COLUMN:

TRADE AND THE ENVIRONMENT: AN OVERVIEW OF THE CARBON BORDER ADJUSTMENT MECHANISM AND COMPATIBILITY WITH WTO RULES

1. INTRODUCTION

In recent years, countries around the world have in succession introduced, or are considering introducing, policies for environmental conservation. While environmental protection is, of its own, an important policy objective beside trade liberalization, the risk of trade friction through restriction and distortion of trade exist for some of these policies. The challenge, in light of such risks, is how best to coordinate environmental conservation policies with trade policies.

Within environmental policy, climate change has heretofore been recognized as an especially important and common challenge of the international community. In 1992, the "United Nations Framework Convention on Climate Change" (UNFCCC) was adopted, establishing a framework for international cooperation on this matter. The Kyoto Protocol, which included numerical goals for reduction of greenhouse gas emissions in developed countries, was then adopted in 1997, coming into effect in 2005. Thereafter, a new international framework for greenhouse gas reduction for 2020 and beyond, the Paris Agreement, superceded the Kyoto Protocol at the Twenty-First Session of the Conference of the Parties (COP21) held in December 2015.

In international negotiations on climate change, the "Common But Differentiated Responsibilities and Respective Capabilities" (CBDR-RC; see Article 3, Paragraph 1 of the UNFCCC) of the developed and developing countries set forth in the UNFCCC has been shared as an established principle, and such negotiations have been conducted on the premise that developed countries bear more responsibilities than developing countries. However, some countries, including the United States, have been calling for a review, against a backdrop of substantially increasing emissions from emerging countries such as China or India. The Paris Agreement adopted at COP21 included the requirement that all countries, including major emitters, submit and update their emission reduction targets every five years and report on their status for review, while also continuing to refer to CBDR-RC, and in line with such implications, the phrase "in the light of Different National Circumstances: DNC" was added. On the other hand, as large-scale reduction of greenhouse gas emissions implies a heavy economic burden, certain countries are calling for the adoption of a carbon border adjustment mechanism (CBAM) against imports from countries where the effort toward reduction is insufficient, by imposing duties on such imports or by other means. There are also discussions on ways to adjust the imbalance in the burden associated with reducing emissions of each country's products in addition to CBAM, such as setting an international minimum carbon price, agreeing on international emissions credit transactions, and establishing a common first-mover market where green products may be accorded priority. In this column, we will be discussing CBAM unless otherwise stated.

The grounds on which the arguments that trade measures such as CBAM are necessary are as follows:

(i) Securing the effectiveness of climate control measures: CBAMs would prevent what is commonly called the issue of "carbon leakage", namely, that upon the introduction of domestic regulations for greenhouse gas reduction, domestic products are replaced by those imported from a country not subject to such regulations, which impedes the global reduction of greenhouse gas emissions.

*In addition to the above meaning, "carbon leakage" may also refer to the phenomenon where one

country's climate change measures reduce the demand for fossil fuels and other fuels that emit large amounts of greenhouse gases, and these fuels decline in price globally, which causes the increasing consumption of these fuels in other countries, and the increase of greenhouse gas emissions abroad. This column, however, uses the term exclusively to refer to the substitution of domestic products by foreign products (including both cases in which production bases are relocated from home to abroad and cases in which production bases remain in the country, but domestic production decreases as a result of competition with overseas products).

(ii) Maintenance of industrial competitiveness: CBAMs would correct imbalances in competitive conditions of industries, arising from differences among countries in obligations and costs of reducing greenhouse gas emissions.

(iii) Addition of incentives for implementation of climate change measures: CBAMs would induce countries which do not make sufficient efforts to reduce greenhouse gas emissions, or which are reluctant to commit to legally binding targets or actions, to participate in the reduction framework and fulfill their obligations in good faith.

However, upon utilizing trade measures, consistency with international trade rules will become an issue. International trade rules have not been changed in response to the increasing importance of environmental conservation, but instead interpreted to adjust to environmental conservation policies. The GATT, established in 1947, did not provide explicitly for reconciliation between trade and environmental conservation policies. However, under Article XX of the GATT, measures aimed at protecting "human, animal or plant life or health" (Article XX (b)) and "conservation of exhaustible natural resources" (Article XX (g)), which have the effect of restricting and distorting trade, are allowed as "exceptions" to free trade under certain conditions.

The 1994 "Marrakesh Agreement Establishing the World Trade Organization", which established the WTO in place of the GATT, referred to considerations "to protect and preserve the environment" and "sustainable development" in its preamble. The "Ministerial Decision on Trade and the Environment", announced at the same time as the signing of the above agreement, recognized that the multilateral free trade system and environmental policies should be made compatible.

Now, international responses to climate change have developed in the form of CBAMs, which have had a major impact on trade policies. The relationship between climate change measures and the current WTO legal system is becoming a major point of contention in international trade law. This column will, therefore, provide an overview of the current policies on CBAMs and summarize the main discussions regarding their relationship with the current WTO agreements.

2. Carbon Border Adjustment Mechanism

(1) Overview of CBAMs

CBAMs are measures taken to deter carbon leakage when implementing domestic climate change measures, by preventing competitive inequities arising from different levels of strictness of climate change measures between the implementing country and other countries. CBAMs could impose certain costs on imported goods at the border according to their carbon emissions, require refunds for exported goods at the border, or mandate both. This column mainly discusses three types of CBAMs: "a border carbon tax", "the mandatory transfer of emission allowances upon import", and "a rebate on

exports".

A border carbon tax is a system that imposes a financial burden on imported products in proportion to the amount of greenhouse gases emitted in production, in conjunction with a domestic carbon tax (a tax on emissions of greenhouse gases such as carbon dioxide).

The mandatory transfer of emission allowances upon import is a system that obliges an importer of products in industries with high environmental impact to transfer to the government of the importing country emission allowances that are balanced with the costs which the domestic industry of the importing country bears to reduce greenhouse gas emissions. As with the border carbon tax, this system requires imports to bear the same burden as domestic products subject to domestic environmental conservation measures.

Lastly, a rebate on export is a system in which costs that domestic industries bear to reduce greenhouse gas emissions are refunded when products from those industries are exported, so that such exported products will not be less competitive (and thus susceptible to carbon leakage) in an export destination country which does not impose such burden on its domestic products.

As basic elements in the design of the system of trade measures related to climate change measures (including CBAMs), the following need to be explored: (1) how to set targets for countries and industries in the relevant measures; (2) whether to factor in the policy intensity of emissions-producing countries (such as explicit and implicit carbon prices) as a benchmark of efforts to reduce emissions; and (3) how to calculate the carbon intensity (CO2 emissions per unit of energy consumption; this indicates the amount of carbon emitted in the manufacture of a product) of products as a result of measures to reduce emissions (such as whether to consider emissions other than direct emissions, how to measure emissions on a product-by-product basis, and how to certify emissions) as well as what standards should be set based on the calculated carbon intensity. It should also be noted that, in theory, if the carbon intensity of an imported product is equal to or less than that of a domestic product, carbon leakage will not occur because increases in the market share of the imported product or the transfer of production bases to the producer country will not increase carbon emissions.

＜Explorations within the EU＞

The EU operates the EU-ETS (Emissions Trading System), the world's largest greenhouse gas emissions trading market. The EU has not yet established any CBAM, and has been addressing concerns for carbon leakage through free allocation of emission allowances under the EU-ETS rules since 2013, although such free allowances are being gradually reduced.

The EU published the "European Green Deal" in December 2019, which included an explicit statement that a proposal on the details of their CBAM would be made in 2021. Subsequently, after a call for public comments in 2020, the European Commission published the draft CBAM in July 2021. The basic scheme proposed in the draft measures would impose a levy on imports into the EU on importers in proportion to the product carbon content of the imports, in the form of the obligation to purchase EU CBAM certificates.

