Study on behalf of Gesamtmetall

Economic Evaluation of a Due Diligence Law

Final Report

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Kiel, 28 September 2021

This study is a translation of the original study that was written in German.

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Summary of the Results

This short report critically examines the Supply Chain Due Diligence Act (LkSG; in the following in short: Supply Chain Act), which passed the German Bundestag on June 11, 2021. Many of the observations are also relevant for corresponding European initiatives. Overall, the report concludes that the Supply Chain Act could have significant developmental side effects that diminish the intended positive impacts on the human rights and environmental situation in the countries concerned.

The core problem of the law is that additional costs and risks are imposed on domestic companies if they want to do business with suppliers in poor countries with weak institutions. These costs are largely independent of the turnover with the suppliers in question and are incurred per supplier relationship (key account). It can therefore be assumed that German buyers will reduce the number of suppliers from which they purchase primary products and withdraw completely from countries where conditions are suspected to be particularly problematic.

The law could hit small and medium-sized suppliers particularly hard, because too little turnover is made with them for the establishment of audit and control mechanisms or the costs of reporting to supervisory agencies to be worthwhile. In addition, German companies would withdraw from or adjust their purchasing volume in precisely those countries that could particularly benefit from participation in German industrial value-added networks. In other contexts, the importance of fixed market entry costs for firms' export and import behavior is empirically well established (Melitz and Redding, 2014; Bernard et al., 2018); therefore, the concerns expressed above are well founded. In terms of additional costs, it is not only the direct accounting effort that is relevant, but also the diffuse legal risk arising from the supply chain law.

Equally well documented is the fact that exporters of industrial inputs, especially from poorer countries trading with Germany or the EU, are positively selected firms from the formal sector (Bernard et al., 2018). In other words, such exporters pay higher wages, are more productive and innovative, pay higher taxes, and so on. While it is debatable how much of the positive effect is actually caused by exporting itself, it is undisputed that exporting opens opportunities of growth for the more successful firms. The growth of these firms benefits larger shares of the population, particularly in poor countries.

Should German companies withdraw as buyers from poorer countries, this would weaken the development-promoting integration of companies from poorer countries into international value chains. Research suggests that this can be associated with a reduction in real per capita income in poor countries (Ignatenko et al., 2019). The correlation of per capita income with many other development policy goals – such as moving away from child labor, a reduction in the informal sector, better employment opportunities for women, higher wages – is very high. Similarly, these variables are strongly positively correlated with indicators of de iure openness of economies. Both are shown in this study. It follows from the evidence that higher openness and higher per capita incomes are good predictors of good living conditions in poorer countries. In contrast, the International Trade Union Confederation's (ITUC) assessment of countries' working conditions correlates weakly or not at all with the outcome variables.

It follows from the analysis that good legislation on international supply chains should not increase the effective costs of trading with poorer countries, because otherwise there is a risk of counterproductive effects. The approach of a supply chain law, which is welcome from an ethical point of view, could thus become a questionable undertaking from the point of view of responsibility. The German Supply Chain Act and similar, even more far-reaching initiatives at EU level must therefore be classified as problematic.

This is not to be seen as a rejection of an active human rights policy that uses economic relations between European companies and suppliers from poorer countries as a lever for improving the situation in the latter countries. Instead, this report argues that a negative list approach is the better solution, as it would be both cheaper and more effective in strengthening human rights. Such an approach should therefore become the core of a European regulation.

1. Introduction and Motivation

In many countries, including Germany, and also at EU level, so-called supply chain laws are being discussed that oblige companies to monitor their suppliers with regard to compliance with human rights and environmental standards. This study examines the effects and side effects of such regulations and makes proposals on how the enforcement of international standards in supply chains can be achieved expediently while minimizing collateral damage. The focus of the analysis is on the German government's draft law on corporate due diligence in supply chains (Drucksache 19/28649) of 19 April 2021 (German Government, 2021), which was adopted by the German Bundestag on 11 June 2021 in an amended version (Drucksache 16/30505) (Bundestag, 2021).

At the latest since the formulation of the United Nations Millennium Development Goals (MDGs) in 2000 and their supplementation by the Sustainable Development Goals (SDGs) fifteen years later, life-saving and life-protecting production methods as well as respect for fair working conditions and wages have become the globally accepted benchmark for the sustainability of economic growth in general and world trade in particular. It is now an accepted standard that this benchmark should apply to all actors in all stages of the value chain around the globe, starting with the production of raw materials and ending with consumption by consumers.

However, it is also clear that neither the UN Guiding Principles on Business and Human Rights (UNGPs) (UN, 2011), nor the OECD rules on Due Diligence Guidance for Responsible Business Conduct (OECD, 2018a), nor the eight ILO core conventions on labor protection (ILO, 2021a; ILO, 2021b) have yet become justiciable and sanctionable rules at the multilateral level. International organizations lack the instruments of law enforcement; they rely on member states for enforcement. If a UN member state fails to implement the rules or implements them inadequately, the other contracting parties are left with sanctions, which relate to international trade in goods and services, capital movements or the mobility of natural persons. However, such sanctions regularly have the problem that not only the sanctioned state but also the sanctioning states suffer.

Early approaches, such as Art. XX in the GATT General Agreement on Tariffs and Trade, which laid down the preconditions for the use of trade-restrictive measures for the protection of nature and life (including the authorization of trade-restrictive measures against goods produced under prison labor), have not been able to create a breakthrough towards a global set of rules. The measures in this article were too closely tied to requirements of necessity and proportionality, while the protection of non-discriminatory global trade was the primary concern. With only one instrument, the tariff, and several objectives (freedom of trade, environment, life), the conflict of objectives and the inconsistency of measures were preordained.

For this reason, many established industrialized countries, also under pressure from non-governmental organizations, have taken two different approaches. The first approach makes use of the possibilities of international law and relies primarily on trade sanctions, positive and negative alike, to convince countries to comply with international standards; the second approach, on the other hand, starts with domestic companies and obliges them to monitor and, if necessary, sanction their trading partners under the threat of penalties.

In accordance with the first approach, governments are attempting to set binding targets for sustainability and fair working conditions in trade and investment agreements with emerging and developing countries, but also with other industrialized countries. More recently, and within the EU's sphere of responsibility, the EU's trade agreements with Japan, South Korea and the Latin American Mercosur group have been the model for this. In the Japan–EU Free Trade Agreement, for example, the contracting parties are explicitly obliged to comply with the ILO conventions and, if necessary, as in the case of Japan, to postpone the ratification process of two conventions that have not yet been ratified (European Commission, 2017). In the field of investment, the EU–China agreement, which was finalized at the end of 2020 and commits China to ratify two ILO conventions against forced labor, is likely to be important for future bilateral agreements on investment protection. The first path thus obliges the contracting states to observe sustainability goals.

The second way is through the adoption of national supply chain laws or, as in the case of the EU, a directive on due diligence in supply chains that is binding on all EU members. These laws are intended to oblige companies to make demonstrable and clearly documented efforts to encourage and monitor their suppliers to comply with international agreements on the protection of people and nature, and to disengage from them if they fail to do so.

France was the first country to introduce a supply chain law ("Devoir de Vigilance") for large companies (5,000 employees in France, 10,000 in France and abroad) in 2017 (République Francaise, Journal Officiel 2017). The law obliges companies to draw up their own company-specific list of possible risks from business operations ("risk mapping") that could lead to a violation of human rights and due diligence obligations. In addition, mechanisms are to be outlined that are suitable for remedying violations of due diligence obligations. The law covers all significant direct and indirect supply relationships and provides for a dispute resolution mechanism that also includes penalty payments. However, there is only an obligation to make efforts, not an obligation to succeed.

Initial results show weaknesses from the perspective of non-governmental institutions (Constitution Blog, 2020). Criticism is essentially ignited by the fact that the methodology and criteria of the risk assessment are in the discretion of the companies and are unclear. As of mid-2020, it was still unclear which companies were covered by the law. A quarter of companies had not yet submitted a risk assessment plan (Business-and-Human-Rights, 2019).

The United Kingdom (UK) (as of August 2020) is following two paths. It is planning a supply chain law which, however, is limited to the conformity of the use of renewable raw materials in the agricultural sector with national laws. The aim is to prevent the illegal deforestation of rainforests for the cultivation of plantation products such as rubber, palm oil, cocoa, coffee and soya (GOV.UK, 2020).

Secondly, the UK enacted legislation in 2015 requiring any company with a domestic turnover of more than £36 million to ban any form of slavery including human trafficking from its business (Modern Slavery Act) (LEGISLATION.GOV.UK, 2015). This Act was strengthened following a parliamentary review in 2019 to extend reporting requirements and remedies. In addition, public bodies with a budget of more than £36 million are now covered by the Act (Twobirds, 2020).

The Netherlands is planning a law specifically dedicated to the fight against child labor (*Wet Zorgplicht Kinderarbeid*). It is expected to come into force in mid-2022 (Allen and Overy, 2020).

Italy bases its supply chain law on a 2001 legislative decree on corporate liability, which provides for corporate liability in the event that human rights violations are committed by Italian companies operating abroad. This liability applies in particular to cases where violations of human rights have also been committed in Italy. To avoid liability, companies must prove that they have implemented programs that address the respect for human rights (ECCJ, 2019).

In Switzerland, a supply chain law that would have obliged companies in Switzerland to respect human rights and environmental protection by amending the Swiss constitution failed in a referendum on 29 November 2020 due to the so-called Ständemehr. The bill had already passed initial parliamentary hurdles in 2019 and also achieved a narrow majority in the popular vote. However, the additionally required majority of the 23 cantons was missed (Brot für die Welt, 2020).

At the EU level, the Council mandated the Commission at the end of 2020 to launch an EU action plan focusing on the sustainable design of global supply chains and the promotion of human rights, social and environmental due diligence standards and transparency. It also aims to present an EU legal framework for sustainable business management, including cross-sectoral due diligence requirements for companies along global supply chains. The European Parliament (EP) has already given its consent in principle to this and in March 2021 adopted recommendations for the drafting of an EP and Council directive on due diligence and corporate accountability (European Parliament, 2021a). As things stand, the Commission intends to present a proposal for a directive on "Sustainable Corporate Governance" in autumn 2021. Following the EP's objectives, the directive should cover both direct and indirect suppliers and also apply to listed small and medium-sized enterprises as well as to companies operating in high-risk sectors. These sectors are to be named later. Furthermore, in addition to due diligence obligations for the protection of human rights, environmental protection goals and goals of good governance are to be included.

For the metals tin, tantalum, tungsten, their ores and gold, a new EU regulation on conflict minerals has already come into force on 1 January 2021, with far-reaching inspection and due diligence obligations along the supply chain. It is intended to prevent European companies from participating in the extraction and processing of these metals if they originate from conflict regions in which human rights and environmental protection are violated.

The regulation is similar to the Kimberley ("blood diamonds") regulation, which aims to prevent the extraction of diamonds from conflict regions. It has also materialized in the US by Sec. 1502 Dodd–Franck Act of 2010, which requires American publicly traded companies to disclose their business activities related to the extraction of certain minerals and metals from the East African conflict states along the "Great Lakes", with a focus on the DR Congo thereby exposing them to public scrutiny. German companies that would be suppliers to these companies could be affected by these legal actions (BGA, 2010; European Parliament, 2020a).

In a different direction, various approaches based on the US Magnitsky Act of 2012 impose sanctions such as asset freezes on individuals and institutions (including companies) that violate human rights

(DOS, 2020). The UK and Canada have followed this Act, as did the EU in December 2020 with the so-called European Magnitsky Act (European Parliament, 2020b; Atlantic Council, 2020).

For Germany, a draft bill of the Federal Ministry of Labor and Social Affairs on corporate due diligence in supply chains has been available since 28 February 2021 (BMAS, 2021a). After being revised several times (BMAS, 2021b), it was forwarded by the Federal Government to the Bundestag in a letter dated 19 April 2021 (Printed Paper 19/28649) for adoption (German Government, 2021) and adopted by the Bundestag in the version amended by the Committee on Labor and Social Affairs (Printed Paper 16/30505) on 11 June 2021 (Bundestag, 2021).

The adopted law contains the following main points:

- It affects companies with headquarters or branches in Germany with initially (from 2023) 3000 employees; from 2024 the threshold is to be 1000 employees.
- It contains a list of 14 international standards for the protection of human rights and the environment with specifications from the UN, OECD, ILO and the EU. This is supplemented by a long catalogue of protective rights, e. g. on the minimum age of children in employment under national law or the ban on the export of hazardous waste.
- The company's responsibility includes its own business unit, all direct suppliers as well as indirect suppliers if the company has substantiated knowledge of an infringement by a supplier.
- It obliges companies to develop a risk management system, to carry out risk analysis and to draw up, implement and monitor preventive measures and take remedial action.
- In addition, a complaints procedure must be established and there are reporting and documentation obligations.
- The law provides for a catalogue of sanctions and a supervisory authority; details are still to be determined by ordinance.

The analysis of previous national proposals and laws on the due diligence obligations of companies to supervise their supply chains shows the following results, which are of importance for the recommendations for any actions at company and government level.

1. So far, the initiative on corporate due diligence with regard to the protection of workers' rights in supply chains has come from the European side. Neither the Asia–Pacific industrialized countries nor the emerging and developing countries worldwide have followed this initiative. With the Magnitsky Act, the USA, in contrast to the more ethical-humanitarianly rooted European initiatives, is primarily pursuing strategic-political and possibly economic-political goals in the national interest, but given the possibility of concrete sanctions against individuals and institutions (including companies) it is opening up options for alternatives to the European approaches. This is important insofar as European companies must expect competitive disadvantages in the short term compared to companies based in countries that do not pursue such initiatives. Such disadvantages can be derived from the operational and economic costs of implementing due diligence obligations. Long-term advantages as a "first mover" in sustainability goals are possible but uncertain.

2. Within the European initiatives, there are considerable differences in the group of companies affected, in the objectives and the scope of due diligence in the supply chains. Phased plans initially focus on large companies, which are later to be followed by smaller companies. The distinction between workers' rights and environmental protection is often just as vague as the distinction between production methods, which companies are most likely to be able to influence through their suppliers, and wage issues, where this influence is weaker, especially in developing countries with large informal labor markets. In particular, all initiatives neglect labor market conditions in developing countries. Regarding the scope of due diligence in supply chains, the German Supply Chain Act mainly obliges companies to monitor direct suppliers, while the European Parliament's legislative initiative report wants to extend this obligation to the entire supply chain. In addition, good corporate governance is also to be included in the catalogue of objectives, alongside the enforcement of environmental standards. These differences in national initiatives could alter the conditions of competition between companies from different EU countries, just as a strict EU supply chain directive could worsen short-term competitive conditions between EU companies and competitors from third countries. None of the legislative initiatives take into account the specific conditions of companies in the Covid-19 pandemic. The EU Parliament's Trade Committee has clearly addressed these conditions in its opinion on the proposed EU Directive in that "*the EU economy is facing the greatest global economic crisis since the Great Depression of the 1930s and businesses across Europe are particularly hard hit*". It "*stresses that, in particular at this stage, no legislative initiatives of an economically inhibiting or damaging nature should be launched, such as those that create a greater administrative burden or lead to legal uncertainty.*" (European Parliament 2021b, A9-0018,73)
3. The European initiatives do not distinguish between supply chains that operate within the internal market, and are thus subject to the labor and product standards agreed at EU level and thus give rise to a duty of care on the part of the EU institutions, and those that operate in trade with companies outside the EU internal market. Such a distinction would be very useful and the EU Conflict Minerals Regulation could serve as a model here.
4. All the initiatives limit their comments on costs to accounting costs, estimate them very low and completely neglect economic costs. In particular, it is disconcerting that the initiatives envisage ongoing dynamization or updating without taking into account that both technological change and changes in the trade policy framework and geostrategic challenges also require constant change in the length and composition of supply chains. This change is likely to bring new suppliers into the market, whose verification by European companies of compliance with labor rights and environmental protection is likely to be considerably more cost-intensive than the verification of long-standing suppliers.
5. Formulations on due diligence and liability are vague in terms of their reach across the supply chain or only to direct suppliers, and open up considerable potential for legal conflict.
6. A study commissioned by the EU Commission on various options for the exercise of due diligence by companies from the point of view of more than three hundred companies surveyed and almost three hundred business associations and non-governmental organizations of civil society (NGOs) surveyed confirms, firstly, an increasing transposition of the international guidelines into national law in the EU member states, secondly, a quite discernible willingness

on the part of companies to enter into further obligations on the basis of due diligence obligations already entered into on their own initiative, primarily with the aim of gaining reputation and market share, thirdly, greater resistance on the part of business associations to further legally anchored due diligence obligations compared to the statements of individual company representatives, and fourthly, a clear preference on the part of NGOs for legally – anchored obligations on the part of companies that are as far-reaching as possible (European Commission, 2020).

7. The above-mentioned study of the EU Commission limits its analyses to the question of the obligations of companies and EU member states and does not take into account obligations of countries outside the EU, although those are the countries that are responsible for the working and environmental conditions of all employees working in their areas of application, including those working in informal labor markets. Nor does it address how EU-based companies can remain competitive after due diligence is enforced against competitors from countries that do not have due diligence laws and therefore continue to do business with suppliers that demonstrably ignore human rights and environmental protection.

Conclusion: Overall, the initiatives reveal both a poor knowledge of the complexity of supply chains (actually, they are typically networks) and of the conditions on labor markets in poor countries, as well as a lack of willingness to work together with the governments of the countries of origin of suppliers, especially from developing countries, to develop and implement consensual minimum rules for workers' rights and environmental protection in global supply chains. Options and alternatives are only discussed within the narrow framework of national supply chain laws.

The so-called "economic impact" analysis in the legislative initiatives remains in the accounting area of the time spent on controls and ignores possible changes in production technologies, the length and diversity of supply chains and the spatial structure of trade flows. Economic losses in supplier countries, which are quite possible, are obviously not the subject of the due diligence obligations of the governments of the EU countries. The latter must therefore face the criticism that supply chain laws are becoming an instrument to correct failures and abuses in developing countries from their point of view and thus also to relieve the governments of these countries of some of the responsibility for their own policies.

2. International Division of Labor and Economic Development

2.1 The Integration of Developing Countries into the International Division of Labor: On Average a Success Story

The integration of developing countries into the international division of labor has not been an uncontroversial development strategy in the post-war period and to some extent even until very recently. For a long time, the academic and political discussion was dominated by the export-pessimistic theses of the "dependencia" theory and the long-term deterioration of the terms of trade to the disadvantage of the commodity-producing developing countries. The academic discussion was shaped by economists such as Hans Singer (1950), the creator of the Prebisch–Singer thesis together with the first Secretary-General of the UN Conference on Trade Raúl Prebisch (1950), and John Spraos (1980). They were followed by social scientists such as André Gunder Frank, Samir Amin, Paul Baran, Paul Sweezy, Giovanni Arrighi, Immanuel Wallerstein and Johan Galtung. Above all, however, the Nobel Prize winner in economics, W. Arthur Lewis, dominated the economic debate for a long time.

In his Nobel Prize Lecture in 1980, he still saw the fate of the developing countries as traditional suppliers of raw materials tied to the declining growth of the industrialized countries as the only major demanders, spoke of a decoupling of industrialized countries and called for more South–South trade protected from the competition of the industrialized countries (Lewis, 1980). He and others propagated a strategy of import substitution (IS) for developing countries based on the old infant industry argument.

On the political level, the academic demands for decoupling (independent of the special case of Cuba) were essentially taken up and politically implemented by Latin American politicians such as former presidents Juan Perón (Argentina) Henrique Cardoso (Brazil), Rafael Correa (Ecuador), Evo Morales (Bolivia), Alan García (Peru), Salvador Allende (Chile) and in sub-Saharan Africa by Julius Nyerere, the first president of Tanzania ("collective self-reliance"). Studies by the Club of Rome (1972) and the Brandt Report (1980) "North–South: A Programme for Survival" followed the export-pessimistic view.

The instruments of import substitution included not only tariff barriers such as high nominal tariffs, but also high so-called effective tariffs in favor of the final processing stages thanks to increasing nominal tariffs with increasing degree of processing. If this was no longer sufficient to protect local production from import competition, IS was pursued excessively. Quantitative import restrictions and even temporary import bans were imposed, and financial barriers to the import of competing goods (e.g. the requirement to establish interest-free advance import deposits) or skewed exchange rates were introduced to the detriment of imports and the advantage of exports. Overall, import protection acted as an implicit tax on exports (Clements and Sjaastad, 1984).

The effects of excessive import substitution were, in addition to the export weakness

- High unemployment, because protection subsidized the less abundant factor of capital in developing countries, thus favoring capital-intensive modes of production;

- Overcapacity, which became apparent more quickly in smaller economies with a weaker domestic market than in larger economies with absorptive domestic markets, but originated also in these markets lately;
- Balance-of-payments problems because weak exports were accompanied by high demand for labor-saving capital goods from industrialized countries;
- Divisions in society between a small, highly protected and thus privileged workforce in the formal sector and the army of unprotected workers in the informal sector;
- Lack of learning curves as a result of the disconnection from world markets and their know-how.

