



The Political Economy of Due Diligence Legislation

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Executive Summary

The policy challenge. Citizens and politicians in Western democracies have increasingly become aware of the importance of human rights, civil liberties, social rights, and sustainability issues as well as the different adherence to basic rights (such as equal treatment) all over the world. This trend has recently materialized in laws in the United States (US), Europe, Australia, and elsewhere. To varying extents, these oblige domestic businesses to comply with, and enforce, Western values and standards along their international supply chains. This values-based due diligence legislation has caused ongoing controversies over compliance costs, impacts on foreign relations – particularly with developing countries – and effectiveness in achieving legislative objectives.

Clearly the economic and political judgement of due diligence legislation in principle and in detail is very complex. Aiming to structure key contours of the political discussion on values and trade, in this policy brief we develop a conceptual, descriptive overview of the fundamental political economy challenges inherent to designing due diligence legislation.

The policy response. We do not question the necessity of adhering to human rights and civil liberty; rather to chart ways to achieve legislative objectives with reasonable costs to companies, governments, and civil society in jurisdictions enacting such legislation. Furthermore, in our view, legislation should allow for developing countries' institutional trajectories by acknowledging that some standards, such as labour and environmental, develop in tandem with economic growth – as can be seen in developed countries economic history. Which is to say that these requirements should be formulated in a nuanced manner that balances idealism with pragmatism.

To keep the analysis manageable, we focus on human and labour rights. Next, we briefly review relevant objectives of due diligence legislation in the West. Section 3 applies economic reasoning to these, showing the challenges hampering the successful and consistent application of legislation through interpreting such challenges as budget constraints. The final section concludes.

The Policy Challenge: The Rise of Values-Based Trade

Wealthy liberal democracies societies have tended to turn more attention to issues such as environmental sustainability¹ and core values (individualism, personal responsibility, equality) once life's physiological and safety needs such as access to clean air, water, food, shelter, etc., can be satisfied. They also tend to externalize their values beyond their national borders through domestic legislation governing trade relationships and trade agreements², insisting that human rights, civil liberties, labour and environmental standards are met in trade partners.

These legislative initiatives broadly reflect Western citizens interest in the conditions under which their consumption basket is produced. In our globalised world the average consumption basket is derived from supply chains linking multiple countries, many being economically underdeveloped. As Western citizens and politicians want to avoid being complicit in undermining environmental standards or the rights of foreign workers supplying their domestic markets, they demand trade partners adhere to their



values and standards as a precondition for trading – often labelled values-based trade³. The topic and the need for action is not controversial. However, the details of the different legislative approaches listed below make it clear that the exact definition of relevant and non-negotiable values can be difficult and controversial when being detailed legally. Yet, societies tend to have a general understanding of their core values, and liberal democracies who are most active in values-based trade have well-established values and norms around human rights, labour rights and the environment which serves as the foundation for legal obligations in trade agreements. Furthermore, the enforcement of legislation differs with respect to the social, political, economic, strategic, and security interests of the imposing country.

The world's largest trade bloc for goods and services, the European Union (EU), has a long history of negotiating non-trade values into its trade relationships⁴ although the intensity of its commitment to such values-based trade changes over time. The past decade has seen a strong focus on non-trade issues, expressed by the EU's

2015 trade strategy document wherein the values-based agenda was laid out in high-level terms, requiring that “trade policy will become more responsible, meaning it will be more effective, more transparent and *will not only project our interests, but also our values*”⁵. The European Parliament's (EUP) current legislative agenda seeks a binding and far-reaching due diligence framework for firms⁶.

The EU's leading trade power, Germany, has also introduced its own far-reaching domestic due diligence law titled the “Act on Corporate Due Diligence in Supply Chains (Supply Chain Due Diligence Act)”, which came into effect on January 1, 2023. This law is an illustrative example of the tensions, debate, and trade-offs that due-diligence legislation is facing. The Federal Ministry of Labour and Social Affairs and the Federal Ministry for Economic Cooperation and Development initial proposal outlined due-diligence requirements deemed so onerous that they provoked a substantial business sector backlash. Ultimately this led to a watered-down law being approved by the Bundestag. That development reflects the business community's fierce opposition

– not to Western standards but to what they argued were excessive obligations regarding oversight of all areas of the supply chain, including suppliers and users not directly supervised by a given company but rather third-party suppliers feeding into the overall supply chain, or even end-users of final products. Also, the initial proposal would have allowed non-government organizations (NGOs) not involved in supply chains the right to sue businesses for violations, opening the door to incalculable legal risk.

