Border Tax Adjustments and the WTO Law Compatibility of ETS/CBAM Export Rebates: *Aut Simul Stabunt, Aut Simul Cadent*

An expanded and differently structured version of this paper is forthcoming as:

Giulia Claudia Leonelli, 'Export Rebates and the EU Carbon Border Adjustment Mechanism: WTO Law and Environmental Objections' 46(6) *Journal of World Trade* (2022).

The European Parliament's June 2022 proposed amendments on the inclusion of export rebates under the ETS/CBAM raise a number of questions. This paper focuses on the question of the WTO law compatibility of this proposal, following a specific analytical approach and enquiring into the potential categorisation of the ETS/CBAM as adjustable product taxes or charges. The analysis cuts across relevant provisions in the GATT 1994 and the SCMA, and addresses five questions in turn. To begin with, the paper enquires whether the CBAM would qualify as a (i) *charge*; (ii) *equivalent* to an internal tax or charge; (iii) that is imposed on *products*; (iv) *consistently with Article III:2 GATT*. It suggests that all of these questions may be answered in the negative; this would make ETS/CBAM export rebates WTO law incompatible. If all of these questions *except* the fourth were answered positively, the BTA and export rebates may still be 'saved' under Article XX GATT and the Chapeau thereof; this would also 'save' ETS/CBAM export rebates. However, this is unlikely to occur. The structure, design and practical application of the CBAM are rather difficult to reconcile with the Chapeau requirements. Against this backdrop, the paper concludes that ETS/CBAM export rebates are unlikely to be WTO law compatible.

1. Levelling the Economic Playing Field through ETS/CBAM Export Rebates: Environmental Pitfalls

The publication of the July 2021 European Commission's proposal for a Regulation establishing a carbon border adjustment mechanism ('CBAM') has sparked a lively academic and policy debate.[1] The CBAM aims to prevent carbon leakage, i.e. the potential relocation of firms operating in carbon-intensive sectors to jurisdictions with more lenient greenhouse gas ('GHG') emission reduction policies.[2] It seeks to achieve this goal by levelling the *economic playing field*; the CBAM arrangements have been designed in such a way as to ensure that imported products will 'bear' the same exact economic costs that are 'borne' by EU producers due to the operation of the EU emission trading system ('ETS').[3]

This reallocation of economic burdens occurs via the mandatory requirement for importers to purchase CBAM certificates to offset all the GHG emissions embedded in their

[1] European Commission, Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, COM(2021) 564 Final.

[2] See e.g. European Commission, Commission Staff Working Document, Impact Assessment Report Accompanying the Document Proposal for a Regulation Establishing a Carbon Border Adjustment Mechanism, SWD(2021) 643 final, part 2/2, Annex 11.

[3] For an in depth analysis of the notion of an 'economic level playing field', see Giulia Claudia Leonelli, 'Practical Obstacles and Structural Legal Constraints in the Adoption of 'Defensive' Policies: Comparing the EU Carbon Border Adjustment Mechanism and the US Proposal for a Border Carbon Adjustment' 42 *Legal Studies* (2022). The ETS has been established by Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a system for greenhouse gas emission allowance trading within the Union and amending Council Directive 96/61/EC, OJ L 275, 25.10.2003.

products. The price of the certificates is linked to the average weekly auctioning price of ETS allowances, as further adjusted to account for the distribution of any free allowances to EU operators.[4] The GHG emissions embedded in the imported products should be calculated and verified by importers; where this proves impossible, default values apply.[5]

The regulatory design of the CBAM is informed by a narrow economic level playing field rationale; this involves reference to the criterion of economic equivalence between products, and recourse to economic remedies.[6] Redressing distortions of competition between products yields *direct* economic benefits, and can *indirectly* achieve environmental goals.[7] If any doubts surrounding the economic rationale of the CBAM persisted, they would have been dispelled by the ongoing EU debate on export rebates under the ETS/CBAM. Granting export rebates perfectly conforms to an economic framing of the notion of a level playing field.

The CBAM *levels* the *economic playing field* on the *EU internal market*;[8] however, it cannot redress potential *distortions of competition* between *EU exports* and *foreign products* sold on *foreign markets*. This lies at the heart of the export rebates controversy. In June 2022, the European Parliament reached an agreement on the reform of the ETS and the CBAM; inter-institutional negotiations are currently ongoing at the EU level. The gradual phase out of free ETS allowances proved the main sticking point in the negotiations; the continuation of the free allowances system is irreconcilable with the introduction of the CBAM, as the two pursue the same exact goals. Agreement on phasing out free allowances has finally been reached; yet, this has come at a cost. The amendments proposed by the European Parliament include the first express reference to the potential introduction of *export rebates* under the ETS/CBAM.[9]

