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CLIMATE TAXES AND THE WTO: IS THE MULTILATERAL TRADE REGIME A FURTHER OBSTACLE FOR EFFICIENT DOMESTIC CLIMATE POLICIES?

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Abstract

Industrialized countries are often required to make unpopular policy choices in order to efficiently tackle climate change. On the one hand, domestic industries might consider national climate measures as an excessive burden that may damage their competitiveness. On the other hand, the public may not be willing to pay a higher price for climate friendly products. Furthermore, an obstacle may arise from other international legal regimes whose goals may be undermined by domestic climate measures. In this paper I will examine this last possibility. In particular, I will assess whether the international trade regime may constitute an obstacle for future domestic climate measures. An affirmative or negative conclusion will be drawn after having answered three crucial questions.

First, have domestic climate measures already clashed with trade regimes? In 2001 the problematic relationship between a taxation scheme adopted by Finland to improve energy efficiency and EC rules on the free movement goods highlighted this possibility.

Second, are taxation schemes still being used in order to tackle climate change? Current climate policies show that not only are taxes being established, but that measures based on border tax adjustments are also being taken into consideration for the future.

Third, are climate taxes WTO compatible? The discussion of this point will involve an analysis of those WTO rules with which the domestic climate measures may come into conflict and the environmental exceptions that could be applied to the climate taxation schemes.

Although trade regimes should not constitute an obstacle for domestic climate measures, as the EU example demonstrates, this is not always the case. Therefore, proposals able to combine the goals of the two regimes must be put forth in order to prevent the WTO from being considered another obstacle for efficient domestic climate policies.

1. Introduction

Industrialized countries are often required to make unpopular policy choices in order to efficiently tackle climate change. On the one hand, domestic industries might consider national climate measures as an excessive burden that may damage their competitiveness. On the other hand, consumers may not be willing to pay a higher price for climate friendly products. Furthermore, an obstacle may arise from other international legal regimes whose goals may be undermined by domestic climate measures. This paper looks at this last possibility and, in particular, it assesses whether the international trade regime may constitute an obstacle for future domestic climate measures,[1] focusing the analysis on climate-related taxes.[2]

[1] It is interesting to see whether domestic climate measures have already clashed with trade regimes. The answer is positive and one can look at the European Union for an example. In 2001 the difficult relationship between a taxation scheme adopted by Finland to improve energy efficiency and EC rules on the free movement of goods highlighted this possibility. See

For the purposes of this paper, climate taxes will be divided into three categories. First, they can focus on a specific product that is relatively dangerous for the climate. This will be the case of a tax on energy products in which specific non-environmentally friendly raw materials such as oil or coal will be more heavily taxed than others such as gas. Throughout the paper this kind of measure will be referred to as a *feedstock tax*. Second, climate taxes can focus on the way a product has been produced. This will be the case for example of a tax on tiles based on the kind of energy that has been used in their process or production method (PPM). This kind of measure will be called a *PPM tax*. Finally, a third kind of climate tax can focus on the energy efficiency of a product. In this last case the tax will depend neither on the product itself, nor on the way it has been produced, but on its environmentally friendly, or unfriendly, impact throughout its lifetime. I will refer to this kind of measure as an *efficiency tax*.

The paper will be divided into two main parts. The first will assess the compatibility of climate taxes with the multilateral trading system. The study of the WTO rules on internal taxation provided for in GATT article III, and the study of the concepts of likeness and direct competitiveness and substitutability inherently contained in it , lead to the general conclusion that in most cases climate taxes will be considered a *prima facie* violation of the national treatment principle. The second part of the paper will consider whether the three kinds of climate taxes can be saved under the general exceptions provided for in GATT article XX. The study of the content and of the application of the three climate taxes will lead to slightly different considerations in each case. Finally, the legal conclusions will lead to a number of policy recommendations whose goal is to bridge the current gap between climate taxes and the multilateral trading system.

Finland's Fourth National Communication under the United Nations Framework Convention on Climate Change, 2006, available at http://unfccc.int/resource/docs/natc/finnc4.pdf, p. 101: "In 2001, Finland decided to lower taxation of imported used vehicles because of a decision of the European Court of Justice, as the European Communities considered the taxation in Finland was discriminatory from the point of view of free movement of goods within the European Union."

[2] Climate taxes are part of the wider family of environmental taxes. The rational behind these instruments is one of the reasons for their success. Environmental taxes apply the polluter pay principle according to which the burden of environmental degradation should be taken by whoever is responsible for it; see G. Goh, "The World Trade Organization, Kyoto and Energy Tax Adjustments at the Border", *Journal of World Trade* (2004) 38 (3), pp. 395-423, p. 397. For more information on environmental taxes see O.K. Fauchald, *Environmental Taxes and Trade Discrimination*: London-The Hague-Boston; Kluwer Law International (1998), pp. 30-33. Switching to climate taxes, the *ratio* behind them is to put pressure on those who are more directly responsible for climate change. However, climate taxes are usually not adopted upon production but at consumption, in which case the final effect of the climate tax is a price increase of the final product and consumers will be affected by the tax. For more information on climate taxes and further possible classifications see Kommerskollegium, *Climate and Trade Rules - Harmony or Conflict?* (2004), pp. 107; available at http://www.kommers.se/binaries/attachments/3430_Climate%20and%20Trade%20Rules.pdf, pp. 22-23; and S. Charnovitz, "Trade and Climate: Potential Conflicts and Synergies", Pew Centre on Global Climate Change Working Draft (2003), pp. 32; available at http://www.pewclimate.org/docUploads/Beyond_Kyoto_Trade.pdf, pp. 5-6.

2. Are climate taxes WTO compatible?

The WTO rule that most directly relates to internal taxation is GATT article III, which establishes the national treatment principle according to which States must give imported products, once they have cleared customs, the same treatment given to domestic like products.[3] The provision that deals with internal taxation reads as follows:

> The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.[4]
>
> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.[5]
>
> A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.[6]

WTO rules on internal taxation distinguish between like products and directly competitive and substitutable products.[7] The difference is important

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[3] *Japan – Taxes on Alcoholic Beverages (Japan – Alcoholic Beverages II)*, Appellate Body Report (Doc. WT/DS8/AB/R, 4 October 1996), section F: "The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures." *GATT* Article III:2 resembles very closely *EC Treaty* Article 90. See on this point M.M. Slotboom, "Do Different Treaty Purposes Matter for Treaty Interpretation? The elimination of Discriminatory Internal Taxes in EC and WTO law", 4 *Journal of International Economic Law* (2001), pp. 557-579.

[4] *General Agreement on Tariffs and Trade (GATT)*, Article III:1, in *The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations*: Cambridge; Cambridge University Press (1999) p. 427. Hereinafter *The Legal Texts*.

[5] *Ibid*, art. III:2 in *The Legal Texts*, p. 427.

[6] *Ibid*, note ad art. III:2 in *The Legal Texts*, p. 479-480.

