Incompatibility of International Carbon Taxation with WTO Laws: Making a Case for a Separate Multilateral Treaty

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Abstract

"Today when environmental protection has become a global concern, a conflicting interaction between economic policy of the nations and need for environmental protection is bound to happen. This is primarily because fossil fuels are the major drivers of production and are also major source of green house gases emission. In economic theory, pollution being a negative externality can be countered through taxation which can provide for incentives to shift production to environment friendly methods. However if any country tries to impose such a tax on the basis of carbon footprint, it will lead to carbon leakage as manufacturers will shift their production to other country where no taxes are imposed on carbon footprint of the product. Moreover any such unilateral imposition of carbon tax by a country will be perceived as a trade barrier and would attract WTO disputes. This article seeks to assess the international regime of such carbon taxation while analysing the impact and effectiveness of any unilateral carbon tax imposition by a country to the conclusion that there is an urgent need for a separate multilateral treaty with respect to carbon taxation in order to achieve the goal of environmental protection

Keywords: Carbon Taxation; Carbon Leakage; Likeliness of Products in International Trade; Unilateral taxation in International Law.

Introduction

Taxation is an important component of the policy framework of any country. In the present times where the world is unprecedentedly industrialised and scale of production has increased manifolds, environmental concerns beg the attention of the international community. In numerous international conferences and conventions, the nations have committed themselves to the cause of environmental protection.[1] However, large scale production using carbon based energy is continuing to pollute the environment through the emission of CO2 and other Green House gases.[2] On one hand production is necessary for a country's economy while, on the other hand, it is imperative to protect the environment for future generation. This interplay between the environmental issues and public policy of the countries raises concerns as to how the balance can be struck between these two conflicting goals. Many academicians have raised the argument that taxingthe pollutants can settle this conflict. Though the *polluter pays* doctrine incorporates this idea in international law[3] but it comes into action only after the polluter has already caused pollution. Taxation on various economically essential but environment damaging activities can go a long way in solving this problem.This can be achieved by incentivising the movement towards less polluting technologies and norms. One such type of tax known as *carbon tax* which is generally imposed on the basis of respective carbon emissions discharged in the production of a good.

Though the implementation of such a carbon tax regime is perceived to do well in the domain of municipal law but there are fundamentally unresolved issues if one seeks to perceive such a tax regime on international front. Though the nations have committed themselves to reduce their carbon emissions over time but any unilateral imposition of carbon tax, on goods produced by the polluting industry in any other country, will amount to tariff and trade barriers beingincompatible with WTO provisions.[4] The recent row over the unilateral imposition of carbon tax by USA[5] and EU[6] has increased the worries of developing

nations. India has warned USA and EU that if any such measure is taken up then India would bring the dispute before WTO.

It is to note that though at present an international regime of carbon taxation seems difficult to achieve but it is very much required. Anylocal imposition of carbon tax at the local level without any support from the international community will facilitate carbon leakage[7] and inefficient pricing.

The nature of carbon tax and its incidences are examined below in order to derive a mid-way where both national and international framework, regarding carbon taxation, can co-exist.

Literature Review – 2011-2018

The objective of this article is to bring out the legal regime and on ground situation relating to Carbon Tax. To achieve this objective, the author has reviewed journals both from pre-2015 period and 2015-2018, which are validated through a peer-reviewing processes and made available for global public consumption. However, the author has restricted the scope of literature review only to those articles which are either general in nature or pertain specifically to south asia.

Studies published in pre 2015 period generally deal with specific issues incidental to carbon tax . For example, Parry et al. (2015)[8] and Parry et al. (2014)[9] outline other environmental benefits, particularly local environmental benefits, of carbon tax. Murray and Rivers (2015)[10], Gevrek and Uyduranoglu (2015)[11], Goulder and Schein (2013)[12], compare carbon tax with cap and trade policy. Murphy and Jaccard (2011)[13] compare carbon tax with energy efficiency standards.

Carbon tax studies published during the 2011-2015 periodare majorly sector specific, such as, Klier and Linn (2015)[14] analyzing carbon tax to reduce emissions from the transport sector;

Nurdianto and Resosudarmo (2016)[15] assessed the economic costs of a carbon tax at the regional level for the member countries of ASEAN (Association of South East Asian Nations). Pradhan et al. (2017)[16] analyzed impacts of a carbon tax on international trade of China and India. van der Ploeg and de Zeeuw (2016)[17] examine how would the level of vulnerability to climate change and stage of development affect a country's cooperation to the global efforts to mitigate climate change.

