EGMONT POLICY BRIEF 331

– FEBRUARY 2024 –

From Carrots to Sticks, To Carrots Again?

The EU's Changing Sustainable Trade Agenda

Victor De Decker

Over the past decades, the European Union's trade policy has evolved significantly, shifting from a historical focus on market access to a contemporary strategy that intertwines trade agreements with enforceable sustainability aims.

This policy brief consists of three parts. First, there will be an overview of how Trade and Sustainable Development (TSD) chapters have gained prominence in European Free Trade Agreements. The second part will be dedicated to the autonomous, unilateral EU initiatives - the Carbon Border Adjustment Mechanism (CBAM) and the Corporate Due Diligence Directive (CSDDD). To conclude, there will be a brief analysis of how the EU is working within a multilateral setting on the issue of climate change.[1]

In 2015, the United Nations adopted the 2030 Agenda for Sustainable Development, a landmark framework renowned for its far-reaching vision encompassing 17 Sustainable Development Goals (SDGs) and 169 targets.[1] These goals collectively constitute the "universal policy agenda," aiming to address global challenges and foster inclusive economic growth. Notable among these goals is the promotion of sustainable international trade, identified as a pivotal policy instrument contributing to overarching SDGs. The 2030 Agenda positions international trade as "an engine for inclusive economic growth and poverty reduction" while actively contributing to the broader pursuit of sustainable development.

Also in 2015, the Juncker Commission issued a new trade policy strategy named "Trade for All".[2] This strategy was based on the principles of effectiveness, transparency, and values. In his 2017 State of the Union address, President Juncker repeated the Commission's commitment to the "Trade for all" strategy.[3] Not much later, the Commission published a report on the implementation of this new strategy.[4] Within this strategy, trade agreements are highlighted an important tool to enforce sustainability criteria in trading relationships. Henceforth, modern FTAs must hold rules on trade and sustainable development.

TRADE AGREEMENTS AND TSD CHAPTERS

Notwithstanding, the EU's commitment to embedding sustainability in trade agreements did not start with the iteration of the UN SDGs in 2015. Already before, the EU has been incrementally using FTAs to foster international cooperation on sustainability. Specifically Trade and Sustainable Development (TSD) chapters include labour and environmental provisions and commitments by the trade partners with the aim to further sustainable development through its trade.

The watershed FTA for including sustainability criteria within a European trade agreement has been the FTA signed with South Korea. From the 2011 EU Free Trade Agreement with South Korea onwards, European trade agreements include "Trade and Sustainable Development" (TSD) chapters. Next to the usual chapters on trade liberalisation, these chapters consider a number of

1 Although sustainability criteria include references to human, social and labour rights as well as broader environmental concerns, this policy brief will focus on measures related to carbon emission reduction in relation to the Paris Agreement.

commitments on labour and environmental standards. In short, the EU used its market access and soft power to embed sustainability objectives into trade agreements. Also, the EU's Comprehensive Economic Trade Agreement with Canada (CETA), signed in 2016, has a TSD chapter, acknowledging that economic growth, social development, and environmental protection are interlinked. More specifically, commitments were made to create a Joint Committee on Trade and Sustainable Developments to oversee the implementation of the TSD chapter.

From 2018 onwards, the EU Commission went as far to vow never to sign a new trade agreement without containing a TSD chapter that specifically mentions the Paris Agreement.[5] The Economic Partnership Agreement between the EU and Japan that entered into force in 2019, locked in the Paris Agreement's climate commitments into a trade agreement for the first time, including a first time specific mention to the Paris Agreement.[6]

In 2020, the appointment of the Chief Trade Enforcement Officer within DG TRADE and the launch of Single Entry Point (SEP), provided further improvements in strengthening the EU's implementation and enforcement agenda for TSD chapters.[7] These institutions provide EU stakeholders with the opportunity to submit cases of violations of the TSD chapters.

