



ROUND TABLE ON SUSTAINABLE DEVELOPMENT

Connecting Climate Ambition and Trade: How to align policies and build international consensus?

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Introduction

Addressing the climate emergency, including sharp reduction of greenhouse gas (GHG) emissions, remains a non-negotiable global priority. Despite a temporary fall due to a drop in economic activity during the COVID-19 pandemic, GHG emissions trajectories are not compatible with the Paris Agreement objective of limiting the global temperature increase to well below 2°C above pre-industrial levels.

Countries are setting increasingly ambitious climate goals, with notable developments occurring over the past six months. In September 2020, Chinese President Xi Jinping announced that China would aim to reach net-zero emissions by 2060. In December, the European Commission adopted an EU-wide net GHG emissions reduction target of at least 55% below 1990 levels by 2030 (up from 40% previously), and committed to reaching net-zero GHG emissions by 2050 at the latest. In February 2021, the United States rejoined the Paris Agreement, and US President Biden has publicly stated his wish to put the country on track to net-zero emissions by 2050. These announcements by the top three GHG emitters, which account for 41.5% of total global emissions, provide hope for a growing global consensus to tackle the climate crisis.

A number of other countries have also revisited their emissions targets. In October 2020, both Japan and Korea committed to achieving net-zero emissions by 2050. In December 2020, Prime Minister Boris Johnson set a UK objective to cut emissions by 68% by 2030 and announced that the country would ban the sale of petrol and diesel cars by 2030.

Carbon pricing is a key policy tool for achieving emissions reductions. However, carbon prices are often not high enough to act as meaningful mitigation incentives, let alone to reach Paris Agreement targets. Across 44 OECD and G20 countries, responsible for more than 80% of CO₂ emissions from fuel combustion, more than 70% of CO₂ emissions are untaxed. Effective carbon rates, which include both taxes and prices from emissions trading systems, need to reach EUR 60/tCO₂ to drive deep mitigation for just 19% of emissions from fuel combustion. While there is an expectation of an extension of carbon pricing around the world, especially in the EU, there is no certainty that effective carbon pricing will be achieved quickly enough to deliver urgently needed emissions reductions. Many important emitting nations still face obstacles, including political, to carbon taxes. Hence, other policies, including regulatory reform, need to be considered.

In addition, fossil fuel subsidies remain very high, which, apart from distorting markets and trade, undermines climate policies (including carbon pricing). Total support for fossil fuel production and consumption across 50 OECD, G20 and EU Eastern Partnership countries rose by 5% in 2019 to USD 178 billion, driven by a 30% rise in support for fossil fuel production primarily in OECD countries (OECD 2021, forthcoming). This figure rises to USD 475 billion across 81 economies when combined OECD-IEA estimates, which integrate the IEA's "price-gap" subsidy estimates, are taken into account. Despite long-standing commitments in the G20, G7 and APEC to phase out fossil fuel subsidies, large- and wide-scale reform remains elusive.

The European Union currently operates the world's largest emissions trading system (ETS). It is considering extension of its ETS to additional sectors, phasing out free allocation of emissions permits, and ratcheting down its emissions cap. Auctioning emissions permits increases the average carbon price for emitters that previously received them for free, which could increase the risk of carbon leakage from relocation of carbon-intensive production to countries with lower carbon prices, and reduce the effectiveness of mitigation policies. To limit this risk, the European Commission has announced its

intention to implement a carbon border adjustment mechanism (CBAM) in 2023, with a formal proposal scheduled for June 2021.

Background papers for the two 2020 meetings of the OECD Round Table on Sustainable Development (RTSD) recognised that border carbon adjustment could limit carbon leakage. BCAs are justified by economic efficiency arguments, to the extent that they put a price on embodied carbon in imports not subject to an equivalent carbon price (or similar instrument) in their countries of origin (OECD, 2020a; OECD, 2020b; OECD, 2020c).

