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TAXES AND CHARGES FOR ENVIRONMENTAL PURPOSES - BORDER TAX ADJUSTMENT

Note by the Secretariat

I. INTRODUCTION

The following Note has been prepared by the Secretariat on request by the Committee on Trade and Environment. It is organized in three parts: (a) a brief presentation of various policy instruments to address environmental problems; (b) a discussion of the wider economic and trade implications of eco-taxes and -charges; and (c) an overview of WTO provisions and dispute settlement practice pertaining to the application of domestic taxes and charges to traded goods.

II. CURRENT USE OF ENVIRONMENT-RELATED TAXES AND CHARGES

A. General features

1. Environmental policies in many countries continue to shift from relying predominantly on remedial actions to controlling pollution and other environmental effects. There is an increasing focus on correcting the causes underlying environmental problems and preventing over-intensive resource use, rather than on curing symptoms. The causes are often associated with the failure of market prices to correctly reflect environmental scarcities and/or social values.[1]

2. While governments may use a wide array of measures to pursue public policy objectives, including environmental goals, two principle approaches can be distinguished: command-and control measures such as prohibitions or quantitative controls on the one hand, and price-based instruments such as tariffs, taxes or subsidies on the other. In practice, both approaches may be combined. Quantitative limits may be employed, for example, to circumscribe maximum permissible levels of an activity, e.g. the release of effluents into an eco-system, while price-based instruments are to encourage behavioural changes within such limits. Ideally, the sanctions (or premiums) used in this connection should reflect the social damages (benefits) resulting from an action and/or the investment costs associated with environmental rehabilitation.

3. From an economic perspective, price-based measures are generally preferable to quantitative controls. While such measures are introduced and modified through government decree, i.e. on a mandatory basis within a jurisdiction, the ensuing economic changes are decided upon and discharged

[1]To give a simple example: the considerations involved in clearing a standing forest for commercial use traditionally hinge on comparing revenues associated with different economic alternatives such as timber sales, agricultural output, housing rents, or improved industrial siting. From that perspective, the benefits of forestry clearing may significantly outweigh the benefits of conservation since indirect economic and ecological functions -e.g. preventing land degradation, providing a habitat for rare species, acting as a sink for certain gas emissions -are disregarded or, at least, insufficiently valued.

by individual market participants. Contrasting with command-and-control systems, consumers and producers are free to identify and take the actions deemed to be most economically attractive or, alternatively, least unattractive. Rather than being subject to rigid administrative criteria, requiring for example behavioural changes on a pro-rata basis, they remain in charge of, and accountable for, their personal response.

4. An eco-tax on industrial emissions, for example, leaves it to the individual firm to balance the cost of pollution abatement - through investment in new equipment, process innovation, etc. - with its tax liability under status quo conditions. Adjustments are likely to occur in particular in those firms where the abatement costs are relatively low compared to the tax savings and, correspondingly, the environmental benefits achieved. From an economy-wide perspective, a given environmental effect can thus be attained at lower cost than under a system of administrative controls which ignores the individual polluter's capacity to respond. Hence, price-based sanctions make better use of an economy's overall potential for investment, innovation and adjustment. However, they do not obviate the need for quantitative controls or even bans to prevent serious and irreversible environmental damage associated with, for example, the discharge of toxic wastes.

5. Market-based measures (e.g. tariffs) are generally more transparent in their operation and provide less scope for discriminatory application, intentionally or otherwise, than administrative controls (e.g. import quotas). They are less prone to informal information and decision-making channels operating to the detriment of companies, sectors or groups without a strong domestic base. Ideally, all market participants - regardless of location, nationality, past economic performance, etc. - are being conveyed the same price information and afforded the same opportunities to respond. In turn, the transparency and predictability associated with such systems tend to facilitate foreign access, encourage longer-term consumption and investment planning and, thus, promote overall economic expansion.

6. In a textbook economy, there is no principle difference between using monetary incentives (subsidies) or sanctions (taxes and charges) to encourage adjustment. Subsidies may be employed, for example, to promote environmentally-beneficial product or process innovation or, as in agriculture, to compensate for production cuts. However, apart from legal, fiscal or institutional constraints, polluter subsidies may run counter to public perceptions of justice and accountability - it is generally held that the perpetrator should compensate the victim rather than *vice versa*. In addition, with no limits on market access, subsidies risk enticing new producers or users into the areas concerned.[2]

7. The following section is intended to give a stylized summary and some examples of different types of environmental taxes and other price-based instruments. They may be applied to either production inputs, technologies, equipment, final products or pollutants released during the production process.

[2]However, temporary adjustment aid may be viewed in a different light. Under the WTO Agreement on Subsidies and Countervailing Measures, assistance to promote adaptation of existing facilities to new environmental requirements is considered to be non-actionable if specified conditions are met (it must be a one-time non-recurring measure; be limited to 20 per cent of adaptation cost; must not cover the cost of replacing and operating the assisted investment; be directly linked to and proportionate to the environmental results and must not cover manufacturing cost savings; and be available to all firms which can adopt the new equipment and processes).

B. Types of instruments

(a) Taxes and charges

(i) Emission Taxes or Charges

8. Emission taxes and charges have been used by several countries to limit the discharge of various pollutants and, possibly, raise funds for remedial action. Tax levels are generally levied in relation to the quantity as well as quality (e.g. toxicity) of the emissions concerned.

Waste: The most commonly-used emission charges are imposed on generation, storage, treatment and disposal of various kinds of industrial or household waste. Comparable to traditional user charges,[3] they may help to cover the costs associated with the relevant operations, including landfill, incineration, etc.

Agriculture-related Pollutants: Farmers in several countries are allocated allowable baseline emission levels for nutrients, with excess emissions triggering a charge. For similar reasons, charges are also applied on various agricultural inputs, in particular agro-chemicals.

Air Pollutants: Emission charges and taxes have been used for over 30 years to help reduce air pollution. They are applied to sulphur dioxide, nitrogen oxides, volatile organic compounds, particulate matter, hydrochloric acid and, more recently, carbon dioxide. Tax rates are often calculated on a volume basis, with increasing rates applied over and above pre-determined baselines of allowable emissions. In several countries, sulphur dioxide bears the highest per-tonne rate. In some schemes, tax revenues are used to finance enforcement activities, encourage research into abatement technologies, compensate individuals for pollution damages (e.g. asthma, bronchitis) or assist industries in purchasing pollution abatement equipment.

