E. HULL, dissenting, 9-10.
[191] *Ibid*., H.E. HULL, dissenting, 11.
[192] California Supreme Court (US), Order Denying Petition for Review, 29 June 2017, *Morning Star Packing Co., et al. v. CARB*.

3.2.3. Importance

92. As explained with respect to the EU qualification of the EU ETS, the internal qualification of a measure is not decisive for its qualification under the WTO legal order but could be taken into account by the AB. As for the EU ETS, it is clear that the Californian cap-and-trade system is internally not considered to be a tax, but the WTO-qualification of the system remains uncertain.

93. A comparative study of the EU ETS and the Californian cap-and-trade system demonstrates that both systems have many similarities. The distribution through a combination of auctioning and free allocation and the sale of EU ETS allowances on the secondary market are the most important ones with respect to the qualification of the system.[193] However, under the EU CBAM, free allowances would be phased out and trade in CBAM certificates would be limited.[194] This demonstrates that carbon border adjustment systems can differ. Hence, even if there would have been extensive literature on the WTO-qualification of the Californian system, this would not necessarily mean that the qualification propound in this literature, could be adopted *mutatis mutandis* for the EU CBAM.

3.3. Learning from doctrine

94. The definition of a tax or a charge cannot be found in the WTO agreements, nor in the analytical index which guides the interpretation and application of these agreements. There is no GATT/WTO jurisprudence on carbon border adjustment measures either. However, the 1970 Working Party report on BTAs, as well as some subsequent WTO reports, refer to the OECD definition.[195] As noted by Ulrike Will, "*the WTO working parties do not have the legitimacy to define legal terms of the GATT in a legally binding manner but the report is part of the subsequent practice of GATT interpretation and was cited in GATT and WTO disputes"*.[196] The OECD definition describes taxes as "*compulsory, unrequited payments to general government*".[197] OECD guidance further clarifies that "*taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments*."[198] Therefore, the OECD definition is often translated in literature to "*a compulsory payment for which taxpayers receive nothing identifiable in return*".[199] The hallmarks used by

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[193]E. WOERDMAN and M. KOTZAMPASAKIS, "Linking the EU ETS with California's Cap-and-Trade Program: A law and economics assessment", *CEREM* 2020, vol. 4, no. 4, (9) 13.
[194]Rec. 11 and 22 EU CBAM Proposal, *supra* fn. 4
[195]GATT Working Party Report, Border Tax Adjustments, L/3464, adopted 2 December 1970, 4 (hereafter: Working Party Report on BTA).
[196]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 118.
[197]OECD, Report of the Negotiating Group on the Multilateral Agreement on Investment (MAI) - Expert Group No. 3 on Treatment of Tax Issues in the MAI, DAFE/MAI/EG2/A(96)9, 1996, 14 (hereafter: OECD, Treatment of Tax Issues).
[198]OECD, Note of the Definition of Taxes by the Chairman of the Negotiating Group on the Multilateral Agreement on Investment (MAI), DAFE/MAI/EG2/A(96)3, 1996, 3 (hereafter: OECD, Note on the Definition of Taxes).
[199]See e.g. M. GENASCI, "Border Tax Adjustments and Emission Trading: The Implications of International Trade Law for Policy Design", *CCLR* 2008, vol. 2, no. 1, (33) 38; K. HOLZER, *Carbon*,

the Californian Court of Appeal thus stem from the OECD definition. It is clear that the holding of emissions allowances by the companies subject to the EU ETS is 'compulsory', as sanctions are imposed in case of non-compliance, but there is no consensus between legal scholars on whether or not the obligation to surrender those allowances qualifies as an 'unrequited' payment to general government.

3.3.1. Price-based measure

95. Many legal scholars, among which Joost Pauwelyn and Javier De Cendra, argue that the surrendering of emission allowances is a payment for which nothing identifiable is given in return and thus qualifies as a tax.[200] Some of these authors even argue that this is also the case when emission allowances are distributed for free. They argue that compliance with the EU ETS imposes certain indirect costs on companies such as compliance costs, as well as an opportunity cost: if a company would cut its emission, it could sell its spare allowances on the market.[201] Thus, despite the absence of a direct payment in the case of free allowances, the EU ETS does place a financial burden on the subjected companies.[202] The Commission's proposal limits the possibilities to trade CBAM certificates on the market. However, companies can request the authorities to re-purchase their excess CBAM certificates.[203] Kasturi Das is also of the view that the obligation qualifies as a tax, even when allowances are distributed for free. She quotes the Black Law Dictionary definition of a tax, which states that "*a tax must not necessarily be payable in money*"[204], to support her argument that a financial burden imposed in the form of an 'opportunity cost', can qualify as a tax.[205]

96. Others, such as Javier De Cendra, Joachim Englisch and Tatiana Falcao, by contrast, only consider the obligation to acquire emission allowances to be a price-based measure when allowances are not distributed for free.[206] The

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supra fn. 11, 104; R. ISMER and K. NEUHOFF, "Border Tax Adjustments: A Feasible way to Address Nonparticipation in Emission Trading", *CMI Working Paper* 2004, no. 36, 11, https://www.repository.cam.ac.uk/bitstream/handle/1810/388/EP36.pdf?sequence=1&isAllowed=y (hereafter: R. ISMER and K. NEUHOFF, *BTA: A Feasible way*); J. PAUWELYN, *US Federal Climate Policy, supra* fn. 153, 21; R. QUICK, "Carbon Border Adjustment: A dissenting view on its alleged GATT-compatibility", *ZEuS* 2020, vol. 4, (549) 564 (hereafter: R. QUICK, *dissenting view*).

[200]J. DE CENDRA, *Emission Trading Schemes, supra* fn. 150, 131; R. ISMER and K. NEUHOFF, *BTA: A Feasible way, supra* fn. 199, 11; C.E. MCLURE, *Primer, supra* fn. 46, 464; J. PAUWELYN, *US Federal Climate Policy, supra* fn. 151, 22; K. DAS, *WTO-legal*, *supra* fn. 39, 70.

[201]K. HOLZER, *Proposals, supra* fn. 73, 58; J. PAUWELYN, *US Federal Climate Policy, supra* fn. 151, 22.

[202]K. HOLZER, *Carbon*, *supra* fn. 11, 70.

[203]Rec. 22 and art. 23 EU CBAM Proposal, *supra* fn. 4.

[204]B.A. GARNER and H.C. BLACK, *Black's Law Dictionary (9th ed.),* Chicago, West Publishing House, 2009.

[205]K. DAS, *WTO-legal*, *supra* fn. 39, 71.

[206]J. DE CENDRA, *Emission Trading Schemes, supra* fn. 150, 135; J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10866; C.E. MCLURE, *Primer, supra* fn. 46, 464; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 119.

argumentation of Englisch and Falcao is not built on the definition of a tax, as they consider the obligation to qualify as a charge, rather than a tax. To support this claim, they refer to the *Argentina-Hides and Leather* case, in which the Panel interpreted the term 'charge' as covering "*a pecuniary burden and liability to pay money laid on a person*".[207] The obligation to purchase emission allowances imposes a financial burden and should thus, in their view, be regarded to constitute a charge.[208] However, the case dealt with the interpretation of the term charge in the context of article III:2 GATT. As will be further explained in the chapter on the legality assessment of carbon border measures, this is not the provision that deals with BTA. Moreover, the article on BTA refers to "*a charge equivalent to an internal tax*".[209] Hence, according to the wording of this article, for the EU CBAM to be considered a charge, the EU ETS would have to qualify as a tax, hence would have to meet de OECD definition. Nonetheless, they give some convincing arguments to support their view that the BTA provision should be interpreted as to apply to all border charges. First of all, as explained in the following chapter, the BTA provision is an exception to article II:1(b), which prohibits the imposition of charges and other duties, in excess of the maximum tariffs laid down in the schedules of concessions. They argue that this article seems to apply irrespective of the nature of the imposed pecuniary burden.[210] Their second argument regards the cross-reference in the BTA provision, to article III:2 GATT. Although the text of the BTA provision refers only to "*[an] internal tax imposed consistently with the provisions of article III:2*"[211], the Ad Note to article III clarifies the extent of this cross-reference and refers to the entire article III:2.[212] Finally, they assert that the preparatory work of the provision, as well as an AB report, confirm their view. With regard to the preparatory work, they derive from the fact that the Legal Drafting Committee referred uniformly to 'duties' for which border adjustment could be made, that the provision's drafters did not perceive the need to differentiate between different types of charges with regard to their eligibility for border adjustment.[213]

97. Border adjustment is thus possible for unrequited taxes and possibly also for charges, but the same is not true for custom fees. Whereas a tax is a payment to the government for which taxpayers receive nothing identifiable in return, a charge or fee is a payment for a service rendered by the government.[214] Charges or fees are thus by definition 'requited'. The difference between custom fees and other charges is that the former are rendered specifically in return for services in connection to importation or exportation, such as certificates, licensing or

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[207]WTO Panel Report, Arg*entina – Measures Affecting the Export of Bovine Hides and the Imports of Finished Leather*, 19 December 2000, WT/DS155/R, adopted 16 February 2001, para. 11.143.
[208]J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10866
[209]Art. II:2, a) GATT, *supra* fn. 54.
[210]J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10866.
[211]Art. II:2, a) GATT, *supra* fn. 54.
[212]J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10866-10867.
[213]Appellate Body Report, *India-Additional and Extra-Additional Duties on Imports From the United States*, 30 October 2008, WT/DS/360/AB/R, adopted 17 November 2008, para 215 (hereafter: *India – Additional Import Duties*); J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10867.
[214]OECD, Note on the Definition of Taxes*, supra* fn. 198, 15.

inspection.[215] If the emission allowance requirement would be found to constitute a 'requited' payment, it would have to be qualified as a charge, other than a customs duty, in order to still be eligible for border adjustment. As prescribed by article VIII GATT, customs fees must not exceed the amount of the cost of services rendered. Holzer notes that, as the customs authorities provide no service in return for the surrendered emission allowances, this obligation to surrender emission allowances would automatically qualify as a custom fee in excess of the cost of services rendered.[216] However, it is highly unlikely that the emission allowance requirement would fall within the scope of GATT article VIII, as the emission allowance requirement relates to the ETS of the importing country and not to a service related to importation.[217]

