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Sustainability in Supply Chains: An EU-wide solution instead of national rules

Galina Kolev / Adriana Neligan, 8 March 2021

The European Parliament outlines its view for a legislative initiative by the EU Commission for binding supply chain due diligence rules. A European solution is welcome as national rules lead to a diversion of trade barriers and distortions of competition in the internal market. Yet, it is key to define the scope of due diligence so as to avoid negative effects for the EU economy and third countries.

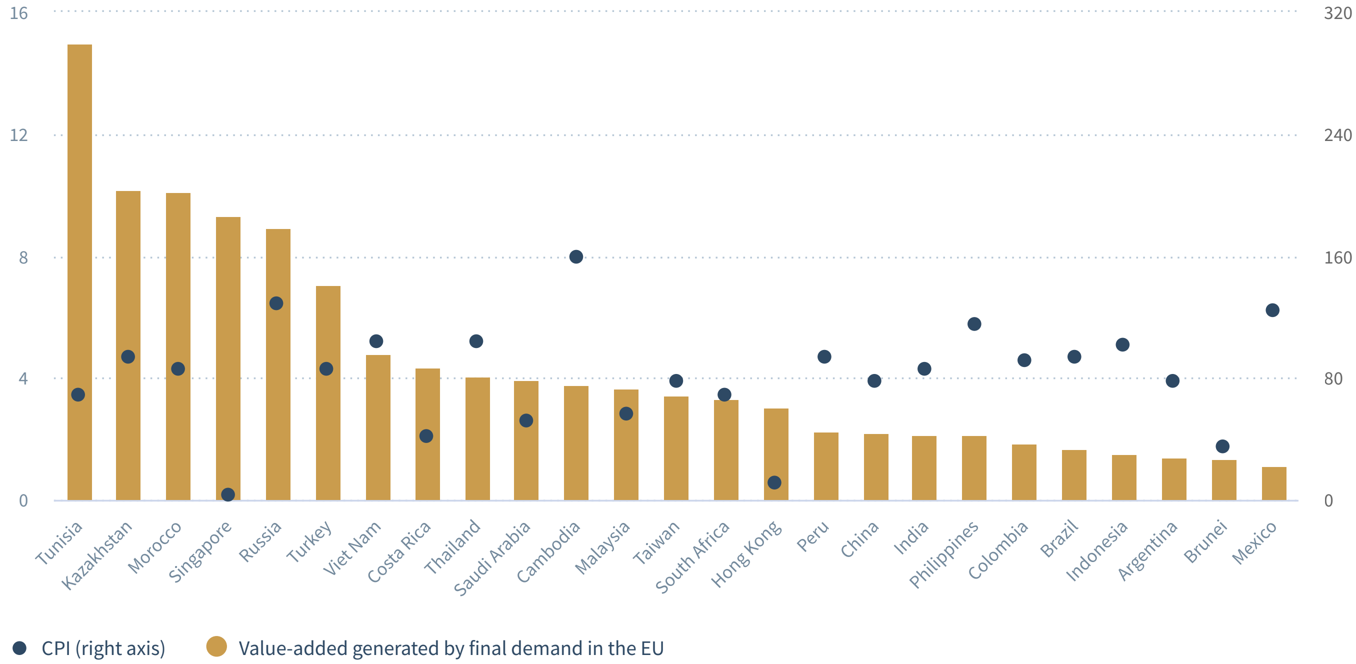
The European Parliament has requested a legislative initiative to introduce binding due diligence rules for EU companies within their value chains. A EU solution would ensure that there are fewer distortions of competition in the common market compared to national rules. But here, too, it is important to keep in mind the complexity of today's international supply chains and to make realistic demands. Analogue to the recently approved German legislation corporate due diligence should focus on their own operations and those of their direct suppliers, as the possibilities for companies to audit the entire supply chain are limited (BMAS, 2021). Otherwise, there is a risk of a massive loss of competitiveness of European companies on the world market and adverse effect on developing and emerging economies. The efforts should rather be focused on investigating individual companies if there are clear indications of disregarding sustainability issues, as practiced in the US.

