

Rudloff, Bettina; Wieck, Christine

## Research Report

Sustainable supply chains in the agricultural sector: Adding value instead of just exporting raw materials. Corporate due diligence within a coherent, overarching and partnership-based EU strategy

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# SWP Comment

NO. 43 SEPTEMBER 2020

## Sustainable Supply Chains in the Agricultural Sector: Adding Value Instead of Just Exporting Raw Materials

Corporate Due Diligence within a Coherent, Overarching and Partnership-based EU Strategy

*Bettina Rudloff and Christine Wieck*

The corona pandemic has placed supply chains back on the agenda. The economic repercussions spotlight the complexity of today's global division of labour. Current German and European initiatives are seeking to tighten the responsibility of final business consumers for human rights and sustainability in their supply chains. The objective is to enforce sustainable production in sovereign third countries. In the case of agriculture these explicitly supply chain-based approaches need to be backed up by improvements in the European Union's trade, investment and agricultural policies. Influencing agricultural supply chains in such a way as to overcome their specific sustainability and human rights problems will require all approaches to be combined. Currently, conventional approaches treat supply chains in isolation, and only address imports flowing into the EU. As such, they consider developing countries exclusively in their traditional role as suppliers of raw agricultural commodities and ignore options for increasing local value added and fostering development.

Global frameworks like the United Nations Sustainable Development Goals (SDGs) set targets for sustainability in areas including production, consumption, agriculture and nutrition, working conditions and environmental protections. They promote integrated, partnership-driven approaches involving multiple actors including corporations.

The role of the latter sparked political interest in the course of major forest fires associated with land clearance in Brazil in 2019. This coincided with the conclusion

of negotiations for the EU-Mercosur Trade Agreement, which – like all EU trade agreements today – includes sustainability clauses. The enforceability of these provisions is, however, generally limited. Alternatives for protecting the rain forest as a public good (and addressing climate change) without having to rely on the support of the Brazilian government were discussed, including once again supply chain approaches. These intervene at the place of final consumption of the product whose



origination creates sustainability risks. They can be established with political support in the country of consumption, but the concrete effects in far-away sovereign states may in fact undermine sustainability efforts.

These approaches make final business consumers responsible for upholding human rights and sustainability standards along the entire supply chain – which involves multiple actors, often in different countries and various stages including primary production, transport, processing and distribution, for example. Depending on the specifics they may be obligatory or voluntary; they require monitoring of risks, search for solutions or even liability for violations of standards (see Table). The main motivation for other actors in the supply chain to fulfil the respective standards is their economic interest in securing sales to major markets and final business consumers.

The supply chains rules currently in use differ in their specific sustainability and/or human rights goals, sectors addressed, incentive structures, measures and level of obligation (see Table). Those already in place are predominantly voluntary and focus more on human rights than sustainability. The United Nations Guiding Principles on Business and Human Rights of 2011 include corporate “due diligence”. The OECD’s Guidelines for Multinational Enterprises are also voluntary; they reserve grievance mechanisms exclusively for human rights violations. The UN Food and Agriculture Organisation (FAO) adopts a broader approach in its Voluntary Guidelines on the Right to Food and Voluntary Guidelines on the Responsible Governance of Tenure, which address various sustainability objectives as well as human rights.

Compulsory requirements are rare; in the European Union the Regulation on Conflict Minerals defines due diligence duties requiring business actors to avoid human rights violations in this sector; these take full effect from 2021. At the level of member states only France and the Netherlands have mandatory rules, which also cover all other sectors (the United Kingdom also has such arrangements). Similar provisions are

under preparation in Belgium, Finland and Germany. According to the German coalition agreement, mandatory approaches for implementing the aims of the National Action Plan for Business and Human Rights (NAP) would be considered if the current voluntary ones transpire to be inadequate. Additionally, the government stressed its wish to overcome the existing patchwork of different approaches. An inter-ministerial paper laying out details of the proposed legislation was expected at the end of August, but has been postponed three times now after disagreements across the responsible ministries. The points of divergence apparently include the size of companies to be included, the scope of goals (whether to include ecological objectives), the extent of liability, and the reach (how far along the chain responsibility applies).

In Germany companies that are already implementing the voluntary rules (20 percent according to a survey) fear competitive disadvantages if they are not applied across the board. Competition effects also speak for a pan-European solution of the kind the EU Justice Commissioner is proposing for 2021. This builds on a proposal by the Environment, Oceans and Fisheries Commissioner (which was restricted to the environmental goals of climate and forest protection in deforestation-free supply chains). The European Parliament is currently preparing a proposal for the first plenary session in the autumn. It will include sustainability targets as well as human rights and cover other sectors alongside agriculture. The German government stressed in its coalition agreement that it generally supported an EU Action Plan on due diligence, but the scope and type of binding remained unclear.