3.3.2. Regulation

98. Other authors consider the EU ETS as a regulation rather than a tax or charge.[218] Reinhard Quick and Charles Mc Lure, for example, contest that a payment in allowances is 'unrequited'.[219] They argue that the companies, by contrast, do receive something identifiable in return for complying with the EU ETS, namely a permit to emit GHG.[220]

99. However, OECD guidance explicitly states that *"a levy could be considered as 'unrequited' where the government is not providing a specific service in return for the levy which it receives even though a licence may be issued to the payer".*[221] Such a levy could qualify as an unrequited charge. The guidance provides the example of a fishing or shooting licence granted by the government, which is not accompanied by a right to use a specific area of government land.[222] In this context, Ismer and Neuhoff argue that since the government does not give a more or less specific service in return for the payment, it is unrequited.[223] This, in contrast to, for example, a fee paid for using a motorway or a fee paid for a broadcasting licence. In these examples, they argue, the service given to the individual compensates for the paid fee. In the case of a motorway fee, the individual receives a service only because the government has provided the infrastructure thereto and this service could have equally been provided by

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[215]K. HOLZER, *Carbon*, *supra* fn. 11, 105.
[216]*Ibid*., 104.
[217]*Ibid*., 105.
[218]L. BARTELS, "The Inclusion of Aviation in the EU ETS: WTO Law Considerations", *ICTDS - Trade and Sustainable Energy Series* 2012, no. 6, 8-9, https://www.files.ethz.ch/isn/144532/the-inclusion-of-aviation-in-the-eu-ets-wto-law-considerations.pdf (hereafter: L. BARTELS, *Aviation*); S.D. LADLY, *BCA, WTO-law and CBDR, supra* fn. 39, 64; R. QUICK, *dissenting view, supra* fn. 199.
[219]R. QUICK, *dissenting view, supra* fn. 199, 564-565; R. QUICK, "'Border Tax Adjustment' in the Context of Emission Trading: Climate Protection or 'Naked' Protectionism?", *Global trade and customs journal* 2008, vol. 5, no. 3, (163) 166.
[220]C.E. MCLURE, GATT-*Legality, supra* fn. 156, 286; R. QUICK, *dissenting view, supra* fn. 199, 564-565.
[221]OECD, Treatment of Tax Issues, *supra* fn. 197, 15.
[222]*Ibid*; OECD, Note on the Definition of Taxes*, supra* fn. 198, 4.
[223]J. DE CENDRA, *Emission Trading Schemes, supra* fn. 150, 135; R. ISMER and K. NEUHOFF, *BTA: A Feasible way, supra* fn. 199, 11.

private players. Likewise, a broadcasting license serves the interests of applicants, as it protects them from others trying to broadcast on the same frequency which would make their broadcast inaudible. They assert that an emission permit does not compensate the individual for the costs incurred, hence, it is not a more or less specific service. Javier De Cendra gives a similar argumentation. He asserts that if the licence provided by the government would be considered a 'benefit' and that the payment, therefore, could not be qualified as a tax, the payment would still qualify as an unrequited charge. He argues that although an emission licence authorises the installations to emit, it does not constitute a property right under public law. Hence, it is similar to the example of a hunting licence in the OECD guidance, where the applicant receives a right to hunt which is not accompanied by the right to use a specific area of government land.[224] It thus follows from the OECD guidance and the argumentation of these authors, that despite receiving an emission licence, the surrendering of allowances can still constitute an unrequited payment. This is somehow logical, as the requirement to hold a permit for carbon emitting serves the wider community, rather than the subjected companies.[225]

100. To support his view that the EU ETS qualifies as a regulation, Lorand Bartels refers to one of the arguments given by the ECJ in the *ATAA* case, namely the argument that the price paid for an allowance is not fixed by the government in advance, but is dependent on free market forces.[226] Although a classical tax is indeed fixed by the state in advance, the OECD definition does not pose this characteristic as a requirement to qualify as a tax. Likewise, a classical tax is payable in money, but the tax definition in the Black Law Dictionary clarifies that this is not a precondition to qualify as a tax.[227] This characteristic is also absent in the OECD's explanation of charges.[228] With regard to the authority of the argument, it was already explained that, first of all, the *ATAA* case dealt with provisions of other international agreements than the GATT. Secondly, it is not because a measure is not considered a tax in the internal legal order, that it could not qualify as one under the WTO rules.

101. Some other arguments invoked by those who consider cap-and-trade systems to be regulations, rather than taxes, rely on the possibility of trade in permits on the secondary market.[229] For example, Quick argues that companies could accrue benefits from their 'payment' since permits are tradable and could thus be sold on the secondary market at a profit.[230] Furthermore, it could be argued that in the case of permits bought on the secondary market, there is no

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[224]J. DE CENDRA, *Emission Trading Schemes, supra* fn. 150, 135-136; OECD, Note on the Definition of Taxes*, supra* fn. 198, 4.

[225]K. DAS, *WTO-legal*, *supra* fn. 39, 70; R. ISMER and K. NEUHOFF, *BTA: A Feasible way, supra* fn. 199, 11; J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 486.

[226]L. BARTELS, *Aviation, supra* fn. 218, 8.

[227]B.A. GARNER and H.C. BLACK, *Black's Law Dictionary (9th ed.),* Chicago, West Publishing House, 2009.

[228]OECD, Note on the Definition of Taxes*, supra* fn. 198, 4.

[229]L. BARTELS, *Aviation, supra* fn. 218, 8; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 118; R. QUICK, *dissenting view, supra* fn. 199, 565.

[230]R. QUICK, *dissenting view, supra* fn. 199, 565.

payment to the government, hence the OECD definition of tax is not satisfied.[231] However, as mentioned, the EU CBAM proposal limits the possibility of trade in permits on the secondary market, so that these arguments cannot be sustained in this case.[232] Likewise, the argument of some authors that there is no payment to the government when allowances are distributed for free[233], cannot be used to support the claim that the EU CBAM proposal is not a tax proposal, as the proposal envisages the phasing-out of free allowances.[234]

3.3.3. Hybrid system

102. By contrast, Warren Maruyama, who served as Associate General Counsel at the Office of the United States Trade Representative and the White House Office of Policy Development, argues that cap-and-trade systems are hybrid systems that resemble taxes in some respects, but also incorporate elements of traditional government regulation.[235] In his view, import restrictions based on a cap-and-trade system cannot qualify as border taxes, nor as regulatory adjustments.[236] Although Maruyama's analysis is mainly based on the Waxman-Markey carbon border measures that were never adopted, his analysis remains relevant for this thesis as he argues that cap-and-trade systems cannot qualify for border adjustment in general.

103. Maruyama first argues that the cost imposed by cap-and-trade systems cannot be considered a tax or a charge equivalent to a tax. He points out that the core of the cap-and-trade system is its permit requirement, which he considers a traditional regulation requirement.[237] He argues that, unlike a tax, the majority of the revenues generated by the cap-and-trade system would not flow to the government, but to private parties from selling their unused allowances.[238] This argument cannot be invoked to qualify the EU CBAM as a hybrid system, as the EU CBAM proposal rules out trade in CBAM certificates. However, he also argues that GATT/WTO precedents indicate that emission allowances would not qualify as a tax. To support this argument, he refers to the *EEC-Measure on Animal Feed Proteins* case.[239] The case dealt with a compulsory purchase programme for skimmed milk powder, imposed on both producers and importers of vegetable proteins. The programme was introduced by the European Economic Community to reduce the surplus public stocks of skimmed

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[231]C.E. MCLURE, *Primer, supra* fn. 46, 464; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 118.
[232]Rec. 22 and art. 23 EU CBAM Proposal, *supra* fn. 4.
[233]J. DE CENDRA, *Emission Trading Schemes, supra* fn. 150, 135; R. ISMER, "Mitigating Climate Change Through Price Instruments: an Overview of the Legal Issues in a World of Unequal Carbon Prices" in C. HERMANN and J. TERHECHTE, *European Yearbook of International Economic Law*, Berlin, Springer, 2010, 220-221; C.E. MCLURE, GATT-*Legality, supra* fn. 156, 288-289.
[234]Rec. 11 EU CBAM Proposal, *supra* fn. 4.
[235]W.H. MARUYAMA, *Climate change and the WTO, supra* fn. 109, 694.
[236]*Ibid*., 698.
[237]*Ibid*., 695.
[238]*Ibid*.
[239]GATT Panel Report, *EEC – Measures on Animal Feed Proteins*, adopted 14 March 1978, BISD 25S/49.

milk. The EU argued that the security deposit, which served as an alternative to the compulsory purchase of skimmed milk qualified for BTA. The GATT Panel, however, was of the opinion the security deposit was not of a fiscal nature but was rather an enforcement mechanism to ensure that the purchase requirement was complied with.[240]

104. However, it can be questioned whether this case implies that emission requirements are not of a fiscal nature either. The Panel has stated that "*the security deposit was not of a fiscal nature, because, if it had been, it would have defeated the stated purpose of the ECC Regulation which was to increase the utilisation of denatured skimmed milk powder. In addition, the revenue from the security deposit accrued to ECC budgetary authorities only when the buyer of vegetable proteins had not fulfilled the purchase obligations*".[241] Purchasing emission allowances, by contrast, is not an alternative option under the EU ETS. It is an obligation for which no alternative option is available. Furthermore, revenues for the EU budget are generated when the EU CBAM is complied with, as this entails that certificates are being purchased.

105. To support his claim that the cap-and-trade system is not a regulation but a hybrid system, he argues that the effects of a cap-and-trade system are similar to those of a carbon tax, as it also creates a carbon price signal.[242]

106. Maruyama thus considers cap-and-trade systems to qualify as hybrid systems. The fact that revenues generated by the system might flow to private parties, rather than to the government, leads him to conclude that the system cannot qualify as a tax. However, as mentioned before, the EU CBAM limits trade on the secondary market. Another one of his arguments is based on a GATT Panel ruling. However, the case he refers to deals with a system that significantly differs from cap-and-trade systems. It is not convincing that the Panel would arrive at a similar conclusion if a cap-and-trade system were to be at hand. The obligation to surrender emission allowances is not a mechanism to enforce the fulfilment of obligations, nor an alternative option to the fulfilment of such obligations. Cap-and-trade systems and carbon taxes, on the other hand, he argues, can have similar effects as they both create a carbon price signal.