All countries are subject to this measure, and only a few countries that have a system that is fully linked to the EU-ETS (Iceland, Liechtenstein, Norway, Switzerland) are excluded. There is no exception for developing countries.

It is expected that the focus will be on steel, aluminum, cement, fertilizers, and electricity, which are

understood to be industries energy-intensive and trade-exposed (EITE) industries.

However, as described below, there are plans to consider expanding the scope of the target industries based on the information collected from importers' reports during the transition period.

The specific calculation method of the levy is as follows.

Import charge = EU CBAM certificate price (P/CO2-ton) × emissions per unit of goods (CO2-ton/Q) × quantity of goods (Q)

Of the factors required for the above calculations, only direct emissions have been included in terms of the emissions scope. However, the inclusion of indirect emissions will be considered in the future.

In addition, if the authorities are unable to properly verify actual emissions, they may set default values for each exporting country and product (excluding electricity), by adding country-specific mark-ups to the average emission intensity of each exporting country (details are left to the implementation regulations). In the absence of reliable data on the average emission intensity of the exporting country, the default value is set on the basis of the average emission intensity of the production sites in the lower 10% of the emissions of each production process in the EU for the product concerned. The plan is to adjust the default value in consideration of the specific circumstances of each producer country, such as the energy used.

The EU CBAM certificate price will be set based on the average closing price of all EU-ETS tenders during the previous week and is intended to be at the same level as the domestic regulatory carbon price. However, tax or emission allowances paid outside the EU may be deducted from the EU CBAM certificate price. That is, the carbon price paid in the country of origin is deducted from the import levy. With regard to the consideration of the carbon price paid in a third country (the country of origin), the EU may conclude an agreement with that country to take into account the carbon price mechanism of that country.

In addition, the EU CBAM is explained as being an alternative measure to free allowances and electricity cost compensation, which are measures for carbon leakage risk under the EU-ETS, and the plan is to adjust import charges (the number of EU CBAM certificates to be submitted) to reflect the extent of free allowances. However, it remains unclear how the free allowances will be phased out, and how the existence and extent of the free allowances will be specifically taken into consideration.

Moreover, according to the European Commission's proposal, the EU CBAM is scheduled to be implemented from January 2023, but the three-year period until January 2026 will be designated as a transition period. During the transition period, importers will not be obliged to pay import charges, but will be obliged to report information such as emissions volume per product unit. The report includes emissions volume per product unit (both direct and indirect emissions) and carbon prices paid in exporting countries. The details of the report will be used to consider expanding the scope to indirect emissions and other goods and services, and to develop emission calculation methods in the operation of the system after the transition period.

The revenue of the European Commission from the import charges will be appropriated for the operational expenses of the EU CBAM system, and the remaining amount is scheduled to be directed to the EU budget. Furthermore, the EU is separately planning to procure €750 billion from the market for

the “Recovery Fund” to mitigate the impact of COVID-19, and has announced that the fund resources would be from CBAMs, revenue from emissions allowance auctions, and digital taxes.

In response to the European Commission’s proposal, the European Council agreed on March 15, 2022 on a general approach to the EU CBAM, but deferred resolution on key issues such as how to reduce the free allocation of emission allowances. In the future, the European Parliament will first present a parliament draft for a resolution from May to June 2022, which will then be followed by a tripartite adjustment process between the European Council, European Parliament, and the European Commission. As of March 2022, relevant committees of the European Parliament proposed amendments with regard to the various elements of the European Commission’s proposal, and the Committee on International Trade (INTA), one of the relevant committees, rejected the proposed amendments on February 28, 2022. The outlook, therefore, is uncertain, and it should be noted that the details of the said proposal may be substantially modified in the future.

＜Explorations in the United States＞

In the United States, emission trading bills (such as the Boxer-Lieberman-Warner Climate Security Act (110th Congress: S. 3036), submitted to the Senate in May 2008, and the Waxman-Markey bill (111th Congress: H.R. 2454) submitted in April 2009), deliberated in the U.S. Congress, included requirements for the transfer of emission allowances; however, the Waxman-Markey bill failed to pass the Senate and was consequentially scrapped. On the other hand, President Biden (Democratic Party), who took office in November 2020, made a pledge in his presidential election campaign to “impose carbon adjustment fees or quotas to mitigate adverse effects on international competition” in line with the introduction of domestic policies for reduction of carbon emissions. The Democratic Party’s report submitted in July 2020 by the House Select Committee on the Climate Crisis also included the proposal that CBAMs (import tariffs and export subsidies) be enacted upon the introduction of domestic measures for major emission-intensive industries including EITE products. The USTR’s “2021 Trade Policy Agenda and 2020 Annual Report” published in March 2021 listed carbon border adjustment as an area of cooperation with allied and partner countries in relation to climate change.

In July 2021, the Democratic Senator Coons and Representative Peters proposed another bill regarding CBAM in the United States. In comparison to the European Commission’s proposal, the CBAM in this bill is unique in that it takes into account not only the carbon price but also the cost of complying with U.S. laws and regulations for the purpose of reducing greenhouse gas emissions (“Domestic Environmental Costs”) when determining the costs borne by domestic products. However, the bill itself does not provide for a specific method for calculating such Domestic Environmental Costs. There is also no provision as to whether costs incurred in the country of origin are deductible.

The target industries will initially be limited to those that have high levels of carbon intensity and are also exposed to trade competition, such as steel, iron, aluminum, and cement, but it has been noted that other industries may be added. A country-specific exclusion will apply to least developed countries and to countries determined by the U.S. Department of Treasury as (1) not imposing border adjustment measures on U.S. products, and (2) having laws and regulations designed to reduce greenhouse gas emissions that are at least as ambitious as U.S. federal laws and regulations for the same purpose.

<Explorations in Other Countries>

From August 2021 to the autumn of the same year, the Government of Canada conducted two consultation processes on border adjustment measures, first with local governments, industrial organizations, labor environment organizations, and experts, and then with the general public. In the course of the consultations, a discussion paper was published, setting out the issues to be considered in designing the CBAM (the setting of emission scopes, calculation method of emission costs, etc.), but the results of the consultations have not been published.

(2) Evaluation from the Viewpoint of the Influence of Climate Conservation Measures on Industries

Even if measures against climate change differ in stringency among countries, if costs of complying with such measures could be managed through normal business efforts, or if such costs could be passed on to prices of products without significant impact on consumers' demand, foreign products in emission intensive industries would not replace domestic products, and carbon leakage would not occur. For example, if costs that increase with climate change measures, such as energy costs, do not account for a large share of the total production costs, the impact may be limited. On the other hand, climate cchange measures could significantly affect industries where energy costs take up a large share of the production costs, or where competition with emerging countries that are not obliged to reduce greenhouse gas emissions at the same level as developed countries is intense.

The Government of the United States prepared the report on the industrial impact caused by the implementation of the Waxman-Markey bill in the United States, which refers to various estimates of the effects of allowance trading in the United States if such trading system is introduced. The primary estimates are as follows:

- In the manufacturing industry as a whole, the decrease in domestic production and increase in imports caused by differences in environmental measures were only around 0-1%, and the level of carbon leakage was also low.
- In industries which are both emission intensive and trade exposed, such as paper and steel industries, differences in environmental measures cause a greater impact than average; however, the percentages for reduction in domestic production and increase in imports remain around 1-3%.
- However, some of these emission intensive or trade exposed industries may suffer a larger impact, such as decline in domestic production by more than 5%.

