

BRIEFING

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# Trade Related Aspects of a Carbon Border Adjustment Mechanism. A Legal Assessment



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## BRIEFING

# Trade Related Aspects of a Carbon Border Adjustment Mechanism. A Legal Assessment

### ABSTRACT

This briefing provides a legal assessment – under WTO and EU law - of three policy options for an EU carbon border adjustment mechanism. These options are, first, a carbon tax adjusted at the border; second, the inclusion of importers under the EU emission trading scheme; and, third, import tariffs on products from third countries that do not pursue climate policies in line with the Paris Agreement. In the first part of the briefing, these three policies are evaluated against the benchmark of vulnerability to WTO legal challenge. The second part of the briefing assesses the EU decision-making procedures that are applicable to the three policies and the varying degrees of efficiency and democratic participation they imply.

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# 1. Feasibility under WTO Agreements

## 1.1 Background on the nature and constraining power of WTO Agreements

### The EU is bound by WTO rules under international law

- Both the EU and its Member States are parties to the WTO. They are hence bound, under international law, to comply with WTO agreements.
- WTO rules may constrain EU climate action. They also protect EU trade interests abroad on a reciprocal basis.
- WTO agreements do *not* have direct effect before EU courts <sup>(1)</sup>. WTO rules can only be enforced by other WTO members under state-to-state dispute settlement, conducted in Geneva.
- Only other countries (not private industries) may thus challenge any eventual EU carbon border adjustment mechanism for alleged violation of WTO rules.

### Giving meaning to (old) WTO provisions

- Relevant WTO rules date mostly from the 1940s when the original GATT was concluded. Potentially applicable subsidy rules have been updated at the creation of the WTO in 1994. None of these rules explicitly address climate change.
- Whether EU action complies with WTO provisions depends predominantly on the *actual text* of those provisions. What is, for example, a 'tax' or 'subsidy' for EU law purposes or from an economic perspective, is not necessarily a 'tax' or 'subsidy' under the text of WTO rules.
- Past WTO rulings have also been referred to in order to guide the meaning of WTO provisions. However, for many questions addressed below, there are no 'precedents' and WTO provisions are vague. This makes it very difficult to predict whether a particular carbon adjustment mechanism would be WTO consistent.

### Limited remedies

- Even if the WTO dispute settlement body were to find a WTO violation, any remedy provided is purely prospective and excludes monetary compensation.
- This means that, at worst, the EU could be compelled to change its mechanism with effect only *after* an adverse WTO ruling and a reasonable period of time to implement (which normally takes several years). In this sense, the WTO allows for a degree of 'trial and error'.
- The EU can also decide to keep any violation in place and instead conclude mutually agreed solutions with other countries, or accept to suffer equivalent trade retaliation (as it did, for example, in the *Hormone beef* dispute with the US and Canada).

### Relevance of WTO crisis

- The current crisis at the WTO has left the second-stage Appellate Body inoperable (the US is blocking the appointment of new Appellate Body members). First-level panels remain, however, available, but adoption of their reports may now be blocked simply by filing an appeal (to a body that no longer exists and can hence not complete the appeal).
- On the one hand, the potential to block adverse WTO rulings (by appealing 'into the void') could be seen as a weakening of the constraining power of the WTO. On the other hand, the threat of a dysfunctional WTO dispute settlement system means that countries who consider that EU carbon

<sup>1</sup> Case C-149/9, *Council v Portugal* [ECLI:EU:C:1999:574], paras 44-49.

border adjustment violates WTO rules may 'take the law in their own hands' (and retaliate against the EU) without going through the required WTO proceedings.

## 1.2 Overview of relevant WTO disciplines

Whether carbon border adjustment complies with WTO rules has been a subject of debate for many years. Most commentators today agree that at least certain types of adjustment could pass muster at the WTO, and that much will depend on the details of any such mechanism<sup>2</sup>. Although widely discussed and anticipated, few actual examples of carbon border adjustment can be found. None have been challenged before the WTO to date.

### 1.2.1 Relevant WTO rules that could be invoked against carbon adjustment on imports

- **Tariff bindings:** For each product imported into the EU, the EU 'bound' itself to a maximum rate of import duties or tariffs (under GATT Article II). A carbon adjustment on, for example, imported steel, if construed as an import tariff, could be found to exceed the EU's tariff binding on steel. GATT Article II:2(a) explicitly allows, however, for 'border tax adjustment', that is, an import 'charge equivalent to an internal tax ... in respect of the like domestic product [here, EU steel] or ... an article [e.g. steel inputs] from which the imported product has been manufactured or produced in whole or in part'. This could excuse certain carbon levies on imports 'equivalent' to a domestic carbon 'tax', as discussed below (under 1.3.1).
- **National treatment:** The EU promised not to discriminate (either *de jure* or *de facto*) imported products as compared to like EU products (under GATT Article III). To the extent the carbon adjustment on, for example, cement imported from China were to be construed not as a tariff (on imports only) but as part of, or equivalent to, an indirect tax or regulation on both domestic and imported cement, the EU must ensure a 'level playing field' (see below under 1.3.2 and 1.3.3).
- **Prohibition on quantitative import restrictions (QRs):** If the EU carbon adjustment were not seen as an import tariff or duty, nor as an internal tax or regulation, but rather as a border restriction that limits imports, GATT Article XI could be violated.
- **Most-favored-nation treatment (MFN):** Whatever the classification of the carbon adjustment, it cannot discriminate between like products imported from different countries, e.g. between aluminum from Canada versus like aluminum from the US. If it does, GATT Article I (or XIII, for quantitative restrictions) would be violated (see below under 1.3.4).

