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The New Wave of Defensive Trade Policy Measures in the European Union:

Design, Structure, and Trade Effects

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LISTS OF ACRONYMS

ACI	Anti-Coercion Instrument
ASCM	Agreement on Subsidies and Countervailing Measures
ASEAN	Association of Southeast Asian Nations
CBAM	Carbon-border Adjustment Mechanism
CN	Combined Nomenclature
DSB	Dispute Settlement Body
DSU	Dispute Settlement Understanding
EEA	European Economic Area
ERTD	Enforcement Regulation on Trade Disputes
ETS	EU Emission Trading Scheme
EU REACH	EU Registration, Evaluation, Authorization and Restriction of Chemicals Regulation
FDI	Foreign Direct Investment
FRC	Forest Risk Commodities
FSI	Foreign Subsidy Instrument
FTA	Foreign Trade Agreement
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GPA	Government Procurement Agreement
GTA	Global Trade Alert
ILO	International Labour Organization
IMF	International Monetary Fund
IPCEI	Important Projects of Common European Interest
IPI	International Procurement Initiative
IPR	International Property Rights
LDCs	Least Developed Countries
LPF	Level Playing Field
M&A	Mergers and Acquisitions
MENA	Middle East and North Africa
MFN	Most Favoured Nation
MPIA	Multiparty Interim Appeal Arbitration Agreement
OECD	Organization for Economic Cooperation and Development
QMV	Qualified Majority Voting
R&D	Research and Development
SMEs	Small and Medium Enterprises
TBT	Technical Barriers to Trade
TED	EU Tenders Electronic Daily
TER	Trade Enforcement Regulation
TFEU	Treaty of the Functioning of the European Union
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
UNGPs	UN Human Rights Council Guiding Principles on Business Conduct
WTO	World Trade Organization

PREFACE

There was a period – quite a long period, in fact – when the debate on trade policy centred around the question of multilateralism versus bilateralism. The objective, however, was always the same – to increase market access – and the debate was only over the best means to advance the free trade.

Those days are gone. Now, the debate has little to do with market access or simplifying trade; in the European Union, the focus lies on identifying various ways to reduce access to the European market. Many legislative initiatives are being developed – or have already been implemented – to regulate or close down trading opportunities. Most of these are not traditional protectionism as we know it – although there is certainly an element of that – but rather their aims are security, sustainability and level playing fields.

This report aims to provide a comprehensive and fact-based overview of these new laws. It is vital to understand them, as they will have a profound impact on future of trade, both individually and in combination. The purpose of the report is not to debate the merits of these proposals, but rather to describe and analyse them factually, in order to enlighten the debate. Trade policy is changing at its very core, and we need to understand the how and why.

It is for these reasons that the Confederation of Swedish Enterprise has taken the initiative in commissioning this report. Henrik Isakson, Trade Policy Director at the Confederation, initiated the report and approached ECIPE – the European Centre for International Political Economy – with the concept. ECIPE possesses an exceptional capacity to analyse these issues from an economic, political and legal perspective. The report was fully funded by the Confederation.

Henrik Isakson, together with our Chief Analyst Jonas Berggren and our policy expert on State Aid and competition Stefan Sagebro, has contributed to the report. However, the research, analysis and drafting has been undertaken by the staff at ECIPE. Our hope is that this report will be a timely contribution to a central European discussion on the future for global trade.

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EXECUTIVE SUMMARY

This study undertakes a comprehensive review of proposed and adopted defensive trade policy instruments in the EU, with the purpose of better understanding their design, functioning, and implications. The study covers eight policy instruments at different stages of development. These are: Anti-Coercion Instrument (ACI), International Procurement Instrument (IPI), Carbon Border Adjustment Mechanism (CBAM), Foreign Subsidy Instrument (FSI), Corporate Sustainability Due Diligence (DD), Level Playing Field Provisions in the EU-UK Trade and Cooperation Agreement (LPF), Enforcement Regulation (ER), and the Deforestation Initiative (DI).

It is understandable that the EU seeks both redressive and retaliatory measures in its trade policy. However, these measures would have the total effect of Europe producing more for itself and being less dependent on imports. This is a significant policy shift, because in their totality the defensive trade policies make the EU more inward-looking. This can lead to major negative consequences. An extensive distortion of trade and markets would reduce the gains from trade and prompt a reallocation of European resources. Notably, the EU is a larger supplier of goods and services than it is a buyer, and an inward-looking policy that leads to retaliation from EU's trading partners can harm its exports and trade surplus. There are also potential strategic consequences that could follow, and their importance has increased considerable as a result of the Russian war against Ukraine. Under these measures, the EU could introduce new trade frictions with friends and allies, and with countries that the EU seeks closer cooperation with to provide for a safer geopolitical environment.

For each of these defensive measures, the study takes an extensive look at the objectives of the instruments, their legality, proportionality, and subsidiarity, the working of the instruments and the division of labour between institutions, as well as their enforceability in conjunction with existing multilateral and bilateral rules affecting the EU. It also attempts to capture the impact and potential for retaliation for the EU and its partners as a result of the implementation of the instruments. The study highlights the areas where the instruments lack clarity, particularly in the implementation of the instrument, the division of labour between the EU and EU member states, and the compliance of the instruments with WTO rules and bilateral FTA provisions.

The instruments share some general characteristics. Many of the instruments have been created as retaliatory measures against coercion and unfair trade practices by partner countries. Very often, the partner countries most affected by the instruments are also the same. The United States, China, Russia, the UK, and Turkey are likely to be on the receiving end of the instruments due to the significant volumes of trade and economic interdependence with the EU, but also because they either do not follow the same trade rules as the EU, or

the EU wants to maintain with them the current level of competitiveness. Most instruments also use restrictions to the EU market as the main policy lever. The objective is not just about creating an equal playing field but also ensuring that the rest of the world follows EU rules. Particularly, the EU aims at regulating non-EU companies directly and unilaterally through EU policies, which increases the risk of retaliation against the EU.

At the same time, there are also important areas of departure in the specifics of each instrument, as illustrated by the varying objectives, measures, compatibility with international obligation, affected sectors, and whether the measures applies automatically or at the discretion of the EU.

TABLE: DEFENSIVE TRADE POLICY MEASURES

Trade Policy Measures	Objective	Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
ACI	Deter and counteract coercive actions by third countries through the use of the EU's own trade defence arsenal.	The measures include the suspension of tariff concessions, imposition of customs duties. and restrictions on the importation of goods, access to EU's public procurement, and suspensions in trade in services and trade-related aspects of intellectual property rights (IPRs). Other non-conventional measures can also be taken.	Depends on its final implementation.	All sectors can be subject to ACI. Trade in services and IPR are included but the EU may not always have the capacity to act due to existing obligations.	Discretionary.
IPI	Leverage market access in procurement markets for EU firms and to restrict access to the EU's procurement market for companies, from countries where EU companies face restrictive or discriminatory measures in public procurement.	The IPI has two types of measures: score adjustments, which are penalties that procurement authorities have to apply to a company subject to the IPI; and the exclusion of tenders from a third country and sector subject to the IPI.	Compatible.	IPI applies to procurement above €5 million. All sectors in EU procurement can be subject to IPI.	Discretionary.
CBAM	Avoid carbon leakage by adding a cost to certain carbon-intensive imports from countries with a different carbon-cost policy than the EU.	A levy on imported products which value corresponds to the level of embedded carbon in the affected products.	Depends on its final implementation.	Cement electricity, fertilisers, iron and steel, and aluminium.	Automatic.

Trade Policy Measures	Objective	Specific Measures	Com-patibility	Affected sectors	Discre-tionary or automatic
FSI	Address the distortive effects of foreign subsidies.	The EU Commission can impose redressive measures such as reducing their market presence, refraining from certain investments, or repayment of the foreign subsidy to companies using foreign subsidies in mergers and acquisitions, public procurement, and other market situations in the EU.	Compatible.	All sectors can be subject to FSI. However, the sectors with a higher prevalence of foreign subsidiaries are more likely to be impacted by FSI.	Discretionary.
Corporate Sustainability Due Diligence	Identify, prevent, mitigate, and end adverse human rights and environmental impacts in companies' operations, subsidiaries, and value chains.	Businesses need to integrate due diligence, identify adverse effects, and take measure to prevent or eliminate these effects.	Compatible.	All sectors can be subject to due diligence. Large EU and non-EU companies as well as smaller companies in high-risks sectors will be directly impacted by these new obligations. SMEs will be impacted indirectly as long as they are part of a larger supply chain.	Automatic.
EU-UK LPF	Establish rules to safeguard fair competition between EU and British businesses. These rules are to ensure that there is no regression from the current standards maintained between the EU and the UK, which could distort international trade and provide either of them with a more competitive edge.	The provisions commit both parties to upholding high standards of protection on labour and the environment. The UK or the EU can impose redressive measures if the other changes its labour or environmental regulation to provide an unfair advantage to their companies.	Compatible. LPF falls under the EU-UK Trade and Cooperation Agreement (TCA).	All sectors can be subject to LPF.	Automatic.
Updated Enforcement Regulation	Grant the EU the right to action in response to a measure maintained by a country, and when the WTO dispute settlement mechanism is blocked for non-cooperative reasons by this country.	The EU can take countermeasures when there is a failure to implement a panel in the WTO because of paralysis in the Appellate Body or when a similar situation arises under other international trade agreement.	Not compatible.	All sectors can be subject to Updated Enforcement Regulation. Trade in services and IPR are included but the EU may not always have the capacity to act due to existing obligations.	Discretionary.
Deforestation Initiative	Ensure sustainable and deforestation-free supply chains for products placed on the EU market.	Mandatory due diligence rules for companies and a benchmarking system used by the European Commission to assess countries' risk of deforestation and forest degradation driven by the commodities.	Depends on its final implementation.	Coffee, cocoa, cattle, palm oil, soy, and wood, as well as derived products including leather, oil cakes and chocolate.	Automatic.

1. INTRODUCTION

The purpose of this report is to provide a better understanding of the design, execution, and trade consequences of several new defensive policy measures that have been proposed or are considered in the European Union (EU).

The starting point for many – if not all – measures covered in this report is a growing view in Brussels and notable national capitals that Europe is ill-equipped to address new types of inequities, challenges, and restrictions in global trade. Generally, the European Commission has taken the view that Europe is too dependent on other countries for the supply of certain goods and technologies, and this stance also informs more specific trade proposals. Furthermore, the European Commission has argued that a new world of geoeconomic frictions is emerging, and that Europe needs to be prepared to economically defend itself, and its strategic and economic interests, in a better way than now. Even if some of the proposals covered in this report only have a tangential relation to these motivations, it is clear that the climate of opinion in Europe is shifting towards a more defensive attitude to globalisation and the economic opportunities presented by trade openness.

Recently, the context for the future direction of defensive trade policies – and, more generally, the geopolitics of trade – has shifted markedly. In February 2022, Russia started a full-scale war against Ukraine. Europe, along with its allies and partners, has responded with an unprecedented package of sanctions that will have very deep effects on the Russian economy. Europe is starting to prove it is a serious geopolitical actor, and other countries are noticing that Europe is prepared to act with great resolve and accept the costs of its own actions. Many of the defensive measures covered in this paper have been presented as deterrence measures: Europe would lay down a policy that hopefully would never be used as other countries would accommodate Europe's reaction before they act in bad faith. As Europe has demonstrated its preparedness to go as far as to sanction Russia's central banks, the importance of some of the defensive measures shrink in comparison. Moreover, the new geopolitical situation is also prompting new questions about deeper economic integration among allies. Many of the defensive measures proposed would have consequences for trade with allies such as the United States. Interestingly, some would especially hurt exports from countries like Ukraine, and it is unlikely that the EU would want to stick with such policies. Hence, the unfolding geopolitical questions should prompt the EU to re-consider the design of some of these measures.

Many of the new proposals cover policy instruments that are novel in the EU hemisphere: they are policy innovations. Some of them are also new in a global context, which may complicate matters as their compliance with the rules of the World Trade Organisation (WTO) may be in doubt. Most measures have consequences for the agreements that the EU has signed with other countries, but it often remains unclear how the EU plans to address frictions with third countries that will arise as a consequence of the new instruments.

Novelty sometimes breeds confusion – and there is a degree of confusion of how some of the proposed instruments actually will work. There is a decision-making hierarchy to understand: who will make decisions about activating a new defensive policy instrument. It is also critical to grasp the actual implementation: who is responsible for implementing a measure – in most cases, blocking certain imports and suppliers – as the European Commission itself does not control the execution of many policies.

The new policy instruments covered in this report are the Anti-coercion Mechanism (ACI), the International Procurement Instrument (IPI), the Carbon-border Adjustment Mechanism (CBAM), the Foreign-Subsidy Instrument (FSI), the Updated Enforcement Regulation, the Corporate Sustainability Due Diligence Directive, Level-playing Field Provisions (LPF) in the EU-UK Trade and Cooperation Agreement and the Deforestation Initiative. This list is not exhaustive: there are several other defensive measures that are making the rounds in Europe, and they include FDI screening, anti-dumping, sanctions, exports credits, and new sustainability standards in trade agreements as well as parts of the new Industrial Strategy that aim to encourage the production of certain products in the EU by the use of public subsidies. However, the policy instruments that will be covered are the most developed proposals.

To get an overview, these measures can also be sorted on the basis of their intentions. Most of the new defensive measures proposed by the EU – including those that have not been covered in this study – aims to either establish a "level playing field", support sustainability or provide for better security protection in the EU. Some measures have more than one overarching intention. Table 1.1 classifies the measures.

TABLE 1.1: CLASSIFYING COVERED MEASURES

	Level-playing field	Sustainability	Security
ACI			
IPI			
CBAM			
FSI			
Updated Enforcement Regulation			
Corporate Sustainability Due Diligence			
LPF in EU-UK TCA			
Deforestation Initiative			

In this report, each chapter will cover a new policy instrument. We have followed a fixed methodology for the initial parts of the analysis. Once we get into potential consequences of the new measures, the analysis will differ between the policy instruments – mostly because of the varied nature of the measures but also because of data limitations. The analysis of the measures is based on three types of "sources". First, we draw on actual proposals or other written documentation (such as a Commission consultation). Second, we have been helped by interviews that we have done with senior officials in the European Commission. Third, we have used our own judgment when considering how a measure will work in practice.

2. ANTI-COERCION INSTRUMENT (ACI)

2.1 What is the Anti-Coercion Instrument (ACI)?

The basic idea behind the Anti-Coercion Instrument is to deter and counteract coercive actions by third countries. This initiative has its origins in a concern among international actors, such as the United States, Australia, Japan, and the European Union, about the increase in economic coercive practices by some countries. In the words of the European Commission, these coercive practices by non-EU countries "are measures which seek to influence the EU and/or its members states not to take, or withdraw, particular policy measures."[1] Therefore, the ACI instrument aims to act against these practices and deter countries "from using coercion or the threat of coercion against the EU or a member country; and minimising the negative effects of any coercion that has taken place, by swiftly enacting trade, investment or other policy measures against the country responsible."[2] Ultimately, says the Commission, the goal is to reinforce the EU's open strategic autonomy and effectively protect the interests of the EU and its member countries.

The ACI proposal considers as coercive practices foreign interference in EU domestic affairs, something it sees as a violation of its sovereignty. Because of this, these coercive measures breach customary international law "which prohibits certain form of interference in the affairs of another subject of international law when there is no basis in international law for doing so."[3] This concept of illegitimacy is therefore at the centre of the EU analysis and its definition of economic coercion.

While some aspects of the proposal are clear, other parts are less clear. An essential component of the ACI regulation is the broad scope of its remedies and countervailing measures: they could cover trade in goods, services, and trade-related aspects of IPRs. For a more extended discussion on the potential issue arising from the application of the ACI in services and IPR see the chapter on the Updated Enforcement Regulation. Moreover, the EU could also suspend tendering rights in public procurement and impose measures affecting foreign direct investment. However, there are some situations that may arise where the type of response remains less clear. For instance, although the ACI regulation takes into account non-conventional forms of diplomatic coercion – such as cyber-attacks, debt-traps[4] and boycotts – there is still ambiguity about the type of response in such cases. This

[1] In the EU's view, these coercive practices by third countries undermine EU's open strategic autonomy. Therefore, in the legislative process to amend the EU Trade Enforcement Regulation, the European Parliament and EU member states raised concerns about these practices. This led to a political agreement on a Joint Declaration of the Commission, the Council and the European Parliament to create a new legislative instrument to deter and counteract coercion. The initiative was announced by President von der Leyen in her Letter of Intent to the President of the Parliament and President.

[2] European Commission, 2021, Inception Impact Assessment: Instrument to deter and counteract coercive action by third countries.

[3] European Commission, 2021, Inception Impact Assessment: Instrument to deter and counteract coercive action by third countries.

[4] Debt-trap diplomacy is a term in international finance which describes a creditor country or institution extending debt to a borrowing nation partially, or solely, to increase the lender's political leverage.

uncertainty is exacerbated by the stated intention in the ACI proposal to respond against foreign coercion in a way that reflects the injury caused by the coercion. Equally, it is unclear in what situations there could be a suspension of FDI market access and what measures on IPRs mean in practice.

BOX 2.1: EU'S SANCTIONS RESPONSE TO THE RUSSIAN INVASION TO UKRAINE IN 2022

Since the beginning of the invasion of Russia and its military aggression against Ukraine in 2022, a coordinated alliance of Western nations and their allies enacted a package of sanctions and restrictive measures against Russia. The adoption and imposition of these measures was carried out as Russia's military aggressions under Ukrainian territory escalated. These measures also had a knock-on effect on private business which suspended operations in Russia. The ACI proposal includes an open-ended list of actions which can be adopted as a response to a foreign coercion. After Russia's invasion of Ukraine, the EU has shown that it is willing to use not just traditional trade defence measures to reduce market access, but also non-traditional measures that inflict significant economic pain to another country. The list of EU sanctions on Russia present below illustrate which measures the EU could take under ACI in the face of foreign coercion.

Finance
- Removal of selected Russian banks from the SWIFT international payment system.
- Equity restrictions and prohibition of acquiring new debt to the Russian Agricultural Bank, Credit Bank of Moscow, and Gazprom Bank, among others.
- Blacklisting a major Russian sovereign wealth fund and expanding restrictions on buying Russian debt.
- A ban on Russian deposits above €100,000 in EU banks on Russian accounts held by EU central securities depositories and on selling euro-denominated securities to Russian clients.

Transport
- An export ban on all aircraft, spare parts and equipment to Russian airlines, as well as to the Russian space industry. This includes a prohibition on insurance and reinsurance and maintenance services.

Technology and Defence
- A ban to EU-based companies from exporting technology to Russian weapons maker JSC Kalashnikov, military communications units and shipyards.
- A ban on the export of dual-use goods and technology, including semiconductors.

Energy
- Suspension of the certification of Nord Stream 2 gas pipeline.
- A ban on the sale, supply, transfer or export to Russia of technologies in oil refining and restrictions for related services.

Restrictions on business

- EU companies are banned from doing business with the following state-owned companies: arms maker Almaz-Antey, Truck-maker Kamaz, Novorossiysk Commercial Sea Port, Rostec, Russian Railways, nuclear submarine maker Sevmash, hydrocarbons shipping company Sovcomflot, United Shipbuilding Corporation and gas industry insurance company Sogaz.

Restrictions on media

- Suspension of broadcasting of state-owned media company Sputnik

Restrictions on multilateral agreements

- Suspension of projects in Russia and Belarus by the World Bank (INT)

Individuals

- A freeze of foreign-held assets to President Vladimir Putin, Foreign Minister Sergei Lavrov, Defence Minister Sergei Shoigu, Chief of the Russian armed forces Valery Gerasimov, 351 members of the Duma, among others.

2.2 Legal basis, subsidiarity, and proportionality

In December 2021, the European Commission unveiled its ACI proposal, building on a stakeholder consultation and previous petition from the European Parliament about introducing a measure to counteract economic coercion. The legal basis for this initiative is Article 207 of the Treaty on the Functioning of the EU – the common commercial policy. The ACI effectively builds upon the current EU Trade Enforcement Regulation (TER), which recently has been amended to empower the EU to "suspend and withdraw concessions" in international trade agreements without first obtaining a final ruling in its favour.

Since the present regulation falls under the common commercial policy, indicated in Article 3 (1)(e) of the TFEU, the principle of subsidiary does not arise. This means that an EU member state cannot put in place a national legislation to cover economic coercion as intended in the ACI. EU member states shall comply with their international commitments and can defend their rights under international law but without implementing measures where the Union is exclusively competent. The proposal also respects the principle of proportionality, as it structured in a multi-step process, in which the first actions are oriented to resolving issues without resorting in countermeasures.

Moreover, the Commission says that the ACI will also build on other and possible future initiatives countering the extra-territorial application of measures by countries outside the

EU, such as the Blocking Statute which prohibits compliance by EU operators with any requirement or prohibition based on specified foreign laws.[5]

However, legal complications could arise because of the ambiguities in both defining economic coercion and the assignment of a remedy. Article 2 of the ACI proposal sets out what is considered as a coercive measure, but it is still works with a broad – if not open-ended – definition. For example, Art. 2 (1) states that the regulation "applies where a third country interferes in the legitimate sovereign choices of the Union or a Member State by seeking to prevent or obtain the cessation, modification or adoption of a particular act by the Union or a Member State, by applying measures affecting trade and investment."[6] The proposal does not explain in detail what type of actions that could be considered as "interference" or what it means that another country is "seeking to prevent or obtain" certain policies in the EU. The reference to sovereignty is also notable. While it cannot be argued now that foreign coercion challenges sovereignty in domestic choices – policies still need to be approved in the EU and member states according to democratic treaties and constitutions – it is a nod to situations when the EU makes choices about policies that apply on European actors in third countries but where the integrity of these policies is challenged by another third country (e.g., US sanctions on Iran affecting EU traders).

It is also notable that accompanying material to the Commission's ACI proposal says that "Whether a third country action fulfils those conditions would be decided on a case-by-case basis", which suggests that there will be significant discretion for the Commission to decide whether to activate the instrument. This is also made clear in conversations with Commission officials. Moreover, the same material says that an EU policy intervention under this instrument will be compatible with international law and that "countermeasures would be deployed when necessary and in response to a breach of international law by the coercing country."[7] However, such a proviso is not reflected in the text of the actual regulation.

The advantage of having a broad definition of coercion and flexible conditions for applying the instrument is that the Commission can address coercion that may not violate international law or in other ways be clearly defined measures with an obvious intent to coerce. The disadvantage is that it can lead to diverse and conflicting opinions about whether coercion has happened and what remedy that is proportional: the process can be centred too much on a negotiation between the Commission and EU stakeholders about the activation of

[5] European Commission, Blocking Statute. Accessed at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/blocking-statute_en

[6] European Commission, 2021, Proposal for a regulation of the European Parliament and of the Council on the protection of the Union and its Member States from economic coercion by third countries, Art. 3 https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf

[7] European Commission, 2021, Questions and answer: Commission proposal for an anti-coercion instrument. https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_6643

the instrument. It can become an instrument that is used when large member states favour activating, but not when they are opposing it.

Prior to the publication of the ACI proposal, a senior official in the Commission could not clarify how the concept of coercion, now specified in Art. 2, differs from what are common practices in international trade and economic relations: governments inform other governments about their reaction function – if country X does A, country Y will respond with B. This ambiguity was not clarified in the proposal, and it will be important to observe whether the Parliament or the Council make amendments to clarify more exactly the scope of coercion.

The definition of coercion is also central for how the instrument will sit in the EU. If the definition of coercion gets narrowed down to instances when there is obvious economic coercion against policies that fall under the EU competence, then it is likely that the EU could establish the ACI under core treaty articles for trade and the common commercial policy – effectively leading to a process for decision making that is similar to what exists for the TER and anti-dumping. However, conversations that we have had with senior Commission officials suggest that the ACI, in their words, is "more political" and that it will work with a broader scope of coercion. While there is a rational behind that, it also invites some issues about legality and EU competence – especially in events where the scope of economic coercion is less obvious or less central.[8] An indiscriminate use of the ACI would likely prompt legal problems in the EU, which the Commission is fully aware of.

Once the regulation is adopted, the Commission will execute the regulation and is legally responsible for introducing the measure. No implementation plan is required for this initiative as the initiative does not involve any transposition of legislation by EU member states because the proposed act would be directly and generally applicable in all member countries. Hence, the Commission will work with implementation and delegation acts (in the event the remedy would include rules of origin) when activating a measure.

2.3 How does ACI work?

While the Commission's DG Trade will manage the instrument, it is useful to consider in greater detail the type of actions, the country coverage, the process for making decision and the scale of the ACI measure that could be the result of the Commission's current work.

[8] Freya Baetens & Marco Bronckers, 2022, The EU's Anti-coercion Instrument: A Big Stick for Big Targets. EJIL Talk!, https://www.ejiltalk.org/the-eus-anti-coercion-instrument-a-big-stick-for-big-targets/; Deepak Raju, 2022, Proposed EU Regulation to Address Third Country Coercion – What is Coercion? EJIL Talk!, https://www.ejiltalk.org/proposed-eu-regulation-to-address-third-country-coercion-what-is-coercion/

a) *Type of actions.* The specific measures that the EU may employ to tackle coercion, pursuant to Articles 7 and 8 can be found in Annex I of the proposal. The measures include but are not limited to the suspension of tariff concessions, imposition of customs duties beyond MFN and restrictions on the importation of goods in the form of quotas, import or export licences. Additionally, the regulation envisions the suspension of international obligations concerning the right to participate in public procurement tenders, and suspensions in trade in services and trade-related aspects of intellectual property rights. Other measures related to investment-related policies that fall under EU competence are also considered, but they are deemed to be less workable – especially when determining the origin of the investment, whether "it is engaged in substantive business operations in the Member state." Furthermore, such measures do not allow for as much political targeting in counter-measures that import restrictions do. The list of measures in Annex I of the proposal is indicative of "Measures which may be adopted" which means that other measures could also be considered. The use of measures which have not been used in the past, such as data restrictions or banning companies to register in regulatory records like REACH for chemicals, will open their own set of questions with regard to their legality and if they fall within EU competence.

While actions that are directly part of EU's conventional trade policy are likely to be dominant in any future use of the instrument, it is notable that the ACI also includes intellectual property rights. However, this can cause much problem. First, policies on intellectual property are not as anchored in EU law as conventional trade policy. Second, IPRs are property rights, and these rights (and the withdrawal of the rights) are decided by courts. For instance, when the unitary patent is introduced in 2022, it is the new unitary patent court that will resolve matters of patent rights for holders of a European unitary patent. Third, withdrawal from international agreements on intellectual property rights is not a simple exercise: the EU cannot suspend convention rights for one country in international IPR conventions in the same way they could suspend concessions in a trade agreement. Fourth, the EU will open itself up for counter-retaliations from other countries that can be very damaging to EU economic interests.

b) *Country coverage.* The ACI is a horizontal instrument, and the European Commission has stated that the triggers that would activate the instrument would be the same for all third countries[9]. Conversations with officials, however, makes it clear that the likely targets for the instrument are first and foremost China and, in the second place, the United States. The concerns with China are widespread and don't attach to just one form of coercion. With the US, it is specifically the country's sanctions policy (e.g., Iran sanctions and previous threats of Nordstream II sanctions) that is referenced.

c) *Process of decision-making.* The first part in the process to activate the ACI, established in Article 11, is that the Commission will establish a process for activating an ex officio investigation into possible coercion. While parties can make complaints, the Commission sees it as crucial that there is discretion for the Commission to initiate investigations. This process would be similar to what has been established or proposed for existing or future contingent policies, like anti-dumping and the foreign-subsidy instrument. The Commission will then work with diplomatic efforts to eliminate the coercive practice – in effect, to consult with the coercing country about whether it can withdraw the activity before facing an EU reaction. Based on these consultations, the Commission will decide to propose introducing (or not) a measure against another country. The Council will decide by negative Qualified Majority Voting (QMV). There is a review process. Measures will terminate or be withdrawn once the coercion has ended. After termination, the Commission will evaluate any Union response measure, and it will assess the effectiveness of the response measure.

d) *Scale of the measure.* The Commission thinks there should be proportionality in the EU's response to coercion. This response will be determined according to the "intensity, severity, frequency, duration, breath, and magnitude of the third country's measure and the pressure arising from it; whether the third country is engaging in a pattern of interference seek. Or whether the third country, before the impositions of the measure, has acted in good-faith to settle the manner."[10] In the first place, the Commission will establish the type and scale of economic injury that coercion has created or has the potential to create. Based on these estimates, the Commission will propose a course of action that corresponds with the injury. In cases where injury still has not happened, the Commission thinks that targets for its actions will become more political. If injury has already taken place, the counter action is going to be more like-for-like.