[7] The latter are a sub-group of like products according to *Japan – Taxes on Alcoholic Beverages (Japan – Alcoholic Beverages II)*, Panel Report (Doc. WT/DS8/R, 11 July 1996), § 6.22.

because if a domestic and an imported product are *like products*, and the imported one has been subject to a higher tax than the domestic product, then the tax will be a violation of the national treatment principle and it will be non-compatible with WTO law.[8] On the other hand, if a domestic and an imported product are *directly competitive or substitutable*, and the imported one has been subject to a higher tax than the domestic product, then the tax will not be *per se* a violation of the national treatment principle and it will not be automatically non-compatible with WTO law. In this case a third condition must be fulfilled in order to finally condemn a tax of this kind: the tax must have been applied so as to afford protection to the domestic product.[9]

2.1. Like products vs. directly competitive or substitutable products

Therefore, in relation to the WTO compatibility of climate taxes the first issue that must be raised is whether the products that are being taxed differently are like products or directly competitive or substitutable products. It is evident that a State that has applied a climate tax will try to prove that they fall within the second category.

How does one decide whether two products are like or just directly competitive or substitutable? WTO case law has repeatedly used four main criteria to determine the concept of likeness:

- physical properties,
- end uses,
- consumer's preferences and
- tariff classification.[10]

Physical properties are the first element that must be taken into consideration. The closer the physical characteristics of two products, the most likely is it that they will be considered like products.[11] The second criterion used to determine the likeness of two products is *end uses*. If two products satisfy the same demand in a specific market they will have the same end uses and the

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8 *Japan – Alcoholic Beverages II*, Appellate Body Report, section H.1.

9 *Ibid*, section H.2.

10 *Report of the Working Party adopted on 2 December 1970* (Doc. L/3464), § 18: "The Working Party concluded that problems arising from the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the *different elements that constitute a "similar" product*. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "similar": the *product's end-uses in a given market*; *consumer's tastes and habits*, which change from country to country; the *product's properties, nature and quality*. It was observed, however, that the term "... like or similar products ..." caused some uncertainty and that it would be desirable to improve on it; however, no improved term was arrived at." See also on this point *European Communities - Measures Affecting Asbestos and Asbestos-Containing Products (EC – Asbestos)*, Appellate Body Report (Doc. WT/DS135/AB/R, 12 March 2001), § 101.

11 In the GATT period physical properties were considered to be crucial at the moment of determining whether two products were like. In the *Tuna – Dolphin* cases the Panel strongly underlined that in a likeness exam tuna as a product had to be compared to another tuna in relation to its physical properties and not taking into account the way the tuna had been caught. The latter was insignificant to the likeness exam. See *United States - Restrictions on imports of tuna* (Doc. DS21/R, 3 September 1991), § 5.15.

two goods will be like products.[12] The third criterion is *consumer's preferences*. If a consumer will choose either one to satisfy his/her specific demand, the two products will be similar according to the consumer's preferences and they will be seen as like products. Finally, the fourth criterion is *tariff classification*. If two products share the same, according to the World Customs Organization's Harmonized System, the two products will be like products.

The only difference between like products and directly competitive or substitutable products in relation to internal taxation is that the former respond to all four criteria, while the latter will not have exactly the same physical properties.[13] In other words, two products that share the same end-uses and are considered similar by the consumers but do not share the same physical properties will not be like products, but they will be directly competitive or substitutable.

2.2 The nature of the tax

Once two products have been declared in one way or another, the following step will be to look at the nature of the tax. In the case of like products it will be quite easy to determine whether the tax violates article III because even the slightest difference in the taxation of the two like products amounts to a WTO non-compatible measure.[14] On the other hand, if the two products are directly competitive or substitutable, two other conditions must be met before asserting the WTO non-compatibility of the measure: the tax to which the imported product is subject must be different than the one on the domestic product and it must afford protection to the domestic product.

The first condition implies that a slightly higher tax on imported products may not be sufficient to consider it a violation of article III.[15] The threshold over which the difference in the two taxes becomes a violation has not been clearly established by case law, since it has only maintained that the burden on imported products must be more than "*de minimis* in any given case".[16]

The second condition that must be met is that the final effect of the tax must be to afford protection to the domestic product. Current case law has indicated that if the difference in taxation responds to a need of the policy objective to which the tax measure is linked, this must not be taken into account by Panels or the Appellate Body. The WTO is not interested in *why* a tax measure has been taken, but in *how* it has been applied.[17] Therefore, the goal

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12 End uses are demonstrated by elasticity of substitution, which implies that they satisfy the same demand; see *Japan – Alcoholic Beverages II*, Panel Report, § 6.22.

13 On the difference between like products and directly competitive and substitutable products see *ibid*, § 6.22.

14 *Japan – Alcoholic Beverages II*, Appellate Body Report, Section H.1.b).

15 *Ibid*, section H.2.b).

16 However, the *de minimis* threshold has not been specified by the WTO jurisprudence; see *Japan – Alcoholic Beverages II*, Panel Report, note 118, confirmed in *Canada - Certain Measures Concerning Periodicals*, (Doc. WT/DS31/AB/R, 30 June 1997), Appellate Body Report, section VI.B.2.

17 There has been a moment at the end of the GATT period, and at the beginning of the WTO, in which the policy objective of a specific measure seemed to be important within the likeness criteria exam. According to the so called *aim and effect test*, one of the criteria to determine whether two goods were like products would have been precisely the reason behind

of the analysis will be to see whether the application of the tax measure (regardless of its objective, be it environmental, social or to increase revenue) has led to the protection of domestic products. How can one assess this? Case law has suggested that "the design, the architecture, and the revealing structure of a [tax] measure" may guide Panels and the Appellate Body in the assessment of the protectionist nature of a specific tax measure.[18]

Summarizing the WTO regulation of internal taxation and linking it to the WTO compatibility of the three kinds of climate taxes that have been previously underlined, the following steps must be taken:

1) Are the two products that are being compared (energy products, products produced with different energy sources and products with different energy efficiency) like products or directly competitive or substitutable products? The analysis of their physical properties, their end uses, the study of the consumer preferences and their tariff classification will give us an answer.

2) If they are like products, one must assess whether the imported product is subject to a higher tax than the domestic product. If that is the case, the climate tax will be a *prima facie* violation of GATT article III.

3) If they are directly competitive or substitutable products, one must see, on the one hand, whether the imported product is subject to a different tax than the domestic product. A slighter higher tax will not be sufficient to prove that the measure is WTO incompatible; a *de minimis* difference in the burden upon the imported product must be proven. On the other hand, one must also see whether the tax on imported products is applied in a way that gives protection to domestic products. The analysis of the design, structure and architecture of the measure will reveal the protectionist nature of the tax. If both conditions are met in relation to directly competitive or substitutable products, then even in this case a *prima facie* violation of GATT Article III will be assessed.

Now the paper will move on to see whether the climate taxes that have been previously identified deal with like products or directly competitive or substitutable products.