This is bound to produce environmental externalities and undermine the environmental integrity of the ETS/CBAM. To begin with, questions surrounding *export-related* carbon leakage risks are highly controversial. Data suggests that the absence of export rebates could affect the economic competitiveness of EU products.[10] Whether this actually results in carbon leakage, however, will depend on different factors: these include the level of trade intensity on foreign markets, the carbon intensity of foreign or imported products vis-à-vis EU exports, and the carbon prices 'borne' by products sold on foreign markets. In fact, the Commission's 2021

[4] Arts 21(1) and 31 of the Commission proposal.
[5] Arts 6, 7(2) and 8 and Annex III.
[6] As opposed to the criterion of *environmental equivalence* between *products* or between *states*, and recourse to punitive remedies. Leonelli, supra n. 3.
[7] I.e. preventing potential carbon leakage, promoting more ambitious environmental standards in third countries, and creating incentives for firms to reduce their own GHG emissions.
[8] In fact, it may under specific circumstances afford protection to EU products – see section 7.
[9] European Parliament, Amendments adopted by the European Parliament on 22 June 2022 on the proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme, and Regulation (EU) 2015/757 (COM(2021)0551 – C9-0318/2021 – 2021/0211(COD)), P9_TA(2022)0246, Revision of the EU emission trading system; and European Parliament, Amendments adopted by the European Parliament on 22 June 2022 on the proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism (COM(2021)0564 – C9-0328/2021 – 2021/0214(COD)), P9_TA(2022)0246, Carbon border adjustment mechanism.
[10] Aaron Cosbey, Alexandra Maratou, Andrei Marcu and Michael Mehling, *Border Carbon Adjustment in the EU: Treatment of Exports in the CBAM*, European Roundtable on Climate Change and Sustainable Transition (2022).

impact assessment suggests that export-related carbon leakage risks are very limited; as a result, the Commission did not include export rebates in its proposal.[11]

Further, invoking the carbon leakage hypothesis to defend economic measures is bound to undermine the environmental integrity of the CBAM and the credibility of the EU environmental protection agenda. Export rebates would stretch the carbon leakage hypothesis too far. *Imposing* the EU 'explicit' carbon price on *imported products* aims to *extend* the transnational scope of carbon pricing. This can achieve environmental goals indirectly. *Waiving* the EU 'explicit' carbon price to benefit *EU exported products reduces* the transnational scope of carbon pricing. Requiring foreign products to 'bear' the EU carbon price while waiving that price for EU exported products short-circuits the environmental rationale of the entire ETS/CBAM framework. This is expressly acknowledged in the Commission's impact assessment.[12]

Finally, export rebates would produce several environmental externalities in third countries.[13] Granting ETS/CBAM export rebates to EU exported products places them at a competitive advantage vis-à-vis domestic products or other imported products sold on foreign markets; these products may have 'borne' high 'explicit' or 'implicit' carbon costs in the foreign country or in their different country of origin. Under a recent proposal, export rebates should only be granted to EU exports sold in low ambition countries; this, however, is associated with two problems.[14]

First, assessing the stringency and effectiveness of different GHG emission reduction policies poses a range of methodological and technical difficulties.[15] Second, limiting rebates to products destined to low ambition countries would have far-reaching negative environmental impacts. This system would ensure that EU exports compete on an equal footing with highly polluting (and cheap) products sold in low ambition countries; for this reason, however, it would also place *green products* produced in those countries or imported from other countries at a competitive disadvantage, entrenching the competitive advantage of more polluting products. Symmetrically, from a state-based perspective, granting export rebates to EU products destined to low ambition countries would *eliminate any incentive* for these countries to adopt more stringent environmental policies; maintaining low ambition policies would be necessary for manufacturers to produce goods that can be sold at a competitive price on their domestic market. In this sense, export rebates can trigger a vicious circle in these countries.

As this concise analysis has endeavoured to demonstrate, the inclusion of export rebates under the ETS/CBAM framework would conform to a narrow economic rationale and would come at a very high environmental cost. An analysis of the WTO law compatibility of export rebates triggers several further considerations; this question is the specific object of analysis of this paper. The next section provides a brief introductory overview of the WTO law debate on this matter. The following sections then turn to an in depth examination of the (in)compatibility of ETS/CBAM export rebates under the WTO law system.

---

[11] Impact Assessment Report, supra n. 2, part 2/2, 65 ff. and 187 ff.
[12] Impact Assessment Report, supra n. 2, part 2/2, 42.
[13] Questions surrounding the *internal* effects of export rebates may also come into play; these, however, can be addressed more easily. For an analysis of this point, see Cosbey, Mehling et al., supra n. 10.
[14] Ibid.
[15] Leonelli, supra n. 3.

2. WTO Law Compatibility: Border Tax Adjustments and Export Rebates. *Aut Simul Stabunt, Aut Simul Cadent*

An interesting argument regarding the coexistence of 'fiscal' and 'non-fiscal' elements under the CBAM has been recently put forward.[16] This argument has important implications in the context of the debate on export rebates; for this reason, it deserves a close look. According to this argument, the pecuniary burden associated with the purchase of CBAM certificates would qualify as the 'fiscal' element of the scheme; this would mirror the 'fiscal' element underlying the operation of the ETS at the domestic level, i.e. the pecuniary burden associated with the purchase of ETS allowances by EU operators.