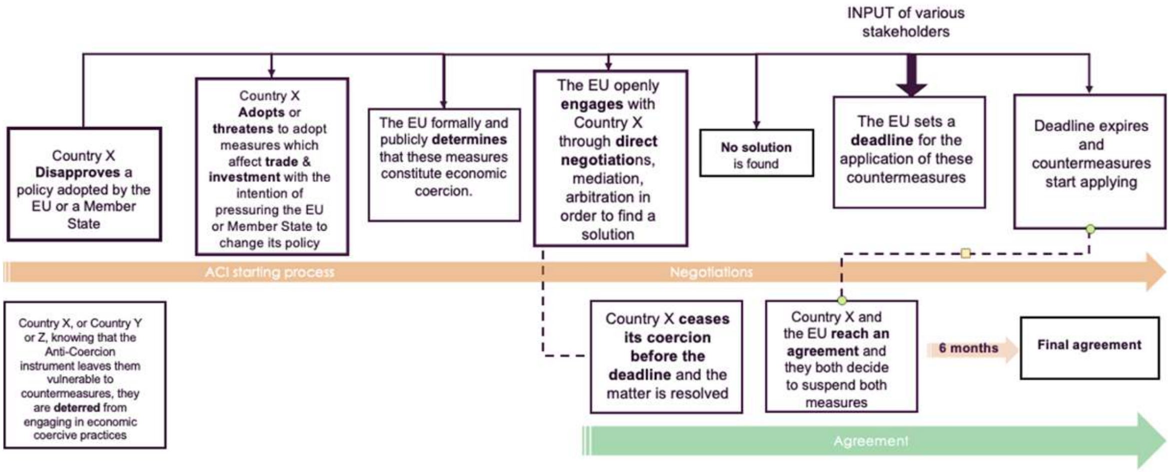
[9] European Commission, 2021, Inception Impact Assessment: Instrument to deter and counteract coercive action by third countries.

[10] European Commission, 2021, proposal for a regulation of the European Parliament and of the Council on the protection of the Union and its Member States from economic coercion by third countries, Art. 2 (2) https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf

BOX 2.2: HYPOTHETICAL EXAMPLE OF ECONOMIC COERCION TARGETING THE EU AND OF POSSIBLE EU REACTION UNDER ACI INSTRUMENT

The EU Commission makes a proposal to the European Parliament and Council to adopt a new regulation to protect intellectual property rights in the EU-market. A third country dislikes the new legislation as it opposes some of its economic, commercial, or diplomatic interests. Thus, the third country decides to impose an import ban on a product X of the EU. Because of the import restriction of product X, certain EU companies suffer from economic damage. This economic injury consequently creates pressure at the EU's domestic level and compromises the adoption of the new policy, even though the new legislation is consistent with international law. Afterward, the EU notifies the third country of its interference, and offers to engage in negotiations to remove the export ban and resolve the matter cordially. In parallel, the EU establishes a deadline and warns the third country that if no action is taken, the EU will resort in the adoption of countermeasures. If this primary negotiation proves to be unsuccessful, and/or the deadline is met for the third country to remove the economic coercive practice, the EU would explore different options of countermeasures. This response would be conducted incorporating different stakeholders' views in order to minimize the detrimental economic effects in its own market. Then, a decision is made and the EU resolves to impose a range of countermeasures (for instance, import duties or quotas) to selected products from the third country. After some weeks, the third country enters into talks with the EU, and both parties agree to suspend both measures for six months. During this time, the negotiation process continues until a final agreement is reached for the definitive lifting of both measures.

FIGURE 2.1: PATHWAY OF THE ACI



2.4 *The EU's ability to act*

While it is obvious that WTO rules have consequences for the ACI, it is equally obvious that the Commission intends to defend actions that are inconsistent with its WTO obligations under national security exceptions in Article XXI. This is a self-declaratory process that allows for more flexibility, but it does not mean that anything can be declared as a national security exception. There will still have to be established that significant coercion has occurred and that it has violated or threatened to violate the national security of the EU. Equally, many of the FTAs that the EU have signed will have consequences for the activation of the ACI against an FTA partner country. Furthermore, if an EU action would include IPRs, there are – depending on the action – several international conventions that could be violated.

2.5 *The potential impact of ACI*

2.5.1 *Potential EU's trade and investment impacted by ACI*

Even if ACI covers all of the EU's trade, investment, and procurement, the amounts that ACI would entail will be significantly smaller and have a more targeted approach towards combatting coercion and unfair trade practices by partner countries[11].

The EU's anti-dumping cases offer some insight about the volumes of trade that could be affected by the ACI. The example of anti-dumping is indicative in the sense that the scale of the measure will be proportional to the coercion in a kind of like-for-like framework, which is how trade defence measures are mostly applied. Table 2.1 shows a list of EU anti-dumping

[11] In principle, ACI has the potential to cover all EU trade, investment, and procurement. Therefore, the EU could target EU total imports of goods which in 2019 were equal to €2 trillion, EU's inward investment flows which accounts for €397 billion, or European Union's public procurement market, which as we will see in chapter 3, is valued by EU officials at roughly €2 trillion.

cases for different countries and sectors, and the value of imports affected by this trade defence instrument. First, the table shows the variety of sectors that can be targeted by anti-dumping, and which could also be subject to ACI: from fruits and aluminium to ceramics and solar panels. Second, most of the cases cover EU imports from China, although other countries like Indonesia, Argentina, and Russia are also included. Finally, the amounts of imports from the products subject to anti-dumping cases varies significantly – from €19.7 million to €8 billion in the listed cases.

TABLE 2.1: EU ANTI-DUMPING INVESTIGATION, COUNTRY AFFECTED AND IMPORT VALUES

Trade Defence Case	Country Affected	Import value (year)
Anti-dumping duties on citrus fruits (EU 2021/1447)	China	€19.7 million (2019)
Anti-dumping duty on aluminium extrusions (EU 2021/546)	China	€853 million (2019)
Anti-dumping duty on biodiesel (EU 2019/2092)	Indonesia and Argentina	€1.7 billion (2018)
Anti-dumping duty on iron and steel products (EU 2017/1795)	Brazil, Iran, Russia, Ukraine	€1.5 billion (2016)
Anti-dumping duty on cast iron products (2017/1480)	China	€233 million (2016)
Anti-dumping duty on steel products (EU 2017/141)	China and Taiwan	€36 million (2015)
Anti-dumping duty on solar panels (EU 1238/2013)	China, (extended to Taiwan and Malaysia, 2016)	€8 billion (2012), €3.6 billion (2015)
Anti-dumping duty on ceramic tiles (EU 917/2011)	China	€224 million (2010)

Source: Eurostat.

Another instructive case to better understand how ACI may work is the Airbus-Boeing dispute between the EU and the US. This case was resolved in June 2021 after 17 years of disputes. During these years, the EU and the United States were allowed to take measures to counter each other's subsidies in the civil aircraft sector. For example, in November 2020, the WTO allowed the EU to impose countermeasures on $4 billion worth of US exports to the EU. These countermeasures took the form of additional import tariffs on aircraft but also on non-aircraft goods such as nuts, tobacco, and spirits.

In a similar vein, the EU-US tariff war on exports of steel and aluminium also provides us with an illustrative example of EU thinking when it comes to countermeasures. In 2018, the United States slapped a 25% duty on steel imports and 10% on inward-bound shipments of aluminium from EU producers representing €6.4 billion worth of exports. The EU, in retaliation, imposed duties worth €2.8 billion immediately on goods such as steel, aluminium, but also on peanut butter, whiskey, motorcycles, and jeans. Yet, it stopped short of targeting the remaining €3.6 billion in retaliatory charges. This is because it wanted to give negotiations a chance to succeed. The expectation for the ACI is likely to be similar: it will not be used as a big political instrument but rather as a retaliatory instrument to avoid coercion.

Both these cases are instructive for the ACI because, when the ACI is introduced, the EU will have the power and flexibility to decide which economic flows – trade, investment, procurement and IPR – will be targeted as a response to a potential or factual coercive action from a third country. When choosing these flows, the EU will need to prioritise the economic sectors where foreign suppliers are not indispensable. For instance, if ACI is set as an increase in tariffs to Chinese or US goods, then the EU would need to find which Chinese or US goods represent a small proportion of EU total imports for that particular product category and are supplied by several other countries in addition to the United States or China. Moreover, the EU will have the capability to design a retaliatory measure which does not overshoot in its response and strategically targets products which will hurt all the same. For instance, in the case of the steel tariffs, the EU chose to target good produced in US states with significant support for Trump.

Another way to estimate the amount of trade, investment, or procurement affected by the EU's anti-coercion mechanism is to look at the existing trade measures against the EU. Again, since the EU will follow a proportional approach, the amount of EU trade impacted by partner country defence measures provides a useful yardstick to analyse the kind of trade the ACI may affect through countermeasure. Table 2.2 below presents three examples that correspond to the type of coercive measures identified by the European Commission ACI Impact Assessment and the amount of trade flows potentially affected.

For instance, an example of coercion came in 2015, when the United States re-imposed sanctions on Iran and barred from the US market companies not obeying these sanctions. The trade value affected included trade in airplanes, cars, energy, and financial services. As a result, several EU companies were affected and EU exports to the United States between 2014 and 2016 on goods subject to US sanctions fell by €7.6 billion. Another example of coercion was the Chinese threat of tariffs on European cars to pressure Germany into accepting Huawei's bid to build 5G infrastructure in Germany, a threat that had the potential to impact €14.6 billion of German exports to China. Or Turkish President open call to Turks to stop buying French goods which harmed some of the €230 million of French agricultural exports to Turkey.

TABLE 2.2: EXISTING TRADE MEASURES AGAINST THE EU AND VALUE OF TRADE POTENTIALLY AFFECTED

Case	Implementing Country	Type of trade affected	Trade value affected
EU bypass of US sanctions on Iran	US	EU exports to the US[12]	€37 billion (2018)
China's threat of car tariffs on Germany if Huawei is banned from German market	China	German car exports[13] to China	€14.6 billion (2020)
Boycott of French-labelled products by Turkey	Turkey	French agricultural exports[14] to Turkey	€0.23 billion (2020)

Source: UN COMTRADE, Eurostat.

2.6 The risk of retaliation

While the ACI is designed to deter and counteract coercive actions by third countries, EU countermeasures could lead to further escalation. This risk is real, and third countries will have plenty of products and sectors to retaliate against the EU since the EU is the largest supplier of almost one-third of all exported goods[15] and its outward FDI flow accounts for €406 billion or 34% of global outward FDI flow[16]. The likelihood of retaliation against the EU will depend, among other things, on the EU not overshooting in its own countermeasure to the foreign coercion.

Since the ACI is a reactive measure, the size of EU countermeasure needs to be equivalent to the harm caused by this country to the EU economy. Calculating this equivalence will be cumbersome because some of the actions that this regulation is meant to address are different from the regular contingent instruments such as import tariffs, regulatory barriers, and anti-dumping measures. If China slows down the Internet connection of a particular EU company, the EU will need a methodology to calculate an equivalent response to these actions, which will not be an easy task and will need to be based on a transparent methodology. The risk of not having such a transparent methodology to calculate the size of the ACI is further escalation and potentially a tit-for-tat trade policy dispute.

[12] US sanctions on Iran were on the following sectors: commercial planes, cars, precious metals, carpets, energy, finance, insurance, shipping. (HS codes: 2709, 271111, 2843, 57, 8703, 880240, and Services: SCB, SF, SG).

[13] HS code 8703.

[14] HS codes 00 to 24.

[15] Oscar Guinea & Vanika Sharma, 2021, Who is Afraid of Global Trade, Blog post European Centre for International Political Economy (ECIPE). Accessed at: https://ecipe.org/blog/who-is-afraid-of-global-trade/

[16] UNCTADStat FDI data.

The ACI is likely to become a controversial trade instrument. As explained before, the broad definition of a coercive measure in Article 2 of the ACI proposal, the broad scope of its remedies which includes good, services, trade-related aspects of IPR, public procurement, and foreign direct investment, as well as its application based on a case-by-case basis could lead to so much ambiguity that becomes an open door for its arbitrary implementation. This is a real possibility since the selected countermeasure will impose a cost on the EU's importers that may be different from the sector that has suffered from coercion. The risk is that the ACI could become a hostage to trade policy's oldest political economy problem: how the costs and benefits of the measure will be distributed between different sectors and member states.

3. INTERNATIONAL PROCUREMENT INITIATIVE (IPI)

3.1 What is the International Procurement Initiative (IPI)?

The International Procurement Instrument (IPI) aims at providing leverage to the EU in negotiations with third countries for opening up their markets[17]. The EU could use IPI to restrict access to its procurement market for companies, goods and services coming from countries where EU companies face restrictive or discriminatory measures. The instrument would allow the EU to, on a case-by-case basis, limit or exclude access to its public procurement markets to firms from countries that apply discriminatory restrictions against EU businesses.

This chapter starts with a description of how IPI would work in the EU policy-making process, from the initial investigation to the implementing act. The next section explains how IPI will change the public procurement of goods within the EU. Finally, the chapter presents an appraisal and discussion of the potential impacts of the IPI in the EU economy and worldwide.

3.2 Legal basis, subsidiarity, and proportionality

3.2.1 From the identification of a trade barrier to an IPI implementing act

The European Commission will be responsible for starting an investigation in case of an alleged trade barrier against EU companies in procurement markets outside the EU[18]. The Commission will invite the country concerned to start consultations to remedy the situation in case the existence of the trade barrier is confirmed. And, as a last resort, after consultations with EU member states, the Commission could apply measures restricting the access from the third country concerned to the European procurement market.

[17] See amended proposal for a Regulation of the European Parliament and of the Council on the access of third-country goods and services of the Union's internal market in public procurement and procedures supporting negotiations on access of Union goods and services to the public procurement markets of third countries. 5752/16. Access at: https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52016PC0034 Recital 24 of the draft regulation "Any measures under this Regulation should not have a negative impact on on-going trade negotiations with the country to which the measure refers. Therefore, where a country is engaging in substantive negotiations with the Union concerning market access in the field of public procurement, the Commission may suspend the measures during the negotiations".

[18] Article 2 of the draft regulation defines third country measure or practice as "any legislative, regulatory or administrative measure, procedure or practice, or combination thereof, adopted or maintained by public authorities or individual contracting authorities or contracting entities in a third country, that result in a serious and recurrent impairment of access of Union goods, services and/or economic operators to the public procurement or concession markets".

The individual steps behind the implementation of IPI are the following:

- *Step 1:* the process starts with the identification of a procurement barrier in a third country which has a negative effect on EU firms. This investigation could begin as a result of the European Commission own initiative or due to a complaint by an EU firm or a member state. After receiving such a complaint, the European Commission will investigate its validity.[19]

- *Step 2:* if the European Commission concludes that there is a genuine trade barrier in the procurement market of a third country, it will start an investigation. During the investigation, which can take up to 14 months, the affected third country will be consulted.

- *Step 3:* once the investigation is finalised, the European Commission will publish a report[20]. This report will feature the findings of the investigation which, among other things, may include the identified trade barrier, the extent to which that trade barrier harms EU firms, and the proposed course of action.

- *Step 4:* the European Commission can stop the investigation if the trade barrier causes no harm or if the third country eliminates the identified barrier. However, if the barrier results in a cost to EU firms and it persists, the European Commission – through an implementing act – will apply the IPI in a proportional way so firms from the third country in a particular sector will see their access to the EU public procurement market restricted.

- *Step 5:* finally, the European Commission may decide to stop, reinstate, or renew the IPI according to its view on whether the trade barrier persists or not.

The next box presents the steps behind the activation of the IPI in more detail.

[19] A similar process already exists for instance in the EU Market Access Strategy and Market Access Partnership where EU member states and firms inform the European Commission about trade barriers in third countries.

[20] Recital 21 of the draft regulation states "It is of the utmost importance that the investigation is carried out in a transparent manner. A report on the main findings of the investigation should therefore be publicly available".

BOX 3.1: PROCESS TO ACTIVATE THE IPI

	Steps of process of activation
Step 1: Initiation of investigation	• Initiation on own initiative of Commission or substantiated complaint of EU interested party or member state • Interested parties and member states can provide information to Commission within a specified period of time (Art. 4.1)
Step 2: Investigation and consultation period	• After publication of the notice, Commission invites the third country concerned to submit its views and enter into consultations to remove the alleged third country measure or practice. (Art. 4.1a). • Investigation and consultations to be concluded after 9 months. Extension of 5 months possible in duly justified cases. (Art. 4.2)
Step 3: Publicly available report on findings	• After conclusion of the investigation and consultations, Commission publishes a public report on findings of the investigation and proposed course of action. (Art. 4.2a)
Step 4.1: Termination of investigation	• Commission can terminate investigation if measures are not maintained or if they do not result in serious and recurrent impairment to EU. (Art.4.3)
Step 4.2: Suspension of investigation	• Suspension of investigation by Commission if third country: takes satisfactory corrective measures; ends or phases out the measure in a reasonable period of time and no later than six months; or negotiates a new international agreement or to extend the scope of an existing one regarding procurement. Negotiations to be concluded within a reasonable period of time and no later than six months. • Commission may resume the investigation at any time if it finds that reasons for the suspension are no longer valid. (Art.4.4a)
Step 4.3: Adoption of IPI measure	• If Commission finds, after the investigation and consultations, that a third country measure or practice exists, it may adopt an implementing act to impose an IPI measure. (Art.5.1). • Commission to consider a wide variety of aspects of political, economic or any other nature on the impact of the investigation. Opening third country markets and limiting any unnecessary administrative burden should also be taken into account. Member states and interested parties should have the possibility to present their views. (Recital 19)

Step 5.1: Withdrawal of measure	• Commission "may withdraw the IPI measure or suspend its application if the third country takes satisfactory corrective actions or undertakes commitments to end the measure or practice in question" (Art. 5.9).
Step 5.2: Reinstatement of measure	• If corrective actions are considered by the Commission "rescinded, suspended or improperly implemented", it may "reinstate the application of the IPI measure at any time" (Art. 5.9).
Step 5.3: Expiry or extension	• The measure is to "expire five years from its entry into force or its extension, unless a review shows a need for continued application". • Commission can initiate review "nine months before the date of the expiry" and the review "shall be concluded within six months" (Art. 5.10)

Source: European Council[21].

The IPI has two types of measures at its disposal: score adjustments and the exclusion of tenders. Moreover, the IPI implementing act could use a combination of these two measures if different sectors are subject to the IPI. First, score adjustments – which can be up to 40% of the evaluation score – are penalties that procurement authorities have to apply to the offer by a company subject to the IPI during the scoring of the offers received to fulfil a public procurement contract. Second, the exclusion from the EU procurement market of all companies from a third country and sector subject to the IPI is seen as a more extreme option which would apply only when the third country barrier is sufficiently severe and the potential negative impact due to the fall in the number of suppliers is small. If the procurement authority only receives offers from companies based on a country subject to the IPI, then the procurement authority could decide not to apply the IPI. However, if the IPI applies an exclusion of tenders, it is unlikely that any company originating from a country subject to IPI would submit a bid for that contract.

The severity of a market access barrier faced by EU companies in the procurement market of a third country will be assessed by the European Commission during the investigation. In principle, the European Commission could implement IPI if the investigation "confirms the existence of the restrictive measures or practices"[22] and those measures or practices "result in serious and recurrent impairment of access"[23] to the public procurement of a third country. Therefore, the bar for the potential application of the IPI is set relatively low. The European Commission only needs to demonstrate

[21] See: Council of the European Union, 2021, Amended proposal for a Regulation of the European Parliament and of the Council on the access of third-country goods and services to the Union's internal market in public procurement and procedures supporting negotiations on access of Union goods and services to the public procurement markets of third countries. Accessed at: https://data.consilium.europa.eu/doc/document/ST-9175-2021-INIT/en/pdf.

[22] Recital 22 of the draft regulation.

[23] Recital 17 of the draft regulation.

the existence of a trade barrier and that the barrier itself results in lower market access to the public procurement market of that country for EU firms.

Yet, while the IPI can be activated relatively easy, the size of the IPI measure, which is the corresponding limitation in the access to EU procurement markets by foreign firms, should be proportional to the third country trade barrier. This proportionality element is important as it provides context into the application of the IPI, which will be used as a like-for-like tool as much as other trade defensive measures and practices in international trade. The proportionality of the IPI will be critical when deciding the severity of the trade barrier that the IPI will counter and therefore whether IPI uses score adjustments, exclusions, or a combination of the two. Moreover, the application of the IPI is also limited by the "availability of alternative sources of supply for the goods and services concerned in order to avoid or minimise a significant negative impact on contracting authorities"[24]. This self-imposed limitation in the implementation of the IPI is likely to lead to fewer cases of exclusion of tenders as it would be difficult to assess ex-ante the number of alternative sources of supply for a tender. Moreover, as previously explained, even if the procurement authority could decide not to apply the IPI in the case of only receiving offers from countries subject to the IPI, it is likely that, if the IPI is implemented, companies from these countries will decide not to compete for those contracts.

The IPI also includes some exceptions. First, the IPI will not be launched against least developed countries (LDCs) that benefited from the "Everything But Arms" unless there are indications of circumvention of any IPI measure. Partly as a result of the risk of circumvention, the draft regulation requires that even if a company that wins a public contract is not subject to the IPI, no more than half of the value of the contract can be supplied from a subcontractor subject to the IPI. Otherwise, the wining company would have to pay a charge between 10% and 30% of the value of the contract. The second exception refers to SMEs. Procurement authorities will not apply the IPI to SMEs bidding for procurement contract. Again, to avoid circumvention of the IPI, these SMEs will have to demonstrate that they manufacture the goods or provide services using a description of the manufacturing process (including samples, descriptions, or photographs) and extract of relevant registers or financial statements for the origin of the services. This exemption also applies to SMEs with which the EU has concluded international agreements in the field of procurement.

Whether an IPI investigation will be initiated or not, depends on whether the European Commission considers if such as investigation is "in the interest of the Union"[25]. To determine this, the commission "should weigh up the effects of starting the investigation against the

[24] Article 5.2. of the draft regulation.

[25] Recital 19 of the draft regulation.

impact of the investigation on the EU's broader interests". The draft regulation states that, on the benefits side of the IPI balance, the European Commission should consider "the general objective of opening third country markets and improving market access opportunities for EU economic operators" while on the cost side, the European Commission should weigh the need for "limiting any unnecessary administrative burden for contracting authorities and economic operators".[26] It is unclear whether this decision will be made by the European Commission alone or together with EU member states and whether the quantification of this cost-benefit analysis will be made public in the report of the findings of the investigation.

The draft regulation does not include some details which may be developed later through guidelines or by sheer experience. For instance, according to the draft regulation the main findings of an investigation should be made public.[27] However, the exact format of this report and the process leading to the publication of the report remains unclear. It is unclear whether the report will include any specific assessment of the impact, or whether the process of finalising the report will involve stakeholder feedback or feedback from other EU institutions. Furthermore, the Commission should review the "scope, functioning and efficiency" of the regulation and report the results of the review to the European Parliament and the Council. But again, the nature of this report, the timeline, and the participation of other parties like stakeholders is uncertain.

3.2.2 The Governance of the IPI

The IPI process described above helps us to understand the steps behind the IPI. However, knowing who takes the decisions in that process is equally critical. In the case of the IPI, it will be the European Commission who can start the process as well as lead on the investigation that results in the implementation of the IPI. The draft regulation states that implementing powers should be conferred on the European Commission and the IPI will be delivered through implementing act which are non-legislative acts adopted by the European Commission.

Yet, decisions such as if the harm caused by the procurement barrier in a third country requires the implementation of the IPI or whether the corrective measures from a third country are satisfactory will be taken by the European Commission and the EU member states. Article 10 of the draft regulation states that the Commission will be assisted by a committee represented by EU member states. If there is no opposition by Qualified Majority Voting (QMV) from this committee, the Commission will be able to launch the IPI through an implementing act.

[26] Recital 19a of the draft regulation.

[27] Recital 21 of the draft regulation.

3.3 How does the IPI work?

The IPI does not apply to all public procurement contracts but only to those with an estimated value equal or above €15 million for works and concessions, and equal or above €5 million for goods and services. Therefore, the procurement authorities will only need to take account of the IPI when their public contract meets these thresholds[28].

Once a public procurement authority published a tender that meets these thresholds, it needs to check if the EU has published any implementing act under the IPI covering the same sector as the public tender. If that is the case and there is a company belonging to a country subject to the IPI that presents a bid, then the procurement authority will have to apply a penalty to this company's evaluation score which would be up to 40%. This penalty only applies in the scoring of the bids and not in the final price to which the winning bidder sells its products. In other words, if a company based on a third country subject to the IPI wins a public procurement contract despite the penalty, the price paid by the procurement authority will be the offered price before the penalty[29]. In the case when the implementing act excludes all companies based on a third country and sector from applying to EU procurement, and if despite the exclusion a company from a third country submits a bid, the procurement authority will have to disregard that proposal entirely at least there are only offers from companies based on the country subject to the IPI, in which case, the procurement authority can decide not to apply the IPI.

As mentioned, the draft regulation also includes additional obligations on the successful tenderer, even if the company winning the contract is not based in a country subject to the IPI. Procurement authorities will need to check that the winning company do not subcontract more than half of the total value of the contract from companies based on a country subject to the IPI. Therefore, when submitting their bids, companies will need to submit evidence such as a certificate of origin, supplier declaration, or import declaration from their subcontractors[30], and procurement authorities will need to check that more than half of the total value of the contract is not originated from a country subject to the IPI. For example, assuming that IPI applies to a third country in medical goods, if a German company wins the procurement contract of personal protective equipment such as gowns, gloves, or facemasks from a French hospital, the German company will not be able to supply more than 50% of the value of the contract with goods bought from another company based in a country subject to the IPI. If the Germany company does not meet this condition, the

[28] This is not necessarily new for procurement authorities since they already follow similar processes in relation to WTO GPA or EU free trade agreements such as EU-Canada CETA.

[29] Recital 23 of the draft regulation states "A score adjustment measures should be applied only for the purpose of the evaluation of tenders submitted by economic operators originating in the country concerned. It should not affect the price actually due to be paid under the contract to be concluded with the successful tenderer.

[30] Article 2.1 (i) of the draft regulation.

procurement authority will impose a 10-30% charge of the total value of the contract. This 50% threshold only applies to the sectors and countries subject to the IPI. If a procurement contract includes more than one sector e.g., machinery and electric wire and the IPI only applies to machinery, then the 50% threshold will refer to machinery and not the whole public contract.

The requirement that half of the contract is not delivered by a third country subject to the IPI has two main objectives. The first one is that the IPI cannot be circumvented by companies importing goods from a third country where the IPI applies without adding additional value. These companies could be based in the EU but also in other countries, including least developed countries (LDCs) where the IPI exemption applies. The second objective is to account for foreign subsidiaries based in the EU. For instance, a Chinese company may establish a small subsidiary in the EU to gain access to EU human capital in a highly specialised sector. That subsidiary has substantive business operations within the EU and is constituted under the law of an EU member states. Therefore, for any EU procurement contract, that company should be treated as any other EU company. If a procurement authority publishes a contract above the IPI thresholds, that subsidiary could bid and present an offer for that contract. However, since that subsidiary is relatively small, it would need to buy a significant part of the value of the contract from other companies. If more than half of the value of the contract is delivered by companies based in a third country subject to IPI, the company will be penalised by a 10-30% charge of the total value of the contract. SMEs are exempted of demonstrating the 50% requirement as long as they can demonstrate that they can manufacture the good and provide the service. In other words, an SME could subcontract 52% of the value of the contract from a country subject to the IPI as long as it can provide proof that it can manufacture the good itself.

The IPI does not necessarily apply to every EU procurement authority. The draft regulation states that some sub-central contracting authorities can be exempted[31]. However, it is up to EU member states to provide a list of which sub-central authorities that can be exempted. These sub-central procurement authorities will be exempted only if the value of the contracts above the IPI thresholds is lower than 75% of the value of the procurement contracts open to competition within the EU published by the sub-central procurement authority.