However, as the inclusion of TSD chapters within EU FTAs proliferated, the efficacy of TSD chapters themselves has been increasingly called into question, especially given that the exact impact of TSD chapters on achieving sustainability goals is hard to quantify. In response to these concerns, the European Commission published a communication on a new TSD action plan in June 2022, highlighting twenty action points, ensuring that European trade agreements do indeed follow up on their own commitments.[8]

On 22 June 2022, the Commission adopted its communication on "the power of trade partnerships: together for green and just economic growth'.[9] This was the result of the Trade and Sustainable Development (TSD) review of the action plan for improving the implementation and enforcement of TSD chapters in trade agreements, announced in the Trade Policy Review communication of 2021. This Communication defines how to enhance the contribution of EU trade agreements to promoting the protection of the environment and labour rights worldwide. It fosters shared ownership by all EU institutions and Member States to achieve concrete change.

One of the most crucial elements proposed here has been the possibility to include trade sanctions as a last resort for serious violations of fundamental ILO principles or the Paris Agreement. Although EU FTA's TSD chapters became incrementally comprehensive, they did not go as far as to include a penalising mechanism – a "stick" - before. Such a strong enforcement mechanism included would enter into force trade sanctions in case the TSD commitments were not followed.

It was the EU-New Zealand Trade Agreement that translated this proposal into action. For the first time in an EU FTA, the TSD chapter of this particular FTA foresaw the possibility of trade sanctions as a matter of last resort, in the instance of a serious violation of core TSD commitments, amongst which the Paris Agreement on Climate, thereby effectively making the Paris Agreement legally binding.[10] As a consequence, the EU-New Zealand FTA deal received overwhelming support in the European Parliament, even from the Green Group, who have been traditionally opposed to FTAs.

Important to note here is that New Zealand is an advanced economy, which has climate goals that were broadly in line with the EU in the first place. Integrating enforceable environmental sustainability targets in an FTA with a low- or middle-income country will prove more difficult.

This became obviously clear with the EU-Mercosur trade deal. Although scheduled to be signed late 2023, after nearly a quarter of a century of negotiations, the deal fell short after French President Macron pulled the plug based on environmental concessions obtained by the Latin-American partners.[11] A leaked draft text of the trade deal from Spring 2023 even revealed that the FTA's TSD chapter failed to meet the EU's own criteria, as set out by the 2022 TSD Review.[12]

In short, while it was politically motivated environmental ambition that helped materialise the EU-New Zealand Trade Agreement, it is now hampering the conclusion of the EU-Mercosur trade deal.

CBAM

Whereas TSD chapters supply a solid basis for entrenching sustainability into bilateral trade agreements, there are also unilateral measures that the EU is taking to embed a stronger sustainability angle throughout its trade policy.

In order to put a price on carbon emissions during the production of carbon intensive goods that are entering the EU, thereby avoiding the risk of "carbon leakage", the Carbon Border Adjustment Mechanism is the EU's landmark tool. October 2023, the CBAM entered into application in its transitional phase, with the first reporting period for importers ending in January 2024.[13] CBAM will initially apply to imports of certain goods and selected precursors whose production is carbon intensive and at most significant risk of carbon leakage: cement, iron and steel, aluminium, fertilisers, electricity and hydrogen. With this enlarged scope, CBAM will eventually – when fully phased in – capture more than half of the emissions in Emissions Trading System (ETS) covered sectors.

For the success of CBAM, the EU relies heavily on the "Brussels effect", that the EU would set the standard for a carbon pricing structure that will be picked up by third countries. This anticipation has been in stark contrast with the reception that the mechanism received by large trading partners. CBAM has drawn the ire of various countries.[14] In April 2021 Brazil, South Africa, India and China have jointly expressed their "grave concern regarding the proposal for introducing trade barriers, such as unilateral carbon border adjustment, which are discriminatory."

Their argument is essentially that the Brussels effect will not work this time. Rather than convincing the rest of the world to come on board with the EU, they fear that CBAM will create a two-tier system wherein clean energy products will be sent to Europe and dirty energy products will be traded amongst the rest of the world.[15]

Despite this strong rhetoric, it should be noted that China has the second most trade covered under CBAM. However, studies have shown that affected trade will only represent less than 2% of China's total exports to the EU in the initial phases. The expected impact on EU-China trade will thus be marginal.[16]

As the first reporting phase comes to a closing, it remains to be seen whether CBAM will achieve its goals and if it has the potential to become the carbon levy standard for trade amongst third countries as well.