4. Ruling out the hybrid middle ground

107. Qualifying the obligation to surrender emission allowances as a 'hybrid system' seems a bit too simplistic. Qualifying the EU CBAM as either a tax or a regulation might be a difficult exercise but it is a necessary preliminary step for assessing its WTO-legality. Declaring it a 'hybrid' system does not offer any solution, as it is unclear how 'hybrid' translates into WTO terms and provisions. The terms tax, charge and regulation, by contrast, can be found in the GATT provisions.

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[240] *Ibid*., para 4.4.

[241] *Ibid*.

[242] W.H. MARUYAMA, *Climate change and the WTO, supra* fn. 109, 698.

108. In this respect, it is important to distinguish the obligation to surrender emission allowances or CBAM certificates from the EU ETS and the EU CBAM in their entirety. These systems are complex sets of rules of which the obligation to surrender allowances or certificates is just one aspect.[243] Although this obligation could arguably meet the OECD definition of a tax, this is obviously not the case for, for example, the reporting obligations imposed by the EU CBAM. Hence, a 'hybrid' qualification might seem appealing. However, this thesis deals with the core of the system, which is the extension of the emission allowance requirement to imports and its WTO-legality. The reporting obligations, for example, are subsidiary to the requirement to surrender certificates and are intended to enable the functioning of this system. Thus, the qualification of the obligation to surrender emission allowances is determinant for the qualification of the EU ETS, and subsequently for the qualification of the EU CBAM.

[243]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 102.

Interim conclusion

109. The qualification of the EU ETS obligation to surrender emission allowances will most likely determine whether the EU CBAM is a border tax adjustment measure (BTAM), or a different border adjustment measure (BAM). The name of the Commission proposal, the legal basis of the EU ETS and the Commission proposal, and the ECJ case law indicate, that none of the systems are to be considered taxes. However, the internal qualification of these systems does not prevent them from qualifying as taxes under the WTO legal order. The economic impact of the systems is decisive for their WTO-qualification. It is not inconceivable however, in light of the judicial activism of the AB, that this body would take into account European case law when deciding upon the WTO-qualification of the measure.

110. It is also not possible to conclusively derive the WTO-qualification from existing carbon border adjustment mechanisms, as there is only one such mechanism to date, a sub-national one, which has not sparked international trade concerns. As for the EU ETS, it is only clear that the system does not internally qualify as a tax. Moreover, even if there would be clarity regarding the WTO-qualification of the Californian border adjustment system, it is not certain that this qualification could be adopted *mutatis mutandis* for the EU CBAM as the two systems show important differences.

111. However, the first place to look for guidance on the WTO-qualification of measures is in the WTO legal texts, GATT and WTO panel rulings and other official documents. In this respect, the GATT Working Party Report on BTAs refers to the OECD definition of a tax. According to this definition, taxes are compulsory unrequited payments to the government. The case law on the internal qualification of the EU ETS does not refer to this definition. Therefore, it is important to analyse doctrine arguments based on the OECD definition and to determine their relevance in light of the specific characteristics of the proposed EU CBAM.

112. Many legal scholars assert that the obligation to surrender emission allowances is a price-based measure, as it meets the OECD definition. Some do so, even when allowances are distributed for free as they argue that the EU ETS imposes certain compliance costs, as well as an opportunity cost on firms. Others argue that the EU ETS is a charge instead of a tax, but that certain charges, other than custom fees, are nevertheless eligible for border adjustment. It is rather unlikely that the measure would qualify as a customs fee, given that it has no connection to any service related to importation. Hence, the measure could possibly be eligible for border adjustment, even if it would not meet the requirements of the OECD definition.

113. The main counterargument of those that qualify the EU ETS as a regulation, is that the payment is not unrequited, as applicants receive a 'licence to emit' in return. However, OECD guidance and doctrine have clarified that the fact that a licence is granted does not prevent a levy from qualifying as an unrequited charge. In this context, some authors emphasise that the emission allowance requirement significantly differs from other types of licences that are accompanied by a specific service, such as the protection from others. Emission licences, by contrast, are not accompanied by a specific service and serve the

wider community. Another argument propound is that the ECJ held that the price for taxes is fixed in advance by the government, whereas the price for ETS allowances is based on supply and demand. However, the OECD definition of a tax does not require the amount of the levy to be fixed in advance. In addition, the internal qualification is not determinant for the qualification of a measure under the WTO legal order and the case that is referred to does not even deal with GATT provisions. Finally, those who consider the EU ETS as a regulation provide a range of arguments that rely on the free allocation of emission allowances and the possibility to purchase permits on the secondary market. These arguments could sustain for the qualification of the EU ETS system as implemented in previous years, but the EU CBAM proposal envisages the phasing-out of free allowances and limits the possibility of trade in permits on the secondary market.

114. Finally, Maruyama qualifies cap-and-trade systems as hybrid systems. Although cap-and-trade systems might combine elements characteristic to both taxes and regulations, it is not clear how this qualification translates into WTO law. Therefore, this qualification should not be withheld.

115. Hence, despite the EU qualification of the system, the EU CBAM is likely to qualify as a BTAM once emission allowances are fully auctioned. However, in the absence of WTO jurisprudence, it is not possible to provide a definite answer to the qualification question.

CHAPTER IV. THE LEGALITY ASSESSMENT

116. This final chapter aims at providing a legal analysis of carbon-related import-BAMS. The economic or environmental efficiency of the EU CBAM will not be assessed.

117. Border adjustment is possible under WTO law, but as will be explained in further detail, not all sorts of policy measures are eligible for border adjustment. The use of border adjustment for carbon reduction purposes, in particular, remains debated.[244]

1. Importance of the qualification

118. It is important to correctly qualify the EU CBAM as the WTO rules for BTAMS partially differ from those for BAMS. This chapter will first analyse the provisions specific to BTAMs and subsequently the provisions specific to BAMs. Finally, the provisions relevant for both types of measures will be examined.

2. BTAM-specific legality assessment

119. The first distinguishment to be made, once it is established that the EU CBAM is a price-based measure, is between custom duties, which are also referred to as 'border taxes' and internal taxes or charges applied to imports. Border taxes that exceed the scheduled tariff bindings would violate article II:1 (b) GATT. These schedules of concessions reflect the commitments of WTO members regarding tariffs. Raising tariffs would require renegotiations. The price of EU CBAM certificates would initially be relatively high and would increase as the EU implements and expands the EU CBAM and takes other climate initiatives.[245] Thus, it would likely go beyond the scheduled tariff bindings. Internal taxes and charges, by contrast, are permitted under article III:2 GATT, regardless of their amount, provided that they are non-discriminatory.

120. The AB has clarified the distinction between these measures in the *China-Auto Parts* case.[246] The measure is an internal tax or charge if the obligation to pay is triggered by an internal event such as the sale or distribution of the imported product. If the obligation to pay the charge, by contrast, is triggered by the event of importation, then the measure qualifies as a border measure.[247]

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[244]See e.g. C. KAUFMANN and R. WEBER, "Carbon-related border tax adjustment: mitigating climate change or restricting international trade?", *World Trade Review* 2011, vol. 10, no. 4, 497-525; C.E. MCLURE, *Primer, supra* fn. 46, 456-465; J.P. TRACHTMAN, "WTO law constraints on border tax adjustment and tax credit mechanisms to reduce the competitive effects of carbon taxes", *National Tax Journal* 2017, vol. 70, no. 2, 469-494; Z. ZHU, "A Discussion on the Legitimacy of Carbon Tariffs under the WTO", *J. WTO & CHINA* 2015, vol. 5, no. 2, 86-94.
[245]J. BACCHUS, "Legal Issues with the European Carbon Border Adjustment Mechanism", *CATO Briefing Paper* 2021, no. 125, 3, https://www.cato.org/briefing-paper/legal-issues-european-carbon-border-adjustment-mechanism (hereafter: J. BACCHUS, *Legal issues*).
[246]Appellate Body Report, *China – Measures Affecting Imports of Automobile Parts*, 15 December 2008, WT/DS339, WT/DS340/AB/R, WT/DS342/A/B/R, adopted 12 January 2009.
[247]*Ibid.,* 158.

Under the Commission's proposal, the requirement to buy emission allowances seems to be triggered by the event of importation, hence the measure would fall under the more stringent article II GATT.[248]

121. Nonetheless, the measure could still be permitted since article II:2(a) GATT creates an exception to the general rule of article II:1(b) GATT. This provision allows for BTA, phrased in GATT terms as "*the imposition of a charge equivalent to an internal tax in respect of the like domestic product".*[249] The AB has clarified in *India-Additional Import Duties*, that the equivalence assessment should regard both qualitative and quantitative aspects of a measure.[250] *In casu*, the AB held that the measure called into question could not be considered a BTAM because there was no 'equivalent' internal tax. Hence, the measure fell within the scope of article II:1(b) GATT instead of article II:2(a) GATT.[251] Furthermore, in order to fall within the scope of article II:2(a) GATT, the charge must be imposed consistently with the provisions of article III:2 GATT.[252] Article III:2 GATT stipulates the requirements of the national treatment principle and, when applied to BTAMs, must be read in conjunction with the equivalence requirement. Since BAMs must also comply with the national treatment principle, these requirements will be analysed in detail under the section on the overlapping provisions.

122. The time at which the charge is collected is not decisive for the qualification of the measure as either a border tax, an internal tax applied to imports or a BTAM. As noted by the WTO Secretariat, "*BTA does not necessarily take place at the border […] but the adjustment is to be made because the goods cross the border*."[253] Likewise, the purpose of a tax is not decisive for its qualification. The GATT panel in the *US Superfund* case held that *"the tax adjustment rules of the GATT […] do not distinguish between taxes with different policy purposes".*[254] Thus, the fact that the requirement to buy emission certificates under the EU CBAM proposal seems to be triggered by the event of importation and the fact that this obligation serves foremost an environmental purpose, do not prevent the mechanism from falling within the scope of the BTA provision of article II:2(a) GATT.