(ii) Product taxes and charges

9. Eco-taxes and charges are levied on goods used as inputs at the production stage or, more commonly, at the consumption level. They tend to concentrate on products such as automobiles, lubricants, pesticides and agro-chemicals, tires, feedstocks, batteries, plastic bags, non-returnable beverage containers, ozone depleting chemicals, and product packaging. Such taxes and charges may also be linked to performance standards. For example, numerous countries apply differential tax rates on automobiles, according to factors such as fuel efficiency or type of equipment (e.g. catalytic converters). An OECD country recently introduced an environmental rating system for automobiles based on comparative environmental performance, with the tax rate reflecting fuel efficiency and similar criteria.

(b) Subsidies

10. Subsidies and the environment may be linked by alternative causation mechanisms. The first involves the impact of certain subsidies, for example on farm inputs, on environmental degradation.[4] The second relates to the use of subsidies to promote environmental protection. Such subsidies may be extended via grants, rebates, soft loans, tax allowances, deferrals and exemptions (for conservation

[3]User charges have long been applied for park visitors, etc.

[4]With this in view, a Southeast Asian country recently revised its policy on pesticides, cutting farm support schemes which included the subsidization of pesticides by over one-half and banning the use of numerous pesticides particularly harmful to the environment.

measures, research and development and the like), investment refund schemes or accelerated write-offs (e.g. for anti-pollution equipment). Several countries have introduced energy tax allowances, including tax rebates for energy-efficient or alternative energy technologies. A wide range of sectors may be covered, including agriculture, forestry, energy, mining, and fisheries.

11. A related approach relies on incentive instruments, such as tax-free environmental bonds, environmental mutual funds, flow-through shares or after-tax financing instruments, which are intended to lower a firm's environmental capital and operating costs.

(c) Deposit-refund schemes

12. Deposits may be demanded from buyers of potentially polluting products. They are refunded when the products or their residuals are returned with a view to encouraging recycling and/or covering the costs of waste disposal. Refund schemes have been applied in numerous countries to a broad range of consumer goods, including glass beverage containers, metal cans (primarily consumer beverage cans for soft drinks and beer), plastic consumer and other goods (e.g. plastic reusable bottles, PET-bottles, beer and soft drink containers), automobile parts (e.g. car hulks), batteries (e.g. automobile and consumer batteries) and automobile lubricating oils.

(d) Tradeable emission schemes

13. At present, tradeable emission schemes are used primarily to address air pollution at the national level. They are normally based on quotas of allowable emissions for defined substances. According to prescribed formulae (e.g. past, current and projected emissions), quotas may be allocated to individual polluters who thus exert a property right subject to market pricing. Quotas or permits can be retained to meet the allocated emission level, or additional permits may be purchased within specified time periods to cover additional needs. The relevant zones where permits can be purchased or sold are generally defined along political or geographical demarcations.

III. ENVIRONMENTAL TAXES AND CHARGES: AN ECONOMIC PERSPECTIVE

A. Limits to eco-taxation - apparent and real

14. Corresponding to the polluter-pays-principle, eco-taxes and charges operate as disincentives. Their purpose is essentially twofold. On the one hand, they aim to discourage, through changes in the price structure, the use of products or processes deemed to be environmentally unsound (e.g. fossil fuels, mercury-containing batteries, pesticides and fertilizers); on the other hand, as described above, eco-taxation may initiate adjustments towards and research into more environmentally benign activities.

15. Like all taxes, eco-taxes generate government revenue. They may thus be considered a welcome contribution to budget consolidation by some governments, while other governments may resent the introduction of new taxes in view of their perceived negative impact on economic resilience and growth. However, both positions are subject to qualifications as: (a) the revenue effects of an eco-tax which actually achieves enduring adjustment may prove limited - the tax base will dwindle over time - and, otherwise, (b) any significant receipts could be neutralized through cuts elsewhere in the tax system.

16. Eco-taxes may be subject, however, to various technical and political constraints.

Immediate risks to life and health: as already indicated, taxes may prove unreliable in high-risk or emergency situations or in the event of synergy reactions between individual emissions.

Valuation problems: establishing the tax rate corresponding to a given environmental target, e.g. reducing pesticide run-offs by a specified percentage, can be very difficult. Governments may prefer in such cases to define emission ceilings for entire regions and to use market mechanisms for the allocation of entitlements among polluters (e.g. via tradeable emission schemes).

Policy constraints: at times of high unemployment, large trade deficits, etc., eco-taxes are generally unpopular. This applies in particular to producer taxes deemed to disadvantage a domestic industry vis-à-vis its foreign competitors.

17. Such considerations may explain why many environmental taxes are fixed at levels unlikely to have a strong structural impact. A recent OECD study concludes that: "one of the major problems of measuring the relationship between environmental taxes and trade is the fact that environmental taxes are generally low - in most cases probably quite below their optimal level - thus making it impossible to deduce with statistical methods the impact of optimally set environmental taxes on trade volumes and trade structures".[5] In many countries, strict taxation of consumer goods on health grounds (e.g. tobacco and alcoholic products) seems to meet less public resistance than environmentally-motivated taxes with a potential impact on production and investment decisions (e.g. energy- and transport-related taxes).

B. Need for policy coordination?

18. For the purpose of policy making, it is safe to assume that economic incentives have a decisive impact on a countries' environmental performance. The existence of a fixed, linear relationship between production (or consumption) and pollution, regardless of economic considerations, is likely to be an exception rather than the rule. In order to exploit a market economy's scope for adjustment, it is thus important that the environmental effects of an activity be truly reflected in a producer's or consumer's decision-making process. This implies, for example, that pollution is taxed as closely as possible to its source and at rates mirroring its environmental impact. Ideally, the tax burden facing any individual polluter would reflect the amount and toxicity of the pollutants released as well as the carrying capacity of a given location. In turn, in a competitive situation, a producer would thus be required to monitor options for environment-related process, technology and, possibly, locational change. Depending on the relevant investment cycle, any ensuing decisions need time to produce results.

19. For reasons of "competitiveness", however, it may prove difficult for governments to tackle production-related pollution head-on. To ease adjustment pressures, they may prefer to pass the tax burden on to consumers and/or otherwise cushion the cost impact on the industries concerned. For example, rather than assessing actual emissions of pollutants, eco-taxes may be operated as excise taxes on final products. This would exonerate exports and supplies to downstream domestic industries, but include all supplies - domestic and foreign - for consumption. However, while appropriate to address consumption-related pollution, excise taxes are not geared to tackle production externalities which, of course, occur regardless of the final destination of a good. Moreover, in the absence of cross-border pollution, the inclusion of imports seems to be lacking a convincing environmental rationale. Their assessment could even result in "double taxation" if the exporting country relies on policies, e.g. administrative controls, whose costs to producers are non-transparent or otherwise do not qualify for refunds on exportation.