Moreover, the IPI also includes exceptions. Article 8 of the draft regulation states that procurement authorities can decide not to apply the IPI if: (i) there are only offers from companies based in the country subject to the IPI or only one of the tenders meet the requirements; (ii) due to reasons relating to public interest; (iii) if the application of the measures led to a disproportionate increase in the cost of the contract. This disproportionate

[31] Article 6 of the draft regulation.

increase in the cost of the contract will be assessed by comparing the remaining offers with the value of the contract notice. The exception should only apply in the case where the estimated value is significantly lower than the value of the remaining offers, making the execution of the contract economically unviable. There is certain ambiguity around what constitutes a *significantly lower* and *economically unviable.* However, it is reasonable to assume that if a procurement authority receives offers from one company that is not subject to the IPI and the offer meets the requirement while the remaining offers are from companies subject to the IPI, the exception will not apply. Similarly, if the price offered by a company that is not subject to the IPI is in the range of the offered price of a company subject to the IPI or within the budget of the procuring authority for that tender, the exception will not apply either.

3.4 EU's ability to act

The draft regulation includes several recitals (7, 11,) and an article (2.1) explaining that IPI will only affect "non-covered procurement"[32]. In other words, the EU cannot implement the IPI against countries with whom it has signed international agreement to access each other's public procurement markets. Not all procurement is included under EU multilateral and bilateral obligations but the volumes of procurement which have been negotiated under these treaties are not affected by IPI. This includes countries which are members of the WTO Government Procurement Agreement (GPA) which covers countries like Canada, Japan, the Unites States, and the United Kingdom (Annex 2 includes the list of countries which are members of the WTO GPA) and EU bilateral trade agreements that includes provisions on public procurement. This is important because even through the EU has signed FTAs with 92 countries (Annex 2 includes a list of these countries) only 17 of these FTAs include a procurement chapter. Moreover, procurement provisions are expected in the FTAs that the EU is currently negotiating with New Zealand or Australia and in the negotiated, although not yet ratified, EU-Mercosur FTA.

3.5 The potential impact of the IPI

3.5.1 EU public procurement affected by the IPI

The IPI will be a powerful tool. If ratified, the EU will be able to exclude countries from its €2 trillion public procurement market[33] - although only a smaller proportion of that public procurement market is actually open to foreign competition - in all public contracts exceeding €5 million. And although only 7% of public contracts are beyond this threshold, there are many sizeable public projects that could be affected by this regulation:

[32] Article 2.1 (fb) states that "'non-covered procurement' means procurement procedures for goods, services or concessions regarding which the Union has not undertaken market access commitments in an international agreement in the field of procurement or concessions".

[33] Zornista Kutlina-Dimitrova, 2018, Government Procurement: Data, Trends and Protectionist Tendencies, Chief Economist Note, EU Commission, DG Trade.

from the construction of a bridge in Croatia (€345 million) or water projects in Poland (€53 million) by Chinese companies to gas pipelines in Romania by Turkish contractors (€127 million)[34].

As mentioned, the IPI will only affect "non-covered procurement", which includes procurement markets in countries which are not members of the WTO GPA and with which the EU does not have an FTA with provisions on public procurement. Therefore, the IPI could be implemented against large and middle-income countries like Brazil, Indonesia, or Argentina. However, it was in the context of a review of relationships with China, that the European Commission called on the European Council and the European Parliament to revive the idea of an instrument that creates leverage for the EU to gain market access in procurement markets abroad and push for its ratification[35].

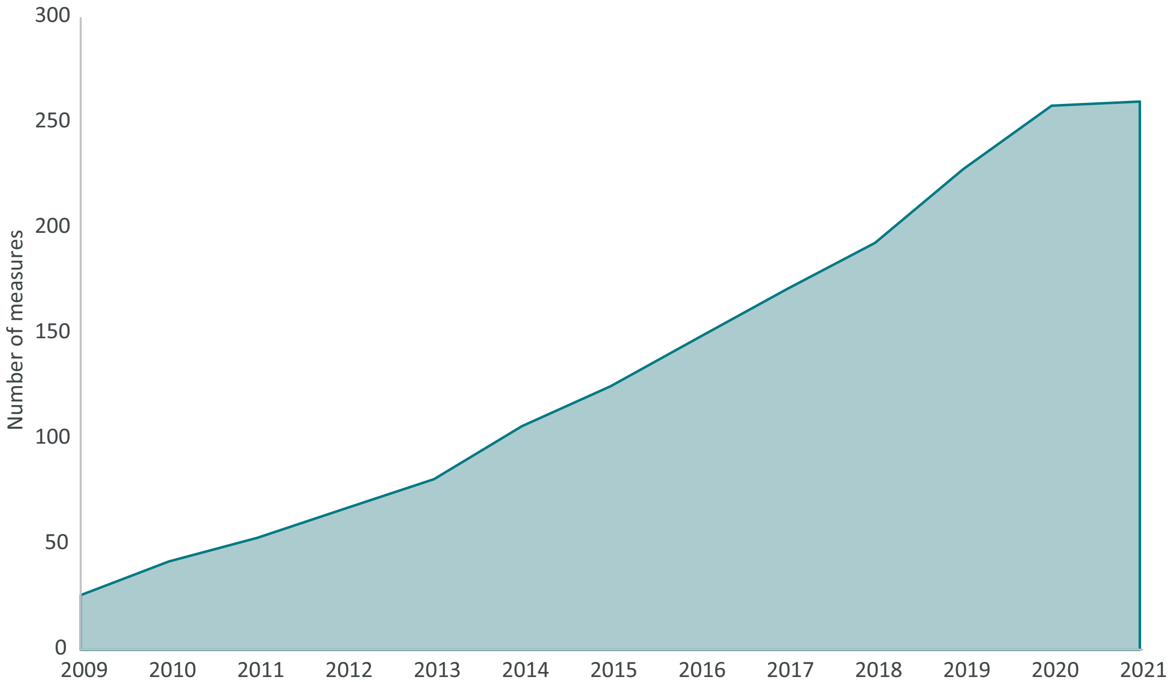
3.5.2 Market restrictions in global procurement markets

The IPI is intended as an offensive rather than as a defensive tool. The rationale behind the IPI is that non-EU countries should offer a similar level of market access in public procurement as the EU offers to them.

The data shows a steady rise in the number of protectionist measures imposed by countries on their procurement markets. In 2021, there were 260 discriminatory procurement measures, ten times more than the number of active discriminatory procurement measures in 2009. The US, India, and Russia are the worst offenders, accounting for more than half of the world's restrictive procurement measures. Meanwhile, the EU has imposed four discriminatory procurement measures.

[34] See: See EU Parliament Briefing, 2020, EU International Procurement Instrument. European Parliamentary Research Services. P.E. 649.403.
[35] European Commission, 2021, A New EU International Procurement Instrument. Legislative Train.

FIGURE 3.1: NUMBER OF CUMULATIVE PROTECTIONIST MEASURES IN PUBLIC PROCUREMENT MARKETS



Source: GTA. Author's calculation. The Chart reports only discriminatory (red) measures still reported as currently in place, as of 30 August 2021.

BOX 3.2: CHINA'S CENTRALISED STATE PROCUREMENT IN MEDICAL TECHNOLOGY

Let us look at a typical case for the IPI. Before the outbreak of Covid-19, several Chinese provinces had taken the first steps toward realising Beijing's ambitions on the medical technology through procurement policies that preference domestic manufacturers over foreign imports. In 2018, state hospitals in the Sichuan province, with a population almost as big as Germany, were required to procure domestically produced devices in 15 product categories or risk losing out on lucrative state-insurance reimbursements. In 2019, provinces and major cities across China released a series of increasingly restrictive procurement policies. The Ningxia province was first to release a notice requiring state hospitals to justify any foreign medical device imports with a lengthy audit. Suzhou and Tianjin, major economic hubs with a combined population of 26.34 million, soon followed suit with identical notices.

This discrimination against foreign companies in the Chinese procurement market of medical technology has been amplified by a policy of centralised state procurement. Chinese centralised state procurement is designed to achieve the maximum reduction in prices which can only be met by domestic Chinese companies sustained by national subsidies channelled through Chinese industrial policy. The nationwide centralised state tender for coronary stents is an instructive example. The tender led to a reduction of the price of stents by over 90%. Out of the 20 participating bids, eight companies got chosen and six of them were Chinese.

As a result of Chinese industrial and procurement policy, as well as the growing demand of medical goods as a result of Covid-19, a €1.3 billion trade deficit for China in medical technology products in 2019 turned into a €5.2 billion surplus in 2020. Between 2019 and 2020, the number of Chinese MedTech manufacturers jumped by 46%. What is remarkable in the radical change of Chinese trade balance of medical technology is not its export performance, but that Chinese imports of medical technology goods from the EU – one of major foreign suppliers in China market of medical goods – have declined in the past year. And what is equally remarkable, if not more, is that the fall in Chinese imports of medical technology can especially be observed in the medical technologies that went through centralised state procurement. Products like syringes, needles, and catheters, artificial joints, and pacemakers have experienced a steady fall in their annual growth of imports since 2015. In 2020, it turned negative.

China's procurement practices fit with the purpose of the IPI. Once agreed, the IPI might be an instrument to put pressure on the Chinese government to agree to free and fair competition in the public procurement of medical technologies.

Source: China's Public Procurement Protectionism and Europe's Response: The Case of Medical Technology (ECIPE, 2021).

3.5.3 Global procurement markets and the role of imports

OECD data on public procurement expenditure, which includes 17 countries but does not include large economies like China and India, shows that government procurement was at least equal to €6.3 trillion in 2017.

The OECD also estimates that public procurement has increased by €0.13 trillion between 2007 and 2017, which contributes to the sense of urgency from the European Commission to gain market access in growing public procurement markets for EU firms. Table 3.1 shows that the EU is one of the largest procurement markets in the world. The data also shows that the size of EU procurement market reflects the size of its economy as EU's government procurement as a percentage of GDP is below other countries like Japan, Brazil, or Australia.

TABLE 3.1: PUBLIC PROCUREMENT EXPENDITURE ACROSS COUNTRIES IN 2017

Country	Government procurement (current PPP, billions)	Government procurement as a percentage of GDP
EU22	1,855	12.6
United States	1,601	9
Japan	759	16
Brazil	519*	16*
Russia	377***	10.6***
United Kingdom	340	13
Indonesia	228***	7.5***
Turkey	239	12
Korea	230	13
Canada	200	13.2
Australia	166	14.7
Mexico	105	5
South Africa	78	11.7
Colombia	70	11
Switzerland	44	9
Norway	41	14.6
Iceland	2	14
China		2.7**
India		20*

Source: OECD, EU Parliament (2016, 2017). * India, Brazil (2011 figures), ** China (2014 figure)
Source: EU Parliament (2017), ***Russia (2015 figure), Indonesia (2016).

Yet, despite the size of the public procurement market, the reality is that public procurement markets are generally not very open. Table 3.2 shows that import penetration in public procurement markets in 2011 averaged at 6.7% whilst global imports as a percentage of GDP during the same year was equal to 30%[36].

[36] The World Bank Data. Imports of Goods and Services as percentage of GDP.

TABLE 3.2: IMPORT PENETRATION IN PUBLIC PROCUREMENT MARKETS

	2001	2006	2011
EU27	3.7	4.6	5.3
Australia	5.8	5.9	5.8
Brazil	3.5	2.9	3.7
Canada	5	4.6	4.3
China	3.3	5.7	4.7
India	4	6.3	6.2
Indonesia	11.6	8.9	8
Japan	2.3	3.8	4.8
Korea	9.3	9.9	14.4
Mexico	4.9	5.9	7.4
Russia	4.7	3.3	3.2
Turkey	7.2	11.3	6
United States	3.5	4.3	4.8
Rest of World	7.2	9.1	6.7
World	5.2	6.7	6.7

Source: EU Parliament (2017). 'Openness of public procurement markets in key third countries', DG for External Policies.

Unfortunately, the data on cross-country provisions of goods and services presented above is relatively old. Yet, Table 3.2 points to a regular complaint from the European Union and a raison d'être for the IPI – the EU public procurement market is more open than other countries of similar economic size like Japan, China, and the US, although just by a small margin. This relative level of openness is also reflected in EU's international commitment. For instance, the EU has committed €352 billion to bidders from GPA signatories while the United States and Japan have only committed to open €178 and €27 billion of their public procurement markets to competition from foreign firms[37].

However, there are other countries like Korea, Mexico, or India for which imports make a larger share of their procurement markets than the EU. As pointed in Table 3.2 and by other researchers[38], EU public procurement markets are not necessarily much more open than other countries. This is important as an economic drawback of the IPI is the potential reduction in competition for EU public procurement contracts which may lead to higher costs.

[37] EU Parliament, 2017, Openness of public procurement markets in key third countries, DG for External Policies.

[38] Patrick Messerlin & Sébastien Miroudot, 2012, EU public procurement markets: How open are they?, Sciences Po, Groupe d'Economie Mondiale.

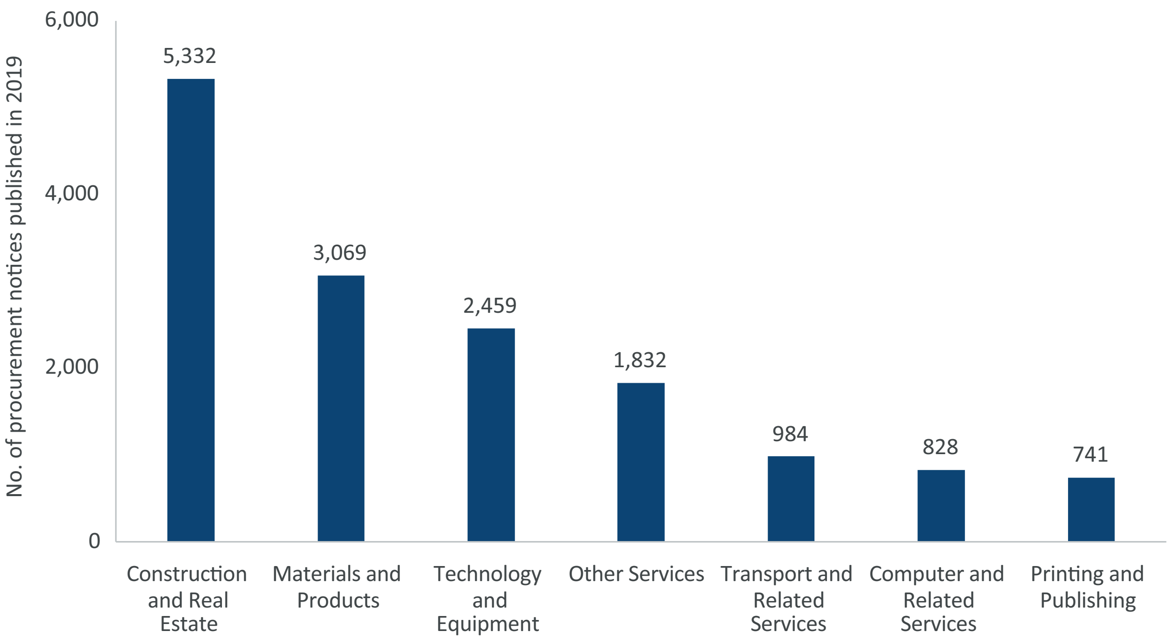
3.5.4 The EU's procurement market supplied by foreign firms

Openness of public procurement should not be measured just by the direct provision of imports to fulfil a public contract. In the case of EU procurement, Cernat and Kutlina-Dimitrova (2020) found that, out of the near €50 billion received by foreign firms in EU procurement in 2017, direct cross-border represent just 9%; 55% was supplied by EU subsidiaries of foreign firms; and 36% were goods and services provided by foreign suppliers indirectly to EU public authorities.

Score adjustments or exclusion of tender include goods and services supplied cross-border or by subsidiaries of foreign firms which together represents 64% of the €50 billion received by foreign firms in EU procurement in 2017. Meanwhile the penalty to wining companies that subcontract more than half of the value of the contract from companies based on IPI affected countries could affect the remaining 36% of these €50 billion.

Even though the EU's Tenders Electronic Daily (TED) database does not provide information about the indirect provision of foreign goods in EU procurement, it provides valuable information about the sectors that could be subject to the IPI. Figure 3.2 presents the number of public procurement contracts over €5 million, published in 2019, by the corresponding sectors they belong to.

FIGURE 3.2: NUMBER OF PROCUREMENT* NOTICES OVER €5 MILLION BY SECTOR



Source: TED. *Contract Award Notices.

From the total number of 127,863 EU public procurement tenders (contract award notices) published in TED in 2019, 10,544 (8.2%) were above the IPI threshold of €5 million. Considering that some notices included more than one sector, the figure above shows the top seven sectors. The sector with the highest number of procurement notices was the construction and real estate sector, followed by materials and products, and technology and equipment. Other sectors such as computer services, transport services, printing and publishing, and other services also had a significant share of notices published.

The indirect provision of foreign goods and services within the EU public procurement markets assessed by Cernat and Kutlina-Dimitrova (2020) can also be proxied using the OECD TiVA database. This database calculates the value that foreign firms contribute to domestic production across countries and sectors. In the case of the EU, €11 trillion of foreign value was added to the economy in 2015. We can use the contribution of non-EU countries to the EU's economy as a proxy for the amount of indirect foreign goods and services that could be subject to the IPI. Therefore, Table 3.3 below multiplies the percentage of a country value-added into EU's final demand by EU's total procurement market. The data shows that from the total of €2.2 trillion of EU public procurement in 2015, €88 billion could be indirect foreign goods and services subject to the IPI. Even though this figure is an upper limit as procurement markets tend to be less open than the average market for goods and services, it provides an estimation of the values that could be subject to the 50% limit on subcontractors to countries affected by the IPI.

Table 3.3. shows that China has the largest potential value of the total EU procurement market indirectly delivered by foreign firms – close to €42 billion or 47% of the €88 billion EU procurement that could be subject to the IPI. China is followed by Russia with 22% and Turkey with 11%. The remaining four countries together represent 18% of the potential value in the indirect procurement market. Out of this 18%, India and Brazil still hold significant shares with €8 billion and €5 billion respectively.

TABLE 3.3: APPROXIMATION OF INDIRECT GOODS AND SERVICES FROM FOREIGN FIRMS IN 2015

Countries	Percentage of country's goods and services in EU final demand	Potential value of total EU procurement indirectly delivered by foreign firms (euro, billion)
China	1.90	41.89
Russian Federation	0.95	20.91
Turkey	0.46	10.10
India	0.36	7.83
Brazil	0.23	4.97
South Africa	0.08	1.78
Colombia	0.04	0.93

Source: OECD Trade in Value Added (TiVA) database. Author's calculations.

3.6 The risk of retaliation

The implementation of the IPI will not go unnoticed and non-EU countries may retaliate if the EU imposes restrictions on access to its public procurement market. Governments will be fast to point out that EU member states impose similar restrictions on their public procurement markets or that the EU's share of imports in procurement is relatively low (See Table 3.2).

China, for instance, is notorious for using counter-retaliation measures. In 2013, the European Union imposed anti-dumping duties on solar panels from China which was set to impact close to €21 billion of solar panels exported to the EU from China in 2011[39]. In response, China started its own anti-dumping investigations into imports from Europe of polysilicon, the main raw material for making solar panels. It also filed a case with the WTO accusing some EU member states of violating free trade rules with policies that favoured the purchase of solar energy equipment produced in Europe[40].

This is important as EU firms are well-known for winning important public procurement contracts abroad. From trains to airports, to windfarms and hospitals, EU businesses are leading in many public procurement markets. The risk of using the IPI is that the EU may not gain market access and instead faces additional barriers that harm EU businesses. Since procurement markets across the world are relatively closed, and the proportion of direct contracts awarded to foreign companies in the EU remains under 5%[41], other countries may see the option of closing their own procurement markets as an attractive alternative.

[39] Simon Evenett, 2013, China-EU solar panel trade dispute: Rhetoric versus reality, VoxEU. Accessed at: https://voxeu.org/article/china-eu-solar-panel-trade-dispute-rhetoric-versus-reality

[40] Keith Bradhser, 2012, China Files WTO Case Against Europe, New York Times.

[41] Briefing, 2020, EU International Procurement Instrument, EU Parliament.

Table 3.4 presents EU exports and the EU's market share on two markets where public procurement is relatively dominant: medical technologies and railway vehicles. This table demonstrates that – in the case of these two specific markets – EU firms are relatively successful as they account for a significant percentage of the foreign goods bought by non-EU countries across China, the US, Russia, and Brazil. Despite the perception that foreign procurement markets are closed, when non-EU countries need to buy products which are not produced domestically, they often go to EU producers. The data shows that the EU's market share is the highest in China's imports of railway vehicles, as well as in Russia's imports of medical technologies. Meanwhile, it also holds a significant share of the US and Brazilian markets. The risk of retaliation is real, and this retaliation could hurt EU companies, particularly when non-EU countries may be naturally inclined to use procurement expenditure as a tool to support the domestic industry.

TABLE 3.4: EU EXPORTS OF MEDICAL TECHNOLOGIES AND RAILWAY VEHICLES TO CHINA, US, RUSSIA, AND BRAZIL IN 2019

	China		US		Russia		Brazil	
	€ mn	Market share	€ mn	Market share	€ mn	Market share	€ mn	Market share
Medical technologies*	5,630	35%	1,9205	46%	2,343	68%	821	33%
Railway vehicles**	411	69%	219	5.4%	175	24%	17	11%

Source: UN COMTRADE. Author's Calculations. * Medical technologies are defined as per Fitch Solutions, Medical Devices Factbook 2021, Healthcare Expenditure. ** Railway vehicles refer to STIC Rev 3, 791 Railway vehicles & associated equipment.

4. CARBON BORDER ADJUSTMENT MECHANISM (CBAM)

4.1 What is the Carbon Border Adjustment Mechanism (CBAM)?

The main objective of the carbon border adjustment mechanism (CBAM) is to fight climate change. The long-term ambition with the carbon border adjustment mechanism is to ensure that the price of imported goods reflects more accurately their carbon content. The concept was put forward by the European Commission in 2019 as part of a commitment to make further cuts to carbon emissions.[42] The Commission has already released a legislative proposal[43] for CBAM, and in March 2021 the European Parliament adopted a resolution advocating for the introduction of a WTO-compatible carbon border adjustment mechanism.[44]

The thinking behind CBAM is pretty straightforward. As part of the Green New Deal, the EU Emission Trading Scheme is going to be revised, and the revision will most likely lead to a reduced cap on total carbon emissions.[45] To avoid that a higher cost of carbon in Europe will prompt a reallocation of production away from Europe – that is then substituted by imports – the EU want to manage the risk of so-called carbon leakage by a adding a cost to certain carbon-intensive imports from countries with a different carbon-cost policy. There already exist certain measures to counter carbon leakage which includes the free allocation of EU ETS allowances and financial measures to compensate for indirect emission costs from increases in electricity prices due to the EU ETS. CBAM is going to replace these over time. Some sectors, like steel, are already making the argument that CBAM will not provide the same degree of "competitive neutrality" as free allowances.[46]

4.2 Legal basis, subsidiarity, and proportionality

There is a clear legal basis under Articles 191-193 of the Treaty on the Functioning of the European Union ('TFEU') that confirm and specify EU competencies in the area of climate change.[47] Climate change is a trans-boundary challenge and requires EU action – it is in

[42] However, this is not the first time that the European Commission has announced its ambition to propose a measure that will border adjust the price of imports on the basis of carbon-emission costs. This was first proposed by the Commission in 2009.

[43] European Commission, 2021, Proposal for a Regulation of the European Parliament and of the Council establishing a Carbon Border Adjustment Mechanism. COM (2021) 564 final. https://ec.europa.eu/info/sites/default/files/carbon_border_adjustment_mechanism_0.pdf

[44] European Parliament, 2021, A WTO-compatible EU Carbon Border Adjustment Mechanism. Adopted on 10 March 2021. https://www.europarl.europa.eu/doceo/document/TA-9-2021-0071_EN.html

[45] The proposed revision of the overall emission cap equals an 18% increase in the emissions reductions through the ETS to be achieved by 2050 under the current legislation. This will be achieved by a one-off rebasing of the emission amount and a faster annual reduction in annual emission amount.

[46] Sylvia Pfeffer and Mehreen Khan, 2021, "Europe's Steel Industry Fears Abrupt End of Free Carbon Permits", Financial Times June 1, 2021. https://www.ft.com/content/be4a4224-8eb2-4ad7-b923-08845b0f4e7d

[47] In accordance with Articles 191 and 192(1) of TFEU, the Union shall contribute to the pursuit, inter alia, of the following objectives: preserving, protecting and improving the quality of the environment, promoting measures at international level to deal with regional or worldwide environmental problems, and in particular combating climate change. Regarding legal competence, in the case of the environment it is shared according to Article 4 of the TFEU between the EU and the Member states.

line with the principle of subsidiarity.[48] When it comes to proportionality, the proposed product coverage of CBAM is framed by the sectors and emissions covered by the EU ETS. It is unlikely that there will be any fundamental treaty problems with CBAM as long as the border charges on imported goods are clearly linked to the ETS. The current treaty basis for CBAM and the use of Article 256 for Customs procedures leads to an ordinary procedure for EU decision making, meaning that the EU Council will make decisions by qualified majority voting and that the European Parliament has legislative co-responsibility. It will also allow for the Commission to work with implementing acts to determine specific aspects of the regulation. In short, it is a basis that allows for significant influence for the Commission to shape the actual workings of CBAM.

4.3 How does CBAM work?

It is pretty established how the CBAM will work in practice – provided that the Commission's proposal will be approved. CBAM will take the form of a regulation for uniform and direct application and enforcement throughout the EU. However, certain tasks related to implementation and enforcement will be conferred to authorities in charge of climate and customs in member states. The Commission will ensure that arrangements are in place to monitor and evaluate the functioning of the CBAM, including its enforcement against fraudulent practices, and evaluate it against the main policy objectives.

It is useful to consider CBAM in different steps. Since CBAM is intended to work in a commonly known fashion (it is based on the EU ETS and border-administrative practices) it does not include a huge scope for discretionary action, at least not when compared with other defensive policy instruments covered in this report. The CBAM system is rather planned to work by a high degree of automaticity and through institutions that are already established.

1. *Product coverage*. The Commission's proposal defines the coverage of CBAM clearly by listing the CN codes for the covered goods (henceforth the CBAM goods).[49] CBAM goods are classified in five different product groups: cement, electricity, fertilisers, iron and steel, and aluminium. While some products included in the relevant CN code has been excluded, the Commission's norm is that all products under a certain CN code will be covered by the measure. However, this is likely to be challenged by some member states.

[48] CBAM is inherently a border measure and therefore, there is clear added value in placing the intervention at the EU level, although its implementation and enforcement will be better performed at member states level. An EU wide CBAM will ensure equivalence between the carbon pricing policy applied in the EU's internal market and the carbon pricing policy applied on imports. See also Annex III.

[49] See Annex I in the Commission's proposal. European Commission, 2021, Proposal for a Regulation of the European Parliament and of the Council establishing a Carbon Border Adjustment Mechanism. COM (2021) 564 final. https://ec.europa.eu/info/sites/default/files/carbon_border_adjustment_mechanism_0.pdf

2. *Declaration responsibility.* The next step is to establish which exporters could be subject to a CBAM levy. Companies from EEA countries and Switzerland are excluded: all other exporters for the relevant CN codes can in principle be subject to a CBAM levy. However, it is not principally the task of the exporter to pay the fee or declare the carbon content of the product. This will be the task of the importer. Any importer of a CBAM good will first need to be authorised by a competent authority to import these goods. If a CBAM good that passes the border is not imported by an authorised importer, custom authorities should deny entry.

   Every year, each authorised declarant of imported CBAM goods should submit a CBAM declaration that includes the total embedded carbon emissions and a settlement on carbon allowances cost. External verification is required. Again, even if this system in practice means that the exporter will need to work with the rules of CBAM, the legal obligations fall on the importer. The European Commission assumes that the technical burdens of declaring carbon emissions – at product level or importer level – will be moderate. However, this is unlikely to be the case. Even if importers will work with default values (see point 3 below) there will be a substantial cost for importers to record and declare embedded carbon emissions.

3. *Declaration methodology.* In order to determine the embedded carbon in a product and hence what CBAM allowances that need to be purchased, the importer is offered two options for all CBAM goods but electricity. The first option is that the importer declares the calculated embedded carbon in a product by using a mathematical formula for direct emissions. The second option is to rely on default values that the Commission will supply periodically.

