

November 2023

Proposals for an Efficient and Effective Corporate Sustainability Due Diligence in Europe

ASCI Policy Brief

Gabriel Felbermayr, Klaus Friesenbichler, Peter Klimek

Proposals for an Efficient and Effective Corporate Sustainability Due Diligence in Europe

Gabriel Felbermayr^{1,4}, Klaus Friesenbichler^{1,4}, Peter Klimek^{1,2,3}

November 2023

Executive Summary

ASCI! proposes a revision of the EU directive on supply chain due diligence, the EU Corporate Sustainable Due Diligence Directive. The directive is based on European values and is to be welcomed. ASCI! suggests that the Directive should focus, where possible, on direct monitoring of suppliers rather than on bilateral relationships between buyers and sellers. The directive should be amended to allow the use of negative and positive lists of countries and suppliers. Such lists contain foreign suppliers that are prohibited (negative lists) or authorised (positive lists) to participate in EU supply chains. When contracting with companies on positive lists, EU importers do not have to carry out due diligence on the companies. They are prohibited from doing business with companies on negative lists. The Directive will continue to apply to non-listed companies. This reduces the overall cost of the regulation for EU importers, reduces the likelihood of unwanted side-effects and makes the instrument more effective, as non-compliance by a foreign supplier leads to delisting throughout the EU, not just with a single buyer. It would also increase effectiveness by reducing legal uncertainty and extending the scope of the regulation beyond EU-based production networks.

1 Supply Chain Intelligence Institute Austria. Josefstädter Straße 39, A-1080 Vienna.

2 Medical University of Vienna, Section for Science of Complex Systems, CeDAS. Spitalgasse 23, A-1090 Vienna.

3 Complexity Science Hub Vienna, Josefstädter Straße 39, A-1080 Vienna.

4 Austrian Institute of Economic Research. Arsenal Objekt 20, A-1030 Vienna.

Founding Members



Funded by

Proposals for an Efficient and Effective Corporate Sustainability Due Diligence in Europe

Gabriel Felbermayr, Klaus Friesenbichler, Peter Klimek

1. **The integration of emerging and developing countries into the global production networks of industrialised countries has brought great progress to hundreds of millions of people around the world.** This is well documented in many studies. For example, World Bank data suggest that the number of people living in absolute poverty has fallen from around 2 billion in 1990 to less than 650 million in 2019, even as the world's population has grown from 5.3 billion to 7.8 billion. Other indicators of progress tell a similar story. It is not always possible to identify the causal effect of globalisation on these outcomes. However, the academic economic literature provides causal evidence on the average growth-enhancing effects of trade integration, see for example Felbermayr & Gröschl (2013) or Feyrer (2019, 2021). However, trade integration has its downsides: It can increase economic inequality in rich and poor countries (see the review by Helpman, 2021), and its impact on environmental outcomes is ambiguous to say the least (see, e.g., Cherniwchan et al. (2017) for a review).
2. The global community has developed and ratified a significant number of legal texts that implement the provisions of the 1948 Universal Declaration of Human Rights, such as those prohibiting the worst forms of child labour. Similarly, there are various environmental conventions, the 2015 Paris Agreement on climate change being a prominent and almost universally accepted example. **Although these norms and regulations are universally acceptable and desirable, they are often in breach.** The risk of such events has increased with the recent rise of autocratic or illiberal governments around the world. According to the V-Dem Institute (2023), 72% of the world's population lived in autocracies in 2022, the highest level since 1986. Similarly, according to the World Bank's Carbon Pricing Dashboard, only 23% of global CO₂ emissions occur in countries with some form of carbon pricing, signalling the uneven level of government commitment to tackling climate change.
3. Since human rights conventions, international environmental treaties or agreements setting labour standards are provisions of international law, they must in principle be enforced by the states or by the international community. **In the absence of international enforcement mechanisms, it is legitimate for governments to involve the private sector - companies - in monitoring compliance and addressing non-compliance in their supply networks.** Moreover, there appears to be a strong preference among citizens in the EU that goods or services consumed at home should not have been produced abroad in violation of these standards. Finally, in 2011, the UN agreed on "Guiding Principles on Business and Human Rights", in which private companies are empowered to act as agents of society at large in the enforcement of human rights. Countries are therefore under an obligation to have in place appropriate frameworks for such engagement.
4. A survey of Austrian firms shows that **many have already implemented responsible corporate governance concepts**, but the systematic integration and monitoring required for reporting and documenting supply chain due diligence has so far been limited. **Small and medium-sized enterprises** in particular are **less likely to have already implemented** the necessary measures (Meyer and Reinstaller, 2022). This is not surprising. Stricter sourcing standards by individual importers, even large ones, are unlikely to have any measurable marginal impact on the human rights situation or environmental pollution in developing countries, while inevitably increasing their sourcing costs. **The incentives for companies to act autonomously are therefore too weak. To solve this variant of the "tragedy of the commons", government action is justified.**
5. In a number of countries, due diligence laws have already been enacted to regulate the supply chain. This is particularly the case in France (Loi de vigilance, effective from 2017) and Germany

