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## Article

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Gabriel Felbermayr and Klaus Friesenbichler

# Considerations for Member States Implementing the EU Supply Chain Regulation

## KEY MESSAGES

- **The EU Corporate Sustainable Due Diligence Directive shifts the costs of compliance with social and environmental rules to private entities within complex supply networks**
- **To ensure effective and cost-efficient implementation, the Directive should aim to reduce economic complexity**
- **Regulations should exempt countries with strong regulatory systems**
- **Public agencies should establish harmonized standards, and organize a private certification scheme that focuses on suppliers rather than the entire network**
- **The new European Parliament may need to adjust the legal framework accordingly**

The integration of developing countries into global production networks has led to a more specialized division of labor and a greater inclusion of developing economies in global value chains (Timmer et al. 2014). At the same time, internationalization of production has facilitated the alleviation of poverty worldwide. World Bank data indicates that the number of people living in absolute poverty decreased from 2 billion in 1990 to less than 650 million in 2019, even as the global population grew from 5.3 billion to 7.8 billion. This economic integration has driven growth and improved economically defined social welfare indicators (Felbermayr et al. 2022).

However, it has also led to increased economic inequality (Helpman 2018; Feyrer 2019) and mixed environmental outcomes (Cherniwchan 2017). The relocation of production to countries with lower labor costs and weaker social and environmental standards has resulted in human rights abuses and environmental degradation. Despite international frameworks like the 1948 Universal Declaration of Human Rights and the 2015 Paris Agreement, compliance remains inconsistent, exacerbated by the rise of autocratic governments. According to the V-Dem Institute, 72 percent of the world's population lived in autocracies in 2022, the highest level since 1986 (Papada et al. 2023).

In response to the unintended consequences of globalization, several countries are introducing supply chain due diligence regulations (Smit et al. 2020). In the United States, there are similar regulations, such as the Slave-Free Business Certification Act of 2022. In Europe, France implemented the “Loi de Vigilance” in 2017, and Germany enacted the “Lieferkettensorgfaltspflichtengesetz” in 2023. To prevent fragmentation of due diligence requirements across the EU's single market, the EU adopted the Directive on Corporate Sustainability Due Diligence.

The aim of this paper is to assess this Directive from an economic policy perspective. There are no comprehensive econometric evaluation studies of existing due diligence laws, and the Directive has just been passed. This is why we apply classical economic concepts to make progress. We do this in a changed economic and political environment: the new European Commission prioritizes growth and security. The Deforestation Directive, another controversial piece of legislation with similar motivation, has been postponed. And even within the German government, a champion of supply chain regulation, vice-chancellor Habeck from the Green party declared that the legislation took a “completely wrong turn.” He went so far to say that one needs “to start the chainsaw and cut the whole thing down.” The European Supply Chain Directive should be implemented with as little bureaucracy as possible.<sup>1</sup>



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<sup>1</sup> <https://www.welt.de/politik/deutschland/article253819876/Beim-Lieferkettengesetz-sei-man-voellig-falsch-abgebogen-sagt-Habeck.html>.

## THE EU DIRECTIVE ON CORPORATE SUSTAINABILITY DUE DILIGENCE

The EU Directive on Corporate Sustainability Due Diligence (CS3D) aims to address adverse societal and environmental impacts of international trade by enhancing corporate governance and promoting sustainable practices throughout global value chains. Originally proposed in 2022 (CS3D; 2022/0051/COD), it entered into force on July 25, 2024 (Directive 2024, 1760), after intense discussions and adjustments. It aims to foster sustainable and responsible corporate behavior in companies' operations and across their global value chains. The regulations seek to ensure that companies identify and address adverse human rights and environmental impacts of their actions inside and outside Europe. Firms operating in the EU need to ensure that they abide by the EU's ethical, environmental, and labor standards throughout their operations.

The rules will apply to approximately 6,000 large EU-based companies with more than 1,000 employees worldwide and a net turnover exceeding EUR 450 million. It will also affect approximately 900 large non-EU companies with a net turnover exceeding EUR 450 million within the EU. The Directive includes provisions to facilitate compliance and minimize the burden on companies, both in scope and throughout the value chain. Companies will have to bear the burden of establishing due diligence processes and adjust their operations if necessary. Micro companies and SMEs are not directly covered by the proposed rules. However, they will be indirectly affected as they are integral parts of the supply chains. EU member states are required to transpose the Directive into national law and communicate the texts to the European Commission by July 26, 2026. One year later, the rules will start to apply to the first group of companies, following a staggered approach, with full application on July 26, 2029.