Thus, if it is not the entire manufacturing industry, but only specific businesses which suffer from the decline in industrial competitiveness and carbon leakage, preventive measures for them should apply to the relevant products only, rather than targeting a wider range of products.

Other measures are also available in mitigating the effects of carbon leakage and the decline in industrial competitiveness, such as the free allocation of emission allowances, and appropriate measures should be determined according to individual circumstances.

(3) Trends in International Discussions

Conflict

While countries that are proactive in the adoption of CBAMs assert that they are necessary to reduce

global emissions, those expecting to be subjected to such measures (especially CBAMs for imports), in particular developing and emerging countries such as China or India, remain strongly opposed, because they believe that the export of their products will be grievously hindered.

In addition, some others oppose CBAMs or demand careful consideration, reasoning that the relationship of the mechanisms with WTO rules is not always clear, as well as that there are risks of these CBAMs being interpreted as protectionist measures and triggering trade wars, or that they would adversely affect global warming negotiations.

Trade Measures in the United Nations Framework Convention on Climate Change

Article 3, Paragraph 5 of the UNFCCC (adopted in 1992) and Paragraph 90 of the "Cancun Agreements" concluded in 2010 are the two established international agreements regarding this issue.

○ Article 3 of the UNFCCC (Underline added for emphasis)

In their actions to achieve the objective of the Convention and to implement its provisions, the Parties shall be guided, inter alia, by the following:

(*Omitted*)

5. The Parties should cooperate to promote a supportive and open international economic system that would lead to sustainable economic growth and development in all Parties, particularly developing country Parties, thus enabling them better to address the problems of climate change. Measures taken to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade.

The text of Article 3, Paragraph 5 of the UNFCCC retraces the chapeau of Article XX of the GATT, and does not present specific prohibitions or interpretation guidance beyond the rules established in the GATT.

○ Paragraph 90 of the Cancun Agreements

Reaffirms that the Parties should cooperate to promote a supportive and open international economic system that would lead to sustainable economic growth and development in all Parties, particularly developing country Parties, thus enabling them better to address the problems of climate change; measures taken to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade.

As demonstrated above, paragraph 90 of the Cancun Agreements only confirms the provisions of the UNFCCC, and does not indicate any new rules or interpretations.

Development of Discussions at COP

In response to Western countries considering the introduction of CBAMs, CBAMs have been discussed as one of the issues in the negotiations over the post-2013 international framework on climate change.

In August 2009, India proposed tightening the treaty rules to stipulate that "no unilateral border adjustment measures on account of climate change shall be adopted". Emerging economies such as China and Saudi Arabia strongly agreed with India, but developed countries, including Japan, opposed a total ban on CBAMs in the absence of agreement on greenhouse gas reduction targets. As a result, the conflict between developed and developing countries regarding CBAMs was not resolved at the COP 15 in December, and the "Copenhagen Accord" which summarized the discussions at COP 15 did not mention this point of contention. At COP 17 in 2011, India proposed that "as unilateral trade measures have negative environmental, social, and economic impacts on developing countries and undermine the principles of the United Nations Framework Convention on Climate Change, the parties should explicitly prohibit the application of unilateral trade measures". However, developed countries refuted this proposal on the grounds that the issue was already being discussed by other expert international organizations, and as a result, the report subsequently prepared by the secretariat only stated that "relevant discussions were held at COP 17". The matter was not discussed specifically at the subsequent COPs, and the Paris Agreement adopted at COP 21 in 2015 did not include any mention of trade measures either.

Discussions at the WTO

Review and readjustment of the relationship between the WTO Agreements and multinational environmental agreements are one of the items for negotiation in the Doha Round in 2001 (Paragraph 31(i) of the Doha Ministerial Declaration). Discussions have thus far been focused on the relationship between existing WTO rules and multinational environmental agreements that include specific rules on trade, such as the Washington Convention banning international trade of endangered species and the Basel Convention regulating the cross-border movement of hazardous wastes. The formation of agreements concerning climate change has not been the central focus.

Outside the Doha Round, the "Informal Trade Ministers Dialogue on Climate Change Issues" took place during the Thirteenth Session of the Conference of the Parties (COP 13), held in Bali, Indonesia in 2007. The parties confirmed on that occasion that trade policies and climate change measures were not contradictory to each other, and that one should contribute to the realization of the other. The countries agreed unanimously that it was necessary to wait for the results of climate change negotiations in order to establish new international trade rules in response to climate change issues.

This policy of "climate change negotiations first, review and adjustment of trade relations later" was reaffirmed after COP 15 at the end of 2009 in the ministerial discussions held at the WTO Informal Ministerial Meeting in conjunction with the World Economic Forum (Davos Conference) in January 2010.

On June 26, 2009, the WTO and the United Nations Environment Programme (UNEP) jointly published a report analyzing the relationship between trade and climate change from various perspectives. While the document summarized and reexamined precedents and theories on CBAMs under the WTO Agreements, it did not serve to indicate the WTO Secretariat's particular opinion on CBAMs' compatibility with WTO rules, and neither would the report affect the legal status of WTO members.

One recent development has been the discussion regarding the EU CBAM at various committees of the WTO (the Goods Council, Market Access Committee, Trade and Environment Committee, and Trade and Environmental Sustainability Structured Discussions (TESSD)) after the publication of the

proposals regarding the EU CBAM by the European Commission in July 2021.

(Relevant Discussions at Other International Forums)

① Proposal for comprehensive framework regarding carbon price at OECD

In September 2021, OECD Secretary General Cormann proposed a comprehensive framework for agreement on how to price the carbon tax (explicit carbon price) and other environmental regulations (implicit carbon price) in the most adequate manner, and discussions are currently under way.

② International Carbon Price Floor (ICPF) arrangements at the IMF

The IMF/OECD presented a draft International Carbon Price Floor Arrangement (ICPF) at the 2021 G20 meeting of finance ministers and central bank governors. The IMF first analyzed that global minimum carbon prices are essential to match the temperature target of the Paris Agreement. The IMF then estimated that it will be possible to heighten climate mitigation measures at relatively low macroeconomic costs, with the continuation of economic development, by having a few large emitter countries imposing minimum carbon prices according to income levels. On the other hand, the IMF also estimated that a scenario in which CBAM is implemented with only high-income countries taking countermeasures would be ineffective.

In the ICPF proposal, the initial arrangements will be limited to the core group of high emitter countries, and other countries are scheduled to be allowed to participate once the details in design and the decision-making process have been established among the core countries. The proposal also focuses on the establishment of a common floor for all participating countries, but will allow for differentiation of such floor prices, according to the level of development, as well as possibly allowing financial or other transfers, in order to address international equity. In addition, the proposal suggests that countries should be able to meet their requirements with non-pricing policies that will have an impact on emission volume that are comparable to those for floor prices. However, the proposal suggests that the initial focus of the agreement be on the nominal (easily observable) carbon price.

With regard to the target industries, the establishment of carbon prices will be required for the electricity and industrial sectors, and it is contemplated that the scope will be gradually expanded to a broader source of greenhouse gas emissions, to include other fossil fuel CO2 emissions.

(Other Relevant Discussions for International Frameworks)

(a) Climate Club (G7, G20 (Proposed by Germany)

In August 2021, the German Federal Government announced the Climate Club, a framework for volunteer countries to achieve ambitious reductions in greenhouse gas emissions and eliminate competitive disadvantages, particularly in energy-intensive industries. The initial concept includes the obligation for Members to commit to the 1.5°C target in the Paris Agreement and climate neutrality by 2050 at the latest, and then (1) agree on a common explicit and implicit carbon price calculation and product carbon content measurement methods, (2) explore the comparability of different climate policies and regulations, (3) establish a common lead market for “climate-neutral materials and products” for

energy-intensive products such as steel and chemicals, and (4) introduce joint protection measures against carbon leakage into third countries. Germany is the chair of the G7 in 2022, and it plans to hold discussions on the concept with the G7 and G20 partner countries.