Nature of Carbon Tax

A carbon tax is levied on the carbon content of the fuel. Since GHG emissions caused by the combustion of fossil fuels are clearly related to the carbon content of the respective fuels, a tax on these emissions can be levied on the carbon content of the fossil fuels. This can be levied at any point in the product cycle of the goods manufactured by utilising any such fossil fuels.

A carbon tax can be considered to be a pigovian tax.[18] Such a tax was first proposed by Arthur Pigou who recommended imposing taxes on polluters to force them to internalise the social cost of the environmental pollution.[19] Imposition of such a tax on the manufacturers on the basis of their GHG emissions could increase the cost of a carbon intensive production.Subsequently, promoting the manufacturers to reduce the amount of emissions to the optimum level, where the marginal cost[20] will be equal to marginal benefit[21]. Taxes increasing the cost of environmentally damaging activities can serve as 'extraordinary restrains' which can bring down the external environmental cost.

A carbon tax addresses a negative externality. Externalities arise when an individuals' production or consumption activities imposes incidental costs on other person. In our case, we can refer such a cost as "social cost".[21] It can be said so as the GHG emissions negatively impact the entire society. Also, taxing manufacturers on the basis of their GHG emissions can help the government redress such social cost by the revenue so collected.

A carbon tax can also be considered as an indirect tax if the government chooses to tax the final produced goods. In such a case, the price of the goods increases and it is eventually the consumers and not the manufacturer who is paying the tax by paying for the increased prices. In thissense, it will be a regressive tax as it imposes the burden to pay taxes on the consumers rather than on more economically empowered manufacturers or industry owners. It is to note that even if the manufacturers are made to pay such taxes then also, practically, it may lead to price rise which will again impact the consumers. Nevertheless the case for a carbon tax looks even stronger after an examination of the other options on the table.[22]

Carbon Taxation: its International Context

India is among the 16 countries that have been invited to attend a US-led initiative[23] to decide on what action should be taken at the global level against the imposition of the European Union-Emission Trading System.Under the system, which came into effect from January 1, the 27-member European Union asked all the international airlines flying in and out of the region to meet a specific carbon emission requirement, failing which they would have to pay tax..[24] The US feels that the EU-ETS violates territorial sovereignty and goes against accepted international practices and yet it is the same US President's who said at a Democrat fundraiser in Seattle in January 2014 that the world's top emerging economies hold the key to preventing dangerous levels of climate change. He warned that "we'll be four feet underwater" if China and India end up consuming energy like the USA.[25] Obviously in the international arena, the issue of carbon taxation is a highly disputed one and seems to place developing economies on a back foot.

Although nations have adopted carbon taxation in their domestic trade but at the same time they are reluctant to agree to any such arrangement on an international level. Due to lack of any such arrangement, the purpose of any domestic policy in this regard remains questionable as a tax on carbon today will definitely facilitate "carbon leakage".Whenever a country would try to impose such carbon taxes on its domestic production of goods, the production would most likely shift to another country having favourable norms of GHG

emissions. This would ultimately lead to carbon leakage and in such a case the domestic carbon policy doesn't seem to achieve its purpose.

One can argue that nations can offset these phenomena of carbon leakage by imposing taxes or duties on the products of the countries without proper regulations of GHG emissions. However, this very idea goes against the fundamental norms of WTO that is "equal treatment".[26] No such taxation will pass the touchstone of the "likeliness"[27] provisions of WTO and it is most probable that any such measure by one country will be perceived as a trade barrier by other countries attracting disputes before the WTO. [28]

The problem is further complicated when the developing nations looks first to the developed one for reducing GHG emissions.[29] In the present legal framework of international law and WTO provisions, it seems that a regime of international carbon taxation is not to be achieved easily.

Equitable Aspect of the Claim of the Developed Nations

"Polluter Pays" principle has been well accepted by the international community.[30] It states that one who pollutes should pay for it. Going by the previous emissions America has a greater obligation to reduce its emissions rate (or to pay for equivalent reductions elsewhere) than centrally planned Asia. In fact, even if America instantly reduced its emissions to zero, it would not be until 2030 that centrally planned Asia caught up to an equal degree of obligation, at its present rate of cumulative emissions growth. Therefore, the developed nations must bear the greater burden as they have far exceeded their carbon commons allocations. [31]

It is also the mandate of WTO that the developed nations should bear the greater burden. [32] Now when the developed countries have robust economy by far exceeding their just allocation of carbon emissions, it would be inequitable and unjust to impose unilateral tariffs on the product of developing economies. This will hamper their economic growth as it will adversely affect their export.