The adoption and implementation of due diligence in accordance with the proposed EU CS3D is fraught with barriers and challenges, particularly with respect to the requirements to identify, mitigate, and prevent human rights abuses and adverse environmental impacts throughout the value chain. Although an increasing engagement of companies in international business has led to a larger number of firms reporting on corporate responsibility and supply chain due diligence to meet the demands of suppliers, buyers, investors, customers, and regulators, many companies do not yet comply with the required due diligence practices as proposed by the EU CS3D (Meyer and Reinstaller 2022). The cost of implementing and monitoring the CS3D depends on the stage of the supply chain, the industry, and the location of trading partners.

The rationale of the CS3D is to address the lack of public enforcement in third countries by involving

private companies in monitoring compliance. While some companies have voluntarily improved their supply chains, many have not due to the associated costs. Government intervention is necessary to prevent a “tragedy of the commons,” but private companies cannot fully replace public enforcement mechanisms. The Directive aims to avoid fragmentation of due diligence requirements across the EU, ensuring a consistent approach to enforcing international law. It reflects the EU's commitment to social and environmental sustainability and responds to public demand for goods produced in compliance with these standards (Felbermayr et al. 2024).

## TOWARD AN EX-ANTE ASSESSMENT

### Firms' Reactions

The CS3D could lead to EU importers withdrawing from certain countries if compliance costs and the risks of continued operations become too high, negatively impacting diversification and economic development in those regions. Withdrawal could push employment into the informal sector, where conditions regarding human rights and environmental standards are worse. Preliminary evidence from France indicates that importers have withdrawn from small, risky countries, consistent with research showing that supply chain disruptions can harm company value (Duthilleul and de Jouvenel 2020; Kolev and Neligan 2021). There is also a risk of trade diversion, with trading partners from other countries with weaker requirements, such as China, filling the gap left by EU companies.

The Directive's impact on international economic relations must be carefully monitored to avoid unintended consequences. If costs become prohibitive, EU importers may reduce their engagement with certain source countries, undermining efforts to diversify EU imports and strengthen resilience. This could also hinder the economic development of poorer countries losing access to the EU market. The CS3D may unintentionally drive employment into less regulated informal sectors, exacerbating human rights and environmental issues. Trade diversion to non-EU importers could aggravate these dynamics.

### Complex Inter-Firm Relationships

Effective assessment of supply chain regulations is hindered by limited data availability. In a recent technical paper published by the Supply Chain Intelligence Institute Austria (ASCI), this challenge was addressed by a synthetic dataset of EU firms. The dataset makes it possible to quantify the likelihood of links to firms that are potentially involved in human rights or child labor abuses in their supply chain (Hurt et al. 2023). The findings indicate that nearly every company in Europe faces supply chain risks because networks of suppliers and customers are very dense. The CS3D

could apply to approximately 20,000 EU-based companies, affecting millions of supply relationships. Monitoring these relationships is complex, as companies often lack a complete picture of their entire supply chain due to data protection and privacy concerns.

The extensive network of supply chains means that even small companies are exposed to risks through indirect relationships. On average, companies have thirty to fifty suppliers, with large firms having thousands. This complexity necessitates comprehensive monitoring, which the CS3D aims to address. However, the requirement to monitor such vast networks poses challenges in terms of data availability and the ability to effectively track compliance. The Directive's implementation will require innovative solutions to manage these complexities and ensure compliance across multiple levels of the supply chain.

### Transaction Costs

The CS3D increases transaction costs, which may lead to fewer suppliers and reduced diversification. The Directive aims to improve local conditions but may result in withdrawal if operations become unprofitable. While increased monitoring can reduce the likelihood of abuses, it cannot eliminate risks entirely. The effective relationship-specific fixed costs include direct bureaucratic costs, the probability of failure, and potential fines and reputational costs. Companies may withdraw from foreign countries if they perceive high risks, leading to a concentration on fewer suppliers and undermining efforts to diversify the EU's supply base (Melitz 2003; Helpman et al. 2008).