The G7 is also promoting the Industrial Decarbonisation Agenda (IDA), an initiative proposed by the United States and the United Kingdom to discuss decarbonisation of heavy industries through innovation, procurement, standards, and finance. The Climate Club is also expected to use the IDA as a platform for discussions on industrial decarbonisation.

(b) FMC (First Movers Coalition) (Proposed by the United States)

Under the United States' proposal, the FMC was launched at COP26, as a platform for the world's leading global companies to commit to the procurement of net-zero products or products that meet certain emission standards, in order to create an early market for critical technologies that is necessary to achieve net-zero by 2050. The target industries are steel, cement, aluminum, chemicals, shipping, aviation, truck transport, and direct air capture.

(c) Glasgow Breakthrough

The Glasgow Breakthrough is the United Kingdom's initiative that aims for international cooperation over the next 10 years to accelerate the development and deployment of clean technologies that are necessary to achieve the goals of the Paris Agreement. Specifically, this initiative presents the direction that the whole world should aim toward in 2030 in the fields of electricity, land transportation, iron, hydrogen, and agriculture. 42 countries and regions, including all G7 members, China, Australia, India, and Turkey, have endorsed the agreement. Japan has also endorsed the agreement as a whole and participates in four fields other than agriculture. The directions presented for each field are as follows.

- Electricity: That clean electricity should become the cheapest and most reliable option to efficiently meet electricity demand in all countries by 2030.
- Land Transportation: ZEVs should become commonplace, becoming accessible, affordable, and sustainable in all regions by 2030.
- Iron: Efficient, near-zero emission steel in all regions should be established by 2030, and such steel should be the desired choice of steel in the global market.
- Hydrogen: Affordable, renewable, low-carbon hydrogen should become accessible worldwide by 2030.
- Agriculture: Climate resilient and sustainable agriculture should be an option chosen by farmers worldwide by 2030.

(d) United States and EU's Global Arrangements for Excess Production Capacity and Carbon Intensity of Steel and Aluminum

On October 31, 2021, the United States announced that with regard to the additional tariff measure for steel and aluminum imports under Article 232 of the Trade Expansion Act of 1962, it would impose a tariff quota for the EU, and that no additional duties would be imposed within the quota. In addition, the United States and the EU issued a joint statement on the same day for the purpose of addressing the

excess production capacity of steel and aluminum as well as climate change, where it was announced that a working group would be established for the negotiation of a global arrangement that would consider market access restrictions for non-participating countries not meeting market-oriented conditions or low-carbon standards in the steel and aluminum sectors. The arrangement is expected to open the door to countries interested in improving market orientation and reducing carbon intensity in the steel and aluminum sectors. Moreover, in a bilateral joint statement with the United States on February 8 and March 22, 2022, Japan and the United Kingdom respectively announced that they would hold dialogues regarding the initiation of discussions toward a global arrangement.

(4) TRENDS IN JAPAN

(A) Basic Opinions Regarding CBAM

In line with the EU's moves to introduce CBAMs which have reinvigorated international discussions on such measures, and at the "Study Group on Economic Approaches to Achieving Carbon Neutrality across the World", the Ministry of Economy, Trade and Industry of Japan presented its basic concept on CBAMs (the Ministry of the Environment of Japan's "Subcommittee on the Use of Carbon Pricing" upheld the same plan). The "Green Growth Strategy Through Achieving Carbon Neutrality in 2050 (formulated on June 18, 2021)" describes the following basic concepts.

CBAMs are designed, in implementing one country's own measures, to prevent inequities in competition arising from different levels of stringency of climate changemeasures taken by other countries, and thereby to avoid carbon leakages. This is a system in which the corresponding cost is imposed on imported goods at the border in accordance with their embedded carbon, or the corresponding cost is refunded in relation to exported goods at the border, or both of the above.

Japan's basic policy is to encourage the international community through dialogue and other means so that major emitters and emerging countries would make efforts to reduce emissions according to their capabilities. Therefore, the introduction of CBAMs should not be an end in itself, but instead, should function as an incentive for countries around the world, including emerging countries, to undertake effective climate change measures, while avoiding adverse impacts on international trade.

With regard to CBAMs, the following measures will be taken with close attention paid to the progress and trend in discussions in other countries, in parallel with the consideration of carbon pricing contributing to domestic growth.

(a) CBAMs will be based on the premise that their institutional design is compatible with WTO rules, and Japan will deliberate them while closely monitoring the progress of discussions in other countries.

(b) Japan will lead the development and application of international rules for internationally reliable measurement and assessment methods that balance carbon emissions per product unit from the viewpoints of accuracy and feasibility (e.g. ISO development). Japan will also encourage countries to ensure the transparency of relevant data.

(c) Japan will verify carbon costs incurred by subject goods, both within Japan and in countries which have introduced CBAMs.

(d) Japan will cooperate with other countries that share the same position on the adequacy of the

introduction and role of CBAMs, from the perspective of preventing carbon leakage and ensuring fair conditions for competition.

(B) Proposal of the GX League

The Ministry of Economy, Trade and Industry of Japan has proposed the establishment of the "GX League" as a mechanism for industrial, governmental, and academic collaboration to engage in the transformation of the entire economic and social system to shift to carbon neutrality (green transformation (GX)), to create and nurture a competitive group of companies in international business, and to engage in discussions and implement the creation of new markets for such purposes. The GX League aims to develop policies through dialogue among operators leading pioneering initiatives by providing three venues.

(a) Dialogue on future vision: A working group will be established, consisting of a wide range of stakeholders from the industrial sector, the government, the academia, and the private sector, to create a sustainable vision for the future that will achieve carbon neutrality by 2050.

(b) Market rulemaking: A place to discuss the creation of markets and rulemaking (for example, a certification system for zero CO2 products) in the age of carbon neutrality.

(c) Voluntary emissions trading: A place where each company voluntarily sets high emission reduction targets, discloses their promotion of efforts to achieve them, and conducts emissions trading.

The basic concept of the GX League was announced in February 2022, and the secretariat for the establishment of the GX League will be launched in the future to commence recruiting companies that support the basic concept. Detailed design discussions and the implementation of initiatives will be carried out in the 2022 fiscal year.

3. MAJOR POINTS OF DISCUSSION REGARDING THE WTO AGREEMENTS

The relationship between CBAMs and the WTO Agreements is not limited to legal and technical issues of interpreting the rules that allow the unilateral imposition of a higher cost on imports than the tariff agreed with each country, or the rules that allow the refund of indirect taxes upon export. It is also directly linked to the policy debate regarding the extent to which each country should be allowed to take individual actions in the absence of an international agreement on the cost burden of global environmental protection.

This column will provide an overview of the points of contention in considering the general compatibility of CBAM with the WTO Agreements ((1) and (2) below), and also examine how to take into account, when considering such compatibility, the fact that CBAMs focus on the production process of a product (PPM (Process and Production Methods) measures), not on physical characteristics of such product ((3) below). Furthermore, with regard to the compatibility between the WTO Agreements and CBAMs for imported goods in particular, the balance of burdens on domestic and imported goods (and hence the appropriate method for calculating the burden on imported goods) is a core point of consideration, and therefore typical factors for such consideration will be summarized ((4) below).