Crucially, even if any of the above four WTO rules (tariff bindings, national treatment, prohibition on QRs, MFN) were found to be violated, **GATT Article XX health and environmental exceptions** (see below under 1.3.5) can justify such violation on condition that the import adjustment is:

- a measure 'necessary to protect human, animal or plant life or health' (GATT Article XX(b)) or 'relating to the conservation of exhaustible natural resources' (and 'made effective in conjunction with restrictions on domestic production or consumption') (GATT Article XX(g)), and

<sup>2</sup> See, for instance: Dias, Anna, Stéphanie Seeuws, Agnieszka Nosowicz (2020): *EU Border Carbon Adjustment and the WTO: Hand in Hand Towards Tackling Climate Change*, 15 Global Trade and Customs Journal, Issue 1, pp. 15–23. Porterfield, Matthew (2019): *Border Adjustments for Carbon Taxes, PPMs, and the WTO*, U. Pa. J. Int'l L. Vol. 41:1. Will, Ulrike (2019): *Climate Border Adjustments and WTO Law: Extending the EU Emissions Trade System to Imported Goods and Services*, Brill. Trachtman, Joel P. (2016): *WTO Law Constraints on Border Tax Adjustment and Tax Credit Mechanisms to Reduce the Competitive Effects of Carbon Taxes*, Resources for the Future Discussion Paper 16-03. Marceau, Gabrielle (2016): *The Interface between the Trade Rules and Climate Change Actions*, in: Park, Deok-Young (Ed.): *Legal Issues on Climate Change and International Trade Law*, Springer, 3-39. Pauwelyn, Joost (2013): *Carbon Leakage Measures and Border Tax Adjustments under WTO Law*, in: Van Calster, Geert & Denise Prévost (eds.), *Research Handbook on Environment, Health and the WTO*, 448.

- ‘not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail’ or ‘a disguised restriction on international trade’ (the so-called *chapeau* of GATT Article XX).

### 1.2.2 Relevant WTO rules that could be invoked against carbon adjustment on exports

Carbon border adjustment could include not only a duty or imposition on imports, but also a **rebate of carbon cost when certain EU products are exported**. Rebating energy-intensive exports may address competitiveness concerns of EU producers on the world market. Yet, such rebates may also delay climate efforts within the EU as EU producers could then avoid paying the cost of carbon simply by exporting carbon-intensive products. For this reason, most initiatives and commentators propose to adjust carbon measures only on imports, not on exports.

If an EU adjustment mechanism were, nonetheless, to include an exemption or rebate for exports, other WTO members could challenge this as an **export subsidy**, as such exemption or rebate could be seen as a ‘financial contribution’ by the EU in the form of ‘government revenue that is otherwise due’ (e.g. a carbon tax or cost of carbon allowance) which is ‘foregone or not collected’ contingent on exporting the product. Export subsidies are prohibited under the WTO’s Agreement on Subsidies and Countervailing Measures (ASCM) (Article 3.1(a)).

Crucially, however, the ASCM Agreement (footnote 1) **explicitly allows for the ‘exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption’**, for as long as it merely ‘levels the playing field’, i.e. the rebate is ‘not in excess’ of the carbon cost that would have been imposed if the exported product were consumed within the EU.

Note that border adjustment, be it on imports or exports, is a *right*, or *permitted* under WTO rules. There is *no obligation* to do it. Thus, by currently not adjusting the EU ETS, the EU is not violating any WTO rule. Moreover, if the EU decides in the future to adjust only on imports and stays within the limits described above, it is not obliged to adjust also on exports.

### 1.3 Key cross-cutting questions for carbon adjustment on imports to be WTO consistent

Generally speaking, two distinct motives inspire calls for carbon adjustment on imports:

- (i) **competitiveness** or ‘level the playing field’ concerns (EU producers pay a carbon cost, which imports do not), and
- (ii) **environmental** concerns (fighting carbon leakage and/or inducing other countries or foreign producers to cut emissions).

The WTO disciplines outlined above under 1.2 provide legal shelter for both, subject to certain limitations. Competitiveness concerns are addressed in GATT Article II (tariff bindings) and GATT Article III (national treatment). Environmental concerns are allowed for in GATT Article XX (health and environmental exceptions).

Whether an EU carbon measure can be adjusted on imports depends on whether the measure meets the criteria set out in the WTO provisions that allow for border adjustment, notably GATT Articles II and III. In other words: does the EU measure fall within the scope of these provisions in the first place? Sections 1.3.1 and 1.3.2 below set out the scope of EU measures that are adjustable in line with WTO law.

If the EU measure is, according to the relevant GATT provisions, border adjustable, it must pass a second test: does the measure violate the National Treatment provisions of GATT Article III or the MFN principle

enshrined in GATT Article I. Section 1.3.3 (national treatment) and section 1.3.4 (MFN) below discuss this very question.

Finally, even if the EU measure at issue does violate one of the above-mentioned WTO border adjustment or non-discrimination rules, it may still be justifiable under the General Exceptions of GATT Article XX, which protects – under certain conditions – health and environmental measures from WTO inconsistency. This is discussed under 1.3.5 below.

