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Trade and Climate Change: How to Design Better Climate-Related Provisions in Preferential Trade Agreements

Clara Brandi, Kateryna Holzer, Jean-Frédéric Morin, Harro van Asselt & Katharina Weber

Summary

Linking trade to environmental goals is gaining momentum. Ever more discussion about trade and climate interlinkages are prevalent in both the trade and climate policy communities. The dedicated Trade Day at the 28th Conference to the Parties (COP28) of the United Nations Framework Convention on Climate Change (UNFCCC) underlines the growing interest in trade and climate interlinkages. Given the urgency of the climate crisis, using the toolbox of trade policies to help tackle climate change should be a priority.

Preferential Trade Agreements (PTAs) are a promising trade policy tool to accelerate the transition toward greener economies and help address the climate crisis. PTAs – agreements that reduce trade barriers among their parties – are mushrooming around the world and they include an increasing number of environmental provisions. These provisions in PTAs can help reduce environmentally harmful subsidies, incentivise the green transition, and favour the diffusion of environmental technologies.

But so far, climate-related environmental provisions in PTAs have not been designed in ways that enable them to live up to this potential. Many such climate provisions in PTAs remain vague, weak, and not very innovative. This policy brief outlines why we should use PTAs as a policy tool; discusses pitfalls of their current design; and shows how negotiators should improve the design of climate-related provisions to unlock their full potential.

We discuss three types of provisions that have the potential to strengthen climate protection through PTAs:

Fossil fuel subsidies: Climate provisions in PTAs should seek to eliminate or phase down fossil fuel subsidies, provide for Special and Differential Treatment (SDT) for developing countries, and increase transparency on fossil fuel subsidies.

Environmental goods and services (EGS): Climate provisions in PTAs should eliminate tariffs and non-tariff trade barriers for EGS, offer SDT for developing countries in the context of EGS, and should incentivise climate-friendly production through preferential tariffs.

Investment: Climate provisions in PTAs should be designed so as to shield climate policy measures from legal challenges by providing a treaty-wide exception specifically for climate policy measures, reaffirming the right to regulate explicitly in relation to climate policy measures or carving out measures taken to address climate change from the application of Investor State Dispute Settlement (ISDS).

We also outline five general **policy recommendations for promoting the effectiveness of climate provisions in PTAs**:

1) Prioritise win-win solutions;
2) facilitate the participation of non-state actors;
3) strengthen capacity-building and assistance;
4) enhance impact assessment, and knowledge diffusion; and
5) promote compliance and enforcement.

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Introduction

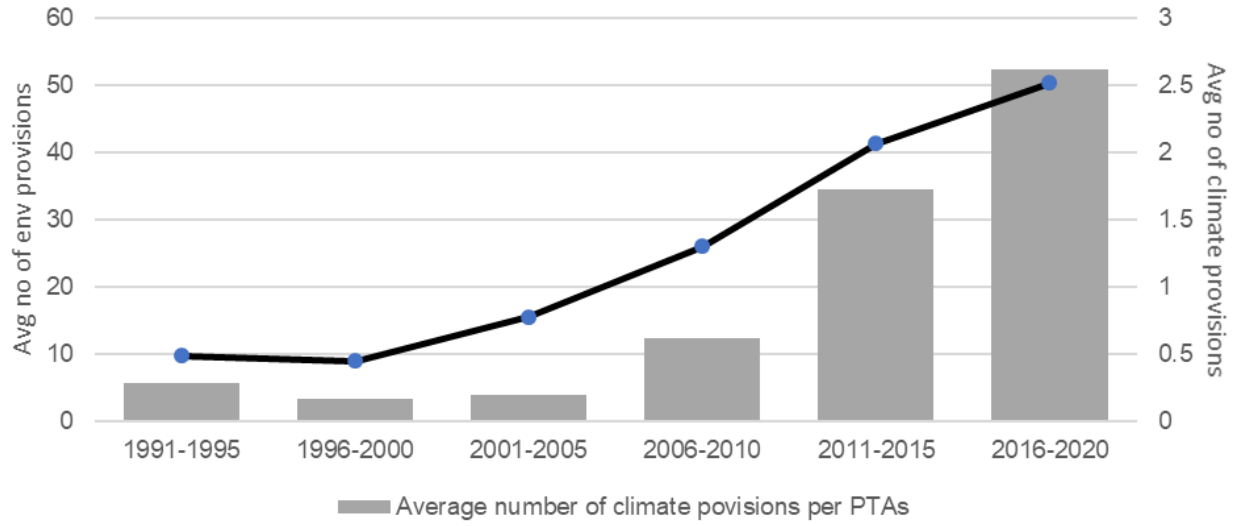
The number of preferential trade agreements (PTAs) is mushrooming around the world. Since 1947, more than 700 PTAs have been concluded. These agreements include an increasing number of environmental provisions. In fact, several recent PTAs include more than 100 different environmental provisions as documented by the TRade and ENvironment Database (TREND) (Morin et al., 2018), which covers almost 300 different provisions across 770 PTAs.