(Lieferkettensorgfaltspflichtengesetz, LkSG, effective from 2023). The EU is drafting its own Corporate Sustainability Due Diligence Directive (CS3D), which, once adopted by the EU institutions, would need to be transposed into the national laws of its Member States. **Ensuring the integrity of the EU single market makes more sense with one common framework than with many possibly incompatible national rules.** Both the drafting of EU directives and subsequent national legislation should build on and improve existing legislation. **This policy brief deals with the practical implementation of the Directive. The decision to adopt the Regulation is taken as given** (see, for example, Tichy (2023) for a critical evaluation of EU policy).

6. The CS3D closely follows the **Corporate Sustainability Reporting Directive (CSRD)**, which entered into force earlier this year. It is part of a wider trend to shift responsibility for enforcing international law beyond governments to individuals and businesses. Examples of recent EU legislation aimed at promoting sustainable practices along European supply chains include the EU-regulation on deforestation, the EU Timber Regulation, the regulation on conflict minerals, and the draft regulation banning products made with forced labor.
7. **The European Commission has proposed a text for a Corporate Sustainable Due Diligence Directive (CS3D).** The EU Parliament's committee on legal affairs has proposed several amendments, which the Parliament has adopted as its position on 1 June. Meanwhile, the trilogue - inter-institutional negotiations between the European Parliament, the European Council and the European Commission - has started. Once the CS3D is formally adopted - possibly by 2024 - Member States will have two to three years to transpose it into national law. This means that countries, such as Austria, that do not have any supply chain-related due diligence laws would have to create a national supply chain law. Countries such as Germany, France or the Netherlands, which already have legislation in place, would have to ensure that their laws do not fall short of the standards set by the EU directive.
8. In a nutshell, **companies would be required to conduct due diligence on their own behaviour and that of their direct and indirect suppliers.** They would have to identify and prevent, end or mitigate any actual or potential adverse impacts on human rights and the environment in their own operations, in their subsidiaries and in the value chain. The CS3D would require companies to integrate due diligence into policies and management systems to identify risks. Companies would have to implement risk management systems and a grievance mechanism. They would have to produce an annual report describing due diligence efforts and objectives and monitoring the effectiveness of due diligence measures.
9. The CS3D proposal is different from previous supply chain legislation in a number of ways. First, it is one of the few to cover both human rights and environmental impacts of value chains. Second, it **covers direct and indirect suppliers, upstream and downstream in the value chain.** Third, it goes a step further than previous reporting requirements by requiring companies to disclose their risk mitigation strategies.
10. The CS3D will introduce **"duties for directors"** of EU companies falling within its scope. According to the proposal, these duties include establishing and monitoring the implementation of due diligence processes and integrating due diligence into the company's strategy. Directors will have to consider the impact of their decisions on human rights, climate change and the environment in fulfilling their duty to act in the best interests of the company. Companies found to be in breach of the new regulation will be subject to sanctions, including fines and compliance orders, and victims of violations will be compensated.
11. **The CS3D will apply directly to the following companies:** (i) EU companies with more than 500 employees and a global turnover of more than €150 million; (ii) non-EU companies with a turnover in the EU market of more than €150 million; (iii) EU companies with more than 250 employees and a total turnover of at least €40 million, of which 50% is generated in a high-risk sector; (iv) non-EU companies with a turnover in the EU market of more than €40 million, of which 50% is generated in a high-risk sector.
12. **Recent research from ASCII shows that virtually every company in Europe is vulnerable to supply chain risk when considering indirect relationships.** This is because supply networks are extremely dense: On average, there are 30-50 suppliers per company. Large companies have up to

10,000 suppliers and up to 100,000 customers. In Austria, the probability of an importer being exposed to a risky product/country combination is almost 100% from the second link in the supply chain onwards. This is not unusual for small, open economies. But even companies in the larger and/or less open EU countries are almost fully exposed from the third (or higher) link in the supply chain (Hurt et al., 2023).