The United States (US) also has a track record of applying values to trade relations. The 1930 Smoot-Hawley Tariff Act banned all goods made with forced labour. The EU's combination of “interests *and* values” mirrors contemporary American trade policy framing. The Obama administration's approach was to negotiate “new opportunities to advance [a trade] agenda consistent with American interests and American values, including putting labour and environmental protections at the core of trade policy”⁷. The Trump administration re-negotiated NAFTA⁸ to include more extensive labour and environmental rights

and prepared the ground for the Biden administration's signing into law of the Uyghur Forced Labor Prevention Act (UFLPA) in December 2021.

In Australia the Commonwealth's Modern Slavery Act that came into force on January 1, 2019, addresses forced labour and other human rights abuses. Amongst other things it establishes a requirement for Australian businesses with more than A\$100 million in annual revenue to report their actions to assess, and address, modern slavery, and human rights risks in their global supply chains.

Challenges to Achieving the Objectives of Due Diligence Legislation

Formulating the minimum acceptable standards and values for engaging economic relations with other countries⁹ is relatively easier than the complexities of living up to the promise. Regarding due diligence legislation both imposing and target countries are constrained.

The first challenge is to **balance idealism, pragmatism, and economic competitiveness**. Some markets are very lucrative and large. If a company is in the market before the implementation of the respective laws the opportunity costs of abstaining from it are substantial. Therefore, with respect to different countries and values-based trade Western governments have long negotiated FTAs and enforced laws differently – depending on market size and/or importance of the sold or sourced good. Lechner¹⁰ shows that the intensity of human rights provisions in Free Trade Agreements (FTAs) concluded by Western countries with developing nations is positively correlated with potential import competition and wage pressure from these partner countries and that the more export opportunities Western companies envisage, the less intense human rights provisions become.

Competitiveness is crucial, and can refer to various dimensions: economic, strategic, and political. Excessively strict due diligence legislation can undermine economic competitiveness, such as by necessitating that certain inputs can only be integrated into the supply chain at much higher costs or – in the worst case – certain goods can no longer be produced and offered. For example, China heavily dominates value-added refinement of critical minerals crucial to electric vehicles

and renewable energy systems production¹¹. At the same time China is criticized for poor environmental standards and questionable labour standards, including forced labour¹², all of which keep costs low compared to nations with higher environmental standards and where forced labour is illegal. For values-based and geopolitical reasons the EU's Battery Alliance¹³, and other international collaborations such as the Resilient Supply Chain Initiative¹⁴ involving Australia, India, and Japan, as well as President Biden's "100 Day Supply Chain Review" report¹⁵, all envisage unwinding China's dominance of mineral refining and battery production. Yet this will take many years, significantly increase batteries costs, and may not guarantee significant success. Meanwhile, nations must choose between continuing to trade with China or foregoing the critical materials and inputs needed for the global green transition.

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Here we see the conundrum between idealism and pragmatism in implementing a values-based trading policy. While clearly forced labour in supply chains must be a red-line issue that cannot be tolerated, how should we treat lower labour and

environmental standards in developing countries? Clearly, at least some higher standards are causally related to, and made possible by, successful economic development. Taking China as example again, in response to social pressures for reform from Chinese workers in a process reminiscent of 19th century industrializing Europe¹⁶, since the 2000s the country has seen significant labour law reforms with the goal of improving worker protections and social insurance¹⁷. China is also engaging efforts at improving environmental standards¹⁸, as the severe pollution wrought by rapid industrialization and economic development has become a major political issue. Prior to China's 1980s economic boom neither large-scale migrant workers' flows nor industrial pollution presented top priority policy problems. Hence, these issues are part of a normal development process that broadly mirrors the governance evolution of today's developed economies, which had little to no labour or environmental standards during initial industrialization. Still, it is also the case that nations at similar levels of development may differ on specific details that reflect each nation's political system, civil norms, and rights. The point is that values-based trade must allow for both red lines and legitimate developmental differences.