123. A second distinguishment to be made in the context of price-based measures is the distinguishment between direct taxes and charges and indirect taxes and charges. Direct taxes are taxes on producers such as income taxes, social security charges and taxes on profits, whereas indirect taxes are taxes on products such as retail or sale taxes.[255] Only indirect taxes and charges are

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[248]J. BACCHUS, *Legal issues, supra* fn. 245, 3; J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10865.

[249]Art. II:2, a) GATT, *supra* fn. 54.

[250]*India–Additional Import Duties*, *supra* fn. 213, para. 153.

[251]*Ibid*., para. 298.

[252]Art. II:2, a) GATT, *supra* fn. 54.

[253]WTO, Committee on Trade and Environment, Taxes and charges for environmental purposes – border tax adjustment, Note by the Secretariat, 2 May 1997, WT/CTE/W47, 3.

[254]*US Superfund*, *supra* fn. 154, para. 5.2.4.

[255]Working Party Report on BTA, *supra* fn. 195, para. 14.

eligible for BTA.[256] The main *rationale* therefore, is that it is assumed that direct taxes are calculated into consumer prices, whereas producer taxes are shifted backwards to the manufacturer and are therefore not reflected in the price of the product. Thus, according to this fictitious view, producer taxes do not influence the price of the product and therefore do not affect the competitiveness of the product, so that there is no need for a border adjustment to level the playing field.[257] Carbon taxes related to the production of goods could arguably qualify as indirect taxes. First of all, because there is a reasonably strong link between the tax and the product.[258] They can be considered taxes, imposed on goods used indirectly in making the product.[259] Secondly, as noted by Ulrike Will, although EU ETS certificates are paid by producers, their price is likely to be shifted towards the consumer.[260] Lastly, Jegou notes that "*as border taxes are classified as indirect taxes, it seems logical to classify a carbon tax as an indirect tax*".[261] Although in the absence of a WTO precedent, it is not possible to state with complete certainty that the EU ETS imposed charges qualify as indirect taxes, this qualification seems likely, given that the EU ETS aims to create a price signal.[262] The tax would thus change the terms of competition so that border adjustment is needed and should be permitted in order to restore a level playing field.[263]

124. However, it is often questioned whether taxes on inputs that are not physically incorporated into the final product are eligible for BTA. According to article II:2(a) GATT, a charge can be levied provided that it is "*equivalent to an internal tax [..] 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*." Hence, the provision leaves no doubt that BTA is possible with respect to articles, physically incorporated in the final product. However, the same cannot be said for taxes on products that are not physically incorporated in the final product such as, for example, taxes levied on energy or transportation. These types of taxes are referred to as 'hidden taxes' or 'taxes occultes'. The issue of taxes occultes was examined by the 1970 Working Party on BTA but the BTA Report does not provide a conclusion regarding the legality of BTA for

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[256]GATT Panel Report, *United States Income Tax Legislation* (DISC), L/4422, BISD 23S/98, adopted 7 December 1981; Working Party Report on BTA, *supra* fn. 195, para. 14.
[257]J. DE CENDRA, *Emission Trading Schemes, supra* fn. 150, 139; A. PIRLOT, *Environmental Border Tax Adjustments and International Trade Law: Fostering Environmental Protection*, Cheltenham, Edward Elgar Publishing, 2017, 30 (hereafter: A. PIRLOT, *Environmental BTA*); J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 477; U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 70.
[258]J. BACCHUS, *Climate Waiver, supra* fn. 45, 13; J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 479-480.
[259]U. WILL, *Climate Border Adjustments*, *supra* fn. 13, 123.
[260]*Ibid*.
[261]I. JEGOU, "Competitiveness and Climate Change Policies: Is There a Case for Restrictive Unilateral Trade Measures?", *ICTSD information note* 2009, no. 16, 9, https://seors.unfccc.int/applications/seors/attachments/get_attachment?code=KPE7FAH5YPDAXMDD7FBCCUMLCBASK2P2.
[262]J. ENGLISCH and T. FALCAO, *Part One, supra* fn. 70, 10869; J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 480.
[263]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 480.

carbon taxes. It simply notes that "*there was a divergence of views with regard to the eligibility for adjustment of [...] inter alia, tax occultes. It appeared that adjustment was normally not made for tax occultes […].*"[264]

125. In sum, if the price-based measure meets the requirements of article II:2(a) GATT, it will not be regarded as a border tax that would violate the GATT rules if it exceeded the scheduled tariff bindings, but as a BTAM. However, the domestic carbon tax will only be eligible for such border adjustment if it does not qualify as a direct tax. Although carbon taxes are more likely to qualify as indirect taxes, for which border adjustment is permitted, they could also be qualified as taxes occultes, in which case, their BTA-eligibility remains questionable.

3. BAM-specific legality assessment

126. Like price-based measures, internal regulations such as standards and labelling requirements can be border adjustable.[265] BAMs are however, in part, regulated by different legal provisions than BTAMs. With respect to domestic carbon regulations, the Ad Note to article III GATT is of particular importance as it sets out the line between quantitative restrictions, generally prohibited under article XI GATT and generally permitted domestic regulations in the sense of article III:4 GATT.[266] According to the Ad Note, internal regulations can be eligible for border adjustment provided that they are *"enforced in the case of imported products, at the time or point of importation"*.[267]

127. However, as for price-based measures, not all domestic regulations can be adjusted at the border. Only internal regulations which affect one of the following activities are eligible for border adjustment: the offering for sale, the purchase, the transportation, the distribution or the use of products.[268] The list of internal activities cited in the provision is exhaustive. Hence, again the questions arise as to whether the carbon measure is an internal measure, and if so, whether a carbon regulation that regulates a process or production method (hereafter: PPM) instead of a product or physical input thereof, 'affects' products and is thus eligible for border adjustment.

128. With respect to the first question, the EU CBAM seems to regulate the event of importation rather than one of the internal activities, exhaustively summarised in art. III:4 GATT. Whereas for BTAMs, it was possible to resort to art. II:2(a) GATT if the tax or charge could not qualify as an internal one, no such fall-back option exists for BAMs. However, it is not inconceivable that a panel would adhere to a less stringent reading of this provision and accept that the EU CBAM sufficiently affects the sale of the products falling within its scope.

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[264]Working Party Report on BTA, *supra* fn. 195, para. 15.
[265]Ad Note art. III GATT, *supra* fn. 54.
[266]J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 481.
[267]Ad Note art. III and III:1 GATT, *supra* fn. 54.
[268]*Ibid*; Art. III:4 GATT, *supra* fn. 54.

129. When answering the second question, *i.e.* the question whether regulations regulating PPMs that leave no physical traces in the end product are eligible for border adjustment, the *Tuna-Dolphin* dispute must be discussed. The GATT Panel clarified the distinction between quantitative restrictions on importation and internal regulations applied to imports in this case. It held that "*while restrictions on importation are prohibited by article XI:1, contracting parties, are permitted by article III:4 and the Note Ad article III to impose an internal regulation on products imported from other contracting parties* […]".[269] The Panel found that the measure in question fell under article XI:1 instead of article III:4 because it did not apply to 'products' but to PPMs.[270] The Panel considered that, as BTA is only possible for indirect taxes on products and not for direct taxes on producers, it would be inconsistent to allow border adjustment for regulations not applied to products as such.[271] Thus, according to the GATT Panel report, regulations concerning PPMs fall outside the scope of article III GATT. However, it must be noted that the report was never formally adopted by the GATT parties and thus has no legal value. Furthermore, WTO panels and the AB have taken a much more accommodating approach towards PPM measures in later cases.[272] One possible explanation therefore, is that the *Tuna-Dolphin* dispute stems from the GATT days whereas, as explained in the introductory chapter of this thesis, the treaty provisions must be interpreted in accordance with the objectives of sustainable development and environmental protection since the establishment of the WTO.[273]

130. Another similarity with price-based measures is that answering the question whether an internal regulation is eligible for border adjustment does not depend on the purpose of the measure.

131. In conclusion, the Ad Note to article III GATT indicates that border adjustment is also possible with respect to internal regulations. For regulations, there is no differentiation to be made between 'direct' or 'indirect' measures. However, to be eligible for border adjustment, the regulation must affect an internal activity and it is not clear whether the EU ETS meets this requirement. Therefore, it could be preferable to qualify the EU CBAM as a price-based measure. Furthermore, as for carbon taxes, the PPM nature of carbon measures creates uncertainty regarding the border adjustment eligibility of carbon regulations. Hence, the measure risks qualifying as a quantitative restriction in the sense of article XI GATT.

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[269]GATT Panel Report, *United States – Restrictions on Imports of Tuna*, DS21/R, 3 September 1991, unadopted, para. 5.9 (hereafter: *US Tuna*).
[270]*Ibid*., para. 5.8.
[271]*Ibid*., para. 5.13.
[272]See e.g. Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, 12 October 1998, WT/DS58/AB/R (hereafter: *US Shrimp*); Appellate Body Report, *Canada-Measures Relating to Feed-in Tariff Program*, 6 May 2013, WT/DS412/AB/R, WT/DS426/AB/R, adopted 24 May 2013, para 5.63 (hereafter: *Canada-Feed-in Tariff*); Appellate Body Report, *EC-Measures Affecting Asbestos and Asbestos-Containing Products*, 12 March 2001, WT/DS135/AB/R, adopted 5 April 2001, para. 117 (hereafter: *EC Asbestos*).
[273]Marrakesh Agreement, *supra* fn. 58, preamble.

4. Overlapping provisions

132. The legality assessment, until now, has focused mostly on the differences between border adjustment for carbon taxes and border adjustment for carbon regulations. However, there are also a number of overlaps in the legality assessment of both types of measures. First of all, both BTAMs and BAMs must comply with the principle of national treatment (hereafter: NT) and with the most favoured nation (hereafter: MFN) principle. These principles are often referred to as the 'non-discrimination rules'. Explicit reference is made to both principles in the Commission's proposal.[274] Thus, even if border adjustment is possible for a carbon tax and/or regulation, the measure will not be permitted if it violates one of these two principles. Finally, regardless of whether the EU CBAM would qualify as a tax or as a regulation, one or more of the general exceptions of article XX GATT could be applicable.