4. *Determining the final CBAM levy.* The starting point is that the importer will buy CBAM allowances corresponding with the level of embedded carbon in the imported CBAM product. The price of the CBAM allowance will reflect the price of the ETS allowance. Importantly, the authorised declarant/importer may make a claim in the CBAM declaration for the number of CBAM allowances that should be surrendered because of a carbon price paid in the country of origin. In other words, if an exporter has already paid some price for its direct carbon emission, this price should be deducted from the initial CBAM allowance costs.

   This part of CBAM is likely to invite controversy and technical problems. In its current form, the Commission seems only to include a direct payment for carbon emissions in its scope for carbon costs that can be deducted. This is unlikely to hold up since many producers of CBAM goods in third countries pay carbon taxes and

> other forms of non-direct levies for their direct carbon emissions, and it would be unfair and WTO incompatible to exclude those. Even if the staff working documents that accompany the Commission's proposal includes a discussion about the scope of legitimate deductions, the Commission is not providing anymore guidance. The national competent authorities are therefore likely to make different judgements about the actual practice of CBAM deductions based on costs in the country of origin.

According to the European Commission, this version of CBAM – only based on selected goods – is a first development towards a CBAM that could encompass a greater number of goods. It will first establish the administrative part of CBAM but not apply CBAM allowances fees until the end of the trial period. By then, it is assumed that the Commission will have phased out most of its free ETS allowances.

4.4 The EU's ability to act

Obviously, CBAM raises issues about what the EU could do under its current international treaty obligations. It seems safe to assume that other countries will file complaints with the WTO, arguing that CBAM is inconsistent with the EU's WTO obligations. Statements to that effect have already come from countries like Brazil, China, India, and South Africa.[50] Some countries, like South Korea, has also challenged the compatibility of CBAM with EU obligations under its Free Trade Agreement with South Korea.

This is not the place to adjudicate a possible WTO complaint and determine how a case will be approached by the dispute-settlement body. There are legal arguments used by both supporters and detractors of CBAM. While the Commission is a bit over-optimistic when it says that CBAM is in safe WTO territory, an actual case will crucially depend on the exact implementation of CBAM, and some of these aspects are presently not known.

However, it is useful to better understand what type of complaints that could be filed and how they relate to the actual design of CBAM – and the ETS more generally – and what tit-for-tat actions that potentially could follow.

First, countries that will file complaints at the WTO are likely to claim – with reference to core GATT rules and WTO jurisprudence – that CBAM is a tax or charge on imports that is discriminating like products, e.g., discriminating between similar products from different countries. That claim seems rather obvious. CBAM could therefore be inconsistent with the WTO's rule of non-discrimination, which requires that any advantage granted to the imported products of one WTO member must be accorded immediately and

[50] Joe Lo, 2021, Emerging Economies Share 'Grave Concern' over EU Plans for a Carbon Border Tax, Climate Home News.

unconditionally to like products originating from all other WTO members.[51] In judging some WTO members on the extent and quality of their climate actions, and thus picking and choosing whose products will need emissions certificates [52], the EU will be showing a bias towards certain WTO member states[53].

By applying a charge on imported products that could be higher than the EU's agreed customs duty ceilings and other charges connected with importation, CBAM could be in contravention of other WTO obligations[54]. Moreover, CBAM could potentially be inconsistent with the WTO's 'national treatment rule', which requires that imported products be given "no less favourable" treatment than that given to similar domestic products. If European producers continue to receive free emissions allowances, while imports are taxed on their emissions, then the EU will be acting inconsistently with the "national treatment" rule. This is because imported products will be denied an equal opportunity to compete competitively with comparable domestic products within the European market[55].

Failing these WTO tests does not mean that CBAM will declared illegal in the WTO: it could still pass through the general exception clause – GATT Article XX. However, other countries will argue that CBAM does not qualify for Article XX exceptions because CBAM is not consistent with the chapeau requirements for environmental measures that are discriminatory. To qualify, discriminatory measures should not be "arbitrary" or a "disguised restriction on international trade". Many other green measures have fallen exactly on these requirements because the "revealing architecture" of a measure have made it clear that it is not directly and unconditionally linked to the stated objective. Environmental measures that qualify under GATT Article XX can usually reference the support of a Multilateral Environmental Agreement for the specific action. In the case of CBAM, this will be difficult. The relevant agreement – The Paris Agreement – does not include border measures. The Paris Agreement builds on a fundamental principle of "common but differentiated responsibilities and respective capabilities", and the EU has signed an international treaty accepting the National Determined Contributions to carbon-emissions reductions by other signatories. Therefore, the Paris Agreement can legally be used against CBAM.

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[51] Reinhard Quick, 2020, Carbon Border Adjustments. https://www.nomos-elibrary.de/10.5771/1435-439X-2020-4-549.pdf?download_full_pdf=1

[52] According to the CBAM proposal, the "EU ETS and the CBAM have a common objective of pricing GHG emissions embedded in the same sectors and goods through the use of specific allowances or certificates." See: https://ec.europa.eu/info/sites/default/files/carbon_border_adjustment_mechanism_0.pdf

[53] James Bacchus, 2021, When Two Global Agendas Collide: How the EU's Climate Change Mechanism could fall afoul of International Trade Rules. World Economic Forum.

[54] James Bacchus, 2021, Legal Issues with the European Carbon Border Adjustment Mechanism, Cato Institute. Accessed at: https://www.cato.org/briefing-paper/legal-issues-european-carbon-border-adjustment-mechanism#_ednref9

[55] James Bacchus, 2021, When Two Global Agendas Collide: How the EU's Climate Change Mechanism could fall afoul of International Trade Rules. World Economic Forum. Accessed at: https://www.weforum.org/agenda/2021/07/how-the-eus-carbon-border-adjustment-mechanism-could-fall-afoul-of-wto-regulations/

Second, and related to the first point, complaining countries may not just go after CBAM but could also include the EU ETS. Since the EU now makes a direct link between the ETS and CBAM, also the design and performance of ETS becomes relevant. As the ETS allocates allowances for free and has done so since its inception, there are actionable concerns about subsidies – like claims that the EU has made in cases against third countries that have used systems of internal allocations to give some producers a better position than others. Furthermore, during the three past phases of the ETS, firms have also been allowed to sell their free ETS permits if they did not need them – leading to a subsidy of these firms that also is actionable under WTO rules.

The system of free allowances has been substantial. In the ETS regulation between 2013 and 2020, 57% of all allowances where auctioned and the rest could be allocated for free.[56] The explicit motivation for the free allocation was, logically, that the EU did not want to raise costs for producers that were exposed to potential carbon leakage. In phase 4 of the ETS, between 2021 and 2030, there will still be free allocations: in addition to the already set free allocations, the Commission has reserved a buffer of 450 million allowances so that "Europe's industrial competitiveness [can] be safeguarded".[57] It will still be allowed for EU member states to take compensatory actions, within state-aid rules, to firms for indirect carbon costs. The EU Innovation Fund will also use revenues from ETS permits to subsidise industries to reduce their carbon costs through technology. All these subsidies are open to challenge under WTO. Some of these ETS policies may be changed under current proposals, but since the system of free allowances will prevail – albeit in a smaller form – after the introduction of the CBAM, a dispute that includes the entirety of the ETS should be expected.

Furthermore, the EU agreed last year on the revised benchmarks for the system of free allocations to installations.[58] This is a highly technical area, but it is important for Europe's relation to other countries in the WTO. And it relates to a critical question: how can correct levels of carbon leakage be evidenced without using competitiveness benchmarks? For leakage to happen, current or future production needs to shift from Europe to territories with lower carbon costs. But all extra costs for carbon in Europe don't lead to a shift in current production from Europe to other parts of the world: in fact, only a small part of increased carbon costs have that effect.[59]

[56] See European Commission, EU Emissions Trading System, Free Allocation. Accessed at: https://ec.europa.eu/clima/policies/ets/allowances_en#tab-0-0

[57] European Commission, 2017, Questions and answers on the provisional agreement to revise the EU Emissions Trading System (EU ETS). Accessed at https://ec.europa.eu/clima/sites/default/files/ets/revision/docs/high_level_qa_en.pdf

[58] European Commission, Implementing Regulation (EU) 2021/447, 2021, Determining revised benchmark values for free allocation of emission allowances for the period from 2021 to 2025 pursuant to Article 10a(2) of Directive 2003/87/EC of the European Parliament and of the Council, Accessed at https://eur-lex.europa.eu/eli/reg_impl/2021/447. See also on benchmarks and competitiveness methodologies European Commission, 2015, Ex-post investigation of cost pass-through in the EU ETS. Accessed at: https://ec.europa.eu/clima/sites/default/files/ets/allowances/docs/ex-post_investigation_of_cost_en.pdf

[59] Antoine Dechezleprêtre et. al., 2019, Searching for Carbon Leakage in Multinational Companies, Centre for Climate Change Economics and Policy Working Paper No. 187.

Some estimates suggest that there is no evidence at all of carbon leakage from the ETS when trade flows of embodied carbon are modelled.[60] Just as with other mandated cost increases for firms (e.g., compliance with other environmental regulations), firms will manage them differently depending on their competitiveness and the technological capacity for greenhouse gas efficiency. Some firms will do very little about their capital and technological structure; other firms will address these carbon efficiency problems as part of their overall capital strategy and improve their efficiency.[61] In fact, the annexes to the updated methodology still show there is a significant difference among Europe's installations in their greenhouse gas efficiency. The effect of increasing carbon cost for one installation isn't the same as for the other, meaning that the potential size of leakage is surely a factor of firm-specific and not just cost-specific effects.[62] These firm-specific effects could be amplified by the market structure, especially the market share held by firms that can reallocate their supply across various factories around the world. Hence, the linkage between increasing carbon costs and carbon leakage is far more complex than presumed. Consequently, CBAM levies in the EU could have the effect of indirectly subsidising some firms in the EU that are perfectly competitive without the protective levy.

These observations could be problematic for the EU in a trade dispute because there are inherent subsidies in the ETS system that other countries will attack. But not just that, they will also make a direct link between the free allocations and CBAM: isn't a strong intention of CBAM, just like the free allocations, to avoid negative effects on EU firm competitiveness? Obviously, it is not the paramount intention, but it's clear that it is an important intention and that EU leaders aren't shy about putting that intention to the public.[63]

Third, some countries may not wait for complaints to work their way through the WTO system: they may retaliate directly or take measures that counteract the new CBAM costs. Retaliatory measures can take many forms: they can target like-for-like products or go after other products that have economic and political importance but are not directly related to an actual dispute.[64] Since retaliatory measures are actionable, the EU is likely to respond by challenging them at the WTO. However, the result is likely to be a decline in total trade and in total EU exports. That also has consequences for total carbon emissions in the world since EU exports overall have a lower carbon intensity than world production. In a static world,

[60] See for example Helene Naegele and Aleksandar Zaklan, 2019, Does the EU ETS Cause Carbon Leakage in European Manufacturing? Journal of Environmental Economics and Management, vol. 93, pages 125-147.

[61] Over the lifetime of the ETS, there has been very many simulations suggesting significant carbon leakage from heavy industries like steel and cement. Ex-post studies, however, has shown most of them to be wrong. See for instance Julia Reinaud, 2008, Issues Behind Competitiveness and Carbon Leakage: Focus on Heavy Industry, International Energy Agency, and Jane Ellis, Daniel Nachtigall and Frank Venmans, 2019, Carbon Pricing and Competitiveness: Are they at Odds? OECD Environment Working Paper No. 152.

[62] Shon Ferguson and Mark Sanctuary, 2014, Firm Productivity and Carbon Leakage: A Study of Swedish Manufacturing Firms. IFN Working Paper No. 1035.

[63] Camilla Hodgson, 2021, EU Rebuffs US Concerns over Carbon Border Tax Threat, Financial Times. Accessed at https://www.ft.com/content/d31ec6c9-453a-4705-b47b-1c9e46de817a

[64] For instance, the EU's retaliatory action against the US steel and aluminum tariffs partly targeted US products from swing states or Republican states in the US.

it is better for the climate if other countries buy their goods from Europe than elsewhere.[65] Other governments can also agree to compensate their firms for the CBAM costs, directly or indirectly, leading to growing subsidies of fossil fuels. But they will argue that, under the Paris Agreement, they have already taken on a package of measures to reduce their carbon emissions that the EU has approved, and that the EU is trying to change that with CBAM. It is in our view likely that CBAM will unleash a string of actions that will expand the scope of an initial CBAM dispute.

4.5 The potential impact of CBAM

The European Commission established 19 trade codes that will be subject to CBAM, so every product traded under these codes will be affected by the measure. These trade codes – presented in the Annex 1 of this report – include very specific products such as nitric acid and broader sectors such as iron and steel. In this analysis we grouped these products under the following categories: cement, aluminium, electricity, fertilisers, and iron and steel. Using this naming convention, the subsequent analysis presents trade data based solely on the trade codes selected by the EU.

4.5.1 EU imports affected by CBAM

The amount of EU imports that could be subject to the CBAM is around €60 billion, representing 3% of the EU's total imports in 2019. Among the five sectors included, EU imports of aluminium, and iron and steel, are the largest.

TABLE 4.1: EU IMPORTS OF CBAM AFFECTED GOODS (2019, BILLION EUROS)

	Nominal value (billion euros)	Percentage of EU total imports
Cement	0.3	0.01%
Aluminium	16.6	0.8%
Electricity	4	0.2%
Fertilisers	4.4	0.2%
Iron and Steel	34.5	1.7%

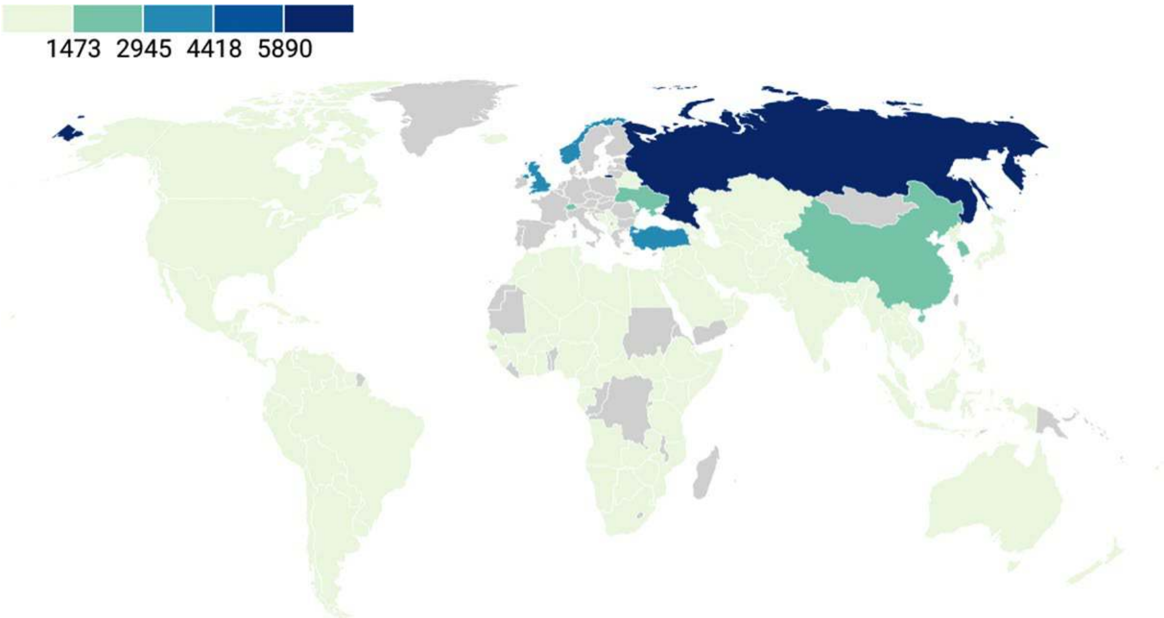
Source: UN COMTRADE. Authors' calculations.

The EU buys these goods from a variety of countries. For cement, Turkey is the largest exporter to the EU (€108 million) followed by Colombia (€26 million). In terms of electricity, Switzerland (€638 million) and Russia (€613 million) are the most important EU suppliers.

[65] Hana Nielsen and Astrid Kander, 2020, Trade in the Carbon-Constrained Future: Exploiting the Comparative Carbon Advantage of Swedish Trade, Energies, vol. 13:14.

Russia (€592 million) and Algeria (€421 million) are also the largest exporters of fertiliser to the EU. For iron and steel, Russia and Turkey are the top two EU suppliers (Russia exported €3.3 billion and Turkey exported €2.6 billion). Meanwhile, Norway was the largest exporter of aluminium to the EU (€ 3 billion) followed by Russia (€2.7 billion). Imports from many other countries such as Ukraine, South Korea, India, UAE, Mozambique, Egypt, Brazil, Belarus, and the UK will also be subject to the CBAM. The map below presents the countries and the value of EU imports that could be impacted by the CBAM.

FIGURE 4.1: EU IMPORTS OF CEMENT, ALUMINIUM, ELECTRICITY, FERTILISERS, AND IRON AND STEEL PER COUNTRY (MILLION EUROS, 2019)



Source: UN COMTRADE. Authors' calculations.

4.5.2 The EU as a global buyer of cement, electricity, fertilisers, iron and steel, and aluminium

The EU is one of the largest global importers of cement (3% of global imports), electricity (14% of global imports), fertilisers (10% of global imports), iron and steel (9% of global imports) and aluminium (17% of global imports). Altogether, if the EU were to implement CBAM, 11% of global imports of all these products will be affected.

Yet, trade may not be a good yardstick to measure the importance of these goods on the economy. This is because many of these products are produced for domestic consumption within national borders. For example, due to its weight, in the case of cement, or its physical properties, in the case of electricity, EU member states produce and consume many of these goods domestically. For instance, in 2019, only 20% of the quantity of EU's domestic consumption of cement came from outside the EU. For similar reasons, the five largest foreign suppliers to the EU of cement and electricity only represent one-tenth of EU total imports of these products, when the EU internal market is taken into account. On the other hand, for fertilisers, aluminium, and iron and steel, the top-five non-EU suppliers to the EU account for a significant 46%, 25% and 18% of EU total imports of these products[66]. In the case of aluminium, for which comparative production data is available, 57% of the quantity of aluminium consumed within the EU was imported from abroad.

EU suppliers of these goods are not necessarily the largest global exporters. As can be seen in Figure 4.1, when the EU imports these goods from abroad, it is mostly from neighbouring countries such as Turkey, Norway, the UK, and Russia. This is an important caveat as one of the drivers of the regulation is to lower CO2 emissions while in reality the largest producers of these goods are not necessarily the EU's largest suppliers.

Table 2.2 below shows that most of the EU's top-five suppliers are within its vicinity. Only a few countries outside the EU's neighbourhood stand out, such as Colombia, China, the UAE, and Korea. Moreover, the EU's top-five suppliers are not necessarily the top-five global exporters. Except for some cases where one of the EU's top-five suppliers is also a global supplier (for example: Turkey for cement, China for aluminium, Russia for fertilisers), the share of exports of the top global suppliers to the EU is minuscule. An even when a top global supplier is also a top-five EU supplier, the share of its exports that goes to the EU is relatively small. For instance, in the case of cement, Turkey – which is a top global supplier and an EU top-five supplier – sells 13% of its global exports of cement to the EU. And this figure does not account for Turkey's cement production used in the Turkish economy. On the other hand, for the same product, the combined percentage of Vietnam, Thailand, and Canada's exports to the EU of their global exports in cement is only 0.38%. Therefore, even though most top global cement suppliers export to the EU, the EU is not a particularly large market for them, and this is also the case for the other four products.

[66] These figures over-represent the importance of trade on the consumption of these products as domestic consumption of domestic production is not take into account.

TABLE 4.2: EU TOP-FIVE SUPPLIERS AND TOP-FIVE GLOBAL SUPPLIERS (2019)

	EU top-five suppliers	Global top-five suppliers
Cement	Turkey (13%)	Vietnam (0.8%)
	Colombia (64%)	EU
	Ukraine (90%)	Turkey (13%)
	Belarus (30%)	Thailand (0%)
	Morocco (25%)	Canada (0.007%)
Aluminium	Norway (98%)	China (11%)
	Russia (56%)	EU
	China (11%)	Canada (4.9%)
	Switzerland (87%)	Russia (56%)
	United Arab Emirates (27%)	US (7.3%)
Electricity	Switzerland (97%)	EU
	Russia (72%)	Canada (0%)
	Norway (99%)	Switzerland (97%)
	Serbia (78%)	China (0%)
	Ukraine (99%)	Paraguay (0%)
Fertilisers	Russia (9.2%)	Russia (9.2%)
	Algeria (38%)	China (0.04%)
	Egypt (28.5%)	EU
	Trinidad and Tobago (9%)	US (0.5%)
	Ukraine (31%)	Morocco (9.4%)
Iron and Steel	Russia (20%)	China (1.8%)
	Turkey (23%)	EU
	Ukraine (27%)	Japan (0.5%)
	United Kingdom (31%)	Korea (6.1%)
	Korea (6.1%)	Russia (20%)

Source: UN COMTRADE. Authors' calculations. Note: Iceland, Norway, Liechtenstein, and Switzerland are part of the EU ETS and will not be covered by the CBAM. Electricity is traded through physical interconnectors and therefore limited by geography.

4.5.3 CBAM impact on the EU's suppliers and their possible reaction

Some countries will be directly impacted by the CBAM. As mentioned earlier, Turkey sells 13% of its cement to the EU. Similarly, there are also other countries that export a significant share of their goods to the EU. For example, Russia (56%) and United Arab Emirates (27%) in aluminium, Serbia (51%) for electricity, Russia (9%) for fertilisers, or Russia (19%), Turkey (18%), and the UK (31%) for iron and steel. All these countries' exports will be impacted by the CBAM.

As discussed in the previous section, the unanswered question is how these countries will react to the CBAM. The imposition of the CBAM obligation on EU importers will indirectly increase production cost for non-EU exporters, who may decide to export elsewhere or sell more domestically to avoid the CBAM. If they decide to export to the EU and pay the carbon levy, the extra cost will be shared between foreign producers and EU consumers depending on the bargaining power each of them holds and the availability of alternative suppliers and buyers.

Foreign producers may decide to incur the CBAM's cost and pass-on part of this cost to their EU consumers. Non-EU countries may decide to compensate their domestic producers for the additional cost of the CBAM or set-up an alternative scheme to demonstrate that their firms have to pay a carbon price similar to EU's firms. Whether the EU will succeed or not in convincing other countries to tax carbon emissions will depend on the degree of dependencies that these countries have on the EU's single market. This market dynamic will be further dictated, not only by the EU's economic size but also by EU's future demand for these products. Unfortunately for the EU, the centre of gravity of the global economy is shifting away from the EU and towards emerging and middle-income countries. The following table shows the growth in exports of cement, aluminium, fertilisers, iron, and steel from EU's top suppliers to the EU, East Asia and Pacific, Middle East and North Africa (MENA), and Latin America and the Caribbean. We have excluded electricity as this product is traded through physical interconnectors and therefore limited by geography.

TABLE 4.3: EXPORT GROWTH (%, 2015 – 2019) OF CEMENT, ALUMINIUM, FERTILISERS, IRON AND STEEL FROM EU'S MAIN SUPPLIERS

	EU top-five suppliers	EU	East Asia & Pacific	MENA	Latin America and the Caribbean
Cement	Turkey	72	2,875	-35	217
Aluminium	Russia	-22	-31	92	-57
	China	62	-9	7	118
	United Arab Emirates	-9	-20	74	-45
	Turkey	24	72	14	193
Fertilisers	Russia	29	42	148	6
	Egypt	66	195	156	6,252
	Ukraine	-70	-99	-95	-99
Iron and Steel	Russia	27	191	-14	17
	Turkey	170	614	6	52
	Ukraine	23	3,288	-20	115
	United Kingdom	2	-32	-27	-36
	Korea	38	5	-50	19

Source: UN COMTRADE, Authors' calculations. Note: Iceland, Norway, Liechtenstein, and Switzerland are part of the EU ETS and will not be covered by the CBAM.

As can be seen from the table, for cement, the increase in Turkish exports over the 5-year period has been 40 times greater in East Asia compared to the EU. Turkey's exports of cement to Latin America have also grown much faster than those for EU. Even though for most of these countries, the exports to the EU have grown, the growth has been larger for one of the three other regions. For instance, Egypt's exports of fertilisers grew by 62% to the EU. But during the same time, they grew by 195% to East Asia, 156% to the Middle East and North Africa, and by 6,252% to Latin America (albeit starting from a low base). In a similar fashion, China's exports of aluminium to the EU have grown at a rate of 54% (larger than that to East Asia and MENA), but the growth of exports in aluminium to Latin America have grown even faster reaching 118%. With the exceptions of Ukraine's exports of fertilisers, and UK and Korea's exports of iron and steel, for all other countries, the importance of EU as the primary market has been replaced by one of the other three regions. This is important when considering the likely reaction to CBAM from EU's trade partners as most of its top suppliers have alternative markets that they can supply too, and which have already overtaken the EU as their most important foreign market.

4.5.4 CBAM and the EU's supply chains

Goods affected by the CBAM are inputs used in the production of other goods produced and consumed in Europe: fertilisers for agriculture, iron and steel for cars, cement for construction, aluminium for infrastructure, and electricity for any manufacturing process. Because the CBAM aims at equalising the cost of CO2 emissions across countries, it is bound to make EU imports more expensive. Therefore, to assess the potential impact of the CBAM into the EU's competitiveness, it is important to understand the role that EU's import play in EU's own production and exports. For example, imports of basic metals and fabricated metal products – which include aluminium, and iron and steel – contribute €50 billion to EU's final demand[67] and €28.6 billion to EU's exports.

Table 4.4 shows the contributions of foreign aluminium, steel, and iron inputs into the total final demand of EU member states. The table helps us to understand the impact of CBAM on the competitiveness of downstream EU producers which is key to understanding the economic costs of CBAM to the EU. Economically larger member states such as Germany, France, and Italy receive close to €12 billion, €8 billion, and €6 billion in foreign value added on their final demand whilst as a percentage of their total demand, Ireland and Malta come on top. In terms of foreign value-added to EU exports, the competitiveness of Germany and Italy is the most dependent on foreign inputs whilst as a percentage of total value-added on the value of their exports, Malta and Cyprus are the most reliant on basic metals bought from outside the EU. Therefore, given the amounts of foreign inputs of aluminium, iron and steel embedded into EU's final demand and exports, CBAM will be more costly for the EU economies which are more integrated with the rest of the world.

[67] Author's calculations from OECD Trade in Value Added (TiVA) database.

TABLE 4.4: CONTRIBUTION OF FOREIGN ALUMINIUM, IRON AND STEEL INTO EU MEMBER STATES FINAL DEMAND

EU Member State	Foreign Value Added in Final Demand (euro, billion)	Foreign Value Added in Final Demand (percentage of total final demand)	Foreign Value Added in Exports (euro, billion)	Foreign Value Added in Exports (percentage of total exports)
Austria	1.5	20.7	1.0	8.4
Belgium	2.1	31.1	1.2	15.4
Bulgaria	0.4	33.7	0.3	24.5
Croatia	0.1	18.1	0.1	9.0
Cyprus	0.08	38.2	0.0	33.7
Czech Republic	1.1	27.5	1.2	13.8
Denmark	1	30.9	0.5	16.2
Estonia	0.14	35.6	0.1	21.1
Finland	0.8	23.5	0.5	11.5
France	8.2	26.7	3.0	13.7
Germany	12	21.5	7.5	11.3
Greece	0.9	32.6	0.3	14.6
Hungary	0.6	27.5	0.8	17.9
Ireland	1.2	55.6	0.7	23.0
Italy	6.6	21.2	3.9	13.2
Latvia	0.1	35.0	0.1	21.4
Lithuania	0.2	30.3	0.1	25.0
Luxembourg	0.1	36.6	0.2	19.3
Malta	0.06	45.7	0.0	45.1
Netherlands	2.4	28.2	1.1	14.2
Poland	2.8	26.0	1.5	13.7
Portugal	0.5	22.0	0.3	11.6
Romania	0.7	22.0	0.3	11.9
Slovak Republic	0.6	30.6	0.8	15.8
Slovenia	0.2	23.9	0.2	11.7
Spain	4.1	23.5	1.8	12.3
Sweden	1.7	22.3	0.8	10.1

Source: OECD Trade in Value Added (TiVA) database. Author's calculations.