The second challenge is to **strike the right balance**. Getting it wrong can ultimately lead to a loss in national economic welfare if there is a failure to differentiate between red line issues and developmental issues, and if there is a failure to balance



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economic welfare domestically against the costs of non-redline issues with major trading partners. Significant welfare losses can ultimately undermine political support for values-based trade. Thus, while acknowledging that red line issues must be acted on, other forms of due diligence legislation leading to a permanent and significant loss of export price competitiveness in a developed country will likely not be economically or politically sustainable. Moreover, Europe's return to burning coal¹⁹ owing to the sanctioning of Russian gas illustrates the issues. Political values trumped economics in the initial decision to sanction Russian gas, even as politicians and the public understood the ramifications of such an action. However, economic needs trumped environmental values when large reductions in living standards were likely. Furthermore, negative indirect consequences might also arise from due diligence legislation. Strict adherence might restrict domestic businesses from building a presence in certain "strategically relevant" markets, potentially hindering domestic priorities such as sustainable transformation of the economy, wherein the partner in question is the market leader.²⁰ Finally, political competitiveness, or the competition between different societal value systems, also matters. Nations with less robust institutional frameworks than developed countries, and/or different value systems, might be afraid of losing their social cohesion by incorporating Western values into their social system. Hence, competition among co-existing values is likely to arise, making implementation of due diligence legislation even more difficult for domestic businesses.

The third challenge is to **address developing countries' concerns**. Even if developing countries were willing to follow Western values and standards, they often face substantive hurdles. Two classes of problems emerge. The first class is best described as institutional setting. Institutions are the rules and norms that govern human interactions. In a two-by-two matrix, these rules both evolve spontaneously or are created purposefully in a process of collective decision making, whether formal or informal. Traditional institutions such as gender relations, sexual orientation, and political authority may constrain countries in adhering to human rights as laid down in the Universal



Declaration of Human Rights²¹ or Western labour standards²². This may be regarded by the Western side as unacceptable – but it must not be ignored how long it took the West to codify and broadly enforce the related rights over a span of two centuries starting with early industrialization. Institutions differ between (and even within) countries and it takes time to adapt them, particularly to external designs.

The second class of problems is economic. It may be impossible for citizens in some developing countries to make their living without child labour, much as British families sent their children to work in nineteenth century factories. Domestic firms in developing countries may not be able to immediately accept high labour standards common to developed societies without going out of business. In other words, the opportunity costs of immediate and full adherence to high standards and selected human rights may be too high for many developing countries at too low a level of national income to sustain such standards, and with little capacity to enforce them. It is worth noting that Western governments can support developing countries in their

attempt to adhere to such values and standards by accepting that some issues are developmental and setting longer-term soft targets for their trade partners to adopt higher standards and rights.

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The final challenge concerns **managing the complex interplay of forces** at work. Enforcement is an important determinant in the implementation of due diligence legislation. The higher the costs of enforcement, the more unlikely that values-based trade can be implemented in its original sense. Enforcement costs exist for both Western countries and trade partners. Taking the perspective of enforcing nations, if Western countries are dependent on certain inputs such as natural resources,

e.g., cobalt from the Democratic Republic of the Congo (DRC), double standards emerge – even though the DRC does not adhere to the full spectrum of Western values, trade is still tolerated owing to the importance of inputs for domestic industry. This behaviour undermines due diligence legislation. Taking the perspective of trading partners that have not yet adopted the enforced values, and dependent on the current value system of the respective economy, a change to Western values over time can become very difficult. For example, granting equal rights to men and women in Saudi Arabia. These enforcement costs thus directly affect values-based trade.

Policy responses: Evolution of the frontier, rather than revolution

Values-based trade cannot be simply a yes-or-no decision, that is, either a trading partner fully complies with the full range of Western values or there will be no further trade relationships. It may be difficult to base a law on a fixed set of values. Instead, it may be preferable for Western nations to rather interpret values as a point on a frontier of societal values development,

framed by co-existing and competing values. From this standpoint, developed democracies should aim to incrementally advance the frontier of values-based trade enforcement by trying to convince trading partners to adopt more of their values over time. “Revolutionary” approaches, in general and as discussed above, are likely to lead to major problems, including rising domestic political contestation, undermining own-competitiveness, and souring relations with the developing world – that represents current and future consumers. The decision to engage in trade should depend on the fulfillment of a predefined minimum set of core values such as adherence to basic human rights, labour rights and environmental standards. Red line issues must also be addressed in all instances and the numerous potential consequences thoroughly canvassed and internalised by the society so doing. Then, an allowance for developmental evolution in partner countries should be considered, much in the spirit of the World Trade Organization’s Special and Differential Treatment allowances. If this minimum set of predefined values is fulfilled over time, trade might be reasonably acceptable.