While a CBAM is a trade measure with new elements in the sense that its main regulatory objective is to promote the reduction of carbon emissions in other countries (and through this, prevention of carbon leakage or reduction of global carbon emissions), and that in light of this regulatory objective, carbon emissions from both domestic and imported goods need to be appropriately converted into the price amount, the WTO Agreements contain no provision that explicitly assumes such mechanisms. In addition, there is no established theory of interpretation yet as to whether CBAMs fall within the scope of border tax adjustments contemplated by the GATT. On the other hand, there is no reason either to believe that the WTO Agreements do not allow CBAMs in general. It is understood that the basic rules of the GATT may impose various constraints on the institutional design of CBAMs. Therefore, it is considered that CBAMs' compatibility with the WTO Agreements may depend on the specific institutional design for specific measures.

(1) Basic Related Rules: Tariff Concessions, National Treatment, Most Favored Nation Treatment, Export Subsidy

Firstly, if a CBAM is a taxation measure based on domestic measures of taxes aimed at reducing carbon emissions ("Border Carbon Tax"), such mechanism may be interpreted as being a so-called "border tax adjustment". A "border tax adjustment" is a measure that adjusts the difference between national taxes in each country for products traded across national borders. For example, consumption taxes imposed upon the purchase of domestic products may also be imposed on imports (import border tax adjustment), or consumption taxes on exported domestic products may be refunded (export border tax adjustment). Under the WTO Agreements, the rules on border tax adjustments are stipulated in Article II, Paragraph 2 (a) and Article III, Paragraph 2 of the GATT for imported goods, and Article VI, Paragraph 4 and the Explanatory Notes to Article XVI of the GATT and Agreement on Subsidies and Countervailing Measures for exported goods ((A) below). Secondly, if a CBAM is based on domestic measures other than taxes, such as an emissions trading system, this will not constitute a "border tax adjustment", and the main issue would be Article III, Paragraph 4 of the GATT ((B) below).

(A) Carbon Border Adjustment Measures as Border Carbon Tax

(a) Recognition of Border Carbon Tax as Border Tax Adjustment

The Border Carbon Tax is not a measure that the GATT envisaged at the time of its drafting. There is no precedent as to whether or not the Border Carbon Tax may fall under a "border tax adjustment" mechanism permitted by the GATT, apart from regular tariffs. There are arguments both for and against it.

A "border tax adjustment" is a mechanism under which the cost burden upon import or tax refund upon export (in either case to the extent that internal tax is imposed on the products, if any) will not be regarded as a violation of tariff concessions or as a subsidy. Cost burden upon import is permitted under Article II, Paragraph 2 (a) and Article III, Paragraph 2 of the GATT. Due to these provisions, for example, imposing a cost equivalent to the domestic consumption tax on imports does not constitute a breach of tariff concessions.

Article II, Paragraph 2 (a) of the GATT requires that an internal tax be "imposed [omitted] in respect of the like domestic product or <u>in respect of an article from which the imported product has been manufactured or produced in whole or in part</u>;" (underline added for emphasis) as one of the requirements for it to be adjusted at the border. This is because an internal tax which may be adjusted at

the border usually covers the products themselves, or the materials or parts of the products.

If it is interpreted that a carbon tax is imposed on "products" (e.g. steel products), the conditions underlined above in Article II, Paragraph 2 (a) of the GATT will automatically be satisfied, and, in theory, a border adjustment will be deemed possible (however, it is also necessary to examine the requirements for "like products" explicated in (2) below as well as whether a carbon tax exceeds an internal tax imposed on domestic products).

On the other hand, if it is considered that a carbon tax is levied on "carbon dioxide" (or other greenhouse gases), the issue will be whether the object of an internal tax needs to: (i) remain physically in the product; and (ii) have been used in the manufacture of the product (whether active inputs such as energy should be treated differently from byproducts such as carbon dioxide), in order for such internal tax to be adjusted at the border. While one theory admits the possibility of recognizing the taxation of carbon dioxide as a permissible border tax adjustment based on the provisions regarding a border tax adjustment upon export and the wording of the GATT Working Party Report on Border Tax Adjustments in 1970, another theory opposes this conclusion, and the debate has not been settled.

(b) National Treatment Obligations (GATT Article III, Paragraph 2): "Like Products"

The first sentence of Article III, Paragraph 2 of the GATT states that imported goods "shall not be subject [*omitted*] to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products" (underline added for emphasis), and provides that internal taxes on imported products should not exceed, even slightly, the tax on "like domestic products". Here, the matter in question is what "like products" are; for example, whether iron produced with a large amount of greenhouse gas emissions and those produced with a low level of emissions could be defined as "like products".

i. Criteria for "Like Products"

Precedents set forth the following four features to take into consideration when determining "like" products, based on the premise that whether a domestic product and a foreign product referred to in Article III, Paragraph 2 of the GATT are "like products" should be determined based on individual and specific circumstances (the cases of Japan - Alcoholic Beverages II and EC - Asbestos):

① Physical properties;

② The extent to which the products are used in a similar application;

③ The extent to which consumers recognize and treat a product as a substitutable product; and

④ International tariff classification

By making a determination based on ①, ② and ④ above, the amount of greenhouse gas emissions in production does not affect the properties of a product after production, and accordingly would not affect the judgment of whether the product is a "like product" either.

On the other hand, based on ③, the emission amount in production may affect whether certain

products are judged to be “like products”. For example, on the assumption of a market in which consumers base their consumption behavior on the emission amount in the manufacturing process, products with low and high greenhouse gas emissions respectively may still be considered “like products” if they are directly competitive or substitutable. However, when considering the actual application of this approach, it is not always easy to measure the emission amount in production. It is not clear how to determine the emission amount which differentiates “like products” from “not like products”. Therefore, some argue that in order to determine whether a product is a “like product” based on the emission amount, it is necessary to at least develop international standards or criteria for judgment.

ii. Impacts of the Determination of “like products” on Border Carbon Tax Assessment

If it is assumed that “the emission amount in production does not affect whether the final product is a “like product””, the conformity of the Border Carbon Tax (whose amount is determined according to the emission amount in production) with the first sentence of Article III, Paragraph 2 of the GATT must be considered.

In this regard, for example, a tax is imposed in the amount of JPY 1,000 per ton of greenhouse gas emission. If domestically produced iron emits 1 ton of greenhouse gas and the equivalent amount of imported iron emits 2 tons, the tax burden of the former is JPY 1,000, while that of the latter is JPY 2,000. The imported iron will bear a heavier tax burden (JPY 2,000 against JPY 1,000). If the domestically produced iron and imported iron are considered to be “like products”, this will amount to internal taxes or charges being imposed “in excess” of those applied to “like” domestic products, as is prohibited in the first sentence of Article III, Paragraph 2 of the GATT, and therefore, the prevailing interpretation is that such measure is in violation of the said Article. This interpretation focuses solely on the difference in the tax amount between the like products. If the tax amount itself is the same, such tax would not be in violation of the first sentence of Article III, Paragraph 2 of the GATT, regardless of any differences in greenhouse gas emissions between domestic and imported products, and the grounds for justification explored in (2) below would not be considered.

(c) Most Favored Nation Treatment Obligation (GATT Article I, Paragraph 1)

The above (a) and (b) discussed issues in the cases where a WTO member against a Border Carbon Tax would claim that its exported products are treated disadvantageously compared to domestic products of the export destination when the Border Carbon Tax is imposed on its exported products (in violation of the national treatment obligation). However, a member might claim that its exported products are treated disadvantageously compared to the exported products of other countries (in violation of the most favored nation treatment obligation).