Numerous environmental provisions within PTAs have great potential for environmental protection. Some provisions promote the implementation of environmental treaties, facilitate civil society participation, and require the transfer of environmental technologies to developing countries. These provisions cover a wide range of environmental issues, such as limiting deforestation, protecting fish stocks, and mitigating CO2 emissions.

In recent times, there has been a growing trend among PTAs to focus on the issue of climate change (Morin & Jinnah, 2018; WTO, 2022). The first acknowledgment of the "greenhouse effect" within a PTA occurred in the 1989 Lomé IV agreement, which was established between the European Economic Community and countries from Africa, the Caribbean, and the Pacific regions. Notably, this happened three years prior to the conclusion of the United Nations Framework Convention on Climate Change. Since then, an increasing number of PTAs address climate adaptation, promote renewable energy, favour the harmonisation of climate regulations, or call for the ratification of climate treaties. Yet, there are still many PTAs with detailed environmental chapters that do not address climate change specifically or only do so superficially.

While this Policy Brief shines the spotlight on the role of PTAs within the context of climate change mitigation, climate provisions in PTAs – and international trade more generally – are also important with a view to adaptation and resilience. For example, PTAs can help to mitigate the agri-food-related climate challenges by balancing food supply between surplus and shortage areas and preventing income losses (Gouel & Laborde, 2021), thereby creating positive social externalities.

Figure 1: Growing number of environmental and climate provisions per year



Source: Authors

Why use PTAs for climate action?

First, numerous attributes of PTAs can be leveraged to fight the climate crisis. PTAs are a useful tool to regulate the flow of goods, foster civil society activity, raise public awareness, and promote governmental capacity. They can thus be used in a way to incentivise trade in Environmental Goods and Services (EGS). They can also provide legal mechanisms for private actors and civil society organisations to claim their environmental rights, which might not be available under domestic law.

Second, PTAs are a powerful tool due to their legal enforceability. They provide the possibility to strengthen the enforceability of multilateral environmental agreements, such as the Paris Agreement, which usually rely on soft voluntary measures (Jinnah, 2011).

Moreover, PTAs incorporating trade sanctions, private remedies, and dispute settlement mechanisms have the potential of making those environmental issues enforceable, which are otherwise mostly governed by reputational concerns. They also offer a forum to promote cooperative approaches.

Recent studies show that the inclusion of environmental provisions in PTAs is linked to a reduction in greenhouse gas (GHG) emissions (Baghdadi et al., 2013; Martínez-Zarzoso & Oueslati, 2018; Sorgho & Tharakan, 2022; Weber, 2023; Zhou et al., 2020). While the effect of general environmental provisions remains an open question with contrasting findings in research, specifically climate-related provisions are associated with a reduction of emissions in trading partners (Sorgho & Tharakan, 2022). Results also show that effects can occur both ex ante and ex post (Postnikov & Bastiaens, 2014; Weber, 2023).

The link between environmental provisions in PTAs and emission reductions might be driven by a positive relationship between environmental provisions and changes in domestic environmental legislation (Brandi et al., 2019). It is this pathway that may lead to a reduction in the emissions of trading partners: commitments to reduce emissions will strengthen national regulation regarding climate change mitigation. Changes in national legislation subsequently influence the behaviour of both producers and consumers, ultimately leading to a reduction in emissions (Sorgho & Tharakan, 2022).

