WTO Rules and Procedures and Their Implication for the Kyoto Protocol

A Discussion Paper

Prepared by

Timothy E. Deal
Senior Vice President
United States Council for International Business
January 2008
Introduction

The Kyoto Protocol to the United Nations Framework Convention on Climate Change sets legally binding reductions for greenhouse gas emissions in the so-called Annex 1 states, essentially OECD countries and countries in transition to a market economy. The Protocol introduces three international flexibility mechanisms: international emissions trading, joint implementation, and the clean development mechanism. The article defining the flexibility mechanisms notes that their use must be supplemented by domestic actions.

A paper prepared by ZhongXiang Zhang and Lucas Assunção for the Fondazione Eni Enrico Mattei entitled “Domestic Climate Policies and the WTO” notes that the Kyoto Protocol gives countries considerable flexibility in meeting their emission commitments. Possible climate policies might include carbon or energy taxes, subsidies, energy efficiency standards, ecolabels, and government procurement policies. Putting such policies into effect, however, could raise questions about their consistency with WTO rules if they somehow discriminate between domestic and foreign producers. Zhang and Assunção summarize the dilemma as follows:

“In order to meet their Kyoto emission targets with minimum adverse effects on their economy, it is highly likely that Annex 1 governments with differentiated legal and political systems might pursue these policies in such a way as to unfairly favor domestic producers over foreign ones. Such differential treatment could occur in governing eligibility for, and the amount of, the subsidy, in establishing energy efficiency standards, in the determination of the category of ecolabeled products and the procedures of establishing ecolabels, in the specifications in tenders, and in specifying condition(s) for participating in government procurement bids. In (the) case where a country unilaterally imposes a carbon tax, it may adjust taxes at the border to mitigate (the) competitiveness effects of cheaper imports not subject to a similar level of the carbon in the country of origin. Measure(s) of this sort may well raise complex questions with respect to the WTO consistency and the conditions under which border taxes can be adjusted to accommodate a loss of international competitiveness.”

The possibility of a clash over climate change commitments under the Kyoto Protocol and WTO rules arises because of the U.S. decision to abandon Kyoto. Strong resentment over this action, particularly in Europe, could lead the EU, and perhaps others, to undertake actions to penalize American and other non-Annex 1 firms for alleged competitive advantages resulting from their non-adherence to Kyoto, although the probability of such action is low at the present time.

---

1 Zhong Xiang Zhand and Lucas Assunção, Domestic Climate Policies and the WTO, Fondazione Eni Enrioc Mattei, Milan, Italy, December 2001, p.3.
2 Zhang and Assunção, ibid, p.3.
In 2002, the United States Council for International Business (USCIB) produced an earlier version of this paper. At the time, the notion of trade action in the form of a carbon tax against non-Kyoto compliant countries was highly speculative in nature and supported mainly by NGOs such as Greenpeace International and Friends of the Earth Europe. Since then, politicians on both sides of the Atlantic have talked more openly about carbon taxes.

At the time, the official EU position was outlined in a policy statement posted on its website:

“The EU also wants to clarify that measures taken to tackle environmental problems under Multilateral Environmental Agreements (MEAs), such as the Kyoto Protocol on Climate change, are not contrary to WTO rules. For example, problems could arise if a country imposed a trade measure for environmental purposes on another WTO Member that had not signed the MEA. Could the country affected use WTO rules to overrule the trade measures? The EU wants WTO Members to agree that this should not be allowed to happen.”

But some European politicians have suggested more aggressive action. In November 2006, then French Prime Minister Dominque de Villepin stated, “Europe has to use all its weight to stand up to environmental dumping”, adding that France would urge its European partners to study “the principle of a carbon tax on the import of industrial products from countries which refuse to commit themselves to the Kyoto Protocol after 2012.” That same year, in a letter to EU Commission President Barroso, EU Enterprise and Industry Commissioner Günter Verheugen backed de Villepin’s proposal, saying that if Europe remained alone in cutting emissions, there was a risk that companies could shift their production to countries where standards were more lax. He added that border tax adjustments for developed countries that have not implemented Kyoto could balance out such effects.

In October 2007, in an environmental forum in Paris current French President Nicolas Sarkozy said, “We need to profoundly revise all of our taxes … to tax pollution more, including fossil fuels, and to tax labor less.” Sarkozy urged EU Commission head Barroso to “…examine the option of taxing products from countries that do not respect the Kyoto Protocol.” He argued that since Europe was setting tough standards on its producers for the benefit of the global climate, it was unfair for its competitors to be exempted.