4.1. National treatment

133. First of all, the measure must comply with the NT principle which prohibits the discrimination between products imported from WTO Members and domestic products. Both BTAMs and BAMs must comply with the principle as set out in article III GATT, but for carbon taxes and charges, the second paragraph of the provision must be studied (Art. III:2 GATT), whereas for carbon regulations the fourth paragraph must be analysed (Art. III:4 GATT).

134. Distinctions on the basis of an objective criterion such as the carbon content of goods, might not appear to be discriminatory against foreign products. However, the NT principle prohibits not only *de jure* discrimination but also *de facto* discrimination. Even if a measure does not discriminate directly on the basis of the origin of products (*de jure*), it can still be discriminatory against foreign traders in its effect (*de facto*). The embedded emissions of products imported from developing countries will most likely be higher than those of domestic goods, since the companies in those countries often lack the resources necessary to invest in energy-efficient PPMs. Furthermore, as explained in the first chapter of this thesis, it is alleged that some carbon-intensive industries have relocated to so-called 'pollution havens' to subsequently export their carbon-intensive products to the EU. Hence, PPMs used in the EU could in general be less carbon-intensive so that discriminating against high carbon-products could *de facto* discriminate against imported goods.

4.1.1. BTAM: GATT Art. III:2

135. Article III:2 GATT is twofold. The first sentence of the provision sets out the NT principle for imported products that are 'like' domestic products and the second sentence of the provision, which needs to be read in conjunction with paragraph 2 of the Ad Note to article III GATT, articulates the NT rule for 'directly competitive or substitutable' products. With regard to like products, the provision stipulates that taxes or charges imposed on imported products must

[274]Explanatory memorandum EU CBAM Proposal, *supra* fn. 4, 12.

not be "*in excess of those applied […] to like domestic products*".[275] For directly competitive or substitutable products, no dissimilar taxation may be applied "*so as to afford protection to domestic production*".[276]

136. Thus, in order to determine what the applicable rule is, it must first be determined whether carbon-intensive imported goods are 'like' domestic low-carbon goods or whether they are 'directly competitive or substitutable' to the latter. The AB has held that the term 'like products' in article III:2 GATT, first sentence, must be construed narrowly.[277] A stronger degree of substitutability is thus required for like products than for products resorting under the second category.

137. The GATT does not define what products are to be considered 'like products'. The traditional criteria, used in jurisprudence to assess the likeness of products, are the physical properties of products, the end-uses of products, consumer tastes and habits in respect of products and the tariff classification of products.[278] These criteria must be read cumulatively and should not be regarded as a closed list. Furthermore, the likeness of products must be assessed on a case-by-case basis.[279] Thus, different weight could be attached to different criteria, depending on the case specifics of a matter.[280] Products must not be identical in order to be qualified as like products. However, they must be highly similar.[281]

138. Most of the traditional criteria regard the physical characteristics of products. The physical characteristics of low and high-carbon products, however, do not differ. The criterion regarding consumer preferences, on the other hand, might allow for a distinction between products with different PPMs. It is not inconceivable that consumers, increasingly confronted with the climate change challenge, would take into account the carbon footprint of products.

139. The traditional GATT jurisprudence has not been very favourable to the distinction between products on the basis of PPMs. In the *Tuna-Dolphin* dispute, referred to earlier in this chapter, the Panel found that tuna caught in a dolphin-friendly manner and tuna caught in a dolphin-unfriendly manner, which taste and look the same, are like products.[282] In the *EC-Asbestos* case, the question of likeness of products with different PPMs rose again but was this time dealt with by the WTO AB, which had to take into account the sustainable development

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[275]Art. III, §2 GATT, *supra* fn. 54.
[276]Art. III, §1 GATT, *supra* fn. 54; WTO Analytical Index: Guide to WTO Law and Practice – GATT 1994, Article III (Jurisprudence), 30, https://www.wto.org/english/res_e/publications_e/ai17_e/gatt1994_art3_jur.pdf.
[277]Appellate Body Report, *Japan-Taxes on Alcoholic Beverages*, 4 October 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, 19-20 (hereafter: *Japan-Alcoholic Beverages*).
[278]*EC Asbestos*, *supra* fn. 272, para. 101; Working Party Report on BTA, *supra* fn. 195, para. 18.
[279]*Japan-Alcoholic Beverages*, *supra* fn. 277, 20.
[280]K. HOLZER, *Carbon*, *supra* fn. 11, 110.
[281]*EC Asbestos*, *supra* fn. 272, para. 91.
[282]*US Tuna*, *supra* fn. 269, para. 5.10-5.16.

objective enshrined in the preamble of the Marrakesh Agreement. The AB in this case did not examine evidence regarding consumer preferences, but simply assumed that consumers would prefer asbestos-free products given the public awareness regarding the dangers of asbestos for human health.[283] However, it did stress the importance of consumer preferences and the evidence thereof, stating that "*evidence about the extent to which products can serve the same end-uses, and the extent to which consumers are or would be willing to choose one product instead of the other to perform those end-uses, is highly relevant in assessing the likeness of those products under GATT article III*."[284] Thus, if it can be proven that consumers draw distinctions in their purchasing behaviour on the basis of the carbon footprint of goods, low and high-carbon products will not be considered to be like. As noted by Kateryna Holzer, the taking into account of health risks caused by asbestos-containing goods by the AB, could be an argument against the likeness of carbon-free and carbon-containing products. Although the purchase of carbon-containing goods, unlike the purchase of an asbestos-containing good, will not directly affect human health, the entirety of GHG emissions and the global warming it causes, do pose a threat to human health.[285] In conclusion, although the case law under the GATT days seemed to indicate that differences in PPMs which do not leave physical traces in the end products did not make products 'unlike', the WTO jurisprudence has most certainly opened the door to the consideration that environmentally harmful PPMs can be taken into account for the likeness assessment of goods, provided that consumers distinct on the basis of the carbon content of goods in their purchasing behaviour. However, such proof is yet to be provided and will be particularly difficult to provide in the context of the EU CBAM, since it covers wholesale sectors rather than retail sectors.[286] Consumers are usually unaware of the carbon content of the commodities incorporated into the finished products they purchase. Thus, it is rather likely that high and low-carbon products, given the identicality of their physical characteristics, would be considered to be like products.

140. If low and high-carbon products were indeed found to be like (and the EU ETS and the EU CBAM were to be regarded as price-based measures), it would have to be ensured that the tax burden imposed by the EU CBAM would not be in excess of the tax burden imposed on domestic production by the EU ETS.

141. If by contrast, it could be proven that carbon-intensive and low-carbon goods are not like because consumers draw distinctions in their purchasing behaviour on the basis of the carbon content of goods, low and high-carbon goods could alternatively fall within the category of directly competitive or substitutable products. This would have important consequences for the legality assessment of the BTAM as in this case dissimilar taxation would be permitted as long as it is not introduced to afford protection to domestic production. Contrary to what the wording of the article seems to imply, the intent of the regulator to

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[283] *EC Asbestos*, *supra* fn. 272, para. 123-126.
[284] *Ibid*., para. 117.
[285] K. HOLZER, *Carbon*, *supra* fn. 11, 112.
[286] R. ASTORIA, "Design of an International Trade Law Compliant Carbon Border Tax Adjustment", *Arizona Journal of Environmental Law and Policy* 2015, vol. 6, no. 1, (491) 504.

engage in protectionism is of no importance. The AB in the *Japan-Alcoholic Beverages II* held that a panel does not need to sort through the many legislative reasons for a measure. If the measure is applied to imported products so as to afford protection to domestic products, then it does not matter whether or not the legislator intended to engage in protectionism.[287] Evidence of protectionist intent is thus not required, but could nonetheless be an important element in the examination of the protectionist character of a measure.

142. As for like products, there is no definition of directly competitive or substitutable products in the WTO Agreement and the assessment of competitivity or substitutability must be made on a case-by-case basis.[288] In the *Canada-Feed in Tariffs* dispute, the AB observed that "*what constitutes a competitive relationship between products may require consideration of inputs and processes of production used to produce the product.*"[289] For the remainder, it is not entirely clear where the dividing line between like and directly competitive and substitutable products should be drawn. Identicality of products is required for neither of these categories and the traditional criteria used to assess the likeness of products are also used to determine whether products are directly competitive or substitutable.

143. It is inconceivable that low and high-carbon products would be found not to be like products, nor directly competitive or substitutable products. The main *rationale* for the introduction of a border adjustment mechanism is to address competitiveness concerns of domestic firms. If low and high-carbon products did not compete, there would be no economic need for border adjustment.

4.1.2. BAM: GATT Art. III:4

144. As for price-based measures, when extending domestic regulations to imported products, the NT principle must be complied with. For domestic regulations, article III:4 GATT provides that imported products may not be treated less favourably than like domestic products. Thus, the NT analysis for carbon regulations is somewhat easier as there is only one category, namely the category of likeness. There is no separate category of directly competitive or substitutable products.

145. With regard to the interpretation of the term 'like', the AB has held that "*the product scope of article III:4, although broader than the first sentence of Art. III:2, is certainly not broader than the combined product scope of the two sentences of Art.III:2 of the GATT 1994*."[290] The degree of substitutability must thus be stronger than for directly competitive products, but must not be as strong as is required for 'like' products in the sense of article III:2 GATT, first sentence.

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[287] *Japan-Alcoholic Beverages*, *supra* fn. 277, 27, c).
[288] *Ibid.,* 25, a).
[289] *Canada-Feed-in Tariff*, *supra* fn. 272, para 5.63.
[290] *EC Asbestos*, *supra* fn. 272, para 99.

146. The AB has provided guidance on what the requirement of 'no less favourable treatment' entails. It held in *Korea-Various Measures on Beef* that "*a formal difference in treatment between imported products is neither necessary, nor sufficient to show a violation of article III:4. Whether or not imported products are treated less favourably than like domestic products should be assessed instead by examining whether a measure modifies the conditions of competition in the relevant market to the detriment of imported products*."[291] The examination of whether imported products are treated less favourably will thus require a careful analysis of the market implications of the EU ETS and the EU CBAM.