Mainly, the commodity-intensive developing countries of Africa and Latin America, plus India, adopted this strategy, reinforced by occasional episodes of commodity price hikes and their negative exchange rate effects on the export competitiveness of the non-traditional industrial goods sector ("dutch disease"). It is therefore no surprise that the aftermath of the oil price shocks of the 1970s and the subsequent debt crises primarily affected countries based in Latin America. They remained exposed to the so-called resource curse.

The East and Southeast Asian countries (initially Singapore, South Korea, Taiwan, Hong Kong, followed by Malaysia, Thailand, Indonesia, the Philippines, and later Vietnam, Cambodia and Laos) behaved quite differently. Under the influence of investments from Japan, which wanted to open up world markets from these countries with their own finished goods-related industrial production, they lowered their nominal tariff barriers, equalized tariffs between processing stages, and thus reduced the difference between the higher effective tariffs and the lower nominal tariffs. They also introduced temporary subsidies strictly linked to export performance and reduced non-tariff barriers. The fact that they relied heavily on the "learning on the job" factor and thus on high employment effects of their industrial policy as well as on high educational achievements boosted their chances on world industrial goods markets beyond the effects of trade policy.

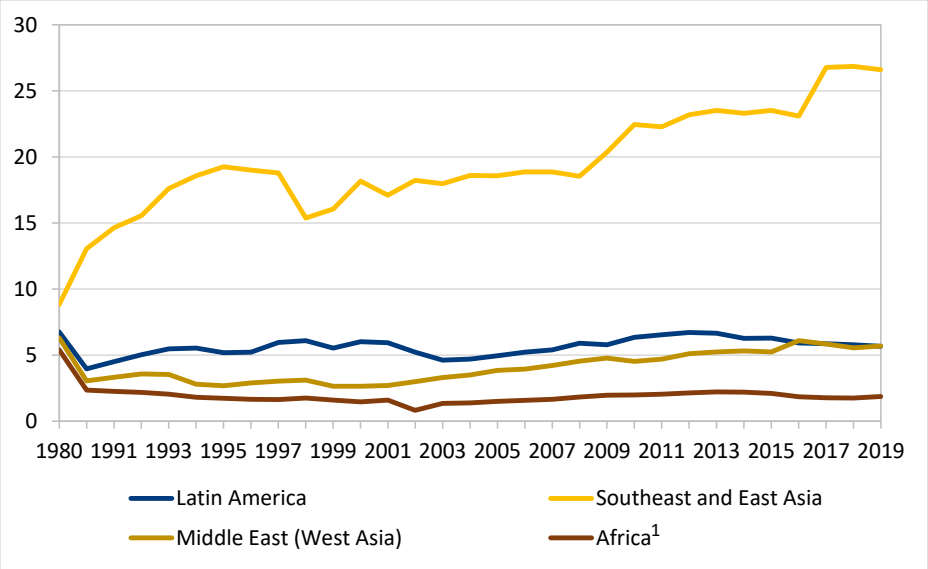
A much-cited study by World Bank economist David Morawetz (1981) entitled "Why the Emperor's New Clothes Are Not Made in Colombia: A Case Study in Latin American and East Asian Manufactured Exports" summed up the difference in the industrialization strategies of the two major developing regions. Cultural differences such as higher manual dexterity in Asia (important in the garment industry), higher work ethic and discipline in Asia, or different levels of investment propensity (shaped by different domestic savings rates) complemented the different incentive signals emanating from import substitution and export diversification. Numerous country studies published by the World Bank in the 1980s under the leadership of the American economists Anne Krueger (1983), Jagdish Bhagwati (1991) and Balasubramanyam and Salisu (1991) (also with the participation of the Institute for the World Economy) deepened Morawetz's findings.

In a comparison of these two developing regions, the Middle East (West Asia) and sub-Saharan Africa remained in the traditional pattern of commodity suppliers and were closer to the Latin American than the East Asian model in all key parameters such as savings and investment rates.

However, the country studies also showed that many developing countries were able to learn from the mistakes of excessive IS and reduce the negative incentives against export diversification with their own trade liberalization. Turkey stands as an example of successful course changes. Often the linking of countries to important markets in the industrialized countries with the help of free trade agreements (such as Mexico to the USA, Turkey to the EU, the ASEAN countries to Japan) also helped. South–South agreements of their own, most of which exist on paper in sub-Saharan Africa, have never been able to match the trade-stimulating effects of South–North agreements. They also often remained stuck in the announcement phase.

Between 1980 and 2019, the share of Latin American countries in world manufactured exports fell from 7 % to 6 %, but that of Asian countries rose from 9 % to 27 %. Middle Eastern (West Asian) countries remained in the 5–6 % range, and sub-Saharan African countries in the 1–2 % range.

Figure 2–1: Share of Developing Regions in World Industrial Goods Exports 1980-2018.



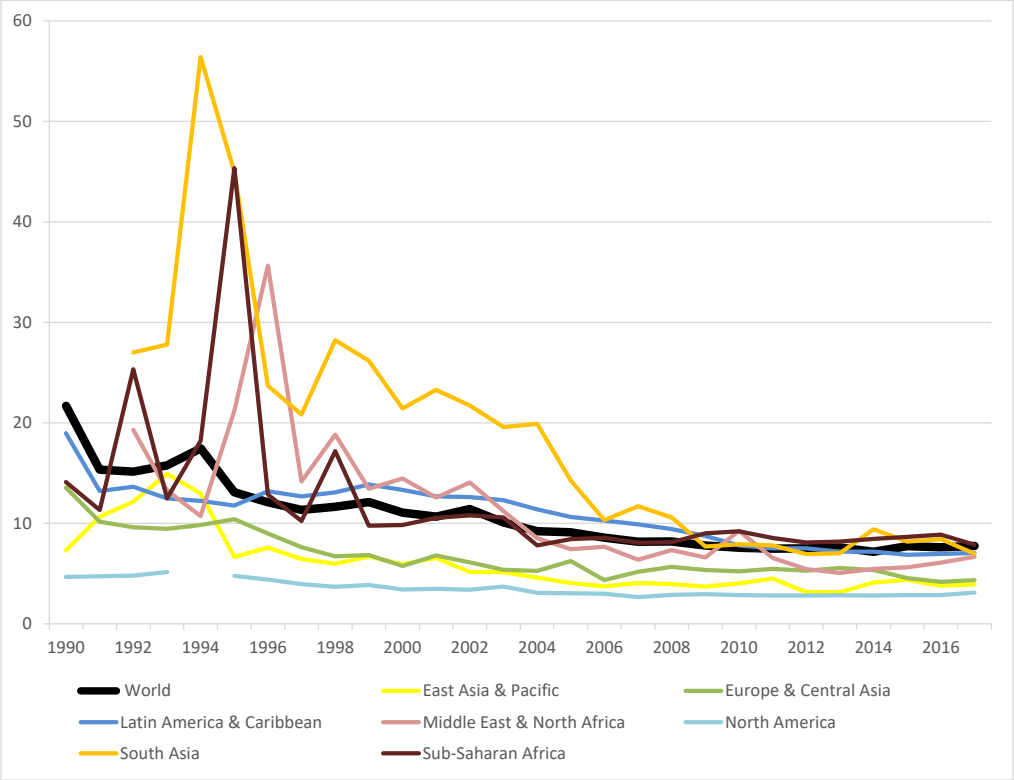
Note: In percent. (1) Africa as of 2002 Sub-Saharan Africa. SITC 5 + 6 + 7 + 8 -67 – 68

Source: UN, Monthly Bulletin of Statistics, various years.

Roughly speaking, African developing countries remained exporters of mineral raw materials, Latin American developing countries exporters of mineral and agricultural products, the West Asian developing countries exporters of energy raw materials, while only the Southeast and East Asian developing countries made the leap into the category of industrial goods suppliers. It is undisputed that China played a major role in this leap after its opening (after 1978). Among the South Asian countries, only Bangladesh managed to become a noteworthy supplier on world markets in the textile and clothing sector. India remained a country divided in its external orientation. A small, highly competitive business services sector contrasts with a manufacturing sector paralyzed by high market access barriers and a lack of competitive pressure, along with an agricultural sector that is still barely competitive.

It fits into this picture that African countries (together with South Asian countries) continue to have the highest tariff barriers and Asian countries the lowest, even after strong tariff reductions in 2017.

Figure 2–2: Weighted Average MFN Tariff, 1990–2017.



Source: WITS (2021).

By income category, low-income countries and South–South trade had the highest tariff levels and high-income countries and North–North trade had the lowest levels (Espitia et al., 2018). This is true for tariffs on an MFN basis as well as for tariffs taking into account trade agreements (preferential tariffs).

The evidence thus shows that three out of four major developing regions (Africa, Latin America and the Middle East) remain trapped in the old division of labor as commodity producers or suppliers of commodity-related products, and only the fourth region (Southeast and East Asia) has advanced to become an important supplier of industrial goods. Of course, the countries of the Middle East in particular have been able to profit from their role as suppliers of energy-related products and, especially the Gulf states, have thus acquired wealth. To the extent that they are open to workers from other regions, these can also benefit from this prosperity through guest worker remittances.

However, sustainable prosperity for broad sections of the population has only been achieved by those countries that have integrated themselves into international supply chains with industrial goods, mostly finished goods, for the production of which they import inputs from other countries. Countries that allowed tariff escalation to shrink and thus did not excessively protect the last stages of the value chain before the final product had advantages in this respect. The World Development Report 2020 (Figure 9.5) shows that while all countries had this escalation effect in their tariffs, the level of tariffs on raw materials, intermediate goods and final goods was by far the highest in low-income countries.

This made it more difficult for these countries to participate in international supply chains and excluded them from the growth of world trade in recent decades, as this growth was mainly based on

intermediate goods trade rather than final goods trade. It can be shown that the early growth of world trade in final goods benefited greatly from falling border costs. These included falling tariff and non-tariff barriers. It is estimated that since the 1970s these costs have fallen by about 13 % per year for manufactured goods, but by only 8 % per year for intermediate goods. This difference can be explained by the fact that finished goods trade bears the full cost of tariff and non-tariff barriers to inputs, while intermediate goods trade, with fewer inputs, bears more the cost of coordinating the production process. As trade policy barriers were dismantled, finished goods trade thus lost one of its main stimulants to intermediate goods trade (Franco-Bedoya and Frohm, 2020).

Significant advances in logistics technology, such as containerization and port expansion, as well as falling information costs thanks to increasingly efficient information and communication technology (ICT), have opened up opportunities for many developing countries to become part of the supply chain. Linkages with developed countries through bilateral free trade agreements have been another driving force, especially when they have included other elements of economic and technological cooperation and assistance in addition to lowering border crossing costs.

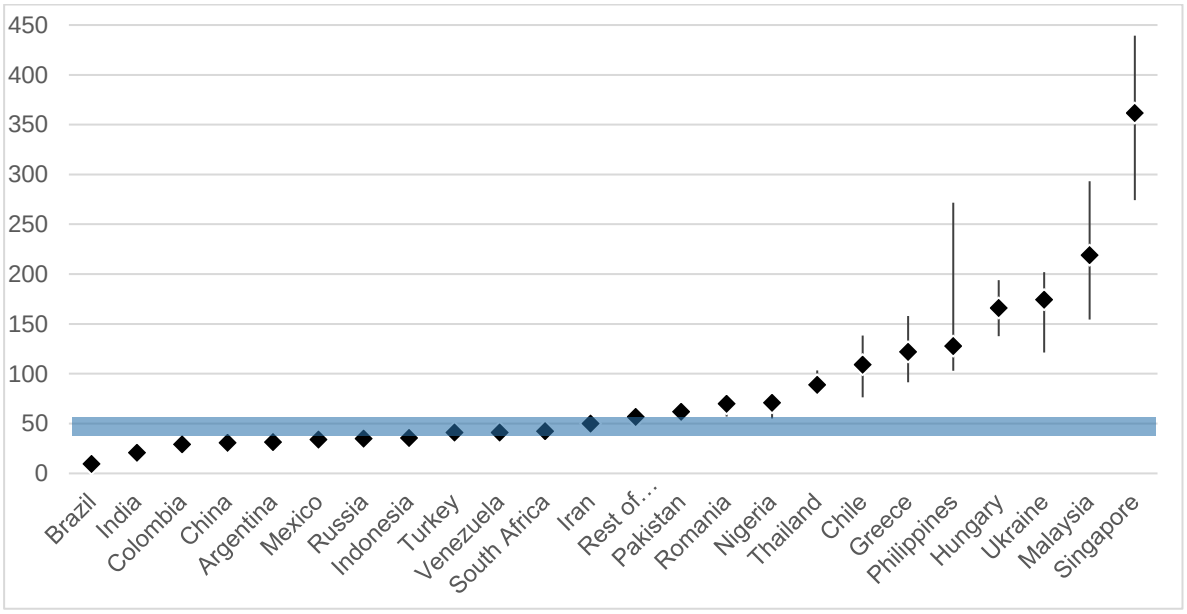
Baldwin (2016) calls this the second unbundling, after the first unbundling of production and consumption. This progress was necessary but not sufficient. Without economic policy efforts of their own, such as fiscal and monetary discipline or the establishment of special economic zones and export processing zones, whose preferential trade treatment was only successful if the distance to trade policies relevant for the rest of the country could be kept as small as possible, even logistical progress could have had little effect.

WTO research (Hollweg, 2019) on the evolution of developing country participation in supply chains from 2000 to 2017 distinguishes (a) by geographic region and (b) by supply chain direction (towards final product: forward linkages, towards raw material (backward linkages) and (c) by level of complexity (simple supply chain with single border crossing or complex supply chains with more than one border crossing).

The regional breakdown shows the significant growth of supply chains in the Asian region ("Factory Asia") compared to the pre-financial crisis dominance of supply chains in Europe ("Factory Europe") dominated by supply chains between Western and Central Europe and North America ("Factory North America") dominated by the three NAFTA members Canada, Mexico and the US (WTO, 2019: 19 ff., Figure 1–10). This increase in the importance of supply chains in the Asian region is mainly due to the growth of intra-regional trade in Asia, rather than inter-regional growth, which has tended to benefit the other two spaces in trade with Asia. In this context, an increase in the importance of complex supply chains can be observed. A characteristic feature of trade in Asia, in addition to the important intra-regional trade, is the larger integration of lower middle-income countries.

Overall, it can be seen that the prosperity of small poor countries in particular is very much dependent on their involvement in international trade. For example, in a study of 50 countries, Ossa (2015) shows that median real per capita income is almost 56 % higher than in a world without trade. However, the extent of trade gains varies widely across countries, as illustrated in Figure 2–3 for selected poorer countries.

Figure 2–3: Per Capita Income Gains from Trade, in %.

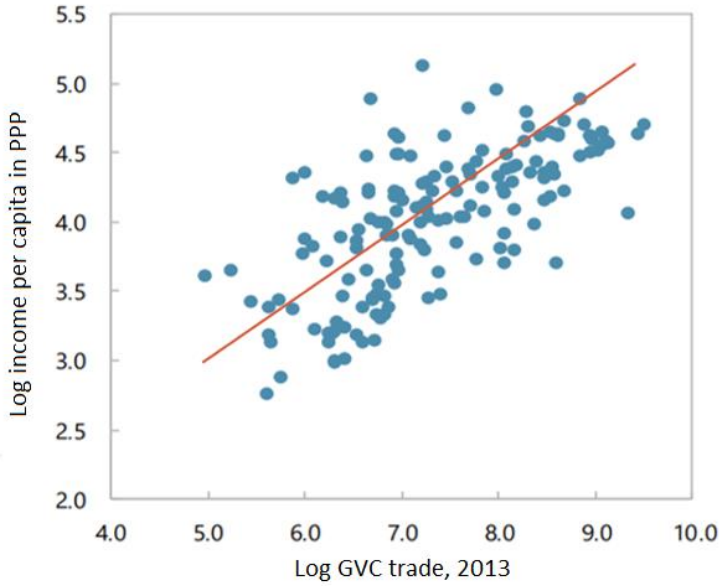


Note: Point estimate and 95 % confidence interval. The blue area indicates the median value. Germany is around 40 %.

Source: Ossa (2015). Own representation.

There is also a strong positive correlation between a country's involvement in global value chains and per capita income, as Figure 2–4 illustrates. Ignatenko et al. (2019) show a significant positive correlation between a country's share of trade via global value chains, per capita income and investment.

Figure 2–4: Global Value Chains and Per Capita Income



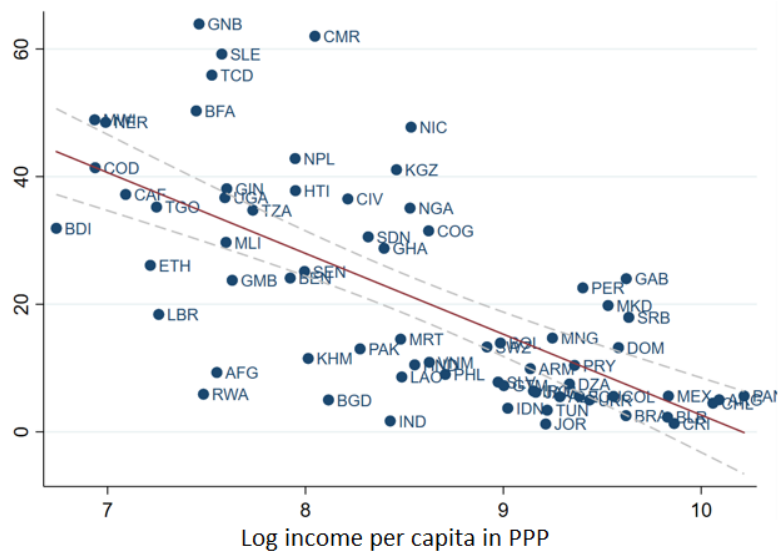
Note: Global Value Chains (GVC) trade on the X-axis, per capita income (in purchasing power parity) on the Y-axis.

Source: Ignatenko et al. (2019), 189 countries / 26 sectors based on EORA.

The level of per capita income in turn correlates strongly with other indicators that are relevant in relation to human rights. For example, Figure 2–5 shows a significant negative correlation between the level of per capita income and the proportion of working children in the population of 7–14 year olds for 69 poorer countries. According to a simple linear regression, a doubling of per capita income is associated with a decline of 8.78 percentage points in the share of child labor. While this simple analysis does not prove a clear causal relationship, it does make clear that the overall level of prosperity of an average country is clearly related to the fight against child labor. Closer integration of poorer countries into global value chains, which has been shown to promote this prosperity, should therefore definitely continue to be pursued if child labor is really to be combated.

A consideration of the average per capita income of a country may neglect inequality. Another indicator worth looking at in this context is therefore the poverty rate. It measures the proportion of people with a labor income of less than USD 1.90 per day. As shown in Figure 2–6 there is a strong positive relationship between poverty rate and child labor. Thus, a halving of the poverty rate is associated with a decrease of 3.42 percentage points in the share of child labor. It can therefore be concluded that a sustainable fight against poverty, for example by increasing the involvement of the countries concerned in international trade, should also go hand in hand with a reduction in child labor.

Figure 2–5: Child Labor and Per Capita Income



Note: Proportion of working children in the population of 7–14 year olds (Y-axis) as a function of per capita income (X-axis). 69 poorer countries for which data are available in the period 2010 – 2019.

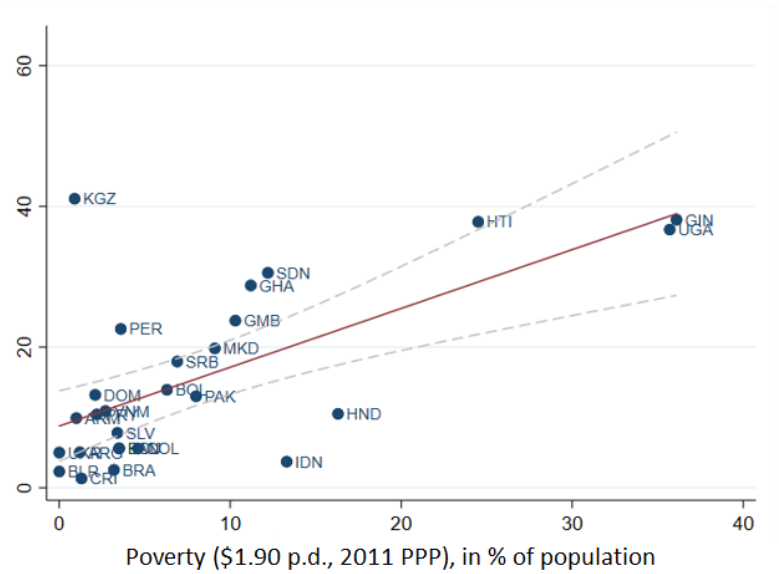
Source: World Development Indicators, World Bank (2021), own calculations and illustrations.

Following the above line of reasoning, it is hardly surprising that both poverty and child labor correlate negatively with the openness of an economy as measured by the KOF de iure Globalization Index. Thus,

a 10-point increase in openness is associated with a 9.2 percentage point decrease in a country's child labor share (Figure 2−7) or a 7.5 percentage point decrease in the poverty rate (Figure 2- 8).[1]

The share of women in precarious employment also correlates negatively with the degree of openness (Figure 2−9). The same applies to the share of employees outside the formal sector, which also correlates significantly negatively with the degree of openness of an economy (Figure 2−10). A higher degree of openness is also associated with better control of corruption (Figure 2−11) and the rule of law (Figure 2−12) among the poorer countries surveyed.