Under this construction, the 'fiscal' element of the CBAM would qualify as a border tax adjustment ('BTA') under Article II:2(a). Pursuant to this Article, nothing in Article II shall prevent the contracting Parties from imposing at any time on the importation of a product '*a charge equivalent to an internal tax* imposed *consistently with the provisions of paragraph 2 of Article III* in respect of the *like domestic product or in respect of an article* from which the imported product has been manufactured or produced in whole or in part' (emphasis added). This Article regulates internal taxes that are levied on both imported products and the 'like' domestic products and adjusted at the border. Excises are one such example; in accordance with the destination principle, these taxes are levied in the country where the goods are consumed.

This would have crucial implications in terms of the WTO law compatibility of ETS/CBAM export rebates. According to the destination principle, internal taxes or charges that comply with the requirements of Article II:2(a) may be the object of border adjustment *and* of WTO law legitimate export rebates. The entire system is designed to be competition-neutral. *Adjustable* taxes 'borne' by the 'like' domestic products may be levied on imported products that will be sold on the domestic market. Symmetrically, domestic products that are destined to foreign markets may be granted export rebates; the relevant taxes or charges will then be levied by the importing country. Indeed, footnote 1 to Article 1 of the Agreement on Subsidies and Countervailing Measures ('SCMA') stipulates that 'in accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the *exemption* of an *exported product* from *duties or taxes* borne by the *like product* when destined for *domestic consumption*, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall *not* be deemed to be a *subsidy*' (emphasis added). These are two sides of the same coin; questions surrounding BTAs and export rebates are indissolubly intertwined.

As rightly emphasised, Article 3.1(a) of the SCMA sets out a *blanket prohibition* on '*subsidies contingent*, in law or in fact, whether solely or as one of several other conditions, *upon export performance*, including those illustrated in Annex I' (emphasis added).[17] There

[16] Ingo Venzke and Geraldo Vidigal, *Are Trade Measures to Tackle the Climate Crisis the End of Differentiated Responsibilities? The Case of the EU CBAM*, Amsterdam Law School Research Paper 2022-02.
[17] Cosbey, Mehling et al., supra n. 10.

can be no doubt that ETS/CBAM rebates would qualify as 'subsidies' under the SCMA. By implication, *'saving' the BTA categorisation of the CBAM* is the only possible way to *'save' ETS/CBAM export rebates. Aut simul stabunt, aut simul cadent.*

This paper engages in the academic and policy discussion on the WTO law compatibility of export rebates and follows a specific analytical perspective. It approaches the relevant questions from a distinctive analytical angle; more specifically, it focuses on the categorisation of the CBAM or its 'fiscal' component as a BTA under Article II:2(a). The analysis cuts across relevant provisions in the GATT 1994 and the SCMA. The following sections address five questions in turn. To begin with, the paper enquires whether the CBAM or its 'fiscal' component would qualify as a (i) *charge*; (ii) *equivalent* to an internal tax or charge; (iii) that is imposed on *products*; (iv) *consistently with Article III:2 GATT*. It suggests that all of these questions may be answered in the negative; this would make ETS/CBAM export rebates WTO law incompatible. If all the questions above *except* the fourth were answered positively, the BTA and export rebates may still be 'saved' under Article XX GATT and the Chapeau thereof. However, this is also unlikely to occur; the structure, design and practical application of the CBAM are rather difficult to reconcile with the Chapeau requirements. Against this backdrop, the paper concludes that ETS/CBAM export rebates are unlikely to be WTO law compatible.

3. Can the ETS/CBAM or their Fiscal Components Qualify as a *'Charge'*?

For the purposes of the present enquiry, the first relevant question is whether the CBAM/ETS or their 'fiscal' components could qualify as a 'charge' under Articles II:2(a) and III:2. The findings of the dispute settlement organs in *Argentina – Hides and Leather* have been relied on to support this construction.[18]

In *Argentina – Hides and Leather*, the Panel embraced a broad interpretative approach and found that the term 'charge' denotes a 'pecuniary burden' and a 'liability to pay money'.[19] Under this broad construction, the 'pecuniary burden' associated with the purchase of CBAM certificates by importers and ETS allowances by EU operators would qualify as a 'charge'. However, several reasons militate against this categorisation in the specific context of the ETS regime.

Carbon taxes and emission trading (or cap-and-trade) systems are both examples of price-based GHG emission reduction policies. However, they operate in a very different manner.[20] The amount of carbon tax levied by public authorities is 'fixed' and can be predetermined in advance by the relevant stakeholders. In the case of cap-and-trade systems, by contrast, the price of emission allowances fluctuates; once the 'cap' has been established, the overall levels of GHG emissions of installations and 'trade' in emission allowances will

[18] Venzke and Vidigal, supra n. 16.