CSDDD

Ever since the 1990s, global value chains (GVC) have expanded rapidly, making for the fact that about 70% of international trade involves GVCs as parts and components across countries and continents are incorporated into final products.[17] As a consequence, individual companies hold significant sway over trade through the management of their own supply chains. The EU has been actively working on various initiatives to promote sustainability here as well.

To address sustainability challenges throughout these supply chains, in March 2021, the European Parliament called on the Commission to give a legislative proposal on mandatory value chain due diligence. Also, on 3 December 2020, the Council in its conclusions called on the Commission to present a proposal for an EU legal framework on sustainable corporate governance, including cross-sector corporate due diligence along global value chains.

Eventually, the European Commission adopted a proposal on the Corporate Sustainability Due Diligence Directive (CSDDD) in early 2022.[18] If adopted, the proposal will require companies to identify, prevent, or mitigate impacts of their activities on the environment and on human rights abuses. Furthermore, this would require companies to not just perform due diligence on their own operations but also on the activities of their subsidiaries and other entities within their value chains, keeping both direct and indirect business relationships. They must create and execute 'prevention action plans,' secure contractual assurances from their direct business partners regarding plan compliance, and subsequently verify compliance.

Several EU Member States have already introduced national rules on due diligence[19] and according to the 2023 Thomson Reuter Institute's 2023 Corporate Global Trade Survey Report, 88% of businesses collect information for ESG purposes from their suppliers at least once a year.[20]

To help the EU race to net-zero, the CSDDD would oblige a subset of companies to ensure their business models and strategies are compatible with the Paris Agreement. On top of that, companies that identify climate change as a "principal risk for, or principal impact of" their operations would have to include emission reduction objectives in their business plans.

The proposed directive would be enforced at Member States'-level. Two new enforcement levers will be central: Directors' Duty of Care, and Civil liability. Whereas the latter will hold companies liable for damages if they do not comply with their obligations, the former will hold directors of EU companies responsible for overseeing due diligence requirements – and proposed climate change requirements would be reflected in their variable renumeration.

Late 2023, the Council and the European Parliament agreed on a compromise text after about half a year of trilogues. Once adopted, Member States will have two years to transpose the Directive into national law and communicate the relevant texts to the Commission.

The CSDDD has received mixed reactions. While welcomed by civil society groups, there are concerns about possible negative impacts on economies in the Global South, where sourcing and labour are often cheaper and less regulated.[21] Specifically, concerns are raised regarding the risk of legal uncertainty, which could unintentionally harm smallholders, and artisanal and small scale miners. Hence, to be a success, the directive should be accompanied by relevant technical aid and capacity-building initiatives for upstream stakeholders, while also prompting downstream actors to incentivise suppliers committed to sustainability.

WTO & OECD

The bottom-up international climate regime, as agreed in the Paris Agreement, has put the "climate-ball" primarily in the court of national governments, who must come up with their own nationally determined contributions and mitigation actions. This has resulted in widely varying levels of uncoordinated climate policy measures – also coined a "spaghetti bowl".[22] This fragmentation has made a coordinated, global approach through multilateral institutions arguably more difficult to formulate, although not less necessary. Consequently, trade tensions resulting from this uncoordinated approach, have become increasingly prominent on the WTO agenda.

Given that the WTO Appellate Body is no longer able to deliver binding resolutions of trade disputes, the WTO had to reinvent itself as a coordinator, rather than an arbitrator, between the myriad of climate related trade policies that have come to the front.

The EU has been co-sponsoring several WTO initiatives to strengthen the role of the Organization as a forum for coordination and dialogue. Arguing that climate change is a global problem that requires a global solution, at the 12th Ministerial Conference (MC12) in 2022, the EU has co-sponsored three plurilateral WTO initiatives on trade and environmental sustainability, plastic pollution, and sustainable plastic trade, as well as the reform of fossil fuel subsidies. Zooming in specifically on carbon reduction efforts, the EU actively supported the launch of the Trade Ministers' Coalition for Climate. Also, within the OECD, the EU is promoting amendments in the set of rules covering official export credits to foster alignment on climate goals. In view of the upcoming 13th WTO Ministerial Conference (MC13), the EU has highlighted trade and environmental challenges as a priority for WTO engagement.