Figure 2−6: Child Labor and Poverty

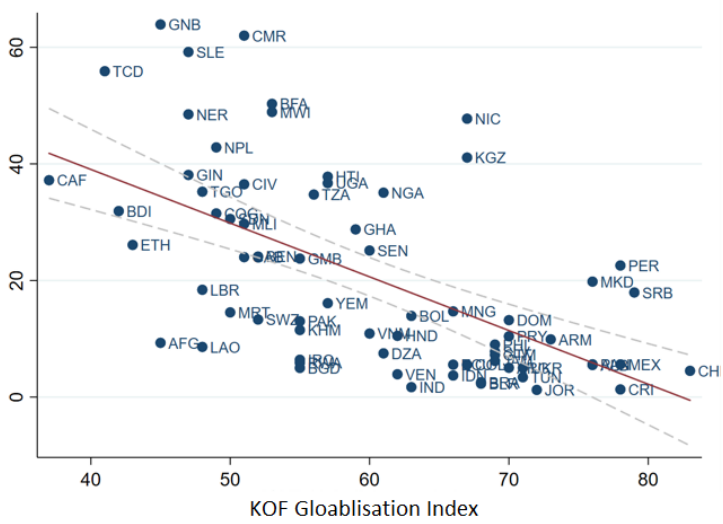


Note: Proportion of working children in the population of 7−14 year olds (Y-axis) as a function of the poverty rate (proportion of people with a labor income of less than USD 1.90 per day in purchasing power parities, X-axis). 27 poorer countries for which data are available in 2010 – 2019.

Source: World Development Indicators, World Bank, own calculations and illustrations.

[1] Other measures of openness or other subcomponents of the KOF Index have quite similar effects. It is important, however, that the value of international trade as a percentage of GDP is not used as a measure of openness; this indicator is highly distorted by price effects, especially for developing countries; see Alcala and Ciccone (2004). The KOF's de iure indicator does not have this problem.

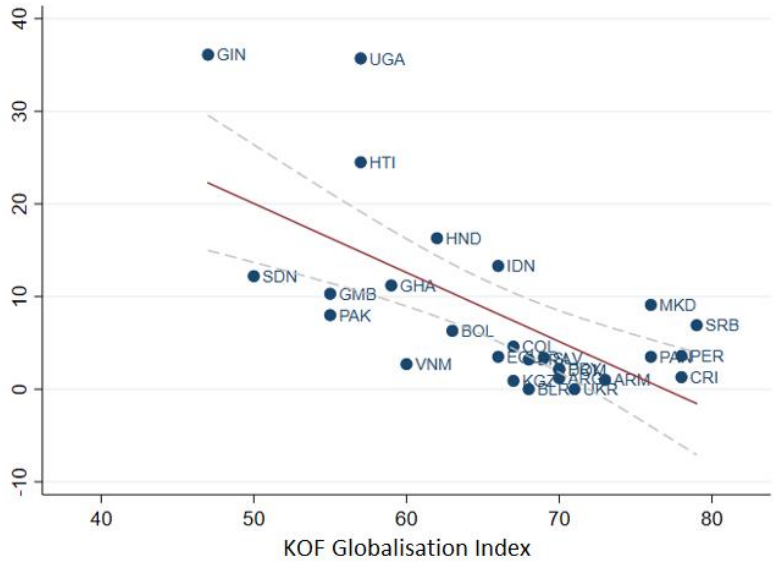
Figure 2–7: Child Labor and Openness



Note: Proportion of working children in the population of 7 to 14-year-olds (Y axis) and KOF de iure globalization index (X axis). 69 poorer countries and KOF Globalization Index for 2015.

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

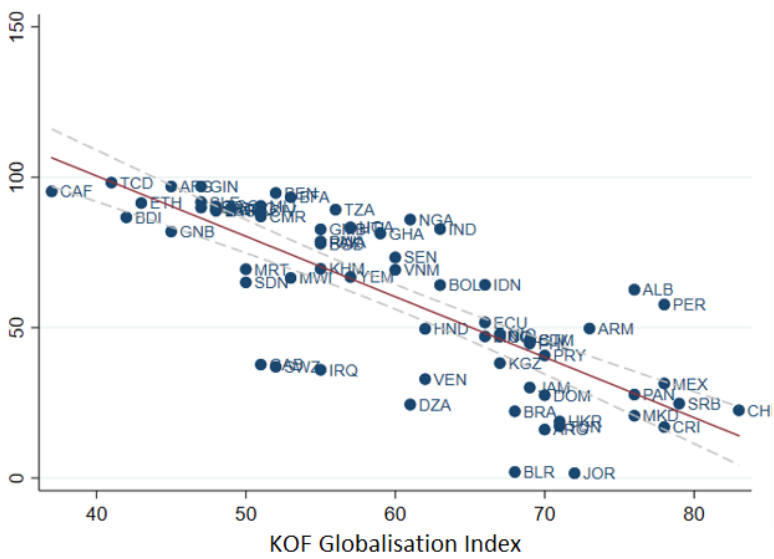
Figure 2- 8: Poverty and Openness



Note: Proportion of people with a labor income of less than USD 1.90 per day in purchasing power parities, (Y-axis) and KOF de iure Globalization Index (X-axis). 27 poorer countries for which data are available in 2010 – 2019.

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

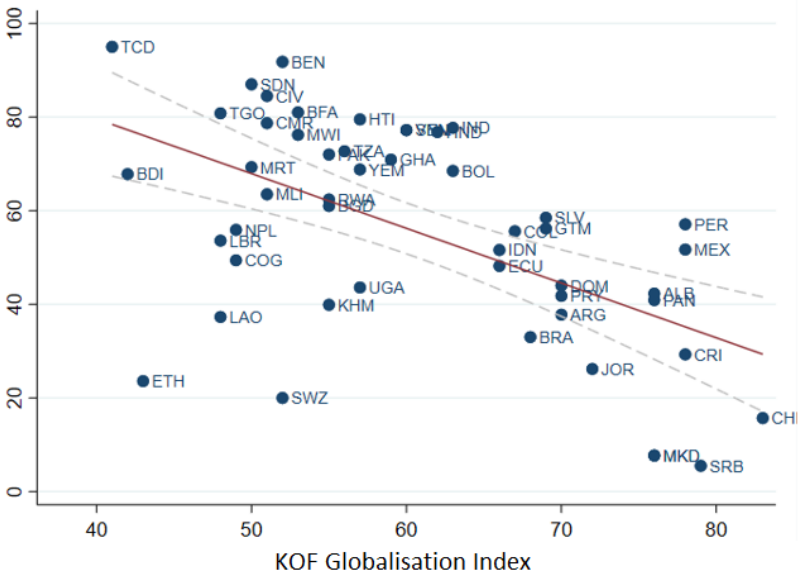
Figure 2–9: Precarious Female Employment and Openness



Note: Share of women in total employment of women who are precariously employed (ILO estimate, (Y-axis) and KOF de iure globalization index (X-axis). 70 poorer countries for which data are available in 2010 – 2019.

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

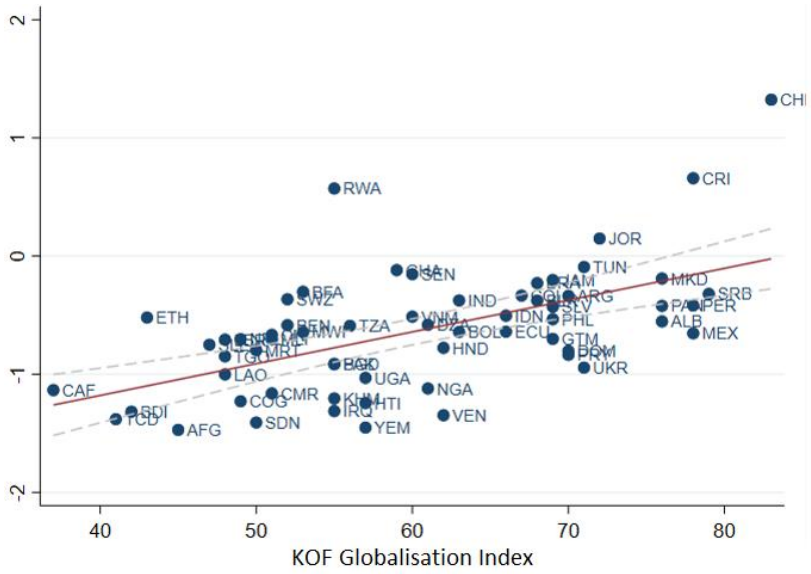
Figure 2–10: Proportion of Employees Outside the Formal Sector and Openness



Note: Share of employees outside the formal sector (Y-axis) and KOF de iure globalization index (X-axis). 50 poorer countries.

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

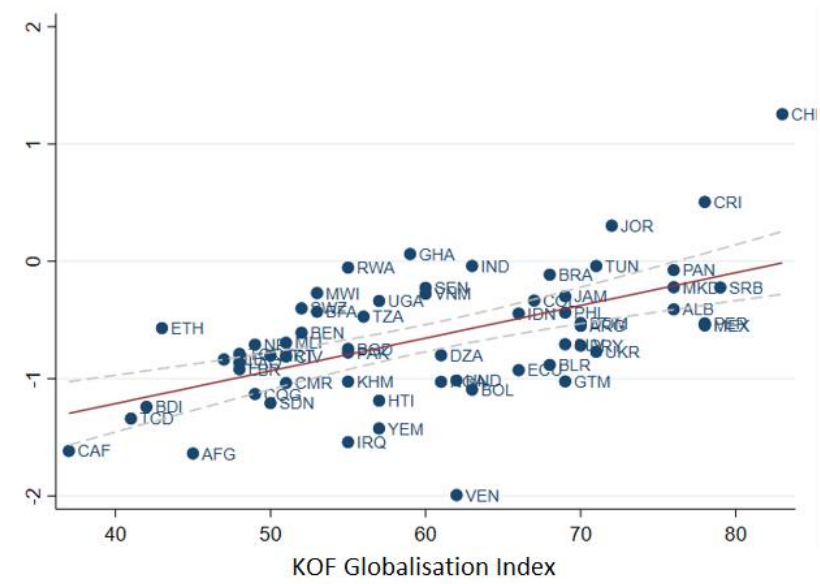
Figure 2–11: Corruption Control and Openness



Note: Degree of corruption control (Y axis) and KOF de iure globalization index (X axis). 61 poorer countries

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

Figure 2–12: Rule of Law and Openness



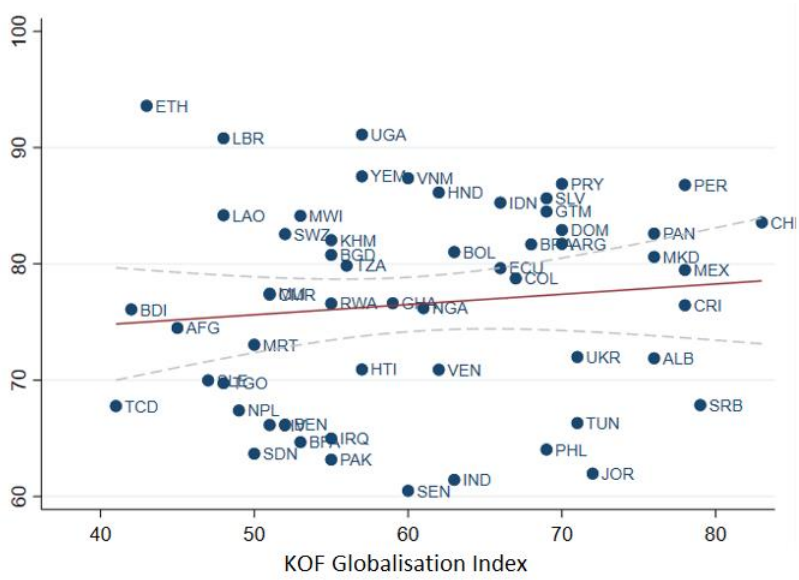
Note: Degree of rule of law (Y axis) and KOF de iure globalization index (X axis). 61 poorer countries

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

While the share of the labor force with advanced education is positively associated with a country's degree of openness, the correlation is not statistically significant (Figure 2–13). This may be surprising at first sight, but it ignores differences between exporting and non-exporting firms within the same country. For example, Bernard and Jensen (1995) and Bernard et al. (2007) show that exporting firms pay higher wages on average than those firms that only serve the domestic market (see also Section 3.2). Moreover, these firms employ more workers with advanced education (Verhoogen, 2008).

Interestingly, for the poorer countries considered, there is no statistically significant relationship between child labor and democracy (Figure 2−14) and a negative relationship between press freedom and the degree of openness (Figure 2−15).

Figure 2−13: Workers with Advanced Education and Openness



Note: Share of employees with advanced education (Y-axis) and KOF de iure globalization index (X-axis). 56 poorer countries

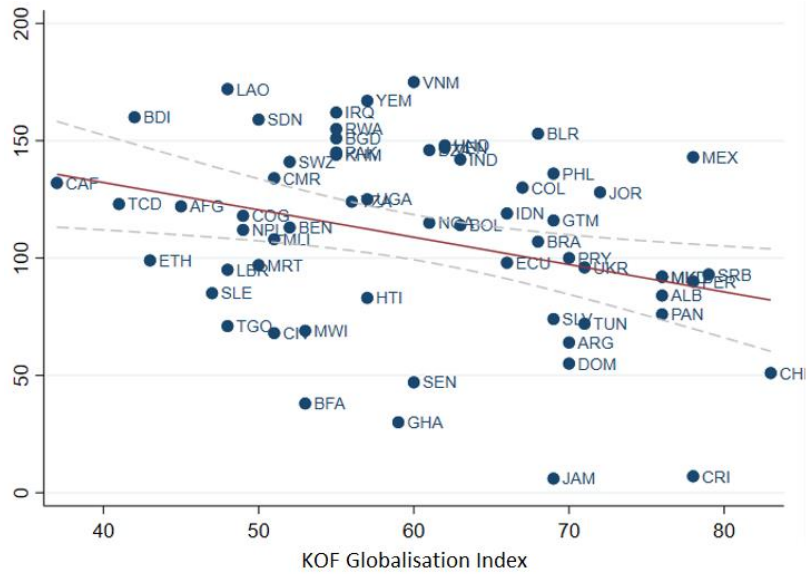
Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

Figure 2−14: Child Labor and Democracy

Note: Proportion of working children in the population of 7- to 14-year-olds (Y axis) and Polity Index (autocracy vs. democracy, X axis). 69 poorer countries, plus Polity Index for 2015.

Source: World Development Indicators, World Bank, own calculations and illustrations.

Figure 2–15: Freedom of the Press and Openness



Note: Degree of press freedom (Y axis) and KOF de iure Globalization Index (X axis). 62 poorer countries

Source: World Development Indicators, World Bank, KOF, own calculations and illustrations.

To sum up, the following lessons can be drawn from the experience of developing countries with their integration into the global division of labor:

1. The study clearly shows that those developing countries that were already prepared half a century ago to open up both as a location and a target market for non-traditional production, i.e. industrial goods later services, were able to achieve greater prosperity and faster economic and social advancement. Geographically, this group can be located in East and Southeast Asia (first South Korea, Taiwan, Singapore and Hong Kong, followed by ASEAN countries Malaysia, Indonesia, Philippines and Thailand. Other countries such as Vietnam and Bangladesh are also trying to follow this path. These countries have managed to strike a relatively stable economic policy balance between production for the domestic market and the export market, visibly improve the skills of the workforce through investment in education, and successfully attract FDI after a period of reluctance to do so. A strong private-sector momentum of risk-taking and profit orientation has also shaped large segments of domestically oriented investors in these countries.
2. Set off against this group of countries are most Latin American countries, parts of South Asia with India as an anchor country, and most African countries with the exception of the North African Maghreb countries (Morocco, Algeria and Tunisia), which have historically had close ties with the EU. Latin American countries, which became independent as early as the 19th century, came under the influence of the export-pessimistic "dependencia" theory after the Second World War, which propagated an import substitution (IS) strategy, sought regional instead of global markets, and gave wide scope to the so-called infant industry argument. These countries benefited episodically from commodity price increases, but failed to isolate these temporary income gains in their effects on price stability and lapsed into debt crises and social conflict in the 1970s. To the extent that they had large domestic markets (Brazil, Mexico), they were able

to delay the harmful effects of excessive IS for a time, especially as foreign investment concentrated on supplying the domestic market. Special trade policy regimes (e.g. passive wage processing), as in Mexico with its maquiladores industries, created trade-segregated spaces within countries. In these countries, IS favored the emergence of a 'labor aristocracy' in protected industries, opposed by a large 'industrial reserve army' in informal labor markets. Social inequalities are still a defining feature of Latin American countries today

3. After gaining independence, the African countries have hardly been able to follow in the footsteps of the Asian countries, which have outgrown the production of labor-intensive, simple industrial goods in terms of costs. Together with India, they still maintain the highest level of protection, unsettle foreign investors (with the notable exception of China) due to a lack of legal certainty, high levels of corruption, high productivity-adjusted production costs, insufficiently skilled labor, infrastructure in need of improvement, and high transaction costs in neighboring trade, and therefore remain exposed to the volatility of commodity markets. Environmental problems, climate change and increasingly volatile rainfall conditions, together with high population growth, leave little room for sustainable agriculture.
4. Demand-side benefits (non-reciprocal tariff preferences and development cooperation) were not able to compensate for the supply-side disadvantages mentioned under (3). However, it is also undeniable that these benefits were seen as “gifts” and often remained materially limited and/or benefited the donors rather than the recipients.
5. As a result, only one developing region (East and Southeast Asia, even without China) has been able to gain an increasing share of world industrial goods exports (of more than a quarter, including China), while the other three regions (Latin America, Africa and the Middle East) have so far stagnated in their shares at a low level. Sporadic successes in the services sector (e.g. tourism in East Africa, transport services from the Gulf region or business services in India) have lagged far behind what has become the most important source of income in many developing regions: remittances from migrant workers.
6. Germany is an important destination market for many developing countries. Here, however, the expected picture also emerges. The contribution of German final demand to value added in the developing countries is highest in the Asian countries and lowest in the Latin American countries. The African countries do not play a role.
7. Many of the key indicators measuring respect for human rights, particularly in the social sphere, correlate positively with per capita income or openness. There is a risk that reducing the globalization gains of developing countries will not improve the overall situation on these countries.

2.2 Working Conditions and Workers' Rights in Host Countries of German Direct Investment and Supplier Countries

The German Supply Chain Act is based on the various guidelines of the United Nations, the OECD and the ILO mentioned in Chapter 1 on the protection of human rights, which globally operating companies shall comply with.

In the following, the question will be examined whether and, if so, how intensively German companies maintain trade and investment relations with countries in which working conditions deviate so clearly from the commitments that these countries have entered into internationally that one can assume government failure in these countries rather than failure on the part of German companies. This would raise the question of whether companies or partner governments are the most promising actors when it comes to remedying poor working conditions. Furthermore, this sub-chapter examines whether analyses of human rights risks at country level based on existing data are sufficiently robust to serve as a basis for decision-making by affected companies.

Key labor protections include the eight ILO Conventions on Freedom of Association and Protection of the Right to Organize, Protection of the Right to Collective Bargaining, Equal Remuneration, Elimination of Forced Labor, Anti-Discrimination (Employment and Occupation), Minimum Age for Employment, and the Prohibition and Elimination of the Worst Forms of Child Labor (ILO, 2021a).

As of early 2021, 146 countries had ratified all eight conventions, another 14 had ratified seven, 11 had ratified six, and another 5 had ratified five. The main outlier are the US, which have ratified only two conventions (on the elimination of forced labor and against the worst forms of child labor). China has ratified only half of the conventions. To date, China has not ratified the conventions on freedom of association and collective bargaining and against forced labor. The Chinese government has pledged to seek to ratify the conventions against forced labor as part of the negotiations on an investment agreement with the EU concluded at the end of 2020.

At first glance, it seems that even the poorest developing countries have taken their obligations to protect human rights in the world of work seriously. Among the countries that have ratified all eight conventions are almost all African countries (47 countries).

However, the reality published in annual surveys of working conditions in many countries by the International Trade Union Confederation (ITUC) shows a clear discrepancy between commitments and implementation (ITUC, 2020).

The ITUC categorizes violations of workers' rights from mild and sporadic (Category 1) to serious and accompanied by the breakdown of the legal system (Category 5+). Based on ITUC research for 2020, it shows that out of 141 countries for which both ratification data and data on violations are available, 65 countries that had ratified seven or even all eight conventions were rated as having poor to catastrophic working conditions (4–5+) (46 % of all countries). Fifty-seven countries (40 %) had working conditions in the upper range (1–3). The remaining 19 countries had ratified fewer than six conventions. Countries rated as having poor working conditions included the US (Category 4) and China (Category 5).

2.2.1 Economic Relations of German Companies at the Investment Level

The trade relations of German companies with suppliers from countries, especially developing countries, that respect workers' rights in different ways are discussed below. In addition to trade, direct investments by German companies offer the opportunity to influence working conditions in host countries, whether through appropriate remuneration, the use of production methods that are beneficial to the health of employees in subsidiaries of German companies, or the influence on local

suppliers to pursue the goals of the ILO conventions. In this context, it is also important to examine the question of whether poor working conditions or even exploitation could be positive investment incentives for German companies, so that German investments are preferably made in countries with critical to poor working conditions.