4.1.3. Practical (un)importance

147. Although article III GATT contains different sub-provisions for taxes or charges on like products, taxes and charges on directly competitive or substitutable products and regulations with respect to like products, the practical importance of this differentiation must not be exaggerated. Article III:2 GATT is often referred to by GATT and WTO members in disputes on article III:4 GATT and *vice versa*.[292] Furthermore, it is not inconceivable that the question of likeness would not even be raised once it is found that carbon taxes or regulations can be adjusted at the border.[293]

4.1.4. Does the EU CBAM violate the NT principle?

148. The drafters of the EU CBAM proposal have tried to avoid *de facto* discrimination. The phasing-out of free allowances allocated to domestic industries, for example, is an illustration thereof. If the EU CBAM proposal would not have foreseen in the phasing-out of free allowances granted to domestic industries, it would have most certainly violated the NT principle. However, even with the phasing-out of free allowances, the EU CBAM might still not pass the NT-test. The first reason therefore, was already addressed. Imported products might overall be characterised by a higher carbon footprint. In addition, there are some differences between the EU ETS and the EU CBAM which may cause the mechanism to be found discriminatory. The EU ETS, for example, allows the trade of allowances, whereas CBAM certificates will not be tradable. Companies can only request the authorities to re-purchase their excess certificates, but will not be able to sell them on the secondary market at a potentially higher price. Whether the EU CBAM could pass the NT-test despite this small difference, could depend on the qualification of the mechanism and the qualification of the products falling within the scope of the mechanism. Especially if the EU CBAM were to be qualified as a tax or a charge, and if low and high-carbon products would be found to be like, the NT principle could threaten the legality of the EU CBAM as in that case the measure would have to comply with the most strict, 'no taxation in excess', requirement.

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[291]Appellate Body Report, *Korea-Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, 11 December 2000, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, para. 137 (hereafter: *Korea-Various Measures on Beef*).

[292]A. PIRLOT, *Environmental BTA*, *supra* fn. 257, 213.

[293]K. HOLZER, *Carbon*, *supra* fn. 11, 108; J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 489.

4.2. Most favoured nation

149. Both BTAMs and BAMs must also comply with the MFN principle, enshrined in article I GATT. This principle prohibits discrimination between the same goods imported from different WTO Members.[294] Advantages granted to products originating from one country, must be accorded to all like products originating from any WTO Member. For the reasons cited in the preceding section on the NT principle, it is to be expected that goods produced in a carbon-intensive manner and goods produced with low-carbon technologies will be considered to be like products.

150. The wording of article I:1 GATT, the provision on the MFN principle, illustrates that the requirement must be strictly interpreted. Any advantage must be 'unconditionally' and 'immediately' accorded to all like products from other Members.

151. In the context of border adjustment, the MFN principle requires that the B(T)AM is applied equally to all imported products, regardless of their origin. As for the NT principle, the MFN principle covers both *de jure* and *de facto* discrimination. A carbon-equalisation system is an origin-neutral measure. Hence, there is no question of *de jure* discrimination. However, if the measure would provide advantages to imports from certain countries, it would *de facto* discriminate and thus violate the MFN principle.[295]

4.2.1. Does the EU CBAM violate the MFN principle?

152. It will be extremely difficult for the EU to justify the EU CBAM exemption for countries with ETSs linked to that of the Union. The EU self-judges the ETSs of other countries in order to assess whether they are eligible for linkage and thus for exemption from the EU CBAM. So far, the EU only has an agreement regarding the mutual recognition of emission allowances with Switzerland.[296] This design specificity does not only provide an advantage to Swiss producers, but grants complete immunity to Swiss imports.

153. In addition and for the same reason, the possibility to deduct the carbon price already paid in the country of origin could threaten the MFN-compatibility of the mechanism. In order to receive a deduction or a refund, importers would have to prove that they have paid a carbon price abroad or have to provide proof of the actual performance of carbon-efficient technologies. After an assessment of the proof provided, a decision on the reimbursement would be made.[297] Of course, from an environmentalist perspective, it would be unacceptable that countries with carbon pricing policies in place would have to pay the carbon price twice. However, this issue should be resolved at the level of the country

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[294]Art. I:1 GATT, *supra* fn. 54.
[295]WTO Panel Report, *Canada-Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, 11 February 2000, para. 6.174.
[296]Agreement between the European Union and the Swiss Confederation on the linking of their GHG emission trading systems, *OJ. L.* 7 December 2017, 322, 3.
[297]EU CBAM Proposal, *supra* fn. 4, 31.

exporting to the EU. These countries should rebate the costs borne by their producers upon exportation to the EU. The assessment of carbon pricing policies and technologies should not be left to the EU, as this compromises the WTO-legality of the mechanism.

4.3. General exceptions

154. The analysis of the EU CBAM in light of the GATT provisions has brought forward some potential pitfalls of the mechanism. The measure could, for example, be found to be an import duty in excess of the scheduled tariff bindings, a direct tax ineligible for border adjustment or a quantitative restriction on importation. Alternatively or additionally, the EU CBAM could fail to meet the NT and/or the MFN-requirements. In all these cases, the EU CBAM could still be legal in terms of WTO-law. Article XX GATT provides a list of general exceptions to all GATT provisions for measures prompted by certain public policy concerns. These exceptions allow sovereign nations to autonomously pursue certain non-trade policy goals, which will need to be adequately balanced against their obligations under the GATT provisions that seek to ensure free trade.[298]

155. During the GATT days, the predominant view was that these exceptions needed to be interpreted narrowly. This restrictive approach was later renounced by the AB.[299] The prevailing view today is that the exceptions should be applied reasonably and that they should be placed on equal footing with the other GATT provisions.[300] In essence, this entails that the general exceptions should not be abused, but should not be rendered meaningless either.[301]

156. For a carbon measure to be justified under one of the exceptions in article XX GATT, it must pass a two-tiered analysis.[302] First of all, the measure must fall within the scope of one or multiple of the specific exceptions in article XX(a)-(j) GATT. Secondly, the requirements of the chapeau of article XX must be satisfied.

157. It was already hinted at in the introductory chapter of this thesis that the purpose of a measure, although not relevant for the qualification of the measure, nor for its eligibility for border adjustment, could be important to determine whether GATT violations can be justified under the general exceptions. The general exceptions most relevant for environmental measures are: XX(b) regarding "*measures necessary to protect human, animal or plant life or health*" and XX(g) which covers "*measures relating to the conservation of exhaustible natural resources […]*". The main objective of the mechanism, as put forward in its proposal, is to prevent carbon leakage. The fact that the mechanism also addresses competitiveness concerns, does not render it ineligible for justification under one of these environmental exceptions.

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[298]C.R. CONRAD, *Processes and Production Methods (PPMs) in WTO Law: Interfacing trade and social goals*, Cambridge, CUP, 2011, 266-267 (hereafter: C.R. CONRAD, *PPMs*).
[299]Appellate Body Report, *EC-Measures Concerning Meat and Meat Products (Hormones),* 16 January 1998, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, para. 104.
[300]C.R. CONRAD*, PPMs, supra* fn. 298, 265-266.
[301]*US Shrimp*, *supra* fn. 272, para. 156.
[302]*US Gasoline*, *supra* fn. 170, 22.

158. Some literature also refers to art. XX(a) regarding "*measures necessary to protect public morals*" in relation to carbon border adjustment measures.[303] Member states have the discretion to determine for themselves what concerns their 'public morals', thus this could indeed include environmental matters.[304] Nonetheless, a justification on the basis of one of the other two general exceptions is to be preferred for multiple reasons. First of all, the link with environmental matters is far more explicit for these exceptions than for the public morals exception. Secondly, as will be explained further in this chapter, the exception relating to the conservation of exhaustible resources is more likely to be applicable than the public morals exception. Thirdly, if the EU were to impose its 'public morals' on third countries, this could add to the protectionist appearance of the mechanism which could frustrate these third countries and make it more difficult for the mechanism to pass the second-tier test. Hence, this thesis will focus solely on article XX(b) and XX(g) GATT.

159. Thus, the general exceptions can justify violations of GATT provisions. Nonetheless, the EU CBAM drafters were right to put their focus on designing a WTO-compatible mechanism as these general exceptions are not a *panacea*. As just explained, a measure must meet a two-tier test in order for a general exception to be applicable. In addition, whereas the burden of proof primarily relies on the complainant with regard to the general GATT provisions, the burden of proof under article XX GATT relies primarily on the defendant. Hence, if an opposed trading partner were to challenge the EU CBAM, the EU would have to present a *prima facie* case that the mechanism is justified under article XX GATT.[305]

4.3.1. First-tier test: the scope of application

160. Nor article XX(b), nor article XX(g) GATT, explicitly refer to environmental protection. However, the case law indicates that these provisions should be read in a broad manner, encompassing environmental matters. When ruling on the eligibility for justification on the basis of article XX(b) GATT in *Brazil-Retreaded Tyres*, for example, the Panel acknowledged that "*the preservation of animal and plant life and health […] constitutes an essential part of the protection of the environment*".[306] It further stressed the importance of environmental protection, *inter alia*, by referring to the preamble of the Marrakesh Agreement.[307] With regard to article XX(g) GATT, the AB in *US Shrimp* considered that the

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[303]See e.g. C.R. CONRAD, *PPMs*, *supra* fn. 298, 281; A. PIRLOT, *Environmental BTA*, *supra* fn. 257, 247.
[304]WTO Panel Report, *United States – Measures Affecting Cross-border Supply of Gambling and Betting Services*, WT/DS285/R, 10 November 2004, para. 6.461.
[305]WTO Panel Report, *EC-Measures Affecting Asbestos and Asbestos-Containing Products,* WT/DS135/R, 18 September 2000, para. 8.177-8.183; Appellate Body Report, *United States-Measures Affecting Cross-Border Supply of Gambling and Betting Services*, 7 April 2005, WT/DS285/AB/R, adopted 20 April 2005, para. 306-311; *US Gasoline*, *supra* fn. 170, 22; A. PIRLOT, *Environmental BTA*, *supra* fn. 257, 243.
[306]WTO Panel Report, *Brazil – Measures Affecting Imports of Retreaded Tyres*, WT/DS332/R, 12 June 2007, para. 7.112.
[307]*Ibid*.

expression 'exhaustible natural resources' must be read in light of "*contemporary concerns of the community of nations about the protection and conservation of the environment*".[308] This evolutionary approach could be used as an argument for considering environmental measures to fall within the scope of this general exception, as the negotiations under the UNFCCC clearly illustrate that reducing GHG emissions is one of the most important contemporary concerns of the international community. Furthermore, clean air, for example, was found in GATT case law to constitute an exhaustible natural resource.[309] Hence, there is no reason why the atmosphere, *i.e.* a layer of gases that envelops the earth, could not be conceived as an exhaustible natural resource.