### 1.3.1 Is the EU carbon measure imposed on EU production an ‘indirect tax’ or ‘affecting’ an EU product’s internal use or sale?

Competitiveness concerns are catered for under the theory of ‘border tax adjustment’ and ‘national treatment’: if a domestic tax or regulation is sufficiently product or sales related (think of VAT, an excise tax on cigarettes or a dolphin-safe labeling requirement for the sale of tuna), it can be imposed or adjusted also on imports and this to ensure equal conditions of competition. Yet, other taxes or regulations, targeting not so much products or their inputs, but rather producers, employees or profits (think of corporate or payroll taxes or environmental land use restrictions), cannot be adjusted on imported products.

The key question is, therefore, whether a carbon tax or regulation, *as it is imposed domestically within the EU*, is more like an adjustable VAT (targeting products, inputs or consumption) or a non-adjustable payroll tax (targeting predominantly producers).

In WTO legal terms, the EU ETS, for example, can be adjusted on imports based exclusively on competitiveness concerns, if, but only if, it can be construed either as

- (a) an ‘internal tax or other internal charge of any kind ... **applied, directly or indirectly**, to ... [EU] **products** [e.g. energy used or cement produced in the EU]<sup>3</sup>, or
- (b) a law, regulation or requirement ‘**affecting** ... [an EU **product’s**, e.g. EU energy or cement] **internal sale**, offering for sale, purchase, transportation, distribution or use’<sup>4</sup>.

What matters is the nexus between the ETS and *inputs or products* used or produced in the EU (e.g. does the ETS apply at least indirectly to EU cement as a product?), that is, the measure’s *target*; not the *reason* for the measure, e.g. whether it relates to something physically in the product (say, a sugar versus a carbon tax) or to something that happened in or outside the EU (say, carbon emissions in the EU or China).

Further guidance on precisely what types of taxes are adjustable at the border can be found in the ASCM Agreement, which addresses the flip side of adjustment on imports, namely rebates on exports. There, it is confirmed that only ‘indirect taxes’<sup>5</sup> – and not ‘direct taxes’<sup>6</sup> – are border adjustable. However, adjustable ‘indirect taxes’ are broadly defined as ‘all taxes other than direct taxes’. Direct taxes, in turn, are limited to income and property taxes. **Since a carbon tax is neither an income nor property tax it would most likely be qualified as an adjustable ‘indirect tax’.** In addition, adjustable ‘indirect taxes’ explicitly include not only consumption taxes or taxes on final products (such as VAT) but also inter-mediate taxes ‘in

<sup>3</sup> GATT Article III:2.

<sup>4</sup> GATT Article III:4.

<sup>5</sup> SCM footnote 58 defines ‘indirect taxes’ as ‘sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges’; border adjustment permitted in line with SCM Annex I(g) and (h).

<sup>6</sup> SCM footnote 58 defines ‘direct taxes’ as «taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property»; border adjustment prohibited pursuant to SCM Annex I(e).



**respect of the production and distribution’ of products’**<sup>7</sup>. In other words, process or production taxes including taxes on inputs<sup>8</sup> such as fuels (and fuel-related carbon emissions) could be ‘indirect taxes’ adjustable at the border<sup>9</sup>.

### 1.3.2 Is the EU carbon measure imposed on EU production a ‘tax or other charge’ or a ‘regulation’?

As noted earlier, pursuant to GATT Article III, not only indirect ‘taxes or other charges’ but also internal regulations (sufficiently related to the sale, purchase or use of a product or input) can be adjusted on imports<sup>10</sup>. In this sense, no major difference is made between taxes and regulations. Both can be border adjustable.

That said, border adjustment of taxes or other price measures is somewhat more flexible. An internal EU carbon tax can be adjusted simply by applying it at the point of sale or consumption in the EU of, say, cement, irrespective of whether the cement was made in the EU or imported from China (pursuant to GATT Article III:2). An internal carbon tax or charge can also be adjusted at the border with a border tariff or charge ‘equivalent to’ the internal carbon tax (pursuant to GATT Article II:2(a)).

An internal regulation, in contrast, can only be adjusted for imports by applying the same or an equivalent regulation also on imports. Think, potentially, of an emissions allowance requirement imposed for both EU production and imports<sup>11</sup>. Border adjustment of an internal regulation by means of a border tax is not provided for in GATT Article II. Article II only permits border charges ‘equivalent to an internal tax’, not border charges equivalent to an internal regulation.

### 1.3.3 Is the carbon measure on imports discriminatory compared to that on ‘like’ domestic products?

Assuming that the EU carbon measure on EU production can be adjusted also on imported products (pursuant to GATT Article II or III), such adjustment cannot impose a heavier burden on imports as compared to ‘like’ domestic products. Let’s take the example of steel:

- The carbon cost imposed on ‘like’ steel imported from, for example, China cannot be in excess of that imposed on EU steel production. Past WTO rulings have found products to be ‘like’ based on their competitive economic relationship in the market place. This means that, most likely, EU and Chinese steel *irrespective of their carbon footprint* would be found to be ‘like’. If, on the whole, China exports ‘dirtier’ steel to the EU compared to ‘cleaner’ EU steel, then a finding of *de facto* discrimination is possible, on the ground that the group of imported steel from China is hit harder

<sup>7</sup> SCM Annex I(g).