2.3. Taxes on energy products (feedstock tax)

Taxes on energy products are levied on different kinds of energy-related raw materials. Current efforts to tackle climate change will lead to establish or

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the less favorable treatment given to one of the two products. Within the context of GATT article III:4, which deals with domestic regulations and not fiscal measures, if discrimination was due to the fulfillment of a legitimate non-commercial objective, then the two products would not be like and less favorable treatment would be allowed; otherwise, the two products would be like and less favorable treatment would amount to a violation of the national treatment. See *United States — Taxes on automobiles (US – Automobiles)*, Panel Report (Doc. DS31/R, 11 October 1994), § 5.9: "However, the first step of determining the relevant features common to the domestic and imported products (likeness) would in the view of the Panel, in all but the most straightforward cases, have to include an examination of the aim and effect of the particular tax measure… The Panel concluded that its interpretation was consistent with previous ones, but made explicit that issues of likeness under Article III should be analyzed primarily in terms of whether less favourable treatment was based on a regulatory distinction taken so as to afford protection to domestic production."

[18] *Japan – Alcoholic Beverages II*, Appellate Body Report, section H.2.c).

consolidate the setting of higher taxes on non-environmentally friendly sources, such as oil or coal, and lower taxes on greener energy sources, such as gas.[19]

In order to assess their WTO-compatibility, the first question is whether oil and gas, for example, are like products or directly competitive or substitutable products. The examination of the four criterions of the likeness test must be carried out. *End uses* must be assessed in the marketplace through the criterion of elasticity of substitution.[20] If both products can fulfill the same demand for consumers, then the two products will have the same end uses. This is clearly the case for oil and gas. A second criterion to determine the likeness of two products is *consumer preferences*. Do consumers react differently to oil or gas as an energy source? One should take into account that this must be a case by case assessment and that it is therefore very difficult to generalize. Even in those countries in which consumers are very concerned about environmental factors it is fair to say that, as far as primary energy sources are concerned, consumers still do not clearly distinguish the two products. One must then look at the crucial element at the moment of determining the likeness of two products: *physical properties*. According to this criterion, oil and coal are not like because they do not share similar physical properties. The final criterion, *tariff classification* is a supplementary criterion that may help when the others fail to give a clear answer. In the case of energy products there is no uniformity of tariff classification and, therefore, they do not meet this requirement.

In sum, energy products only share the same end uses. In fact, consumers do not seem to consider them similarly, they do not have the same physical properties nor do they meet the tariff classification requirement. Oil and coal are, therefore, directly competitive or substitutable products.[21]

Table 1. Analysis of likeness for taxes on energy products

OIL / GAS	DIRECTLY COMPETITIVE OR SUBSTITUTABLE PRODUCTS
End uses	✓
Consumer preferences	X/✓
Physical properties	X
Tariff classification	X

Once the nature of the energy products has been established, two further questions must be posed in order to ascertain whether the tax on energy products is WTO-compatible. On the one hand, the difference in taxation will not be a crucial element as in the case of two like products. In fact, two directly competitive or substitutable products, such as energy products, can be taxed differently without this leading automatically to a WTO violation. The tax will be deemed non compatible with the multilateral trade regime only if a *de minimis* difference in the burden of the tax on the imported product is proven. On the other hand, one must also see whether the tax on imported products is applied

[19] A in depth study of the WTO compatibility of taxes on energy products has been carried out by S. Zarrilli, "Domestic Taxation of Energy Products and Multilateral Trade Rules: Is This a Case of Unlawful Discrimination?", 37.2 *Journal of World Trade* (2003), pp. 359-394.

[20] *Japan – Alcoholic Beverages II*, Panel Report, § 6.22.

[21] See S. Zarrilli, above n. 19, p. 379.

in a way that gives protection to domestic products. This is precisely where current taxes on energy products may fail.[22] In fact, the analysis of the inherent structure of a tax reveals in many cases the protectionist nature of the measure.

2.4. Taxes based on the energy used in the process or production method (PPM tax)

The second kind of climate tax is a measure based on the kind of energy that has been used in the production of a product. Even in this case, in order to assess the WTO compatibility of the PPM tax, the first step will be to undertake a comparison between two products. To stay with our example, is a tile produced in a factory that uses oil and coal as energy sources *like* another tile produced by a company that relies on solar energy? The tax is levied on the product, but the amount of the tax is based on elements that are not related to the products itself, but to its production. According to the traditional likeness criterion study, the two products have the same *end uses*; in fact, both tiles fulfill the same consumer demand. Furthermore, both have exactly the same *physical properties* and the same *tariff classification*. *Consumer preferences* is the only element of likeness that could determine that two goods are not like-products. There is only one fundamental question to be answered here: Do consumers consider a product produced with renewable energy differently compared to another that has been made with environmentally unfriendly energy? This is a case by case study that must be done in a specific market. It is probable that in very environmentally-concerned societies the way products are produced and their impact on climate change are very important for consumers. A special *niche* in the market may exist that may constitute an element in favor of defending the non-likeness of two products from a consumer perspective.[23] Since WTO case law has strongly affirmed that the likeness of two products should be decided in the marketplace,[24] the possible differentiation between tiles based on the energy source used to produce them could be an important element. However, if consumers do not see two products as two different ways of satisfying their personal needs, then those two products will be alike for them.

Thus, if consumers in a specific market do not consider two products differently on the basis of the energy used in their production, the two tiles will be like products, and the higher tax on the one produced with oil will be a violation of GATT article III. On the other hand, if the market analysis shows that consumers perceive the two tiles as two different products, then they will not be alike, and the higher tax on the tile based on the energy used in its production will be WTO compatible.

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22 See *ibid*, p. 382.

23 If people are starting to go to shops where just organic food is sold, that is because those consumers do not consider a genetically modified tomato like an organic tomato. Once this perception is established, the market reflects it and the two products become part of two different sectors.

24 *Japan – Alcoholic Beverages II,* Appellate Body Report, section H.2.a).

Table 2. *Analysis of likeness for taxes based on the energy used in the production process*

TILE PRODUCED WITH POLLUTING ENERGY (OIL) / TILE PRODUCED WITH LESS POLLUTING ENERGY (GAS)	LIKE PRODUCTS
End uses	✓
Consumer preferences	✓/X
Physical properties	✓
Tariff classification	✓

2.5. Taxes based on the energy efficiency of a product (efficiency tax)

The last kind of climate taxes that have been underlined in this paper are energy efficiency related taxes. These depend on the environmental impact and, in particular, on the product's contribution to climate change throughout its lifetime. This kind of tax is closely related to the previous tax – the PPM tax - which is based on the energy used in the production of a product that will not, *per se*, constitute a threat to climate change: *i.e.* a PPM. This kind of tax focuses rather on a product once it has already been produced: *i.e.* a car, a refrigerator, which may constitute a threat throughout its life. The tax, therefore, aims to reduce this threat by imposing a higher burden on those products that have a lower energy efficiency.