[19] WTO Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather* [*Argentina – Hides and Leather*], WT/DS155/R and Corr.1, adopted 16 Feb. 2001, para. 11.143. The Panel also noted that Article III:2 refers to 'internal taxes or other internal charges of any kind'.

[20] For a discussion, see Javier de Cendra de Larragán, 'Emission Trading Schemes and WTO Law: A Typology of Interactions' in Geert Van Calster and Denise Prévost (eds), *Research Handbook on Environment, Health and the WTO* (Edward Elgar, 2013), 636-668.

determine the latter's price. According to the advocates of emission trading, the tradability of emission allowances results in a more economically efficient system; in other words, it enables market actors to achieve GHG emission reductions at the lowest possible economic cost. Low polluting firms can sell their 'excess' emission allowances to high polluting firms; the relevant economic profit can then be employed to make further investments in decarbonisation. The traditional differentiation between carbon pricing mechanisms under environmental law militates in favour of drawing a distinction between taxes or charges, on the one hand, and the purchase price for emission allowances, on the other.

The findings of the European Court of Justice ('ECJ') in the famous *ATAA* case resonate with this traditional categorisation in the field of environmental law. This point has been acknowledged by the proponents of the 'fiscal' element construction.[21] Advocate General ('AG') Kokott noted that the monetary amount associated with the purchase of ETS allowances is neither 'levied' by public authorities,[22] nor 'set' by public authorities.[23] Further, the price of emission allowances is governed by supply and demand on the market; this means that the monetary amount that is due cannot be predetermined in advance according to specific criteria, such as the tax rate and basis of assessment.[24] Against this overall backdrop, she concluded that ETS allowances could not qualify as 'taxes' or 'charges'. The ECJ adhered to the Opinion.[25]

EU law and EU case law, as emphasised, do not have any legal value under WTO law.[26] Yet, some of the above considerations may come into play in a WTO law context. For the purposes of the present analysis, we will assume that the dispute settlement organs take a broad approach and categorise the 'fiscal' element of the ETS/CBAM as a 'charge'. The following question is then whether the 'fiscal' component of the CBAM is 'equivalent' to the 'fiscal' component of the ETS: is the CBAM a 'charge' that is 'equivalent to an internal tax or charge'?

4. Is the CBAM a Charge that is *'Equivalent to an Internal Tax or Charge"*?

It is well known that an internal tax or regulatory measure and its corresponding adjustment at the border need not be identical.[27] In the case of the CBAM and ETS, however, we are perhaps facing unprecedented levels of asymmetry and divergence.

The ETS applies to domestic operators in carbon-intensive sectors and targets the *GHG emission output* of *installations*. The CBAM, by contrast, applies to importers and targets the GHG emissions *embedded* in a circumscribed group of *products*. The two instruments are thus radically different; notably, there is no direct correspondence between the object of 'taxation'

[21] Venzke and Vidigal, supra n. 16.
[22] Opinion of AG Kokott in Case C-366/10 *Air Transport Association America and Others* EU:C:2011:637, para. 214.
[23] Ibid., para. 214.
[24] Ibid., para. 214.
[25] Case C-366/10 *Air Transport Association America and Others* EU:C:2011:864, paras 143 ff.
[26] Venzke and Vidigal, supra n. 16.
[27] As regards adjustable regulations under Article III:4 and their domestic counterparts, *see* Panel Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/R, adopted 5 April 2001, paras 8.94 ff. As regards adjustable taxes under Article III:2, *see* WTO Panel Report, *Argentina – Hides and Leather*, paras 11.150 ff.

of the ETS, on the one hand, and the product-based scope of application of the CBAM, on the other. Consequently, and unsurprisingly, the criteria, arrangements and basis of assessment diverge considerably. The ETS applies in respect of all reported GHG emission outputs. In a different vein, the CBAM provides for consideration of the verified emissions embedded in products *or* recourse to default values; where importers cannot provide verified information on all embedded emissions, the average carbon intensity of the country of origin of the product or the carbon intensity of the EU worst emitters are employed for the purposes of the calculation.[28]

Another crucial difference is that the price of ETS allowances is determined in auctions. As briefly mentioned above, allowances may also be allocated free of charge. Further, 'virtuous' operators may keep 'excess' ETS allowances and sell them at a following stage to 'non-virtuous' operators that need them. This can alter the carbon price 'borne' by different operators. For instance, it can yield a profit to 'virtuous' operators; these actors may sell their 'excess' allowances at a higher price than the one that they originally paid. In the case of the CBAM, by contrast, the prices of CBAM certificates are simply determined by reference to average weekly auctioning prices.