<sup>8</sup> GATT Article II:2(a) on border tax adjustment explicitly allows for border adjustment of internal taxes not only ‘in respect of ... domestic products[s]’ but also in respect of ‘an article [or input] from which the imported product has been manufactured or produced in whole or in part’. As a result, not only taxes on the final product (such as excise taxes on cigarettes) but also taxes on inputs (such as a tax on alcohol used in the production of perfume) can be adjusted on imports (of e.g. cigarettes or perfume made with alcohol).

<sup>9</sup> SCM Annex I(h) which addresses a specific sub-group of indirect taxes (namely, ‘prior-stage cumulative indirect taxes’) explicitly includes as adjustable ‘taxes ... levied on inputs that are consumed in the production of the ... product’ which are later (in Annex II, footnote 61) defined as including not only ‘inputs physically incorporated’ in the final product, but also taxes on inputs such as ‘energy, fuels and oil used in the production process’.

<sup>10</sup> See Ad Note to GATT Article III: ‘Any ... law, regulation or requirement ... which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as ... a law, regulation or requirement ... subject to the provisions of Article III [national treatment].’

<sup>11</sup> Whether the requirement to hold emission allowances can be seen as a ‘tax or other charge’, or is rather a ‘regulation’, for purposes of GATT Article III, remains an open question. For purposes of the EU-US Open Skies Agreement, the ECJ rejected the notion that the obligation to buy emission allowances is a tax or charge and construed it rather as a special type of regulation (*Air Transport Association of America et al. v. Secretary of State for Energy and Climate Change*, Case C-366/10, 21 December 2011, paras. 142-143), discussed below under 2.2.2.

than the group of EU steel. However, any such *de facto* discrimination (in violation of GATT Article III) could still be justified under environmental exceptions discussed under 1.3.5 below.

- One way to avoid such *de facto* discrimination is to impose on imports of steel from China the *average* carbon price levied on EU steel. By using the EU group average, *de facto* group equality can be ensured. In addition, individual Chinese exporters could be allowed to demonstrate that they emitted *less* than the EU average, and on that basis pay a lower carbon price. If so, the overall group of Chinese imports only stands to be treated *more favorably* than the group average of EU steel producers.
- Another way to avoid *de facto* discrimination is to focus on, i.e. tax or regulate, inputs rather than the final product. If the EU taxes energy used in the production of steel, the adjustment on imported steel could be equally calculated with reference to the energy used abroad (say, the coal used in the production of Chinese steel). Doing so, the EU could then be said to tax imported energy (and emissions) embedded in imported steel at the same level of 'like' energy (and emissions) used in the production of EU steel. The 'like products' (and related tax burdens) to be compared are then energy as inputs (say, coal, treated equally, be it EU or Chinese coal), not the end product steel (which may *de facto* be discriminated, depending on how 'clean' or 'dirty' overall EU v. Chinese steel production is).

### 1.3.4 Does the carbon measure discriminate between like imports from different countries?

#### i. Adjusting for carbon cost already paid in the country of production

Traditional 'border tax adjustment' operates on the basis of the destination principle: domestic consumption, including imports, is taxed; exports are rebated. This means that, technically, EU carbon border adjustment could levy the *full* carbon price on imports *irrespective of the country of origin*, on the assumption that the country of origin has rebated whatever carbon price charged there. Put differently, the EU could fully adjust imports of, for example, Canadian steel, as normally whatever carbon price Canada imposes can be rebated by Canada upon export of the steel. In the end, only the carbon price at (EU) destination would then be levied.

In practice, however, and for reasons mentioned in section 1.2.2, carbon adjustment *for exports* is not likely. As a result, the EU may want to adjust the carbon price on imports with reference to the price already paid in the country of production. If so, the EU should ensure not to discriminate between 'like' products from different countries (GATT Article I MFN, see section 1.2.1).

#### ii. Exemptions for imports from specific countries

Instead of a varying carbon adjustment depending on the actual or average carbon cost already paid in the country of origin, the EU could also exempt imports on a country-specific basis. For example, the adjustment could be waived for imports from least developed countries or from countries that are party to the Paris Agreement or have climate legislation equivalent to the EU. As such differentiation would be origin-based, it would most likely constitute a violation of GATT Article I MFN. However, like any violation discussed so far, it could be justified on environmental grounds, discussed next.

### 1.3.5 Can the EU border adjustment on imports be justified on environmental grounds?

Any GATT violation – be it a tariff violation under GATT Article II or national treatment or MFN discrimination under GATT Articles I or III – can still be saved under GATT Article XX. At this juncture, what

counts is no longer competitiveness concerns of 'leveling the playing field', but **whether the adjustment is grounded on environmental concerns** such as carbon leakage:

- There can be little doubt that, generally speaking, EU measures combatting climate change, including adjustments at the border, relate to a health or environmental concern with a sufficient nexus to EU territory (referred to in GATT Article XX(b) and (g)): Because GHGs mix in the atmosphere, all emissions, whether they occur in the EU, China or the US, pose the same local risk to EU citizens. This distinguishes climate measures from measures aimed at tackling purely extraterritorial concerns (such as ground water protection in China, or minimum wages in Bangladesh).
- There must also be a close enough nexus between the adjustment on imports and the climate change (e.g. carbon leakage) concerns it aims to address. In this respect, the key question is whether a less trade restrictive measure could achieve the same level of climate protection. Free allowances are one option, but as they involve not imposing a carbon cost at all on certain production, this option probably does not achieve the same level of climate protection. In addition, border adjustment never bans imports; it only charges a certain price for embedded carbon. As such, border adjustment, while it restricts trade, remains a relatively open policy.