A majority of participants in these meetings agreed that BCAs could in principle limit the risk of carbon leakage. At the same time, limited real-world experience and complexity of implementation mechanisms raise concerns over the ability to design BCAs effectively geared towards this purpose. In addition, the risk of “climate protectionism” and the question of compatibility with World Trade Organization (WTO) rules were recognised. The actual impact of and reactions to a BCA are likely to depend on the carbon price implicit in the mechanism and on design features including how climate policies in countries subject to the BCA are taken into account, products covered, and the use of revenues.¹

As Europe’s BCA project advances, questions arise about how such measures can be made politically acceptable to non-EU countries and international industries so that they strengthen collaboration on climate goals rather than lead to an escalation of trade disputes. An important part of the discussion is how countries in other parts of the world aim to deliver on their heightened climate ambitions and address potential carbon leakage.

This background note 1) provides an update on the main developments on BCAs since the last RTSD meeting in October 2020; 2) considers some of the consequences of BCAs for trading partners, from major economies to developing countries; and 3) examines the potential for aligning trade agreements and climate policies, such as the Agreement on Climate Change, Trade and Sustainability (ACCTS).

Recent developments on ETS, BCA and related climate policies

The European Commission aims to complete a revision of its core energy and climate legislation by June 2021. Two anticipated proposals expected in the second quarter of 2021 are reform of the EU ETS and possible introduction of a border carbon adjustment mechanism (CBAM). Since July 2020, the Commission has carried out public consultations on both initiatives.

The public consultation on a possible EU CBAM concluded in October 2020. Overall, many respondents agreed that carbon leakage was already happening, that a CBAM could be justified by differences of ambition between the EU and other countries on climate change mitigation, and that such a measure would not impose unnecessary burdens on EU industry. Widely different views were expressed on possible approaches for computing the carbon content of imported products. Some respondents also recognised that a CBAM could generate potential negative effects on the living standards of lower-income households that would need to be compensated (European Commission, 2021).

On 10 March 2021, the European Parliament adopted its own-initiative report entitled “Towards a WTO-compatible EU carbon border adjustment mechanism”. The resolution recommends covering a targeted list of sectors, specifically the “power sector and energy-intensive industrial sectors like cement, steel, aluminium, oil refinery, paper, glass, chemicals and fertilisers,” as well as “imports of products and commodities covered by the EU ETS, including when embedded in intermediate or final products”, and to use the revenue collected to provide finance for countries most vulnerable to climate change. It supports the introduction of an EU CBAM “provided that it is compatible with WTO rules and EU free trade

¹ Chair’s Summary of the 40th Round Table on Sustainable Development, <http://www.oecd.org/sd-roundtable/meetings/Chair%20Summary%20RTSD%2040%20FINAL.pdf>.

agreements (FTAs) by not being discriminatory or constituting a disguised restriction on international trade”, highlights the necessity for the CBAM to “uphold(s) the highest environmental integrity”, and calls for the measure to “enter into force by 1 January 2023 at the latest.” (European Parliament, 2021).

Upon adoption of the resolution, rapporteur Yannick Jadot, Member of the European Parliament, described the EU CBAM as “a great opportunity” and “political and democratic test for the EU, which must stop being naïve and impose the same carbon price on products, whether they are produced in or outside the EU, to ensure the most polluting sectors also take part in fighting climate change and innovate towards zero carbon. This will give us the best chance of remaining below the 1.5°C warming limit, whilst also pushing our trading partners to be equally ambitious in order to enter the EU market.”²

In February 2021, the European Commission concluded its consultation on various aspects of the EU ETS, including addressing the risk of carbon leakage, possible extension to other sectors (e.g. transport, buildings and maritime transport), the Market Stability Reserve, use of revenues, and low-carbon support mechanisms.

The EU ETS is the largest established carbon-pricing programme in the world, covering its 27 members. South Korea and New Zealand also have a national ETS, while the United Kingdom is considering establishing its own carbon-pricing scheme.

The topic of national ETS and BCA is being studied by the United States, but as yet there has been no public statement on what policies would be used to achieve emissions targets and the goal of carbon neutrality (by 2050).³ Since 2009, some US states have put a price on carbon, namely the ten north-eastern states in the Regional Greenhouse Gas Initiative (RGGI), which covers only the power sector, and California, whose economy-wide ETS is currently the 4th largest in the world.⁴ California’s cap-and-trade system is linked with that of the Canadian province of Quebec via the Western Climate Initiative. The Canadian government also recently announced its plan to increase the carbon tax to CAN \$170 per ton by 2030 and is exploring the potential of border carbon adjustments, including planned discussions on the topic with other countries.