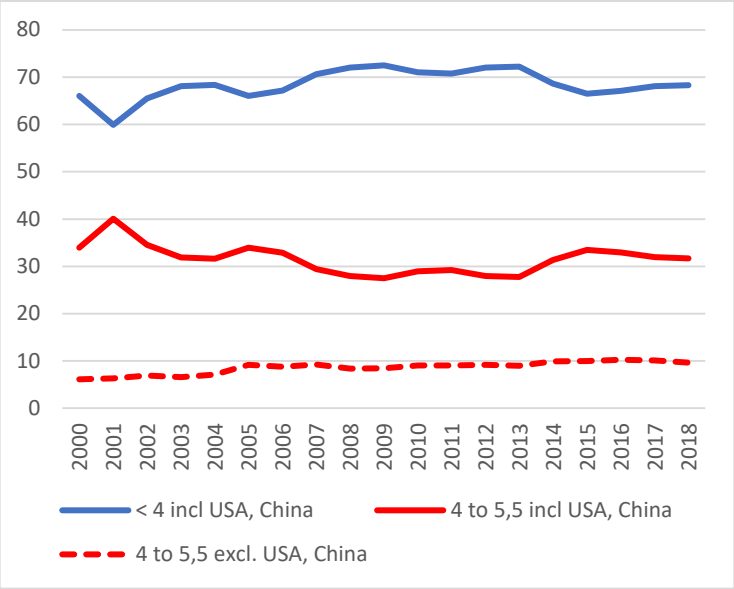
In order to answer this question, one should not start with the formal agreement to the ILO conventions, which, as shown above, have been more or less ratified by almost all countries, but with the actual working conditions, if one follows the ITUC index, which is based on working conditions in Scandinavian countries as a "best case" yardstick.

The empirical basis for this is the stock survey on German direct investment abroad published annually by the Bundesbank, which also provides aggregated data on turnover, jobs and the number of companies in the respective host country across all sectors. In the following, these data will be linked to the ITUC's assessments of working conditions in the 2020 report in the host countries of German direct investment. This is intended to address the question of whether, and if so to what extent, German companies have to deal with the accusation of investing in countries with poor working conditions without making any substantial changes to these conditions. The time period shown here covers the years 2000–2018 and does not allow for a sectoral breakdown by industry for all host countries. Sector breakdowns are only shown for a few large developing and emerging countries that are important for German companies, outside the group of industrialized countries (OECD), as otherwise individual investors could be identified.

The most important statement that stands out is that in 2018 more than two thirds of German investments were made in countries that had good to satisfactory working conditions according to ITUC categories 1–3. This share already existed in 2000 and had even risen to over 72 % by 2009.

Just under a third of investments took place in countries with critical to poor working conditions (ITUC Categories 4–5+) in 2018. The two important host countries, the USA (ITUC Category 4) and China (ITUC Category 5), fall into this lower half of the assessment spectrum. In 2018, these two countries accounted for 27 % and 14 %, respectively, of the stock of all German foreign investment in the manufacturing sector. Without these two countries, the share of German investments in critically to poorly rated countries would only amount to just under 10 % of total investments.

Figure 2- 16: Share of Host Countries of German Foreign Investments According to ITUC Ranking in Total Foreign Investments (in %)



Note: ITUC category 1–3 (good to satisfactory working conditions, blue line includes China and USA); ITUC Category 4–5+ (unsatisfactory to very poor working conditions, red line includes China and USA); ITUC Category 4–5+ (unsatisfactory to very poor working conditions, red dotted line includes, excludes China and USA).

Source: ITUC, Global Rights Index 2020 (Via Internet: https://www.ituc-csi.org/IMG/pdf/ituc_globalrightsindex_2020_en.pdf); Deutsche Bundesbank, Direktinvestitionsstatistiken, versch. years.).

The fact that this share has risen by around 4 percentage points since 2000 highlights the increasing importance in the portfolio of German investors of host countries other than China and the USA, whose working conditions were clearly in need of improvement in 2020, according to the ITUC assessment.

While turnover and the number of companies essentially confirm this overall statement from the investment volume, the distribution across all ITUC Categories shows a somewhat different picture if the number of jobs created is taken as a basis. Here, the significance of the countries rated critical to poor is significantly higher, and this is independent of the two major host countries, China and the USA. In 2018, just over half of the jobs resulting from German direct investment were created in countries rated good to satisfactory (54 %). In 2000, this percentage was still 64 %. By contrast, 46 % of the jobs were created in countries rated critical to poor, and only about one-third (15 %) of these were in the USA and China. This lower half of the assessment spectrum needs to be examined in more detail.

The vast majority of host countries for German investors with critically assessed working conditions are in ITUC Category 4, which the ITUC characterizes as "systematic violations of workers' rights". In addition to the USA, Mexico, Chile, Malaysia, Vietnam, Serbia, Tunisia and Qatar are particularly important host countries for German investors. With Romania, even an EU country is represented in this category. In the worst Category 5+, which according to ITUC Categories stands for "breakdown of the rule of law", a maximum of 0.1 % of all German direct investments (2018: 0.01 %) were made in the entire observation period. Here, a lack of legal certainty and poor market opportunities do not provide a basis for long-term investments and are therefore also avoided by German investors. This category is therefore negligible in terms of magnitude.

This leaves category 5, which the ITUC characterizes as countries with autocratic regimes and lack of access to implement few de iure labor rights. In addition to China, which accounted for about 5 % of all German direct investment in 2018 (and 14 % in the manufacturing sector, as noted above), host countries such as Brazil, Colombia, Greece (as an EU member!), Hong Kong, India, Turkey, South Korea, Thailand, the Philippines and the United Arab Emirates (UAE) are important locations for German investors in this category, also totaling about 5 %. They accounted for about 15 % of jobs created by German direct investment in 2018, with an upward trend, i.e. three times the share of the investment stock. By comparison, direct investment in China accounted for only 9 % of all jobs.

These differences between the investment stock and employment in ITUC Category 5 lead to the assumption that German investments in these countries produce in labor-intensive manufacturing with above average frequency. However, this does not prove that the same poor working conditions prevail in German subsidiaries in these host countries that the ITUC complains about for the country as a whole. The above assumption can be verified by using turnover per job as a measure of the labor or capital intensity of production, broken down by ITUC Category. A low ratio represents labor intensity or a relatively high use of low-skilled labor, a high ratio represents capital intensity and a relatively high use of high-skilled labor. Such a comparison could be distorted if German companies were heavily involved in extractive commodity sectors with high capital input. However, this is not the case. In 2018, only 3 % of German direct investment was active in energy supply and only less than 10 % outside the manufacturing and services. Traditionally, German companies buy commodities on the world market, but hardly invest in commodity sources.

Indeed, in 2018, the per capita turnover of German direct investment in ITUC Category 5 (including China) was only 70 % of the comparable figure in ITUC Category 4 (including the US). In 2000, the gap was even larger (about 29 %). This suggests that the production methods and sector structures between the two categories have converged since 2000. Without China, the gap would have been much wider. The two large host countries, China and the USA, have an important influence on the results in both Categories 4 and 5. In ITUC Category 5, per capita sales without China in 2018 were about a third lower than with China, and in ITUC Category 4, per capita sales without the US were actually over 60 % lower than with China. Both countries are intrinsically in the upper half of the spectrum of working conditions according to the hypothesis that better working conditions are associated with higher per capita turnover data. They obviously attract German investments in other sectors or use more capital-intensive manufacturing methods than German investments in countries that are on the same (lower) level with both countries in terms of working conditions.

As an interim result, the above-mentioned eighteen most important host countries with critical to poorly assessed working conditions (excluding the USA and China) account for just under one-third of all jobs created by German direct investment, mostly in manufacturing industries. Among them are two EU members (Greece and Romania), the two large Latin American host countries Brazil and Mexico followed by predominantly South and Southeast Asian countries as well as South Korea. This means that German companies are important players on the ground, and most of them have been so for many years. Only eight of the eighteen countries have ratified all ILO conventions, including the two EU members and the EU candidate country Serbia. In these three cases, it would be the task of the EU Commission to point out to the countries the discrepancy between ILO ratification and reality and to

ensure a remedy by means of allocations from the EU Commission's budget or its refusal to make payments. In these cases, the EU Commission's initiative in the direction of an EU-wide directive on corporate due diligence must and can be based on the ability of the governments in Greece and Romania to consistently enforce the national regulatory law reflected in the ratification of the ILO conventions. Otherwise, the task of enforcement would fall to the EU institutions.

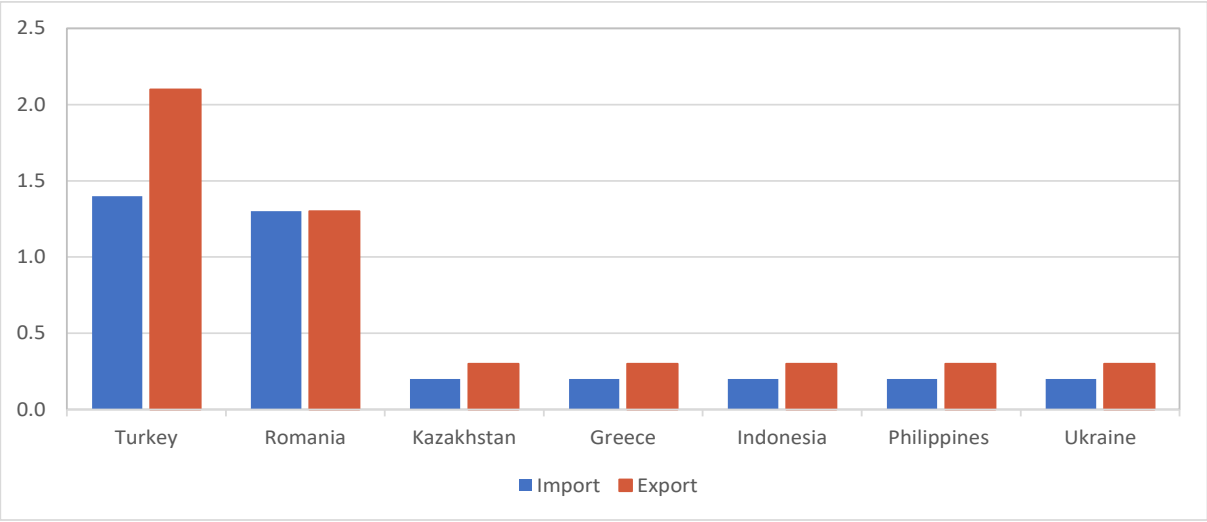
With other countries such as Mexico, Tunisia, South Korea and above all Turkey, which is linked to the EU by a customs union in the manufacturing sector, there are trade agreements in which individual parts refer to fair working conditions. In countries with which there are not yet any EU trade agreements of the latest generation (incorporating sustainability and workers' rights) (apart from the USA and China, these are the ASEAN states and India), this legal assistance by the EU is not yet possible.

2.2.2 Economic Relations of German Companies at the Trade Level

The analysis on the question of what working conditions prevail in countries with which Germany maintains economic relations can be extended from direct investments to the trade flows that are important for supply chains, specifically: how important countries are as procurement markets (German imports) as well as target markets for Germany (German exports) that have ratified all eight ILO conventions on the protection of workers' rights but experience poor to catastrophic ratings for the working conditions prevailing on their territory and thus obviously do not comply with the commitments they have entered into internationally. These are 35 countries that accounted for 6.9 % of all German imports in 2020 and 7.0 % of all German exports (Destatis, 2020).

Out of this group, Turkey stands out with 1.4 % (1.6 %) of German imports (exports) and Romania (1.3 % each of German imports and exports). Kazakhstan, Greece, Indonesia, the Philippines and Ukraine follow far behind, all at 0.2–0.3 % of German imports and exports.

Figure 2-17: Share of German Trading Partners with Poor to Very Poor Working Conditions According to ITUC Ranking in German Imports and Exports 2020 (in %)



Notes: By trading partner, these partners have ratified all 8 ILO core conventions on the protection of workers' rights.

Source: Destatis; ITUC.

The examples of Turkey and Romania show that, compared to a supply chain law, the Federal Republic of Germany and the EU Commission have a much better chance of influencing trade policy by anchoring criteria of sustainable development, which include social standards and human rights. Turkey has been linked to the EU since the beginning of 1996 by a customs union in the industrial goods sector. Modernization has been sought by the Turkish side for years and has been proposed by the European side since 2016, taking into account aspects such as services, public procurement and sustainable development (European Commission, 2015).

If national EU governments or the EU Commission, instead of the companies, were to press for compliance with the commitments Turkey has entered into internationally and bring them into the negotiations on the modernization of the Customs Union, this would have the major advantage that employees in all Turkish companies in Turkey, irrespective of whether they are integrated into supply chains or not, would be protected and there would be no discrimination between supply chain members and other companies and thus displacement effects into less protected areas.

This is even more true for EU members Romania and Greece, whose companies must comply with minimum requirements for working conditions and occupational health and safety as part of the so-called social dimension (European Parliament, 2019).

In summary, this section examined whether the host countries of German investors comply with or violate the eight core conventions of the International Labor Organization for the protection of workers, which they themselves have ratified, according to the (very critical) assessments of the International Trade Union Confederation ITUC, and whether German companies choose host countries in which workers' rights are violated according to ITUC standards. The following results emerge:

1. Two-thirds of German direct investment stocks in 2018 were located in countries rated good to satisfactory according to ITUC criteria 2020. This primarily includes investments within the EU, although the ITUC also lists two EU members with poor working conditions, Romania and Greece. The two-thirds share has been stable since 2000 and even higher at 72 % in 2009. Since direct investments are the basis of supply chains between affiliated companies and German investors pay and employ local workers according to formal rules, this is an indication that the majority of German subsidiaries abroad comply with their due diligence obligations.
2. The one-third of German direct investment that was made in countries with critical to poor working conditions (ITUC Categories 4 and 5) is dominated by the USA (Category 4) and China (Category 5) as the two most important host countries by far. Without these two countries, the share of German direct investment in host countries rated critical to poor would amount to just under 10 % of total direct investment.
3. In countries rated catastrophic (ITUC Category 5+), German investors are almost not active at all (0.1 %).
4. If the number of jobs created by German investments is taken as a basis instead of investment stocks, the importance of host countries with critical to poor working conditions according to ITUC standards grows to almost half of all jobs created by direct investments, with an upward trend. This is not only attributable to the two important host countries, the USA and China, but is also a consequence of investments in relatively labor-intensive manufacturing in traditionally

important host countries such as Brazil and Mexico, to which the ITUC attests poor working conditions. However, it can be assumed that critical to poor assessments apply more to the general working conditions in the countries than to the conditions prevailing in subsidiaries of German companies.

5. Many host countries, including most African countries, have to accept the reproach of a considerable discrepancy between internationally promised labor rights, documented by the ratification of the eight ILO core conventions on the protection of workers, and the reality, represented by the ITUC assessments. The governments of many supplier countries are thus either unwilling or unable to guarantee the promised protection of all workers in their employment relationships on their territories. Here too, the USA is out of the ordinary, having ratified only two of the eight conventions to date, because ratification of all conventions would imply general acceptance of ILO standards and procedures. The latter would require reform of many American laws, for which there is no political majority. Nevertheless, the ITUC rates working conditions in the USA only as critical (Cat. 4).
6. The discrepancy listed under (5) is also visible in the trade in goods. In 2020, 35 countries that have ratified all eight ILO core conventions but were assessed as having poor to catastrophic working conditions accounted for around 7 % of all German exports (6.9 % of imports). This does not include the US and China, which have not ratified all conventions, but does include Turkey and Romania in particular, followed by Ukraine, Greece and the Philippines. Alternative approaches to supply chain laws that appear likely to improve overall working conditions in countries, not just those for companies integrated in supply chains, are visible in these countries. These alternatives include the enforcement of EU rules on labor and product standards (Greece, Romania), agreements on labor protection as a precondition for free trade agreements and deeper development cooperation (ASEAN–EU: Philippines) or closer contractual relations with the EU (Ukraine), or the deepening of the customs union (Turkey).

2.2.3 Import Linkages of German M&E Firms at the Trade Level

Input-output tables from the OECD are used to analyze the importance of countries with high ITUC scores specifically for companies in the metal and electrical industries (OECD, 2018). These provide information on the value of intermediate goods (in USD) purchased by a specific sector in a specific country from another sector in another country. This data can therefore be used to determine the importance of individual countries as suppliers to the German M&E industry.

In total, 66 countries and 36 economic sectors are included in the OECD IO tables.[2] This means that data is not available for all countries identified as problematic by the ITUC. The most recent tables refer to 2015, so the data shown in the figures refer to this year.[3] Furthermore, the following figures only refer to direct intermediate products purchased by companies in the M&E industry. Against the background

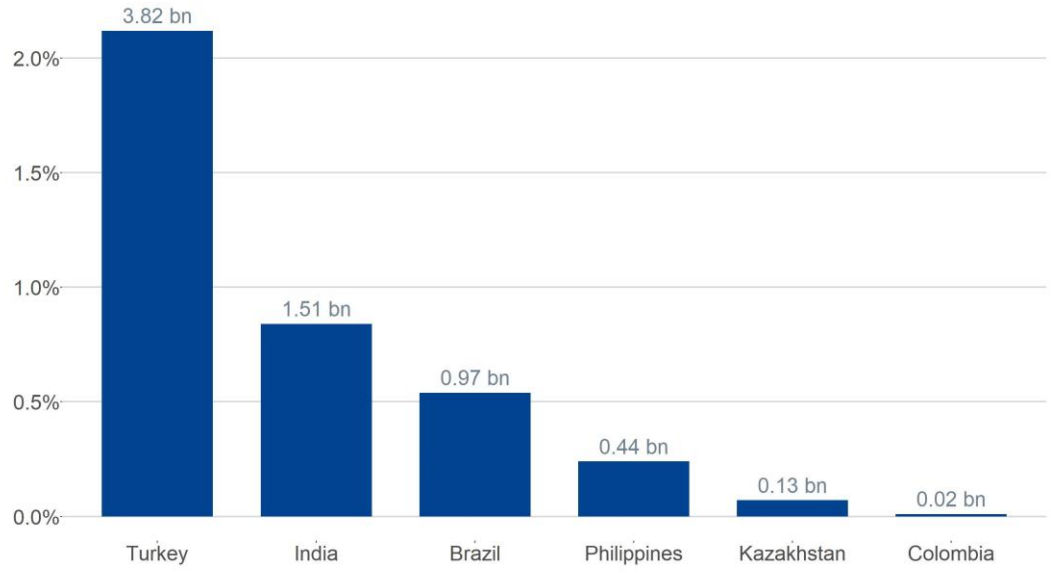
[2] Countries not directly covered are grouped together in the variable 'rest of the world'.

[3] A direct transfer of the values to the year 2021 is therefore only possible under the assumption that the supplier structure has not changed since 2015. Such an approach is not unusual when data availability is limited (see e.g. Felbermayr et al., 2015). Although the absolute values (in USD) will differ, the relative shares of individual countries are likely to be comparable.

of the German law, which sees a direct responsibility of companies only for direct suppliers, this is the relevant linkage. If the corporate duty of care – as currently discussed in the European Parliament – also extends to indirect suppliers, however, indirect linkages also play a role.

Figure 2–18 shows the value of intermediate products (in USD) that the German M&E industry sources from those countries that have the worst working conditions according to the ITUC (2020).[4] The most important source country for the M&E industry in this category is Turkey. Specifically, German companies in the metal and electrical industry sourced goods worth USD 3.82 billion from Turkey in 2015. This corresponds to 2.1 % of the intermediate products imported by the M&E industry or 0.6 % of the total intermediate products used in this sector. It is followed by India with USD 1.51 billion worth of intermediate products (0.8 % of imported or 0.2 % of total intermediate products), Brazil (USD 0.97 billion or 0.5 % of imported intermediate products) and the Philippines (USD 0.44 billion or 0.2 % of imported intermediate products). Kazakhstan and Colombia play a relatively minor role, with shares of 0.07 % and 0.01 % of imported intermediate products, respectively. Overall, the German M&E industry thus sourced direct intermediate products worth USD 6.89 billion from six of the ten most problematic countries according to the ITUC in 2015. This corresponds to a share of 3.8 % of total intermediate products imported by the M&E industry or 1.1 % of the total inputs used in this sector.

Figure 2–18: Value of Inputs in German M&E Companies from Countries with the Worst Working Conditions and Share of Total M&E Industry Imports



Note: Input-output data is only available for six of the ten countries with the worst working conditions according to ITUC (2020). Bangladesh, Egypt, Honduras and Zimbabwe are not shown.

Source: ITUC (2020) and OECD ICIO tables (2018b).