It will not be fair if the developing economies are not allowed to grow by such unilateral imposition of tariffs when the developed nations have already taken the benefits of carbon intensive production. It is quite often the case that such concerns are raised by the developed nations only when they have reaped most of the benefits which places the developing countries on the back foot.

When the WTO prescribes for greater burden sharing by developed nations and when they have exhausted their just allocation of carbon commons, any unilateral imposition of carbon tax by them on the products of developing countries cannot be justified. Even if it is very much necessary for the environmental protection, it has to be achieved with the consent of all by a multilateral arrangement.

Examining the WTO compatibility of Carbon Taxation

The term "like products" is a key concept in the analysis of compatibility of imposing carbon taxes/cross border adjustments on various products with carbon footprint according to GATT Articles I:1, III:2 and III:4, as well as in the TBT Agreement under the WTO regime.The major issue in this regard is that wheteher the production process can be taken into account to determine the likeliness of the products with carbon footprint. Can the steel manufactured with carbon energy be differentiated from the steel manufactured with natual gas. At present such a differentiation seems not to be well accepted among the nations and will definitely attract disputes before WTO. Various decisions of WTO Appellate Body are being analysed below to assess the acceptibility of inclusion of processing and production method as a criteria in determining the likeliness of the products with carbon footprint.

Japan – Alcoholic Beverages II[33]

In this case the Appellate Body explained that the "concept of 'likeness' is a relative one that evokes the image of an accordion. The width of the accordion must be determined by the particular provision in which the term 'like' is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply." This judgement suggest that determination of the like products is a subjective process depending upon the context and circumstances.

Indonesia – Certain Measures Affecting the Automobile Industry (Indonesia –Autos)[34]

The Appellate Body in this case applied the following four criteria to determine whether products are in a competitive relationship that would lead to the conclusion that they are like products under GATT Article III:

1. The physical properties, nature and quality of the products;
2. The extent to which the products may serve the same or similar end uses in a given market;
3. The extent to which consumers perceive and treat the products as alternative means of satisfying a want or demand; and
4. Tariff classification of the products.

EC – Asbestos[35]

In this case the Appellate body noted that these criteria are "simply tools to assist in the task of sorting and examining the relevant evidence. They are neither treaty mandated nor a closed list of criteria that will determine the legal characterization of a product." The source of the first three criteria is the Working Party Report on Border Tax Adjustments, while the fourth criterion was added by subsequent GATT panels. The purpose of the like products analysis is "to take account of evidence which indicates whether, and to what extent, the products involved are – or could be – in a competitive relationship in the marketplace"

US – Tuna (Mexico)[36]

In this case the GATT panel held that the term "like products" did not apply to production processes, but rather to products as such. It therefore did not permit differentiation between products based on production processes that had no effect on the quality of the product.However as an unadopted GATT report, US – Tuna (Mexico) has no normative

value. Nevertheless, a panel may find useful orientation in its reasoning.

US – Malt Beverages[37]

The GATT panel found in this case that beer with a low alcohol content and beer with a high alcohol content were not like products under GATT Article III:4 because the differentiation in treatment of low alcohol beer and high alcohol beer did not afford protection to domestic production.

Chile – Alcoholic Beverages[38]

The Appellate Body found that the differentiation in taxation of alcoholic beverages based on alcohol content was inconsistent with the second sentence of GATT Article III: 2 because the products were directly competitive or substitutable and because the design of the measure did afford protection to domestic production.

It can be inferred from the above decisions that the issue of "like products" still remains unsettled. Though the decision in the Malt Beverages case indicates the possibility of differentiation between like products but an important difference between alcohol content and carbon content is that the former is in fact part of the product itself, whereas carbon 'content' refers to the production process and is not part of the product itself. Thus, if the likeness of products depends on factors that affect the product as such, these cases would be less relevant. The author is of the opinion that it may be more appropriate to address the Product and Processing Methods issue under GATT Article XX, in order to avoid addressing the issue of whether Product and Processing Methods should be used to determine likeness through judicial interpretation, which might be viewed as exceeding the role assigned to panels under DSU Article 3.2.[39]

GATT Article XX - A Safe Gateway

The intention of the WTO members to not permit Product or Processing Method based trade measures under GATT, except under an Article XX exception, is confirmed by the explicit reference in the TBT Agreement to "products and related processes and production methods" and the absence of any corresponding amendment to Article III in GATT 1994, given the prevailing view that such measures were not allowed under Article III of GATT 1947./68 Given the nature of the GATT Article XX as an exceptional clause for environmental concerns, it may be the more appropriate place to decide the complex issues at stake in the trade and environment debate, not only with respect to trade law, but also with respect to public international law.