China is launching a nationwide carbon market for electricity, requiring power generators to buy pollution permits if their plants exceed carbon intensity targets. Companies will either need to cut their emissions or pay to pollute as of mid-2021. Pilot systems put in place earlier will continue to operate where they do not overlap with the national ETS.

The more countries and regions adopt carbon-pricing mechanisms with similar rates, the less need there will be for measures to curb carbon leakage.

Impacts of BCAs on other economies

Impacts on major trading partners

In the absence of an internationally agreed carbon-pricing system, there is a risk that trade partners may react by bringing WTO cases and/or imposing retaliatory tariffs on countries introducing a BCA if they perceive it as a protectionist measure. Factors likely to influence the reception of a BCA mechanism include:

² <https://www.europarl.europa.eu/news/en/press-room/20210304IPR99208/meps-put-a-carbon-price-on-certain-eu-imports-to-raise-global-climate-ambition>

³ <https://www.reuters.com/article/us-usa-biden-climate-reaction-idUSKBN29Q0HD>

⁴ <https://www.c2es.org/content/market-based-state-policy/>

- extent of agreement on the need for additional mechanisms to address climate change;
- extent of advance consultation with affected countries;
- extent of agreement over how to measure the carbon content of imported products;
- rationale given by implementing countries (e.g. competitiveness vs. environmental policy concerns);
- efforts to address other climate-related policies (such as environmentally harmful subsidies);
- the relationship between a BCA and differing obligations and responsibilities of countries in relation to reducing GHG emissions (CBDR).

While many countries outside the EU may be warming up to the need for stronger climate policies, their positions on BCAs remain to be defined, in particular major trading nations and the largest emitters. There is also a need to consider what impact such measures would have on overall co-operation among major trading partners on a range of issues, including on incentives for engaging on joint climate action.

In order to mitigate such risks, the EU could engage with the US, China and other major emitters and trading partners with growing climate ambition to better align trade and climate policies, consult on proposed BCAs and possible alternatives, and seek to reach a plurilateral or multilateral solution to the problem of carbon leakage, including by eventually linking carbon markets internationally.

Such negotiations could be complicated, however. While US President Biden's campaign pledges included a "carbon adjustment fee against countries that are failing to meet their climate and environmental obligations", opposition in Congress places the US at considerable distance from introducing such a measure. The proposed CBAM could therefore introduce trade tensions with the United States. (Leonard et al, 2021, Farand, 2021).

Questions also remain on China's reaction, despite recent commitments to decarbonisation and more carbon pricing, notably given its role as a leading exporter of emissions-intensive products such as steel and aluminium (and parallel concerns by trading partners about government support in these sectors).

Impacts on other economies and industries

International reactions to an EU CBAM are likely to be diverse. Countries who favour strong climate action may welcome the measure, but others, especially those who export emissions-intensive goods – e.g. Korea (steel), Ukraine (steel, cement), Turkey (steel, cement, aluminium) or Norway (paper) – may oppose it (Leonard et al., 2021). To avoid this risk, the EU, US or any global player aiming to establish a BCA should look to engage smaller economies in possible plurilateral or multilateral agreements.

A BCA that does not credit other countries' domestic climate measures may face accusations of double taxation. Logically, if the carbon pricing policy of a country outside of a BCA is as stringent as the one implementing it, there will be no carbon leakage and the measure should not be applied. The question of the applicability of a BCA will arise as trading partners implement other climate policy measures that deliver similar emissions reductions.

It is also critical to address the potential impact of BCAs on developing and low-income countries. According to Weko et al. (2020), an EU CBAM "may give rise to severe, unintended economic risks due to additional costs for exporters and deteriorating terms of trade. Many countries in the Global South, and on the African continent in particular, are exposed to relatively high risks." While there are ways to address such concerns, including exemptions, gradual implementation and use of revenues to support such countries, they are not without complexity. Such measures can raise WTO challenges with regard to differential treatment among countries, given that WTO agreements generally only distinguish between LDCs based on the UN list, and developing countries, who self-select.