Finally, and relatedly, ETS allowances can be sold by private actors; this is inherent to the regulatory logics of cap-and-trade systems. CBAM certificates, on the contrary, are neither tradable nor part of the overall ETS 'cap'. The rationale for the non-tradability of CBAM certificates is twofold. First, this aims to prevent the imposition of a 'cap' on imported products; this would be the direct consequence of a CBAM 'cap-and-trade' system, replicating the ETS model. Second, it seeks to prevent any fluctuations in the price of CBAM certificates; again, this would be the direct consequence of a CBAM 'cap-and-trade' system.[29]

All of these elements may come under consideration in the context of an analysis of compliance with Article III:2.[30] However, they may also suggest that the 'fiscal' components of the two instruments are *too different* in nature for the CBAM 'charge' to be characterised as *equivalent* to the ETS 'charge'.[31] The asymmetries and structural divergencies between the CBAM and ETS bring us back to the point regarding their categorisation as 'charges'. The CBAM is easier to qualify as such; the peculiarities of cap-and-trade systems, on the other hand, make it considerably harder to categorise the pecuniary burden associated with the purchase of allowances as a 'charge'. More importantly, the asymmetries between the CBAM and ETS shed light on one crucial point: while the CBAM applies to *products*, the ETS does *not*. The next section turns to this fundamental aspect, suggesting that the ETS/CBAM cannot qualify as *adjustable product* taxes or charges.

[28] Art. 7(2) and Annex III to the proposal.
[29] This is expressly acknowledged in the Preamble to the Commission's proposal; see Recitals (19), (20) and (22).
[30] See infra, section 6.
[31] Under an alternative construction, the CBAM could instead be regarded as a *regulatory* border adjustment. This construction would perhaps be easier to reconcile with the differences between the two instruments. See Giulia Claudia Leonelli, 'Carbon Border Measures, Environmental Effectiveness and WTO Law Compatibility: Is There a Way Forward for the Steel and Aluminium Climate Club?' 21 *World Trade Review* 1 (2022). Alternatively, the CBAM would fall for analysis under the residual category of 'all other duties or charges of any kind imposed on or in connection with importation', enshrined in Article II:1(b).

5. Can the ETS/CBAM or their 'Fiscal' Component Qualify as *Adjustable Product Taxes*?

The question whether the ETS/CBAM or their 'fiscal' component may qualify as *adjustable product taxes* is of crucial importance. The adjustability of carbon taxes has been the object of discussion for years; nonetheless, this question is still highly controversial. An in depth analysis of this point calls for an examination of relevant provisions in the GATT 1994 as well as the SCMA.

Starting from the GATT, different provisions may lend support to arguments in favour or against adjustment. Article II:2(a) refers to charges imposed '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' (emphasis added). The note *ad* Article III also refers to taxes, charges, laws, regulations or requirements which apply to imported *products* and to the 'like' domestic *products*. Further, the 1970 Report of the Working Party on Border Tax Adjustments militates against the inclusion of producer taxes within the scope of Article II:2(a).[32] As emphasised in the literature, GHG emissions are an 'output' rather than an 'input' of production processes; this would justify a difference in the treatment of carbon taxes, vis-à-vis taxes on input materials.[33] Indeed, the latter qualify as taxes or charges imposed in respect of an 'article from which the product is manufactured or produced' under Article II:2(a).

On the other hand, different scholars have laid emphasis on the wording of the first sentence of Article III:2. This stipulates that imported products 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' (emphasis added). The reference to taxes or charges applied *directly* or *indirectly* to imported and domestic 'like' *products* may underpin a broader interpretation of the notion of adjustable product taxes. The Panel's findings in *US – Superfund* have also been invoked to substantiate the argument that carbon taxes may qualify as adjustable product taxes.[34]

Overall, the relevant GATT provisions do not bring much clarity to the complex question of the scope of application of BTAs. The SCMA provisions on export rebates, by contrast, provide more details and can help demarcate the boundaries of the notion of adjustable product taxes. Yet again, the two questions are two sides of the same coin. If the 'fiscal' component of the CBAM qualifies as the adjustment at the border of the ETS's 'fiscal' component, ETS/CBAM export rebates are WTO law compatible. If ETS/CBAM export rebates are *not compatible with the SCMA*, on the basis of the *text of this Agreement*, it is then legitimate to infer that the 'fiscal' component of the CBAM does *not* qualify as an *adjustable product tax* under the GATT. The two questions are structurally intertwined; for this reason,

[32] GATT Report, *Report of the Working Party on Border Tax Adjustments*, L/3464, 20 November 1970, para. 14.
[33] Patrick Low, Gabrielle Marceau and Julia Reinaud, *The Interface Between the Trade and Climate Change Regimes: Scoping the Issues*, WTO Staff Working Paper ERSD-2011-1 (2011); and Gabrielle Marceau, 'The Interface between Trade Rules and Climate Change Actions' in Deok-Young Park et al (ed), *Legal Issues on Climate Change and International Trade Law* (Springer 2016).
[34] Joost Pauwelyn, *US Federal Climate Policy and Competitiveness Concerns: The Limits and Options of International Trade Law*, Duke University Working Paper (2007).

any inferences drawn through an examination of the SCMA have a range of implications in the context of the ETS/CBAM's categorisation.