The first step in order to determine the WTO compatibility of the tax concerned is the determination of likeness between a car with a high energy efficiency and one with a lower energy efficiency. The analysis will be very similar to the one just undertaken for taxes based on the energy used in the production of a product. *End uses* will clearly be the same; two cars fulfill the same consumer demand. *Tariff classification* is the same also. However, in light of the importance given to fuel efficiency in automobile marketing and of the emphasis given to technical innovation in this domain one may assume that *physical properties* would be considered as being distinctly different. What about *consumer preferences*? The recent increases of the gasoline price have given added importance to this criterion in consumers' purchasing decisions, and perspectives in this regard are not encouraging for cars with high gasoline consumption, not even in the U.S. Furthermore, car advertisements in some countries indicate the CO2 emission in g/km according to certain norms. Consumer preferences therefore point toward non-like products. In sum, only two of the four elements of the likeness exam tilt the decision in favor of considering cars with different energy efficiency as *like products*. Therefore, any tax on imported cars that is higher would presumably be relatively easy to justify under GATT Article III, following also the precedent of *US – Car Taxe*. [25]

[25] Under the GATT dispute settlement system the European Communities brought a dispute against US legislation that differentiated between cars with higher energy efficiency (lower tax) and cars with lower energy efficiency (higher tax). According to the European Communities' position "[A]ll automobiles were like products, because of their common physical characteristics, components and end-use"; see *US – Automobiles*, Panel Report, § 5.19. The Panel, following the above mentioned 'aim and effect' test, see above note 17, decided in favour of the US underlying the importance of the environmental goal of the measure; see *ibid*, § 5.12, 5.13, 5.19, 5.20 and 5.24.

Table 3. *Analysis of likeness for taxes based on the energy efficiency of a product*

CAR WITH HIGH ENERGY EFFICIENCY / CAR WITH LOW ENERGY EFFICIENCY	LIKE PRODUCTS
End uses	✓
Consumer preferences	X
Physical properties	X
Tariff classification	✓

2.6. Conclusions on WTO compatibility of climate taxes *per se*

The analysis of climate taxes within the framework of the national treatment principle provided for in GATT Article III leads to these provisional conclusions. Once two products that are differently taxed are considered like products, the tax will most likely be considered a violation of Article III. On the contrary, if the two products are deemed directly competitive or substitutable, there is more space for States to apply a climate tax without it being automatically WTO incompatible.

Therefore, on the one hand, energy products, such as oil and coal, will probably fall within the second category and the final WTO compatibility of the tax on energy products (the feedstock tax) will depend on one further element: does the different taxation scheme on the two energy products lead to protection of the domestic product? On the other hand, taxes based on the energy used in the production process (the PPM tax) or on the energy efficiency of the final product (the efficiency tax) can be considered WTO compatible only through very environmentally friendly interpretations of the consumer's preference criterion and of the physical properties criterion.

3. Can climate taxes be justified under GATT article XX?

GATT article XX establishes the general exceptions to the other GATT rules and, therefore, it also applies to article III. The protection of the environment *in sensu latu* is one of the non-commercial objectives that may legitimately be pursued through a measure that would otherwise be non-compatible with the multilateral trading system. Any tax that has been considered a violation of the national treatment can be saved by the general exception, if it meets the conditions provided for in GATT article XX.[26] What does this provision say exactly?

[26] In other words, GATT article XX allows some *flexibility* to States in the adoption of environmental taxes. However, O.K. Fauchald, "Flexibility and predictability under WTO's non-discrimination clauses", 37.3 *Journal of World Trade* (2003), pp. 443-482, p. 451, maintains that: "… GATT Article XX can possibly provide some flexibility for environmental taxes that constitute implicit discrimination in violation of Article III. However, case-law has interpreted the exceptions restrictively. In view of the need for predictability when designing environmental taxes, it would in most cases not be acceptable to rely on invoking Article XX in order to justify such taxes."

> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> (*b*) necessary to protect human, animal or plant life or health;
>
> (*g*) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;

In order to see whether a climate tax can be saved by article XX two questions must be posed:[27] does the climate tax fall within one of the two paragraphs, b) or g)? If the first question is answered affirmatively, the second issue will be to see if the tax has been applied in a non-protectionist manner according to the article's chapeau cited above.

3.1. Is the tax a measure that deals with a legitimate non-commercial objective?

The following questions must be asked in order to determine whether the climate tax falls within paragraph b) or g) of GATT Article XX.

Is the climate tax a measure that deals with the protection of human, animal or plant life and health? Or is it a measure that deals with the conservation of exhaustible natural resources? In a way both questions, if answered positively, lead to the same conclusion: the measure fulfils an environmental purpose.

The final goal of a climate tax is the protection of the environment. However, a State may prefer to link its measure to one paragraph or the other. If the tax is due to the protection of human, animal or plant health the measure must be *necessary* for achieving that goal. On the other hand, if the climate tax deals with the conservation of exhaustible natural resources, the measure must just be *related to* that goal. It is evident that the link in the second case is weaker and that it is much easier to prove than in the first case in which a State must deal with the burden of the necessity test.[28]

Therefore, due to the difference between the two kinds of environmental exceptions provided for in GATT Article XX, a State that adopts a climate tax may wish to clearly state that its final objective is, if not solely, also to conserve exhaustible natural resources. However, *vis a vis* a WTO complaint, the State will also have to show that national measures are "made effective in conjunction with restrictions on domestic production or consumption". If the real goal of the

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[27] *United States - Standards for Reformulated and Conventional Gasoline (US – Gasoline)*, Appellate Body Report (Doc. WT/DS2/AB/R, 29 April 1996), section IV, and *United States - Import Prohibition of Certain Shrimp and Shrimp Products (US – Shrimp)*, Appellate Body Report (WT/DS58/AB/R, 12 October 1998), § 119-120.

[28] The difference between *necessary* and *related to* has been underlined already in the old GATT dispute settlement system; *Canada — Measures affecting exports of unprocessed herring and salmon*, Panel Report (Doc. L/6268 - 35S/98, 22 March 1988), § 4.6.

tax is to tackle climate change this should not be a problem, because non-environmentally friendly practices will lead to serious threats to climate change wherever they come from. However, in some cases this requirement can become a drawback for some countries in their climate policies strategies.

To sum up, the first step in examining GATT Article XX concerns the *content* of the tax measure. The overall goal is to see whether the State has adopted a measure that falls within one of the non-commercial objectives that may allow legitimate exceptions. On the one hand, if the climate tax deals with the protection of human, animal or plant health, one must determine whether the climate tax is *necessary*. On the other hand, if the climate tax deals with the conservation of exhaustible natural resources, one must assess whether the climate tax is *related to* the conservation of exhaustible natural resources and if the climate tax is *applied in conjunction* with restrictions on domestic production or consumption.

3.2. Is a climate tax applied in a non-protectionist manner?

The content of a climate tax may be considered legitimate but there is a second overall condition that the measure must fulfill: the tax must not be *applied* in a protectionist manner. There are three requirements that must be met in order for a tax to be applied in a non-protectionist manner: the measure must not be an arbitrary discrimination, and it must not be an unjustifiable discrimination. Finally, the measure must not be a disguised restriction on international trade. All three requirements refer to situations that occur between countries where the same conditions prevail.

The following sections of this paper will analyze whether the content and the application of the three above-mentioned climate taxes can be justified according to GATT Article XX.