If all exporting countries are subject to a Border Carbon Tax at a rate calculated in a uniform manner based on criteria such as the emission amount in the manufacturing process, all countries are treated in the same manner and thus it will appear as if the most favored nation obligation is satisfied. However, a precedent shows that the discipline of Article I, Paragraph 1 of the GATT requires, not pro forma equal treatment among exporting countries, but substantive equal treatment of products of all countries (the case on Canada’s automotive related measures). For example, even if an applicable tax rate is calculated based on the same method, the question may arise as to whether there is a substantial inequality between products of a country with more advantageous conditions such as a high level of technology and easy access to financing, and the possibility of reducing its greenhouse gas emissions with ease, and another country without such conditions. On the other hand, if the rate of a Border Carbon Tax is adjusted

according to the situation of an exporting country in consideration of the above, another question arises as to whether such an adjustment is really appropriate, especially where there is no international agreement on obligations of each country to reduce greenhouse gas emission.

However, some of the CBAMs examined thus far do not cover countries that are parties to international agreements requiring mandatory reductions in greenhouse gas emissions, least developed countries (LDCs), or small countries that have little impact on global greenhouse gas emissions.

Such CBAMs take into account the circumstances of each exporting country. They are, however, highly likely to constitute a violation of the most favored nation treatment obligation against members who are not exempted, in the absence of an international agreement on the criteria for the appropriateness of the different treatment of exporting countries. In this regard, in order to ensure that such exemption from CBAMs does not constitute a violation of the most favored nation treatment obligation in the absence of an international agreement on the criteria (or even if it constitutes a violation, that such exemption is justifiable), it is necessary at least (i) to establish criteria and factors for consideration consistent with the objective of reducing emissions to determine exemptions, and (ii) to be able to explain that the cases where such criteria apply (specific decisions for exemptions) are appropriate and fair.

(d) Export Subsidy

Tax reduction or exemption upon export is incompatible with Article 3, Paragraph 1 (a) of the Agreement on Subsidies and Countervailing Measures, as such measure comprises an export subsidy, which is a prohibited subsidy. The said Agreement, however, allows, as an exception to the ban on export subsidies, the exemption of exported goods from indirect taxes not exceeding those imposed on like domestic products (footnote 1 to the Agreement on Subsidies and Countervailing Measures and Paragraph 1(g) of Annex I of the same). If an indirect tax is imposed on domestic products, the rebate of such indirect tax upon exports may be an exception described above, and therefore compatible with the said Agreement, provided that the rebate amount does not exceed the indirect tax on domestic products.

With regard to a Border Carbon Tax, it may be debatable whether a carbon tax imposed on carbon emissions, which are byproducts of production processes rather than the raw materials, can be regarded as an "indirect tax" or a tax imposed on goods. In addition, it has been pointed out that it is difficult to explain that a rebate upon export would contribute to reductions in emissions because exported goods are exempt from carbon costs imposed on domestic products even though they are produced with greenhouse gas emissions.

(B) Carbon Border Adjustment Measures as Measures other than Border Carbon Tax

The preceding discussions examined the relationship between a Border Carbon Tax and the WTO Agreements. The following is a discussion about CBAMs other than a Border Carbon Tax, taking as an example a system that requires the transfer of emission allowances upon import.

(a) National Treatment and Import Restrictions (GATT Article XI, Paragraph 1)

Unlike a Border Carbon Tax, the mandatory transfer of emission allowances does not require the imposition of taxes on imported goods based on internal taxes and charges, and therefore is not subject to Article II or Article III, Paragraph 2 of the GATT. However, it could be subject to Article XI of the GATT, which provides for "prohibitions or restrictions other than duties, taxes or other charges" or Article III, Paragraph 4, which sets forth the application of domestic regulations to imported products.

If the mandatory transfer of emission allowances is considered to be a CBAM that is not an imposition of tariffs and charges, it would conflict with the wording of Article XI, Paragraph 1 of the GATT ("No

prohibitions or restrictions other than duties, taxes or other charges [*omitted*] shall be instituted [*omitted*] by any contracting party"). This then requires the justification provided for under Article XX of the GATT.

On the other hand, if the mandatory transfer of emission allowances is considered not to be a CBAM, which applies only to overseas products, but to be a part of domestic regulations, it is questionable whether such CBAM is compatible with Article III, Paragraph 4 of the GATT that requires internal regulations to give overseas products "treatment no less favourable" than domestic products. In this case, the compatibility between such CBAM and the GATT would be explained in much the same way as the compatibility between Border Carbon Taxes and Article III, Paragraph 2 of the GATT; however, as discussed in (A)(b)(ii) above, the prevailing interpretation is that the first sentence of Article III, Paragraph 2 of the GATT allows a Border Carbon Tax, if the same amount of tax is imposed (regardless of the emission amount). On the other hand, Article III, Paragraph 4 of the GATT provides relatively wider room for taking into consideration whether the amount of burden corresponds to the emission amount.

The "mandatory transfer of emission allowances" upon import does not aim to impose quantitative import restrictions, but merely imposes a financial burden in the form of the purchase of emission allowances. Therefore, there is a view that such financial burden constitutes "duties, taxes or other charges" and should be handled according to Article II and Article III, Paragraph 2 of the GATT, instead of Article XI or Article III, Paragraph 4 of the same. In this case, the discussion on Border Carbon Taxes would also apply to the mandatory transfer of emission allowances.

(b) Most Favored Nation Treatment

In general, the same as (A)(c) above.

(c) Export Subsidy

If an emissions trading system is implemented domestically, there will be doubt as to whether the burden on domestic products can be considered a tax. If such burden cannot be considered a tax, such burden is not a rebate of indirect taxes upon export, which is a permissible export subsidy as an exception, and the burden would be incompatible with the Agreement on Subsidies and Countervailing Measures, amounting to a prohibited export subsidy.

On the other hand, if the burden on domestic products does not constitute a tax, the refund (reduction or exemption) of such burden would not constitute a tax reduction or exemption, and whether it would constitute a subsidy as a waiver or non-collection of government revenue (Article 1.1(a)(1)(ii) of the Agreement) may itself become a subject for discussion. In this regard, if the measure cannot be construed as a waiver of government revenue in terms of its design, and cannot be regarded as a subsidy, the refund upon export would not constitute an export subsidy in the first place, and it follows that such a measure will not be regarded as being incompatible with the Agreement.

(2) Grounds for Justification (GATT Article XX)

Even if CBAMs (excluding an export rebate) constitute a violation of the most favored nation or national treatment obligations, as discussed in (1) above, this by itself will not lead to the conclusion that CBAMs are incompatible with the WTO Agreements. The next issue would be whether CBAMs are permissible under Article XX (General Exceptions) which provides for exceptional permission of measures that conflict with the other provisions of the GATT.

In order to justify CBAMs under Article XX of the GATT, it is necessary to first demonstrate that one of the grounds for exceptions in Items (a) through (j) apply to a CBAM in question, and then indicate that it meets the negative conditions in the "chapeau" of Article XX of the GATT (which applies in common to Items (a) through (j)).

As environmental conservation measures have often been justified as falling under Item (g) of Article XX, the first discussion will be whether CBAMs meet the conditions of the said Item, based on precedents (in particular, the case on US gasoline standards, the case on US restriction of shrimp and shrimp products, and its initial panel on implementation), and their relationship to the chapeau of Article XX thereafter will be considered.

(A) Article XX (g) of the GATT

(a) "Atmosphere with Continued Low Greenhouse Gas Concentration" as "Exhaustible Natural Resource"

In order to determine whether CBAMs fall under Article XX (g), the initial issue is whether CBAMs are designed to preserve "exhaustible natural resources". If CBAMs aim to preserve an "atmosphere with continued low greenhouse gas concentration", a question is whether such "atmosphere with continued low greenhouse gas concentration" can be called an "exhaustible natural resource". It is highly likely that it can be, because such atmosphere is evidently "exhaustible" and "natural", unless the term "resource" is narrowly interpreted. According to precedents, "exhaustible natural resources" do not exclusively apply to mineral resources such as precious metals, and "clean air" has also been recognized as such (the case on US gasoline standards).