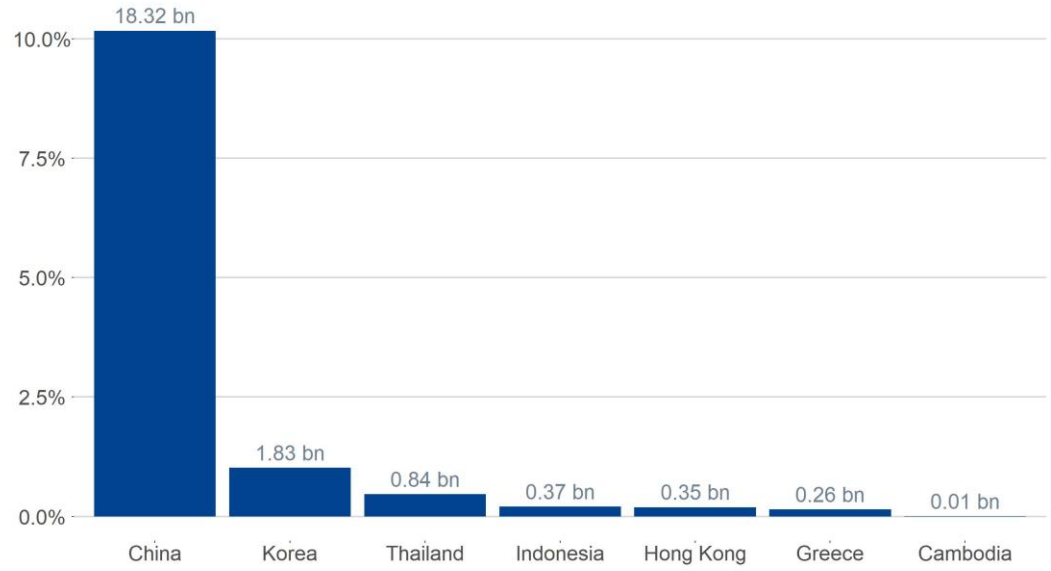
The M&E industry's supplier relationships with other countries with an ITUC score of 5 are shown in Figure 2–19. China in particular stands out here, from where the German M&E industry sourced

[4] The ITUC lists the ten countries with the worst working conditions. However, no IO tables are available for four of these countries, so their share of inputs used in the M&E industry cannot be calculated. These countries are Egypt, Bangladesh, Honduras and Zimbabwe.

intermediate products worth USD 18.3 billion in 2015, which corresponds to a share of 10.2 % of total imported intermediate products or 2.9 % of the total intermediate products used. Far behind, but also significant, are the Republic of Korea (1 % of imported inputs or 0.3 % of total inputs) and Thailand (0.5 % of imported inputs or 0.1 % of total inputs).

Overall, a good 16 % of the intermediate products imported by the M&E industry, or 4.6 % of the total input used in the German M&E industry, originate from the 13 countries with an ITUC score of 5 shown in the two figures. In the case of these intermediate products, it is to be expected that suppliers will at least require closer scrutiny with regard to compliance with human rights. If we also consider the countries with an ITUC score of 4 (Figure 2–20), the proportion of intermediate products from critical countries of origin increases by a further 9.9 percentage points to a total of 25.9 % of imported intermediate products (7.5 % of total intermediate products used). The USA in particular play a significant role here with intermediate products worth USD 12.26 billion (6.8 % of imported intermediate products or 2.0 % of total intermediate products used).

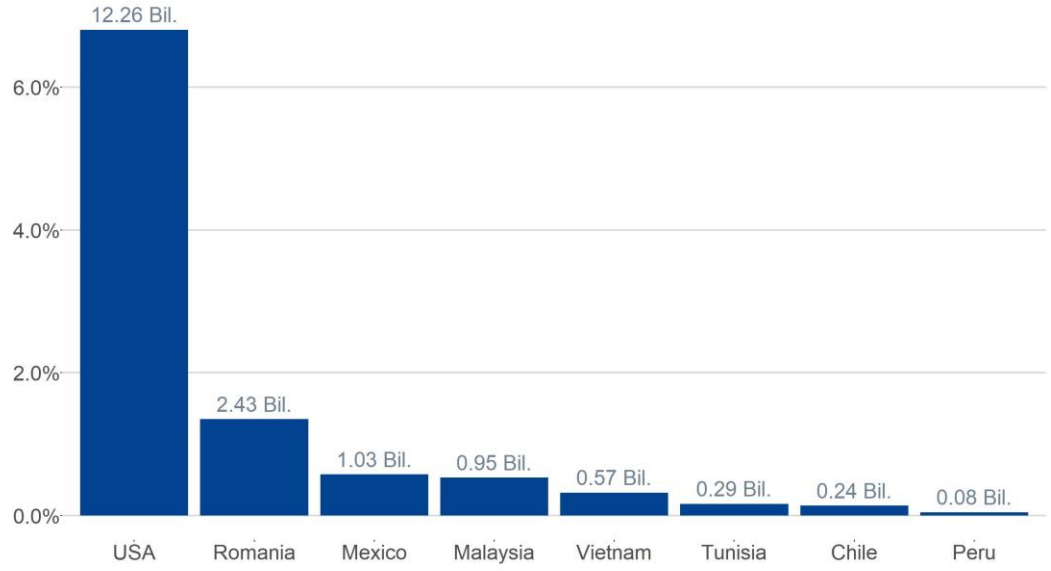
Figure 2–19: Value of Intermediate Products in German M&E Companies from the Other Countries with ITUC Score 5 and Share of Total Imports of the M&E Industry



Note: Input-output data are only available for 13 of the 32 countries with an ITUC (2020) Score of 5. Figure excludes the ten countries with the worst working conditions.

Source: ITUC (2020) and OECD ICIO tables (2018b).

Figure 2–20: Value of Intermediate Products in German M&E Companies from Countries with ITUC Score 4 and Share in Total Imports of the M&E Industry



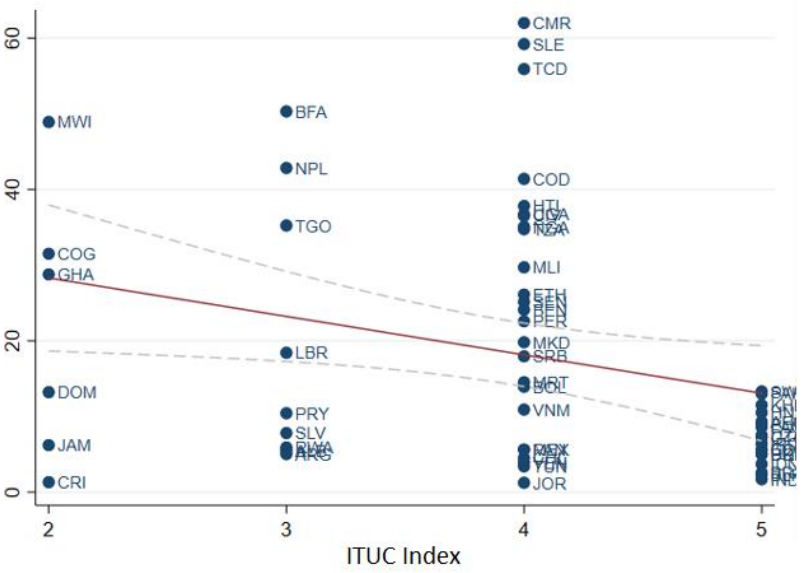
Note: Input-output data are only available for 8 of the total 41 countries with an ITUC (2020) Score of 4.

Source: ITUC (2020) and OECD ICIO tables (2018b).

2.2.4 Validity of the ITUC Score

The ITUC Score is a useful indicator for measuring violations of workers' rights and comparing countries in this respect. However, it does not provide a comprehensive picture of the human rights situation on the ground, which is illustrated by the following examples. Figure 2- 21 shows the correlation between ITUC Score and child labor for selected countries, measured by the proportion of working children in the population of 7 to 14 year olds (in %). A simple regression shows a negative correlation between ITUC Score and child labor: a better situation in terms of workers' rights is – seemingly paradoxically – associated with an increased incidence of child labor. This correlation cannot necessarily be interpreted causally. However, it shows that a focus on the ITUC Score alone is not sufficient to comprehensively assess the human rights situation in a country.

Figure 2- 21: ITUC Score and Child Labor

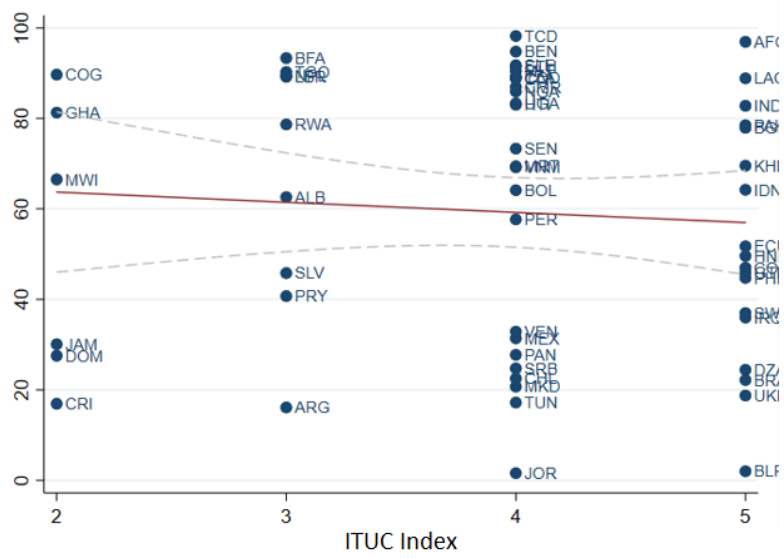


Note: Proportion of working children in the population of 7 to 14 year olds (Y-axis) and ITUC score (X-axis).

Source: World Development Indicators, World Bank, ITUC, own calculations and presentation.

A similar picture emerges when looking at precarious female employment. Thus, for 58 poorer countries, Figure 2−22 relates a country's ITUC Score to the proportion of women in total employment who are precariously employed (ILO estimate). A regression also shows a slightly negative correlation, although this is not statistically significant. Thus, an improvement in workers' rights is not associated with a reduction in the proportion of women in precarious employment. Again, the correlation should not be interpreted causally. Other variables, such as the degree of corruption control, correlate negatively with the ITUC Score, so that countries with a higher ITUC Score (i.e. weaker workers' rights) are also more problematic in terms of corruption (Figure 2−23). Overall, it is clear that a focus on the ITUC Score alone is not sufficient when assessing a country's human rights situation. It cannot therefore serve as the sole basis for decision-making by companies.

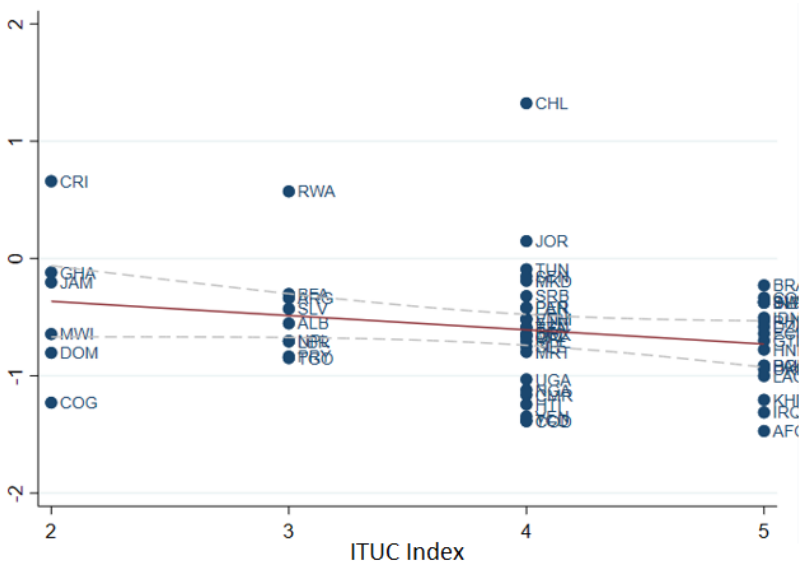
Figure 2–22: ITUC Score and Precarious Female Employment



Note: Share of women in total employment of women who are precariously ("vulnerable") employed (ILO estimate, Y-axis) and ITUC score (X-axis).

Source: World Development Indicators, World Bank, ITUC, own calculations and presentation.

Figure 2–23: ITUC Score and Corruption Control



Note: Level of corruption control (Y-axis) and ITUC score (X-axis).

Source: World Development Indicators, World Bank, ITUC, own calculations and presentation.

Conclusion: One-third of all German direct investments in 2018 took place in countries that, according to the ITUC, are to be classified as critical to poor with regard to the working conditions there (Categories 4 – systematic violations of rights - and 5 – no guarantee of rights). This list includes the US (4) and China (5). In contrast, German investors are virtually not active at all (0.1 %) in countries rated as disastrous (Category 5+). In 2020, 35 countries that have ratified all eight ILO core conventions but were assessed as having poor to catastrophic working conditions accounted for around 7 % of all German exports (6.9 % of imports). Overall, at least 16 % of imported or 4.6 % of total inputs used in the German M&E industry originate from countries with an ITUC Score of 5 or 5+. China accounts for the majority (10.2 % of imported or 2.9 % of total intermediate products). As data are not available for all countries concerned, the actual share is likely to be even higher.

It is striking that among the countries with a poor ITUC Score are also many countries that have ratified all or at least most of the ILO conventions. Ratification of ILO conventions is therefore not a good indicator of the actual human rights situation. The informative value of the ITUC Score is also limited, as can be seen from the example of the negative correlation of the ITUC Score with the incidence of child labor in some countries. There is therefore no single indicator that reliably reflects the local human rights situation and could serve as the sole basis for decision-making for affected companies. Supplier relationships with companies in individual countries can therefore be classified neither as safe nor as risky on the basis of a single indicator.

3. Impact of a Supply Chain Regulation

3.1 Effects on German and European M+E Companies

According to the Due Diligence Act adopted by the Bundestag in June, German companies will be required to "conduct an appropriate risk analysis [...] to identify the human rights and environmental risks in its own business operations as well as those of its immediate suppliers" (German Government, 2021: 11). The following discussion therefore assumes that suppliers only have to conduct a risk analysis of their immediate suppliers. Indirect suppliers are initially excluded from the analysis.

In principle, the companies affected should expect additional costs per supplier relationship (key account). Companies must analyze their direct suppliers with regard to human rights and environmental risks both once (when the law is introduced) and on a regular basis ("once a year as well as on an ad hoc basis", Federal Government, 2021: 11) and document this accordingly. This also already applies to the obligation to make an effort (instead of an obligation to succeed). The level of these costs is difficult to quantify and is likely to vary depending on the type of company. Downstream companies with many supplier relationships are likely to be particularly affected compared to upstream companies.

The optimal (profit maximizing) reaction to such an increase in costs per key account from the company's point of view would be to reduce the number of key accounts, i.e. suppliers. If a company previously procured the same intermediate product from two different suppliers, eliminating one of the two supplier relationships would reduce the costs incurred by the law. The higher the potential penalties in the event of a due diligence violation, the higher the incentive for companies to reduce their exposure. Under the law, violations "can be penalized with a fine of up to 2 % of the average annual turnover" (German Government, 2021: 20), which is a severe penalty for companies that price with small mark-ups. The planned legislation thus underestimates the economic costs if it focuses only on the accounting costs of the time spent on inspections and, above all, ignores the ex-ante risk in the search for and selection of new suppliers.

Based on this logic, it is to be expected that German companies will reduce the number of their suppliers if possible, which would initially lead to an increase in imports from the remaining suppliers. From a company's point of view, such a concentration of suppliers would lead to an increased risk of supply bottlenecks, as possible production problems at one supplier could no longer be compensated for by other suppliers. Such a monopolization of suppliers could also increase their market power, which would make intermediate products more expensive for German M&E companies.

Another possibility to avoid the expected monitoring costs would be a partial relocation of supply chains to Germany or other OECD countries. In this case, companies would not be spared a review of their suppliers, but this would probably be easier for locations in Germany or other EU member states than in many developing countries. This could lead to a transformation from labor-intensive production to capital-intensive production. However, such a regulatory distortion of supplier selection is also likely to be associated with higher costs for the companies concerned.

An additional alternative would be the complete relocation of value creation back to the own company. If production is relocated to Germany, the effects would be similar to those described in the previous paragraph. However, it is also possible that German companies will increasingly invest abroad in order to establish their own production sites there, which in turn would then be easier to control. Such a decision would also be associated with higher costs from the point of view of the companies, but could be advantageous for the countries concerned (see Section 3.2).

In the best case from a company's point of view, the additional costs can be passed on to consumers in the form of price increases. However, depending on the competitive situation, German companies may also be at a disadvantage in international competition if the governments of other countries adopt softer regulations or no regulations at all with regard to corporate due diligence. The current ambitions to introduce a European supply chain law are therefore to be welcomed in order to establish a level playing field at least in the EU.

The analysis so far only refers to the need for auditing of direct (immediate) suppliers by German companies. Additional monitoring of indirect suppliers, as currently being discussed at European level (European Parliament, 2021a), would have much more far-reaching consequences. In its position paper on the Due Diligence Act, the German Electrical and Electronic Manufacturers' Association (ZVEI) cites the example of a microwave oven, which relies on around 1,500 direct and indirect suppliers for its production (ZVEI, 2020). It is more than questionable whether it is possible for a company to monitor all these suppliers. Furthermore, the question of the definition of supply chains quickly arises, as it is often not clear where a supply chain even begins (Görg et al., 2021).

The German law only stipulates that companies must take action if they receive "substantiated knowledge of a possible violation of a protected legal position or an environmental obligation at indirect suppliers" (German Government, 2021: 14). However, it is not clear how to proceed if the direct supplier refuses to respond appropriately to this violation of human rights by its (indirect or direct) suppliers. Furthermore, the likelihood of such human rights violations occurring in the supply chain will have to be taken into account by German companies in their risk analysis and will have a corresponding impact on their choice of suppliers. Again, a likely response by German companies would be to relocate supply chains back to OECD countries or to substitute labor for capital (automation).

Companies will be increasingly motivated, both intrinsically and extrinsically, to strive for the improvement of human rights, the reduction of the consumption of natural resources and the sustainability of production methods within their sphere of influence. Numerous voluntary commitments and implementations at both company and sector level bear witness to this and are also recognized by the public. It is equally clear that both consumer preferences and investor demands will mean that improved sustainability will have to be proven more in the future than in the past. Without this proof, it will no longer be possible to defend market shares or win new ones.

A phase of voluntary commitments preceding a supply chain law, as proposed by Görg et al. (2021), could be used (also from the point of view of avoiding high burdens on companies in the pandemic, as urged by the EU Parliament's Trade Committee) as an opportunity to intensify dialogue with governments from supplier countries and, in contrast to the current approach, to involve them in the

objectives of supply chain controls. The aim of such an upstream phase would be to decouple the short-term costs of supply chain controls from the costs of overcoming losses incurred by the pandemic.

3.2 Effects of Supply Chain Regulation from the Perspective of Developing Countries

The mechanisms described in the previous section inevitably have an impact on companies and employees in developing countries. If the introduction of a supply chain law leads to German companies relocating their supply chains back to Germany, Europe or other OECD countries, this will inevitably lead to a loss of sales for affected exporters in developing countries. It is irrelevant whether business relationships are aborted due to actual human rights violations observed, or whether the costs of monitoring are merely too high or risks are to be minimized. These sales losses in turn lead to business-related layoffs and, in the worst case, to the complete market exit of the affected companies.

Depending on the size of the companies affected, this can in turn have an impact on entire regions. Former employees either become completely unemployed or are pushed into informal and thus unprotected labor markets (Figure 2−10). The economic literature has produced ample evidence that exporting companies pay higher wages on average than those that only serve the domestic market (Bernard and Jensen, 1995; Bernard et al., 2007). This is particularly true for firms in developing countries that export to developed countries (Verhoogen, 2008). There is also evidence of a relationship between export status and increasing productivity of firms ("learning by exporting", De Loecker, 2007) which is even stronger for exports to developed countries. A supply chain law thus hits precisely those companies that already pay relatively high wages. Görg et al. (2017) also show that corporate social responsibility plays a greater role for companies that export to developed countries. If suppliers from developing countries fall out of Western supply chains, the economic catch-up process vis-à-vis the industrialized nations risks being slowed down or even stopped.

In addition, there will be competing players that do not enact their own supply chain legislation or otherwise put pressure on supplier countries to improve working conditions. This may include China, but other emerging economies that stand between developed and developing countries are also likely to remain passive. They will continue to act as buyers of goods produced under poor labor conditions, thus weakening the weight of countries seeking to improve labor conditions in poor countries.

Supply chain laws generally have the major disadvantage that they only cover the working conditions of suppliers who are members of the supply chains. However, the vast majority of jobs are created by companies in predominantly poor countries that merely produce for the domestic market in informal labor markets. Supply chain laws thus deepen the already existing gap between formal and informal labor markets, push workers into informal and thus unprotected labor markets, and make it more difficult for governments in supplier countries to close this gap.

The EU Commission study on due diligence in supply chains (EU Commission, 2020: 349) mentions the problem with the concrete example of child labor in Cambodia, where it cannot be ruled out that the "Better Factories Cambodia" initiative could lead to more child labor in jobs outside controllable supply chains. Income inequalities in the supplier countries would be increased. In the case of opportunistic

governments, it is possible that supply chain laws could even be instrumentalized to cement their power base, which is based in the formal labor market, without any action on their part.

Supply chain laws thus place the burden on the "wrong" actors, namely the buyers in industrialized countries with higher fixed costs, but not on those responsible for poor working conditions in supplier countries, the governments there and the local companies that exploit workers under the protection of inactive governments.