The Directive's impact on fixed costs must be carefully managed to prevent adverse effects on supplier relationships (Wolfmayr et al. 2024). As costs rise, smaller suppliers may be excluded, reducing competition and diversity. This could lead to a concentration of suppliers, increasing vulnerability to supply chain disruptions. The CS3D must balance the need for rigorous compliance with the practicalities of maintaining diverse and resilient supply networks. Strategies to mitigate these costs, such as streamlining monitoring processes and leveraging technology, will be crucial to the Directive's success.

### PILLARS OF THE IMPLEMENTATION

Any such regulation should be effective, i.e., it should improve local conditions, and efficient, i.e., it should not create an extra burden to firms and minimize adverse effects. Given the interwovenness of modern supply chains, complexity reduction is essential to achieve these targets. In practice, this concerns the monitored relationships, the geographic scope of the regulation, and the practical implementation (Felbermayr et al. 2024).

To ensure effective implementation, the Directive should limit fixed costs at the company level. Moni-

toring should focus on suppliers rather than bilateral relationships to reduce complexity and thus costs. Implementing a certification and blacklisting system could decrease monitoring expenses and enhance compliance incentives. Certification by specialized firms should ensure that the Directive's objectives are effectively implemented and relieve EU importers of liability. This should foster a European certification industry, which, in turn, would require efficient and effective regulation and oversight. This more centralized approach would allow for more efficient monitoring by focusing on the nodes of supply networks rather than individual links, reducing overall costs and increasing compliance incentives.

The geographic scope of the regulation should be limited to reduce the bureaucratic burden. It should not apply to transactions with trading partners in countries with strong rule of law, such as EU member states, EFTA countries, the US, Canada, Australia, New Zealand, Japan, and South Korea. A certification system could operate at the country or company level, carried out by public authorities or specialized private companies. This market-based solution would be more efficient than a government solution and can be thought of as resembling the financial auditing sector.

A certification (and blacklisting) system offers significant advantages in terms of efficiency and effectiveness. By pooling due diligence costs, the system increases the overall efficiency of monitoring. Certification would provide a "positive list" of compliant companies, incentivizing suppliers to meet EU standards. Non-compliance would result in delisting, amplifying the consequences for suppliers.

This approach not only reduces costs but also extends the EU's influence on global supply chains, creating a "Brussels effect" that encourages broader adoption of EU standards. Third-country companies that undergo EU certification would demonstrate compliance with norms not only regarding their business dealings with EU companies but with all their global clients and suppliers. In that sense, the CS3D would gain an extraterritorial application.

### POLICY CONCLUSIONS

The CS3D mandates due diligence on companies' operations and supply chains to identify and mitigate adverse impacts on human rights and the environment. In this policy piece, we warn that the focus on supplier-buyer linkages is exponentially more complex than an alternative approach that focuses on suppliers, therefore driving up relationship-specific costs for European importers by more than necessary. The higher the costs, the more damaging the CS3D is to the EU's own narrow economic interests, the lower is the effectiveness of the CS3D, and the stronger are unwelcome collateral effects. Indeed, higher fixed costs per supply link make a withdrawal of EU buyers from risky markets or a concentration on fewer but

larger suppliers more likely. This would jeopardize the EU's goals to foster development in poorer countries and to diversify its own supplier base. So, for an array of reasons, any national implementation of the directive should focus on minimizing such costs.

Therefore, we advocate a certification scheme at the supplier level that could shift liabilities and reduce costs while improving local production conditions. However, residual risks, particularly in concentrated upstream market structures, persist. The system offers an opportunity to extend EU values beyond EU-based production networks, promoting broader compliance with sustainable practices. By effectively pooling the costs of due diligence, a certification approach increases the efficiency of the monitoring system and enhances the EU's influence on global supply chains. Obviously, our proposal achieves maximum effectiveness and efficiency only if all member states cooperate on the proposed certification mechanism. To guarantee this, adjustments to the Directive's legal text may be needed.

The Directive represents a significant step toward ensuring that EU companies uphold high ethical, environmental, and labor standards throughout their operations. While challenges remain, particularly in balancing costs and benefits, the CS3D provides a framework for promoting sustainable and responsible business practices.

Its success will depend on careful implementation, ongoing evaluation, and the ability to adapt to evolving global dynamics. The CS3D has the potential to set a global benchmark for corporate sustainability, driving positive change across industries and regions.

The EU should not do this alone. In the United States, similar policies are being passed, and policies in the EU and the US should be aligned so that they jointly create social and environmental standards that are internationally binding for trading partners with both blocs.

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