4.6 The risk of retaliation

As described previously, the EU's trade partners that will be negatively affected by the CBAM may retaliate. Since the WTO Appellate Body is not functioning, EU's trade partners could retaliate directly by for instance imposing trade cost that are of similar value to the cost of CBAM on foreign producers. Commonly, trade partners have imposed trade barriers on like-for-like products in trade disputes. If this like-for-like retaliation also holds for the CBAM, EU exports of cement, electricity, aluminium, fertilisers, and iron and steel may face new trade barriers in the form of tariffs and non-tariff barriers or may have to comply with similar climate related trade restrictions set up by EU's trading partners.

Even though EU's exports of CBAM products only account for 2.8% (€58.7 billion) of EU's total exports, the EU holds a significant market share in the global exports of many of these goods. Table 4.5 presents the value of EU exports of these goods and its share in EU's total exports and world total exports. The EU is the third largest global exporter of fertilisers, the second largest for cement, iron and steel, and aluminium, and the largest exporter of electricity.

TABLE 4.5: EU EXPORTS OF CBAM AFFECTED GOODS (2019, BILLION EUROS)

	Value (billion euros)	Percentage of EU total exports of goods	Percentage of EU exports on global exports of goods
Cement	0.95	0.04%	12.8%
Aluminium	8.4	0.40%	11.7%
Electricity	3.6	0.17%	21.8%
Fertilisers	2.9	0.14%	10.6%
Iron and Steel	42.7	2.05%	15.8%

Source: UN COMTRADE. Authors' calculations.

If the EU's trade partners retaliate against the CBAM by imposing trade barriers on EU exports of CBAM related products, they will make their imports more expensive. Table 4.6 is the mirror image of Table 4.4 as it shows the value added of EU exports of aluminium, and iron and steel – proxied by basic metals and fabricated metal products – into the final demand of some of the EU's trade partners that will be impacted by the CBAM. In absolute terms, the value-added of EU exports of aluminium, and iron and steel was the largest in the US, China, and the UK. For other countries such as Russia and Brazil, even though EU value-added was relatively small in absolute level, its contribution as a percentage of these countries' final demand was significant. Therefore, as the CBAM will make EU's imports more expensive, retaliating against the EU will also make other countries worst-off.

TABLE 4.6: CONTRIBUTIONS OF EU ALUMINIUM, IRON AND STEEL TO THE FINAL DEMAND OF PARTNER COUNTRIES

Country	Value Added by EU Exports in Final Demand (euro, billion)	Value Added by EU Exports in Final Demand (percentage of total final demand)
Brazil	1.7	8.0
China (People's Republic of)	11.1	3.3
India	2.9	6.2
Korea	1.9	5.8
Russian Federation	2.9	10.1
Turkey	3.9	16.6
United Kingdom	8.7	24.8
United States	17.4	7.5

Source: OECD Trade in Value Added (TiVA) database. Author's calculations.

5. FOREIGN SUBSIDY INSTRUMENT

5.1 What is the Foreign Subsidy Instrument (FSI)?

In March 2021, the EU commission proposed a new instrument that addresses the distortive effects of foreign subsidies in the EU's internal market. The EU's Foreign Subsidy Instrument (FSI) targets foreign public subventions in two key areas of the economy: mergers and acquisitions (M&A), and public procurement. It also includes a catch-all category for other market situations. The draft regulation proposes the introduction of three tools[68] to investigate and redress the distortive effects of subsidies:

1. A notification-based tool to investigate concentrations, such as the merging of two or more previously independent undertakings or the acquisition by one or more persons already controlling at least one undertaking, involving a financial contribution by a non-EU government where the EU turnover of the company to be acquired is €500 million or more and the foreign financial contribution is at least €50 million.
2. A notification-based tool to investigate bids in public procurements involving a financial contribution by a non-EU government, where the estimated value of the procurement is €250 million or more; and
3. A tool to investigate all other market situations and smaller concentrations and public procurement procedures, which the Commission can start on its own initiative (ex-officio) and may request ad-hoc notification.

According to the Commission's Impact Assessment Report on Foreign Subsidies, there are approximately 100,000 companies owned by foreign entities that have operations in the EU single market. In 2017, "these companies had a combined turnover of more than EUR 4 trillion and produced an added value of EUR 917 billion [which] generated roughly 9 million jobs."[69] As opposed to domestically owned businesses, foreign companies do not receive the same level of scrutiny regarding financial contributions from external sources. The EU law[70] prohibits public aid to undertakings which have the potential to threaten and distort competition. Yet, this jurisdiction only applies for Member states, while disregarding similar control mechanisms on foreign subsidies.

Therefore, the EU cannot enforce mechanisms to regulate foreign subsidies or to implement redressive measures when a detrimental effect on an industry has been demonstrated. In this

[68] European Commission, 2021, Commission proposes new Regulation to address distortions caused by foreign subsidies in the Single Market. Accessed at: https://ec.europa.eu/commission/presscorner/detail/en/ip_21_1982

[69] European Commission, 2021, Impact Assessment Report, Accessed at: https://ec.europa.eu/competition/international/overview/impact_assessment_report.pdf

[70] European Commission, Treaty of the Functioning of the European Union. Art. 107. Available at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107

regard, the European Commission adopted a White Paper[71] in June 2020 describing this legislative gap in EU trade legislation, and it outlined the rationale for addressing foreign subsidies that undermine fair competition within the internal market. This document suggests that current legislation prevents the EU from acting against market distortions caused by foreign subsidies, including those that relate to the financing of acquisitions and those that enhance a company's standing in the EU's procurement market. Moreover, the White Paper also details preliminary and substantive orientations for legal instruments to address the regulatory gap.

Subsequently, the EU Commission published a proposal for regulation in May 2021 on foreign subsidies distorting the internal market. The FSI regulation aims to tackle the specific subsidies that have adverse effects on the EU market. Likewise, the FSI will give the EU Commission the power to investigate subsidies granted by non-EU public authorities to companies which operate under the EU territory. Currently, the proposal is being discussed by the EU Parliament and the Council. The Commission expects, optimistically, that the instrument can be in use in 2023.

5.1.1 The context of the FSI

The issue of subsidies has long been discussed within the EU institutions but also in multilateral fora and international organizations such as the WTO, the IMF, and the OECD. Yet, it is important to caveat that most nations recognize the importance of state aid to support individuals or businesses, especially when the economic prospects are adverse – for example, in a pandemic. In fact, some international institutions consider subsidies as an effective policy tool,[72] particularly in developing countries when they are used to incentivize R&D or to protect the environment. Nevertheless, subsidies can seriously harm and distort the competitiveness of businesses that operate in market economies, and this is what is motivating the EU to act. The European Commission also references how subsidies can generate different types of efficiency-losses. For instance, when subsidies are granted to large companies that already have an important market share, they can lead to increased profit margins and higher prices. As a consequence, the company may achieve a dominant position, and will have the incentive to engage in unfair trade practices such as predatory pricing or dumping. Under this scenario, smaller companies will certainly exit the market, creating higher entry barriers that will limiting future competition. These effects have proven to be detrimental to the overall welfare of society and not just the specific sector in which these businesses operate. For the EU, there are specific sectors in which competitiveness is

[71] European Commission, 2020, White Paper on levelling the playing field as regards to foreign subsidies. Accessed at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=COM:2020:253:FIN

[72] Benedict J. Clements, David Coady, Stefania Fabrizio, Sanjeev Gupta, Trevor Alleyne, & Carlo A. Sdralevich, 2013, Energy Subsidy Reform: Lessons and Implications, Washington: International Monetary Fund.

crucial and considered to be challenged, because of their significance for the EU's economy, these sectors are therefore likely to be subject to greater scrutiny by the Foreign Subsidy Regulation. Examples of such industries are steel and aluminium, aviation, railways (in the context of public procurement for infrastructure), oil and gas, and semiconductors.

As mentioned earlier, the FSI regulation will target subsidies which are aimed to facilitate acquisitions or bids in procurement tenders. According to the EU's Impact Assessment Report on the FSI, some market players benefit from foreign subsidies by overpaying to obtain a procurement contract or for their acquisition premiums. The EU Procurement market is cemented under three principles: equal treatment, non-discrimination and transparency, and accounts for over 14% of GDP in the EU, and it is valued around €2 trillion.[73] These guiding principles are intended to ensure competitiveness and maximize value-for-money for the public sector and the taxpayer. Consequently, the issue with the effects of subsidies in the public procurement market is that they are not visible in the short-term. At first glance, subsidized bidders may give the impression that there are generating short-term benefits as they put competitive pressure on the incumbent bidders to become more cost-efficient. However, these short-term positive effects eradicate over time as they gain more market power and reduces competition.

The case is quite similar with distortions in M&A. Sellers from the internal market may benefit from the inflated price in the short-term. Yet, these acquisitions risk causing an expansion of the less efficient company at the expense of the more efficient and non-subsidized company. This notion is consistent with different studies which suggest that, in the long-term, the overall net effect is negative for the EU market, as the harmful impact of foreign subsidies is likely to outweigh positive effects.[74]

In a report conducted by the European Commission on Foreign Investment in the EU, only 3% of the firms in the study were identified as owned by non-EU investors.[75] Although at first sight it may seem a relatively small number, these companies represent more than 35% of the total assets, and account for over 16 million jobs. Furthermore, foreign ownership is heavily concentrated in key industries for the EU economy, such as oil refining, where foreign firms control 67% of the assets, pharmaceuticals 56%, electronic 54% and insurance 45%.[76] Accordingly, the same report notes that the vast majority of these companies are owned by "traditional" investor countries such as the United States, Canada, Japan, Norway and Australia. Nonetheless, in one decade, from 2007 to 2016, the number of M&A from new

[73] European Commission, 2021, Impact Assessment Report. p. 17.

[74] European Commission, 2021, Impact Assessment Report. p. 10.

[75] European Commission, 2019, Commission Staff Working Document on Foreign Direct Investment in the EU. Accessed at: https://trade.ec.europa.eu/doclib/docs/2019/march/tradoc_157724.pdf

[76] European Commission, 2019, Commission Staff Working Document on Foreign Direct Investment in the EU. p. 2.

investor countries such as China, India and Russia quadrupled.[77] Basically, this progressive trend is what motivates the EU to monitor more closely the financing flows to European companies from entities abroad – in particular, the financial flows from these new investors, since it is known that they sometimes finance their strategic sectors with public funding.

Lastly, subsidized companies by foreign entities can benefit from other type of incentives such as getting access to front-line technology. A clear example of this is China's industrial policy "Made in China 2025," which includes large government funds and subsidies with the ability and instruction to orient them to priority sectors.[78] Beijing has indicated that by the year 2050 its national strategy will be oriented towards becoming a global producer of higher value-added manufactures and a technological power. For that purpose, China has invested in cutting-edge sectors such as robotics, electric vehicles, medical equipment, aerospace, maritime and railways, either in Chinese territory or overseas. Foreign acquisitions are also part of the strategy. Many of the companies that operate in these businesses are provided with various financial incentives, such as loans with interest rates that are not in line with market rates. Since China has become the fourth biggest acquirer of EU undertakings[79] and there is a perceived lack of transparency in many of these transactions, the EU has felt compelled to take new measures.

5.2 Legal basis, subsidiarity, and proportionality

The legal basis for the Foreign Subsidy Initiative (FSI) is Article 207 of the Treaty of the Functioning of the European Union (TFEU). Furthermore, the proposed legislation will be based on Article 114 of the TFEU which provides for the adoption of measures for the approximation of measures of the member states which have as their object the establishment and functioning of the internal market. To date, there are no national rules governing foreign subsidies, but it is expected that some member states decide to take action and to incorporate this matter in their national legislation.

The question of subsidiarity arises with respect to Article 114 of the TFEU, as measures must be taken at the EU level. Since subsidies have a distortive effect on the internal market, the member states can also legislate and adopt binding acts. However, many member states have instead requested the Commission to implement a regulation at the

[77] European Commission, 2019, Commission Staff Working Document on Foreign Direct Investment in the EU. p. 2.

[78] Jost Wübbeke, Mirjam Meissner, Max J. Zenglein, Jaqueline Ives, Björn Conrad, 2016, Made in China 2025: The making of a high-tech superpower and consequences for industrial countries, Mercator Institute for China Studies. Available at: https://merics.org/sites/default/files/2020-04/Made%20in%20China%202025.pdf

[79] Agatha Kratz, Mikko Huotari, Thilo Hanemann, and Rebecca Arcesati, 2020, Chinese FDI In Europe: 2019 Update: Mercator Institute for China Studies. p. 9.

EU level on the basis of Article 3 of the TFEU[80], which indicates that the EU is exclusively competent for trade defence instruments, as a pillar of the commercial policy.

The European Commission argues that the proposal is proportionate since it imposes a burden only on those companies that are engaged in economic activities and that receive a foreign subsidy. However, businesses which receive financial contributions from third countries, or are engaged in a large M&A or public procurement may be subject to the regulation and the administrative burden that follows, even though, they have not received a subsidy. The proposal is designed to have two types of systems of notification in accordance with the scale of the company and thus, the distortive effect. For instance, the ex-ante notification involves the systematic notification of the potentially most distortive foreign subsidies, which are often the highest economic transactions. With respect to the smaller M&A or procurement procedures, an ex officio system would be in place to focus on the most significant cases.

5.3 How will the Foreign Subsidy Instrument work?

On its own initiative, the EU Commission will conduct ex-officio examinations of alleged distortive subsidies.[81] Furthermore, when the Commission considers it necessary to assess on a preliminary basis whether the financial contribution under examination constitutes a foreign subsidy, and whether it distorts the internal market, it may request information from the undertaking, the association of undertakings, or the third country. This request of information will indicate its legal basis and its purpose, and will specify which information is required from the part of the undertaking or third country, while setting an appropriate time limit for the company to provide the required information. Likewise, if warranted, the regulation gives the right to the Commission to conduct inspections in and outside of the EU.

Subsequently, when the Commission has been notified about financial contributions in public procurement procedures, it shall carry out the preliminary review no later than 60 days after it received the notification, and may adopt a decision closing the in-depth investigation no later than 200 days after it received the notification. In addition, it is important to note that the Commission's power to enforce the in-depth investigation shall be subject to a limitation period of 10 years, starting on the day in which a foreign subsidy is granted to the undertaking concerned, when no additional actions or measures interrupt the investigation. For any situation involving the former scenario, that is, for each time the process has been interrupted, the limitation period shall start to run afresh.

[80] EU Commission, Treaty of the Functioning of the EU. Art. 3. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E003&from=EN

[81] EU Commission, 2021, Regulation of the European Parliament and of the Council on Foreign Subsidies Distorting the Internal Market. COM/2021/223. Accessed at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=COM:2021:223:FIN

If the Commission considers that there are sufficient indications that an undertaking has been granted a foreign subsidy that distorts the market, based on the preliminary review, it shall adopt a decision to initiate an in-depth investigation. This decision will summarize the relevant issues of fact and law. It shall also include the preliminary assessment of the existence of a foreign subsidy and of the actual or potential distortion on the internal market. Then, the Commission will inform the undertaking concerned and publish a notice in the Official Journal of the European Union which invites interested parties, Member States and the third country concerned to express their views. The regulation also indicates that the undertaking concerned may offer commitments, which the Commission should evaluate if they are appropriate and sufficient to fully and effectively remedy the distortion. Conversely, when the Commission concludes that there are no sufficient grounds to initiate the in-depth investigation, either because it concludes that there is no foreign subsidy or because there are no indications of an actual potential distortion on the internal market, it shall close the preliminary review and inform the undertaking.

In any event, where the undertaking demonstrates signs of non-cooperation with the investigation, the Commission may impose fines and penalty payments. Some examples of non-cooperative behaviour – drawn from the same rulebook as investigations of subsidies – are the failure to provide complete and correct in response to an information request, failure to provide the information requested within the time limit prescribed by the Commission, refusal to submit the Commission's inspection within or outside the Union, or other impediments to conduct the in-depth investigation. Correspondingly, fines will be applicable to non-cooperative parties. These fines shall not to exceed 1% of the aggregate turnover of the undertaking or association of undertakings concerned in the preceding business year. Similarly, periodic penalty payments imposed shall be required not to exceed 5% of the average daily aggregate turnover of the undertaking or association of undertakings concerned in the preceding business year for each working day of the delay, calculated from the date established in the decision until it submits complete and correct information as requested by the Commission. Yet, when setting the amount of the fine or periodic penalty payment, the nature, gravity and duration of the infringement, the principles of proportionality and appropriateness should be duly taken into account.

When the Commission has sufficient evidence of the existence of subsidies in a particular sector, it may conduct a market investigation into the particular sector and the type of economic activity where the foreign subsidy was conceded. The purpose of such investigations is to evaluate and assess the effect and damages that a subsidy caused to that particular sector. The regulation also considers the possibility that the Commission may revoke a decision in cases when the undertaking concerned acts contrary to its commitments or redressive measures imposed or where the decision was based on incomplete, incorrect or misleading information.

If the Commission decides that the foreign subsidy should be remedied it will impose redressive measures if the undertaking does not voluntarily offer commitments. Both commitments and redressive measures shall fully and effectively remedy the distortion caused by the foreign subsidy in the internal market. Some examples of the potential commitments or redressive measures are:

1. offering access under fair and non-discriminatory conditions to an infrastructure that was acquired or supported by the distortive foreign subsidies unless such fair and non-discriminatory access is already provided for by legislation in force in the Union;
2. reducing capacity or market presence;
3. refraining from certain investments;
4. requiring the undertakings concerned to dissolve the concentration;
5. repayment of the foreign subsidy.

After finishing the process of investigation, but before the publication of its decision, the Commission shall provide the undertaking with a right of defence. It is worth mentioning that during the course of the investigation, the Commission will be assisted by a Committee, which may offer its opinion by taking a vote by a simple majority among the members of this Committee.[82] Finally, the FSI regulation considers the need to revise the instrument five years after its entry into force. And for that purpose, the Commission shall present a report to the European Parliament and the Council with relevant legislative proposals.

5.5 EU's ability to act

This proposal is consistent and coherent with the EU trade policy, and complements the existing trade instruments. At the multilateral level, the Foreign Subsidy Regulation is consistent with WTO rules, both the GATT and the Agreement on Subsidies and Countervailing Measures (ASCM) – just as rules on state aid in the EU, going beyond the ASCM) has not been an issue in the GATT/WTO context. The limitation of the ASCM agreement is that it only covers trade in goods, and the GATS does not develop the concern on the distortive effects of subsidies in trade in services. In fact, article XV of the GATS calls members to take action to start negotiations at the multilateral level to avoid the distortive effects, and to implement countervailing procedures. Nevertheless, no such rules have been developed to date.

[82] EU Commission, 2011, Regulation of The European Parliament and of the Council laying down the Rules And General Principles Concerning Mechanisms for Control by Member States of the Commission's Exercise of Implementing Powers. EU No. 182/2011. Art. 4. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32011R0182

5.6 *The potential impact of the EU's Foreign Subsidy Instrument (FSI)*

The EU's Foreign Subsidy Instrument (FSI) targets foreign subsidies in two key areas of the economy: mergers and acquisitions (M&A), and public procurement, and includes a catch-all category for other market situations. Based on two notifications and one general market investigation tool, this instrument focuses on each area under the following conditions. First, M&A where the turnover of the EU businesses that will be acquired by a non-EU company exceeds €500 million and the financial contributions exceeds €50 million. Second, bids in public procurement tenders with a contract value over €250 million that involve financial contributions. Thirdly, the European Commission can start an investigation on its own initiative of any distortive foreign subsidy granted to non-EU companies. An important point to note here is that because no clear data exists on the financial contributions received by a company, a preliminary investigation will be needed from the Commission to assess the amount of financial contribution received. The above-mentioned thresholds on financial contributions are, therefore, set to help ease the administrative burden.

However, prior to any discussion about the impact of foreign subsidies on EU investment and procurement, we need to define what constitutes a subsidy for the FSI. Article 2 of the draft regulation on foreign subsidies distorting the internal market defines foreign subsidies as financial contributions granted by the public sector (governments or public entities) or private entities whose actions can be attributed to the third country. These subsidies include the transfer of funds or liabilities such as capital injections, grants, loans, loan guarantees, fiscal incentives, setting-off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps or rescheduling; the foregoing of revenue that is due; and the provision of goods or services or the purchase of goods or services. Moreover, these subsidies must provide an actual benefit that distorts the EU internal market to be subject to the FSI[83]. Moreover, it should be limited, in law or in fact, to an individual undertaking or industry or to several undertakings or industries[84].

It is important to highlight that the FSI definition of a subsidy is more detailed and covers a larger number of potential subsidies than what constitutes a subsidy under the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement)[85]. This is important as the rationale of the FSI – and other trade policies revised in this study – is for the EU to build its own defensive policies after the WTO dispute settlement system stopped

[83] Article 1 of the draft regulation. Brussels 5.5.2021. COM (2021) 223 final.

[84] Article 2 of the draft regulation. Brussels 5.5.2021. COM(2021) 223 final.

[85] As an example, the WTO Agreement does not include subsidies in the form of purchase of services as the WTO SCM Agreement only covers subsidised imports of goods from third countries. The WTO SCM Agreement classifies subsidies under the category of prohibited (e.g., export subsidies) and actionable (i.e., subject to challenge in the WTO) and classifies foreign subsidies as transfer of funds (grants, loans, or equity infusions, direct transfer of funds or liabilities (e.g., loan guarantees)); government revenue that is otherwise due is foregone or not collected; government provides goods or services other than general infrastructure or purchase or purchase of goods; and government makes payments to funding mechanism or entrusts (See WTO Agreement on Subsidies and Countervailing Measures, Article 1, Definition of a Subsidy).

functioning. The EU continues to engage with the United States and Japan to strengthen the WTO rules on industrial subsidies. However, given the challenges in reaching a concrete output, the FSI is the autonomous answer to the EU's need to build its own anti-subsidy mechanism.

The FSI is also the EU's answer to the heightened and continuous tension between the EU State Aid rules which restrict EU member states from giving subsidies to private companies, and the growing competition within internal market and abroad faced by EU businesses from non-EU companies that benefit from subsidies from non-EU countries[86]. The EU had tried to resolve this tension by embedding part of its own legal system in EU FTAs or by pushing for a limited use of subsidies from WTO members (SCM Agreement). The FSI overlaps with these commitments – particularly those made by the EU and its trading partners in FTAs and the WTO Government Procurement Agreement. If that situation arises, the EU stated that "it appears more appropriate to address the distortion created by foreign subsidy under the dispute settlement or consultation provisions of the respective trade agreement"[87]. Recital 43 of the proposed FSI regulation stated that "The implementation of this Regulation by the Union should comply with Union law, the WTO Agreement and be consistent with commitments made under other trade and investment agreements to which the Union or the Member States are parties".

5.6.1 The increasing use of foreign subsidies

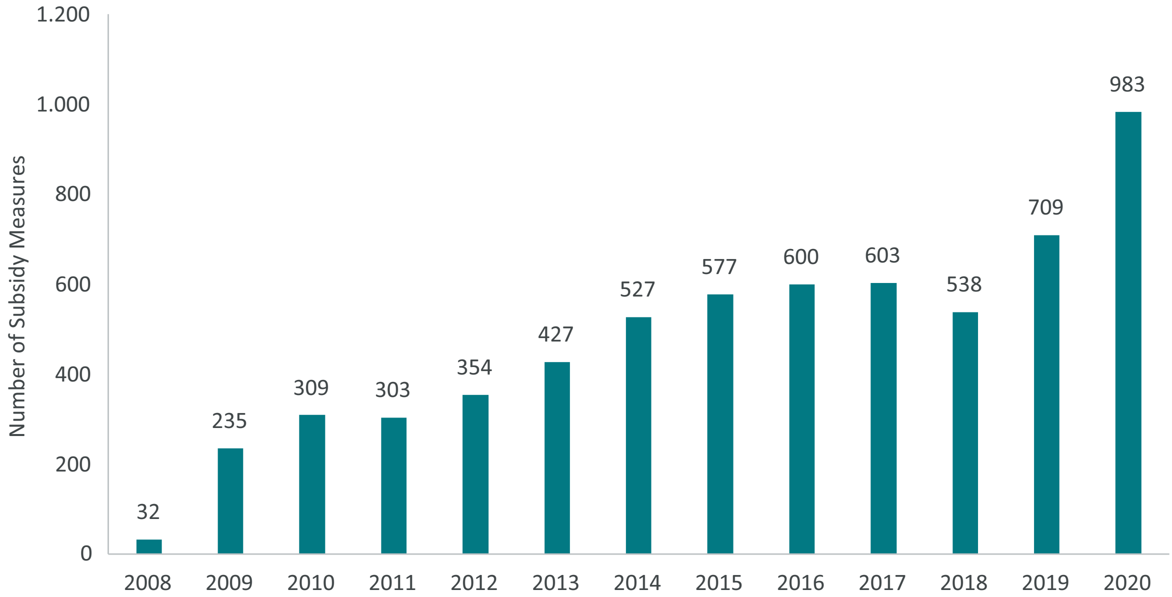
The EU is right to be concerned about foreign subsidies as subsidies by non-EU countries have been increasing since 2009. There was a small fall in 2018, but they increased more than the previous levels in 2019 and 2020. This is not surprising as countries around the world have taken measures to maintain businesses afloat when Covid-19 restrictions stop firms from operating normally, including through subsidies.

Figure 5.1 below shows the number of foreign subsidies – as defined by the FSI – from non-EU countries that had a direct impact on EU economy. The number of foreign subsidies has been increasing since 2012, excluding a small fall in 2018. Foreign subsidies increased by almost 40% in 2020.

[86] EU trade defence instruments can be used when subsidised goods are imported but not when foreign subsidies take the form of subsidised investments, or when services and financial flows are concerned.

[87] EU Commission, 2020, White Paper on levelling the playing field as regards foreign subsidies. COM(2020) 253 final.

FIGURE 5.1: NUMBER OF SUBSIDIES BY NON-EU COUNTRIES AFFECTING THE EU ECONOMY PER YEAR (2008-2020)



Source: GTA. Author's calculations. Note: Active subsidies affecting EU member states.