[5]OECD (1996), Implementation Strategies for Environmental Taxes; OECD (1994), Managing the Environment: The Role of Economic Instruments; and OECD (1997), Evaluating Economic Instruments for Environmental Policy, Paris.

20. Such problems may arise regardless of the WTO legal situation. Although excise arrangements might be compatible with the relevant provisions and case law, their application could entail significant distortions from both an economic and environmental point of view.

21. Parallel application of price-based instruments in appropriate circumstances - albeit with varying intensity according to national conditions - might offer both economic and political gains. Not only could it reduce the potential for domestic inefficiencies and external frictions, including problems of "double taxation", but at the same time strengthen political support for first best solutions. In general, it should prove easier for a convoy of countries than for one single nation to implement environmentally effective measures at the source.

22. In turn, this raises questions of international policy coordination or, more precisely, of a common definition and/or recommendation concerning the range of measures to be used. An analogy might be found in the TBT Agreement, which establishes rules and principles for standardization policies, but does not prescribe a standard's or regulation's actual content. Members may wish to discuss in some more detail the need for, the potential content and coverage, and the wider trade policy implications of such an initiative.

IV. BORDER TAX ADJUSTMENTS UNDER GATT/WTO RULES

23. Governments are in principle free to operate their fiscal regime according to national preferences and constraints. They are, however, subject to WTO rules governing the application of domestic taxes and charges to goods traded internationally.

24. Through border tax adjustment countries may impose domestic taxes and charges on imports, and exempt or reimburse them on exports. The objective is to ensure trade neutrality of domestic taxation. In the absence of an harmonized taxation system between trading partners, border tax adjustment aims at preventing double taxation or loopholes in taxation, and thus to preserve the competitive equality between domestic and imported products.

25. Tax adjustments do not necessarily take place at the border. For example, under certain tax systems, imports are usually taxed, as is home production, by the importing country at the time they are sold by registered traders to other traders or consumers, and so the adjustment takes place after the goods cross the border. However, the adjustment is to be made because the goods crossed a border, whether to be imported or to be exported.

26. Border tax adjustment on imported products in excess of taxes borne by like domestic products is deemed to discriminate, and thus violate the national treatment embodied in Article III. Exemption or rebate of taxes on exported products in excess of internal taxes borne by like products destined for domestic consumption can be considered an export subsidy subject to the disciplines of the Agreement on Subsidies and Countervailing Measures.

A. The 1970 Working Party on Border Tax Adjustments

27. In 1968, GATT CONTRACTING PARTIES established a Working Party on Border Tax Adjustments to examine the provisions of the General Agreement relevant to border tax adjustments, the practices of contracting parties in relation to such adjustments, as well as their possible effects on international trade. The Working Party's report was adopted on 2 December 1970.[6]

[6]BISD 18S/97.

28. For the purpose of its examination, the Working Party used the definition of border tax adjustment applied in the OECD:

> "… any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)". [emphasis added]

The destination principle is to be distinguished from the origin principle, whereby the products are taxed in the country of production. Under the origin principle, there would be no need for border tax adjustment, since all products would be taxed at their point of origin.

29. The Working Party examined border tax adjustment with respect to various provisions of GATT: Articles II and III, on the import side, and Article XVI on the export side; other articles deemed relevant included Articles I, VI and VII. It noted that GATT contained various formulations for import-related and export-related provisions (Article III:2 reads "applied to", whereas Article VI:4 reads "borne by"), but agreed that these different wordings did not lead to differences in interpretation, and that "GATT principles on tax adjustment applied the principle of destination identically to imports and exports". The Working Party agreed that the main provisions of the GATT regarding border tax adjustment represented the codification of practices which existed in commercial treaties at the time it was drafted. Most members of the Working Party noted in particular that" there seemed to have been a coherent approach when the relevant articles of the GATT were drafted and that there were no inconsistencies of substance between the different provisions even if the question of tax adjustment was dealt with in different articles. They added that the philosophy behind these provisions was the ensuring of a certain trade neutrality".

30. As to the amount which is possible to adjust, the Working Party agreed that GATT provisions "set maxima limits for adjustment (compensation) which were not to be exceeded, but below which each contracting party was free to differentiate in the degree of compensation applied, provided that such action was in conformity with other provisions of the General Agreement" and that "countries adjusting taxes should, at all times, be prepared, if requested, to account for the reasons for adjustment, for the methods used, for the amount of compensation and to furnish proof thereof".

B. The distinction between direct taxes and indirect taxes

31. Economists have traditionally distinguished between, on the one hand, indirect taxes which are imposed, directly or indirectly, on products, and, on the other hand, direct taxes which are considered to be imposed on the producer. This distinction has been generally accepted as a basis for GATT/WTO's disciplines on border tax adjustments with respect to both imports and exports.

32. In 1960, the Working Party on Article XVI:4 considered that the following measures were deemed to be export subsidies, and, therefore, did not fall under the category of taxes which were adjustable at the border:

> "(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises;
>
> (d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption; or the payment, in respect of exported goods, of amounts

> exceeding those effectively levied at one or several stages on these goods in the form of indirect taxes or of charges in connection with importation or in both forms;"[7]

33. In examining which taxes should be eligible for border tax adjustment, the 1970 Working Party endorsed that distinction and concluded that

> "there was convergence of views to the effect that taxes directly levied on products [i.e. indirect taxes] were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added. It was agreed that the TVA, regardless of its technical construction (fractioned collection), was equivalent in this respect to a tax levied directly -a retail or sales tax. Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products [i.e. direct taxes] were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes."

34. The WTO Agreement on Subsidies and Countervailing Measures, which also differentiates between direct and indirect taxes, gives the following definition:

> "The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property".
>
> "The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges".[8]

35. The distinction between direct and indirect taxes and the ineligibility of direct taxes for adjustment was confirmed by GATT dispute settlement practice in the case "United States Tax Legislation (DISC)". The US Domestic International Sales Corporation (DISC) legislation allowed certain types of corporations to be partially exempt from federal income tax on their export earnings. The panel which examined the case

> "noted that DISC legislation was intended, in its own terms, to increase United States exports and concluded that, as its benefits arose as a function of profits from exports, it should be regarded as an export subsidy".[9]

36. The preference granted to indirect taxes relies on the assumption that indirect taxes are shifted completely "forward" by the taxpayer; they are eventually reflected in the final price of the product and, thus, are paid by the consumer. On the contrary, it is assumed that direct taxes are shifted "backward": they are finally borne by the manufacturer of the product, and are not reflected in the final price of the product. In brief, WTO provisions on border tax adjustment follow the destination principle for indirect taxes, and the origin principle for direct taxes. Border tax adjustment is therefore not possible for direct taxes, whether levied on imported or on exported products.