13. To allow companies to properly identify adverse impacts in their value chain and to exercise appropriate leverage, the due diligence requirements of the Directive are limited to "**established business relationships**". These are direct and indirect business relationships that are, or are expected to be, of a lasting nature in terms of their intensity and duration and that do not represent an insignificant or ancillary part of the value chain. The classification of a relationship as "established" should be reassessed periodically, but at least every twelve months. Where a company's direct business relationship is deemed to be established, all related indirect business relationships with that company should also be deemed to be established. **The interpretation of this wording will be critical for the scope and thus the effectivity of the Directive.**
14. To assess the likely impact of the CS3D, one can draw on a **growing body of research on the effects of trade costs on firm behaviour**. Starting with Melitz (2003), theoretical and empirical work has shown how firms of different sizes react to changes in the trade cost environment. If the fixed cost of sourcing from a particular foreign supplier rises, low-volume relationships will be abandoned because the operating profits they generate will no longer cover the fixed costs of the key account. In general equilibrium, this allows larger suppliers to gain market share at the expense of smaller suppliers, thereby **reducing the number of suppliers and the degree of diversification**. Helpman et al. (2008) extend this result to a multi-country setting and show that higher fixed trade costs stop trade between countries altogether unless there is a firm-level relationship in which the achievable operating surplus exceeds the fixed costs of maintaining the relationship. The **objective of the Directive** is that **European firms improve local conditions** in third countries rather than withdraw. However, there are no legal means of enforcing such behaviour if firms' operations are not profitable.
15. The **CS3D increases the costs of trade per supplier**. It implies additional direct fixed costs for importers to fulfil the obligations set out in the Regulation. This is recognized by the German Parliament in its legislative impact assessment. It also provides estimates of the direct administrative costs associated with the implementation of the due diligence obligations. However, this calculation remains logically incomplete. The core problem is that European importers are not in a position to judge ex ante whether a particular supplier is "clean" or not. As a result, companies have to invest in costly monitoring activities. Increased monitoring will reduce the likelihood of human rights abuses or environmental crimes, but it will not eliminate the likelihood of a foreign supplier shirking its responsibilities. This means that a risk remains which, if it materialises and becomes known, can lead to reputational costs for the importer and/or even financial consequences. The latter can be high, even if the risk is low, because fines are substantial (up to 2% of turnover). The effective relationship-specific fixed costs are therefore the sum of direct (bureaucratic) costs plus the probability of failure times the probability of detection times the sum of fines and reputational costs.
16. **Companies will withdraw** from foreign countries if they perceive a **high risk of damage**. In third countries, this may result in "clean" suppliers losing business in Europe because they cannot be distinguished from rogue firms. **This "lemon problem" means that a CS3D that increases the effective cost of large customers for European importers may eventually penalise the wrong foreign companies.** The problem is compounded by legal ambiguities that plague the CS3D provisions. For example, it is difficult to determine ex ante how much effort a company will have to expend to comply with the due diligence requirements. Over time, this will be determined by best practice routines and by the courts. However, the risk remains that a firm will be accused, with or without justification, of failing in its due diligence obligations after a risk has materialised.
17. The withdrawal of EU importers from certain source countries **has a negative impact on the degree of diversification of EU imports**. It also has a negative impact on poor countries that lose access to the EU export market. Since exporters are necessarily formal firms, the CS3D may push employment into the informal sector, where the situation regarding human rights, labour standards and environmental pollution is much worse. Finally, a withdrawal of EU imports may lead to trade diversion, with importers from other countries, such as China, filling the gap. There are no

comprehensive econometric evaluation studies of existing due diligence laws. Preliminary evidence on the French law shows that French importers have withdrawn from small and risky countries (Kolev and Neligan, 2021).