Given that the EU and Germany are major consumers of agricultural products, supply chain obligations for businesses operating in the Single Market can potentially have a significant effect. They are also major agricultural producers, and thus appear at both ends of agricultural supply chains. This dualism creates opportunities to tackle the special challenges of

### Typical regulation options for sustainability in agricultural supply chains

| Regulation type and leverage                                     | Main addressee of obligation/implementation  | Position in supply chain              | Target dimension  | Economic sector                     | Usual measures  |
|--|--|---------------------------------------|---|-------------------------------------|---|
| <b>Approaches explicitly focused on supply chains</b>            |  |                                       |   |                                     |   |
| Due diligence in supply chains                                   | Business consumers   | End = import                          | <ul style="list-style-type: none"> <li>■ Human rights</li> <li>■ Environment</li> </ul>                                 | All                                 | Accountability, search for solutions' with partners, liability  |
| Deforestation-free supply chains                                 | Business consumers   | End = import                          | Environment   | In particular agriculture           | Monitoring, certification, facilitate market access   |
| <b>Broader approaches with indirect effects on supply chains</b> |  |                                       |   |                                     |   |
| Agricultural policy  | Primary producers  | Beginning and end = export and import | Protection of agricultural resources  | Agriculture                         | Incentives and cost compensation  |
| Trade policy   | <ul style="list-style-type: none"> <li>■ Depends on goals (e.g. food as human right) and involved businesses</li> <li>■ State</li> </ul> | Beginning and end = export and import | <ul style="list-style-type: none"> <li>■ Human right to food</li> <li>■ Labour and environmental protections</li> </ul> | All (special rules for agriculture) | <ul style="list-style-type: none"> <li>■ Tariff incentives/trade facilitation if implementing sustainability</li> <li>■ Easier access for raw materials</li> <li>■ Export restrictions and/or tariff protections in case of supply risks</li> </ul> |
| Investment policy  | <ul style="list-style-type: none"> <li>■ State receiving investment</li> <li>■ Investing enterprise</li> </ul>                           | Beginning and end = export and import | Flexible objectives in public interest  | All                                 | <ul style="list-style-type: none"> <li>■ Easier access for raw materials/semi-finished products in targeted countries</li> <li>■ Exceptions from compensation for indirect expropriation</li> </ul>   |

agriculture by introducing export-relevant measures to accompany import-focussed supply chain rules.

### Specific Features of the Agricultural Sector

Agriculture is the starting point for the new EU initiative on deforestation, which depends crucially on developments in this sector. It also stands out for the following:

#### Short, Concentrated Chains, Small Producers, Dual Role for EU

*Short agricultural supply chains* involve comparatively small numbers of actors, often concentrated in just a few countries. They are often uni-directional, with developing countries exporting unprocessed raw materials for processing (added value) in developed countries including the EU. Import concentration is also an issue, with the EU for example importing 90 percent of its

cocoa beans from Africa. Animal feed such as soybeans represents a large proportion of the EU's unprocessed agricultural imports. Conversely, a high proportion of the EU's food exports (40 percent) are processed products with high added value. It tends to be easier for final business consumers to enforce their supply chain obligations where short chains are concentrated in just a few countries, because fewer actors have to be tracked, monitored and disciplined, and they are geographically grouped.

On the other hand, where *primary production is small-scale*, as is the case in developing countries, it is harder to implement supply chain rules because the company at the end of the chain has to shoulder the cost of dealing with large numbers of small, often spatially dispersed, producers. Small farmers, especially in developing countries, may often find it too expensive to fulfil all their obligations, or to document their compliance. This may see them squeezed out of the market, with consequential loss of income in countries that are already poor.

*The EU's dual role in supply chains.* In regulatory approaches explicitly focussing on supply chains (as in the current legislative proposals) the import side is decisive. Here the EU plays a particularly important role in products associated with deforestation: almost 50 percent of its palm oil comes from Indonesia, 25 percent from Malaysia; for soybeans the figures are almost 50 percent from the United States and 35 percent from Brazil. But the EU also exports significant amounts of basic foodstuffs, claiming large market shares capable of affecting security of supply in importing countries. Almost 50 percent of Africa's total milk imports come from the EU, as do 30 percent of its poultry imports.