37. The distinction between direct and indirect taxes, and the assumptions which underlie it, has been questioned at times. For example, some members of the 1970 Working Party considered that

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[7]BISD 9S/185, para. 5.

[8]Footnote 58, related to Annex I, "Illustrative List of Export Subsidies".

[9]BISD 23S/98, para. 69.

> "the main provisions of the GATT relevant to tax adjustments represent an attempt at the codification of a wide range of past practices based on assumptions which are not now universally accepted. In particular, they felt the assumption of full shifting of direct taxes is not a reflection of economic reality. They considered that the present GATT rules favour countries which rely heavily on indirect taxes and discriminate against countries which rely predominantly on direct taxes. Further, in their view, the present rules are ambiguous and lead to differing tax adjustment practices for similar types of taxes. They concluded that the current GATT provisions and tax practices are not trade neutral."[10]

38. The Working Party also noted a divergence of views regarding the eligibility for adjustment of certain categories of tax:

> "(a) "Taxes occultes" which the OECD defined as consumption taxes on capital equipment, auxiliary materials and services used in the transportation and production of other taxable goods. Taxes on advertising, energy, machinery and transport were among the more important taxes which might be involved. It appeared that adjustment was not normally made for taxes occultes except in countries having a cascade tax;
>
> "(b) Certain other taxes, such as property taxes, stamp duties and registration duties … which are not generally considered eligible for tax adjustment. Most countries do not make adjustment for such taxes but a few do as a few do for the payroll taxes and employers' social security charges …"

However, the Working Party decided not to investigate this matter further.[11]

C. Border Tax Adjustment on Imported Products

(a) Relevant provisions

39. The imposition of taxes and charges on imported goods for the purpose of border tax adjustment is addressed in Article III of GATT 1994. The relevant parts of Article III read as follows:

> "1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production. [footnote omitted]"
>
> "2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1. [footnote omitted]"

[10]BISD 18S/97, para. 8. See also para. 21 and 22 of the report.

[11]In footnote 58 of the Agreement on Subsidies and Countervailing Measures, machinery and stamp taxes are now classified as indirect taxes, and property tax as direct tax.

40. Notwithstanding the obligations set forth in the relevant provisions of Article II (Schedules of Concessions) of GATT 1994, Article II:2(a) allows any Member to impose

> "at any time on the importation of any product:
>
> (*a*) a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III [footnote omitted] in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part; …".

(b) Purpose of Article III

41. In GATT/WTO dispute settlement practice, Article III:2 has been interpreted as regulating the treatment of products as opposed to regulating the behaviour of producers. The Panel on "United States - Section 337 of the Tariff Act of 1930" found that the "no less favourable" treatment set out in several GATT provisions are "an expression of the underlying principle of equality of treatment of imported products as compared to the treatment given either to other foreign products, under the most favoured nation standard, or to domestic products, under the national treatment standard of Article III".[12]

42. One of the basic purposes of Article III is to ensure that internal charges and regulations are not such as to frustrate the effect of tariff concessions granted under Article II.[13] However, Article III applies whether or not the product concerned is subject to a tariff concession and whether or not adverse trade effects occurred[14] . The purpose of that provision is to establish certain competitive conditions for imported products in relation to domestic products; it is not to protect expectations on export volumes. The panel report on "United States - Taxes on Petroleum and Certain Imported Substances" found that

> "[I]t is conceivable that a tax consistent with the national treatment principle (for instance, a high but non-discriminatory excise tax) has more severe impact on the exports of other contracting parties than a tax that violates that principle (for instance a very low but discriminatory tax). The case before the panel illustrates this point: the United States could bring the tax on petroleum in conformity with Article III:2, first sentence, by raising the tax on domestic products, by lowering the tax on imported products or by fixing a new common tax rate for both imported and domestic products. Each of these solutions would have different trade results, and it is therefore logically not possible to determine the difference in trade impact between the present tax and one consistent with Article III:2, first sentence, and hence to determine the trade impact resulting from the non-observance of that provision. For these reasons, Article III:2, first sentence, cannot be interpreted to protect expectations on export volumes; it protects expectations on the competitive relationship between imported and domestic products. A change in the competitive relationship contrary to that provision must consequently

[12]Adopted on 7 November 1989, BISD 36S/345, para. 5.11. See also the panel reports on "United States - Taxes on Petroleum and Certain Imported Substances", adopted on 17 June 1987, BISD 34S/136, and "United States - Restrictions on Imports of Tuna", not adopted, BISD 39S/155.

[13]See the panel report on "Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies", adopted on 18 February 1992, BISD 39S/27, paras. 5.30 - 5.31.

[14]See the panel report on "United States - Taxes on Petroleum and Certain Imported Substances", adopted on 17 June 1987, BISD 34S/136, para. 5.1.1.

> be regarded *ipso facto* as a nullification or impairment of benefits accruing under the General Agreement."[15]

(c) The notions of "like" products and of "directly competitive or substitutable" products in Article III:2

43. The determination of a discriminatory taxation is made by comparing domestic and imported like products. Under Article III, it has been constant practice for panels to first determine whether imported and domestic products are "like" before examining whether the measure is discriminatory. The notion of "like product" has been analyzed on a case-by-case basis in a number of GATT/WTO dispute settlement panels.

44. The most recent analysis of "like product" in the context of Article III:2 can be found in the 1996 case on "Japan -Taxes on Alcoholic Beverages"[16]. In examining the consistency with Article III:2 of the Japanese taxation system of certain alcoholic beverages, the panel found that this provision "is concerned with two different factual situations: Article III:2, first sentence, is concerned with the treatment of like products, whereas Article III:2, second sentence, is concerned with the treatment of directly competitive or substitutable products, i.e. products other than like products …". It noted that "[t]he Interpretative Note ad Article III:2 further clarifies this distinction by providing an example where the first sentence of Article III:2 is not violated whereas the second is …"[17]. Therefore, the panel concluded that Article III:2 contains two distinct legally binding obligations.[18]

45. The panel then examined the relation between the two sentences. It found that like products are a sub-category of directly competitive or substitutable products, in the sense that all like products are, by definition, directly competitive or substitutable products, whereas the contrary is not necessarily true. In the view of the panel,

> "the appropriate test to define whether two products are "like" or "directly competitive or substitutable" is the marketplace. … [T]he decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, *inter alia*, as shown by elasticity of substitution. The wording of the term "like products" however, suggests that commonality of end-uses is a necessary but not a sufficient criterion to define likeness. … [T"]he term "like products" suggests that for two products to fall under this category they must share, apart from commonality of end-uses, essentially the same physical characteristics."[19]

The Appellate Body confirmed this interpretation and endorsed at the same time the basic approach which had been set out by the Working Party on Border Tax Adjustments regarding "like products":

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[15]See the panel report on "United States - Taxes on Petroleum and Certain Imported Substances", adopted on 17 June 1987, BISD 34S/136, para. 5.1.9. See also the Appellate Body report on "Japan - Taxes on Alcoholic Beverages", p. 16, WT/DS8/11, 8 November 1996.