Meanwhile, many in the academic and scientific communities in Europe have supported action against the US for failure to ratify Kyoto including, for example, John Hontelez, Secretary General of the European Environmental Bureau. Hontelez told BBC News, “Border tax adjustments … are a justifiable threat to irresponsible governments like those of the US and Australia, the only rich countries which refuse to implement Kyoto.”

---

European views on the subject are not unanimous, however. In December 2006 EU Trade Commissioner Peter Mandelson dismissed de Villepin’s plan as “highly problematic under current WTO rules and almost impossible to implement in practice.” He pointed to the practical difficulties of choosing which goods to target, when faced with imports from China, which has ratified Kyoto but has no targets, and the US, which has not ratified Kyoto but where certain states such as California have ambitious climate change policies.

Nonetheless, according to a January 7, 2008 report on Planet Ark’s website, “The European Commission is debating whether to push for a carbon tariff on imports from countries that do not tackle their greenhouse gas emissions…” Planet Ark cites a Reuters report, stating that “…companies importing goods into the European Union that do not similarly restrict greenhouse gas emissions would have to buy EU emissions permits.” The article goes on to say that “the measure would be the equivalent to a carbon tariff, taxing imports based on the price of emissions permits in Europe and the amount of greenhouse gases produced in the manufacture of the goods outside the EU.”

In light of these contradictory political statements, USCIB considered it appropriate to update its 2002 paper to take account of calls in some quarters for action against the US and some recent academic work on the subject.

The purpose of this paper is to provide a general overview of WTO rules pertaining to trade and environment. It also refers to the decision by the WTO’s Appellate Body in the Shrimp-Turtle case, which has important implications for the interpretation and enforcement of those rules. That decision may have opened the door for the use of trade measures to promote environmental objectives based on the way that a product is made.

There is also a separate, but equally important, question relating to the legality of border tax adjustments in the context of a carbon tax scheme. The Uruguay Round Agreement on Subsidies and Countervailing Measures changed the rules concerning the legality of indirect tax rebates on inputs consumed in the production process, and that may also have relevance to this issue.

GATT/WTO Rules on Trade and Environment

The WTO came into existence on January 1, 1995. Although the WTO is a relatively new international body, its roots go back to the creation of the GATT in 1948. The GATT was originally established as a body to regulate tariffs on goods, primarily industrial goods. Over time, the GATT took up non-tariff barriers such as standards and quotas. The Uruguay Round extended the reach of the GATT, and ultimately the WTO, to services, trade aspects of investment policy, intellectual property, and agricultural goods.

---

There are important institutional differences between the GATT and WTO. For example, signatories to the GATT were “Contracting Parties”, not “Members”, terminology that reflected the contractual nature of the relationship. With the conclusion of the Uruguay Round, GATT Contracting Parties became WTO members.

These changes were important in themselves, but perhaps the really critical distinction between the GATT and WTO was the creation of a binding dispute settlement system. Under the GATT, Contracting Parties could bring cases before the international body, but there was no effective enforcement mechanism. Creation of the WTO changed all that, and over the last six years the judicial procedures and case law have developed further.

The GATT/WTO rules that are – or may become – sources of conflict between the WTO and Multilateral Environment Agreements (MEAs), such as the Kyoto Protocol, are as follows:

1. GATT Article I, the Most Favored Nation clause, requires equal treatment among WTO signatories. Yet a number of MEAs require parties to those agreements to apply more restrictive trade rules against non-parties to the agreements than parties.

2. GATT Article III, the National Treatment clause, requires imported products to be treated no less favorably than “like” domestic products. Under the rules in effect, at least until the Shrimp-Turtle case, governments could under Article III put controls on imports comparable to those imposed on domestic goods with respect to their physical characteristics and performance. However, they could not impose restrictions on how a product was made if those production methods had no effect on the product’s performance or characteristics. Under the “like” product definition, import restrictions on the basis of non-product related process and production methods (PPMs) were not permitted. The Woodrow Wilson Center offered the following example of a possible trade and environmental conflict under Article III. It noted that a semiconductor made with ozone-depleting substances would be banned under the Montreal Protocol. Yet the WTO definition of “like” product (pre-Shrimp-Turtle) would prohibit such trade discrimination.5

3. GATT Article XI bans quotas and the use of import or export licenses. However, some existing MEAs impose licensing requirements, which might violate Article XI.