Article XX(g) applies to measures "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption".[40] In US – Shrimp, the Appellate Body interpreted the term "exhaustible natural resources" to include both living and non-living natural resources.[41] The Appellate Body and GATT panels have found the following to be exhaustible natural resources: clean air;[42] migratory sea turtles;[43] salmon and herring;[44] and tuna;[45]

Multilateral environmental agreements on climate change could serve as evidence that measures aimed at the reduction of greenhouse gas emissions relate to the conservation of the global climate. This could include measures such as differential tax treatment based on the different carbon emissions resulting from production processes, provided that there is a close and genuine relationship between the general structure and design of the measure and the policy goal of reducing carbon emissions to conserve the global climate[46] which in the present scenario will be difficult to prove with respect to unilateral carbon tax primarily due to the carbon leakage phenomena.

Article XX(b) applies to measures "necessary to protect human, animal or plant life or health". This paragraph requires that the policy goal at issue falls within the range of policies designed to protect human, animal or plant life or health. In Brazil – Retreaded Tyres,[47] the panel accepted that measures aimed at protecting Brazil's environment fell within the range of policies covered by Article XX(b).

A combined reading of clause b and g of the GATT Article XX may facilitate a way out in implementation of carbon taxation in international horizon on the pretext that it is necessary to protcet human,animal or plant life or health and that it relates to the conservation of exhaustible natural resource i.e. Global Climate.

Conclusion

Even though GATT Article XX may seem to allow for imposition of carbon tax and cross border adjustment in this regard, any such unilateral move without the support of international community will most likely not be able to meet the "policy goal of reducing carbon emissions to conserve the global climate" prescribed in the same article . In order to achieve this goal there has to be a multilateral agreement in this regard. When the provisions of WTO and the necessity of the governments to promote trade and commerce do not leave much room for any unilateral cross-border carbon taxation, a separate arrangement between nations is required.Economic efficiency requires that those who generate emissions should pay the cost, and the simplest way of forcing them to do so is through a carbon tax. However unilateral trade barriers, are not the best alternative towards implementing a similar carbon price across the global economy.[48] Best results can only be achieved through an international agreement where every country would impose a carbon tax at an agreed rate reflecting the global social cost.[49] When all the economies join together to regulate the regime of carbon taxation, then various issues like carbon leakage and the cascading effect of such taxes can be ruled out. It is to note that under any such arrangements the carbon tax so imposed over the goods of another country should be remitted to the traders. This will prevent carbon leakage as when the tax imposed is returned, the cost of manufacturing the goods remain the same and the manufacturer will have no incentive to shift the production to other countries. On the one hand, the remission would settle most of the objections raised by various nations, on the other hand, it will also discourage the consumers from purchasing the

products with high carbon footprint as they will be costlier than the environmental friendly alternatives. It is also suggested that while entering into any such multilateral arrangement, greater burden should be shared by the developed nations. It will not only be equitable by the criteria of carbon commons but will also reassure the commitments made by the developed nations under WTO.

Despite the narrow provisions under WTO in this regard, an international regime on carbon taxation is possible if the nations come forward for a multilateral arrangement on this issue and the developed nations are ready to share the greater burden. Until then disputes such as that of Indo-US carbon tax and EU ETS will continue to arise as any unilateral imposition of carbon tax on the goods or services of other countries will not only be incompatible with WTO provisions but will also be unacceptable to other nations as it places them in a position of competitive disadvantage.

Endnotes

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18. *A Pigovian tax will tax a negative externality to facilitate internalisation of social cost. SEE A.C. Pigou, THE ECONOMICS OF WELFARE, 1st ed. 1920, p. 168*
19. *Ibid*
20. *It implies the change in total cost that comes from making or producing one additional item. The purpose of analyzing marginal cost is to determine at what point an organization can achieve economies of scale. The calculation is most often used among manufacturers as a means of isolating an optimum production level.*
21. *It implies the additional satisfaction or utility that a person receives from consuming an additional unit of a good or service. A person's marginal benefit is the maximum amount they are willing to pay to consume that additional unit of a good or service. In a normal situation, the marginal benefit will decrease as consumption increases.*

22. *Social cost indicates the expense to an entire society resulting from a news event, an activity or a change in policy. When assessing the overall impact of its commercial actions in terms of social costs, a socially responsible business operator should take into account its own production expenses, as well as any indirect expenses or damages borne by others.*
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