[16]WT/DS8/11, WT/DS10/11, WT/DS11/8, adopted on 1 November 1996, Appellate Body Report and Panel Report.

[17]The Interpretative Note ad Article III:2 states that "[a] tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed".

[18]WT/DS8/11, WT/DS10/11, WT/DS11/8, adopted on 1 November 1996, Panel Report, para. 6.11 - 6.12.

[19]WT/DS8/11, WT/DS10/11, WT/DS11/8, adopted on 1 November 1996, Panel Report, para. 6.22.

> "problems arising from the interpretation of the term [like product] should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a "similar" product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "similar": the product's end-uses in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality."[20]

(d) Article III:1

46. The 1996 panel report on "Japan - Taxes on Alcoholic Beverages" examined the relationship between Article III:2 and Article III:1. It considered that the wording of Article III:1 made it clear that this provision "does not contain a legally binding obligation but rather states general principles". As a consequence, "recourse to Article III:1, which constitutes part of the context of Article III:2, will be made to the extent relevant and necessary". In the same case, the Appellate Body confirmed this interpretation and added that "[t]he purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in the other paragraphs of Article III, while respecting, and not diminishing in any way, the meaning of the words actually used in the texts of those other paragraphs".[21]

(e) Methods of taxation and discriminatory tax rates

47. In determining whether an internal tax discriminates against imported goods, GATT dispute settlement panels have examined, on a case-by-case basis, the rate of the applicable internal tax, the taxation methods (e.g. different kinds of internal taxes, direct taxation of the finished product or indirect taxation by taxing the raw materials used in the product during the various stages of its production), and the rules governing tax collection (e.g. basis of assessment). They have considered that Article III:2 does not prescribe the use of any specific method or system of taxation, nor does it contain any presumption in favour of a specific mode of taxation. As a consequence,

> "there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products. …[i]t could be also compatible with Article III:2 to allow two different methods of calculation of price for tax purposes. Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, …, whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products".[22]

48. The two different legal obligations contained in the two sentences of Article III:2 (see above para. 44), result in two different tests to assess the discriminatory effect of a tax. Regarding "like products" (first sentence), the 1996 panel report on "Japan - Taxes on Alcoholic Beverages" found that "[t]he phrase "not in excess of those applied … to like domestic products" should be interpreted to mean at least identical or better treatment". The Appellate Body confirmed this interpretation, adding

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[20]WT/DS8/11, WT/DS10/11, WT/DS11/8, adopted on 1 November 1996, Appellate Body Report (p. 19-20 and p. 25-26); BISD 18S/97, para. 18.

[21]WT/DS8/11, WT/DS10/11, WT/DS11/8, adopted on 1 November 1996, Panel Report, para. 6.12, and Appellate Body Report p. 18.

[22]See the panel report on "Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages", adopted on 10 November 1987, BISD 34S/83, paras. 5.8-5.9. See also the panel report on "Japan - Taxes on Alcoholic Beverages", adopted on 1 November 1996, WT/DS8/R, WT/DS10/11, WT/DS11/8, para. 6.24.

that "[e]ven the smallest amount of "excess" is too much"[23]. Thus, the requirement contained in the first sentence of Article III:2 is not conditional upon a trade effect nor is it qualified by a *de minimis* standard.

49. The test is different in the second sentence of Article III:2, because, as noted by the Appellate Body in the same dispute, "[t]o interpret "in excess of " and "not similarly taxed" identically would deny any distinction between the first and second sentences of Article III:2". In examining the second sentence of Article III:2, the Appellate Body considered that "to be "not similarly taxed", the tax burden on imported products must be heavier than on "directly competitive or substitutable" domestic products, and that burden must be more than *de minimis* in any given case". As for like products, this is determined on a case-by-case basis.[24] Considering that the second sentence of Article III:2 refers to Article III:1, a further enquiry is needed when directly competitive and substitutable products are found to be "not similarly taxed": it must then be examined whether the tax in question is applied "so as to afford protection". According to the Appellate Body, such an examination

> "requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe that it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.
>
> Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such a protective application …. Most often, there will be other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case".[25]

(f) Policy purpose of the tax

50. In the case "United States - Taxes on Petroleum and Certain Imported Substances", the EC argued that the tax imposed by the United States on certain chemicals should not be eligible for border tax adjustment because it was designed to tax polluting activities that occurred in the United States and to finance environmental programmes benefitting only United States producers. Consistent with the Polluter-Pays Principle, the EC argued, the United States should have taxed only products of domestic origin because only their production gave rise to environmental problems in the United States. As to this argument, the panel found that

> "the tax adjustment rules of the General Agreement distinguish between taxes on products and taxes not directly levied on products; they do not distinguish between taxes with different policy purposes. Whether a sales tax is levied on a product for general revenue purposes or to encourage the rational use of environmental resources, is therefore not relevant for the determination of the eligibility of a tax for border tax adjustment. For these reasons, the Panel concluded that the tax on certain chemicals, being a tax directly imposed on products, was eligible for border tax adjustment independent of the purpose it served. The Panel therefore

[23]WT/DS8/11, WT/DS10/11, WT/DS11/8, adopted on 1 November 1996, panel report, para. 6.24, and Appellate Body report p. 23.

[24]Ibidem, Appellate Body Report, p. 27.

[25]Ibidem, Appellate Body Report, p. 29.