## Special Sustainability Goals

In summer 2019 the European Commission published a list of deforestation-relevant and thus climate-relevant "risk products". It is topped by agricultural and arboricultural commodities such as soybeans, beef, palm oil, maize, coffee and cocoa. In addition to

the climate effect, the agricultural sector also has specific effects on other dimensions of sustainability and human rights:

(1) *The human right to food.* Production and consumption of agricultural products are intimately bound up with the human right to food. The FAO has been developing and refining concepts to realise that right for more than fifty years. They operate from both ends of the agricultural supply chain. The FAO assumes that the right to food can be realised by domestic production, imports and exports – making it susceptible to change through trade, agriculture and investment policy, among others (see Table).

At the *end of the supply chain* – as importers – developing countries often require cheap food imports in order to guarantee the right to food. But imports can create risks if they displace more expensive local production: this can negatively affect producers' income and successively weaken the domestic agricultural sector. Imports often remain the only available option for responding rapidly to acute shortages, but require sufficient volumes to be available at affordable prices on the global markets.

Supply risks can also arise on the *export side*, typically in connection with flows of agricultural commodities from developing countries to the EU. If the land used to grow these export crops expands, the area available for domestic consumption shrinks, sometimes through expropriation. For example the area devoted to palm oil in Indonesia and Malaysia has expanded steadily for the past thirty years; this is believed to be responsible for one-third of the loss of forest. Pressure to intensify production can also lead to excessive pesticide usage at levels harmful to health and the environment. These risks to the right to food weigh against the benefits of export revenues – which can also be used to address supply risks by purchasing food.

(2) Agriculture is the biggest user of *child labour*, accounting for more than 60 percent of all known cases; according to the International Labour Organisation (ILO) almost 100 million children are affected. Child labour is most prevalent in African agri-

culture, which also poses the greatest safety risks to children in the form of accidents and improper use of pesticides. The drivers include poverty and lack of parental income.

## EU Leverage to Improve Sustainability and Human Rights in Supply Chains

A study by the EU Commission on due diligence in supply chains published in February 2020 explores various options for regulating supply chains. It emphasises the importance of combining existing approaches but restricts itself to those specific to supply chains. These should be integrated into other policy areas like agriculture, trade and investment. This enables the EU to promote specific sustainability goals at both ends of international supply chains. Here the character of supply chains can be radically transformed rather than merely tinkered with. All these approaches need to be applied in concert and backed by development support.

## Agriculture Policy

The EU's Common Agricultural Policy (CAP) shapes international supply chains via production and consumption effects. The current reorientation process for the new CAP phase — as part of the EU's new Multi-annual Financial Framework beginning in 2021 — should therefore take account of risks to sustainability and human rights. The "Farm to Fork" strategy recently proposed by the EU Commission for the same period as part of the European Green Deal is also relevant for the CAP and stresses in at least general terms the external significance of European supply chains. But concrete action to improve their sustainability is still lacking.

*Reduce residual risks of export pressure.* The risk that the CAP traditionally posed to developing countries originated in artificially cheap exports, which were capable of displacing producers in developing countries

from the global market and even from their own domestic markets, potentially increasing poverty, hunger and child labour. Reforms to date have sought to decouple subsidies from current production (see SWP Comment 21/2018). But the EU member states still retain limited scope to apply the old coupled payments. In fact they all do so, apart from Germany. These production-stimulating payments should be abolished.

*Prevent risks from climate and import pressure.*

The FAO estimates that livestock farming accounts for about 14 percent of global greenhouse gas emissions. If certain costs are externalised, livestock numbers exceed optimal levels. One consequence is direct harm to the climate with potential knock-on effects for the right to food in the form of droughts and flooding. These are the main global causes of famine alongside armed conflict. Another consequence of this politically driven "excess" livestock farming arises throughout the supply chains, for example increasing demand for feed in the EU and elsewhere. In the EU at least the protein component has to be imported in the form of soybeans. This makes the EU an attractive export market offering revenues and income as soybean production increases — but risks like climate burden due to burning or expropriation due to changes in land use can appear as well.

One approach currently under discussion in Germany is the animal welfare label. Operating via pricing or surcharges, this measure would increase the price of meat (and thus potentially reduce consumption) while compensating farmers for their costs and losses. A tax on meat would also be conceivable (or in Germany application of the full VAT rate), although this would require compensating measures if broad public acceptance was sought.