Another possibility already discussed is that German companies do not relocate their supply chains but merely consolidate them by reducing the number of suppliers. In the supplier countries, this could lead to a monopolization of individual sectors, which would increase the bargaining power of the surviving companies vis-à-vis workers, which in turn could exert downward pressure on wages.

Regardless of the decisions of German importers, a supply chain law would also have costs for the suppliers concerned if, for example, they want to comply with their documentation obligation (Rudloff and Wiek, 2020). Since these costs only occur when exporting (after all, no additional documentation requirement is needed for the domestic market), such costs can be modeled as trade costs. The literature clearly shows that such an increase in trade costs reduces the quantity exported by the firms concerned and even forces the least productive exporters to withdraw from the export business (Melitz, 2003; Melitz and Ottaviano, 2008).

On the one hand, this decline in exports would in turn lead to lower economic activity and employment in the affected countries. If the companies concerned continue to operate in their home market, as described in the literature, there is also the possibility that they will no longer feel bound by existing labor standards that they had introduced for their customers in industrialized countries (see Chapter 2). Another reason for higher wages in exporting companies is that products manufactured for countries such as Germany often have to meet higher quality standards, which in turn requires a more qualified workforce (Verhoogen, 2008). If the corresponding destination market disappears, this could have a negative effect on the qualifications and wages of the employees.

Supply chain legislation neglects differences in the scope for companies to intervene in production methods (relatively high) and remuneration conditions (relatively low). If different objectives are pursued as in the planned EU directive (working conditions, environmental protection, good corporate governance), conflicts of objectives may arise with only one instrument (supplier relationship). In particular, companies that are forced to raise safety standards may have to lower wages paid in order to remain competitive.

From a political point of view, the present supply chain laws or their drafts have also been developed without consultation with the governments of the supplier countries. They are "patrimonial" in character and reflect political preferences in the rich countries. They make labor in the supplier countries more expensive, thus paving the way for labor-saving production methods and exacerbating not only the employment problem but also the skills problem in the labor markets, because "learning on the job" is made more difficult. Ultimately, they have a protectionist effect in favor of competing value added in the countries that introduce supply chain legislation, make manufacturing processes more expensive and reduce the real income of consumers there.

3.3 Effects of Supply Chain Regulation on the German Economy

The Supply Chain Act can be considered as a so-called non-tariff trade barrier. These are policy instruments that implicitly increase trade costs and thus sometimes severely restrict trade (Bratt, 2017; Ghodsi et al., 2017; Kinzius et al., 2019). A typical example of non-tariff barriers are different standards that require companies to adapt their products depending on the individual standard of the target country. A due diligence law, which requires importers to check their suppliers for human rights violations and to document everything accordingly, also affects trade costs and can therefore be considered a non-tariff trade instrument.

A supply chain law would have the following effects, as described in Chapter 3.1. If the existing supplier relationships remain in place, the documentation obligation for direct suppliers will increase the procurement costs of the companies concerned, which corresponds to an increase in trade costs. Alternatively, if supply chains are shortened or relocated to Germany or Europe, this will also increase production costs, as the advantages of specialization are lost and intermediate products are no longer produced where this is most cost-effective (Caliendo and Parro, 2015; Eaton and Kortum, 2002). The consequences in both cases are higher prices for consumers and higher production costs for downstream firms, whose competitiveness is reduced accordingly. In the worst case, this could in turn have negative effects on employment.

The effects of non-tariff trade barriers on real income in Germany have recently been analyzed in detail in the context of the discussion on a relocation of supply chains to Germany and Europe due to the COVID-19 pandemic. For example, Eppinger et al. (2020) and Sforza and Steininger (2020) show that an increase in non-tariff trade barriers leads to significant income losses. Felbermayr et al. (2020) carry out similar calculations specifically for Germany and Europe and arrive at comparable results.

If a supply chain law creates an incentive for companies to reduce the number of their suppliers, this also has a negative impact on the resilience of supply chains. In the event of a production shock, a lack of options for diversification quickly leads to supply bottlenecks that can no longer be compensated for by switching to other suppliers. A current example of this would be lockdowns due to the COVID-19 pandemic. If a company has diversified supply chains with several suppliers, production losses in individual countries or regions can be at least partially compensated. Thus, if a supply chain law reduces the optimal number of suppliers from a company's perspective, this could increase the vulnerability of the German economy to locally occurring shocks. This scenario is also suggested by a simulation by the OECD (2020), in which a production shock in a de-globalized world has a stronger impact on real income than in a world with lower trade barriers.

The extent to which a law on companies' due diligence obligations in their supply chains will affect the German economy depends on the extent to which German companies will ultimately be obliged to monitor their indirect suppliers (see Chapter 3.1). In this respect, concerns have been voiced that the German law will cover all suppliers and not just direct suppliers through deliberately vague wording on due diligence and liability (ZVEI, 2021). According to Section 3 (1) No. 9 of the Draft Act, companies' due diligence obligations also refer to the implementation of due diligence obligations with regard to risks associated with indirect suppliers pursuant to Section 9 of the Draft Act. In contrast, the obligation to

carry out a risk analysis only relates to the company's own commercial activities as well as to its direct suppliers, Section 5 (1) of the Draft Act. However, according to Section 5 (2) Draft Act, where a company has entered into an abusive arrangement with its suppliers or a circumvention transaction has been made in order to avoid the due diligence requirements with regard to the direct supplier, an indirect supplier is deemed to be a direct supplier. The "preventive measures" required by Section 6 (4) of the Draft Act likewise apply only to direct suppliers, as do the remedies given under Section 7 of the Draft Act and the obligation to establish a complaints procedure under Section 8 of the Draft Act.

Only Section 9 of the Draft Act imposes obligations on the addressees of the legislation vis-à-vis indirect suppliers. Pursuant to Section 9 (1) Draft Act, the company has to set up the complaints procedure pursuant to Section 8 in such a way that it also enables persons whose legal position may have been infringed by the economic activities of an indirect supplier to report such an infringement. Pursuant to Section 9 (3) Draft Act, in the event of "substantiated knowledge" of possible violations of a legal position or violations of environmental obligations by indirect suppliers, among other things, the company has to conduct a risk analysis within the meaning of Section 5 of the Draft Act. It further has to set preventive measures within the meaning of Section 6 vis-à-vis the perpetrator of the infringement, prepare and implement a concept for minimizing/avoiding the infringement and, if necessary, update its policy statement pursuant to Section 6 (2) of the Draft Act. It is also noteworthy that the Federal Ministry of Labour and Social Affairs, together with the Federal Ministry for Economic Affairs and Energy, is authorized to adopt implementing legislation (Rechtsverordnungen) on the content of the obligations under Section 9 (4) of the Draft Regulation.

Violations of some of the obligations set out in Section 9 of the Draft Act are punishable by fine pursuant to Section 24 of the Draft Act. However, this only applies with regard to the failure to carry out a risk analysis or to do so adequately and the failure to set up a complaints procedure. Nevertheless, it should be noted that in order for a fine to be imposed pursuant to this provision, the Draft Act requires "substantiated" knowledge of the (possible) infringements by indirect suppliers and thus, of course, knowledge of the identity of the indirect suppliers in the first place. When exactly such substantiated knowledge can be assumed to exist is not detailed in the Draft Act, and will probably have to be defined further by the competent authority or the (national) courts.

Finally, supply chain regulation could also be counterproductive from a geo-economic perspective. If German and European companies withdraw from developing countries due to increasing regulation, the space for strategic rivals such as China becomes larger.

Conclusion: A German supply chain law would increase the costs per supplier relationship of German companies if every supplier has to be regularly audited with regard to human rights and -environmental risks. It is to be expected that companies will reduce the number of their suppliers accordingly. This will particularly affect developing countries, where compliance with human rights and environmental standards is relatively difficult to monitor. Accordingly, supply chains will either be shifted back to Europe, or there will be a monopolization of suppliers in developing countries. Either way, the production costs of German companies will rise, which will be reflected in higher prices for consumers and reduced competitiveness. The likelihood of supply bottlenecks due to idiosyncratically occurring shocks increases, which weakens the resilience of the German economy as a whole.

From the point of view of companies in supplier countries, export costs increase if evidence of compliance with human rights and environmental standards has to be provided, which is unlikely to be affordable for smaller companies in developing countries in particular. Suppliers in these countries will therefore reduce their export activities or withdraw from the market altogether. As a result, jobs are lost or migrate to informal labor markets, which are typically characterized by lower wages and worse working conditions. A supply chain law would thus burden precisely those companies in developing countries that adhere to above-average standards.

4. Excursus: The German Law[5] and its Compatibility with the Requirements of World Trade Organization Law

Recently, the requests by members of civil society[6], but also by legal scholars, according to which legal specifications of the due diligence obligations of German and EU companies along their respective supply chains are needed, [7] have been taken up in national politics as well as on the EU level. With regard to the compatibility of the German law with EU law and the international treaties to which the Federal Republic of Germany (Germany) is a party, the Draft Act merely states that the compatibility is guaranteed.[8]

The EU likewise plans to present a directive in autumn this year. The directive will impose due diligence obligations on companies with regard to compliance with human rights, social and environmental standards along their supply chains.[9] This chapter analyses selected EU and international trade law issues resulting from the introduction of a "supply chain law" or "due diligence law" at the national and the EU level.

4.1 Compatibility with Art. XI: 1 GATT

The law of the World Trade Organization (WTO) is among the international treaties the planned German legislation has to be compatible with.[10] In particular, Art. XI:1 GATT 1994[11] is of relevance in this regard. The provision prohibits the introduction or maintenance of non-tariff trade barriers in the form of prohibitions or restrictions on imports from or exports to other WTO members, both in the form of

[5] The Legal Assessment is based on an earlier draft of the legislation finally adopted. However, the substance of the law has not changed throughout the legislative process, so the considerations apply mutatis mutandis to the finally adopted legislation.

[6] A prominent advocate of the introduction of legally binding regulations for companies with regard to compliance with environmental and social standards along their supply chains is the *Supply Chain Act initiative*, which has been joined by various organizations such as Oxfam, the German Trade Union Confederation or the *European Center for Constitutional and Human Rights,* cf. https://lieferkettengesetz.de/. Unless otherwise stated, all online sources were last accessed on 21.04.2021.

[7] See e. g. *Schmidt*, Supply Chain Legislation: Diligence!, in: EuZW 2021, 273 (on the German draft law); *Krajewski*, Völkerrechtliche Verpflichtung der Bundesrepublik zum Erlass eines Lieferkettengesetzes, post dated 05 June 2020 on Verfassungsblog.de, <https://verfassungsblog.de/voelkerrechtliche-verpflichtung-der-bundesrepublik-zum-erlass-eines-lieferkettengesetzes/>.

[8] Draft law of the Federal Government: Draft law on corporate due diligence in supply chains of 03 March 2021, p. 24.

[9] See most recently the European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and accountability (2020/2129(INL)), calling on the Commission to present a draft law on the subject, <https://www.europarl. europa.eu/doceo/document/TA-9-2021-0073_EN.html>.

[10] External trade law is an exclusive competence of the EU, as can be seen from Article 3 (1) (e) TEU, and the EU is also an independent member of the WTO. Nevertheless, the Member States remain members in their own right and are also bound by the provisions of the WTO agreements. Cf. in detail *Herrmann/Streinz*, in: *von Arnauld (*ed.), Europäische Außenbeziehungen (2014), Die EU als Mitglied der WTO, p. 587 ff.

[11] General Agreement on Tariffs and Trade 1994 of 15 April 1994, OJ EC No L 336 pp. 11.

quotas or import and export licenses and in the form of other measures.[12] Further, some scholars argue that the planned German Due Diligence Act must also conform with the national treatment obligation contained in Art. III: 4 of the GATT.[13] However, this is not the case. Art. III: 4 GATT prohibits the differential treatment of domestic and foreign goods with regard to internal taxes and other regulations. The provision thus addresses non-tariff barriers to trade, as does Article XI GATT. Accordingly, the scope of application of the two norms must be delineated from each other. This delineation must be made according to whether a regulation deals with the product itself and its marketing. Where this is the case, the national treatment obligation of Art. III:4 GATT is applicable. On the other hand, where a regulation makes specifications with regard to the production process of a product ("*process and production methods*" or "PPMs"), but where these factors of production are not reflected in the physical characteristics of the end product, the regulation is to be measured against Art. XI GATT.[14] The planned German Due Diligence Act is not linked to the different physical characteristics of the goods, but to their production process. Therefore, it does not fall within the scope of application of Art. III:4 GATT.[15] Instead, Art. XI: 1 GATT is the correct standard of review.

By also outlawing measures other than quantitative restrictions, Art. XI: 1 GATT has a very broad scope of application.[16] It includes *de iure* as well as *de facto* trade restrictions.[17] This covers all governmental, non-fiscal measures that make the market access of goods impossible or impede it.[18] Consequently, trade barriers resulting from differing social, environmental and consumer protection standards in the WTO members can also be measured against the yardstick of Article XI: 1 GATT. This extends to bans on the import of products in the interest of environmental or animal protection that have been manufactured using certain production methods.[19]

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[12] See also *Van den Bossche/Zdouc*, The Law and Policy of the World Trade Organization (2017), p. 482 ff; *Herrmann/Weiß/Ohler,* Welthandelsrecht (2007), p. 199 ff.

[13] *Grabosch*, Legal Opinion on the Design of a Supply Chain Act (commissioned by the Supply Chain Act Initiative), p. 66.

[14] *Matsushita/Schoenbaum/Mavroidis/Hahn*, The World Trade Organization (2015), p. 242; *Herrmann/Weiß/Ohler*, Welthandelsrecht (2007), p. 204; *Senti*, System and Functioning of the WTO (2000), para. 701 et seq. See also Report of the Panel in *United States - Restrictions on Imports of Tuna*, DS29/R, para. 5.9 et seq. and Report of the Panel of 6 November 1998, *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/R, para. 7.12 et seq.

[15] Even if one follows the opposing view, only a *de facto* discrimination between foreign and domestic products as a result of the indiscriminate application of the planned Due Diligence Act would come into consideration, whereby it would be questionable at this point what the de facto disadvantage of foreign products would consist of - the newly introduced obligation to comply with the due diligence obligations burdens domestic and foreign companies in the same way. In any case, a violation of Art. III: 4 GATT would also be justifiable via Art. XX GATT.

[16] Report of the Panel of 19 December 2000, WT/DS155/R, *Argentina - Hides Leather*, para. 11.17, where the "other measures" within the meaning of Art. XI: 1 GATT are described as a "*broad residual category*". *Wolfrum* considers such a broad understanding to be necessary in order to achieve the GATT objective of the most comprehensive trade liberalization possible. *Wolfrum*, in: *ders./Stoll/Hestermeyer (eds.),* WTO - Trade in Goods (2011), Art. XI GATT, para. 1, 30.

[17] See, *inter alia*, Report of the Panel of 19 December 2000, WT/DS155/R, *Argentina - Hides Leather*, para. 11.17; Report of the Panel of 6 April 1999, *India - Quantitative Restrictions*, WT/DS90/R, para. 11.17.

[18] *Wolfrum*, in: *ders./Stoll/Hestermeyer (eds.),* WTO - Trade in Goods (2011), Art. XI GATT, para. 11.

[19] *Herrmann/Weiß/Ohler*, Welthandelsrecht (2007), p. 201 and the WTO case law in footnote 12.

Accordingly, the planned Due Diligence Act must be reviewed against the standard of Art. XI:1 GATT. In order for it to violate Article XI:1 GATT, the law would need to have a trade-restrictive effect. Whether WTO dispute settlement bodies would follow such a claim seems questionable. In particular, it is doubtful whether the Act would have any effect on the import of goods into Germany, as it merely creates an *ex post* civil liability of companies located in Germany in case of non-compliance with the best effort obligation as formulated in the Act, but not obligations regarding a result or a guarantee liability. The Act does not provide for import bans or restrictions on the import of goods by companies that do not comply with the obligations set out in the Act. Furthermore, it is unlikely that the Act would develop steering effects in that regard, which can create *de facto* restrictions to trade. In particular, it should be noted that the cases in which the WTO adjudicating bodies found that the requirements set out in Art. XI: 1 GATT have not been complied with always involved a ban on imports of goods which did not comply with the specifications regarding production set out in the respective regulation of the WTO member. However, the Due Diligence Act does not provide for a *de iure* import ban, and even a *de facto* effect to that would have to be considered as being very limited and of an indirect manner.

However, a parallel between the German Due Diligence Act and the EU Regulation laying down the obligations of operators who place timber and timber products on the market[20] could be drawn. It is argued in academic literature that the latter constitutes a *prima facie violation of* Art. XI:1 GATT.[21] Here, too, the Regulation imposes certain obligations on market participants with regard to traceability along their supply chain as well as certain due diligence rules,[22] the violation of which may result in sanctions.[23]

It should be noted that the mere fact that each market participant may decide on his or her own whether to comply with the due diligence obligations imposed by the law does not preclude a measure from being considered a trade restriction within the meaning of Article XI: 1 GATT. This has already been confirmed in the jurisprudence of the WTO adjudicative bodies. In *Korea - Beef,* the WTO Appellate Body has held that the existence of various options for market participants does not relieve a WTO member of the responsibility for the restrictive effects of a measure.[24]

4.2 Justification Under Art. XX GATT

If one assumes that the Due Diligence Act were to have a *de facto* trade-restrictive effect, the question arises as to a possible justification of the violation of Art. XI:1 GATT.

[20] Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010 laying down the obligations of operators who place timber and timber products on the market, OJ EU L No 295/23. In this respect, it should be noted that the Regulation does not prohibit the *import of* the products themselves, but only the placing on the market of illegally harvested timber and timber products.
[21] *Geraets/Natens*, in: *Wouters et al. (*eds.), Global Governance through Trade (2015), Governing through trade in compliance with WTO law: a case study of the European Union Timber Regulation, p. 282 ff.
[22] Articles 4, 6 of Regulation (EU) No 995/2010.
[23] Article 19 of Regulation (EU) No 995/2013.
[24] Report of the Appellate Body of 10 January 2001 in *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef,* WT/DS161/AB/R, WT/DS169/AB/R, para. 146.

The Due Diligence Act is aimed at contributing to the improvement of the international human rights situation.[25] Thus, a possible justification via Art. XX lit. a) GATT has to be considered. Accordingly, the Act would be compatible with the provisions of the GATT if it constituted a measure necessary for the protection of public morals. Furthermore, according to the requirements of the *chapeau* as formulated in Art. XX GATT, it must not constitute a disguised restriction on international trade and should not be implemented in such a way that it operates as a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail.

In contrast, a justification via Art. XX lit. b) GATT is not possible. The provision permits measures necessary to "protect human life or health". According to settled jurisprudence of the WTO adjudicative bodies, this only extends to measures that serve to protect the member's *own* population from dangers that would arise as a result of the import of the goods,[26] but not measures aimed at the protection of workers from risks arising from the production conditions in the exporting country or the population of the exporting country.

(a) The scope of the standard

The WTO Dispute Settlement Bodies have addressed the concept of measures necessary for the protection of public morals in *United States - Gambling*[27] , *European Communities – Seal Products*[28] *and China – Publications and Audiovisual Products*[29].

i. Concept of "public morals"

As can be deduced from the Panel Report in *United States - Gambling,* the concept of public morals is a dynamic one. Each WTO member must be granted a margin of discretion in defining and applying the concept of public morals within its own territory and in accordance with its own values.[30] The Panel ruling was later upheld by the Appellate Body. The vagueness of the concept as such and the discretion of WTO Members in their understanding of the concept result in the standard having a broad scope of application.[31] This would potentially include measures aimed at outlawing child labor as well as

[25] Draft law of the Federal Government: Draft law on corporate due diligence in supply chains of 03 March 2021, p. 1.

[26] See Report of the Panel of 7 November 1990, *Thailand - Cigarettes*, BISD 37S/200, para 73; Report of the Panel of 5 April 2001, *European Communities - Asbestos,* WT/DS135/R, para 8.194; Report of the Panel of 17 December 2007, *Brazil - Retreaded Tyres,* WT/DS332/R, paras 7.71 and 7.82.

[27] Report of the Panel of 10 November 2004, WT/DS285/R, United States - Measures Affecting the Cross-Border Supply of Gambling and Betting Devices.

[28] Appellate Body Report of 22 May 2014, WT/DS400/AB/R; WT/DS401/AB/R, European Communities - Measures Prohibiting the Importation and Marketing of Seal Products.

[29] Report of the Appellate Body of 21 December 2009, WT/DS363/AB/R, China - Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products.

[30] Report of the Panel of 10 November 2004, WT/DS285/R, *United States - Measures Affecting the Cross-Border Supply of Gambling and Betting Devices*, paras. 6.461, 6.479-6.487. The interpretation of the term "public morality" here was made in relation to Art. XIV GATS, but can be applied *mutatis mutandis* to the parallel provision of Art. XX GATT.