Even if the carbon adjustment on imports, because of its positive, global climate change impact, is 'necessary' or sufficiently 'related to' health or the 'conservation of exhaustible natural resources' in the EU (under paragraph (b) or (g) of GATT Article XX), it must also be **applied in a way that does not amount to 'arbitrary or unjustifiable discrimination between countries where the same conditions prevail'** (under the chapeau of Article XX):

- Even if calibrating the border adjustment to the carbon cost already paid in the country of origin may involve a form of discrimination, it is arguably justified and not arbitrary since based on environmental grounds (i.e. internalising the social cost of carbon, wherever it is paid).
- Similarly, exempting least developed countries (LDCs) is probably discriminatory, but could be justified on environmental grounds: LDCs have historically emitted far less than developed countries and such differentiation is enshrined also in the Paris Agreement.
- In both examples, the countries treated differently could also be said to be countries where *different* 'conditions prevail', so there is arguably no discrimination in the first place.
- What prior WTO rulings have, however, condemned is measures that have an 'intended and actual coercive effect on the specific policy decisions made by foreign governments'<sup>12</sup>. Taxing the average or actual carbon content of imports from, say, China, does not require any policy change in China. It merely implies that that part of China's production which is sold in the EU will need to pay the EU's carbon price. In contrast, imposing a 'punitive' carbon tariff on imports from countries that are not party to the Paris Agreement or do not have the same carbon price policy in place as the EU, is conditioned on the overall policy in the country of origin. This could be seen as coercive, and would be more difficult to justify.

<sup>12</sup> Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted 6 November 1998, para. 161.

## 1.4 Instrument-by-instrument conclusion

### 1.4.1 Carbon tax adjusted at the border

An EU (or member state) indirect tax on the use or consumption of energy or energy-intensive products (and their related GHG emissions) is the option that can most easily be adjusted also on imports (in line with GATT Articles II:2(a) and III, and the corresponding provision on export rebates in SCM footnote 1 and Annex I(g)). Care must then, however, be taken not to discriminate *de jure* or *de facto* against imports, or between different sources of importation. Importantly, even if some discrimination were found, it can still be justified under GATT Article XX to the extent the differentiation made is sufficiently linked to health or environmental concerns (rather than trade protectionism or competitiveness concerns).

### 1.4.2 Including imports into a 'cap and trade' system

On the assumption that a 'cap and trade' system is closer to an internal regulation than an internal (indirect) tax, also internal regulations can be adjusted for imports, but only with an equivalent regulation (not an import tariff or tax). The regulation must, however, be affecting the sale or use of products (GATT Article III:4). Here as well, no discrimination can be made against or between imports. If some discrimination were found, it could still be justified under GATT Article XX to the extent it sufficiently relates to health or environmental concerns (rather than trade protectionism or competitiveness concerns).

### 1.4.3 Import duties for countries outside the Paris Agreement or not charging for GHG emissions

This option is likely discriminatory in violation of GATT Article I MFN. In addition, since it is conditioned on the overall policy in place in the country of production (rather than the embedded carbon in the imported product or average carbon footprint of the specific foreign producer), it could be seen as coercive, and not in line with the *chapeau* of the health and environmental exception in GATT Article XX. This option is most vulnerable to WTO challenge.

## 2. Feasibility under EU Law

In recent climate change legislation, the European Parliament and the Council outlined a legislative path towards adopting EU measures that have the potential to prevent carbon leakage. The legislators contemplate that a review of the EU ETS 'could consider whether it is appropriate to replace, adapt or complement any existing measures with carbon border adjustments or alternative measures' so as to render 'importers' of products produced in sectors covered by the ETS subject thereto<sup>13</sup>. Albeit in aspirational language, the European Parliament and the Council hereby delineate a broad realm of possibilities for future carbon leakage legislation.

This section assesses the legal feasibility under EU law of three distinct policy options falling within this realm. For each option, the assessment responds to the following questions: Is the Union competent to act? If so, is the Union competence exclusive or shared with the Member States? What is the legal basis for Union action? Which legislative procedure applies? Is the European Parliament involved as a co-legislator or not? Does the Council decide by qualified majority voting or unanimity?

The three policy options under evaluation are:

- i. EU legislation harmonising the imposition of a carbon tax or, alternatively, the imposition of a carbon tax by one or several Member States.

<sup>13</sup> Directive (EU) 2018/410 of the European Parliament and the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814, recital 24

- ii. The inclusion of importers of like domestic products in the EU ETS.
- iii. The imposition of 'punitive tariffs' on imports from countries that do not pursue policies in line with the Paris Agreement.

## 2.1 EU and Member State carbon tax legislation

### 2.1.1 An EU carbon tax

#### i. EU competence and legal basis

The EU shares competence for 'environment' with the Member States, as listed in Article 4(e) TFEU. Moreover, Article 191(1) under TFEU Title XX on 'Environment' provides that 'Union policy on the environment shall contribute to pursuit of the following objectives: - preserving, protecting, and improving the quality of the environment, - protecting human health, - the prudent and rational utilization of natural resources, - promoting measures at international level to deal with regional or worldwide environmental problems, and in particular combating climate change.'