18. The proposed CS3D **could shift power from small and medium-sized enterprises (SMEs)**, which are still the backbone of the European economy, **to large multinational**. SMEs could struggle to cope with the burden, potentially leading to a greater importance of large global companies, which are less influenced by the EU. This shift could undermine the intended objectives, particularly in the area of economic or corporate policy. There may be a slowdown in business dynamism as a result of a growth pattern favouring large, international companies, potentially hampering structural change.
19. Policies should minimise these risks. Firstly, an increase in fixed costs at company level must be contained. The best way to do this is to ensure that the overall cost efficiency of the monitoring system is maximised. Consider a network of M buyers in the EU and N sellers abroad. To achieve efficiency, it is obviously preferable to monitor the N potential sellers rather than the MxN potential bilateral relationships. In a global network where each of the K firms is potentially a buyer and a seller to every other firm, focusing on firms rather than relationships reduces the monitoring activities from $K \times (K-1)$ to K, i.e. almost to the square. In other words, **focusing on the nodes of the networks rather than on the links significantly reduces total costs, including the fixed costs of large customers. Lower costs imply that fewer EU importers withdraw from risky countries or concentrate their sourcing on fewer suppliers within the same country.**
20. Depending on the precise definition of high-risk sectors, ASCII estimates that the CS3D directly applies to approximately 20,000 EU-based companies under the CS3D. These companies are estimated to have 5 million suppliers along 9 million supply relationships. In addition, these companies will have to monitor their own supply chains. ASCII estimates that 30 million EU companies and virtually all global companies importing into the EU are no more than three levels away in the supply network from the original 20,000 companies, giving **a maximum of 900 million supply relationships that would need to be monitored** under CS3D. Note that firm-level tax data from Hungary also show that 30-50% of supply relationships exist for more than one year, suggesting a high degree of temporal stability in supply networks (Borsos and Stancsics, 2020). Therefore, it is likely that virtually all firms are still directly or indirectly exposed to risk in supply networks where links last at least one year, unless due diligence efforts focus on a small subset of links.
21. **Effectiveness is greatly increased by concentrating efforts on foreign suppliers.** A non-compliant supplier risks losing all buyers in the EU rather than just one. The risk multiplies the incentive for the supplier to comply due to the EU Single Market. ASCII estimates that there are approximately 750,000 supply links from non-European companies to companies to which the Directive applies.
22. **A certification system is needed** to move monitoring from the bilateral to the (monadic) supplier level. In principle, such certification can be at the country or company level and can be carried out by public authorities or specialised private companies. It can also result in a negative list (explicitly excluding certain countries or suppliers from supply chains involving EU companies) or a positive list (explicitly including certain countries or suppliers). For entities on a negative list, no bilateral due diligence is required because the potential suppliers are already officially banned from EU supply chains; for entities on a positive list, no bilateral due diligence is required because the potential supplier has already been cleared and declared "safe".
23. **Negative lists** should be drawn up and maintained by public authorities, e.g., a European version of the German Bundesamt für Wirtschaft und Ausfuhrkontrolle (BAFA), in accordance with legal requirements. Similarly, **positive lists** of countries would also be drawn up by public authorities. The negative listing of a country or a foreign company by an EU public authority would undoubtedly provoke political opposition abroad, including the risk of retaliation. This is not necessarily a disadvantage, as such possibilities require an analysis of the trade-offs involved. Moreover, in certain cases the politicisation of the process is to be welcomed. Leaving the decision whether or not to import from a particular country to EU importers, or to EU courts interpreting or ruling on the CS3D, removes geopolitical considerations from the debate, whereas it may be in the European interest to include them. For example, it may be politically desirable to continue sourcing from a high-risk

country if decoupling would cause the foreign government to change its allegiance. Different actors, from trade unions, business associations, NGOs to private individuals, should be allowed to provide information to the authorities responsible for maintaining and amending the lists.