As explained above, footnote 1 to Article 1 SCMA stipulates that 'in accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of *Annexes I through III* of this Agreement, the exemption of an *exported product* from *duties or taxes* borne by the *like product* when destined for *domestic consumption*, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall *not* be deemed to be a *subsidy'* (emphasis added). As expressly acknowledged and as reiterated by the dispute settlement organs, the text of the footnote must be read *in the light of* and *in accordance with* the provisions of the Annexes.[35] These provide crucial interpretative context and guidance to ascertain whether carbon taxes may fall within the footnote 1 exemption; were this not to be the case, as already seen, ETS/CBAM export rebates would be the object of the blanket prohibition enshrined in Article 3.1 SCMA.

Annex I includes an illustrative list of prohibited export subsidies. Paragraphs (g), (h), and (i) are of particular relevance in the context of the present analysis. Annex II provides further guidelines on the consumption of inputs in the production process, which apply to paragraphs (h) and (i).

Paragraph (g) includes within the illustrative list the 'exemption or remission, *in respect of the production and distribution of exported products*, of *indirect taxes in excess* of those levied *in respect of the production and distribution* of *like* products when sold for *domestic consumption*'. Under footnote 58 to the SCMA, 'indirect taxes' shall mean 'sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges'. *If* the 'fiscal' component of the ETS/CBAM qualified as a 'border tax', it would fall within the purview of footnote 58. The ensuing and connected question, however, would be whether the 'fiscal' component of the ETS/CBAM qualifies as an *indirect tax* levied in respect of *the production and distribution of products*, in accordance with paragraph (g) of Annex I.

It is legitimate to suggest that this would not be the case. In *US – FSC*, the AB clarified that 'the tax measures identified in footnote 1 as not constituting a subsidy involve the exemption of exported *products* from *product-based consumption taxes*' (emphasis added).[36] The ETS or its 'fiscal' component, however, cannot qualify as a *product-based consumption tax.* As already seen, the ETS cap-and-trade-system applies to EU *installations* and their *overall GHG output*. There is no link between the monetary burden associated with compliance with the ETS, on the one hand, and specific 'products' or specific 'articles' from which the products have been manufactured or produced, on the other. On these grounds, it is rather difficult to regard the ETS's 'fiscal' component as a duty or tax that is *borne* by *domestic products* and *remitted* to *exported products*.[37]

---

[35] WTO Panel Report, *India – Export Related Measures* [*India – Export Related Measures*], WT/DS541/7, circulated 31 Oct. 2019, para. 7.171.

[36] WTO Appellate Body Report, *United States – Tax Treatment for 'Foreign Sales Corporations'* [*US – FSC*], WT/DS108/AB/R, adopted 20 March 2000, para. 93.

[37] Again, the wording of Footnote 1 expressly refers to the exemption or remission of duties or taxes *borne by the like product* when destined for domestic consumption.

Paragraphs (h) and (i) lend further support to the argument that the 'fiscal' component of the ETS/CBAM would not be the object of WTO law compatible export rebates (and qualify as a BTA). Paragraph (h) includes within the list of prohibited export subsidies the exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services *used in the production* of *exported products in excess of* the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services *used in the production* of 'like' *products* when sold for *domestic consumption*. Prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported products *even when* this treatment is *not accorded* to the 'like' domestic products, *provided that* these prior-stage cumulative indirect taxes are levied on *inputs that are consumed in the production of the exported products*.[38] Paragraph (i) provides the same in respect of the remission or drawback of *import charges in excess of* those levied on *imported inputs that are consumed in the production of the exported products*.[39]

Footnote 58 defines 'prior-stage' indirect taxes as 'those levied on goods or services used *directly or indirectly* in making the product' (emphasis added). This is a rather broad definition, and could potentially include carbon taxes. Nonetheless, the scope of paragraphs (h) and (i) is narrowed down to a considerable extent by the provisions of Annex II. Footnote 61 to Annex II provides that *inputs consumed in the production process*, as per paragraphs (h) and (i), are *inputs physically incorporated*, *energy*, *fuels* and *oil* used in the production process and *catalysts* which are consumed in the course of their use to obtain the exported product. This is an *exhaustive* rather than an illustrative list.[40] Part II of Annex II provides an equally narrow definition of the notion of *inputs physically incorporated*; these are defined as '*inputs … used in the production process* and … *physically present in the product exported*' (emphasis added). The dispute settlement organs have embraced a narrow interpretation of this notion.[41] The 'fiscal' component of the ETS/CBAM could then hardly fit within the circumscribed boundaries of paragraphs (h) and (i) of Annex I, as interpreted in accordance with the definitions of Annex II.

Against this overall backdrop, it is fair to suggest that ETS/CBAM export rebates would *not* be *compatible with the SCMA*; symmetrically, the 'fiscal' component of the ETS/CBAM would *not* qualify as an *adjustable product tax* under the GATT. It might still be possible for the dispute settlement organs to 'save' export rebates by providing a very expansive interpretation of the relevant SCMA provisions; however, if the specificities of the SCMA are taken into account, this seems like an unlikely scenario.