Overall, PTAs offer a promising tool to be leveraged further in climate change governance (see also Brandi et al., in press). They offer the opportunity to experiment with innovative ways to use trade policies to tackle climate change. At the same time, the relationship between international trade and environmental protection is complex and multi-faceted (see, for instance, Brandi & Morin, 2023). Negotiators need to take these complexities into account, including in terms of the environmental *and* the social effects of trade and trade policy, when shaping future PTAs.

How to design better climate provisions in PTAs

So how do we design better climate-related provisions in PTAs? This Policy Brief focuses on three types of provisions that have the potential to strengthen climate protection through PTAs: provisions on fossil fuel subsidies; provisions on promoting trade in EGS; and provisions on investment protection (for more details, see also Brandi et al., in press). In what follows, we briefly discuss each type of provision in a separate section, assessing their current design and their pitfalls, and outlining recommendations for how to strengthen them.

1. Fossil fuel subsidies

Despite numerous voluntary commitments to phase out fossil fuel subsidies, they amounted to USD 697.2 billion in 2021 (OECD & IEA, 2022). Fossil fuel subsidies often have adverse environmental and socio-economic effects, leading to increased greenhouse gas emissions and carbon lock-in as well as a distortion of international trade (Moerenhout & Irschlinger, 2020). Few PTAs so far include provisions on fossil fuel subsidies – and where they do, provisions are usually vague and broad.

PTAs should eliminate or phase down fossil fuel subsidies

PTAs should seek to prohibit either all, or a subset of, fossil fuel subsidies. In 2022, World Trade Organization (WTO) members supported this approach for fisheries, and a similar logic should be extended to fossil fuels. In a first step, PTAs could either include a non-regression clause prohibiting any subsidies increase in absolute terms, a commitment to subsidise renewable energy more than fossil fuel, or a progressive phasing down of fossil fuel subsidies over a given period. To provide clarity for the scope a provision covers, parties can opt for a standard definition of a "subsidy", with Article 1 of the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement) as a strong example of this definition. Alternatively, instead of reaching a consensus on a specific definition, parties could list particular types of targeted subsidies, like subsidies to coalmines or for fossil fuel exploration.

PTAs should entail Special and Differential Treatment for developing countries

A significant portion of the wealth in high-income economies has historically been tied to the use of fossil fuels. Low-income countries are confronted with a unique set of obstacles when trying to transition away from their reliance on fossil fuels. This transition should not impede the progress of the world's most economically disadvantaged countries. To address this concern, PTAs could include granting a (temporary) exemption from certain regulations, particularly concerning subsidies for fossil fuels that are aimed at ensuring energy access for the most impoverished and vulnerable populations. Negotiators should thus consider repurposing fossil fuel subsidies (Malerba, 2023) or consider other social safeguards. Additionally, provisions on fossil fuel subsidies should be complemented by provisions that demand technical and financial assistance as well as technology transfer to promote the adoption of clean energy solutions in low-income countries.

PTAs should increase transparency on fossil fuel subsidies

Parties to PTAs should include provisions in their trade agreements that enhance transparency regarding fossil fuel subsidies through various mechanisms. One approach is to establish a system where parties are required to report their fossil fuel subsidies. Alternatively, drawing on the practices of organisations like the G20 and APEC (Asia-Pacific Economic Cooperation), countries can periodically submit reports detailing their fossil fuel subsidies and the progress they have achieved in reducing them. These reports could then undergo peer reviews by other countries.

2. Environmental goods and services

Promoting trade in EGS could contribute to the diffusion of climate technologies, such as solar panels and wind turbines, making the uptake of these technologies cheaper and faster. As multilateral and plurilateral negotiations on the liberalisation of EGS have failed, PTAs are a good alternative to promote a reduction of trade barriers for these types of goods and services. However, while there are more than 70 PTAs that mention the benefits of liberalising EGS, only a few include clearly **defined** commitments. Most provisions merely require vague best efforts, where parties only "recognise the importance" (United States, Mexico & Canada, 2019) or strive to "facilitate" (EFTA & Turkey, 2018). But there are also some innovative approaches. For example, the 2019 EU-Vietnam PTA is the first one to define remanufactured goods. The idea is to open the door for trade in remanufactured goods as a way of driving the circular economy approach forward.