24. **Positive lists at the company level could be drawn up by specialised private firms.** This would imply the creation of a certification market similar to the market for financial audits. Private firms would take on both public oversight tasks and liabilities. The certifying companies would have to be contracted by the EU authorities to carry out due diligence and issue a certificate for a certain period of time, exempting the foreign company's EU customers from carrying out bilateral due diligence. Such specialised firms would charge a fee for their services. Crucially, they would assume liability for their due diligence, so that EU importers themselves would be fully relieved. EU authorities would need to accredit and supervise such certification companies.
25. **Advantages of a supplier based positive-list approach:**
 - a. By effectively pooling the costs of due diligence, a positive list approach significantly increases the efficiency of the monitoring system as a whole. It also increases effectiveness because non-compliance by a single supplier leads to the delisting of that supplier for the entire EU market. This multiplies the incentives for compliance. As a result, both the **efficiency and the effectiveness of a system that focuses on the manufacturer is orders of magnitude higher than that of a system that focuses on the bilateral relationship.**
 - b. Once a supplier has been approved and certified, the European label can be used by importers anywhere in the world. Suppliers therefore have an interest in being certified and listed. This gives the EU measure much more clout, creating a desired '**Brussels effect**' (Anu Bradford, 2020). Without this mechanism, the CS3D strictly covers only those foreign exporters who sell to the EU.
 - c. A CS3D that allows companies to outsource liability to specialised certification firms would create a **European supply chain certification industry** that could set global standards and pursue opportunities in many economies and jurisdictions. The existing structure of comparative advantages puts the EU in a good starting position.
26. **CS3D, as presently envisaged, should apply in cases where a supplier is not included in either positive or negative lists.**

References

- Borsos, Andras, and Martin Stancsics (2020). Unfolding the hidden structure of the Hungarian multi-layer firm network. MNB Occasional Papers No. 139, Magyar Nemzeti Bank, Budapest, <https://www.econstor.eu/handle/10419/241068>.
- Bradford, Anu (2020). The Brussels effect: How the European Union rules the world. Oxford University Press, USA.
- Cherniwchan, Jevan, Brian Copeland, and Scott Taylor (2017), Trade and the Environment: New Methods, Measurements, and Results, *The Annual Review of Economics* 9: 59-85
- Felbermayr, Gabriel and Jasmin Gröschl (2013), Natural disasters and the effect of trade on income: A new panel IV approach, *European Economic Review* 58: 18-30 (<https://doi.org/10.1016/j.euroecorev.2012.11.008>).
- Feyrer, James (2019), Trade and income — Exploiting Time Series in Geography, *American Economic Journal: Applied Economics* 11(4): 1-35 (<https://doi.org/10.1257/app.20170616>).
- Feyrer, James (2021), Distance, trade, and income — The 1967 to 1975 closing of the Suez canal as a natural experiment, *Journal of Development Economics* 153: 102708 (<https://doi.org/10.1016/j.jdeveco.2021.102708>).
- Helpman, Elhanan (2021), *Globalization and Inequality*, Cambridge (MA): Harvard University Press (<https://www.hup.harvard.edu/catalog.php?isbn=9780674984608>).
- Helpman, Elhanan, Marc Melitz and Yona Rubinstein (2008), Estimating Trade Flows: Trading Partners and Trading Volumes, *Quarterly Journal of Economics* 123: 441–487 (<https://doi.org/10.1162/qjec.2008.123.2.441>).
- Hurt, Jan, Katharina Ledebur, Birgit Meyer, Klaus Friesenbichler, Markus Gerschberger, Stefan Thurner, and Peter Klimek (2023). Supply Chain Due Diligence Risk Assessment for the EU: A Network Approach to estimate expected effectiveness of the planned EU directive. Supply Chain Intelligence Institute Austria. Mimeo.
- Kolev, Galina V., and Adriana Neligan. (2021), Trade Effects of Supply Chain Regulations: Empirical Evidence from the Loi de Vigilance, Working paper, presented at the Research Conference on Sustainability of Global Value Chains, 7 December 2021.
- Melitz, Marc J. (2003). "The impact of trade on intra-industry reallocations and aggregate industry productivity." *econometrica* 71.6: 1695-1725, (<https://doi.org/10.1111/1468-0262.00467>).
- Meyer, Birgit, and Andreas Reinstaller (2022). Doing Well by Doing Good: Verantwortungsvolles Unternehmertum als Wettbewerbsvorteil österreichischer Unternehmen. No. 2022-04. FIW-Research Reports.
- Tichy, Gunther (2023), „Sic transit gloria, Europa?“, in: Michael Steiner Ed., WAS 116: transit, 2023, LitVerlag Münster/Wien, 67-78.
- United Nations (2011), *Guiding Principles on Business and Human Rights*, New York and Geneva (https://www.ohchr.org/documents/publications/guidingprinciplesbusinesshr_en.pdf)
- V-Dem Institute (2023), *Democracy Report 2023: Defiance in the Face of Autocratization*, University of Gothenburg (https://www.v-dem.net/documents/30/V-dem_democracyreport2023_highres.pdf).