3.3. Can climate taxes on energy products be justified under GATT article XX?

Once a climate tax on energy products has been considered a violation of article III, one must see if the measure can be saved by the general exception under GATT Article XX.[29] The first question will be to see whether the content of the climate tax falls within one of the categories that justify otherwise non-compatible WTO measures.

3.3.1. Feedstock tax & paragraph b)

Is the feedstock tax *necessary* for the protection of human, animal or plant health? The issue here is twofold. The question is whether climate change is a threat to human, animal or plant health. Some of the problems associated with climate change are precisely its negative effects on human health,[30] as well as

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[29] S. Zarrilli deals with this issue in S. Zarrilli, above n. 19, pp. 383-388.

[30] Climate change is responsible for the increase in malaria due to higher temperatures and to the spread of mosquitoes in larger parts of the world. Furthermore, desertification caused by climate change leads to more droughts which lead to human health problems. See *Summary for Policymakers. Climate Change 2001: Impacts, Adaptation, and Vulnerability,* A Report of

on the animals' and the plants'. However, even if climate change is related to health problems, is the tax measure really *necessary* to solve these problems? The linkage between the measure and the non-commercial purpose must be very strong in this case. The necessity test in GATT article XX b) has been subject to many criticisms in the past because panels and the Appellate Body interpreted it very restrictively through the *least trade restrictive test*. According to this approach, the State applying the tax had to prove that there was no other possible measure, which would have been less restrictive of international trade than the one actually adopted.[31] Case law has evolved and now the necessity test has developed into something closer to a *proportionality test*.[32] The interpreter must balance the negative effects on international trade with two important factors: the nature of the non-commercial interest pursued by the measure and the role of the measure in fulfilling such a goal.[33] Therefore, the final questions are whether climate change is a vital interest and if the tax measure is essential to combat climate change.

If one is truly concerned by climate change, then his/her interpretation is that solving current negative climate change trends is vital for mankind and, therefore, for the international community. A feedstock tax is an instrument whose goal is to promote less polluting kinds of energy products. Thus, in view of the importance of energy in the overall climate change problem, a tax on energy products is crucial for an efficient climate policy.[34]

However, it must be recalled that not all States agree on the dangers of climate change and some would argue against the efficiency of taxes on energy products. Probably, in a case before the WTO Dispute Settlement Body (DSB) scientific expertise would be of great relevance in order to assess how important climate change really is. In such a case IPCC reports must be considered as an important element of proof in favor of those countries that defend measures taken in order to tackle climate change.

3.3.2. Feedstock tax & paragraph g)

What would happen if a State that has adopted a tax on energy products decides to defend itself on the grounds of paragraph g), instead of arguing under b)? Is the climate tax measure *related to* the conservation of exhaustible natural resources? In this case the examination will be threefold.

Working Group II of the Intergovernmental Panel on Climate Change (2001), § 3.5, available at http://www.grida.no/climate/ipcc_tar/vol4/english/pdf/wg2spm.pdf.

[31] The least trade restrictive test posed a very heavy burden on those States that decided to adopt non-commercial policies that could enter into conflict with the multilateral trading system. See *United States - Section 337 of the tariff act of 1930*, Panel Report (Doc. L/6439, 16 January 1989), § 5.26; and *Thailand – Cigarettes*, Panel Report Doc. DS10/R - 37S/200, 7 November 1990, § 75.

[32] J. Wiers, *Trade and Environment in the EC and in the WTO. A Legal Analysis*: Groningen; Europa Law Publishing (2002), p. 242 compares it with the proportionality principle present in the EC Treaty, art. 30.

[33] In other words, the more important, more vital, the interest that is being pursued by the measure is, the more likely will it be to be necessary. Likewise, if the tax is a crucial measure for the State's efforts in relation to the vital non-commercial interest, it is more likely to be necessary. See *Korea - Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Appellate Body Report (Doc.WT/DS161/AB/R, 11 December 2000), § 164.

[34] See S. Zarrilli, above n. 19, p. 385.

The first question is to see whether climate change affects exhaustible natural resources. The main cause of climate change is the increase of greenhouse gases, and particularly of carbon dioxide, in the atmosphere that absorb the solar infrared radiation that has been reflected by the earth's surface. This radiation is re-emitted to the earth causing the warming of the earth's surface and of the troposphere. If the atmosphere itself is a natural resource, then climate change is responsible for its deterioration. If this possible interpretation should fail to convince some critics of climate change, then one could look at WTO case law for guidance. In *US - Reformulated Gasoline* clean air was considered an exhaustible natural resource. Some authors consider that, if this is the case, the concept of clean air can be widened meaning that the dangerous levels of greenhouse gases in the atmosphere constitute a threat to an exhaustible natural resource.[35]

The second question is to determine whether the tax on energy products is *related to* the non-commercial goal. In this case, does a feedstock tax relate to climate change efforts, considered as measures whose goal is to promote the conservation of exhaustible natural resources? In this case WTO jurisprudence has developed a reasonableness test according to which the second requirement in GATT Article XX g) will be met if there is a reasonable relationship between the means (in this case the energy product tax) and the end (tackling climate change).[36] The reasonableness test will be easier to meet than the necessity test in paragraph b). A feedstock tax is clearly related to the goal it intends to pursue, which is to promote cleaner kinds of energies. This instrument is clearly *related to* the overall end, which is to tackle climate change caused to a great extent by non-environmentally friendly energy sources like oil.

Finally, there is a third condition that must be met in order for taxes on energy products to be considered compatible with GATT article XX g). The tax must be *applied in conjunction* with restrictions on domestic production or consumption. This makes sense from an environmental perspective and it places an obligation of impartiality upon the State that adopts the tax.[37] If oil is a problem for climate change, where it comes from does not make any difference. However, this third requirement may be a big problem for many States that wish to defend their climate taxes on energy products. In fact, most industrialized States tax non-environmentally friendly energy products heavily but, at the same time, subsidize domestic production of the same energy product.[38]

Oil is a perfect example. On the one hand, it is heavily taxed but, on the other hand, national refineries are being helped economically and more funding is provided in order to discover new, and maybe the last, oil deposits. States

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35 See J. Wiers, above n. 32, p. 239.

36 *US – Shrimp*, Appellate Body Report, § 141.

37 *US –Gasoline*, Appellate Body Report, section III.C; *US – Shrimp*, Appellate Body Report, § 144-145.

38 Furthermore, this practice goes against *Kyoto Protocol* Article 2.1.a) v) that calls for the elimination of all market based instruments that run against the objectives of the protocol: "Each Party included in Annex I, in achieving its quantified emission limitation and reduction commitments under Article 3, in order to promote sustainable development, shall [I]mplement and/or further elaborate policies and measures in accordance with its national circumstances, such as: [P]rogressive reduction or phasing out of market imperfections, fiscal incentives, tax and duty exemptions and subsidies in all greenhouse gas emitting sectors that run counter to the objective of the Convention…"

might be able to defend their awkward position before their voters, but it will be much more difficult to convince the WTO DSB that the tax on energy products has been applied in conjunction with domestic efforts, if imported oil is being taxed while oil exploration or processing is being subsidized domestically.[39]

In conclusion, should this be the case, a feedstock tax will not be compatible with the multilateral trading system and it will not be saved by the general exceptions provided for in GATT article XX, if the adopting State decides to argue under paragraph g). Should the climate tax be defended under paragraph b), however the measure might stand more chances of being saved as an exception to the multilateral trading system.