[31] On the report of Appellate Body Jurisprudence in United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Devices: Matsushita et al, The World Trade Organization (2015), p. 618.

measures aimed at the protection of human rights and the environment.[32] Furthermore, the jurisprudence of the WTO Appellate Body in *European Communities – Seals* shows that WTO jurisprudence grants the Members of the organization a wide margin of discretion with regard to the determination of the objects of protection within the framework of public morals within the meaning of Art. XX lit. a) GATT. According to the jurisprudence of the Appellate Body, measures for animal welfare purposes fall within the scope of application of Art. XX lit. a) GATT. They can thus be assumed to be a measure taken for the protection of public morals. Provided they fulfill the other requirements set out in Art. XX GATT, they are permissible under WTO law.[33] Accordingly, it seems likely that the WTO dispute settlement bodies would accept a line of reasoning according to which the Due Diligence Act, being intended to combat child labor, forced labor and all forms of slavery or the disregard of fundamental labor rights[34] constitutes a measure for the protection of public morals within the meaning of Art. XX lit. a) GATT.[35]

ii. Necessity

The Due Diligence Act further would have to be necessary for the protection of public morals. In this respect, regard should be had to the WTO Appellate Body's jurisprudence on the interpretation of Art. XX lit. a) GATT in *China – Publications and Audiovisual Products*. Herein, the Appellate Body held that the likelihood of a measure being considered "necessary" within the meaning of Art. XX lit. a) GATT increases the less restrictive its effects are.[36] As already stated above, it is not evident that the planned Due Diligence Act would result in severe restrictions to trade. Accordingly, this increases the likelihood of it being considered compatible with the requirements of Art. XX lit. a) GATT. In *United States – Gambling,* the WTO Appellate Body further held that the necessity of the measure could not be denied merely because there was the possibility of entering into negotiations with the exporting country. The adjudicative body held that such negotiations could not be accorded the same effectivity in safeguarding public morals due to the uncertainty as to their outcome.[37] With regard to the German Due Diligence Act, it is to be assumed that that the theoretical possibility of cooperative approaches to combating the above-mentioned violations of human rights would also not call the necessity of the measure into question under the standards of WTO law.

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[32] *Berrisch,* in: *Prieß/Berrisch/Pitschas* (eds.), WTO Handbook (2003), Section B.I.1, para. 236; to this effect also *Wenzel*, in: *Wolfrum/Stoll/Hestermeyer* (eds.), WTO - Trade in Goods (2011), Article XX GATT, para. 6, with further references. Critically: *Herrmann/Weiß/Ohler,* Welthandelsrecht (2007), p. 358 f.; however also affirming the application of the norm in constellations that affect the "fundamental interests of society", for example the fight against child and slave labour.

[33] Report of the Appellate Body v. 22 May 2014, WT/DS400/AB/R; WT/DS401/AB/R, *European Communities - Measures Prohibiting the Importation and Marketing of Seal Products*, para. 5.201. See also *Matsushita et al.*, The World Trade Organization (2015), p. 742 *et* seq.

[34] Cf. in this respect the list in Section 2 (2) No. 2 of the planned Due Diligence Act.

[35] Also in relation to compliance with basic standards of the ILO *Marceau*, in: *Bethlehem et al. (*eds.), The Oxford Handbook of International Trade Law (2009), Trade and Labour, p. 550.

[36] Report of the Appellate Body of 21 December 2009, WT/DS363/AB/R, China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products, para. 336 f.

[37] Report of the Appellate Body of 7 April 2005, WT/DS285/AB/R, United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services, para. 317.

b. Territorial scope of the standard

Just as it is the case under Art. XX lit. b), g) GATT,[38] the problem of the territorial scope of Art. XX lit. a) GATT arises. Furthermore, it must be determined to what extent provisions that refer to the production process of the imported product fall within the scope of application of Art. XX lit. a) GATT. Those opposing such an interpretation argue that the norm is an expression of the fact that WTO law respects the different moral and ethical standards of its members. Accordingly, members of the WTO should not be able to impose their own moral standards on another WTO member by relying on Art. XX lit. a) GATT. According to this view, Art. XX lit. a) GATT could only be invoked with regard to production conditions in the exporting country if the provision is relied on to enforce internationally applicable standards which are also accepted by the exporting state.[39] In such cases, which concern basic human rights and ILO standards, Art. XX lit. a) GATT is applicable.[40] Accordingly, the same would apply to the enforcement of provisions of mandatory international law (so-called *ius cogens*), which includes, for example, the prohibition of slavery. Here, the international legal order does not grant the subject of international law any possibility of deviating from its own commitment to the rule of international law *per se*.[41] If one were to follow such an approach, a differentiation would have to be made between the individual objectives pursued with regard to the planned German Due Diligence Act: if a human rights norm of international law is also accepted by the exporting state, an invocation of Art. XX lit. a) GATT would be possible, as would measures intended to combat slavery, the prohibition of which constitutes *ius cogens*.

Nevertheless, it must be stated that it is doubtful whether WTO adjudicating bodies would also pursue such a restrictive approach. The case law in *European Communities – Seals* does not support this conclusion. Here, the question of whether the exporting states took comparable measures to protect animals was not addressed in the context of the European Union's line of reasoning, which based its reasoning relating to the compatibility of the trade-restrictive measures it had imposed on Art. XX lit. a) GATT.

4.3 Result

The German Due Diligence Act may be measured against the standard of Art. XI:1 GATT. A *prima facie* violation of the provision or the law being considered an “other measure” within the meaning of the norm do not appear to be ruled out from the outset, in particular taking into account the very broad scope of application of the norm according to the case law of the WTO adjudicative bodies.

If one finds that the draft Due Diligence Act imposes a *de facto* restriction on trade, the restriction could be justified through Art. XX lit. a) GATT. It can be assumed that a line of reasoning according to which

[38] See Report of the Panel in *United States – Restrictions on Imports of Tuna*, ILM 1991 (30), para. 5.24 et seq; Report of the Panel in *United States – Restrictions on Import of Tuna*, DS29/R, para. 5.15; Report of the Panel in *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R, para. 124 as well as *Stoll/Strack*, in: *Wolfrum/Stoll/Hestermeyer* (eds.), WTO – Trade in Goods (2011), Art. XX lit. b) GATT, para. 52 and *Maz-Lück/Wolfrum*, in: Ebed., Art. XX lit. g) GATT, para. 22 ff.

[39] *Wenzel*, in: *Wolfrum/Stoll/Hestermeyer* (eds.), WTO - Trade in Goods (2011), Article XX lit. a) GATT, paras. 16, 23 ff.

[40] Cf. above.

[41] Cf. on *ius cogens*: *Crawford*, Brownlie's Principles of Public International Law (2019), p. 581 et seq.

the Due Diligence Act constitutes a measure aimed at preventing the human rights violations described above, would be accepted by the said adjudicative bodies, particularly in light of the broad scope of application as affirmed in the jurisprudence of the WTO adjudicative bodies. However, the measure would still have to comply with the necessity requirement of Art. XX lit. a) GATT. Alternative, equally effective measures are not apparent; in particular, in *United States - Gambling*, the Appellate Body found that cooperative approaches in the form of negotiations with the exporting state cannot be considered to be of equal effectiveness. In particular as the trade-restrictive effects of the planned Due Diligence Act would likely be limited in scope, there currently are no fundamental concerns regarding the necessity of the rules as envisaged by the German legislator, although this assessment will certainly depend on the final form of the Act and on the respective arguments raised by the parties in WTO dispute settlement proceedings.

Conclusion: A *prima facie* violation of Art. XI:1 GATT by the German Due Diligence Act does not appear to be excluded from the outset, particularly in view of the broad scope of application of the norm. However, any trade-restrictive effect resulting from the Act would likely be justified under Art. XX lit. a) as a measure necessary for the protection of public morals, especially in light of the case law of the WTO Appellate Body in *European Communities – Seals*.

5. Alternative Solutions

In order to improve the human rights situation in the countries concerned, various alternatives to the German Due Diligence Act are available at the European level, which will be set out in further detail below.

5.1 Regulatory Approaches Currently under Discussion at EU Level

The EU is currently considering the adoption of legislation regulating companies' due diligence obligations in their supply chains of its own. The legislation will be adopted in the form of a directive. The directive, originally announced by the Commission for the beginning of the year, is now to be presented in autumn under the title "Sustainable Corporate Governance". A public consultation on the subject matter ended in February.[42] Already in December 2020, European Parliament adopted a resolution on recommendations on sustainable corporate governance.[43] In March 2021, Parliament adopted a resolution containing recommendations to the Commission on corporate due diligence and accountability, together with a concrete proposal for a draft directive.[44] The proposed legal basis for the draft directive is Articles 50, 83 (2) TFEU and Article 114 TFEU. This illustrates the potential impact of the proposed regulation on the internal market.

In terms of content, the due diligence obligations recommended by the European Parliament go beyond the obligations of companies envisaged in the German Due Diligence Act: the due diligence obligations of companies extend to mitigating the risk of adverse effects on human rights, including social, trade union and labor rights, on the environment, and on good governance principles.[45] Incidentally, the approach advocated by the European Parliament is similar to that of the German legislator and the approach chosen in the EU Conflict Minerals Regulation.[46] Companies can comply with their due diligence obligations under EU law by developing a strategy to identify and assess the nature and context of their activities, also with regard to geographic aspects, and to determine whether their activities and business relationships cause, contribute to or are directly linked to potential or actual adverse effects on the above-mentioned areas.[47] Under the approach taken by the European Parliament, this strategy is to be published and communicated to the company's employee representatives, trade unions and,

[42] Cf. the information on the European Commission's website on the legislative procedure: <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance>.
[43] European Parliament resolution of 17 December 2020 on sustainable corporate governance (2020/2137(INI)).
[44] European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)).
[45] See Recital 20 and Article 1(2) of the Proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.
[46] Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017 establishing supply chain due diligence obligations for Union importers of tin, tantalum, tungsten, their ores and gold from conflict and high-risk areas (Conflict Minerals Regulation), OJ EU 2017 L No 130/1.
[47] Article 4 (2–9) of the Proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.

upon request, to the competent authority in the respective Member State.[48] Similar to the German Due Diligence Act, the draft directive proposed in the parliament's resolution also provides for the establishment of a complaints procedure for stakeholders. This procedure is intended to enable them to express concerns about potential or actual adverse effects of business activities on the above-mentioned areas.[49] Further, the resolution stipulates that Member States must designate one or more competent national authorities responsible for monitoring the application of the directive as transposed into national law.[50] These authorities would also be granted powers of inspection and investigation with regard to compliance with the requirements of the Directive.[51] Finally, Member States are to lay down appropriate penalties for infringements of the national provisions adopted pursuant to this Directive and take all measures necessary to ensure that they are implemented.[52]

In a key difference to the German Due Diligence Act, the Directive covers not only undertakings governed by the law of a Member State or established in the territory of the Union, but also undertakings governed by the law of a third country and not established in the territory of the Union, if they operate in the internal market through the sale of goods or the provision of services. Such an extension of rules to market participants with the nationality of a third state also takes place in other areas of law, such as data protection law.[53] However, Parliament's idea of these third-country undertakings fulfilling the due diligence obligations laid down in the planned Directive by complying with the relevant requirements as transposed into the law of the Member State in which they operate and by being subject to the sanction and liability regimes laid down in the Directive as transposed into the law of the Member State in which they operate appears questionable. In particular, it remains unclear which requirements would apply to third country companies that operate in several EU Member States. This would risk creating considerable legal uncertainty for the economic operators concerned, at least if the proposal were to be adopted along the lines of the resolution of the European Parliament.

Moreover, secondary EU legislation also has to comply with the requirements of WTO law. The EU is a member of the World Trade Organization of its own right. Hence, it is bound by the legal obligations resulting therefrom.[54] Accordingly, a directive which sets out corporate due diligence obligations with regard to the production process and its compliance with human rights and environmental standards

[48] Article 6 of the proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.
[49] Article 9 of the proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.
[50] Article 12 of the proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.
[51] Article 13 of the proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.
[52] Article 18 of the proposal for a Directive of the European Parliament and of the Council on corporate due diligence and accountability, annexed to the Resolution.
[53] Cf. e.g. Art. 3 (2) (a) of Regulation of the European Parliament and of the Council of 27.04.2016 on the protection of individuals with regard to the processing of personal data, on the free movement of such data and repealing Directive 95/46/EC, OJ. (EU) 2016 L 119/1 (General Data Protection Regulation): "*This Regulation applies to the processing of personal data of data subjects located in the Union by a controller or processor not established in the Union where the data processing is related to the offering of goods or services to data subjects in the Union (...)*".
[54] *White,* in: *von Arnauld* (ed.), European External Relations (2014), Treaty-based Trade Policy of the EU, para. 9.

would have to be compatible with Art. XI:1 GATT.[55] As the proposal of the EU Parliament follows a regulatory approach parallel to the one of the German Due Diligence Act, reference can largely be made to the above sections in this respect. Serious doubts as to the compatibility of the planned EU legislation with WTO law arise, however, with regard to the extensive catalogue of international law norms referenced therein, which not only stem from the area of human rights protection, but also from the areas of good governance and environmental protection. As already stated above, in principle, WTO members are entitled to a wide margin of discretion with regard to their interpretation of the concept of "public morals" under Art. XX lit. a) GATT.[56] However, as also outlined above, some voices in the academic literature prefer a restrictive application of the norm with regard to production conditions in the foreign country in order to prevent the importing country from imposing its own standards on other WTO Members. Under this line of reasoning, a country can only invoke Art. XX lit. a) GATT insofar as it aims at upholding such standards which the producing country has also subscribed to. In view of the extensive list of agreements in the areas of human rights and environmental protection and good governance contained in the annex to the EU Parliament's legislative proposal for a directive, this requirement would likely only be met in very few cases, or only to the extent that the country in which the goods are produced has also undertaken to comply with the respective standards.

5.2 Positive or Negative Lists

The introduction of positive or negative lists on which reliable or unreliable trading partners are listed is sometimes mentioned as an alternative solution. In the following, these solutions will be examined with regard to their practicability and their compatibility with EU and WTO law.[57]

5.2.1 Possible Legal Basis and Design

The legal basis of a corresponding secondary EU act depends on the exact form of such an approach. If only natural or legal persons from third countries were to be listed, Article 207 TFEU would likely be the correct legal basis. Pursuant to Article 207 (2) TFEU, the European Parliament and the Council are empowered to adopt, by means of regulations, measures defining the framework for the implementation of the Union's common commercial policy. The Union's legislative power is limited to market access issues.[58] The fact that a trade policy measure also pursues non-economic objectives does not preclude a measure from being based on Article 207 TFEU.[59] Hence, an act of Union law by means

[55] A distinction must be made between this and the question of the "direct effect" of world trade law in the Union legal order. Such a possibility of invoking the WTO illegality of a Union act in the context of an action for annulment is only granted by the ECJ under narrow exceptional conditions (so-called *Nakajima/Fediol case law*), cf. on this *Herrmann/Streinz*, in: *von Arnauld (*ed.), Europäische Außenbeziehungen (2014), Die EU als Mitglied der WTO, para. 118 et seq.

[56] See above, p. 6.

[57] Cf. e.g. the letter from individual MEPs of the EPP Group to Justice Commissioner Reynders, <https://www.handelsblatt.com/politik/deutschland/menschenrechte-cdu-politiker-fordern-digitales-lieferkettenregister-fuer-den-eu-binnenmarkt/26777122.html?ticket=ST-3542204-O0LY9HIKHJmg5Rn1FN9d-ap3>.

[58] Weiß, in: Grabitz/Hilf/Nettesheim (eds.), Das Recht der EU (71st EL August 2020), Art. 207 TFEU, para. 88.

[59] This has also been recognized by the ECJ, see Opinion 2/15 of 16 May 2017, *EU–Singapore Free Trade Agreement*, para 145; ECJ, judgment of 12 December 2002, Case C-281/01, *Commission v. Council (Energy Star*

of which economic relations of EU undertakings with economic operators in third countries are only permissible after their inclusion in a corresponding list would have to be based on Article 207 (2) TFEU.

Conversely, Article 215 (1) TFEU cannot be used as a legal basis. The provision is included in the title of the TFEU on restrictive measures of the EU. Legislation stipulating general requirements to be fulfilled by third-country exporters in order to be granted access to the internal market are not imposed following a specific cause. This, whoever, is necessary for the norm to be applicable.[60]

Accordingly, a regulation based on Article 207 (2) TFEU would standardize the conditions under which a third-country enterprise would fall within the scope of the legal act and which criteria must be fulfilled for it to be included in a positive or negative list. In the interests of flexibility or adaptability of these lists, and as comparable structures exist in other areas of EU external economic law, it is to be expected that the Commission would be named as the authority responsible for carrying out the relevant investigative procedures. It can also be expected that any legislative act would empower the Commission to adopt implementing or delegated acts within the meaning of Article 290 TFEU to establish or amend a list of companies that meet (in the case of a positive list) or fall below (in the case of a negative list) the Union's human rights and/or environmental standards requirements.[61]

5.2.2 Positive lists

If a positive list is used (Caspary et al., 2021), exporting companies are certified by a central body, for example. Companies in Germany and Europe can then purchase primary products from these certified companies without hesitation and without having to carry out their own tests. Such a solution would be more favorable for importers, as they would not have to independently audit all their suppliers (Felbermayr et al., 2020). Exporters in developing countries would also benefit from the fact that they would only have to be certified once and would not have to be individually audited by each of the companies they supply. Costs would thus be lower, although not completely eliminated.

EU foreign trade law is no stranger to list approaches. For example, the Conflict Minerals Regulation also contains a "positive list approach" in the sense that the Commission is obliged to draw up implementing acts establishing or amending a worldwide list of the names and addresses of responsible smelters and refiners.[62] However, this only serves the purpose of providing certainty to downstream

Agreement), paras 39, 43. On the complex, see also Cremona, in Koutrakos/Snell (eds), Research handbook on the law of the EU's internal market (2017), The internal market and external economic relations, p. 498.

[60] *Weiß*, in: *Grabitz/Hilf/Nettesheim* (eds.), Das Recht der EU (71st EL August 2020), Art. 207 TFEU, para. 58.

[61] Comparable structures exist, for example, in the law on trade defense instruments, where the Commission also acts as an investigating authority or adopts the defense measures in the form of implementing regulations. Cf. i.e. *Van Bael/Bellis*, EU Anti-Dumping and Other Trade Defense Instruments (2019), p. 4 et seq. Cf. further Art. 9 Conflict Minerals Regulation. Other examples in which the Commission is empowered to draw up "negative lists" by means of a delegated act are Regulation (EC) No 2111/2005 of the European Parliament and of the Council of 14 December 2005 on the establishment of a Community list of air carriers subject to an operating ban within the Community and on informing air transport passengers of the identity of the operating air carrier, and repealing Article 9 of Directive 2004/36/EC,OJ (EC) L No 344/15, as well as and Council Regulation (EC) No 1005/2008 of 29 September 2008 establishing a Community system to prevent, deter and eliminate illegal, unreported and unregulated fishing, OJ (EC) L No 601/1.

[62] Article 9 Conflict Minerals Regulation.

companies as to the practice of exercising due diligence in the supply chain.[63] In contrast, the Conflict Minerals Regulation does not require that the business relationships of the addressees of the Regulation be limited to those refineries and smelters that are included in the said list. A legal requirement that EU companies may only enter into business relationships along their supply chains with legal entities and/or natural persons that are also on a corresponding EU list would hardly be practicable due to the significant administrative burden that would be expected for the Commission. In particular, it would also pose significant challenges in terms of its compliance with WTO and Union law.

a) WTO Legal Issues

A positive list approach would constitute a clear *prima facie* violation of Art. XI: 1 GATT.

Depending on the structure of these positive lists, a violation of the non-discrimination obligations set out in the GATT must also be considered. In particular Art. III: 4 GATT has to be mentioned here if the "positive lists" and the need to be named in such a list in order to offer one's goods on the internal market were to apply exclusively to companies from third-countries.

In accordance with the WTO case law mentioned above, due to the significant trade-restrictive effects such a measure would have, stricter criteria would have to be met in order to confirm the necessity of the measure to protect public morals, and thus the possibility of the measure to be justified under Art. XX lit. a) GATT.[64] Here, too, the requirement of the *chapeau* contained in Art. XX GATT, according to which the application of the measure in question must not constitute a disguised restriction on international trade, would have to be observed.[65] The provision is intended to prevent any abuse of the rights set out in Art. XX lit. a) to j) GATT on part of the WTO members. It focusses on examining whether the reasons cited as objectives of a trade restriction are merely a pretext, and whether they actually serve to conceal arbitrary or unjustified discrimination between domestic and foreign products or between products from different third countries where the same conditions prevail. The existence of discrimination is to be assessed on the basis of different criteria than it is the case under Art. I and III GATT. According to the jurisprudence of the WTO adjudicative bodies, the compatibility of a measure with the *chapeau* of Art. XX GATT[66,67] is questionable, *inter alia*, where its application has the consequence of exporting countries having to adhere to strict requirements if they wish to export to the respective country, without taking into account the extent to which these requirements are appropriate with regard to the conditions prevailing in the exporting country.[68] In view of this

[63] See recital 16 of the Conflict Minerals Regulation.
[64] See above, p. 7.
[65] That the requirement of the *chapeau* refers to the *application of* the measure, and not its substantive form, was made clear by the Appellate Body in *United States – Shrimp,* WT/DS58/AB/R, para. 160.
[66] Cf. the Report of the Panel in *European Communities - Asbestos,* WT/DS135/R, para. 8.231 et seq.; *Wolfrum*, in: *ders./Stoll/Hestermeyer* (eds.), WTO – Trade in Goods (2011), Article XX GATT [Introduction], para. 45; Herrmann/Weiß/Ohler, Welthandelsrecht (2007), p. 232 et seq.
[67] *Van den Bossche/Zdouc,* The Law and Policy of the World Trade Organization (2017), p. 595; *Wolfrum*, in: *ders./Stoll/Hestermeyer* (eds.), WTO – Trade in Goods (2011), Article XX GATT [Introduction], para. 27; Herrmann/Weiß/Ohler, Welthandelsrecht (2007), p. 232 et seq.
[68] See Appellate Body Report in *United States - Shrimp*, WT/DS58/AB/R, para 164 f: "Section 609, in its application, imposes a single, rigid and unbending requirement that countries applying for certification (...) adopt a

jurisprudence and considering that a positive list approach would *de facto* result in the complete prevention of export opportunities to the EU for a certain period of time prior to the undertaking's inclusion on the list, it has to be questioned whether a positive list approach exclusively applicable to third country undertakings would meet the requirements of the *chapeau of* Art. XX GATT.