6. Is the ETS/CBAM BTA Imposed *'Consistently with Article III:2 GATT'*?

[38] This para. clarifies that normal allowance shall be made for waste, and that the provisions shall be interpreted in accordance with Annex II.
[39] This para. ALSO clarifies that normal allowance shall be made for waste, that the provisions shall be interpreted in accordance with Annexes II and III, and that further caveats may apply.
[40] WTO Panel Report, *India – Export Related Measures*, para. 7.211.
[41] Ibid., paras 7.202 to 7.208. For a more detailed analysis of these points, see Giulia Claudia Leonelli, 'Export Rebates and the EU Carbon Border Adjustment Mechanism: WTO Law and Environmental Objections' 46(6) *Journal of World Trade* (forthcoming 2022).

As illustrated in the previous sections, the CBAM might not qualify as a 'charge' that is 'equivalent to an internal tax or charge'; further, the 'fiscal' component of the ETS/CBAM is unlikely to qualify as an adjustable product tax. All of these considerations militate against the WTO law compatibility of export rebates under the ETS/CBAM. If we assume that the questions raised above are answered positively, the ETS/CBAM must still be imposed consistently with Article III:2 GATT; this is expressly provided in Article II:2(a). This section addresses this point, suggesting that the 'fiscal' component of the ETS/CBAM would be found to be in breach of Article III:2, first sentence.

The considerations developed in section 4 come into play in the context of this analysis. To begin with, the criteria and arrangements applied to the ETS and CBAM diverge considerably; the ETS applies in respect of reported GHG emission outputs, whereas the CBAM provides for consideration of the verified emissions embedded in products or recourse to less 'advantageous' default values. This may result in a finding that imported products are subject to an internal charge that exceeds the one applied to the 'like' domestic products. Even more clearly, the criteria applied in the context of the CBAM may result in a heavier 'tax' burden for imported products.[42] First, the price of CBAM certificates is determined by reference to *average* weekly auctioning prices. Second, ETS allowances may be kept by EU operators and be sold at a later stage; this mechanism can easily alter the carbon price 'borne' by different operators and/or yield a profit to 'virtuous' operators.

This begs a final question: whether the ETS/CBAM could be justified under Article XX GATT. As long as the 'fiscal' component construction stands, i.e. as long as the ETS/CBAM qualify as adjustable taxes or charges, violations of the substantive provisions of the GATT may still be justified under Article XX. This would 'save' the BTA, and 'save' export rebates. The next section turns to an analysis of this conclusive question.

7. Could the ETS/CBAM Be Justified under *Article XX GATT* and the *Chapeau* Thereof?

It is well known that, under the traditional dispute settlement organs' two-tiered analysis, a measure will first have to be provisionally justified under one of the sub-paragraphs of Article XX GATT.[43] This will be followed by an analysis of the elusive Chapeau (introductory clause) of the Article. At this stage, the aim is to ascertain whether the practical application of the relevant measure meets the requirements of the Chapeau.[44]

The dispute settlement organs have embraced a broad interpretation of sub-paragraph (g) of Article XX. This makes it unnecessary to enquire whether the CBAM may be provisionally justified under sub-paragraph (b). The CBAM could rather easily qualify as a measure relating to the conservation of exhaustible natural resources that is made effective in

[42] On this point see also Gary Hufbauer et al, *Can EU Carbon Border Adjustment Measures Propel WTO Climate Talks?*, PIEE Policy Brief (2021).
[43] WTO Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline* [*US – Gasoline*], WT/DS2/AB/R, adopted 20 May 1996, p. 22.
[44] Ibid.

conjunction with restrictions on domestic production and consumption.[45] Meeting the requirements of the Chapeau, by contrast, would be very difficult; as is well known, the Chapeau provides that (provisionally justified) measures shall *not* be *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 'conditions' which are *relevant* to the enquiry into country-based 'arbitrary' or 'unjustifiable' discrimination will be identified by reference to the sub-paragraphs of Article XX under which the measure was provisionally justified, and by having regard to the substantive obligations of the GATT 1994 violated by the measure under challenge.[46] This means that the dispute settlement organs would first and foremost focus on whether the CBAM arbitrarily or unjustifiably discriminates between countries where the *same environmental conditions* prevail. In this context, the so-called 'rational relationship' test applies; discrimination that is *irreconcilable with the measure's* (environmental) *policy goals* is regarded as 'arbitrary' or 'unjustifiable' in nature.

As argued in detail elsewhere, the CBAM is unlikely to meet the requirements of the Chapeau in so far as it arbitrarily or unjustifiably discriminates between countries where the same environmental conditions prevail.[47] The proposed Regulation takes the 'explicit' carbon prices already 'borne' by imported products in their country of origin into account for the purposes of calculating the final number of CBAM certificates.[48] These 'explicit' carbon prices are 'waived'. However, it fails to take into account the 'implicit' carbon prices 'borne' by products originating from countries that have had recourse to non-price-based policies. This has three implications.