CONCLUSION

In summary, the European Union's trade policy has evolved significantly, shifting from a historical focus on market access to a contemporary strategy that intertwines trade agreements with enforceable sustainability aims.

The introduction of Trade and Sustainable Development (TSD) chapters in European Free Trade Agreements (FTAs) signifies a crucial shift, with the EU using economic influence to embed commitments to labour and environmental standards. However, the efficacy of TSD chapters has faced scrutiny, leading to a comprehensive review and action plan by the European Commission.

A milestone was reached with the EU-New Zealand FTA, introducing an enforcement mechanism involving potential trade sanctions for serious violations of TSD commitments, adding a regulatory "stick" to complement incentives. Challenges surfaced in the EU-Mercosur trade deal, revealing difficulties in integrating environmental sustainability targets in FTAs with low- or middle-income countries.

On the unilateral front, the autonomous instruments – the EU's Carbon Border Adjustment Mechanism (CBAM) and the Corporate Sustainability Due Diligence Directive (CSDDD) address carbon emissions and global value chains, respectively. CBAM has been facing resistance from major trading partners, while CSDDD raised concerns about legal uncertainty.

In navigating these complexities, the EU's commitment to sustainable development and climate action in trade policies is clear, marking a paradigm shift. Challenges persist in balancing economic interests and environmental imperatives globally, especially in dealings with the Global South. For countries in the Global South, relying solely on regulatory "sticks" may prove insufficient. There is a pressing need for complementary "carrots" – positive incentives that can be applied through a multilateral framework. As the EU continues to navigate the delicate balance between economic interests and environmental imperatives, fostering global cooperation and offering tangible benefits will be essential for achieving sustainable development goals on a broader scale.

POLICY RECOMMENDATIONS

- Enhance effectiveness of TSD chapters through clearer and more quantifiable indicators for assessing the impact of TSD commitments. Tailor these enforcement mechanisms for diverse economies, especially in the Global South, in a stepwise approach.
- Although to be viewed as an instrument of last resort, foresee the possibility of trade sanctions in instances of serious violations of core TSD commitments on Climate Change.
- Integrate trade agreements with an overarching Global Gateway strategy by integrating green investments measures with bilateral trade agreements.
- Carbon pricing through unilateral measures, such as CBAM, are a first step into an international application of a carbon price. The next step should be to work towards a multilateral carbon pricing mechanism. The EU should work within the WTO and UN towards a multilateral carbon pricing framework.
- Make sure that CSDDD will be accompanied by relevant technical aid and capacity-building initiatives for upstream stakeholders, while also prompting downstream actors to incentivise suppliers committed to sustainability.

Victor De Decker is a Research Fellow in the Europe in the World Programme at the Egmont Institute since. His research centres on geoeconomics, economic statecraft, international political economy, and economic security. He holds a master's degree in international relations from Ghent University and is working towards a PhD in Geoeconomics at both his Alma Mater and the Royal Military Academy.

Endnotes

1 United Nations. (n.d.). Development Agenda. Retrieved from https://www.un.org/sustainabledevelopment/development-agenda/.

2 European Commission. (2015, 14 October). COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS Trade for All Towards a more responsible trade and investment policy. Retrieved from https://eur-lex.europa.eu/legal-content/en/ALL/?uri=celex%3A52015DC0497.

3 European Commission. (2017, 14 September). State of the Union 2017 - Trade Package: Commission unveils initiatives for a balanced and progressive trade policy. Press Release. Retrieved from: https://ec.europa.eu/commission/presscorner/detail/en/IP_17_3182

4 European Commission, Directorate-General for Trade, (2017). Report on the implementation of the trade policy strategy Trade for All : delivering a progressive trade policy to harness globalisation : communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Publications Office. https://data.europa.eu/doi/10.2781/148862

5 Mathiesen, K. (2018, 2 February). EU says no new trade deals with countries not in Paris Agreement. Climate Home News. Retreived from https://www.climatechangenews.com/2018/02/02/eu-difficult-imagine-trade-deals-countries-not-paris-agreement/