4. GATT Article XX exempts certain measures from other WTO obligations if under Article XX (b) they are “…necessary to protect human, animal, or plant life and health…” or under Article XX (g) they relate “…to the conservation of exhaustible natural resources.” However, that Article requires that such

measures must not be applied in an arbitrary or unjustifiably discriminatory manner or act as a disguised restriction on trade.

**WTO Jurisprudence before Shrimp-Turtle**

In a 1998 paper written before the Appellate Body decision in *Shrimp-Turtle*, Gary Sampson, former head of the Trade and Environment Division of the WTO, noted the need for policy coherence between WTO rules and climate change commitments. In this article, he summarized the prevailing views on these issues, which are still held by a number of scholars and even some governments. Referring to the possible conflict between WTO rights and obligations with whatever emerges from future climate change negotiations, he stressed the following points:

- Acceptance of a legal instrument to reduce greenhouse gas emissions would mean that any individual government would have agreed, in effect, to be subjected to the obligations of that agreement.
- If trade measures not authorized by WTO rules were part of the climate change agreement, the WTO members in question would have effectively waived their WTO rights.
- Inconsistencies between the climate change agreement and the WTO would be relevant only if WTO-inconsistent measures were applied to non-parties to the environmental agreement.

Later in the paper, he turns specifically to the “like product” question, which is important in determining the WTO-consistency of certain measures. Under the rules in effect at least through early 1998, he argued:

“It is important for measures taken for climate change purposes, however, that the WTO flexibility only extends to regulation of *products* produced domestically, imported *products*, and domestic *production processes*. It does not extend to flexibility in the extraterritorial application of measures relating to production processes in exporting countries. The manner in which a foreign *product* is produced is not a basis on which WTO rights and obligations are established…Thus, for measures to be WTO consistent, products that have the same physical form are to be considered to be like products by the importing country, irrespective of whether they have been produced abroad in an environmentally friendly manner or not.”

---


7 Sampson, op. cit., p.35.
What does all this mean in practice? Until the *Shrimp-Turtle* case in 1998, one could say with a certain degree of confidence that:

1. Governments were free to set whatever standard of protection they deemed appropriate in the areas of public health, safety, and the environment, provided that they did not treat domestic producers more favorably than foreign producers.

2. Governments could set whatever level of protection they deemed appropriate *domestically*, but they did not have the right to set standards for other countries.\(^8\)

Recent WTO Appellate Body decisions have, however, cast doubt on these interpretations. And they may have paved the way for increased use of discriminatory trade measures to meet environmental objectives.

**The Shrimp-Turtle Case**

As noted earlier, the *Shrimp-Turtle* case decided by the Appellate Body in 1998, broke new ground in addressing the interaction between WTO trade rules and domestic measures designed to protect the environment. In this case, India, Pakistan, Malaysia, and Thailand brought action in the WTO against an U.S. law that restricted imports of shrimp not caught in nets equipped with turtle excluder devices. The four governments challenged this measure, asserting that the U.S. could not apply its laws to foreign process and production methods.

The Appellate Body found that the U.S. shrimp-turtle law fell within the scope of the Article XX (g) exception for measures relating to the conservation of an exhaustible natural resource.

First, the Appellate Body determined that the U.S. law encouraged other countries to adopt sea turtle conservation programs and was thus a measure relating to conservation. It rejected arguments made by the complainants that the U.S. measure fell outside the scope of Article XX (g) because the sea turtles never entered U.S. waters. It found a “sufficient nexus” between the U.S. and the endangered sea turtles because sea turtles are highly migratory and because all of the sea turtle species at issue could be found in U.S. waters, even though no individual sea turtle actually traveled from Asia to the U.S.

Second, it found that endangered species could be deemed “exhaustible natural resources” under the terms of Article XX (g). In doing so, the Appellate Body looked beyond the specific GATT Article to the preamble of the 1994 WTO agreement, which referred to sustainable development, and to the fact that other international conventions used the term “natural resource” to embrace both living and non-living resources.

---

Having made these findings, which established important precedents, the Appellate Body then ruled against the U.S. because of the way the U.S. implemented the law, but not the law itself.  

Implications of Shrimp-Turtle

What is the significance of this decision and what is its relevance to the Kyoto Protocol? According to a study by the Economic Strategy Institute, the Shrimp-Turtle case represents a fundamental shift in WTO jurisprudence. The ESI claims that in Shrimp-Turtle, the Appellate Body completed a transition in dispute settlement reasoning that, if sustained, would permit members to invoke the Article XX exemptions to regulate imports on the basis of non-product related PPMs to accomplish environmental objectives both outside their jurisdiction and in the global commons -- and perhaps to achieve other social objectives.