161. Not only case law, but also scientific evidence can be referred to in order to support the argument that environmental issues fall within the scope of these general exceptions. Scientific evidence indicates that climate change, for example through the heatwaves and floods this phenomenon might cause, could jeopardise human, animal and plant life or health and could deplete exhaustible natural resources. Global warming, for example, adds to the distribution of infectious diseases.[310]

162. Supporting the protection of human, animal and plant life or health, however, is not enough. For a measure to be justified under article XX(b), it must be proven that the measure is 'necessary' to protect human, animal and plant life or health. To resort under the scope of article XX(g), by contrast, a measure must only 'relate to' the conservation of an exhaustible natural resource, but such measure must in addition be made effective in conjunction with restrictions on domestic production or consumption.

163. To fulfil the 'necessity' test, the measure must be suitable to attain the objective pursued and proportional to the importance of those objectives. This does not entail that the measure must be indispensable or of absolute necessity.[311] To determine whether a measure meets these requirements, the objectives of the measure must be weighed and balanced against its trade restrictiveness.[312] The more vital or common the interest at stake, the easier it is for a measure to pass the necessity test.[313] Reducing carbon emissions is a common and crucial interest of WTO Members and a carbon equalisation mechanism is a suitable mechanism to attain this objective. Additionally, necessity requires that there are no alternative, less trade-restrictive measures reasonably available, that could equally contribute to attaining the objective. A carbon equalisation system is not the most far-reaching measure. Import bans, for example, are far more restricting. Nonetheless, the AB found that an import

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[308]*US Shrimp*, *supra* fn. 272, para. 129.
[309]WTO Panel Report, *United States – Standards for Reformulated and Conventional Gasoline*, WT/DS2/R, adopted 29 January 1996, para 6.37.
[310]E.K. SCHUMAN, "Global Climate Change and Infectious Diseases*", International Journal of Occupational and Environmental Medicine* 2011, vol. 2, no. 1, (11) 11.
[311]*Korea-Various Measures on Beef, supra* fn. 291, para. 161.
[312]*Ibid*., para. 164.
[313]*Ibid*., para. 162.

ban on tyres could pass the necessity test.[314] If import bans, which are the most trade-restrictive measures available, can pass the necessity test, the EU CBAM should also be able to pass this test. Furthermore, it is up to the defendant to show that the measure is necessary, but it does not have to show that there are no reasonably less trade-restrictive alternatives available. Hence, the burden of proof in this respect relies on the complainant.

164. The 'related to' test on the other hand, simply requires that there is a substantial relationship between the measure and the conservation of exhaustible natural resources.[315] Additionally, the measures must not be disproportionately wide in their scope and reach in relation to the policy objective.[316] Although it is not inconceivable that the EU CBAM would meet the necessity test, it is even more likely to meet the less stringent requirement as there is a very close nexus between the EU CBAM and the conservation of natural resources, such as clean air and the planet's atmosphere. The 'public morals' exception on the other hand, also requires necessity. Hence, it would be easier for the EU CBAM to be justified under the exception regarding the conservation of exhaustible natural resources, than under the public morals exception or the exception for measures necessary to protect human, animal or plant life or health.

165. To be eligible for justification under article XX(g) GATT, it is also required that the measure is "*made effective in conjunction with restrictions on domestic production and consumption*".[317] The AB has clarified that this is not a requirement of identical treatment but only a requirement of 'evenhandedness' between the measure and restrictions on domestic production.[318] Since a border measure is designed to be symmetric to domestically imposed restrictions, the EU CBAM should easily meet this requirement.

4.3.2. Second-tier test: the chapeau

166. As set out in the chapeau of article XX GATT, measures can only be justified on the ground of a general exception if they are "*not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade*". The terms of the chapeau are rather vague and the amount of jurisprudence clarifying the terms is rather limited. The introductory phrase is nevertheless of crucial importance. It seeks to prevent abuse or misuse of the general exceptions.[319]

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[314]Appellate Body Report, *Brazil-Measures Affecting Imports of Retreaded Tyres*, WT/DS332/AB/R, 3 December 2007, para 155.
[315]*US Shrimp*, *supra* fn. 272, para. 136 and 141.
[316]*Ibid*., para. 141.
[317]Art. XX GATT, *supra* fn. 54.
[318]*US Gasoline*, *supra* fn. 170, 20-21.
[319]*Ibid*., 22.

167. The chapeau is more about the detailed operation of a measure and how it is applied in practice than about the measure itself.[320] The environmental policy goal is important for determining whether the measure falls within the scope of one of the exceptions, but not for the assessment of the measure under the chapeau.[321]

168. The first two conditions, prohibiting 'arbitrary' and 'unjustifiable' discrimination, will be dealt with together as they mostly overlap in terms of coverage. The difference between these forms of discrimination is not entirely clear. However, in order to satisfy these requirements, the measure must tick a series of boxes.

169. The first box that needs to be ticked regards procedures. The procedures for the application of the measure must respect basic fairness and due process. These procedures must also be transparent and predictable.[322] The EU CBAM could entail burdensome verification and reporting procedures. This in itself is not an issue, as long as such procedures are fair, transparent and predictable.

170. Secondly, before a carbon equalisation mechanism can be introduced, a country must engage in serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements on climate change action.[323] It is not required, however, that an agreement is concluded. Since the EU is a party to, *inter alia*, the Paris Agreement, it seems to have demonstrated sufficient engagement on this front.

171. The final box that needs to be ticked regards the taking into account of the conditions in different countries. WTO Members cannot simply coerce other countries to adopt essentially the same policies.[324] Since under the EU CBAM proposal, the carbon price paid in the domestic country can be deducted from the price to be paid under the equalisation mechanism, and since countries with an ETS linked to that of the EU can be exempted from the mechanism, the EU CBAM proposal does demonstrate a certain degree of flexibility. Whereas these two design specificities of the mechanism threaten its legality under the MFN-principle, they would help the mechanism to pass the test of the chapeau. However, the obligation to take into account the conditions in other countries could also force a carbon-restricting country to exempt LDCs and developing countries from the equalisation mechanism, or at least, to lower the burden that the mechanism imposes on these countries. This also follows from the preamble of the Marrakesh Agreement, which states that the environment must be protected in a manner consistent with the different levels of economic development between countries, and from other provisions in WTO agreements such as the Enabling Clause which permits developed countries to give certain preferential treatment to developing countries that would otherwise violate the

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[320]GATT Panel Report, *United States – Imports of Certain Automotive Spring Assemblies*, L/53333, adopted 26 May 1983, BISD 30S/107, para. 56; *US Shrimp*, *supra* fn. 272, para. 136 and 160.
[321]*US Shrimp*, *supra* fn. 272, para. 149.
[322]*Ibid.,* para. 180-181.
[323]*Ibid.,* para. 166.
[324]*Ibid.,* para. 164.

MFN principle.[325] In addition, the potential importance of international law, following the judicial activism of the Members of the AB, was already stressed earlier in this thesis. Hence, the UNFCCC principle of 'common but differentiated responsibilities and respective capabilities', could also be referred to in this respect.[326] On the other hand, although the Enabling Clause offers a certain margin, such a differentiated approach towards developing countries could come into conflict with the MFN principle. This demonstrates that the discrimination, as prohibited by the NT and MFN principles, strongly differs from the prohibition of discrimination under the chapeau of article XX GATT. Consequently, WTO Members, when designing trade-restrictive measures, need to choose whether they will design a measure in compliance with the general GATT provisions or whether they will opt for a measure that is likely to be justified under article XX GATT.[327]

172. The drafters of the EU CBAM proposal seem to have opted for the former approach, as the proposal includes references to the non-discrimination rules and does not foresee exemptions for developing countries. It is stated in the impact assessment report that "*while preferential treatment for LDCs is an established procedure in other areas of trade policy, it raises questions in the case of the CBAM. For example, blanket exemptions from a CBAM should be avoided, as setting up a mechanism that will encourage LDCs to increase their level of emission and run counter to the overarching objective of the CBAM. In addition, these exemptions would be temporary in nature, and would therefore prove counterproductive for the LDCs in the long run"*.[328] The only mention on less developed countries in the actual text of the Commission proposal, is that these countries should be provided with technical assistance in order to facilitate their adaption to the EU CBAM obligations.[329]

173. The European Parliament, by contrast, seems to favour the latter approach. After the publication of the Commission's proposal, the Committee on Development and the ENVI Committee, have issued a draft opinion steering the Commission towards the general exceptions. In this draft opinion, the committees propose certain amendments to the text of the Commission's proposal in favour of developing countries. The biggest critique of the committees on the Commission's proposal regards the use of revenues of the mechanism. The draft opinion states that "*using the CBAM revenue for new climate protection measures in developing countries with particular needs improves its legitimacy as a permissible arrangement under article XX of the GATT*".[330] The committees argue that not using the revenues generated through

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[325]Marrakesh Agreement, *supra* fn. 58, preamble; GATT, Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries, 28 November 1979, L/4903.

[326]See also P. LARBPRASERTPORN, "The Interaction Between WTO Law and The Principle of Common but Differentiated Responsibilities in the Case of Climate-Related Border Tax Adjustments", *Goettingen Journal of International Law* 2014, vol. 6, no.1, (145) 159.

[327]K. HOLZER, *Carbon*, *supra* fn. 11, 173.