"Sustainability subsidies" can play an innovative role. For example the EU's long-established subsidies for organic farming and agri-environmental measures could be expanded to include criteria for sustainable, deforestation-free inputs such as animal feed. This would allow farmers using certified sustainable feed to recoup the higher

cost. Whether this would represent a “green box” measure allowed under the WTO’s rules for agricultural subsidies would need to be verified, but would be conceivable if it was used only to compensate costs without an incentive component. This would require sound certification criteria of the kind already being developed for feed and other products in the EU Commission’s pilot project on product environmental footprints, which also includes land use effects.

European consumption alone cannot solve global problems, not least on account of the substitution effects that occur in complex international supply chains. For example suppliers may seek other markets while the sustainability risks remain. Or cheaper external meat suppliers could out-compete their strictly regulated, sustainable European rivals in the EU market – but without leading to an overall reduction of European demand and the associated risks. While unilateral intra-European approaches can send an important message and serve to gather experience, international initiatives in the sphere of international trade and investment rules are more appropriate.

## Trade and Investment

In principle counterproductive substitution effects can be addressed at the border through international trade and investment rules, which also protect European products against imports of lower standard. Established rules offer different degrees of freedom and levels of enforcement, and operate on both the import and export sides.

(1) *Concretise trade rules protecting the human right to food.* Article XI of the General Agreement on Tariffs and Trade (GATT) permits restrictions and even bans on trade in essential products like foodstuffs (in response to “critical shortages”) that would otherwise be prohibited. Export bans are easily applied – also in connection with the current pandemic – because the criteria and timing are not defined; they are fundamentally inflationary and create supply risks for other import-dependent countries. On the import side protective tariffs can be applied

in situations of particular threat, often to stimulate domestic production. In bilateral agreements the restricted nature of this alternative is frequently criticised by the economically weaker partner. Few agreements refer explicitly to the right to food (one exception being the EU’s economic partnership agreement with West Africa). This aspect could be strengthened. The possibility of greater protection against broader sustainability risks – for which concrete criteria and timing would have to be defined – should also be considered. At the same time premature protectionism may be counterproductive, because it often makes sense to secure supply through cheap imports.

(2) *Full use of the narrow options for tariff incentives.* In the case of deforestation risk commodities, the EU has little leeway to encourage observance of sustainability criteria by means of tariff reductions. Soybeans are already completely tariff-free, for example. There is, however, room for tariff reductions for palm oil, as well as for all highly processed products such as instant coffee and chocolate. This could be relevant for producer countries that have not to date been granted significant tariff preferences by the EU, for example in South America, and at the same time boost the added value that is so central to development and employment.

Fundamentally the WTO places tight limits on incentives for process requirements that do not affect the physical characteristics of the product (and thereby define “like” products not permitting differential treatment), as is generally the case with sustainability and human rights. WTO exceptions are, however, available under GATT Article XX and could potentially apply to the EU’s proposal for a carbon (CO<sub>2</sub>) border tax.

Bilaterally agreed tariff preferences for observance offer greater scope than the WTO level. The EU makes use of this option vis-à-vis developing countries through its expanded Generalised Scheme of Preferences (GSP plus), which currently benefits eight countries that fulfil the ILO’s labour

standards and multilateral environmental norms. Additional tariff incentives are not an issue for the least developed countries (LDCs), as they already enjoy completely tariff-free access under the Everything but Arms (EBA) regime. Here, however, the EU Commission can suspend preferences, for example in response to grave human rights violations – as recently occurred with Cambodia.

Further tariff concessions are also irrelevant to most other African countries, which enjoy completely tariff-free access through the EU's WPAs. However, strict rules of origin sometimes exclude highly processed products like chocolate from benefitting from tariff exemptions where they contain inputs – such as sugar – imported to Africa from third states. A relaxation of rules of origin could be considered – comparable to conditional tariff preferences under GSP plus – to create incentives for employment and income in high-value, sustainable processing.

(3) *Strengthen sustainability standards in bilateral agreements.* All EU trade agreements since 2009 include a sustainability chapter with human rights commitments, on the basis of ILO labour standards and internationally agreed environmental norms. Unlike EBA, the preferences in these agreements cannot at present be suspended in response to human rights violations. There is however a dialogue process that triggers mediation in the country in which the violation occurs, with publicly visible talks including the stakeholders.

The implementation incentive could be expanded, but this is often not what the EU's partners want. The right to food could also be explicitly included in the chapter as a dimension in its own right, or it could be incorporated in the sustainability impact assessments that are already required for all EU agreements. This generally means quantitative assessments, which tend to measure economic variables and often neglect social and ecological effects.