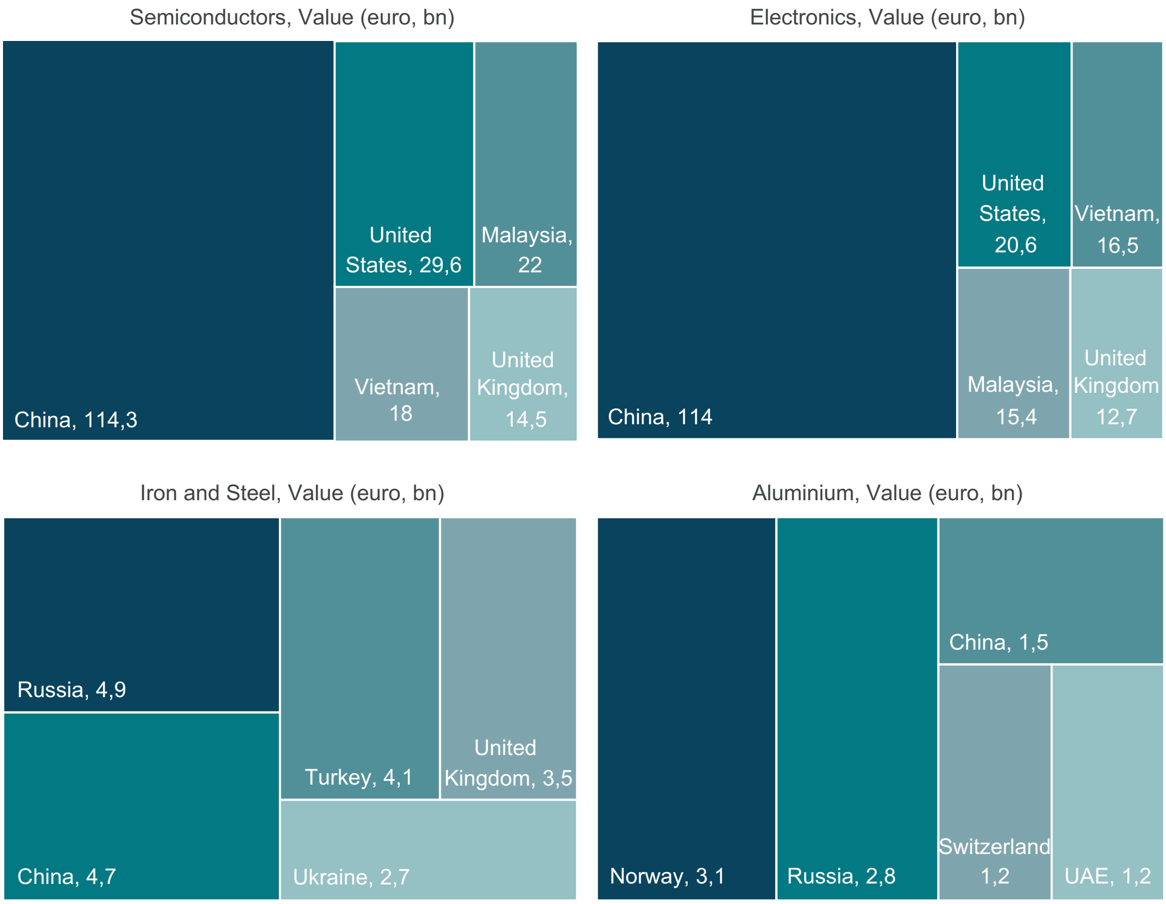
5.6.2 Economic sectors impacted by the FSI

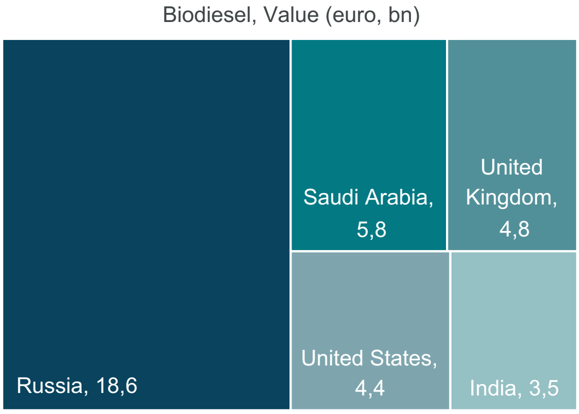
Given the broad definition of what constitutes a subsidy under the FSI and the fact that it is difficult to quantify the number of subsidies across countries, it becomes important to establish what we do know about the subsidy levels in different sectors of the economy. According to the EU's impact assessment and stakeholder consultations, the economic sectors that are more heavily impacted by foreign subsidies include semiconductors, aluminium, iron and steel, chemicals, biodiesel, electronics, and wood and paper.

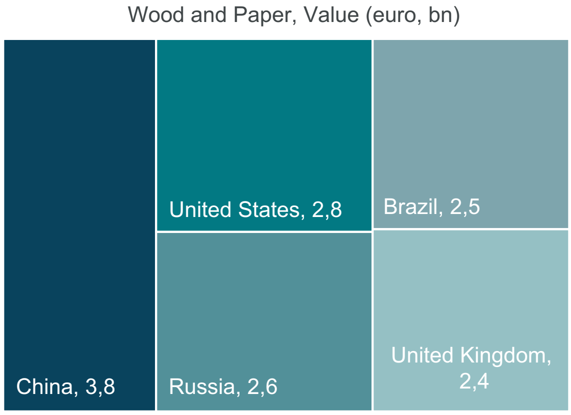
In theory the FSI is country-blind and could impact companies receiving subsidies in any country in the world. In practice, however, not every country has the financial resources to provide substantial subsidies, and few countries have a domestic market large enough to host a firm that can acquire a €500 million EU firm, bid for a €250 million EU public procurement contract, or open a foreign subsidiary in the EU that can distorts competition in the EU internal market. Moreover, it is more likely that neighbouring countries such as the UK or Russia, which companies are significantly integrated with the EU, would be subject to FSI as subsidies from these countries are more likely to distort competition within the EU.

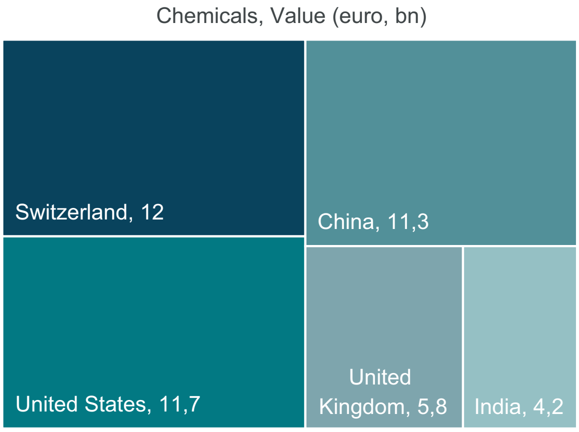
Figure 5.2 presents the EU import value and suppliers of the sectors identified by the European Commission impact assessment and stakeholder consultations that are more heavily impacted by foreign subsidies and the main suppliers. For most sectors, China, United States, the UK, and Russia are always in the top 5 exporters to the EU. They are relatively large countries, that share strong linkages with the EU economy. They also belong to the group of top exporters to the EU in terms of total trade. Moreover, countries such as China, Russia, and the United States are known to providing its companies with subsidies to better compete in foreign markets. Given China's large exports to the EU economy, and the large number of subsidies it provides to its companies in order to be more competitive in foreign markets, China has the potential to be the country most affected by the FSI.

FIGURE 5.2: EU IMPORTS ON ECONOMIC SECTORS IMPACTED BY FOREIGN SUBSIDIES (2019)









Source: UN COMTRADE. Authors' calculations. Note: Semiconductors HS codes from the OECD Trade Policy Paper on Measuring distortions in international markets: The semiconductor value chain. Aluminium, and Iron and Steel HS codes from CBAM proposal Annexe. Chemicals HS codes: 28 and 29. Biodiesel HS codes from the EU Anti-dumping duty on biodiesel (EU 2019/2092). Electronics HS Code: 85. Wood and Paper HS codes: 44, 47, 48.

5.6.3 M&A affected by the FSI

According to the Foreign Ownership Dataset of the European Commission, between 2015 and 2018 there were close to 40,000 M&A. Out of this, 14% (5,508) of the deals had non-EU acquirers. The EU impact assessment for the FSI states that during the same period there were, on annual average, 33 M&A deals above the turnover threshold of €500 million[88].

[88] Other estimates point towards a number of annual cases to be in the range of 50 and 150. See Stefan Sagebro, 2021, Swedish Enterprise: European Commission's estimates on administrative burden in the proposal on Foreign Subsidies are flawed, Swedish Enterprise. Accessed at: https://www.svensktnaringsliv.se/english/swedish-enterprise-european-commissions-estimates-on-administrati_1172452.html

These foreign acquisitions of over €500 million were made by companies of a significant size which are usually based in large economies. The EU's own analysis[89] shows that the UK was the country with the highest number of M&As over €500 million in 2018 with 16 out of 38 deals, followed by China (7), the United States (7), Japan (4), Russia (2), and Switzerland (2).

In addition, and also according to the EU impact assessment, 10% of the above-mentioned 33 M&A deals by foreign acquirers with turnovers above €500 million met the second threshold of a financial contribution larger than €50 million. Therefore, based on the EU calculations, over the period 2015 and 2018, on average 3 M&A deals could have been impacted by the FSI – or 0.05% of the deals with foreign acquirers[90]. This, however, is just an indicative estimate given the lack of available information on foreign financial contributions. As acknowledged by the European Commission own Impact Assessment on the FSI, there is a lack of a precise quantification of the potential number of deals that can be impacted by the FSI. Moreover, if the European Commission establish that an M&A does not distort the internal market, the M&A can be implemented in full or under certain conditions[91].

Sector-wise data on foreign acquisitions in the EU points to large acquisition deals in some of the sectors that the EU identified as subject to significant subsidies (see Table 5.1 in section 5.2.2). Table 5.2 below presents the ten economic sectors with the highest number of foreign M&As, as well as two sectors (basic metals and paper) which are similar to the sectors reported by the EU's own impact assessment as to be more heavily impacted by foreign subsidies (aluminium, iron and steel, and wood and paper). The table shows that, in 2017, there were 86 M&A deals in the manufacturing of computers and electronics – which includes electronics and semiconductors – and 52 M&A deals in the chemical sector with non-EU parties[92]. On the other hand, there were only 14 M&As in basic metals and 10 M&As in paper and paper products by non-EU businesses.

[89] EC-JRC FOWN Dataset (Annexe 5 impact assessment).

[90] Joint ventures can also be subject to the FSI if they meet the same thresholds as M&A. Article 18 of the draft regulation.

[91] Article 23 (c) of the draft regulation. Article 24 of the draft regulation.

[92] The data corresponds to EU28. Source: European Commission, 2019, Staff Working Document on Foreign Direct Investment in the EU. SWD(2019) 108 final.

TABLE 5.1: NUMBER OF DEALS WITH NON-EU COMPANIES AND THE SHARE OF FOREIGN M&A PER SECTOR IN 2017

Sector	Number of deals with non-EU28 parties	Share of foreign M&As in the sector
Information service activities	157	24%
Publishing activities	126	26%
Wholesale trade	92	15%
Manufacture of computer, electronic and optical	86	35%
Computer programming, consultancy	79	17%
Manufacture of machinery and equipment n. e. c.	70	25%
Activities auxiliary to financial and insurance	58	17%
Management consultancy activities	54	18%
Financial service activities	53	13%
Manufacture of chemicals and chemical products	52	32%
Manufacture of basic metals	14	23%
Manufacture of paper and paper products	10	19%

Source: European Commission Staff Working Document on Foreign Direct Investment in the EU. SWD(2019) 108 final. Page 22.

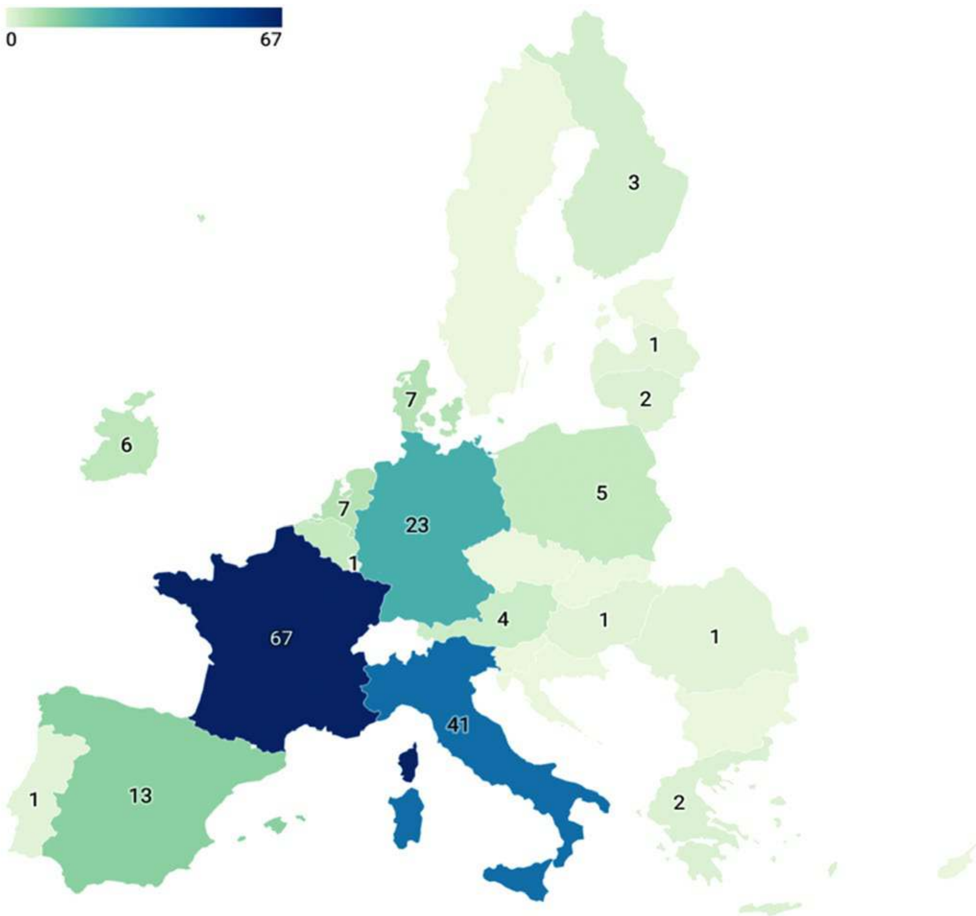
5.6.4 Public procurement affected by the FSI

As a result of the FSI, non-EU businesses will have to declare that the company did not receive any financial contributions during the previous three years or notify to the contracting authority all the financial contributions received during that period. Those non-EU companies that do not submit that information will not be awarded the public contract. Therefore, the foreign subsidy instrument could allow the EU to exclude non-EU firms receiving subsidies from bidding in EU public procurement contracts above €250 million. It is important to highlight that there is always the risk of non-EU companies supplying false information, indicating erroneously that they have not received any financial contributions or only financial contributions under the selective benefit threshold. Moreover, the exclusion of bidders under the FSI need to be compatible with the EU's commitments for covered procurement in the WTO Agreement on Government Procurement and similar FTA provisions.

The European Commission Impact Assessment estimated that there were 108 contract award notices with a value above €250 million between 2015 and 2017. So, per year, an average of 36 contract award notices were published above the threshold and 21 of the 435 businesses winning those contracts were non-EU companies. Therefore, the impact of the FSI on EU procurement may be small. However, this figure only includes winning companies, while many more non-EU companies bid for EU procurement contracts and will have to demonstrate compliance with FSI[93].

In 2019, there were 190 award notices with a value above €250 million published in the EU Public Procurement database (TED)[94]. Across sectors, materials and products (21%), construction (18%), and technology equipment (15%) were the sectors with the largest number of contracts above the €250 million threshold[95]. Across EU member states, France (35%), Italy (22%), Germany (12%) and Spain (7%) were the EU member states with the largest number of procurement contracts above €250 million in 2019. On the other hand, 14 EU member states published just one award notice or none above the threshold.[96]. Figure 5.2 shows the total number of public procurement contracts above €250 million across EU member states in 2019.

FIGURE 5.3: NUMBER OF PROCUREMENT NOTICES ABOVE €250 MILLION BY EU MEMBER STATE (2019)



Source: TED Database. Authors' calculations.

[93] Stefan Sagebro, 2021, Swedish Enterprise: European Commission's estimates on administrative burden in the proposal on Foreign Subsidies are flawed. Swedish Enterprise. Accessed at: https://www.svensktnaringsliv.se/english/swedish-enterprise-european-commissions-estimates-on-administrati_1172452.html

[94] This figure does not specify the number of contracts awarded to non-EU companies.

[95] A contract in TED can be assigned to more than one sector and as a result there is double counting. For example, in 2019, the sum of the total number of contracts above €250 million across all sectors was 362 while the total number of award notices in 2019 above €250 million was 190.

[96] These figures refer to the country where the work will be performed. In this case there is no double counting.

5.6.5 Other economic activities affected by the FSI

The FSI includes a catch-all mechanism which allows the European Commission to start an investigation into foreign subsidies that distort the internal market[97]. This mechanism applies to public procurement or M&A below the thresholds, including green field investment. However, the FSI also applies to any other economic activity within the EU (except for the import of goods which continues to be covered under the existing trade defence rules)[98].

Greenfield investment is a type of foreign direct investment in which a parent company creates a subsidiary in a different country. The EU is concerned that foreign subsidies can be channelled towards foreign affiliates based in the EU and that could provide an unfair advantage to these companies which in turn would distort competition in the EU internal market.

In 2018, there were 67,000 foreign affiliates in the EU and more than 7,000 of them were based in Germany, the EU country with the highest number of foreign enterprises followed by Romania (7,646); the Netherlands (5,125), and the Czech Republic (4,504). The member states that saw faster growth in the number of foreign enterprises between 2013 and 2018 were Lithuania, Slovakia, and Denmark. Foreign affiliates in the EU support 7 million jobs and contributed with €693 billion in value added to the EU economy. The economic sectors with the higher number of foreign affiliates were retail (27,000)[99] followed by manufacturing (12,237); information and communication (8,855), and real estate (8,000). In terms of value-added, manufacturing was the sector where foreign affiliates contribute the most to the EU economy with €336 billion.

In 2018, the United States was the country with the largest number of foreign affiliates in the EU, followed by Switzerland, Norway, and Russia. By turnover, the most important country was the US, followed by UK, Switzerland, and China.

[97] The European Commission stated that subsidies below EUR 5 million are considered unlikely to be distortive. Brussels 5.5.2021. COM (2021) 223 final.

[98] WilmerHale, 2021, Lock, Stock and Two Smocking Notifications: The Proposed European Regulation on Foreign Subsidies.

[99] This category includes wholesale and retail trade, repair of motor vehicles and motorcycles. Source: Eurostat, FATS database.

TABLE 5.2: NUMBER OF FOREIGN AFFILIATES AND TOTAL TURNOVER IN 2018

	Number of Foreign Affiliates	Total Turnover (euro, billion)
United States	20,744	1,627
Switzerland	13,000	378
Norway	4,425	93
Russia	4,413	79
Turkey	2,943	12
Canada	1,723	62
Australia	1,070	11
United Kingdom	N/A	587
China	N/A	127

Source: FATS database Eurostat. Authors' calculations. There was no data available in Eurostat regarding the number of foreign affiliates in the UK and China.

5.7 The risk of retaliation

Subsidies are generally granted by large economies. There might be smaller countries that have one sector that is important for their economies and where there is a close relationship between the government and the firms but in general the FSI will impact large countries. Therefore, any retaliation against the EU because of the FSI will come from large economies, and in particular, countries that actively use subsidies to industrialise their economies, to build up scale and firm size.

These countries could retaliate by restricting access to their own investment and procurement markets to EU businesses. If they follow the same logic as the FSI, EU businesses receiving subsidies will lose market access[100]. However, outside agriculture, the EU follows strict state-aid rules which only allows public subsidies under very specific circumstances.

Yet, EU competition rules have been eased recently and state subsidies have been allowed for Important Projects of Common European Interest (IPCEI) where EU member states support the development of specific value-chains in sectors such as microelectronics or electric batteries. The impetus for IPCEI has continued with the publication of the EU Industrial Strategy and future IPCEI may include electric vehicles, smart health, low-carbon industries,

[100] The FSI set up significant redressive measures closer to competition than to trade policy. Article 6 of the draft regulation includes, among others, reducing capacity or market presence, refraining from certain investments, divestment of certain assets, requiring companies to dissolve concentrations, or the repayment of the foreign subsidy. Article 15 of the draft regulation includes fines and penalty payments when non-EU companies do not cooperate with the EU or supply wrong information. EU companies can face similar measures in retaliation.

hydrogen technologies, industrial internet of things, or cybersecurity[101]. Moreover, as part of the EU Chips Act, the European Commission and national governments plan to spend €11 billion on subsidies to support the production of semiconductor in the EU.

EU subsidies on microelectronics, electric batteries, or semiconductors lay bare the obvious contradictions in the objectives of the different EU defensive policies. On the one hand, the EU industrial policy wants to lower the perceived dependencies on strategic sectors. These are sectors where the EU imports critical inputs – such as semiconductors and electric batteries – to produce other goods which demand will increase as a result of the digital transformation and the energy transition. To reduce this perceived dependency, the EU and EU member states are willing to subsidise the domestic production of these critical inputs. On the other hand, the EU is mindful of the negative impact of foreign subsidies in the EU internal market, and it is ready to approve the FSI to tackle these subsidies. A more detailed description of EU Industrial Policy is provided in Box 5.1.

BOX 5.1: STRATEGIC AUTONOMY AND TRADE DEPENDENCIES IN THE EU INDUSTRIAL POLICY

EU Industrial Policy seeks to further EU's Open Strategic Autonomy by identifying and addressing industrial and technological strategic dependencies.

A May 2021 Communication from the European Commission updated the EU industrial strategy in response to the impact of the COVID-19 pandemic. Among its priorities it includes the goal of supporting EU's Open Strategic Autonomy by reducing foreign dependencies on critical goods with proposals to diversify international partnerships and international alliances. Currently there are EU public-private alliances on hydrogen, raw materials, and batteries. The European Commission is launching new alliances on processors and semiconductor technologies and industrial data and cloud computing. In February 2022, the EU unveiled its Chips Act which includes tools to respond to shortages and support domestic production. The Act is part of the EU's goal to double its share of global chip market to 20% by 2030. To achieve this goal, the European Commission and national governments plan to spend €11 billion to build three pilot facilities for any company to use and member states and businesses are expected to invest an additional €32 billion by 2030.

However, the degree of EU dependency on the rest of the world is rather limited. The European Commission analysis that accompanied the Communication estimated that the EU was highly dependent on 137 foreign products which represent 6% of the EU's goods imports. With regard to the origin of these 137 products, it was determined that 52% of the value of goods came from China.

[101] European Commission, 2019, Strengthening Strategic Value Chains for a future-ready EU Industry. Report of the Strategic Forum for Important Projects of Common European Interest. Accessed at: https://ec.europa.eu/docsroom/documents/37824

In addition to lowering EU dependencies, the main purpose of the new EU industrial strategy is to support the European industry into becoming more green and more digital. However, there is a contradiction between these two goals and the objective to lower dependencies by increasing domestic production. For example, the production of electric batteries in Europe, which is de facto detrimental to lower-cost Chinese battery production, will make the energy transition more expensive. Moreover, by subsidising domestic production, the EU is putting forward measures which are similar to the subsidies that non-EU companies receive abroad and which the EU seeks to challenge with the Foreign Subsidy Instrument.

However, if the EU starts subsidising the production of microelectronics, electric batteries, or semiconductors, it will be impossible that part of this production will not be exported as many of these goods go into cars, machinery, or electronic products where EU firms are leading global exporter. Therefore, non-EU countries will find easy targets for the retaliation against EU subsidies. For instance, the EU automotive sector – a growing user of semiconductors and which production has been halted as a result of the shortage of these products – is one of the leading exporting sectors in the EU economy representing 8% of EU total exports in 2019. As the EU car industry will be one of the beneficiaries of subsidies in electric batteries and semiconductors, non-EU countries may retaliate against the EU by imposing market access and investment restrictions against cars produced in the EU. Furthermore, the retaliation may take the form of a subsidy "arms race", in which other large economies start a "subsidy war" to produce the same products that the EU wants to produce domestically. This is a real concern in the case of semiconductors where other countries such as the United States and China have published plans to subsidise the production of these products.

6. CORPORATE SUSTAINABILITY DUE DILIGENCE

6.1 What is the Directive on Corporate Sustainability Due Diligence?

The European Commission proposal for a Directive on Corporate Sustainability Due Diligence aims to identify, prevent, mitigate, and bring to an end adverse human rights and environmental impacts in firms, its subsidiaries, and value chains. In order to achieve these goals, the Directive requests companies to integrate due diligence to account for actual and potential adverse human rights and environmental impacts. Adverse human rights impacts come as violation of the rights or prohibitions listed in the Annex of the Directive such as violations of the right to life and security, violation of the prohibition of torture, and the violation to enjoy a fair wage. Equally, adverse environmental impacts are also listed in the Annex of the Directive and include, among others, violations of the prohibition of the use of mercury, violation of the prohibition of handling waste that is not environmentally sound, and violation of provisions of several international environmental agreements. In the words of the European Commission, the goal of the Directive is to improve corporate governance practices to mitigate adverse human rights and environmental risks, increase corporate accountability, improve access to remedies for those affected by these adverse effects, and avoid fragmentation of due diligence requirements in the EU single market.

The Directive applies directly to EU companies with more than 500 employees and a net annual worldwide turnover of more than €150 million[102]. It also applies to companies with more than 250 employees and a net annual worldwide turnover of more than €40 million generated in high-risk sectors[103]. In addition, the Directive will also apply to non-EU companies with a net turnover of more than €150 million made from sales in the EU during the last financial year and to non-EU companies with a turnover of more than €40 million but not more than €150 million also made from sales in the EU provided that at least 50% of its net worldwide turnover was generated in one or more of the high-risk sectors. The European Commission argues that the employment criterion was excluded for non-EU companies because the notion of employees was not easy to transpose outside the EU[104].

[102] In addition to the obligations set out in the Directive, EU and non-EU companies with a turnover above €150 million will need to have a plan to ensure that their business strategy is compatible with limiting global warming to 1.5 °C in line with the Paris Agreement.

[103] High risk sectors are: (i) the manufacture of textiles, leather and related products (including footwear), and the wholesale trade of textiles, clothing and footwear; (ii) agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages; (iii) the extraction of mineral resources regardless from where they are extracted (including crude petroleum, natural gas, coal, lignite, metals and metal ores, as well as all other, non-metallic minerals and quarry products), the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment), and the wholesale trade of mineral resources, basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products). The definition of high-impact sectors has been limited to sectors with high risk of adverse impacts and for which OECD guidance exists.

[104] European Commission. SWD (2022) 39 final. Commission Staff Working Document. Follow-up to the second opinion of the Regulatory Scrutiny Board.

Member states – through their respective national administrative authorities – will be responsible for supervising these new rules and will be able to impose fines in case of non-compliance. This supervision will only be as good as the resources to support the activities of the supervisory authorities. The Directive asks member states to ensure supervisory authorities receive sufficient funds to fulfil their duties. In addition to funds, these authorities will have the power to pursue remedial actions to stop infringements, including financial sanctions based on the company's turnover.

The role of the supervisory authorities is not just to act upon infringement when someone brings a case to them but also to ensure that companies carry out periodic assessments of their own operations, their subsidiaries, and value chains. With respect to non-EU firms, the competent supervisory authority would be the member states in which the company has a branch. If the company does not have a branch in any member state, or has branches located in different member states, the competent authority would be the member state in which the company generates most of its net turnover in the EU.

To ensure that companies follow the new rules, the Directive assigns the responsibility for due diligence to the company's directors. Directors will be responsible for establishing and overseeing the due diligence actions laid down in the Directive. In addition, when fulfilling their duty to act in the best interest of the company, directors must take into account the human rights, climate change, and environmental consequences of their actions. Moreover, companies should provide the possibility for persons and organisations to submit complaints in case of concerns of human rights and environmental adverse impacts.

Victims of the adverse human rights and environmental impacts will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures. This means that victims will have the possibility to bring a civil liability claim before national courts. The civil liability concerns companies' own operation and its subsidiaries and established business relationships. However, companies will not be liable for damages by an indirect business relationship if they have carried out their due diligence measures.

The proposed Directive on Corporate Sustainability Due Diligence does not include a ban on products made by forced labour from entering the EU market. This policy will be presented as a separate legislative instrument which will cover goods produced inside and outside the EU.

6.2 Legal basis, subsidiarity, and proportionality

The proposed legal basis is based on Article 50 and Article 114 of the Treaty on the Functioning of the European Union (TFEU). These two articles provide the EU with the competence to act in order to avoid fragmentation and ensure a level playing field for companies within the EU internal market. The European Commission argues that new and emerging laws on due diligence are considerably different[105]. The measures proposed in the Directive are designed to prevent that fragmentation by harmonising the requirements for companies to carry out due diligence. In the absence of the Directive, the European Commission argues, the production and movement of goods and services would be skewed to benefit jurisdictions with no due diligence regimes, or with less demanding ones. The logic of a level playing field also applies to director's requirements to integrate due diligence measures in their duty of care, as well as the application of civil liability in case of infringements.

In relation to subsidiarity the European Commission argues that the Directive is necessary because private sector and member states efforts to tackle these adverse human right and environmental impacts have been insufficient with respect to the scale of the challenge. Even through the use of codes of conduct and supplier assessments has grown[106], the Commission believes it is not enough and argues that action at the EU level is necessary to tackle these adverse impacts and avoid the fragmentation of the single market.

In terms of proportionality, the Directive does not impact SMEs directly. For SMEs, the financial and administrative burden of setting up and implementing due diligence would be relatively high. The larger burden on SMEs compared to large businesses can be attributed to higher administrative costs, lower human resource, tighter contractual obligations, and lack of leverage to extract the needed information from their supply chains. When comparing the costs associated with fulfilling the regulatory obligations of the instrument, a study funded by the European Commission estimated that for a large company with more than 250 employees and revenues of €1 billion, the annual cost of due diligence and reporting will be €50,000 whilst for a SME with less than 249 employees and revenues of €10 million, this cost would be €7,400[107]. Therefore, the reporting cost per revenue would be 15 times higher for a SME than for a large company. Despite SMEs not being directly impacted by the proposed Directive, they

[105] For example, France and the Netherlands have implemented due diligence mechanisms in their domestic laws. The French Law No. 2017-399 requires that companies headquartered in France with more than 5000 employees must establish an effective vigilance plan to allow the risk identification and prevention of violations in environmental and human rights. The Dutch Child Labour Due Diligence Law, which is due to come to effect in 2022, will require Dutch companies to investigate whether their production chain of goods or services has utilized child labour. The law will be applicable to all Dutch companies, regardless of their size or number of employees.