[328]Impact Assessment Report, *supra* fn. 76, 30.

[329]Rec. 55 EU CBAM Proposal, *supra* fn. 4.

[330]Committee Development, Draft Opinion, *supra* fn. 98, 3.

the sale of CBAM certificates for climate purposes, weakens the credibility of the mechanism as a legitimate trade measure under article XX GATT.[331]

174. The final condition of the chapeau is that the measure cannot be applied in a manner which constitutes a disguised restriction on international trade. The traditional criteria used in WTO case law in this respect are the publicity test, the consideration of whether the application amounts to arbitrary or unjustifiable discrimination, and the examination of the design, architecture and revealing structure of the measure.[332] Since the EU CBAM has long been announced and foresees a transitional period, the mechanism is likely to pass the publicity test. However, as explained in the second chapter, the European Parliament's ENVI Committee proposes to shorten the transitional period. The second test overlaps with the first two requirements of the chapeau. The last test regards the design and architecture of the measure. The EU CBAM is not designed in a blatantly protectionist matter so that it should also meet this final requirement.[333]

4.3.3. Extraterritoriality

175. The geographical scope of article XX GATT has been a point of discussion in the literature.[334] The question remains whether measures whereby countries impose their climate policy on other countries, can be justified under the general exceptions. In *US Shrimp*, article XX(g) GATT was invoked to defend the US import ban of shrimp, caught in a manner that did not comply with US rules for turtle protection. Since turtles are highly migratory species, the AB found that there was a sufficient nexus between sea turtles and the US.[335] Hence, XX(g) can be invoked when there is a sufficient nexus between the protected objective and the country imposing the restriction. As argued by Joost Pauwelyn, this nexus should be found to suffice in the case of carbon measures, as the world's atmosphere is a global common and the reduction of GHG emissions is a collective action problem.[336]

176. The *US-Shrimp* case, however, only dealt with article XX(g) GATT. There is no similar jurisprudence on article XX(b) GATT. This leads Bradly Condon to the conclusion that XX(b) can be used to address concerns limited to the territory of

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[331] *Ibid.*, 6.

[332] GATT Panel Report, *United States – Prohibition of Imports on Tuna and Tuna Products from Canada,* L/52198, adopted 22 February 1983, BISD 29S/91, para. 4.8; *US Gasoline*, *supra* fn. 170, 23-25; WTO Panel Report, *United States-Import Prohibition of Certain Shrimp and Shrimp Products – Recourse to Article 21.5 by Malaysia*, WT/DS58/RW, 15 June 2001, para. 5.142.

[333] K. DAS, *WTO-legal*, *supra* fn. 39, 96-97.

[334] See e.g. B.J. CONDON, "GATT article XX and the proximity-of-interest: determining the subject matter of paragraphs B and G", *UCLA Journal of International Law and Foreign Affairs* 2004, vol. 9, no. 2, 147; C.R. CONRAD*, PPMs, supra* fn. 298, 281-286; B. COOREMAN, "Addressing environmental concerns through trade: a case for extraterritoriality?", *The International and Comparative Law Quarterly* 2016, vol. 65, no. 1, 229-248.

[335] *US Shrimp*, *supra* fn. 272, para 133.

[336] J. PAUWELYN, *Carbon leakage*, *supra* fn. 38, 498.

the regulating country and XX(g) should be used to address global concerns.[337] However, XX(b) covers, *inter alia*, measures necessary to protect human health. Human health concerns related to climate change can also require that measures with a certain extraterritorial effect are taken. Conrad refers to the example of toxic fumes. He notes that "*toxic fumes stemming from industrial production in one country may directly affect the health of the population of the neighbouring country*."[338] He therefore suggests that the general exceptions should be interpreted broadly and not be ought to include any geographical limitations.[339] In absence of further guidance from WTO jurisprudence, it remains uncertain which of the opposing views should be given preference.

[337]B.J. CONDON, "GATT article XX and the proximity-of-interest: determining the subject matter of paragraphs B and G", *UCLA Journal of International Law and Foreign Affairs* 2004, vol. 9, no. 2, 147.
[338]C.R. CONRAD*, PPMs, supra* fn. 298, 282.
[339]*Ibid*., 306, 301-302 and 309.

Interim conclusion

177. A comparison of the BTAM-specific legality assessment and the BAM-specific legality assessment demonstrates the importance of the qualification question. For taxes and charges, border eligibility is dependent on two other qualification questions. First of all, the qualification of the measure as either a border tax, an internal tax applied to imports or a border tax adjustment measure can be decisive for its eligibility for border adjustment. Secondly, such eligibility depends on the qualification of the measure as either a direct tax or charge, or an indirect tax or charge. If the EU CBAM were to be qualified as a tax, it would most likely be qualified as an indirect tax and thus be eligible for border adjustment. If the EU CBAM, by contrast, were to be qualified as a regulation, it would have to affect an internal activity and it is not certain that the mechanism would meet this requirement. Consequently, it risks to be qualified as a prohibited quantitative restriction. Qualifying the mechanism as a tax, rather than a regulation, could therefore increase its chances of passing the WTO-legality test.

178. However, the importance of the qualification question must not be exaggerated either. First of all, under both qualifications, the PPM character of the EU CBAM threatens its eligibility for border adjustment. Secondly, there are a number of legal provisions that apply to both types of measures. Under the current state of affairs, low and high-carbon products seem to still qualify as like products. Hence, the mechanism would have to comply with the NT and the MFN principles, which entails that it would not be allowed to discriminate *de jure*, nor *de facto*, between imported and domestic products, nor between products imported from different WTO Members. If the carbon footprint of imported products would overall be higher than the carbon footprint of domestic products, then the EU CBAM could be *de facto* discriminatory. Additionally, small design differences between the EU ETS and the EU CBAM could threaten the NT-compatibility of the mechanism. The EU CBAM could also have trouble passing the MFN-test. Especially problematic in this regard, is the exemption for countries with an ETS linked to the EU ETS and the possibility to receive a reduction or a refund for the carbon price paid in the country of origin of the goods.

179. Finally, regardless of the qualification of the measure, violations of the general GATT provisions, including the non-discrimination rules, could be justified under article XX GATT. In order to be eligible for justification, the measure would have to resort under the scope of one or more of the general exceptions and would have to satisfy the requirements of the chapeau. The EU CBAM could potentially fall within the scope of the environmental exceptions of article XX(b) and/or article XX(g). However, the EU CBAM, as set out in the Commission's proposal, does not seem to meet the test of the chapeau as it does not sufficiently take into account the conditions in developing countries, and does not foresee to exclusively use the revenues of the mechanism for climate purposes. In addition, it remains unclear whether the general exceptions can be used to justify carbon border adjustment measures, given their inherent extraterritorial nature.

Conclusion

180. Under the Paris Agreement, countries are free to decide on their own emission reduction targets. This bottom-up approach has led to asymmetries between countries' climate policies and efforts, which in turn, has sparked carbon leakage and competitiveness concerns amongst climate forerunners like the EU. Trade instruments can be particularly interesting tools to address these concerns. However, trade-restrictive climate policies risk violating the WTO rules. It is conducive for the WTO-legality of trade-restrictive measures, to design them as the import mirror of a domestic climate policy. The Commission has therefore opted to extend the EU ETS to imports. Both the European Parliament and the Council seem to welcome the overall design of the EU CBAM, but the final text of the regulation is likely to differ in some aspects from the Commission's proposal. Most importantly, a wider scope and a speedier implementation of the mechanism are to be expected.

181. In order to carry out a WTO-legality assessment of the proposed EU CBAM, it must first be determined whether the mechanism qualifies as a tax or as a regulation. The core of the mechanism is the obligation to surrender CBAM certificates. Therefore, the internal qualification of the obligation to surrender emission allowances pursuant to the EU ETS and the Californian cap-and-trade system have been looked into. These internal qualifications could be taken into account in WTO dispute settlement proceedings, but are not conclusive for the WTO-qualifications of the systems. In addition, the EU CBAM differs to a certain extent from both the EU ETS and the Californian system. Therefore, the GATT Working Party Report on BTA and doctrine arguments have also been analysed. It follows from this analysis that the question whether the EU CBAM meets the OECD definition of tax, *i.e.* the question whether the EU CBAM imposed cost constitutes a compulsory and unrequited payment, could be determinant for its qualification under the WTO legal order. The authors supporting the view that the obligation does not meet the tax definition and thus qualifies as a regulation, mostly base their argumentation on the tradability of allowances and the allocation of free allowances. However, CBAM certificates, unlike EU ETS allowances would not be tradable and free emission allowances would be phased out. Hence, the EU CBAM, contrary to its internal qualification, is more likely to qualify as a tax under the WTO legal order. It has been clarified in OECD guidance that the fact that CBAM certificates could be said to provide 'a licence to emit' in no way detracts from this.

182. With regard to the legality assessment, both taxes and regulations can be eligible for border adjustment, but the requirements thereto differ. The tax qualification could be conducive for the WTO-legality of the mechanism, as it is not clear what internal activity is affected by the EU CBAM, which could cause it to fall outside the scope of the border adjustment provision for regulations and thus cause it to qualify as a prohibited quantitative restriction. However, the importance of the qualification question must not be overstated either. One of the most problematic characteristics of the mechanism regards the PPM nature of carbon measures, which could prevent the mechanism from meeting the border adjustment requirements under both the tax-specific and the regulation-specific legality analysis. In addition, the non-discrimination rules, which are likely to be violated by the EU CBAM, apply to both types of measures. Nonetheless, regardless of the qualification of the measure, any violation of the general GATT

provisions could be justified under the general exceptions provision. The EU CBAM, as an environmental measure, could possibly fall within the scope of one or more of the general exceptions, but it is unlikely to meet the requirements of the chapeau. In addition, the extraterritorial nature of border adjustment measures raises the question as to whether such measures are eligible for justification in the first place. Hence, even if the EU CBAM were to pass the BTAM-specific or the BAM-specific legality assessment, it seems to be a discriminatory measure that is not eligible for justification and would thus violate the WTO rules. Such violation cannot invalidate Union legislation, but could, *inter alia*, lead to trade sanctions against the EU.

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