> did not examine whether the tax on chemicals served environmental purposes and, if so, whether a border tax adjustment would be consistent with these purposes."[26]

51. Regarding the argument that the United States should follow the Polluter-Pays Principle, the Panel, recalling that the provisions of the General Agreement "set maxima limits for adjustment (compensation) which were not to be exceeded, but below which every contracting party was free to differentiate in the degree of compensation applied, provided that such action was in conformity with other provisions of the General Agreement"[27], concluded that

> "if a contracting party wishes to tax the sale of certain domestic products (because their production pollutes the domestic environment) and to impose a lower tax or no tax at all on like imported products (because their consumption or use causes fewer or no environmental problems), it is in principle free to do so. The General Agreement's rules on tax adjustment thus give the contracting party in such a case the possibility to follow the Polluter-Pays Principle, but they do not oblige it to do so."[28]

(g) Difference between Article II and Article III

52. According to Article II:1(b) of GATT 1994, a product benefitting from a bound tariff concession must be "exempt from ordinary customs duties in excess of those set forth and provided [in the tariff schedules] …" and "shall also be exempt from all other duties or charges of any kind imposed on or in connection with importation in excess of those imposed on the date of this Agreement …". However, Article II:2(*a*) specifically allows Members "to impose at any time on the importation of any product:

> "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III [footnote omitted] in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part".

Thus, a distinction has to be made between, on the one hand, "internal taxes and charges" within the meaning of Article III, which are subject to border tax adjustments, and, on the other hand, other duties or charges … imposed in connection with importation …", within the meaning of Article II:1(b), which cannot be adjusted at the border. GATT contracting parties never formally distinguished between the two categories. However, the preparatory work for the Havana Charter as well as dispute settlement practice have contributed, on a case-by-case basis, to establishing such a distinction.

53. During the Havana Conference, a Sub-Committee which considered Article 18 (on national treatment) of the Charter, stated that

> "The delegations of Chile, Lebanon, and Syria inquired whether certain charges imposed by their countries on imported products would be considered as internal taxes under Article 18. The Sub-Committee, while not attempting to give a general definition of internal taxes, considered that the particular charges referred to are import duties and not internal taxes because according to the information supplied by the countries concerned (a) they are collected at the time of, and as a condition to, the entry of the goods into the importing country, and (b) they apply exclusively to imported products without being related in any way to similar charges

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[26] BISD 34S/136, para. 5.2.3-5.2.4.

[27] Working Party on Border Tax Adjustment, BISD 18S/100.

[28] See the panel report on "United States - Taxes on Petroleum and Certain Imported Substances", adopted on 17 June 1987, BISD 34S/136, para. 5.2.5.

> collected internally on like domestic products. The fact that these charges are described as internal taxes in the laws of the importing country would not in itself have the effect of giving them the status of internal taxes under the Charter".[29]

54. Guidance in that regard can be found in the Interpretative Note Ad Article III which states that

> "[a]ny internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 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 an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III". [emphasis added]

Another indication can be found in the 1980 Council Decision on "Introduction of a Loose-Leaf System for the Schedules of Tariff Concessions", stating that "other duties or charges", in the meaning of Article II "are in principle only those that discriminate against imports".[30]

55. Thus, the fact that the tax levied on imported products is also borne by domestic like products appears to be the determinant criteria in deciding whether a particular tax falls under Article II or Article III. The time and place where the tax is levied are secondary elements.[31]

56. A number of GATT dispute settlement panels have examined whether a measure was an internal tax or charge (Article III) or a duty or charge "imposed on or in connection with importation" (Article II)[32]. The panel report on "EEC - Measures on Animal Feed Proteins" examined an EEC Regulation requiring domestic producers or importer to purchase a certain quantity of skimmed milk powder and to have it denatured for use as feed for animals. When examining the consistency with Articles II and III of these aspects of the Regulation, the panel

> "… recalled its own finding that (a) the EEC measure applied to both imported and domestically produced vegetable proteins (except in the case of corn gluten); (b) the EEC measures basically instituted an obligation to purchase a certain quantity of skimmed milk powder and, as an "internal quantitative regulation" fell under Article III:1; (c) the EEC security deposit and protein certificate were enforcement mechanisms for the purchase obligation.
>
> Having regard to the legal considerations referred to above and taking into account of its own findings in relation to Article III:5 and Article III:1 that the EEC measures were an "internal quantitative regulation", the Panel concluded that the EEC measures should be examined as internal measures under Article III and not as border measures under Article II."[33]

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[29]See Analytical Index, Guide to GATT Law and Practice, Vol. 1, p. 136, referring to Havana Reports, p. 62, para. 42 and to E/CONF.2/C.3/A/W.30, p. 2.

[30]Proposal by the Director-General, adopted on 26 March 1980, BISD 27S/22.

[31]The Working Party on Border Tax Adjustments also noted " … under certain tax systems imports are usually taxed, as is home production, by the importing country at the time they are sold by registered traders to other traders or consumers, and so the adjustment takes place after the goods cross the border" (BISD 18S/96, para. 5).

[32]See Analytical Index, Guide to GATT Law and Practice, Vol. 1, p. 82 and 198.

[33]Adopted on 14 March 1978, BISD 25S/49, paras. 4.17-18.

57. The panel on "EEC - Regulation on Imports of Parts and Components", in examining the legal nature of EEC anti-dumping regulations, considered that the policy purpose of a charge is not relevant to determine whether the charge is imposed pursuant to Article II:1(b) or Article III:2.

> "The Panel … noted that the policy purpose of charges is frequently difficult to determine objectively. Many charges could be regarded as serving both internal purposes and purposes related to the importation of goods. Only at the expense of creating substantial legal uncertainty could the policy purpose of a charge be considered to be relevant in determining whether the charge falls under Article II:1(b) or Article III:2."[34]

58. In the same case, the panel also found that the mere description or categorization of a charge under the domestic law of a contracting party is not relevant to determining whether the charge falls under Article II or under Article III:2. The panel considered that

> "if the description or categorization of a charge under the domestic law of a contracting party were to provide the required "connection with importation", contracting parties could determine themselves which of these provisions would apply to their charges. They could in particular impose charges on products after their importation simply by assigning the collection of these charges to their customs administration and allocating the revenue generated to their customs revenue. With such an interpretation the basic objective underlying Articles II and III, namely that discrimination against products from other contracting parties should only take the form of ordinary customs duties imposed on or in connection with importation and not the form of internal taxes, could not be achieved."[35]

D. Border Tax Adjustment on Exported Products

(a) Principles

59. As noted by the 1970 Working Party on Border Tax Adjustments, "GATT principles on tax adjustment applie[s] the principle of destination identically to imports and exports". As a consequence, products destined for exports can be exempted from taxes borne by like products destined for domestic consumption, the idea being that the exported products will be taxed where they are consumed, i.e. in the country of destination.