[106] The EcoVadis Business Sustainability Risk and Performance Index 2021.

[107] Lise Smit et. al, 2020, Study on due diligence requirements through the supply chain, European Commission.

will be indirectly affected by the due diligence undertaken by larger buyer companies and will need to participate in due diligence. The Directive includes several measures to cushion the blow to SMEs[108], such as the development of individually or jointly dedicated websites, platforms or portals and potential financial support for SMEs; adoption of guidance; technical and financial support provided by member states to facilitate adaptation. This support should also be made accessible in third countries.

These rules will not come into play until member states transpose the Directive into their national legislation which could take up to two years since the Directive is approved at the EU level. Moreover, EU companies with more than 250 employees and a net annual worldwide turnover of more than €40 million but less than €150 million generated in high-risk sectors and non-EU companies under the same turnover bracket will have four years to implement the new due diligence procedures. The Directive will be reviewed seven years after its approval in Brussels and the evaluation of the Directive will include the thresholds and the sectors for companies to be directly impacted by the Directive and whether other adverse climate impacts should also be included under the scope of the Directive.

Due diligence as a policy lever is something that the EU has done in the past and will likely continue with in the future. However, the Directive on Corporate Sustainability Due Diligence represents an assertive step towards a wider use of due diligence to achieve policy objectives and other EU policy initiatives will build upon this Directive. In particular, it is intended to implement EU standards as regards to human rights and the environment outside the EU through European companies and their value chains. This Directive will also complement the Non-Financial Reporting Directive[109], extending the scope of companies that require the audit of reported information and strengthen the standardisation of reported information, and will complement Directive 2011/36/EU on preventing and combating trafficking in human beings and protecting its victims. Other initiatives, such as the deforestation initiative (see chapter 9), will be more prescriptive in some areas as compared to the general due diligence duties under this Directive.

[108] A very recent study on the uptake of corporate social responsibility (CSR) and sustainability practices among European SMEs21 confirms that SMEs may face constraints to conduct due diligence in practice because they lack the resources to monitor their value chains and to investigate beyond their direct suppliers.

[109] The EU Non-financial regulation includes an obligation for companies to be transparent on their activities and demonstrate that they comply with ILO conventions.

6.3 How does the Due Diligence work?

The due diligence process set out in the Directive covers the six steps defined by the OECD Due Diligence Guidance for Responsible Business Conducts[110]. These steps are: (1) integrating due diligence into policies and management systems, (2) identifying and assessing adverse human rights and environmental impacts, (3) preventing, ceasing, or minimising actual and potential adverse human rights, and environmental impacts, (4) assessing the effectiveness of measures, (5) communicating, and (6) providing remediation.

1. The integration of due diligence into policies and management is the responsibility of the director and due diligence should include not just the individual company but also its subsidiaries and supply chain.
2. The identification of actual or potential adverse human rights and environmental impacts should be based on quantitative and qualitative information. The assessment of the impacts should be done in regular intervals i.e., prior to new activity, major decisions, changes in the operation, and at least every year, throughout the life of an activity or business relationship.
3. If a company identifies a potential adverse human rights or environmental impact, it should take appropriate measures to prevent and mitigate these impacts. When the company cannot prevent, terminate, or minimise the adverse impacts, it should prioritise actions and take reasonable measures. Minimisation of the adverse impact should be the closest possible to bringing the adverse impact on an end. To prevent the adverse impacts, companies should mitigate their risks, for instance, by obtaining contractual assurance from a business partner with whom they have an established relationship that it will comply with the code of conduct. The contractual assurances should be accompanied by appropriate measures to verify compliance. If these assurances cannot be obtained, a company can terminate a contract.
4. Member states are responsible for supervising the new rules and will be able to impose fines in case of non-compliance which should be effective, proportionate, and dissuasive.
5. Companies should also carry out consultations with potentially affected groups including workers and other relevant stakeholders to gather information on actual or potential adverse impacts.
6. National administrative authorities will be able to stop infringements and pursue remedial actions to bring these infringements to an end. In addition, victims will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures.

[110] OECD, 2018, OECD Due Diligence Guidance for Responsible Business Conduct. Accessed at: http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf

In comparison with EU Regulations which are transposed into national legislation word by word, member states have certain space to transpose Directives into their national legislation according to their own circumstance. As a result, EU Directives are more open to interpretation than Regulations. To ensure that the transposition of the Directives achieves their objectives, the EU publishes guidelines. In the case of the Directive on Corporate Sustainability Due Diligence, the EU will publish guidelines for member states as well as for companies. The draft Directive states that the European Commission will adopt guidelines about voluntary contract clauses and how companies and member states should fulfil their obligations. These guidelines will be vital as the Directive is open to interpretation as to what companies have to do to "minimise the adverse impacts" or "take reasonable measures". These clarifications are crucial because, as a result of the Directive, companies can be taken to court if they infringe on their obligation and companies' directors have been made responsible for the correct implementation of the due diligence. There is a risk that the interpretation of the "do's" and "don'ts" is done by judges when the first cases are taken to court, which presents tremendous legal uncertainty which could impact businesses decisions making firms more risk averse.

6.4 The EU's ability to act

The proposed legislation on Corporate Sustainability Due Diligence is likely to be compatible with the WTO rules and the bilateral and regional trade agreements of the EU. Even if there are specific GATT rules that could be violated (e.g., rules on documentation and customs procedures), the WTO legislation foresees general exceptions, and allows unilateral trade restrictions under Article XX of the GATT and Article XXI of the GATS. These agreements intend to protect and prevent the adoption or enforcement of necessary measures to protect public morals (XX.a GATT and XIV.a GATS), human, animal, or plant life and health (XX.b GATT and XIV.b GATS), relating to the conservation of exhaustible natural resources (XX.g GATT), and to prevent deceptive and fraudulent practices (XIV.c.i GATS). Indisputably, some of the measures that the EU could take on due diligence may be challenged as discriminatory either by the MFN or national treatment clauses, or for the imposition of additional non-tariff restrictions to trade. Therefore, the EU should design a due diligence process that is transparent, to the maximum extent possible, and meets the highest standards of accountability. Other EU due diligence regulations have passed that test.

6.5 The potential impact of due diligence

Due diligence obligations will bring costs and benefits. The most important intended benefits derive from the reduction in adverse human rights and environmental impacts by firms covered by the Directive – and hopefully also by others. The fact that these benefits are difficult to quantify does not make them less relevant. In addition, companies will also benefit from ensuring that human rights and the environment are better protected in their activities. Consumers demand sustainable and responsibly sourced products and investors consider business sustainability when looking for new investment opportunities. These benefits should encourage companies to adopt the kind of measures that the Directive oblige them to do even without binding rules. However, the European Commission argues that the scale of the challenge – particularly when subsidiaries, supply chains, and non-EU companies are considered – and the possibility of unfair competition and fragmentation within the single market make the Directive necessary.

The Directive will carry considerable costs for businesses. The European Commission estimates that 11,700 European companies will be directly impacted by this regulation, 9,400 belonging to the group of companies with more than 500 employees and a net annual worldwide turnover of more than €150 million, and 2,300 belonging to the group of companies operating in high-impact sectors and with an annual worldwide turnover between €40 and €150 million[111]. The number of third country firms that would fall under the scope of the Directive is estimated to be between 4,000 and 2,600 non-EU companies with a 150 million annual EU turnover and 1,400 non-EU companies with an EU turnover of more than €40 million but not more than €150 million in a high-impact sector. Many more companies will be indirectly impacted by this regulation since the obligations trickle down to companies' subsidiaries and suppliers.

In its impact assessment[112] and staff working document[113] the European Commission identifies two main costs: compliance costs which include the costs of establishing and operating the due diligence procedures; and transition costs which include the costs of changing a company's own operations and value chain to comply with the new due diligence obligations. In relation to these two costs, the European Commission estimates that EU businesses will need to spend €760 million a year[114] and €220 million one-off costs to set up the new processes. Therefore, based on the European Commission figures, the average cost to set up the due diligence process for an EU company directly impacted by the Directive would be around €84,000 during the first year and €65,000 afterwards. These costs come on top of similar administrative costs to private firms in the Corporate Sustainability Reporting Directive which includes requirements to disclose public sustainability and due

[111] The European Commission estimates that the total number of companies belonging to the second category is 3,400 but around 30% of these companies are subsidiaries of larger companies covered within the first group. Therefore, the number of companies in the second group would be around 2,300.

[112] European Commission. SWD (2022) 42 final. Commission Staff Working Document Impact Assessment Report.

[113] European Commission. SWD (2022) 39 final. Commission Staff Working Document. Follow-up to the second opinion of the Regulatory Scrutiny Board.

[114] The European Commission SWD (2022) 39 final uses the term "recurrent" when describing the figure of €760 million. We understand that "recurrent" implies annual, but this is unclear from the text.

diligence related information. This is important as the marginal cost of each new obligation on businesses may be relatively small, but the cumulative effect is likely to be much more significant. The European Commission also estimates that non-EU companies will have to spend €240 million a year and €70 million for initial procedural compliance costs, which average cost per company to comply with the Directive falls within the same range as for EU companies.

In addition to setting up the due diligence systems, there is a risk that compliance may block some customers or sourcing channels, either because of human rights or environmental problems or because legal or practical circumstances make the necessary information gathering impossible. For instance, certain raw materials can only be sourced from countries with high-risk profiles. Under these circumstances, EU companies may have to abandon their suppliers which will make businesses incur in additional costs. It is true that there are certain safeguards in the Directive to ensure that disengagement is a last resort option, such as the emphasis on prevention and mitigation of adverse impacts. However, abandoning high-risk suppliers is a real possibility which could result in European companies paying higher prices if sourcing possibilities become more limited or more expensive. On the other hand, by covering third-country company competitors, the fall in competitiveness of EU companies in the EU single market may be reduced.

The risk of fines or lawsuits could make European companies more risk-averse, exiting from markets where potential human right and environmental violation may happen. If the impact of European companies on human and environmental rights in these markets is positive, exiting those places and trading partners as a result of the new obligations could have a detrimental effect in the human and environmental rights of those places.

The Directive assigns several tasks to member states and the supervisory authorities in the oversight and enforcement of due diligence. In setting up the monitoring systems and hiring the necessary staff to apply the new powers, member states will incur in costs. The European Commission estimates that the total recurring supervisory costs are €5.55 million a year and the initial costs will be €130,000. Given the significant responsibilities assigned to member states by the Directive in the oversight of the new system, appropriate funding of the supervisory authorities will be crucial for the implementation of the new rules. In addition, since the regulation is also governed through civil liability, there might be an increase in the number of court cases which will also entail a cost to public budgets.

BOX 6.1: UNINTENDED CONSEQUENCES OF EU DEFENSIVE TRADE POLICY MEASURES

Instruments in the EU's defensive trade toolkit can be categorised in a variety of ways. One important classification is based on the implementation of the instruments – whether they are implemented automatically after approval or implemented on a discretionary basis by the EU. Based on this distinction, four instruments out of the eight can be considered automatic, i.e., these trade instruments, once approved, will be in place and applied automatically to all trade and trade partners equally. These four instruments are: Carbon Border Adjustment Mechanism, Directive on Corporate Sustainability Due Diligence, Level Playing Field, and Deforestation Initiative. The Level Playing Field, however, only applies to the UK as part of the EU-UK Trade and Cooperation Agreement.

For the remaining three instruments, given their broad scope, it is important to understand who these instruments might be hurting. It is possible that these instruments might bring with them adverse impacts for the EU's trade relations with many of its strategic partners, such as the United States, United Kingdom, Turkey, and more recently Ukraine. The table below gives an approximation of how the three automatic measures affect EU imports from these countries. The table shows that these instruments affect a significant amount of trade, particularly the Directive on Corporate Sustainability Due Diligence. The EU needs to be careful of the burden it puts on its trade partners and the effects it may have on their diplomatic relations.

TABLE 6.1: EU ALLIANCES AFFECTED BY AUTOMATIC MEASURES, EU IMPORT VALUES OF AFFECTED PRODUCTS (EURO, BILLIONS)

	United States	Turkey	United Kingdom	Ukraine
Carbon Border Adjustment Mechanism	0.6	4.0	3.1	2.6
Corporate Sustainability Due Diligence	52.5	32.6	59.2	14.4
Deforestation Initiative	3.9	1.6	3.1	2.7

Note: The list of affected products for each of these instruments can be found in the respective instrument chapters. Product codes included under the Deforestation Initiative are Palm oil (1511), Beef (0201, 0202), Coffee (0901), Cocoa (18), Maize (1005), Rubber (40), Soy (1201).

6.6 EU trade affected by due diligence

The lack of due diligence procedures in supply chains, to ensure that human and environmental rights are not abused, is an issue that concerns many non-EU countries. There are existing claims of labour and environmental rights abuses in the garment industry in Bangladesh, in the extractive metals industry in Central Africa, and in the timber industry in Myanmar and

Gambia. A more recent motivation behind the impetus for the due diligence Directive in the EU are the human rights abuses in Xinjiang, China, which is responsible for producing 80% of China's cotton – most of which is exported as a raw material abroad.

The Directive include two important shifts in EU's existing trade policy that attempt to account for the adverse human rights and environmental impacts outside the EU:

1. There will be an extraterritorial application of human rights and environmental standards by the EU. While human right and environmental provisions are included in the EU's Free Trade Agreements, the application of the Directive to non-EU companies directly and indirectly through EU companies supply chains outside the EU represents a significant step in the application of EU norms outside the EU.
2. A shift in the burden of responsibility of upholding human rights and environmental protection from partner countries to foreign companies. Instead of countries being responsible for having in place legislation that uphold human rights and environmental standards, companies will have responsibility to prevent, mitigate, and end adverse human rights and environmental impacts.

The ability of the EU to accomplish these goals will vary across industries. In sectors with complex supply chains, such as manufacturing, automotive, or electronic sectors, large companies have several tiers of suppliers. Therefore, the cost of the instrument will be larger as due diligence obligations are imposed on the value chain[115].

Due diligence will impact suppliers – SMEs and large firms – across the world, including businesses in developing countries. EU businesses and consumers are large importers of commodities, agriculture, and intermediary products, many of them produced in developing countries. Moreover, some of these developing countries have not adopted the environmental and labour standard required in the due diligence legislation. If companies in developing countries must abide by EU standards, regardless of what national standards are, it would make the lower standards in the third country irrelevant. There is a risk that foreign suppliers will prefer to sell to other regions where due diligence rules are not in place or less stringent.

The ability of the EU to nudge foreign firms to comply with the EU directive will depend on how important the EU market is for non-EU companies. Moreover, the EU itself is not only an important consumer but also a global supplier for many products, making it more difficult for partner countries to circumvent the instrument. This means that, for many businesses in these sectors, the EU is an essential part of their supply chain, which

[115] The Directive defines value chain as activities related to the production of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product as well as the related activities of upstream and downstream established business relationships of the company.

compels firms to comply with the EU reporting obligations. Tables 6.2-6.4 present the EU largest suppliers of the high-risk products in textiles[116], agriculture[117], and minerals[118]. The product codes assigned to each of the groups follow the description of the sectors in the draft Directive. The tables also show the value of EU imports, and the importance of the EU market in each of the supplier's total exports.

The EU is a significant market for its top suppliers across the three groups of high-risk products. For example, the EU imports 19% of Chinese total exports of textiles and 47% of Russian total exports to minerals. Obviously, the relevance of the EU market for Russia has significantly changed after the Russian war against Ukraine and subsequent EU sanctions on Russia. The data also shows that trade with EU's neighbouring countries like the UK, Norway, and Ukraine will be strongly impacted by the new Directive. The amount of EU imports from other countries like the US (agriculture and minerals), Brazil (agriculture), and China (minerals) is large but not large enough as a percentage of their total exports. The final column in each table shows the largest global suppliers of each product category which, in many cases, include EU's top suppliers and the EU itself.

TABLE 6.2: EU IMPORTS OF HIGH-RISK PRODUCTS (TEXTILES)

Largest Suppliers to the EU	Value of EU Imports (euro, billions)	Share of EU imports in the total exports of partner countries	Largest global suppliers and export values (euro, bn)
China	60	19%	China (309)
Bangladesh	20	(no data)	EU (247)
Turkey	16	59%	Vietnam (56)
Vietnam	12	21%	India (37)
India	10	28%	Turkey (27)

116 HS product codes: 4107, 4112, 4113, 4114, 4115, 4201, 4202, 4203, 4205, 50, 51, 52, 53, 54, 55, 56, 57, 58, 59, 60, 61, 62, 63, 64, 65, 66.

117 HS product codes: 01, 02, 03, 04, 06, 07, 08, 09, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 44.

118 HS product codes: 2502, 2503, 2504, 2505, 2506, 2507, 2508, 2509, 2510, 2511, 2512, 2513, 2514, 2515, 2516, 2517, 2518, 2519, 2520, 2521, 2522, 2523, 2524, 2525, 2526, 2528, 2529, 2530, 2601, 260, 2603, 2604, 2605, 2606, 2607, 2608, 2609, 2610, 2611, 2612, 2613, 2614, 2615, 2616, 2617, 27, 38, 68, 72, 73, 74, 75, 76, 78, 79, 80, 81, 82, 83.

TABLE 6.3: EU IMPORTS OF HIGH-RISK PRODUCTS (AGRICULTURE AND FISH)

Largest Suppliers to the EU	Value of EU Imports (euro, billions)	Share of EU imports in the total exports of partner countries	Largest global suppliers and export values (euro, bn)
UK	16	60%	EU (510)
United States	11	10%	United States (117)
Norway	9	77%	China (75)
Brazil	8	13%	Brazil (64)
Ukraine	7	(no data)	Canada (52)

TABLE 6.4: EU IMPORTS OF HIGH-RISK PRODUCTS (MINERALS)

Largest Suppliers to the EU	Value of EU Imports (euro, billions)	Share of EU imports in the total exports of partner countries	Largest global suppliers and export values (euro, bn)
Russia	112	47%	EU (719)
United States	40	15%	United States (270)
UK	37	57%	Russia (238)
Norway	33	55%	China (236)
China	28	12%	United Arab Emirates (197)

Source: UN COMTRADE. Authors' calculations.

6.7 The risk of retaliation

Labour and environmental standards and regulations across countries and sectors are usually different. Imposing specific standards on a partner country in exchange for allowing trade to take place can be considered an arm-twisting demand. In response, an alternate form of retaliation can be for the partner country to subject the EU to the partner country's own standards for trade and undertake its own due diligence and reporting. Even if EU laws already guarantee higher labour and environmental standards, the reporting of these standards will cost EU businesses time as well as resources and hinder international trade between trade partners.

Many non-EU countries have already transposed labour and environmental agreements into their national legislation, although there are issues about the implementation of these commitments. However, the way that some countries decide to implement these commitments may differ from the tools chosen by the EU to verify that adverse human rights and environmental risks have been mitigated. For example, ASEAN countries will deploy an electronic monitoring system to crack down on labour right violations in tuna fishing vessels[119]. It is unclear whether the EU will recognise the validity of these systems or will require a third party to verify them.

Moreover, the probability of retaliation depends on what will happen if third country companies do not comply with the EU standards. It might be the case that EU companies decide to stop sourcing from countries considered as high-risk or non-EU companies selling their goods and services in Europe considering that the new EU due diligence procedures are too burdensome and complain about it. These factors will heighten the probability of retaliation.

[119] Kishimoto Kyozuka & Nakano, 2021, Asean food makers look to correct labor abuses in supply chains. Asian Nikkei. Accessed at: https://asia.nikkei.com/Business/Agriculture/ASEAN-food-makers-look-to-correct-labor-abuses-in-supply-chains

7. LEVEL PLAYING FIELD IN THE EU-UK TRADE AND COOPERATION AGREEMENT

7.1 What is the Level Playing Field (LPF)

The level playing field (LPF) provisions under the EU-UK Trade and Cooperation Agreement (TCA) establish rules to safeguard fair competition between EU and British businesses. LPF is a trade policy term that refers to a set of common rules and standards primarily used to prevent businesses in one country undercutting their rivals in other country[120]. LPF provisions were one of the major sticking points during the negotiations between the EU and the UK to establish a new framework after Brexit[121] which concluded on the 24th of December of 2020 when the UK and the EU agreed on the EU-UK Trade and Cooperation Agreement[122].

During the Brexit negotiations, the UK chose regulatory autonomy over a deeper trade relationship with the EU while the EU insisted that any privileged access to its market should be condition on robust LPF commitments. For the EU, the LPF provisions were necessary due to the high degree of economic integration and close geographical proximity between the EU and the UK. For the UK, there were also benefits in having these provisions, particularly on subsidies. While it is not in the interest of the EU or the UK to abandon their competition policy, in the event of a subsidy war, the EU has deeper pockets.

In comparison with other FTAs signed by the EU, the LPF provisions of the EU-UK Trade and Cooperation Agreement are significantly more ambitious. In the EU agreements with Canada and Japan, the LPF provisions are relatively limited. The LPF provisions of the EU-UK TCA in "Title XI Level Playing Field" commit both parties to upholding high standards of protection on labour and social standards, environmental protection, the fight against climate change – including carbon pricing – and tax transparency. The chapter also contains principles on state aid to prevent either side from granting unfair, trade-distorting subsidies. Generally, the LPF provisions in the TCA also comes with a stronger dispute settlement mechanism than in ordinary FTAs, and it includes non-regression clauses for social and environmental policies, which bind both sides to the level of protection at the time of Britain's withdrawal from the EU.

[120] Alex Stojanovic, 2020, UK–EU future relationship: level playing field. Institute for Government. Accessed at: https://www.instituteforgovernment.org.uk/explainers/future-relationship-level-playing-field

[121] LFP commitments were already mentioned in the Political Declaration which the two sides agreed in October 2019 in the form of "common high standards applicable in the Union and the United Kingdom at the end of the transition period".

[122] While the EU-UK Trade and Cooperation Agreement represents a significant degree of economic disintegration as compared to when the UK was an EU member, the agreement goes beyond traditional free trade agreements. It provides for zero tariff and zero quotas on all goods; it includes a joint management of fish stocks; market access for transport services; and rights for EU citizens and UK nationals in each other's territory. Moreover, the agreement includes a broad range of other areas such as competition, State aid, tax transparency, environmental protection, fight against climate change, social and labour rights and bidding dispute settlement mechanisms and domestic enforcement. Many of these issues are dealt under the LPF provisions.

It is important to remember that both the EU and the UK have high level of standards and the starting point is shared regulation. Therefore, the LPF is designed to manage the divergence of standards between the EU and the UK. It does so not just by committing both parties to the level of social and environmental protection at the time of the UK's withdrawal but the introduction of "rebalancing measures". In the event that the future level of protection significantly diverges between the EU and the UK, and lead to material impacts on trade and investment, the LPF provisions grant each side the right to introduce measures to remedy the imbalance on trade and investment that follows on policy divergence.

Finally, there is also dispute settlement to manage disputes. Notably, dispute settlement for LPF provisions make linkages to the Horizontal Dispute Settlement Mechanism in the TCA – and thus strengthens the opportunity to legally protect social and environmental measures, including when the two sides diverge from each other. This is especially of relevance when measures are taken on a precautionary basis and there are not a full body of evidence suggesting that a measure (and its effects on trade) is merited. The TCA also mentions that to enter into a dispute, any deviation from these "common high standards" should have an impact on trade between the parties. Therefore, the LPF sets out common principles as insurance that both regions must adhere to.

7.2 Legal basis, subsidiary, and proportionality

While the assessment here is about the LPF provisions in the EU-UK Trade and Cooperation Agreement, it should be noted that there has been a long running debate on LFP provisions in EU bilateral trade policy[123]. Lately, the debate has leaned towards a more active use of this kind of provisions in EU trade policy. For example, the EU is consulting on whether it should be able to withdraw concessions if an FTA partner breaches the trade and sustainable development provisions[124]. Legally, it is a pretty straightforward exercise. This is also true for the LPF provisions in the EU-UK TCA. The Agreement specifies the course of action when a party is deemed to be in violation of the Agreement. This includes a sequence of consultation and negotiations. Ultimately, the Agreement gives the right to suspend concessions or the entire Agreement if all other options have failed to produce a satisfactory outcome.

In general, the growing debate about LPF goes hand-in-hand with EU's environmental and energy policies which also underpinned some of the new instruments discussed in this study (for example, CBAM). It can be argued that there is an element of "levelling the playing field" in most of the new EU instruments and LPF provisions should be seen as

[123] Sam Lowe, 2021, Opening Pandora's Box: What the EU-UK trade deal means for trade and conditionality, Centre for European Reform. Accessed at: https://www.cer.eu/sites/default/files/insight_SL_trade_14.10.21_0.pdf

[124] European Commission, 2021, Open public consultation on the Trade and Sustainable Development (TSD) Review. Accessed at: https://trade.ec.europa.eu/consultations/index.cfm?consul_id=301

complementary measures to other instruments that also seek to put EU and non-EU firms in an equal footing. For instance, the EU-UK LFP commitments include provisions on due diligence and subsidies which complement the Corporate Sustainability Due Diligence in chapter 6 and supersede the Foreign Subsidy Instrument analysed in chapter 5.

Many supporters of stricter LPF provisions in EU FTAs argue that to sell goods and services into the EU, non-EU companies should comply with the same obligations as EU companies do. Indirectly, this argument points towards EU's trade partners having to adopt the same legislation as the EU, and ultimately that the EU should condition market access if higher standards are not followed. However, even in the case of the EU-UK Trade and Cooperation Agreement, which includes the most far-reaching provisions on LPF written today, both parties aim at ensuring similar high standards rather than matching the strictest legislation of the two. The EU and the UK are free to design their regulations independently of each other as long high standards are maintained, and trade is carried out under open and fair competition.

7.3 How does the LPF work?

Title XI Level Playing Field of the EU-UK Trade and Cooperation Agreement includes chapters on subsidies, competition policy, taxation, labour and social standards, and the environment and climate. This section describes the LPF commitments and the enforcement mechanism of each chapter. An underlying enforcement mechanism in the entire agreement, however, is of conditional market access. The UK is expected to follow the same rules as those in the EU in order to access the EU single market. If there are divergences in these standards, especially if they are big enough to provide an unfair advantage to an economic operator, then the EU single market can be used as leverage to encourage UK businesses to follow common standards.

Labour and social standards

The EU and the UK committed not to lower the overall level of labour and social protection in a way that impacts trade or investment. However, as there are constant changes to labour law in the EU and the UK, both parties recognise that each one retains reasonable discretion regarding the rules governing their respective labour market. The changes to labour and social standards – such as fundamental rights, fair working conditions, and health, safety, and employment standards – subject to LPF commitments should be of a magnitude that delivers an unfair competitive advantage. This also means that the focus is on the outcome of future rule changes in labour and social standards rather than the UK and EU labour standards should be identical.

In case of a dispute, the UK and the EU should attempt to resolve any issue first through consultation. If consultation does not work, they can be referred to a panel of experts. And while the findings of the panel are not binding, if one party chooses not to comply with them, the other party can suspend some obligations under the agreement such as the imposition of import duties.

Environment and climate

The LFP commitments on the environment and climate – including industrial emissions, air emissions and air quality, natural and biodiversity conservation, waste management, protection of marine and aquatic environment, the protection against chemicals and the management of antibiotics in food production – are similar to the labour and social provision as they both commit to not lower the level of environmental protection in a way that impacts trade or investment. The non-regression level of protection is relatively uncontroversial as both parties have indicated a growing level of ambition on environmental protection and emissions reduction over time. Moreover, the EU and the UK have already passed domestic legislation which includes their respective emission targets to fight climate change. Similarly, the two parties committed to maintaining a system of carbon pricing, which is already in place and to implement their respective obligations under the Paris Agreement.

As in the case of the labour and social LPF provisions, if one party believes the other has made changes to its environmental and climate standards that would lead to an unfair competitive advantage, consultation among the parties is the first step. If the issue is not resolved through consultation, they can be referred to a panel of experts. While the findings of the panel are not binding, if one party chooses not to comply with them, the other party has the right to take countermeasures, which could include imposing duties.