(b) Compatibility with EU Law

At the level of EU law, the requirement to limit one's business relationship to legal and/or natural persons who are included on a list issued by the Commission would in particular constitute a violation of the freedom to conduct a business as protected by Art. 16[69] of the EU Charter of Fundamental Rights. According to the case law of the ECJ, the scope of protection of Art. 16 includes enterprises' freedom of contract,[70] which also extends to the free choice of one's contractual partner.[71] The provision's scope of protection covers national and legal persons of an EU Member State's nationality as well as those possessing the nationality of a third State.[72] Therefore, a positive list approach would constitute a violation of the rights guaranteed under EU law to both EU companies and their business partners in third countries. In order to comply with EU law, such a violation would have to meet the justification requirements under Article 52 of the Charter. The protection of human rights in third states constitutes an "objective of general interest recognized by the Union" within the meaning of Art. 52 (1) sentence 2 of the Charter. However, the ECJ has consistently held that the principle of proportionality must be observed. It thus has to be ensured that the measures adopted do not exceed the limits of what is necessary to achieve the objectives legitimately pursued by the legislation in question, and that the disadvantages they cause are not disproportionate to the objectives pursued.[73] Whether the positive list approach and the significant restriction of the freedom to conduct a business of numerous undertakings imposed by such legislation would satisfy those requirements depends on the precise form of such a Union act. In any case, the introduction of such legislation would likely only be possible after the expiry of transitional periods in order to permit the companies concerned to modify their business relations accordingly.

The Court of Justice has consistently held that respect for the rights of the defense is an essential principle of Union law in all proceedings brought against a person which may result in a measure adversely affecting that person.[74] Moreover, the right to good administration, which includes the right to be heard, is an inherent part of the effective respect of the rights of the defense and is explicitly recognized in Article 41 (2) (a) of the Charter of Fundamental Rights of the EU. This includes, inter alia, the right of a person to have his or her affairs handled impartially, fairly and within a reasonable time by the institutions, bodies, offices and agencies of the Union. This implies the right to be heard before

comprehensive regulatory program that is essentially the same as the United States' program, without inquiring into the appropriateness of that program for the conditions prevailing in the exporting countries."

[69] Charter of Fundamental Rights of the European Union, OJ (EU) 2012 C No. 326/391.

[70] ECJ, Judgment of 22.01.2013, Case C-283/11, *Sky Austria*, para. 42.

[71] ECJ, judgment of 18 July 2013, Case C-426/11, *Alemo-Herron*, para. 32.

[72] *Jarass*, Charter of Fundamental Rights of the EU (2021), Art. 16 GRC, para. 11 f.

[73] *Schwerdtfeger*, in: *Meyer/Hölscheidt (*eds.), Charter of Fundamental Rights of the European Union (2019), Art. 52 GRC, para. 38.

[74] With further references, General Court, judgment of 10 October 2012, Case T-170/09, *Shanghai Biaowu High-Tensile Fasteners Co Ltd*, para. 130.

any individual measure adversely affecting him or her is taken, access to the file concerning him or her and the obligation for the administration to give reasons for its decisions.[75] Accordingly, the (third-country) undertakings concerned should be given the opportunity to effectively exercise their rights in the context of an administrative procedure potentially resulting in their (non-)inclusion on a list compiled by the Commission. This would include both the right to inspect files and the right to be heard prior to a Commission decision on (non-)inclusion on the list of undertakings observing their obligations with regard to the protection of human rights, the environment and good governance principles, as well as the possibility to rectify wrong information. In this respect, a parallel can be drawn with the European Union's trade defense legislation. Here, interested parties are also granted the right to comment as well as rights of participation during the administrative procedures preceding the imposition of the corresponding trade defense measures.[76] While limiting companies' right to comment as well as any participatory rights to a period after the measures have been adopted would reduce the considerable administrative burden for the Commission, it would hardly be possible to reconcile such an approach with the content of the right to good administration as just outlined above.

5.2.3 Negative Lists

The counterpart to a positive list would be a negative list. Foreign entrepreneurs who disregard human rights can be sanctioned with the help of the EU Magnitsky Act. Foreign companies from third countries that disregard human rights could be placed on a "black list" by the EU after a consultation process. This is what the USA are pursuing in their Global Magnitsky Act with the so-called "entity list". It would then no longer be possible to trade with these companies. This ban would be binding for all members of a supply chain and would have to be communicated along the supply chain accordingly.

The advantages of a negative list lie in the accuracy of targeting and in a low level of bureaucracy for companies, as well as in legal certainty, since the necessity of the inevitably subjective examination of "compliance" by companies would be eliminated. The governments of the industrialized countries, which have so far advocated due diligence laws, would be obliged to assess demonstrable violations of workers' rights themselves on the basis of the relevant international standards and national legislation and to practice a concerted procedure in cooperation with like-minded governments. Such an approach at EU level would replace national supply chain laws and would have considerable leverage on companies. Affected companies would be granted the right to sue and, of course, could be removed from the sanctions list once their misconduct has been remedied. The definition of the criteria for placing a company on the list as well as a fair and efficient hearing and appeal procedure would be fundamental principles of the rule of law for the acceptance of such a negative list. Exporters would thus incur significantly lower costs than with a positive list, since they would only have to face a review if they were placed on the negative list.

As a result of the administrative and legal problems that would arise from a positive list approach, as outlined in the previous section, a negative list approach appears to be a worthwhile alternative solution to the objective of safeguarding human rights along the supply chain. In contrast to the approach pursued by drawing up positive lists, a break-off of business relations by EU companies or a ban on the

[75] Article 41 (1), (2) GRC.
[76] See in detail *Van Bael/Bellis*, EU-Antidumping and Other Trade Defense Instruments (2019), p. 399 et seq.

import of goods into the domestic market would only be necessary here if it had previously been established that a third-country company was not working sufficiently towards compliance with human rights and labor standards in its production conditions or was even committing acts of violation itself. Such negative lists already exist in various areas of Union law: for example, on the basis of the Regulation on banned air carriers[77], a list has been drawn up of air carriers subject to an operating ban in the Union as a result of safety concerns. This list is regularly updated by the Commission.[78] Similarly, the EU Regulation on illegal fishing[79] sets out the criteria and procedure for the Commission to establish and update a list identifying vessels engaged in illegal fishing.[80] The Commission may also establish a list identifying third countries which do not cooperate in the fight against illegal fishing.[81] As a consequence of being included in either list, the import into the Union of fishery products caught by fishing vessels flying the flag of a non-cooperating third country or caught by a fishing vessel which is itself on the first-mentioned list is, inter alia, prohibited.[82]

In foreign trade law, the law of the EU's trade defense instruments should be mentioned at this point: here too, the EU's anti-dumping or countervailing duties only apply to third-country exporters for which the existence of dumping or the export of subsidized goods can be positively established (often, however, extended to other companies from the same exporting country in order to avoid circumvention).[83]

Such a "*blacklisting*" approach would not only have the advantage of being much more manageable administratively for the Commission. It would also significantly reduce the legal concerns it would raise, as will be explained below.

(a) WTO Law Issues

An inclusion of third-country companies on a "negative list" likewise constitute a *prima facie* violation of the national treatment requirement set out in Art. III:4 GATT. Here, the uncertainties expressed above as to the possibility of justifying a "list approach" via Art. XX lit. a) GATT only arise to a limited extent. This is due to the lesser restriction of export opportunities from third countries within the EU associated with such a solution, and the measure targeting only companies for which a violation of human rights has been positively established. Only where this is the case would a company's export opportunities be affected by its inclusion in the list and the restriction of its export opportunities associated therewith.

[77] Regulation (EC) No 2111/2005 of the European Parliament and of the Council of 14.12.2005 on the establishment of a Community list of air carriers subject to an operating ban within the Community and on informing air transport passengers of the identity of the operating air carrier, and repealing Article 9 of Directive 2004/36/EC, OJ (EC) 2005 No 344/15 (Air carriers Regulation).
[78] Art. 3, 4 Air Carrier Regulation.
[79] Council Regulation (EC) No 1005/2008 of 29 September 2008 establishing a Community system to prevent, deter and eliminate illegal, unreported and unregulated fishing, OJ (EC) 2008 L No 601/1 (Fisheries Regulation).
[80] Art. 27 ff. Fisheries Regulation
[81] Art. 31 ff. Fisheries Regulation.
[82] Articles 37 and 39 of the Fisheries Regulation.
[83] On the process of an anti-dumping or anti-subsidy proceeding, see *Van Bael and Bellis*, EU Antidumping and Other Trade-Defence Instruments (2019), p. 343 et seq.

b) EU Law Compatibility

As it is the case for a positive list approach, a negative list approach would likewise have to be measured against the yardstick of Article 16 CFR and the rights contained in Article 41 CFR. Here, too, the concerns regarding the justification of an infringement of Art. 16 CFR as a result of an undertaking being named on a negative list are less far-reaching due to the targeted nature of the measures.

With regard to the design of the administrative procedure that would precede an inclusion on the negative list, regard can be had to other areas of EU external trade law. In particular, the aforementioned EU law on trade defense instruments should be mentioned here. It provides for a highly nuanced administrative procedure that precedes the imposition of trade defense measures vis-à-vis the exporters of the products affected by the measures.[84] In this respect, parallels could also be drawn to the EU's anti-dumping and anti-subsidy proceedings with regard to the initiation of proceedings. In EU trade defense law, the Commission may initiate proceedings *ex officio*. In practice, however, the proceedings will usually be initiated following a complaint by the Union industry injured by the import of the dumped or subsidized products. Since the entry into force of the reform of the EU's trade defense instruments in 2018,[85] trade unions may support a complaint to the Commission.[86] Accordingly, EU external trade law already provides for the initiation of proceedings and the participation of non-state actors in administrative procedures. In this respect, it is worth mentioning that non-governmental organizations or consumer associations are also heard in other stages of an anti-dumping or anti-subsidy procedure.[87] With regard to the initiation of proceedings concerning the inclusion of a company on a human rights and/or environmental "negative list", in a parallel to the approach taken under EU trade defense law, it would be possible to provide for the initiation of proceedings by the Commission upon request of members of EU industries, but also by trade unions or non-governmental organizations. An abuse of this right could be prevented by providing for certain criteria an entity must meet in order to be able to file a complaint with the Commission. For example, trade defense law requires that a certain proportion of the EU industry supports the complaint.[88] Formal criteria would also have to be set for trade unions or non-governmental organizations in order to have a right of complaint.[89]

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[84] For details on administrative procedures in EU external trade law, see *Eeckhout*, Administrative Procedures in EU External Trade Law - Note Prepared for the Directorate-General of Internal Policies of the European Parliament (2011), available at <https://www.europarl.europa.eu/RegData/etudes/note/join/2011/432758/IPOL-JURI_NT(2011)432758_EN.pdf>.

[85] Regulation (EU) 2018/825 of the European Parliament and of the Council of 30 May 2018 amending Regulation (EU) 2016/1036 on protection against dumped imports from countries not members of the European Union and Regulation (EU) 2016/1037 on protection against subsidized imports from countries not members of the European Union, OJ EU 2018 L 143/1.

[86] Article 5 (1) of Regulation (EU) 2016/1036 of the European Parliament and of the Council of 8 June 2016 on protection against dumped imports from countries not members of the European Union (Anti-Dumping Regulation), OJ EU 2016 L 176/21 and the parallel provision of Article 10(2) of Regulation (EU) 2016/1037 of the European Parliament and of the Council of 8 June 2016 on protection against subsidized imports from countries not members of the European Union (Anti-Subsidy Regulation), OJ EU 2016 L 176/55.

[87] See Article 21 (2) of the Anti-Dumping Regulation and the parallel provision of Article 31 (2) of the Anti-Subsidy Regulation.

[88] See Article 5 (4) of the Anti-Dumping Regulation and the parallel provision of Article 31 (6) of the Anti-Subsidy Regulation.

[89] For example, Section 11 (2) of the government draft of the German Supply Chain Act provides that the authorization of a trade union or non-governmental organization to bring a legal action for the violation of legal

Yet another parallel with EU trade defense law exists in that here, too, the Commission's possibilities to carry out on the spot investigations, i.e. in non-EU countries, are severely limited. Moreover, the exporters, as potential addressees of a trade defense measure that is detrimental to them, have no incentive *per se* to cooperate with the Commission investigation. EU defense law addresses this issue by permitting the Commission to base its decision on the facts available in cases of non-cooperation by the exporters concerned. This will usually be highly disadvantageous for the exporting producers, and result in higher anti-dumping or anti-subsidy duties.[90] In line with this approach, the administrative procedure preceding the inclusion of a company on a 'negative list' could likewise provide that, in the event of a lack of cooperation with the Commission's investigation, the latter may base its decision on the facts available, i.e. in this specific case, in particular on the information provided by the organizations lodging the complaint. On the other hand, the existing anti-dumping rules also contain a redress mechanism that allows affected companies to comment on the Commission's findings and rebut allegations before duties enter into force. Such an approach can and should be adopted in a European supply chain law. Finally, it should be considered that the EU legal act by means of which such a negative list approach is established should also contain provisions on the prevention of circumvention or non-compliance with the requirements stipulated therein, as well as provisions on sanctions for such circumvention or non-compliance.

In addition, a negative list approach would also align with the structure of EU sanctions in response to human rights violations. The secondary legislation adopted by the EU in December 2020 is particularly noteworthy in that regard. Following the US model of the *Magnitsky Act,* the novel EU legislation provides that restrictive measures can be taken against individuals and organizations responsible for serious human rights violations.[91]

5.3 Further Alternatives

Another option would be to make greater use of existing trade policy instruments, such as sanctions. For example, trade policy offers the possibility to demand minimum requirements or the obligation to ratify and implement international labor standards vis-à-vis supplier countries, and to define these requirements by treaty. In the case of unilateral trade policy measures (such as the Generalized Scheme of Preferences or the Everything but Arms-Programme), benefits can be granted (without any reciprocal obligations by the other party) on the condition that labor standards are complied with. Preferences could be denied in the event of failure. However, these would be harsh measures that would only affect the formal labor market. The informal labor market would remain unregulated. However, the EU would

positions is only possible if it "*maintains a permanent presence of its own and, in accordance with its statutes, is not engaged in a commercial or merely temporary activity to realize human rights or corresponding rights in the national law of a state*." A similar categorization or positive accreditation of relevant organizations could also be considered at EU level.

[90] Cf. in detail *Müller-Ibold*, in: *Krenzler/Herrmann/Niestedt (*eds.), EU-Außenwirtschafts- und Zollrecht (October 2020), Art. 18 BADR, para. 24 et seq.

[91] See Council Regulation (EU) 2020/1998 of 7 December 2020 concerning restrictive measures against serious violations and abuses of human rights, OJ (EU) 2020 L 410/1 and Council Decision (CFSP) 2020/1999 of 7 December 2020 concerning restrictive measures against serious violations and abuses of human rights, OJ (EU) 2020 L 410/13.

also be able to take measures if malpractices were to occur in sectors that do not supply input products to Europe.

Art. XX GATT also offers possibilities for improving the level of protection afforded to people through trade-restrictive measures. This includes, for example, Article XX lit. e) GATT, which permits WTO members to restrict the import of products made by prisoners, subject to proportionality and necessity. These requirements have been interpreted narrowly in the current WTO jurisprudence. This is due to the danger of protectionist abuse of the provision. As a result, Art XX lit. e) GATT has not yet been used to its fullest extent.

Another possibility of advancing the level of social and environmental protection in third countries is the intensification of development cooperation. In practical terms, all development cooperation (economic, financial, personnel) could be directed toward changing the behavior of recipient governments in the direction of better working conditions, which would not only have to be implemented *de iure* (through ratification of ILO conventions), but also *de facto*. Cooperation between bilateral and multilateral development cooperation would boost the influence exerted on the governments of third countries. This influence should be used primarily where governments have already ratified ILO core conventions. If implementations suffer from a lack of resources, this issue could be overcome by development cooperation.

Conclusion: In principle, the legal considerations of relevance to the German Due Diligence Act also apply to the proposal for a directive imposing due diligence obligations on the supply chain at EU level contained in the European Parliament's resolution. The latter chooses an approach similar to the one of the German Due Diligence Act, namely the imposition of due diligence obligations on companies as well as an ex post liability of companies in case of non-compliance with these due diligence obligations. Key differences, from which more serious concerns regarding the prima facie compatibility of the proposal with Art. XI:1 GATT arise are the extensive list of due diligence obligations and the expansion of the scope of application of the planned directive to include third country companies. Nonetheless, it must also be noted here that a violation of Art. XI:1 GATT could probably be justified by means of Art. XX lit. a) GATT.

An alternative worth considering at the EU level appears to be a list approach. Under such an approach, companies that commit human rights violations or do not take adequate steps to prevent human rights violations along their supply chains would be placed on a negative list ("blacklisting"). The consequence of inclusion on such a list would be the exclusion from the EU internal market. A reverse "positive list approach" would be subject to considerable doubts as to its practicability and compatibility with EU primary and WTO law. In contrast, the administrative effort associated with a "negative list approach" would be significantly more limited. Further, the concerns relating to its compatibility with WTO law and EU primary law would also be less far-reaching as a result of the greater precision of such an approach. A negative list approach would also limit the risk of uninvolved parties being affected by the measures.

With regard to the design of the procedure preceding the inclusion of an undertaking on such a negative list, reference could be made to the tried and tested structures and experience from another area of EU external trade law: EU trade defense law. This would also entail that, with regard to individual procedural steps, recourse could be made to past experiences made by the Commission, which would presumably act as the authority responsible for the procedures. In concrete terms, inter alia, formal criteria could be defined that non-governmental organizations would have to fulfill in order to have a right of complaint to the Commission. In addition, legal protection procedures should be established to enable companies to comment on the Commission's preliminary findings and rebut allegations before sanctions take effect or to terminate them.

6. Proposal for Action: Negative List Approach Instead of Due Diligence Law

This report proposes a European negative list approach instead of national due diligence laws. This means a centrally managed list of companies that are not allowed to appear in supply chains with European participation. It would have to be clarified exactly which factors lead to the listing and delisting of companies; this report makes proposals in this regard.

A negative list approach has several advantages, which will be briefly recapitulated here. The most important advantage is that no new monitoring and reporting obligations as well as no further diffuse legal risks would be imposed on companies in Europe and Germany. Monitoring would be centralized in a European authority where all information on possible human rights violations can be collected, evaluated and verified. This would considerably relieve the burden on European companies, which would otherwise have to continuously carry out and update this task for their own supply networks.

The list would minimize legal uncertainties because it would always be clear to companies when "compliance" is given. This would ensure that companies have no incentive to withdraw from poorer countries or to recalibrate their supplier networks in a way that is counterproductive in terms of development policy. The possible undesirable side-effects for developing countries would then be absent. In addition, a level playing field would be created for European companies and the emergence of competitive disadvantages vis-à-vis foreign competitors would be prevented. In order to avoid unjustified sanctions, there is an urgent need for a functioning legal protection procedure including the right to inspect files and to be heard for affected suppliers, e. g. along the lines of existing trade defense mechanisms.

The negative list approach does not lead to a delegation of responsibility for compliance with international standards from public authorities to private companies. This is also an advantage, especially because a state agency would be in control of the listing process. In times of great and increasing geo-economic tensions with state-capitalist countries, it is good to have political bodies, rather than courts, decide whether a foreign company should be sanctioned or not. The EU has had good experience with such structured procedures, such as its anti-dumping instruments. On the other hand, such politicization would run the risk of counter-sanctions by trading partners who see themselves systematically disadvantaged by negative lists.

Another argument in favor of the negative list approach is that it can be exchanged between states, thus making better use of available information. It can serve as a vehicle for cooperation between the EU, the United Kingdom, Switzerland or the USA – to name but a few countries. The latter already have a similarly structured instrument in the form of the "entity list".

Overall, such a negative list approach would strengthen the human rights situation of the affected workers, while minimizing the financial and bureaucratic burden on both European importers and exporters in developing countries. At the same time, it represents an opportunity for international cooperation that would allow Germany and the EU to involve other countries in the process. This would not only increase the effectiveness of the instrument, but also strengthen the EU's geostrategic position.

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