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2. Milewicz, Karolina, et al. "Beyond trade: The expanding scope of the nontrade agenda in trade agreements." *Journal of Conflict Resolution* 62.4 (2018): 743-773.
3. In this brief, we focus on due diligence legislation and neglect another import aspect of the values-based trade agenda, namely a political reaction to economic coercion by authoritarian (non-Western) states, for example as recently applied by the Chinese government to Australia and Lithuania.
4. Drieghe, Lotte, and Diana Potjomkina. "EU's values-based approach in trade policy:(free) trade for all?" *Global Affairs* 5.1 (2019): 63-72.
5. *Ibid*, p. 5, emphasis added.
6. "MEPs: Companies must no longer cause harm to people and planet with impunity", European Parliament, 10 March, 2021. The proposal "would oblige companies to identify, address and remedy aspects of their value chain (all operations, direct or indirect business relations, investment chains) that could or do infringe on human rights (including social, trade union and labour rights), the environment (contributing to climate change or deforestation, for example) and good governance (such as corruption and bribery)".
7. FACT SHEET: Values Driving U.S. Trade Policy, Office of the United States Trade Representative, February 2014.
8. The North American Free Trade Agreement, subsequently renamed the United States, Mexico, Canada Agreement.
9. For example: the right to life, the right to a fair trial, freedom from torture and other cruel and inhuman treatment, freedom of speech, freedom of religion, and the rights to health, education and an adequate standard of living <https://humanrights.gov.au/our-work/education/introduction-human-rights>
10. Lechner, L. 'The domestic battle over the design of non-trade issues in preferential trade agreements', *Review of International Political Economy*, 23(5), 840-871, 2016.
11. Castillo, R., and P. Purdy, 'China's Role in Supplying Critical Minerals for the Global Energy Transition', Brookings Institution, July 2022. Including refining 68% of global nickel, 59% of lithium, and 73% of cobalt. China also provides 78% of current global production capacity for electric vehicle batteries, and 75% of the world's lithium-ion battery mega factories.
12. Tsafos, T., 'Addressing Forced Labor Concerns in Polysilicon Produced in Xinjiang', CSIS, June 2021.
13. The European Battery Alliance was launched by the EU Commission in 2017, and aims to develop an intra-EU battery supply chain that meets the highest social and environmental standards. See: https://single-market-economy.ec.europa.eu/industry/strategy/industrial-alliances/european-battery-alliance_en
14. This is a broad-based initiative aimed at reducing dependence on single nation-state sources of supply for critical supply chain inputs. See: Pailit, A. 'Resilient Supply Chain Initiative: A Political Driver to Revive Asian Regional Growth', *Georgetown Journal of International Affairs*, 2021.
15. The White House, 'Building Resilient Supply Chains, Revitalizing American Manufacturing, and Fostering Broad-based Growth: 100-Day Reviews under Executive Order 14017', June 2021.
16. For example, the British Factory Act of 1833 sought to ameliorate the horrific conditions of workers, especially children. Provisions included the Act making it illegal to employ children younger than nine years old in factories, which was common practice, and required children aged 9-13 years old to work no more than nine hours a day, and children of 13-18 years old to work no more than 12 hours a day. See: <https://www.nationalarchives.gov.uk/education/resources/1833-factory-act/>
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18. Mu, Zhilin, Shuchun Bu, and Bing Xue. "Environmental legislation in China: Achievements, challenges and trends." *Sustainability* 6.12 (2014): 8967-8979.
19. 'Germany turns to coal for a third of its electricity', *Financial Times*, September 2022.
20. China's global leadership in production of photovoltaic solar panels for example.
21. <https://www.un.org/en/about-us/universal-declaration-of-human-rights>.
22. See North, D. C., (1990), *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press. Note that human rights are also part of the institutional setting. Nevertheless, it is possible to treat a part of the institutional setting (in this case human rights) as an objective and other parts (e.g. certain religious attitudes, corruption and others) as budget constraints that support or hinder countries in their efforts to adhere to human rights.

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