First, products originating from countries whose *non-price-based* regulations are as stringent and as effective as the EU *price-based* policies would still have to 'pay' under the CBAM. In these cases, however, the CBAM would simply ensure that these products 'bear' the 'explicit' carbon prices 'borne' by EU products; it would *not* have any beneficial environmental effects, as carbon leakage would *not* occur in the countries of origin of these products. Second, the CBAM fails to account for and 'waive' the 'implicit' carbon prices 'borne' by products originating from countries that have had recourse to non-price-based policies. However, these may be as high as (or higher than) the 'explicit' carbon prices 'borne' by EU products.[49] Third, for the same reason, the CBAM also fails to treat 'environmentally equivalent' products in the same way; this is a consequence of its narrow focus on economic equivalence and 'explicit' carbon prices.[50]

These three points demonstrate that the CBAM arbitrarily or unjustifiably discriminates between countries where the same environmental conditions prevail, and fails to treat 'environmentally equivalent' products in the same way. The attempt could be made to argue

[45] Venzke and Vidigal, supra n. 16; Leonelli, supra n. 31.
[46] WTO Appellate Body Report, European Communities – Measures Prohibiting the Importation and Marketing of Seal Products [EC – Seal Products], WT/DS400/AB/R, WT/DS401/AB/R, adopted 18 June 2014, paras 5.299 ff.
[47] Leonelli, supra n. 3; Leonelli, supra n. 31.
[48] Articles 2(5) and 3(23).
[49] As already noted, 'explicit' carbon prices are alternative rather than additional to 'implicit' carbon prices; the former result from the application of price-based GHG emission reduction, whereas the latter are associated with recourse to non-price-based GHG emission reduction policies.
[50] For an in depth overview, see Leonelli, supra n. 3; Leonelli, supra n. 31.

that this discrimination between countries where the same environmental conditions prevail is not arbitrary or unjustifiable in nature. Yet, it clearly is. The reason is that it affords *protection* to *EU products*, and to *products* originating from *countries that have had recourse to price-based policies*.[51] Further, the *Brazil – Retreaded Tyres* 'rational relationship' test suggests that discrimination that undermines the goals pursued by the relevant measure is automatically regarded as 'arbitrary' or unjustifiable' in nature. Alternatively, the point could be made that the conditions prevailing in countries that have had recourse to price-based and non-price-based policies are not relevantly the same. This argument, however, is unlikely to stand; as explained above, the relevant conditions are identified by reference to the sub-paragraphs of Article XX under which the measure was provisionally justified, and by having regard to the substantive obligations of the GATT 1994 violated by the measure under challenge.

The final point relates to 'coercion'. In so far as it fails to account for the effectiveness of non-price-based policies and 'implicit' carbon prices, the CBAM's rigid arrangements indirectly push third countries to adopt price-based policies. This would grant products originating from these countries an automatic rebate under the CBAM, and would also enable these countries to levy the relevant 'explicit' carbon prices internally. These elements in the regulatory application of the CBAM result in coercive effects. Nor is it clear whether the EU has made sufficient efforts to negotiate with all concerned state Parties, including countries that do not have recourse to price-based policies.[52]

As this section has illustrated, the CBAM is highly unlikely to meet the conditions enshrined in the Chapeau. Yet again, this would result in a finding that ETS/CBAM export rebates are WTO law incompatible. The next section draws all relevant conclusions, making a brief summary of the findings of the paper.

8. Conclusions: the Uncertain Future of ETS/CBAM Export Rebates

At this rather early stage in the inter-institutional EU negotiations, it is difficult to predict whether the Parliament's proposal for export rebates will be included in the final CBAM Regulation. It is no mystery that the European Commission does not support their inclusion, and that it has repeatedly expressed concerns surrounding their WTO law compatibility. Further, as explained in the first section, the Commission's impact assessment has raised several doubts on export-related carbon leakage risks and the need and environmental justification for the adoption of export rebates.

This paper has focused on the question of the WTO law compatibility of the Parliament's proposal, following a specific analytical approach and enquiring into the potential categorisation of the ETS/CBAM as adjustable product taxes or charges. It has suggested that (i) the ETS/CBAM would not qualify as a 'charge'; (ii) the CBAM would not qualify as a charge that is 'equivalent to an internal tax or charge'; (iii) the ETS/CBAM would not qualify as 'adjustable product taxes or charges'; (iv) the ETS/CBAM is not imposed 'consistently with Article III:2 GATT'; and (v) the CBAM cannot be justified under Article XX GATT. If the

[51] Leonelli, supra n. 31.
[52] Leonelli, supra n. 3; Leonelli, supra n. 31.

BTA construction cannot be ‘saved’, for the reasons mentioned above, ETS/CBAM export rebates cannot be ‘saved’ either and would be found to be WTO law incompatible. *Aut simul stabunt, aut simul cadent*.