PTAs should eliminate trade barriers for EGS

PTAs should eradicate all tariffs on EGS. For example, the 2022 New Zealand-UK PTA eliminates tariffs on 293 environmental goods, the largest list ever agreed in a PTA. In addition, and given that non-tariff measures present a major problem for the trade in EGS, it is particularly important to focus on reducing measures that go

beyond tariffs. This needs to go hand in hand with the reduction of the use of antidumping and countervailing duties, which undermines the elimination of tariffs.

PTAs should offer Special and Differential Treatment in the context of EGS

PTAs should offer flexibilities for developing countries such as lower levels of tariff reductions, tariff cuts on a smaller range of goods over an extended period or allowing varied levels of liberalisation for distinct categories of environmental goods. Additionally, there should be provisions focusing on technology transfer and technical assistance relevant to EGS. The goal should be to ensure that developing countries benefit from fostering trade in EGS through PTAs and/or gain from complementary policy measures.

PTAs should incentivise climate-friendly production through preferential tariffs

To encourage the adoption of climate-friendly production methods, tariff-rate differentiation based on sustainability standards could be introduced as a prerequisite for tariff elimination or reduction. This strategy can complement the conventional approach of relying on predefined lists for the liberalisation of environmental goods. A noteworthy example to follow is the 2019 PTA between the European Free Trade Association (EFTA) and Indonesia, which introduces preferential tariff-rate quotas for sustainably produced palm oil in Indonesia.

3. Investment

In discussions regarding investments, the ongoing discussion centres on the necessity of imposing limitations on the utilisation of investor-state dispute settlement (ISDS) concerning claims made by foreign investors with regard to governmental actions addressing climate change. There is also an ongoing debate about expanding regulatory space for governments to safeguard the environment and climate. The presence of ISDS often triggers numerous claims from investors against climate-related policies, potentially causing significant financial losses to state budgets due to incurred damages. This situation could also discourage the implementation of climate policies, creating a “chilling effect”.

So far, environmental exceptions to commitments with respect to investment protection are, for example, designed as general exceptions giving the host state the possibility to lawfully take action directed at environmental protection (in line with Article XX of the General Agreement on Tariffs and Trade (GATT) or Article XIV of the General Agreement on Trade in Services (GATS). Yet, specifically climate-focused carve-outs are likely to be more effective to safeguard the host state’s regulatory space than general exceptions for public policy measures that have so far been commonly used.

PTAs should include a treaty-wide exception specifically for climate policy measures

To this end, it is imperative to revise and specify general exceptions in PTAs, ensuring they explicitly encompass measures undertaken with a focus on climate protection. Specifically referencing climate change within these exceptions is crucial, given the ambiguity surrounding whether public policy exceptions designed in line with the GATT and GATS general exceptions inherently encompass measures aimed at addressing climate change. Clarifications in this regard would ensure more comprehensive coverage and interpretation of policies aimed at mitigating climate change within PTAs.

The right to regulate should be explicitly extended to climate policy measures

The right to regulate in the investment chapter of PTAs should be linked to the specific aim of addressing climate change (see, for example, the 2021 Canadian Model Bilateral Investment Treaty). Moreover, parties to PTAs can permit measures to be taken to implement their Paris Agreement commitments (see the example of the Trade and Sustainable Development chapter of the 2018 EU-Japan Economic Partnership Agreement).

PTAs should include a carve-out from ISDS

Climate policy measures should be protected from legal challenges through a carve-out from ISDS. Although this embodies a highly effective reform, only a very limited number of existing PTAs include such a carve-out. A carve-out from ISDS for climate policy measures or for investments in the energy sector would allow for the broad regulatory flexibility that is needed to undertake ambitious climate action.