Table 4. *Energy products and GATT article XX*

FEEDSTOCK TAX AND GATT ARTICLE XX	GENERAL CRITERION	
Does the tax deal with human, animal or plant health?	Is climate change a threat for human, animal or plant health?	✓
Is the tax necessary for the protection of human, animal or plant health?	Is climate change a vital interest?	✓
	Is the tax measure essential to solve climate change?	✓/X
Is a tax measure related to the conservation of exhaustible natural resources?	Is climate change about exhaustible natural resources?	✓
	Is there a reasonable means-end relationship between the energy products tax and climate change?	✓
	Is the energy products tax *applied in conjunction* with restrictions on domestic production or consumption	X

In the latter case the second phase of the analysis of GATT article XX would be carried out and one must see whether the tax on energy products has been applied in a non-protectionist manner. The same reason why the measure would not meet the requirements in paragraph g) will probably also determine the non-compatibility of the tax with the chapeau.[40] The fact that imported polluting energy products are taxed, while, at the same time, they are domestically subsidized, constitutes clear proof of the protectionist nature of the measure.

Therefore, if States do not stop funding domestically those same energy products that are heavily taxed when they are imported because of their

[39] See S. Zarrilli, above n. 19,, p. 387.

[40] This is also the same reason that leads one to consider that the oil tax gives less favourable treatment to imported energy products and, therefore, constitutes a violation of GATT Article III.2; *vid. supra* section 2.3.

allegedly negative contribution to climate change, it will be very difficult to defend taxes on energy products before the WTO DSB.[41]

3.4. Can climate taxes based on the kind of energy used in the production process be justified under GATT article XX?

A PPM tax is based on the energy used in the production of the product. The tax will most likely be considered a violation of GATT article III and it must be seen if it can be saved as an environmental exception under GATT article XX. The procedure will be very similar to the one described above in relation to the feedstock tax. Two different phases must be carried out: the first in which the content of the measure will be analyzed, and the second in which the goal is to determine whether the tax has been applied correctly.

3.4.1. The PPM tax & paragraphs b) or g)

In the first phase the aim is to see whether the objective of the measure falls under one of the legitimate non-commercial goals provided for in GATT article XX and to evaluate whether a State stands better chances under paragraph b) or g). This is very important for strategic purposes; in fact, should a State decide to argue under paragraph b), two questions must be answered: does the PPM tax deal with the protection of human, animal or plant health? and is the tax necessary for the protection of human, animal or plant health?

The objective of the tax will be to tackle climate change through the promotion of those products that have been produced with cleaner energy sources. The primary objective is not the protection of human, animal or plant health but, if one agrees that climate change is responsible for problems in these fields, then a measure that deals with climate change also deals with the protection of human, animal or plant health.

The second question will be more difficult to answer in a straightforward manner. Taking the position that climate change is a vital interest, it is debatable whether the PPM tax is the least trade restrictive measure that could have been adopted. Still, one has to remember that WTO case law has evolved and that now a proportionality test must be carried out in order to see whether a measure is or is not necessary under paragraph b). Against this background, one can argue that the PPM tax is very important for efficient climate policies because if one cannot intervene on the way products are being produced, if this contributes negatively to current climate change trends, then the correspondent climate policy will be flawed. However, it must be underlined that the necessity test, even if not as strict as it once was, will still be a very hard obstacle for climate taxes based on the energy used in the production methods.

Therefore, it would be wise to switch a States' defense to paragraph g) where three conditions must be fulfilled: the tax must deal with exhaustible natural resources; the tax must be related to the conservation of exhaustible natural resources; and, finally, the tax must be applied in conjunction with restrictions on domestic production or consumption

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[41] See S. Zarrilli's conclusion on the relationship between taxes on energy products and the WTO in S. Zarrilli, above n. 19, p. 388.

Following the previously discussed position in relation to the feedstock tax, the PPM tax deals with the conservation of exhaustible natural resources. Is there a reasonable relation between means and ends? Even in this case such a relation exists because of the relevance of energy for climate change. It is not only the energy product *per se* that causes climate change, but its use in the manufacture of a product, such as a tile, is equally responsible for current negative climate change trends. Finally, if States treat domestic and imported products in the same way with regard to the energy used in their production, the third requirement provided for in paragraph g) will be fulfilled and the content of the tax measure will be compatible with the WTO.

3.4.2. The PPM tax & the chapeau of GATT article XX

The second phase of the GATT Article XX exam must be carried out in order to see if the application of the measure leads to protectionism. Three requirements must be fulfilled in order for a climate tax to be non-protectionist:[42] the measure must not be an arbitrary discrimination; it must not be an unjustifiable discrimination; and the measure must not be a disguised restriction on international trade.

According to the case law elaborated especially in *Shrimp-Turtle* the first two requirements can usually be assessed together and combined in one analysis.[43] Arbitrary and unjustifiable discrimination will be present if the tax measure lacks *flexibility* in its application and if the tax measure has been adopted without prior *negotiation efforts* to deal with the issue bilaterally or multilaterally.

Concerning *flexibility* the DSB in *US-Shrimp* denounced the US measure because it gave more time and possibilities to some countries compared to others.[44] The *ratio* of the flexibility requirement is clear from an environmental perspective. If a PPM elaborated through a polluting energy source is produced in Spain or in China, the impact on climate change will be the same. Therefore, if Spain gives more time to India than to China to adjust its production process, this can reveal arbitrary and unjustifiable discrimination. Therefore, in order for a measure, such as a PPM tax, to be considered WTO compatible, flexibility must be given to all other parties. Another element of the flexibility criterion is the fact that a State must not oblige another State to follow its production methods in exactly the same way. In many cases this would be impossible, especially for developing countries, and it would imply a protectionist measure. A comparable measure approach is preferred by panels and the Appellate Body.[45] If a State is concerned about climate change and adopts a PPM tax, it should allow imports from other countries that have adopted a comparable measure.

In sum, if the real goal behind a PPM tax is to tackle climate change, the first condition of the flexibility test should be easily met because there is no environmental reason to treat countries differently. However, if that is the case,

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42 *US – Shrimp,* Appellate Body Report, § 150, and *United States - Import Prohibition of Certain Shrimp and Shrimp Products - Recourse to Article 21.5 of the DSU by Malaysia (US – Shrimp, art. 21.5 DSU),* Appellate Body Report (Doc. WT/DS58/AB/RW, 22 October 2001), § 118.

43 *US – Shrimp,* Appellate Body Report, § 177.

44 *Ibid,* § 173-175.

45 *Ibid,* § 163.

then the tax measure constitutes a clear example of arbitrary and unjustifiable discrimination. The second element of the flexibility test leaves more space to discretion since states can have different feelings about what is comparable. There is no clear-cut answer and the decision must be taken on a case by case approach.