(4) *Utilise the diversity of bilateral partnership models.* In an equivalency agreement in the veterinary sphere, for example, the EU, the

United States, New Zealand and Canada have agreed to mutually recognise each other's food safety standards. The EU already has thirteen equivalency agreements unilaterally recognising various partners' procedures for organic produce as equivalent to its own. Bilateral partnerships for timber imports are also proposed under the Forest Law Enforcement, Governance and Trade programme.

In all these cases the incentive for the other side is to gain easier access to the lucrative EU market by facilitating customs procedures. These agreements could also be expanded to cover other sustainability criteria and other products.

The EU's import rules for renewable raw materials also function on a voluntary basis, with a set quota for vehicle fuel, to be filled by sustainably produced raw materials, to secure demand and guarantee producer prices. Palm oil was classified as a problem in 2019, because it can be indirectly responsible for land use changes. As a result it will lose its eligibility in 2030 (although the main supplier, Indonesia, has lodged a complaint with the WTO). One could also consider a comparable "sustainable soybean quota", which would require suitable certification criteria. The animal welfare label discussed in Germany includes feed criteria that could also be applied to partner countries' own imports.

(5) Alongside these statutory rules, *commercial approaches* also exist for many deforestation risk commodities: For example criteria for soybeans and palm oil have been drafted in round-table discussions with stakeholders, complete with monitoring and certification systems. This experience should be incorporated into the pending German supply chain law, to permit such flexible sector-specific approaches to coexist with the general solutions.

(6) *Investment rules as part of bilateral investment treaties* (BITs) with sustainability components can complement trade-based measures. They apply to both states and corporations (see Table), which are both central to approaches centring on supply chains, and should therefore be used in parallel.



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**SWP**  
Stiftung Wissenschaft und Politik  
German Institute for International and Security Affairs

Ludwigkirchplatz 3–4  
10719 Berlin  
Telephone +49 30 880 07-0  
Fax +49 30 880 07-100  
[www.swp-berlin.org](http://www.swp-berlin.org)  
[swp@swp-berlin.org](mailto:swp@swp-berlin.org)

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Corporations currently are able to claim compensation for indirect expropriation resulting from political reforms – possibly including those designed to improve sustainability. However the more recent of the more than 1,500 investor protection agreements involving the EU and its member states – for example with Vietnam – offer leeway for political reforms in the public interest such as environmental and social regulation to be exempted from claims for indirect expropriation. The older agreements with stricter provisions should therefore be modified accordingly.

### **Overall Strategy: Flexible Mix and Explicit Involvement of Partners**

Agricultural supply chains touch on many different dimensions of sustainability and specific aspects of human rights. The risks involved differ depending on the positioning of actors and countries along the supply chain. This increases both the need and the opportunity to go beyond the classical supply chain approaches and apply leverage from various policy areas.

The proposed supply chain obligations cover instead only the supply side: imports into Germany and the EU. Here they certainly fill a gap, where the attractiveness of the EU market and the participation of importing businesses opens up possibilities to influence supplier regions. Experience with voluntary supply chain arrangements is valuable, especially in relation to the special risks of the agricultural sector. Generally speaking the commercial approach delegates responsibility for sustainability to private actors, some of which are geographically distant from the place of production. This leaves them reliant on implementation by private actors on the ground and on the goodwill of local political actors.

Therefore the role of various actors – including those in the producer regions – in the process of hashing out the details

should be further expanded. Only then can the specific difficulties be recognised and resolved – for example through development measures – to achieve real sustainability. Germany already works through the NAP, which is linked to German foreign representations in partner countries to ensure close contact. Its success should be monitored and coordinated with other member states' local contacts in partner countries. The possibilities and limits of new technologies for supporting traceability in value chains (for example blockchain) should be assessed. Certain German pilots already operating in the agricultural sector can provide information (spices in Sri Lanka, coffee in Rwanda).

Finally an overall strategy of classical and novel approaches for regulating supply chains would be flexible enough to respond to changes. The direction of supply chains is not fixed: Today's suppliers can become tomorrow's processors at the end of a supply chain – with greater value added. That, not least, should be a development goal for developing countries that are currently resource exporters.

*Dr. agr. Bettina Rudloff is Senior Associate in the EU/Europe Division at SWP.  
Prof. Dr. Christine Wieck is Head of the Agricultural and Food Policy Department at the Institute of Agricultural Policy and Markets at the University of Hohenheim, Stuttgart.*