Does an EU carbon tax fall within the scope of Article 191(1) TFEU? It does. It is established CJEU jurisprudence that the choice of the legal basis for a Union act must rest on factors that, in particular, include the aim and the content of the measure at issue<sup>14</sup>. The application of those criteria amounts to the question whether the imposition by the Union of a tax on certain products – whether imported or not – on the basis of carbon emitted in the course of the consumption or production of these products is aimed at achieving the objectives listed under Article 191(1) TFEU. Notwithstanding the precise design, structure, and operation of an EU act harmonising legislation for a carbon tax, the answer to this question is highly likely to be affirmative for one, several, or all objectives listed in Article 191(1) TFEU. **It follows that the Union is competent to adopt a respective Union policy.**

#### ii. Legislative procedure: *special or ordinary?*

Article 192(1) TFEU provides that Union acts laying down policies contributing to the objectives listed in Article 191(1) TFEU are generally adopted in accordance with the **ordinary legislative procedure (OLP)**<sup>15</sup>. The OLP is codified in Article 289(1) TFEU and Article 294 TFEU. Here, in essence, the European Parliament and the Council co-decide on a legislative proposal tabled by the Commission. In the OLP, the Council acts, by and large, by qualified majority voting<sup>16</sup>.

However, EU legal acts on the environment must be adopted in accordance with a **special legislative procedure** if the provisions of that act are '**primarily of a fiscal nature**'<sup>17</sup>. If so, the Council acts unanimously on a proposal from the Commission after consulting the European Parliament, the Economic and Social Committee and the Committee of the Regions<sup>18</sup>.

The jurisprudence of the CJEU suggests that a scheme, which generates revenue for public authorities and creates a *direct and inseverable link* between a charge on carbon emitted and the production or consumption of a product, makes for a tax<sup>19</sup>. As a tax scheme is an instrument of fiscal policy, it is arguably

<sup>14</sup> See, for instance, Opinion 2/00, ECLI:EU:C:2001:664, para 25; C-268/94, *Portugal v Council*, [1996] ECR I-6177, para 22; Case C-269/97, *Commission v Council* [2000] ECR I-2257, para 43; C-36/98, *Spain v Council*, [2001] ECR I-779, para 58.

<sup>15</sup> Article 192(1) TFEU

<sup>16</sup> Article 16(3) TEU

<sup>17</sup> Article 192 (2)(a) TFEU

<sup>18</sup> *Ibid.*

<sup>19</sup> See the Court's reasoning in C-346/97 – *Braathens* [ECLI:EU:C:1999:291] where the Court, in para 23, observes the existence of a *direct and inseverable link* between fuel consumption and polluting substances taxed by the Swedish carbon scheme at issue, leading the Court to the conclusion that the charge on the pollutants must be "regarded as levied on consumption of the fuel

‘primarily of a fiscal nature’ within the meaning of Article 192(2) TFEU and hence subject to the special legislative procedure laid out in that provision. Taxation, in fact, remains one of the last bastions of policy areas subject to a unanimity requirement in the Council. The Commission, in the recent communication titled *Towards a more efficient and democratic decision-making in EU tax policy*, laments this circumstance and advocates a shift towards qualified majority voting in the Council and the involvement of the European Parliament as a co-legislator<sup>20</sup>.

### iii. Switching from *special* to *ordinary* legislative procedure for the purpose of EU carbon tax legislation?

The EU Treaties allow for a change of legislative procedure. Article 192(2) TFEU provides for the possibility to switch, for the purposes of tax measures in the area of environment policy, to the OLP and hence qualified majority voting in the Council. The so-called ‘passarelle clause’ in Article 192(2), second sentence, stipulates that the Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament, the Economic and Social Committee and the Committee of the Regions, may render the OLP applicable.

This switch from the special legislative procedure to the OLP – as advocated by the Commission as more efficient and democratic decision-making in EU tax policy – would add the European Parliament as a co-legislator in carbon tax legislation.

## 2.1.2 A Member State carbon tax

Notwithstanding the current absence of EU carbon tax legislation, Finland, Ireland, and Sweden have already adopted varying carbon tax schemes<sup>21</sup>. It is hence important whether and under which conditions EU Member States may maintain or adopt carbon tax legislation if the EU enacts a Union wide carbon tax. The following considerations shed light on the ‘preemptive effect’ of a prospective EU carbon tax on Member State carbon tax legislation, irrespective of the question whether such legislation applies to products imported from third countries.

As noted above, carbon tax legislation falls within the area of environmental policy, which is a shared competence as provided by Article 4(e) TFEU read in conjunction with Article 191(1) TFEU. Where the treaty confers on the EU a competence shared with the Member States, the Member States may, as a general rule, only exercise their competence to the extent that the Union has not exercised its competence (Article 2(2) TFEU). In other words, as a general rule, Member State legislation in a specific area of shared competence is ‘preempted’ by the exercise of Union competence in that area.