Geoffrey Shaffer, Assistant Professor of Law at University of Wisconsin Law School, assessed the implications of this decision as follows:

“The Appellate Body’s decision attempts to promote multilateral cooperation and to ensure that domestic decision-making over trade-environment matters takes into account unrepresented foreign interests. In the process, the Appellate Body implies that a unilateral environment-related trade measure based on non-product related PPMs may be implemented in compliance with GATT requirements to protect a shared, but endangered, world resource.”

Dr. Arthur Appleton, a Swiss lawyer who specializes in WTO work and international arbitration, pointed out in a comprehensive article on the WTO and emissions trading that the Shrimp-Turtle case demonstrates that WTO panels and the Appellate do not operate in a political vacuum. Nonetheless, he argues that:

“The near universal acceptance of the climate change instruments, by WTO and non-WTO members alike, coupled with the Appellate Body’s expressed interest in environmental issues, greatly reduces the likelihood that the Appellate Body will ignore, or that WTO members will seek to challenge as WTO-inconsistent, the eventual UN Framework Convention on Climate Change implementation program.”

---

13 Ibid. p. 13.
He concludes that:

“…WTO panels and the Appellate Body would only be willing to countenance the application of trade measures against Kyoto non-participants when climate change remedies satisfy the non-discrimination principle, when those obligations are close to universal acceptance (which they are), when climate change remedies require a very serious trade measure for their resolution, and reasonable cooperative measures to address climate change problems fail.”

Columbia University Professors Jagdish Bhagwati and Petros Mavroidis addressed these issues in a recent article in Cambridge University’s World Trade Review. In this article, they explore what action the EU could take legally, that is, in conformity with WTO obligations for the US failure to ratify the Kyoto Protocol. They argue that the EU could differentiate between products produced in a Kyoto Protocol compliant manner and products produced in violation of such disciplines, by using domestic instruments.

“The dominant discipline in this respect is Art. III GATT, which requires all WTO members too treat all like products (domestic and foreign) in a non-discriminatory manner. The crucial issue here is whether a pair of products (Kyoto-compatible, Kyoto-incompatible) should be viewed as like products.”

They conclude that regulatory distinctions based on the process of production are likely to be held as WTO compatible even in cases where the process of production has not been incorporated in the final product.

The findings of these two distinguished scholars add weight to the debate.

“Can the European Union impose say a carbon tax (or even ban sales of) on Kyoto Protocol-incompatible goods? … (I)respective of whether the production process has been incorporated in the final product, regulatory distinctions based on the production process can be perfectly legitimate, assuming the various conditions included in the relevant GATT provisions have been respected. In case of incorporation of the production process, the issue seems quite straightforward: a reasonable consumer test (whereby ‘reasonable’ means ‘informed’) would lead to the conclusion that a consumer (in the eyes of the Appellate Body) who is aware of the environmental (and eventually health hazard that global warming might

---

14 Appleton, op. cit., p.16.
16 Ibid, p. 303.
17 Ibid, p. 303.
represent, will treat the two goods (*Kyoto Protocol*-compatible, *Kyoto Protocol*-incompatible) as unlike goods.

In case the production process has not been incorporated in the final product then the regulator *might* have to look for a regulatory objective in the list of Art. XX GATT and couch the regulatory intervention in those terms.19

**Border Tax Adjustments and the WTO**

If the arguments outlined above have any validity, it is not difficult to imagine a situation, for example, where the EU takes trade measures against firms to protect their firms from foreign competitors not subject to the Kyoto rules. These advantages might include, for example, lower fossil fuel costs in the U.S. and other non-Annex 1 countries.

Such an approach might involve use of a carbon tax coupled with some sort of border tax adjustment. Consider a situation whereby the EU imposed an internal tax on the carbon emitted in the production of goods. The tax would encourage the reduction of greenhouse gas emissions and the prices of energy-intensive goods and goods whose production caused high greenhouse gas emissions would rise as a result. But the tax would penalize EU producers, who could complain that they could not compete with foreign firms not subject to those taxes. Consequently, the Kyoto signatory country – the EU in this example -- might impose a tax on imported goods equal to what would have been paid had these goods been manufactured domestically. Of course, under such a scheme exported goods probably would be eligible for a full rebate of internal taxes.

The legality of such a border tax system under GATT rules, that is, before conclusion of the Uruguay Round would be doubtful. Border tax adjustments on imports or exports of products were permitted for any indirect taxes levied on the product itself or on products physically incorporated or exhausted in the production of the final good. Adjustments were not allowed for indirect taxes levied on products or services *consumed* in the course of production.