The way forward

PTAs can play a key role as they remain underutilised instruments for promoting climate action. In ongoing and future trade negotiations, there should be a strong focus on developing substantive and procedural options for climate-friendly trade agreements. Looking ahead, decision-makers should ensure that PTAs with environmental provisions are attractive across different types of partner countries, including low-income countries. This could be achieved by offering special advantages to low-income countries (for example, for technology transfer) or implementing complementary measures (for instance, development assistance). The goal should be to generate mutually beneficial solutions for trade, climate and development.

Above, we have highlighted design options for three types of climate provisions in PTAs:

Fossil fuel subsidies: Climate provisions in PTAs should seek to eliminate or phase down fossil fuel subsidies, provide for Special and Differential Treatment for developing countries, and increase transparency on fossil fuel subsidies.

Environmental goods and services (EGS): Climate provisions in PTAs should eliminate tariffs and non-tariff trade barriers for EGS, offer Special and Differential Treatment in the context of EGS, and should incentivise climate-friendly production through preferential tariffs.

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Looking ahead, and given the urgency of the climate crisis, trade and climate change should be a priority (see also Jakob et al., 2022). The following five more general recommendations (see also Brandi & Morin, 2023) are key for **promoting effectiveness of climate provisions in PTAs:**

1. **Emphasise mutually beneficial trade and climate solutions:** Given that certain trade commitments may lead to adverse environmental impacts, it is imperative for trade negotiators to incorporate environmental safeguards across all chapters of any PTA, including those pertaining to foreign investment. This entails safeguarding states' regulatory autonomy over the environment. Furthermore, future PTAs should concentrate on mutually beneficial issues, such as facilitating access to environmental technologies that create synergies between trade and the environment.
2. **Facilitate involvement of non-state actors:** To promote the effectiveness and legitimacy of PTAs, a concerted effort is needed to enhance cooperation with civil society in shaping and overseeing trade agreements, exemplified by strengthening domestic advisory groups. In a broader sense, trade negotiators should leverage environmental provisions mandating the participation of non-governmental organisations or citizens in formulating and implementing environmental measures within PTAs.
3. **Improve capacity-building and assistance:** Policymakers in high-income countries must ensure that PTAs with environmental provisions are also attractive to low-income countries (also beyond Special and Differential Treatment). This involves, for instance, providing assistance for demand-driven capacity-

building on environmental issues by delineating commitments on environmental aid and by specifying targets, amounts and timelines. Additionally, policymakers in high-income nations should extend support to low- and middle-income countries in implementing environmental provisions within their PTAs.

4. **Enhance impact assessment and knowledge dissemination:** Utilising impact assessments more effectively is crucial. Policymakers should undertake periodic ex post environmental assessments of PTAs every 5 or 10 years, fostering better learning opportunities. Tools like TREND Analytics (www.TRENDanalytics.info) can facilitate the accessibility of data on environmental provisions for trade negotiators, civil society, and the private sector.
5. **Strengthen implementation and enforcement:** Decision-makers should focus on tangible actions to ensure the effective implementation and enforcement of existing PTAs. For instance, in the EU, the Chief Trade Enforcement Officer should consolidate mechanisms for implementing and enforcing PTAs, including their Trade and Sustainable Development chapters. Regarding enforcement, a combination of hard sanction-based measures and a softer cooperative approach can coexist within PTAs, complementing each other in making significant enhancements to compliance.

Finally, a Trade Ministers' Coalition for Cooperation on Climate Action (Deere Birkbeck, 2021) could strengthen international dialogue and coordinate strategies, options, and best practices for aligning climate and trade policies in PTAs and beyond.

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Professor Dr Clara Brandi is Head of the research programme “Transformation of Economic and Social Systems” at the German Institute of Development and Sustainability (IDOS).

Email: clara.brandi@idos.research.de

Dr Kateryna Holzer is a Senior Researcher at the University of Eastern Finland.

Professor Dr Jean-Frédéric Morin is Full Professor at the Political Science Department and the Canada Research Chair in International Political Economy at Laval University.

Professor Dr Harro van Asselt holds the Hatton Professorship in Climate Law at the University of Cambridge. He is also a Professor of Climate Law and Policy at the University of Eastern Finland Law School.

Katharina Weber is a researcher at the Faculty of Social and Behavioural Sciences (Programme group: Political Economy and Transnational Governance) at the University of Amsterdam.

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