60. Border tax adjustment on exported products is first addressed in the Interpretative Note *Ad* Article XVI (Subsidies) of GATT 1994:

> "[t]he exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

The Interpretative Note, added in the 1954-55 Review Session, was drawn from the Havana Charter, where it was recorded to cover "the case of remission of duties or taxes imposed on raw materials and semi-manufactured products subsequently used in the production of exported manufactured goods".[36]

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[34]Adopted on 16 May 1990, BISD 37S/132, para. 5.6.

[35]Ibidem, para. 5.7.

[36]See Analytical Index, Guide to GATT Law and Practice, p. 448 and 465.

61. The exemption from, or refund of, taxes borne by like domestic products cannot be subject to anti-dumping or countervailing duties, as stated in Article VI:4 of GATT 1994:

> "No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes."

62. The fact that border tax adjustment on exported products is not countervailable was confirmed by dispute settlement practice. For example, the Panel on "Swedish Anti-Dumping Duties", which examined the application of Article VI:4 where an anti-dumping scheme applied to products benefitting from an export rebate of duties and charges, noted that "there was no disagreement between the parties concerned regarding the obligation to take account of legitimate refund of duties and taxes".[37] Moreover, it is arguable that the relevant aspects of GATT dispute settlement practice regarding import-side border tax adjustment might be taken into account in the context of tax adjustment on exports.

63. The Uruguay Round Agreement on Subsidies and Countervailing Measures (the "Subsidies Agreement") is based on the same principles. Its footnote 1 to Article 1.1(ii) states that

> "In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy".

(b) Scope

64. In establishing disciplines for export subsidies, GATT contracting parties undertook early to categorize which measures should be prohibited as export subsidies and, as a consequence, under which circumstances border tax adjustment is possible on exported products.[38] The 1994 Subsidies Agreement, in particular its Annex I, contains a illustrative list of the type of measures which are to be considered as export subsidies. The Agreement provides thereby a "negative" list of the taxes, and amount, adjustable on exported products.

65. As for border tax adjustment on exported products, the Subsidies Agreement endorses the distinction between direct and indirect taxes. As a consequence, adjustment with respect to "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises" is an export subsidy. The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes is considered to be an export subsidy only when the amount of taxes remitted or exempted exceeds the amount of such taxes levied in respect of the production and distribution of like products when

[37]Adopted on 26 February 1955, BISD 3S/81, para. 16. See also the panel report on "Suspension of Customs Liquidation by the United States", adopted on 16 June 1977, BISD 24S/134, para. 15.

[38]See in that regard the report of the Working Party on Article XVI:4 in BISD 9S/185, and the 1979 Agreement on Subsidies and Countervailing Measures.

sold for domestic consumption; such exemption or remission is then allowed if their amount is equivalent to that borne by domestic like products.[39]

E. Border tax adjustment on inputs incorporated or exhausted in the production process

66. While it is clear that border tax adjustment is possible for indirect taxes levied on products, the extent to which indirect taxes on inputs, incorporated or exhausted in the production process, to the final product can be adjusted at the border, whether on exports or on imports, remains to be clarified.

67. The 1970 Working Party did not reach a conclusion on this point. It noted that "there was a divergence of views with regard to the eligibility for adjustment of certain categories of tax", such as the "taxes occultes", which encompass consumption taxes on capital equipment auxiliary materials and services used in the transportation and production of other taxable goods, as well as taxes on advertising, energy, machinery and transport (see above para. 38). However, the Working Party did not investigate the matter for it felt that "while this area of taxation was unclear, its importance -as indicated by the scarcity of complaints reported in connection with adjustments of taxes occultes- was not such as to justify further examination".[40]

(a) Inputs incorporated or exhausted in the production process of imported products

68. Regarding imported products, a first indication can be found in Article III:2 of GATT 1994 which states that "[t]he products of the territory … shall not be subject, directly or indirectly, to internal taxes …" [emphasis added]. These terms do not correspond to the distinction between direct and indirect taxes (contrary to what is suggested in paragraph 14 of the report of the Working Group on Border Tax Adjustment). If it were so, it would mean that direct taxes could be adjusted at the border, which would be in contradiction with the negotiating history and subsequent application of Article III:2. During the negotiations of the Havana Charter, the expression "directly or indirectly" replaced an earlier version which referred to taxes and other internal charges "imposed on or in connection with like products", because it was considered that the equivalent of the latter was difficult to translate into French. In subsequent discussions, it was stated that the word "indirectly" would cover even a tax not on a product as such, but on the processing of the product.[41]

69. Another indication can be found in Article II:2(a) which stipulates that border tax adjustment can be made with respect to

> "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III [footnote omitted] in respect of the like imported product or in respect of an article from which the imported product has been manufactured or produced in whole or in part" [emphasis added].

During the negotiations of the Havana Charter, it was agreed that the word "equivalent" meant, "for example, if a [charge] is imposed on perfume because if contains alcohol, the [charge] to be imposed

[39]See Annex 1, para. (e), (f) and (g) of the Subsidies Code. The Illustrative List of Export Subsidies contained in the 1979 Subsidies and Countervailing Duties Agreement contained the same definition.

[40]BISD 18S/97, para. 15.

[41]See Analytical Index, Guide to GATT Law and Practice, Vol. 1, p. 141, referring to EPCT/A/PV/9, p. 19 and EPCT/C.II/W.5, p. 5. See also footnote 58 of the 1994 Subsidies Agreement (which contains the same language as footnote 1 of the 1979 Code) defines "prior-stage" indirect taxes as "those levied on goods or services used directly or indirectly in making the product" [emphasis added].

must take into consideration the value of the alcohol and the not value of the perfume, that is to say the value of the content and not the value of the whole".[42]

70. The panel on "United States - Taxes on Petroleum and Certain Imported Substances", examined whether the US tax on "certain imported substances", which taxed certain downstream imported chemicals which were derivatives of taxable chemicals, fell under Article III. It considered that

> "[t]he tax on certain imported substances equals in principle the amount of the tax which would have been imposed under the Superfund Act on the chemicals used as materials in the manufacture or production of the imported substances if these chemicals had been sold in the United States for use in the manufacture or production of the imported substance. In the words which the drafters of the General Agreement used in the above perfume-alcohol example: the tax is imposed on the imported substances because they are produced from chemicals subject to an excise tax in the United States and the tax rate is determined in principle in relation to the amount of these chemicals used and not in relation to the value of the imported substance. The Panel therefore concluded that, to the extent that the tax on certain imported substances was equivalent to the tax borne by like domestic substances as a result of the tax on certain chemicals the tax met the national treatment requirement of Article III:2, first sentence".[43]

Thus, the panel considered that taxes on substances entering in the composition of the final product could be adjusted at the border. However, it is not clear, in this particular case, whether those substances were still physically present in the final product, or whether they had been exhausted in the production process, and the panel made no distinction to that effect.