However, EU primary law, EU secondary legislation, and CJEU jurisprudence qualify the preemption of Member States’ lawmaking powers by Union legislation in various ways<sup>22</sup>. With respect to environmental policy, the TFEU codifies a minimum harmonisation clause: Article 193 TFEU limits the preemptive effect of Union legislation to the extent that protective measures adopted pursuant to Article 192 TFEU ‘shall not prevent any Member State from maintaining or introducing more stringent protective measures’, provided that such measures are ‘compatible with the Treaties’. In other words, Union legislation in the area of environmental policy only sets a floor that may be complemented by stricter (but not less strict) Member

itself” and hence makes for a fuel consumption tax. By contrast, the Court, in C-366/101/EC – *Open Skies* [ECLI:EU:C:2011:864] found that the inclusion of aviation in the EU ETS by means of Directive 2008/101 amending Directive 2003/87/EC did not create a *direct and inseverable link* between a payable amount and the fuel consumed for flights carried out by the operators and could therefore not be considered a tax, fee or charge on fuel consumption. paras. 142-147

<sup>20</sup> European Commission (2019): Communication from the European Commission to the European Parliament, the European Council, and the Council – *Towards a more efficient and democratic decision-making in EU tax policy*, Strasbourg, 15.1.2019.

<sup>21</sup> see <https://www.carbontax.org/where-carbon-is-taxed/>

<sup>22</sup> Arena, Amadeo (2016): Exercise of EU Competences and Pre-emption of Member States’ Powers in the Internal and the External Sphere: Towards ‘Grand Unification’?, *Yearbook of European Law*, Volume 35, Issue 1, December 2016, Pages 28–105



State legislation in the same field. In any event, a Member State's carbon tax legislation must not be incompatible with Article 110 TFEU, which prohibits *inter alia* the imposition of taxation on other Member States' similar products in excess of internal taxation of any kind.

### 2.1.3 Conclusion

It follows that the Union could adopt a carbon tax (including on imports or not) under EU primary law governing environmental policy, either via a special legislative procedure requiring unanimity in the Council, or via the OLP if the Council adopts a Commission proposal to this end by unanimity *ex ante*. Member States may maintain or introduce carbon taxes even in case of EU exercise of lawmaking powers in the area of environmental protection if, and only if, such measures set stricter requirements than respective EU legislation. The above considerations are equally valid for Member State legislation governing trade in carbon emission allowances, which is regulated by the EU ETS<sup>23</sup>.

## 2.2 The inclusion of importers in the EU ETS

One way to establish an emission trading scheme for imports is to amend EU Directive 2003/87/EC – i.e. the EU ETS – to the effect that importers of products from specified sectors are required to surrender an EU wide average amount of allowances necessary for the production of the like domestic product within the EU<sup>24</sup>. Such proposals have been floated by Member States in the past<sup>25</sup>.

### 2.2.1 EU competence and legal basis

Consistent with the determination of Union competence and of the appropriate legal basis detailed above in 2.1.2, the Union is, under Article 191(1) TFEU, competent to adopt a Directive amending the EU ETS to the effect outlined above.

### 2.2.2 Legislative procedure

The European Parliament and the Council can adopt a respective Directive in accordance with the OLP, which is subject to qualified majority voting in the Council<sup>26</sup>.

This Union act, in contrast to carbon tax legislation, does not appear to require adoption under the special legislative procedure designated for acts containing 'provisions of primarily fiscal nature'<sup>27</sup>: In its decision on *Air Transport Association of America and other American Airlines*<sup>28</sup>, the CJEU found that the EU ETS, 'by reason of its particular features, constitutes a market-based measure and not a duty, tax, fee, or charge'<sup>29</sup>. In the same vein, the Court held that the ETS was not intended to generate revenue for the public authorities and does not create a *direct and inseverable link* between consumption quantity (of fuel, in this case) and the pecuniary burden of the consumer at issue (the aircraft operators)<sup>30</sup>.

The EU ETS, and an amendment to the effect of including importers into the ETS, hence arguably does not amount to 'provisions of primarily fiscal nature' within the meaning of Article 192(2) TFEU. On this reading, the special legislative procedure would not be triggered.

<sup>23</sup> The UK, for instance, has maintained a price floor for carbon that requires emitters to pay an additional charge per ton when the EU price for allowances falls below that floor. See <https://www.carbontax.org/where-carbon-is-taxed/>

<sup>24</sup> Directive 2003/87/EC of the European Parliament and 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

<sup>25</sup> See, for instance: <https://www.euractiv.com/section/trade-society/news/france-details-plans-for-carbon-inclusion-mechanism/>

<sup>26</sup> Article 192(1) TFEU

<sup>27</sup> Article 192(2)(a) TFEU

<sup>28</sup> C-366/10/EC – *Air Transport Association of America and others* [ECLI:EU:C:2011:864]

<sup>29</sup> *Ibid.*: para 147

<sup>30</sup> *Ibid.*: paras 142-146

### 2.2.3 Conclusion

The EU institutions could adopt an amendment of the EU ETS via the OLP to include importers of 'like' products in the EU ETS. For the purposes of the OLP, the Council decides on the adoption of such a measure by qualified majority vote.

## 2.3 Import duties for countries outside the Paris Agreement

The Union could envisage suspending tariff concessions vis-à-vis third countries that have not made carbon emission reduction commitments under the Paris Agreement or are failing to implement their reduction commitments. The purpose of such a measure would be to counteract anti-competitive effects of high-carbon imports on domestic production, and to incentivise the adoption of more stringent climate policies that meet the standard of the Paris Agreement. The Union would, in other words, employ a trade policy instrument to achieve both environmental and economic objectives. This duality of objectives can be important for the determination of EU competence and the appropriate legal basis. A dual legal basis for such a Union act may, for instance, have implications for the legislative division of labor within the Union institutions.