(b) Adequacy of the Protection of Exhaustible Natural Resources outside Territories Controlled by Regulating Country

Next, it is necessary to consider whether the protection of "extra-territorial" exhaustible natural resources managed by the regulating country would also form the grounds for invocation of Article XX of the GATT. In this regard, a precedent held that restrictions focusing on the methods of shrimp fishing in the territorial waters of other countries as a measure for the protection of exhaustible natural resources were permissible, based on the ground of the protection of migratory sea turtles (the case on US restriction of shrimp and shrimp products). It may be construed that if there is a certain link between greenhouse gas emissions in other countries and the protection of the atmosphere in a regulating country's territories, a CBAM could also be permitted as a measure to protect such country's own exhaustible natural resources. Greenhouse gas emissions ultimately affect the concentration of greenhouse gases in the atmosphere as a whole, no matter where on Earth they are emitted. Thus, it is not very likely that the application of Article XX (g) would be denied for the reason that the source of emissions is outside the territories controlled by the relevant country.

(c) Whether the Measure "Relates" to the Preservation of Exhaustible Natural Resources

The next issue to consider would be the relationship between the objective of CBAMs and the "conservation of exhaustible natural resources". Although the language of Article XX(g) of the GATT merely requires that a measure in question "relates" to the conservation of exhaustible natural resources, a precedent dictates that a "secondary" or "unintentional" conservative effect of such measure is not sufficient, and that, although the conditions are not so strict as to demand that the measure is "required" for the conservation of natural resources, the primary objective of such measure should be the

conservation of natural resources. Namely, there should be a substantial link between the method and the objective.

If, following the precedent, CBAMs are evaluated as an integral part of domestic carbon taxes, rather than as a measure separate from internal systems, it would be clear that their primary objective is to conserve an "atmosphere with continued low greenhouse gas concentration" through the reduction of greenhouse gas emissions, thus meeting the requirements of Article XX(g) of the GATT.

Some may also argue that CBAMs aim for the maintenance of industrial competitiveness and the securement of employment in developed countries, and therefore that such measures cannot be described as having the purpose of "conserving exhaustible natural resources". However, CBAMs might mitigate competitive inequities resulting from different levels of green regulations among countries, and can be expected to deter carbon leakage, in which emission intensive industries are relocated to foreign countries with less ambitious climate policies and global emissions do not decrease (or may even increase). In view of that, it cannot be definitely said that the CBAMs do not serve their purpose as a measure relating to the conservation of exhaustible natural resources, merely due to the fact that CBAMs contribute in part to the maintenance of competitiveness of domestic enterprises. Whether or not a CBAM could be considered a "measure relating to the conservation of exhaustible natural resources" should be considered from the viewpoint of whether the objective structure of such measure is designed in a way that it can be seen as being a measure against carbon leakage.

(d) Border Carbon Taxes as Measures "in Conjunction with" Reduction of Domestic Consumption

In order to justify measures implemented in relation to the conservation of exhaustible natural resources under Article XX(g) of the GATT, such measures must be "in conjunction with restrictions on domestic production or consumption". This provision does not call for entirely identical treatments between imported and domestic products, and a precedent indicates that "equal treatment" in imposing restrictions on products would suffice (the case on U.S. gasoline standards). Therefore, except for cases where a CBAM has been installed entirely independent of domestic measures, if taxes are imposed on both imported and domestic products, and the absolute tax cost or the tax rate on imports is equal to or lower than their domestic counterparts, this would normally be defined as "equal treatment".

(B) Chapeau of Article XX of the GATT

While the above (A) examined the conditions under which a CBAM could be justified based on Article XX(g) of the GATT, 【AMT：日本語原文が（i）になっておりますが、正しくは（ア）でしょうか。ご確認ください。】 the requirements of the chapeau of Article XX of the GATT must also be met, as described above, in order for such CBAM to be permitted as an exception to the GATT rules under Item (g) thereof.

The chapeau of Article XX of the GATT requires that measures that fulfill the terms of Items (a) through (j) of the Article "are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade".

A precedent confirms that, as a general argument, the measures described in Article XX of the GATT are, by their very nature, "exceptions" to the benefits granted to member countries by the other provisions of the GATT. It also points out that the invocation of Article XX of the GATT by a member may not function as an abuse of rights, and emphasizes that it is necessary to balance the rights of exporting and

importing countries, when determining the compatibility of the application of certain measures with the chapeau of Article XX of the GATT.

In light of the above, the case of US restrictions on imports of shrimp and shrimp products, in examining whether the US measures constituted arbitrary or unjustifiable discriminatory treatment, placed emphasis on whether: (i) the restrictive regulations did not apply to the extraterritorial regions in a uniform manner of the same standards as within its territory, but instead took into consideration the fact that such measures were appropriate in light of different conditions in the exporting country, and that the restrictive regulations were flexible enough to reflect the special circumstances in the exporting country; (ii) appropriate negotiations were conducted with the exporting country before the implementation of the restrictions; and (iii) fair procedures were guaranteed in the process of implementing the restrictions.

(a) Flexibility to Allow Reflection of Special Circumstances in the Exporting Country

While the above precedent determined that imposing economic sanctions on exporting countries and requiring them to adopt measures which are in effect the same as those within the importing country in order to meet environmental standards constitutes "arbitrary or unjustifiable discrimination", it concluded that requiring that the method of fulfilling environmental standards be "comparable in effectiveness" to the restrictions in the importing country, and setting a certain standard as a condition for import permission while allowing for flexibility in the specific mode of compliance, did not amount to "arbitrary or unjustifiable discrimination".

Therefore, the imposition of a specific burden through a CBAM without taking into account the domestic situation of the exporting country may be judged as being "arbitrary or unjustifiable discrimination", even if such burden is the same as within its own country. In this regard, this requirement of flexibility may not be satisfied if the burden on imports under a CBAM does not take into account the greenhouse gas emissions of the exporting country (i.e. it is not reasonable in light of the objective to reduce emission). There also remains a risk that the fact that the balance of burdens between importing and exporting countries, and between exporting countries, is not ensured will lead to the assessment that the emissions of each country has not been considered. In addition, under the Article, when countries in similar conditions are treated differently (without a reasonable justification that it is for regulatory purposes), whether such treatment amounts to arbitrary or unjustifiable discrimination could become an issue.

On the other hand, if a regulation provides that the burden is to be determined by taking into account the domestic situation of the exporting country (such as the stage of economic development) when calculating such burden, this may be considered as fulfilling the requirement of making considerations for the domestic situation of the exporting country. In addition, as the precedent refers to the fact that the trade measures taken by the United States were severe "import bans", the difference with the nature of CBAMs (impositions of financial burdens) as trade measures may be taken into consideration.

(b) Appropriate Negotiations with the Exporting Country Prior to Implementation of Restriction

The precedent points out that while the United States discussed and reached an agreement with some countries on import rules that made environmental considerations, it restricted imports without any consultation with the other exporting countries, including the complaining parties, and considers the lack

of appropriate negotiation efforts as an important factor in determining whether there was "unjustifiable discrimination". Here again, consideration is given to the fact that the measures adopted by the United States may be defined as an "import ban" of products that do not meet US standards, which is "usually the heaviest 'weapon' in a member's arsenal of trade measures".