6 European Commission. (2019, 31 January). EU-Japan trade agreement enter sinto force. Press Release. Retrieved from https://ec.europa.eu/commission/presscorner/detail/en/IP_19_785

7 European Commission. (2020, 24 July). European Commission appoints its first Chief Trade Enforcement Officer. Press Release. Retrieved from https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1409

8 European Commission. (2022, 22 June). Commission unveils new approach to trade agreements to promote green and just growth. Press Release. Retrieved from https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1409

9 European Commission. (2022, 22 June). The power of trade partnerships: together for green and just economic growth. Communication. Retrieved from https://circabc.europa.eu/ui/group/8a31feb6-d901-421f-a607-ebbdd7d59ca0/library/8c5821b3-2b18-43a1-b791-2df56b673900/details

10 European Commission. (2022, 30 June). EU-New Zealand Trade Agreement: Unlocking sustainable economic growth. Press Release. Retrieved from https://ec.europa.eu/commission/presscorner/detail/en/ip_22_4158

11 Valero, J. & Nussbaum, A. (2023, 2 December). Macron Concerns Derail EU-South America Trade Deal yet Again. Bloomberg. Retrieved from https://www.bloomberg.com/news/articles/2023-12-02/macron-concerns-derail-eu-south-america-trade-deal-yet-again

12 Friends of the Earth Europe. (2023, 22 March). Breaking: Civil society denounce leaked joint instrument on EU-Mercosur deal as blatant greenwashing. Retrieved from https://friendsoftheearth.eu/press-release/breaking-civil-society-denounce-leaked-joint-instrument-on-eu-mercosur-deal-as-blatant-greenwashing/

13 European Commission Taxation & Customs Union. (n.d.). Carbon Border Adjustment Mechanism. Retrieved from https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en

14 South African Government. (2021, 8 April). Joint Statement issued at the conclusion of the 30th BASIC Ministerial Meeting on Climate Change hosted by India on 8th April 2021. Retrieved from https://www.gov.za/nr/news/media-statements/joint-statement-issued-conclusion-30th-basic-ministerial-meeting-climate

15 Khalaf, R & Pfeifer, S. (2024, 8 January). How global trade could fragment after the EU's tax on 'dirty' imports. FT. https://www.ft.com/content/ca51ebf5-fbb8-4c88-a93d-ded3d6d3bcdd

16 Assous, A., Burns, T., Tsang, B., Vangenechten, D. & Schäpe, B. (2021, August). A Storm in a Teacup Impacts and Geopolitical Risks of the European Carbon Border Adjustment Mechanism. Report. E3G. Retrieved from https://www.e3g.org/wp-content/uploads/E3G-Sandbag-CBAM-Paper-Eng.pdf

17 OECD. (n.d.) Global value chains and trade. Retrieved from https://www.oecd.org/trade/topics/global-value-chains-and-trade/

18 European Commission. (n.d.) Corporate sustainability due diligence. Retrieved from https://commission.europa.eu/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en

19 Bundestag. (2021, 16 July). Act on Corporate Due Diligence Obligations in Supply Chains. Retrieved from https://www.bmas.de/SharedDocs/Downloads/DE/Internationales/act-corporate-due-diligence-obligations-supply-chains.pdf?__blob=publicationFile&v=3

20 Thomson Reuters Institute. (2023). 2023 Corporate Global Trade Survey Report. Retrieved from https://www.thomsonreuters.com/en-us/posts/international-trade-and-supply-chain/corporate-global-trade-survey-report-2023/

21 Ellena, S. (2023, 25 September). Experts concerned over EU due diligence law's impact on Global South. Euractiv. Retrieved from https://www.euractiv.com/section/economy-jobs/news/experts-concerned-over-eu-due-diligence-laws-impact-on-global-south/?_ga=2.73357652.691424016.1695675627-1073381794.1694505713

22 UNCTAD. (2023, 4 December). COP28: First-ever 'Trade Day' puts focus on trade in climate action. News. Retrieved from https://unctad.org/news/cop28-first-ever-trade-day-puts-focus-trade-climate-action

EGMONT Royal Institute for International Relations

www.egmontinstitute.be