### 2.3.1 EU competence and legal basis

The Union may be competent to adopt such tariff measures in exercise of its exclusive competence for Common Commercial Policy conferred by Article 3(e) TFEU, read in conjunction with Article 207(1) TFEU. This is the case when a measure relates specifically to international trade in that it is essentially intended to promote, facilitate or govern trade and has direct and immediate effects on trade<sup>31</sup>.

It is established CJEU jurisprudence, however, that a Union act cannot be based on only one legal basis if it 'includes, both as regards the aims pursued and its contents, two indissociably linked components, neither of which can be regarded as secondary or indirect as compared with the other'<sup>32</sup>. In Opinion 2/15, moreover, the Court held that 'the exclusive competence of the European Union referred to in Article 3(1)(e) TFEU cannot be exercised in order to regulate the levels of social and environmental protection in the [Singapore FTA] Parties' respective territory'<sup>33</sup>. It is arguable by inference that Article 207 TFEU alone does not suffice as a legal basis for the enactment of tariffs, that unilaterally penalise third countries for their non-ratification of the Paris Agreement. Article 207 TFEU would arguably suffice as the sole legal basis, on the other hand, for the use of a trade instrument to enforce mutual commitments made under the Paris Agreement as the Court considers the objective of 'sustainable development', including of the environment, to make for an "integral part of Common Commercial Policy".<sup>34</sup>

It is for these reasons that a Union act, which seeks to achieve both commercial and environmental objectives to a similar extent while conditioning the use of an external economic policy instrument on a third countries' ratification of the Paris Agreement, **requires reference to both Article 207 TFEU on common commercial policy and Article 191 TFEU on environment**. As noted above, the Union shares competence for the latter with the Member States.

<sup>31</sup> Case C-414/11, *Daiichi Sankyo*, ECLI:EU:C:2013:520, para 51; C-411/06, *Commission vs Parliament and Council*, ECLI:EU:C:2009:518, para 71; C-347/03, *Regione autonoma Friuli-Venezia Giulia and ERSA*, ECLI:EU:C:2005:285, para 75.

<sup>32</sup> Case C-94/03, *Commission v Council*, ECLI:EU:C:2006:2, para 51.

<sup>33</sup> Opinion 2/15, *Singapore FTA*, ECLI:EU:C:2017:376, para 164.

<sup>34</sup> *Ibid.* paras 141-147.



### 2.3.2 Legislative procedure and implementing acts

The European Parliament and the Council could, in accordance with Article 207(2) TFEU and via the OLP adopt a regulation amending Article 1 (subject matter), Article 3 (scope), and Article 4 (exercise of the Union's rights) of EU Regulation 654/2014 to the effect outlined above<sup>35</sup>.

Under the amended regulation, the Commission can then adopt implementing acts determining the appropriate commercial policy measures, notably 'the suspension of tariff concessions and the imposition of new or increased customs duties' (Article 5 of the Enforcement Regulation). The Commission adopts such implementing acts with assistance of the Member States in accordance with the examination procedure codified in Article 5 of EU Regulation 182/2011<sup>36</sup>.

The adoption of implementing acts by the Commission under the examination procedure is relatively permissive for the Commission if viewed in comparison with other procedures applicable to the adoption of implementing acts. In the examination procedure, an act can eventually be adopted even if the committee assisting the Commission does not reach the voting threshold to deliver a positive or a negative opinion.

### 2.3.3 Conclusion

The Union could adopt 'punitive tariffs' by amending the existing 'Enforcement Regulation' via the OLP under Article 207(2) TFEU and Article 191(2) TFEU. In the OLP, the Council acts by qualified majority vote.

## 2.4 Instrument-by-instrument conclusion

### 2.4.1 An EU or Member State carbon tax

The Union could adopt a carbon tax (including on imports or not) under EU primary law governing environmental policy, either via a special legislative procedure requiring unanimity in the Council, or via the OLP if the Council adopts a Commission proposal to this end by unanimity *ex ante*. Member States may maintain or introduce measures even in case of EU exercise of lawmaking powers in the area of environmental protection if, and only if, such measures set stricter requirements than respective EU legislation.

### 2.4.2 Including imports in the EU 'cap and trade' system

The EU institutions could adopt an amendment of the EU ETS via the ordinary legislative procedure (OLP) to include importers of 'like' products in the Emission Trading Scheme. For the purposes of the OLP, the Council decides on the adoption of such a measure by qualified majority vote.

### 2.4.3 Import duties for countries outside the Paris Agreement

The Union could adopt the measure at issue here by amending the existing 'Enforcement Regulation' via the ordinary legislative procedure under Article 207(2) TFEU and Article 191(2) TFEU. In the OLP, the Council acts by qualified majority vote. The adoption of implementing acts by the Commission under the examination procedure, in order to impose duties on respective third countries in line with the amended Enforcement Regulation, is relatively permissive for the Commission in comparison to other procedures applicable to the adoption of implementing acts.

<sup>35</sup> Regulation (EU) No 654/2014 of the European Parliament and the Council of 15 May 2014 concerning the exercise of the Union's rights for the application and enforcement of international trade rules and amending Council Regulation (EC) No 3286/94 laying down Community procedures in the field of the common commercial policy in order to ensure the exercise of the Community's rights under international trade rules, in particular those established under the auspices of the World Trade Organization.

<sup>36</sup> Regulation (EU) No 182/2011 of the European Parliament and of the Council of 16 February 2011 laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers

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