The initial panel on implementation, in which the question of whether the United States had implemented corrective measures was disputed, affirmed the measure's compatibility with Article XX of the GATT, based primarily on the fact that good faith negotiation efforts for an agreement had been conducted, even though no agreement was reached. This indicates that the obligation to make efforts to negotiate does require that such negotiation reach a conclusion.

It is therefore likely that a CBAM could meet this requirement, if an implementing country negotiates in good faith with countries subject to such CBAM, even without reaching any agreement. Moreover, given that trade measures under CBAMs are less severe than an "import ban", it may follow that the degree of negotiation efforts required under CBAMs may be lower than that which the precedent considered was sufficient (such as the hosting of an international conference aimed at agreeing on a multilateral treaty to protect sea turtles).

All major countries, including the United States and European nations, have long been engaged in international negotiations aiming for the reduction of greenhouse gas emissions on a global scale. However, there is a possibility that it may be deemed insufficient to simply have engaged in international negotiations in a formal manner, and it may be necessary to demonstrate that sincere negotiation efforts to avoid the introduction of CBAMs had been conducted.

(c) Guarantee of Fair Procedures in the Process of Implementing Restrictions

The precedent considers the lack of fairness in the procedures for the application of the standards as one of the determining factors for the acknowledgment of "arbitrary discrimination". The criteria for determining the fulfillment of the standards of the importing country was not specifically demonstrated and the judgment process was not transparent. Improvement of these matters was one of the grounds for the recognition that the "arbitrary discrimination" was corrected.

It is therefore important to secure procedures that enable importing countries to claim that they have followed fair and unambiguous criteria in determining the imposition of CBAMs, particularly when determining specific burdens described in (a) above.

(C) Conclusion

In order to justify the incompatibilities of CBAMs with Articles II and III of the GATT by applying Article XX, such CBAMs must first meet the requirements set forth in Article XX(g), and many believe that it is possible to design a system fulfilling these requirements by introducing CBAMs as an integral part of domestic measures.

On the other hand, in order to ensure the compatibility of CBAMs with the chapeau of Article XX of the GATT, and in particular to ensure that CBAMs are not regarded as "a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail", attention should be paid to the institutional design, for example, by allowing the system to be flexible enough so as to allow the burden to be adjusted in consideration of the circumstances of the exporting country (see (4) below).

(3) The Mechanism as a PPM Measure

PPM measures are characterized by the imposition of trade restrictions based on the production process

of imported products rather than on their physical characteristics. Regulations for environmental conservation purposes aim to prevent ill effects in the manufacturing process of a product (e.g. emissions of pollutants) and often fall under the definition of PPM measures.

The WTO Appellate Body has heretofore conducted the following two-stage review of trade measures implemented on the grounds of environmental protection, as seen in the case of U.S. restrictions on imports of shrimp and shrimp products detailed in 3(2) above. With regard to the issue of compatibility with the provisions of Articles II, III, and XI etc. of the GATT, the Body has adopted a method in which they first interpret these provisions narrowly and establish that the measures in question are contrary to these provisions, and then make judgment on whether the individual measures should be permitted as exceptions under Article XX of the GATT, by separately comparing and weighing the rights and obligations of the member states. This has prevented the uncontrolled expansion of PPM measures, which could lead to allowing the import of only products that fulfil the requirements of compliance with labor and human rights standards in the production process similar to those of the importing countries, while allowing trade measures for environmental conservation to a certain extent.

A CBAM which a country introduces based on its own climate change measures may not be recognized as a border tax adjustment, given the previous framework of judgement. In such case, whether the exceptions of Article XX of the GATT apply becomes the key. Therefore, in order to have a measure recognized as an exception under Article XX, in a situation where there is no international agreement on the emission reduction obligation of each country, a CBAM must be designed to mitigate the burden on other countries, in particular the developing countries, from the viewpoint of upholding "Common but Differentiated Responsibilities". On the other hand, as a matter of course, a CBAM must guarantee the effectiveness as a measure against carbon leakage. In designing a CBAM, it is necessary to find ways to meet these two requirements, while giving due consideration to the emission reduction measures taken by each country, especially those by developing countries.

(4) Factors to be Considered Regarding the Adequacy of Proportionality of Burdens and Adjustment Calculation Methods

Since there is currently no international agreement on the calculation of carbon emissions or carbon prices, it is necessary to consider the various requirements, in particular the chapeau of Article XX of the GATT ("arbitrary discrimination"), to determine whether the burden on domestic products and imports from each country is equal under a CBAM, and whether the calculation methods for adjustment adopted by the country implementing the relevant measure is appropriate in terms of their content and method. On the other hand, the more an effort is made to ensure precise balancing of the burden, the more it would make a CBAM less feasible and efficient as an administrative measure and the burden on the implementing country would be greater, which would at the same time lead to a rise in compliance costs on countries subject to such CBAM as well.

The following factors need to be taken into account when considering the equilibrium of the burden among products from the respective countries.

i. The stages of carbon emission to be considered (the boundary): The stages to be considered should be consistent in relation to domestic measures and CBAMs.

- Direct emissions from manufacturing sites and onsite (Scope 1):
- Indirect emissions (Scope 2): Energy equivalents such as electricity or heat, generated offsite

- Indirect emissions (Scope 3): May include all emissions (not including Scope 2) from the whole manufacturing process. It should further be considered which stage of manufacturing to examine: raw materials, intermediate products or final products, and whether to also examine transportation. The more extensive the scope is, the more complicated the calculation method becomes, and there is a concern that if transportation is included, this may be automatically disadvantageous for imported products with long transportation processes.

ii. Combination with other domestic measures: In particular, if a separate measure to reduce the burden on domestic products is in place (such as free allocation of emission allowances in the emissions trading system), this will provide double protection for domestic products, and make it more difficult to secure the equilibrium of the burden between domestic and imported products.

iii. Consideration of environmental conservation measures in the exporting country: Such consideration will contribute more to the prevention of carbon leakage, it is equitable, and it is easier to demonstrate a balanced burden on the products of each country. Whether to take into account only explicit carbon pricing measures or a broader range of environmental conservation measures (which impose costs on imports) is also a matter to be considered. The latter option is fairer, but incurs more administrative costs.

iv. Use of revenue from CBAMs: If revenue from CBAMs is retained domestically and allocated to disadvantaged domestic operators, this may result in double indemnity for domestic products.

(5) Limitations of the Current Rules

Although precedents may show some indication of which CBAMs are permitted under the WTO Agreements, by applying the above method of examining the applicability of each case to the exceptions under Article XX of the GATT and determining WTO compatibility in each case, there is a risk of frequent disputes due to the lack of predictability at the stage of designing a CBAM. Conflicts concerning climate change have large economic impacts and tend to be highly disputed among countries and politicized, and therefore, there are concerns for their impact on the WTO system.

Therefore, it is desirable that a fair and effective international framework, in which all major countries participate, be established through climate change negotiations as soon as possible, and that, within this framework, the treatment of trade measures on the grounds of climate change measures be considered through multilateral negotiations, establishing clear requirements as to what is allowed and what is not. This could be achieved by the amendment of the GATT texts, the establishment of clear interpretative standards, agreement on exemption provisions that would allow exceptions upon conflict between CBAMs and the GATT text, and agreement on the calculation methods for carbon emissions and prices, as issues of particular practical importance (see (4) above). In reality, however, even in the Paris Agreement, which came into effect after being agreed on through years of negotiations as a framework in which all major countries participate, there were no specific provisions included with regard to the relationship between climate change and trade measures, and the issue of how to deal with CBAMs in the absence of international agreement explicitly disciplining the relationship of such two factors remains unsolved.