(b) Inputs incorporated or exhausted in the production process of the exported product

71. With respect to exported products, Article VI:4 and the *Ad* Note to Article XVI, simply refer to taxes "borne by" products; unlike Article III:2, these two provisions do not contain a reference to "directly or indirectly". However, the records of the Havana Charter indicate that the *Ad* Note to Article XVI was understood to cover "the case of remission of duties or taxes imposed on raw materials and semi-manufactured products subsequently used in the production of exported manufactured goods" (see above para. 60).

72. The 1994 Subsidies Agreement is more specific than GATT 1994 regarding border tax adjustment on inputs for exported products. Paragraph (h) of the Illustrative List of Export Subsidies contained in Annex I, elaborates the definition of indirect taxes by addressing prior-stage cumulative indirect taxes[44]. It reads:

> "The exemption, remission or deferral of prior-stage cumulative indirect taxes [footnote omitted] on goods and services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported

[42]EPCT/TAC/PV/26, p. 21, referred to in Analytical Index, Guide to GATT Law and Practice, Vol. 1, p. 86.

[43]Paras. 5.2.7-5.2.8.

[44]Footnote 58 of the Subsidies Agreement gives the following definition:
"Prior-stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product. "Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production.

> products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste[45]). [footnote omitted] This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II."

Paragraph (i) of the Illustrative List addresses the remission or drawback of import charges on imported products that are consumed in the production of the exported products. It reads:

> "The remission or drawback of import charges [footnote omitted] in excess of those levied on imported inputs that are consumed in the production of the exported product (making normal allowance for waste); provided, however, that in particular cases a firm may use a quantity of home market inputs equal to, and having the same quality and characteristics as, the imported inputs as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, not to exceed two years. This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II and the guidelines in the determination of substitution drawback systems as export subsidies contained in Annex III".

These two paragraphs are to be read in conjunction with footnote 61 which defines inputs consumed in the production process as "inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product".[46]

73. To sum up, exemption, remission or deferral, within the meaning of para. (h), of prior-stage cumulative indirect taxes on goods and services used in the production of exported products is permissible, but only to the extent that the goods and services in question are "consumed in the production process" and that the taxes exempted are not in excess of such taxes on goods and services used in the production of like products when destined for domestic consumption. Similarly, paragraph (i) of Annex I allows the remission or drawback of import charges not "in excess" of those levied on imported inputs that are consumed in the production of the exported product.

74. The scope of the current Subsidies Agreement appears to be broader than that of the 1979 Subsidies Agreement, whose Annex I, paragraphs (h) and (i), referred to "goods that are physically incorporated in the exported product". The signatories of the SCM Code had defined these as "such inputs [that] are used in the production process and are physically present in the product exported. The signatories note that an input need not be present in the final product in the same form in which it entered the production process".[47]

75. During the Uruguay Round, some participants questioned the physical incorporation test and supported proposals to the effect that the rules contained in paragraphs (h) and (i) should apply to all inputs, and not only to those physically incorporated. The first formal proposal was submitted by India which stated in relevant part that

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[45]The term "waste" is defined in Annex II, section II, para. 4, of the 1994 Subsidies Agreement as "that portion of a given input which does not serve an independent function in the production process, is not consumed in the production of the exported product (for reasons such as inefficiencies) and is not recovered, used or sold by the same manufacturer".

[46]See Annex 1, para. (h), and footnote 61 of the 1994 Subsidies Agreement.

[47]Doc. SCM/68, para. 4.

> "rebate of prior stage cumulative indirect taxes should not be treated as countervailable subsidy whether or not such taxes have been levied on goods and services physically incorporated in the exported product. Article VI of GATT states that no product can be subject to countervailing duty by reason of the exemption of such product from taxes or duties borne by like products when destined for consumption in the country of origin. This provision clearly suggests that rebate of taxes on auxiliary material (e.g. energy, fuel, lubricants, packing stationery), durable capital goods (e.g. machinery buildings, vehicles) and services (e.g. transport, advertising) cannot be treated as countervailable subsidy."[48]

In a subsequent proposal, India precised its first proposal:

> "The physical incorporation test is bad from the point of view of both equity and economic efficiency. It places at a disadvantage countries with multi-stage cumulative tax systems vis-à-vis those with value-added tax systems as in the latter, there is no impediment to the exporter collecting full credit for all prior stage taxes paid on inputs. If global efficiency is to be promoted, then such taxes levied not only on the final product and the raw materials, but also those levied on the inputs should be allowed to be rebated, as they also have a price-raising effect. The physical incorporation test is also not consistent with Article XI:4 of GATT as it is manifest that prior stage taxes paid on inputs, whether or not physically incorporated in the final product, are "borne by the like product".[49]

The remission of indirect taxes to inputs other than physically incorporated in the exported product was also supported by Switerland whose proposal stated in particular that the physical incorporation test

> "was not fully compatible with the notion of net transfer of funds because all indirect taxes and import charges on services, such as transportation and communication, as well as on machinery, and on fungible inputs such as fuel and electricity used in the manufacturing process are not physically incorporated in the final product. Consequently the rules on indirect taxes and remissions or drawbacks should apply to all inputs".[50]

These proposals lead to the current text and the inclusion of footnote 61.[51] The actual scope of these provisions has never been put to test in a dispute settlement panel.

76. However, other countries expressed concern that the new language might lead to trade distortive effects. In that regard, a letter from a USTR official indicates that the new language has been the object of an informal agreement among developed countries whereby "it was proposed to address a specific and very narrow issue involving certain energy-intensive exports from a limited number of countries. It was never intended to fundamentally expand the right of countries to apply border adjustment for a broad range of taxes on energy, especially in the developed world. … We discussed the matter with other developed countries involved in the Subsidies Code negotiations. We are satisfied that they share our views on the purpose of the text as drafted and the importance of careful international examination before any broader policy conclusions should be drawn regarding border adjustments and energy taxes".[52]

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[48]MTN.GNG/NG10/W/26.

[49]MTN.GNG.NG10/W/33.

[50]MTN.GNG/NG10/W/26.

[51]For further details, see "Negotiating History of Footnote 61 of the Agreement on Subsidies and Countervailing Measures", Note by the Secretariat, in doc. WT/CTE/W16 (1 December 1995).

[52]Letter from D. Phillips, Assistant USTR for Industry, to A. Katz, President US Council for International Business, referred to in *Inside US Trade*, 28 January 1994.