BCAs and the international trade regime

A critical concern regarding BCAs is that they may be considered a protectionist measure. This is especially likely if design and implementation of particular BCA are deemed incompliant with WTO rules. For instance, the Korean Ministry of Trade, Industry and Energy stated in January 2021 that “[...] carbon border adjustment is likely to be contradictory to the principles and rules of the WTO, and the design and operation of the concept need to be managed with transparency so that it does not become another trade barrier.”⁵

OECD (2020c) lays out in detail the potential conditions for a BCA to be compatible with WTO rules. This depends crucially on instrument design and how it relates to national treatment and most-favoured-nation (MFN) obligations, and applicability of GATT Article XX exceptions. In practice, whether or not a specific BCA is WTO compatible will only be clear if it is challenged and there is a ruling. Only WTO members and the dispute settlement process interpret WTO rules.

An important design aspect of any BCA is the ability to demonstrate that its elaboration and implementation actually address climate change. A BCA explicitly aimed at preserving the competitiveness of domestic producers would likely fail to meet the criteria for Article XX exceptions (OECD, 2020c).

The WTO Ministerial Conference or its General Council can offer a climate waiver that would temporarily allow countries to provide incentives or impose restrictions and suspend the applications of specific WTO rules (Bacchus, 2017, Reinsch, 2021). Such waivers, however, require the agreement of three-quarters of the membership.

It is common for trade policy agreements – and WTO agreements in particular – to make cross-references to other international instruments, for example WTO agreements referencing the Codex Alimentarius, or regional trade agreements referencing rules set by the United Nations Commission on International Trade Law (UNCITRAL). Such cross references make it possible to establish relationships between different instruments of international law (Jansen, 2011). Similarly, a carbon-pricing agreement among emitting countries could be cross-referenced with WTO legal texts.

Even if the design and implementation of a BCA is deemed WTO-compatible, there is still a risk of trade tensions and retaliatory measures. For instance, a BCA may be considered to be insufficiently transparent and arbitrary (e.g. if changes are rushed or not adequately consulted, or carbon emissions measures on imported products are considered punitive by foreign producers), or it may introduce additional administrative burdens for foreign producers which are considered discriminatory.

Climate policies and preferential trade agreements

Discussions at the multilateral level on the trade and environment agenda have focused mainly on “the relationship between existing WTO rules and specific trade obligations set out in multilateral environmental agreements (MEAs) with a view to enhancing the mutual supportiveness of trade and environment”.⁶ Further progress at the multilateral level may be achieved by bringing together the trade and climate communities.

A growing number of preferential trade agreements (PTAs) include environmental provisions (Morin et al., 2017; OECD, 2017; George and Yamaguchi, 2018), which has reportedly helped to reduce the share of environmentally damaging goods in exports (van Asselt, 2017; Brandi et al. 2020). There is some evidence that such environmental provisions have contributed to positive environmental outcomes,

⁵ <http://www.businesskorea.co.kr/news/articleView.html?idxno=57917>

⁶ Doha Ministerial Declaration, paragraph 31. See also Jansen (2011).

including through stronger environmental regulations, new institutional arrangements, environmental co-operation and improved public awareness of environmental governance (George and Yamaguchi, 2018; Martínez-Zarzoso, 2018).

However, in general, references to climate involve statements of intent to co-operate in tackling climate change (e.g. the Canada-EU Comprehensive Economic and Trade Agreement, CETA), as opposed to specific policy actions by the different parties to a PTA, such as agreements or commitments on carbon pricing, linking carbon markets and reducing fossil fuel subsidies.

Recent agreements with a strong climate component include the EU-UK Trade and Cooperation Agreement (TCA), signed in December 2020 as part of the UK's exit from the EU. The TCA is the first EU free trade agreement to consider climate change as an "essential element". It includes a non-regression principle on environmental and climate protection, including on carbon pricing. Effectively, this means that neither side can reduce their climate commitments, as it would give the other party the right to terminate or suspend part or all of the agreement.

In February 2021, the European Commission issued the report "Trade Policy Review: An Open, Sustainable and Assertive Trade Policy"⁷ which lays out a trade strategy for Europe making the green and digital transitions key priorities for multilateral and bilateral trade policy. The EU plans to engage with other countries to pursue a strong environmental WTO agenda to advance liberalisation of environmental goods and services, greening of aid-for-trade, and means to tackle fossil fuel subsidies. The report also proposes that respecting the Paris Agreement be considered an essential element in future trade and investment agreements, and makes reference to sustainable food systems and biodiversity protection.