The second criterion that must be used in order to see whether a measure constitutes an arbitrary or unjustifiable discrimination is the presence of *negotiation efforts*. In the *Shrimp-Turtle* case the US measure was deemed WTO incompatible because the US had not started serious talks with the other parties affected by its measures in order to deal with the environmental issue.[46]

The presence of a negotiation effort may be revealed by the status of the PPM tax within the international climate change regime. Kyoto Protocol Article 2 establishes a list of policies that Parties *may* want to take into account for their domestic climate policies.[47] Taxes are part of the list.[48] Does this imply any legal consequence in relation to the study of the WTO compatibility of a tax measure adopted in order to tackle climate change? According to some States, if a trade measure is provided for in a Multilateral Environmental Agreement (MEA), this could override a provision of the WTO.[49] However, the trade measure must be specific, in the sense that it must be clearly provided for in the MEA and Parties must be obliged to adopt it in their environmental policies. Furthermore, a specific trade measure will prevail over a WTO rule only if the Party affected by the trade measure is also Party to the MEA.[50] Therefore, there are two main limits to consider when analyzing the fact that taxes are included in the list of possible climate policies of *Kyoto Protocol* article 2. First, the tax is not a specific trade measure. However, some countries maintain a different position on this point and conclude that even those trade measures which are

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46 *Ibid*, § 172.

47 *Kyoto Protocol to the United Nations Framework Convention on Climate Change*, Kyoto, 10 December 1997, in force 16 February 2005, 37 *ILM* (1998), at 22, art. 2.1.a): "Each Party included in Annex I, in achieving its quantified emission limitation and reduction commitments under Article 3, in order to promote sustainable development, shall: (a) Implement and/or further elaborate policies and measures in accordance with its national circumstances, *such as*…" (Emphasis added).

48 *Ibid*: art. 2.1.a.(v) "Progressive reduction or phasing out of market imperfections, fiscal incentives, tax and duty exemptions and subsidies in all greenhouse gas emitting sectors that run counter to the objective of the Convention and *application of market instruments*;" (Emphasis added).

49 Doc. TN/TE/W/43, Committee on Trade and Environment - Special Session - *Statement by Colombia on the Relationship Between Existing WTO Rules and Specific Trade Obligations (STOs) set out in Multilateral Environmental Agreements (MEAS)* - Statement by Colombia in the Committee on Trade and Environment Special Session at its Meeting of 22 June 2004 - Paragraph 31(i), § 5; Doc. TN/TE/W/2, Committee on Trade and Environment - Special Session - *Mandate under Paragraph 31(i) of the Doha Declaration on Trade and Environment* - Submission by the Argentine Republic - Paragraph 31(i); Doc. TN/TE/W/23 , Committee on Trade and Environment - Special Session - *Relationship between Specific Trade Obligations set out in MEAs and WTO Rules* - Submission by India - Paragraph 31(i); Dc. TN/TE/W/35, Committee on Trade and Environment - Special Session - *Identification of Multilateral Environmental Agreements (MEAs) and Specific Trade Obligations (STOs)* - Submission by China - Paragraph 31(i), § 5.

50 *Doha Ministerial Declaration* (Doc. WT/MIN(01)/DEC/120, 14 November 2001), § 31.i.

just recommended by an MEA can prevail over WTO rules.[51] Second, the trade-specific argument would not be of any help in case the tax affects a non-Party to the Kyoto Protocol.

Despite the fact that the Kyoto Protocol might not be decisive in the final decision, it does have some relevance. If a State maintains that the tax on products based on the energy used in their production is part of their domestic climate efforts provided for in the Kyoto Protocol, this must be taken into account as an element of proof in relation to the negotiation effort criterion. The tax is not a unilateral measure taken without any international coordination. The PPM tax will be part of a more comprehensive approach based on a global MEA. Furthermore, if the measure has a negative effect on trade flows from a non-Party to the Kyoto Protocol, the efforts of the State that is applying the measure to bring the reluctant State back on board of the MEA can also be an element of proof of serious negotiations between the parties involved in the dispute. Case law has clarified that negotiations must be started, but not concluded, before adopting a trade restrictive measure.[52] Therefore, once the State that is adopting the tax demonstrates that negotiations with the non-Party are ongoing, there is no reason why that State cannot apply a tax that negatively affects the trade interests of a non-Party of the Kyoto Protocol.

The third requirement that must be fulfilled in order for a measure to be considered non-protectionist and, therefore, finally compatible with the WTO regime is that it must not constitute a disguised restriction of international trade. The chapeau of GATT article XX is about the *application* of a specific measure. The PPM tax can fulfill a legitimate environmental objective, its application might be flexible enough and the correct dialogue with the affected country has been proved. Even in a case like this, the measure can still constitute a disguised restriction of international trade. What reveals such a nature? The design, architecture and internal structure of a tax measure will reveal its protectionist nature.[53] Therefore, in order for a climate tax not to be denounced by the WTO regime, States must be very careful at the moment of writing the piece of legislation. The clearer the tax measure, the less space for ambiguity and discretion will there be. The design of a measure will reveal a disguised restriction on international trade if it shows a procedure with too many steps and/or unnecessary bureaucratic requirements. However, no matter how clear a State writes its law, the affected country will always consider that its design, architecture and internal structure affects its trade interests negatively and that it reveals an unlawful application. As in other steps in the examination of the GATT article XX, the final decision must be taken on a case by case approach.

Table 5. Taxes based on the kind of energy used in the production and GATT article XX

PPM TAX AND GATT ARTICLE XX	GENERAL CRITERION	
Does the tax deal with human, animal or plant health?	Is climate change a threat for human, animal or plant health?	✓

[51] See Doc. TN/TE/W/1, Committee on Trade and Environment - Special Session - *Multilateral Environmental Agreements (MEAS): Implementation of the Doha Development Agenda* - Submission by the European Communities - Paragraph 31(i), § 25.

[52] *US – Shrimp, art. 21.5 DSU,* Appellate Body Report, *§* 122-123.

[53] *EC – Asbestos*, Panel Report, § 8.236.

Is the tax necessary for the protection of human, animal or plant health?	Is climate change a vital interest?	✓
	Is the tax measure essential to solve climate change?	✓/X
Is the tax measure related to the conservation of exhaustible natural resources?	Is climate change about exhaustible natural resources?	✓
	Is there a reasonable means-end relationship between the energy products tax and climate change?	✓
	Is the energy products tax *applied in conjunction* with restrictions on domestic production or consumption	✓
The tax is not an arbitrary or unjustifiable discrimination	Does the tax allow for sufficient flexibility? Are all States treated equally (comparable approach)?	✓/X
	Have serious negotiations been established with the affected country?	✓
The tax is not a disguised restriction of international trade	Design, architecture and structure of the tax	✓/X

3.5. Can climate taxes based on energy efficiency be justified under GATT article XX?

An efficiency tax is based on the energy efficiency of a product and, therefore, it relates to the environmental conduct of a product throughout its lifetime. As in the PPM case, it is very likely that a tax of this nature will be considered a violation of GATT article III and one must see whether it can be saved under the environmental exceptions of article XX.