But the Uruguay Round Agreement on Subsidies and Countervailing Measures may have called that previous understanding into question. The new agreement is broader in scope than that concluded in 1979 in that indirect taxes on “inputs that are consumed in the production of exported products” may be rebated without being subject to any countervailing duties. Such inputs are further defined as 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.”

While the reference in the agreement is to the rebate of export taxes, it seems reasonable to assume that, under this provision, the WTO would allow full taxation of imports so that domestically produced goods and imports would be treated equally.

---

19 Bhagwati and Mavroidis, op. cit., p. 307-308.
In 1994, then USCIB President Abraham Katz sought clarification from the Clinton Administration on this point. The reply from USTR, which is quoted in a 1997 WTO Secretariat report, indicates that the new language was the object of an informal agreement among developed countries whereby:

“…It was proposed to address a specific and very narrow issue involving certain energy-intensive exports from a limited number of countries. It was never intended to fundamentally expand the right of countries to apply border adjustment for a broader range to taxes on energy, especially in the developed world…We (the U.S.) discussed the matter with other developed countries involved in the Subsidies Code negotiations. We are satisfied that they share our views on the purpose of the text as drafted and the importance of careful international examination before any broader policy conclusions should be drawn regarding border adjustments and energy taxes.”

This so-called “Gentlemen’s Agreement” has never been tested. However, the actual language in the Subsidies and Countervailing Measures Agreement stands as written and ratified. And with the evolution of WTO case law, as exemplified by the Shrimp-Turtle decision, it is conceivable that a Kyoto Annex 1 country could claim that a border tax, for example, is entitled to an environmental exception under GATT Article XX.

Indeed, the 1996 report of the WTO’s Committee on Trade and Environment to the Singapore Ministerial explicitly states, “Scope exists under WTO provisions for Member governments to apply environmental charges and taxes.” The report went on to note that the CTE had done only preliminary work on this latter, concluding that “Further work on this Item is needed.”

Conclusion

The Appellate Body’s decision in Shrimp-Turtle has seemingly established the principle that non-product related PPMs are acceptable restraints on trade where a country claims to be protecting a resource that is found in the global commons. There is some risk then that the EU and other like-minded countries might, in some yet undefined circumstances, resort to trade measures in the form of border tax adjustments or other barriers to offset the competitive advantage allegedly enjoyed by firms in the U.S. and other non-Annex 1 countries because of their non-adherence to Kyoto. And they might have a plausible legal case against a trade challenge launched by those countries in the WTO if recent case law is an accurate guide.

How realistic are these threats? Right now, the risk is probably low. Many of the views quoted in this paper are somewhat speculative in nature with respect to the linkages

---

between a climate change agreement and the WTO. Moreover, it is hard to imagine the EU or any other country or trading bloc being in a position to create some compensatory or trade retaliatory regime before Kyoto is fully implemented. Professors Bhagwati and Mavroidis have also pointed out, “…(E)ven if an action were legally possible … it still does not follow that what is legally possible is also politically prudent.”

They note that it is hardly likely that American politicians and the U.S. public at large would approve of a virtual ban on nearly all US exports simply because the US had not ratified Kyoto.

“The reaction would well be to retaliate, not just with ‘moral’, values-related PPMs that could be advanced against the US but on several other dimensions: there is no dearth of contentious issues that divide the EU from the US from time to time.”

The U.S. Administration appears mindful of the threat – remote as it may be. For the moment then, U.S. officials will wait to see what, if any, specific measures the EU or others develop. They have noted that the Kyoto Protocol is silent on trade measures and that Kyoto imposes no trade obligations. Therefore, it is argued, any trade action taken by the EU or others would have to be consistent with WTO rules and benefit from an Article XX exception. The position of other non-Annex 1 countries is not clear on this point.

But that is the rub. The business community cannot count on any challenge in the WTO against trade measures designed to promote compliance with Kyoto being upheld by a Dispute Panel or the Appellate Body. The Shrimp-Turtle decision and the revised treatment of inputs in the Uruguay Round’s agreement on subsidies have opened the door to such measures. And it is clear that there are some groups and governments that might be prepared to test the system at some future point. Such a challenge would be significant not only for business, but also for the functioning and international standing of the WTO.

22 Bhagwati and Mavroidis, op. cit, 300-301.
23 Bhagwati and Mavroidis, op. cit., p. 310.