In January 2021, a group of US Congress members requested in writing that the Biden administration include the Paris Agreement as a commitment in the United States-Mexico-Canada Agreement (USMCA), expressing a need to incorporate binding climate standards in agreements between the US and its trading partners.⁸ While there are various complexities to such an approach (e.g. potential need to renegotiate existing agreements such as the USMCA, extent to which climate monitoring systems can be integrated into trade agreements), the request demonstrates growing government interest in linking trade and climate policies.

In addition to ensuring convergence in carbon pricing and ETS, and eventually interlinking them, a critical feature of climate commitments within PTAs (or any eventual multilateral or plurilateral trade and climate agreement) would be to address fossil fuel subsidies. PTAs can provide avenues to secure transparency on fossil fuel subsidies and environmentally harmful subsidies in a broader sense, as well as to establish commitments to progressively reduce fossil fuel subsidies between parties to an agreement, such as in the EU-Singapore FTA (Yamaguchi, 2020a). An agreement to remove fossil fuel subsidies would also lessen the urgency for introducing BCAs, and lower a BCA's cost impact on imports that would face a higher carbon price at home. Tracking the change in the level of a subsidy to exported goods, and how this would be treated by the region applying a BCA, have not yet been envisioned, but could prove critical for the acceptability of a BCA by trade partners.

PTAs can also serve as a vehicle to secure the mutual supportiveness of trade and climate policies between parties to an agreement, for example by promoting green investment and the environmental policy space, progressing on environmental regulations and standards, and fostering regulatory

⁷ https://trade.ec.europa.eu/doclib/docs/2021/february/tradoc_159438.pdf

⁸ https://pascrell.house.gov/uploadedfiles/paris_in_new_nafta_-_final.pdf

co-operation with respect to particular products of environmental and climate relevance (Bellmann and van der Ven, 2020; Yamaguchi, 2020a; 2020b; van Asselt, 2017).

In September 2019, New Zealand, Costa Rica, Fiji, Iceland, and Norway (joined by Switzerland in January 2020) launched the Agreement on Climate Change, Trade and Sustainability (ACCTS), with the stated aim of demonstrating “in a concrete and substantive manner how trade measures and trade policy can – and must – support climate and environmental objectives and provide momentum towards an eventual multilateral set of outcomes.”

Current areas covered by the ACCTS include the removal of tariffs on environmental goods and the establishment of new and binding commitments for environmental services; establishment of disciplines to eliminate harmful fossil fuel subsidies; and development of guidelines to inform the development and implementation of voluntary eco-labelling programmes and mechanisms. Parties may also put forward other issues for consideration. As of yet, parties to the agreement have not included carbon pricing and the establishment of ETS among the commitments. They have also not taken a collective position on BCAs.

In early 2020, the six member countries confirmed that the ACCTS is an “open plurilateral agreement” intended to serve as a “template for action”. Once initial negotiations on ACCTS conclude, the agreement will be open to other WTO members who are able to meet the required commitments.⁹ Some observers have called for the UK to join the ACCTS as it seeks to demonstrate global leadership on climate in the context of its hosting of COP26 in 2021 (Tradecraft, 2021).

Conclusion and questions for discussion

As the European Union prepares to introduce a BCA, the stakes for bringing trade policies and agreements closer to climate goals have never been higher. The world’s biggest emitters in particular, and more generally all major trading nations, have a unique opportunity, and limited time, to seek agreements to better align domestic and trade policies with urgently needed climate action.

Against this background, participants in the 41st Round Table on Sustainable Development are invited to consider and discuss the following questions:

- How to align increasingly ambitious climate policies with different countries’ policies trade-related policies?
- How can BCA’s best be supported and complemented to ensure global acceptability and minimise possible tensions among trading partners?
- How can the international trade regime and multilateral, plurilateral and bilateral trade agreements best support accelerated climate action?

⁹ <https://www.mfat.govt.nz/en/trade/free-trade-agreements/climate/agreement-on-climate-change-trade-and-sustainability-accts-negotiations/#:~:text=Negotiating%20an%20agreement%20on%20climate,they%20can%20be%20mutually%20reinforcing>

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