The current proposal calls for due diligence obligation to apply to the entire supply chain of EU companies. In future, large companies and SMEs listed on the stock exchange or with a high share of risk shall be held accountable and liable and fined if they disregard human rights, environmental standards and good governance within their value chain (European Parliament, 2020; 2021). The main argument for a legal solution is that according to a study carried out for the European Commission voluntary measures fail (European Commission, 2020). A survey of the IW Zukunftspanel shows though that three-fifths of German industrial companies attach great importance to sustainability in supply chains - and the proportion is even higher among large and internationalised companies.

Yet, the effects of EU regulation of due diligence are difficult to assess reliably (also see Kolev / Neligan, 2021). The objective is the introduction of measures to increase the sustainability of the supply chain of European companies. With targeted measures it can reduce the incentives for local companies to exploit regulatory loopholes to the detriment of the environment and workers in third countries. However, it can also have negative effects, especially concerning the engagement of European companies in these countries. Their local investments and demand for preliminary products cre-

Corruption Perception Index (CPI) and Value-added generated by final demand in the EU

Value-added by EU final demand: 2015, percent of total value-added; CPI: 2020, ranking among 180 countries (right axis)



Source: OECD, Transparency International, German Economic Institute (IW)

ate jobs. About 215,000 employees in Africa for example owe their jobs to German direct investments according to data by the German Bundesbank, and another 700,000 jobs have been created resulting from German direct investments in Asia outside China.

The international division of labour brings considerable advantages for all countries involved, as evidenced by a look at the OECD statistics on trade in value added (Figure). Final demand of the EU countries generates total value added worth 926 billion US dollars in the listed non-OECD emerging economies as well as for Mexico and Turkey. In Tunisia, more than 15 per cent of the value added is generated by EU demand, in Kazakhstan and Morocco it is more than 10 per cent. The data presented here only capture the value added generated by the final demand of the EU. Further value added and the associated jobs are created due to the demand for intermediate products that flow into the production of export goods.

Overall, the EU accounts for an important part of the value added of the countries concerned. These are often countries with weak governance, less concerned with sustainability aspects, both in terms of ecological as well as social and economic dimensions. In addition to the economic interdependence of the countries with the EU, the figure also shows their rank according to the Corruption Perception Index (CPI) developed by Transparency International. While Singapore and Hong Kong are among the best-ranked countries worldwide, corruption is a serious problem in most other countries, especially compared to the performance of EU countries (for example, Germany ranks 9th). In countries such as Kazakhstan, Morocco and Russia, where about one tenth of domestic value added finds its end use in the EU, the problem of corruption is even more widespread. Cambodia, which generates almost 4 per cent of its own economic output for final demand in the EU, ranks 160th in the world in terms of the prevalence of corruption.

The involvement of Western companies in developing and emerging countries is also associated with improved access to newer and better technologies, for example in the field of environmental and climate protection.

Hence, they promote the growth process and sustainability with their investments and know-how. Furthermore, European companies influence product and production standards of many countries. They are committed to ensure a sufficient level of quality for goods imported from third countries due to the high product standards and the principle of prudence that applies in the EU.

The question now is what effect stricter due diligence requirements will have. Some companies will have to continue sourcing their intermediate products from the same countries as before, due to a lack of alternatives, and put up with potentially higher bureaucratic costs. Other companies, though, might be prompted to review their supply structures because of higher costs due to stricter due diligence requirements and the threat of fines. These costs could force many companies to leave developing and emerging countries and look for alternatives. The consequences for the countries concerned are hardly foreseeable. In these countries Western investors are already competing with Chinese firms that have lower requirements regarding production standards and sustainability aspects of potential investment projects. The withdrawal of European companies would only make it easier for them to take their place - with the corresponding consequences for local product and production standards. Anyone who hopes that this measure will solve the governance problems of the countries concerned could be disappointed. Today, there are alternatives to Western investments and product purchases from Western companies.

The planned tightening of due diligence requirements is also expected to have a negative impact on EU companies. The associated additional costs will be higher for imports from countries with regulatory gaps - which is likely to have the same effect as an increase in tariff rates on products from these countries. As this is a trade barrier, national solutions, such as the German Supply Chain Act, contradict the principles of the internal market and are therefore the wrong way to go.

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