3.5.1. Efficiency tax & paragraph b) or g)

A tax based on the energy efficiency of a product can, according to a specific interpretation, affect the physical properties of a product making it safer for human health.[54] If one agrees with this conclusion, the linkage between the tax measure and the protection of human, animal and plant health will be more easily assessed. As in the PPM tax, the necessity requirement, even in the milder version of the proportionality test, will not be easy to fulfill for the State adopting the energy efficiency related tax.

Even in this case, a State will probably be better off if it chooses to defend its tax under paragraph g). An efficiency tax deals with the conservation of exhaustible natural resources and there is a reasonable relationship between means and ends. A tax based on energy efficiency standards aims to reduce

[54] See above section 2.5.

carbon dioxide emissions, which are the main cause of current negative climate change trends. If the tax is adopted as part of a genuine environmental policy, the same tax will be levied on domestic products and, therefore, the measure will be applied in conjunction with restrictions on domestic production and consumption, as required by paragraph g).

3.5.2. Efficiency tax & the chapeau of article XX

Once demonstrated that the content of the efficiency tax is legitimate, one must turn to its application. Does it constitute an arbitrary and unjustifiable discrimination? The same arguments presented for the PPM tax apply in this case. Flexibility in relation to products from other countries should not be a problem, if the tax responds to a true climate change concern. Flexibility in relation to the characteristics of the foreign measure related to energy efficiency leaves more space to discretion and it will probably be an element of discussion among the parties involved in the conflict. As clarified above, the DSB will decide on a case by case basis whether the imports are allowed. The fact that the State adopting an efficiency tax accepts comparable measures and does not require identical measures will be an element in favor of its climate policy.

The negotiation effort criterion will lead to the same conclusions as for the PPM tax. Depending on the position taken in the Dispute Settlement Body (debate on trade measures in MEAs and their relationship with the WTO), one will give more or less importance to the presence of tax measures in Kyoto Protocol article 2. As maintained before, if a State clearly states that the measure is part of its domestic climate commitments provided for by the international climate change regime, this must be taken into account in the assessment of the fulfillment of the negotiation criterion.

Finally, is the tax measure a disguised restriction on international trade? Once again, the design, architecture and internal structure of the tax measure will reveal its nature. Just as in the case of the PPM tax, there is no clear-cut answer and the DSB will have to undertake a careful analysis of the tax measure to see whether its application leads to unlawful protectionism or not.

Table 6. Taxes based on energy efficiency and GATT article XX

EFFICIENCY TAX AND GATT ARTICLE XX	GENERAL CRITERION	
Does the tax deal with human, animal or plant health?	Is energy efficiency important for human, animal or plant health?	✓/X
Is the tax necessary for the protection of human, animal or plant health?	Is climate change a vital interest?	✓
	Is the tax measure essential to solve climate change?	✓/X
Is the tax measure related to the conservation of exhaustible natural resources?	Is climate change about exhaustible natural resources?	✓
	Is there a reasonable means-end relationship between the energy products tax and climate change?	✓
	Is the energy products tax	✓

	applied in conjunction with restrictions on domestic production or consumption	
The tax is not an arbitrary or unjustifiable discrimination	Does the tax allow for sufficient flexibility?	✓/X
	Have serious negotiations been established with the affected country?	✓
The tax is not a disguised restriction of international trade	Design, architecture and structure of the tax	✓/X

4. Conclusion

The analysis of the compatibility of climate taxes with the multilateral trading system enables us to draw the following legal conclusions, which will then lead to present some policy recommendations whose goal is to help bridge the current gap between climate taxes and the multilateral trading system.

Firstly, it is very likely that all three taxes will be considered a violation of the national treatment provided for in GATT article III. Energy products will be considered directly competitive and substitutable products, which leaves more space to domestic regulation, but current State aid practices connected with domestic non-environmentally friendly energy products will lead a Panel to consider that less favorable treatment is given to the imported energy product. Despite the possibility of considering them as non-like products, based on the energy used in their production or on their energy efficiency, when very environmentally friendly interpretations are used, it is wiser to think that the two will be considered like products, and that any slight difference in taxation in favor of the domestic product will result in a violation of the national treatment principle.

Secondly, the feedstock tax will probably not be saved under GATT article XX general exceptions, if the tax is not applied in conjunction with restrictions on domestic production. Once again, the fact that a State acts one way with imported products, and in the opposite in relation to its own products, is not compatible with the spirit of the multilateral trading system.

Thirdly, a State must decide its strategy under article XX and it can decide to either go for paragraph b) or g). If a State treats imported and domestic products equally, paragraph g) will be a better choice both for a PPM tax and for an efficiency tax. All three requirements therein are easier to fulfill than the ones provided for in paragraph b) in which the necessity test still leaves too much space to discretion, despite its recent evolution.

Fourth, the analysis of the application of a climate tax is usually made when an environmental measure is considered non-WTO compatible, and if it leads to protectionism. One of the criteria to determine whether the measure is or is not an arbitrary discrimination is the negotiation effort criterion and the Kyoto Protocol has a positive role to play in the assessment thereof.

Fifth, two variables may lead to a negative solution for the State adopting the climate tax within the chapeau of GATT article XX. On the one hand, the flexibility requirement, and particularly the obligation that the foreign measure

must be comparable and not identical to the domestic climate tax, can in most cases be strongly criticized by the affected country. The same can be said for the study of the design, architecture and internal structure of the climate tax, which will reveal whether the measure is a disguised restriction on international trade. The difficulty lies in the fact that in both cases the criteria are very subjective and there is no previous standard to follow.

The legal conclusions of this paper lead to five main policy recommendations that may help to bridge the current gap between climate taxes and the multilateral trading system:

1) States must refrain from subsidizing and helping domestic non-environmentally friendly energy products while doing the opposite with imported energy sources;

2) States must clearly state that the objective of their climate tax is the conservation of exhaustible natural resources and they must explain the relation between the objective pursued by the measure and the role of the tax in achieving it. This will give a State more legal grounds, should it find itself defending the climate tax before a WTO panel under article XX, paragraph g);

3) States must maintain that their climate tax is part of the domestic efforts provided for in Kyoto Protocol article 2.1. This will be useful in a WTO dispute in order to prove the fulfillment of the negotiation effort criterion present in the chapeau of GATT article XX;

4) States must be flexible in the application of climate taxes. On the one hand, a State should allow imports from countries that take climate change seriously and that are developing *comparable* measures. On the other hand, if the country that is adopting the climate tax is an industrialized country, the flexibility requirement could imply that technology transfer should be provided to developing countries that lack the material possibilities to deal with climate change in the same way industrialized countries do;

5) Finally, States must be very careful at the moment of drafting a climate tax. The measure must be very clear and not leave any space for possible ambiguity. Furthermore, there must not be an excessive burden on the importing country in relation to bureaucracy and procedural aspects, for example. An approach of this kind will be more useful at the moment of defending itself against a State that considers the climate tax a disguised restriction on international trade.

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