Subsidies

The agreement defines subsidies as financial assistance in the form of direct funds, grants, loans or guarantees, the forgoing of revenue, and the provision or purchase of goods and services that confers an economic advantage to an economic actor[125]. The agreement provides a common set of principles as to how subsidies should be controlled, which ones should be prohibited, and the establishment of an independent authority that provides oversight, which increases the compatibility between EU and UK competition policy[126]. Moreover, the agreement allows for exemptions in the case of temporary subsidies granted to respond to a national emergency[127].

[125] Title XI Level Playing Field, chapter 3 Subsidy Control, Article 363.

[126] Title XI Level Playing Field, chapter 3 Subsidy Control, Article 366.

[127] Title XI Level Playing Field, chapter 3 Subsidy Control, Article 364.

In relation to enforcement, the agreement outlines a commitment for each side to maintain a court that can rule over subsidy cases in accordance with each side's domestic law. In there is disagreement, both parties can request additional information on the subsidy. If a dispute is not solved by consultation, each party can impose remedial measures as they are defined within the EU-UK TCA. However, these remedial measures should "be restricted to what is strictly necessary and proportionate"[128]. Once these remedial measures have been implemented, the affected party can request the establishment of an arbitration tribunal to assess if the measures were necessary and proportionate. If the panel finds the remedial measures were not, the party subject to those measures can ask the panel to set out what compensatory measures it can take in response.

Competition

The LPF provisions on competition policy set out common principles and definitions of competition policy, as well as the possibility of collaboration between both independent competition authorities. These commitments, however, are not enforceable as they are intended to ensure that each sides' competition policy is robust[129].

Taxation

In relation to taxation the agreement commits both parties not to lower standards that have been agreed in the OECD. The standards include requirements for information sharing and rules preventing tax avoidance[130] but do not prohibit the choice to lower or raise taxes. As in the case of the Competition chapter, LPF commitments on taxation are not subject to dispute settlement.

7.4 The EU's ability to act

The main criticism voiced against EU LPF provisions in general relates to enforcement. It has been argued that EU FTAs include multiple carrots – in the form of market access – but no stick to enforce the commitments agreed between the EU and its trade partners. For example, the issue of enforcement has become a stumbling block for the ratification of the EU-Mercosur Association Agreement.

[128] Title XI Level Playing Field, chapter 3 Subsidy Control, Article 374.

[129] Institute for Government, Level Playing Field. Accessed at: https://www.instituteforgovernment.org.uk/publication/future-relationship-trade-deal/level-playing-field

[130] Title XI Level Playing Field, chapter 5 Taxation, Article 383. "The Parties reiterate their support for the OECD Base Erosion and Profit Shifting (BEPS) Action Plan and affirm their commitment to implementing the OECD minimum standards against BEPS. The Parties will promote good governance in tax matters, improve international cooperation in the area of taxation and facilitate the collection of tax revenues".

In principle, enforcement should not be an issue for the EU-UK LPF commitments. The agreement is detailed about the process that each of the parties must follow in case of an alleged breach of the commitments. As mentioned previously, subsidies, labour standards, and environment and climate rules contain procedures and settlement mechanisms to manage disputes between the EU and the UK. In relation to competition and taxation, where the legal text sets out common principle and only commits both parties to international practices, the agreement is clear that the provisions are not enforceable.

Yet, to trigger a LPF related dispute under the EU-UK Trade and Cooperation Agreement, the alleged breach should provide an unfair advantage to an economic operator. This means that the breach should be substantive, which reduces the likelihood that the dispute settlement procedures under a LPF provision will be triggered.

7.5 The potential impact of the LPF provisions

Even though a dramatic divergence between EU and UK standards is unlikely, there are a few areas of contention. Subsidies to certain sectors, enforceable labour standards, and carbon pricing rules are all areas where the LPF has the potential to play a larger role. The impact of these provisions on EU-UK trade and investment are expanded in the following sections.

The LPF is more targeted at trade in goods than services, affecting sectors such as manufacturing, automotive, minerals, and raw materials. These are significant volumes of trade as the EU and the UK economies are highly integrated. Trade in goods between the EU and the UK was €514 billion in 2019: EU exports to the UK represented €320 billion, while UK exports to the EU were €194 billion.

7.5.1 Subsidies under the LPF provisions

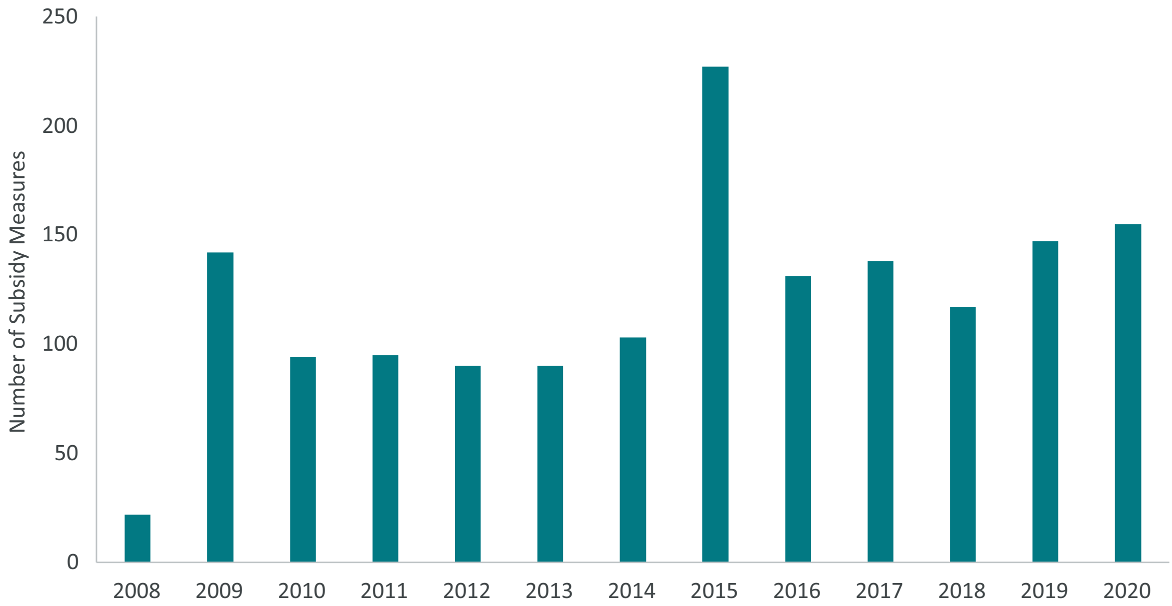
After Brexit, the UK no longer needs to abide by the subsidy rules in place in the EU. The UK has the freedom to provide subsidies to its companies which may be used to outcompete EU firms. This is where the LPF provisions on subsidy control become important. They help replace old rules that no longer apply to the UK, while creating new ones which are specific to the new situation. They help ensure that the EU does not intervene in the UK's regulatory decisions while suitable standards are maintained so the two are on an equal footing.

The argument is that LPF provisions on subsidies are needed because the EU and the UK have strong economic integration. So, subsidy measures undertaken by the UK can significantly affect trade and competitiveness in the EU and vice-versa. Finally, the LPF provisions also act as a barrier to steer clear of conflict between the two regions. As mentioned, the UK might have more regulatory freedom to grant subsidies, but the EU also has deeper pockets.

A subsidy war between the two could prove harmful for both. The provisions under the LPF help limit the scope of subsidies granted by either and creates explicit guidelines on how to resolve any conflict in this area. This is of particular importance since an alternate way to address subsidies and state-aid in the EU is the foreign subsidy instrument (see chapter 5). Unlike the FSI where mergers and acquisitions, and access to the procurement market, is disallowed, the LPF provisions instead provide guidelines on dialogue and negotiations in order to resolve conflict.

Data on subsidy measures from the Global Trade Alert database shows that in 2019, the UK had 8 subsidies in place which affected the EU. In the same year, the EU implemented 139 subsidy measures that had an impact on the UK economy. Figure 7.1 shows the number of subsidy measure implemented by the UK affecting the EU and vice-versa between 2008 and 2020. The number of subsidies reached its first peak in 2015 and has not rebounded to the same level since.

FIGURE 7.1: NUMBER OF NEW SUBSIDY MEASURES IMPLEMENTED BY THE EU AND THE UK AFFECTING EACH OTHER (2008-2020)



Source: GTA.

Existing and future subsidies are often dictated by the industrial strategy adopted by the government. The industrial strategy outlines the sectors where growth needs to be boosted, and subsidies are a well-known tool to make this happen. The United Kingdom's industrial strategy outlines three main areas for growth which are: AI and digital technologies, clean energy, and mobility. They plan to achieve these goals with investment in research and development, human resource, and infrastructure such as transport and digital infrastructure. The EU's industrial strategy, similar to the UK's focuses on workforce development, sustainability, and digitalisation for the same is investing in batteries, raw material, or semiconductors.

A demonstrative example of subsidies dictated by the industrial strategy are the subsidies provided by the two regions to their car industry. The UK recently provided a subsidy worth €118 million to the car manufacturer Nissan for building an electric vehicle hub in Sunderland[131]. At the same time, the EU has approved €2.9 billion of public support for research and innovation on electric batteries[132] and has agreed to spend €11 billion of subsidies to build three pilot facilities to manufacturer chips in the EU.

Subsidies to the EU's and the UK's own car industry contrast with the strong trade and investment linkages between the two regions in the automotive industry[133]. For instance, the EU is the largest exporter of cars to the UK with a value of €42 billion (86.3% of UK's total imports in cars). Meanwhile, the UK is also the largest exporter of car and car parts to the EU with a value of €15 billion (19% of EU total imports in cars) in 2019. This deep integration between their automotive industry provides a good reason to have the subsidy provisions in the LPF. At the same time, since both regions are subsidizing the car industry, it is possible that the LPF provisions may not even be applied, since both regions will be infringing on their commitments while supporting the same sector.

7.5.2 Environment and climate standards under the LPF provisions

The EU and the UK, have climate protection at the center of their development goals and thus, policy creation. Both have undertaken a number of bold actions on climate, environmental, and energy policy. The EU introduced CBAM (see chapter 4), and has adopted several proposals such as the EU Green Deal and Fit for 55 that will help the EU meet its climate ambitions for a climate neutral economy. The UK, in a similar vein, is including more environment friendly provisions in most of its new policy proposals, with climate protection playing a large role in the UK's new industrial strategy.

Although the two regions have similar environmental standards, the importance of the LPF provisions come to the foreground in the spill-over effects of these policy provisions. The EU and the UK not only share a common biosphere for which climate policies are important but are also economically so integrated that policy provisions in the EU will have spillover

[131] Eliot Wilson, 2021, Nissan's £1bn gambit in Sunderland is worth every penny of subsidies for Boris Johnson, City A.M. Accessed at: https://www.cityam.com/nissan-sunderland-batteries-brexit-boris-johnson/

[132] European Commission, 2021, State aid: Commission approves €2.9 billion public support by twelve Member States for a second pan-European research and innovation project along the entire battery value chain. Accessed at: https://ec.europa.eu/commission/presscorner/detail/en/IP_21_226

[133] HS codes: 8703 Passenger cars, 8704 Transportation vehicles, 8705 Special purpose vehicles, 8711 Motorcycles, 8706 Chassis fitted for engines, 8707 Bodies for special motor vehicles, 8709 Parts & access for motor vehicles.

effects for the UK. For instance, consider carbon pricing. The UK, in May 2021, started its own Emissions Trading System (separate from the EU). UK carbon prices were higher than that of the EU. The UK has also put in place tighter limits on a maximum price for when the government can intervene if prices rise too fast. This could lead to more intervention on part of the UK in lowering their carbon prices, potentially affecting trade in several carbon footprint heavy sectors between the two. LPF provisions can help make sure that these standards in both regions have minimum divergence, and thus minimum externalities for both.

Moreover, since the UK is no longer part of the EU ETS, it will also be subject to the EU CBAM. As seen in Section 2.5, for most products affected by the CBAM, the UK is within the top ten suppliers to the EU. Table 7.1 shows EU imports of these goods from the UK and the percentage share of UK imports in EU's total imports of these products. The UK holds a decent share in the export of all these products to the EU illustrating further the deep interlinkages between the two economies.

TABLE 7.1: EU IMPORTS OF CBAM RELATED GOODS FROM THE UK AND UK MARKET SHARE ON EU IMPORTS

Sector	EU imports from UK (€, billion)	Share of EU imports
Iron and Steel	€3.5 billion	10%
Aluminium	€1 billion	6%
Fertilizers	€0.15 billion	3.4%
Cement	€0.008 billion	2.5%
Electricity	€0.19 billion	4.8%

Source: UN COMTRADE. Authors' calculations.

The EU CBAM is in a way similar to the LPF since it could push the UK to follow a similar policy as the EU, ultimately leading to a convergence between EU and UK standards. Alternatively, it could also lead to the UK compensating its suppliers, similar to how the EU has previously given a free allowance to polluting industries. However, the LPF is well-rounded in that these compensations could be considered subsidies falling under the subsidy control provisions of the LPF. Ultimately, if the UK own ETS lead to UK businesses paying a similar price for their carbon emissions than EU businesses, it would be difficult for the EU to argue that UK firms should pay a carbon duty at the border.

Under environmental standards, a targeted sector could be the chemical sector. Protection against chemicals is included within the environmental and climate LPF provisions. The UK's departure from the EU has also meant its exit from the EU REACH system. The EU REACH is the Registration, Evaluation, Authorization and Restriction of Chemicals regulation, which records the production and use of chemical substances, and its effects on human health and the environment. The UK's exit from this system means that it will have to create its own REACH database which could involve the variation of environmental standards for the purpose of testing, production, and use of chemical substances between both parties. The EU and UK chemical industries are interlinked and these changes in standards could have significant negative impacts for both. In 2019, EU imports from the UK in the chemicals sector amounted to €6 billion and UK imports from the EU amounted to €7.3 billion. These represented 8.3% of EU's total chemical imports and 59% of the UK's total chemical imports respectively.

7.5.3 Other provisions under the LPF approach

Other provisions under the LPF include chapters on competition policy, and taxation. As previously explained, these provisions have rules on equal treatment, information exchange, transparency, and maintaining similar systems between the EU and the UK.

The provisions on labour standards are enforceable, which has usually not been the case between EU FTAs. A failure in enforcing labour laws and standards by either of the parties can be considered a divergence from the existing standard. However, as mentioned before, the LPF provision will not come into play if the divergence from labour laws does not adversely affect trade and investment. In most cases, unless drastic changes are made to the labour laws, the LPF is unlikely to be used.

However, an instance where the LPF might come into play is in the free ports being established by the UK. These special economic zones already enforce lower regulations and are exempt from the UK's main tax and tariff rules to attract more trade and investment. With UK's exit from the EU, the UK will no longer be subject to the EU rules on employment protection and workers' rights. Potentially, anyone working in these freeport areas will be subject to lower labour standards and less job security. Moreover, the Free Ports Advisory Panel set out to determine where the ports will be located has no union representation[134]. These are violations that could be picked up by the LPF since these divergences are taking place to give impetus to trade and investment flows in the UK.

[134] Rosa Crawford, 2020, Brexit - why free ports are a race to the bottom on workers' rights, TUC. Accessed at: https://www.tuc.org.uk/blogs/brexit-why-free-ports-are-race-bottom-workers-rights

7.6 The risk of retaliation

The risk of retaliation to the LPF provisions is limited. Since the LPF provisions fall under the Trade and Cooperation Agreement between the EU and the UK, both sides, in essence, agree to the dispute settlement mechanisms listed in the agreement which includes the possibility of imposing harsher measures such as tariffs and duties. Therefore, most retaliation would take place through the agreement. In cases where the retaliation takes place outside of the agreement, the cost is very high, since the entire agreement can be held hostage. Either party could essentially cancel any part of the agreement in case of conflict.

The LPF provisions would only come into play when the level of divergence causes distortions to bilateral trade and investment flows. Given that the UK was part of the EU, most of its rules and standards are borrowed from the EU and thus match the standards and rules set by the EU. There is, therefore, little probability of a dramatic divergence in the rules between the two regions. The tools under the LPF in any case are designed to ensure management of future convergence and divergence of standards. The LPF is thus, seen more as a guideline for what the standards should be rather than something which will be strictly implemented.

8. THE UPDATED ENFORCEMENT REGULATION FOR TRADE DISPUTES

8.1 What is the Updated Enforcement Regulation for Trade Disputes?

Trade conflicts are increasingly infused with political power struggles. Over the last few years, many of the high-level trade conflicts have emerged in response to political reasons and not just because there exist pure trade frictions. The European Union has for long expressed its worry that, in a world without secure dispute settlements, there are risks for Europe's interests – governments as well as firms. For that purpose, the European Union has sought to reassess its commercial policy and create different regulatory mechanisms with the objective of providing certainty and addressing matters of unresolved trade disputes.

This motivation was behind the European Commission's proposal to amend the "Enforcement Regulation" 625/2014[135] of 15 of May 2014 with a focus on the rights of application and enforcement of international trade legislation. As a result, the updated version 2021/167[136] will enable the EU to act more assertively by "suspending or withdrawing concessions or other obligations under international trade agreements in order to respond to breaches by third countries of international trade rules that affect the EU's commercial interests."[137]

Chiefly, the amendments to the Enforcement Regulation (ER) will grant the EU the right to action in response to a measure maintained by a third party, and when the dispute settlement adjudication is blocked for non-cooperative reasons by this third party. A typical example given by the European Commission is when the adoption or implementation of a panel ruling is denied by another country. Accordingly, this regulation will empower the European Commission to adopt countermeasures or suspend concessions even when there is a failure to implement a panel in the WTO because of paralysis in the Appellate Body. Likewise, the ER would apply when an analogous situation arises under other international trade agreements, which is when a third party does not cooperate by either failing to appoint an arbitrator or when there is no mechanism to secure the dispute settlement.[138]

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[135] European Commission, 2014, Regulation concerning the exercise of the Union's rights for the application and enforcement of international trade rules, EU (654/2014). Accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX-:02014R0654-20151105&from=EN

[136] European Commission, 2021, Regulation concerning the exercise of the Union's rights for the application and enforcement of international trade rules, EU (654/2014). Accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0167&from=EN

[137] European Parliament, 2021, Review of EU enforcement Regulation for Trade Dispute. Accessed at: https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/652021/EPRS_BRI(2020)652021_EN.pdf

[138] European Commission, 2021, Regulation concerning the exercise of the Union's rights for the application and enforcement of international trade rules, EU (654/2014), Art 1.4. Accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0167&from=EN

One of the most substantial changes in the amended Enforcement Regulation is the recognition that trade in services and intellectual property rights (IPRs) plays a larger role in current global trade. For that matter, the scope of available trade policy measures was expanded to include concessions or other obligations in not just goods but also services and IPRs.

8.1.1 Context

The Updated Enforcement Regulation is anchored in observed and structural problems at the WTO. First, the WTO's dispute-settlement system has been paralysed by the failure to appoint new members to its Appellate Body. Second, the WTO has been unable to act through negotiation and the improvement of rules to deter members taking unilateral measures. Since the initial Enforcement Regulation does not deal with situations where a dispute settlement mechanism is blocked, the EU has sought to incorporate the right to action in its domestic legislation. According to EU officials, this approach does not diminish the role of the WTO; nor does it stand in the way of WTO modernization. The European Commission argues that the new Enforcement Regulation will principally introduce new flexibilities to a system that remains blocked.[139]

Would measures taken under the new Enforcement Regulation be consistent with WTO rules? It is possible, but not guaranteed. The WTO rules foresee general exceptions allowing unilateral trade restrictions under Article XX of the GATT and Article XXI of the GATS. For instance, measures to protect public morals, human life, animal or plant life or health, conservation of natural resources, and to prevent fraudulent practices. Furthermore, the rules governing the Dispute Settlement Understanding (DSU) in the WTO include the possibility for a member to suspend concessions if the respondent in its complaint fails to move policy to be compliant with WTO rules. However, the DSU is built on the presumption that the dispute-settlement system is functioning, and that both a Panel and the Appellate Body can issue their opinions. It does not provide for unilateral action in the event of a non-solution to a Panel report that has been appealed. There is also a history in the WTO of complaints against a member's method of suspending concession in trade disputes. Hence, measures that the EU could take under the Updated Enforcement Regulation may be challenged as discriminatory either by the MFN or national treatment clauses, or for the imposition of additional non-tariff restrictions to trade.

[139] European Commission, 2019, Commission reinforces tools to ensure Europe's interests and international trade. Accessed at: https://ec.europa.eu/commission/presscorner/detail/en/ip_19_6748

8.2 Legal basis, subsidiarity, and proportionality

The domestic legal basis for this initiative is Article 133[140] of the Treaty of establishing the European Community – the common commercial policy – and Article 308 which also vests powers in the Council to act unanimously on a proposal from the Commission and after consulting the European Parliament. Additionally, the amended version of the Enforcement Regulation is based on the Article 207[141] of the Treaty of the functioning of the European Union (TFEU) which stipulates that for the negotiation and conclusion of agreements in the fields of trade in services and the commercial aspects of intellectual property, the Council should act unanimously.

Under the treaty of Lisbon, the Ordinary Legislative Procedure is the general rule for passing legislation at the EU level. This means that the adoption of any legislation is done jointly by the Parliament and the Council. The legislative procedure begins with the submission of a proposal by the Commission to the Parliament and the Council. However, it is the Parliament that has to act first by approving the Commission's proposal without amendments, modifying or rejecting it. Then, the Council may decide to approve that position, leading to the adoption of the act. In the event that the legislation is rejected or amended by the Council, it has to communicate this resolution to the Parliament for a second reading.

These legal aspects are important. The Updated Enforcement Regulation includes the potential suspension of concessions in services and intellectual property. But for issues related to international aspects of these matters, the Council has to vote unanimously.[142] As explained below, the application of this regulation to trade in services and intellectual property rights may be contentious.

8.2.1 The EU's ability to act on trade in services

The inclusion of services as part of the Updated Enforcement Regulation is reasonable as services represent 54% of EU total exports[143]. However, a closer look at the EU multilateral and bilateral trade negotiations in services[144] shows that, in reality, the EU's exclusive competence on commercial policy is blended with member states domestic preferences. For

[140] Treaty establishing the European Community (Amsterdam consolidated version) - Part Three: Community policies - Title IX: Common commercial policy - Article 133 - Article 113 - EC Treaty (Maastricht consolidated version) - Article 113 - EEC Treaty. Accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A11997E133

[141] Treaty on the Functioning of the European Union, Article 207(4). Accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN

[142] European Council, Unanimity. Accessed at: https://www.consilium.europa.eu/en/council-eu/voting-system/unanimity/

[143] Cernat, L. (2021). We need to talk trade and technology! (No. 8/2021). ECIPE Policy Brief.

[144] Services are usually defined by a list of activities which are considered to be services. The WTO identifies two main categories of services: business services; communication services; construction and related engineering services; distribution services; educational services; environmental services; financial services; health related and social services; tourism and travel related services; recreational, cultural and sporting services; transport services; and other services not elsewhere included. The list clearly shows that a wide range of economic activities are considered services.

example, when the EU negotiates the liberalisation of services, EU member states include specific clauses that indicate their degree of openness in each service sector. Table 8.1 presents examples of member states market access[145] reservations in the liberalisation of services negotiated in the EU-Korea Free Trade Agreement. The table shows that in trade in services, unlike trade in goods where there is a common external tariff, each EU member state commits to different degrees of trade liberalisation that caters to their own domestic regulations and sensitivities.

TABLE 8.1: EXAMPLES OF SERVICE RESERVATIONS IN EU-KOREA FREE TRADE AGREEMENT

Sector	Mode	Country	Reservations
Legal services	Mode 1 and 2	AT, CY, ES, EL, LT, MT, SK	Full admission to the Bar is subject to a nationality condition.
	Mode 3	AT	Korean lawyers' (who must be fully qualified in Korea) equity participation and shares in the operating results of any law firm may not exceed 25%.
	Mode 4	BG	Korean lawyers can only provide legal representation services of a Korean national and subject to reciprocity and cooperation with a Bulgarian lawyer.
Engineering service	Mode 1	BG, CY, EL, IT, MT, PT	No market liberalisation.
	Mode 3	BG	For projects of national or regional significance, Korean investors have to act in partnership with or, as subcontractors of, local investors.
	Mode 4	EE	At least one responsible person must be resident in Estonia.
Advisory and Consulting services incidental to Agriculture, Hunting and Forestry	Mode 1	EE, MT, RO, SI:	No market liberalisation.
	Mode 4	IT	Residency requirements for agronomists.
Distribution Services	Mode 1 and 2	BG, FI, PL, RO, SE	No market liberalisation for distribution of alcoholic beverages.
	Mode 3	FI	No market liberalisation for distribution of alcoholic beverages and pharmaceutical products.
Education services (privately funded)	Mode 1	AT, BG, CY, FI, MT, RO, SE	No market liberalisation in higher education.
	Mode 3	CZ, SK:	Nationality condition for the majority of members of the board.
	Mode 4	EL	Nationality condition for teachers for primary teachers.

[145] We use market access to refer to measures that impede trade in services such as market access, national treatment, and additional commitments and limitations.

Sector	Mode	Country	Reservations
Financial services	Mode 1	AT, BE, CZ, DE, DK, ES, FI, FR, EL, HU, IE, IT, LU, NL, PL, PT, RO, SK, SE, SI	No market liberalisation for direct insurance services except for insurance of risks relating to maritime shipping and goods in international transit.
	Mode 3	RO	Branches of foreign institutions are not allowed to provide asset management services.
	Mode 4	AT	The management of a branch office must consist of two natural persons resident in Austria
Services auxiliary to Maritime Transport	Mode 1	EU	No market liberalisation for maritime cargo handling services and pushing and towing services
	Mode 3	FI	Services can be provided only by ships operating under the Finnish flag
	Mode 4	AT	Nationality condition for the majority of managing directors

Source: EU-Korea Free Trade Agreement. page 1,162-1,245.

The flexibilities included in the liberalisation of trade in services presented in Table 8.1 are also a feature of the multilateral trading system in services and appear in EU Free Trade Agreements. Acknowledging these flexibilities provides a wider context to understand the implementation of the Updated Enforcement Regulation, as well as the Anti-Coercion Instruments. The various degrees of trade liberalisations in services across EU's member states are important because they could lead to a situation where, if the EU were to impose trade restrictions in services, the same measure would have different consequences in terms of market access restrictions across the EU. Moreover, these differences can be wider because the actual level of openness in international trade in services in some member states is larger than what they have committed to in international agreements[146].

This distinction between de jure and de facto level of openness in services is important because, when applying the Updated Enforcement Regulation or the Anti-Coercion Instrument, the EU may not break any international obligation since commitments on market openness in services are limited when compared to the actual level of openness but may impose varying costs across EU member states. The same is true when antidumping or countervailing duties lead to higher EU tariffs on imported goods: the impact across EU member states is stronger in those member states that are larger importers of the affected goods. Nonetheless, there is an important difference between goods and services. When the EU imposes a restriction on services, it is entering the regulatory competence of the EU's member states. This is recognised

[146] At the WTO level, members have the possibility of modification or withdrawal of service commitments. However, the modifying member must negotiate compensatory adjustments, made on a Most Favourable Nation (MFN) basis, at the request of any member that considers to be affected by the modification or withdrawal. S/L/80, Procedures for the Implementation of Article XXI of the General Agreement on Trade (Modification of Schedules) (Adopted by the Council for Trade in Services 29 October 1999) para. 3.

in the liberalisation of services as shown in Table 8.1, but it is not acknowledged in the regulation of the Updated Enforcement Regulation or the Anti-Coercion Instrument [147].

It is difficult to predict how the restrictions of market access in services in the Updated Enforcement Regulation will work in practice. However, there is a risk that, as a result of the novelty of the measure, the unclarity over subsidiarity, and the various levels of impact across member states, the application of market restrictions in services is challenged by member states or firms. Yet, it is also for that reason that, if the EU decides to use market access restrictions for services under the Updated Enforcement Regulation or for that matter the Anti-Coercion Instrument, the EU will choose a service sector and a mode of supply in which the potential for controversy in the application of the measure is minimised.

In relation to the modes of supply, mode 1 (cross-border supply) and mode 3 (commercial presence) are the largest in terms of value and therefore the more likely to be impacted by a market restriction in services. Mode 1 has become more prevalent due to the digitalisation of the economy. Thanks to the Internet, many professional services – from architectural, engineering, or consulting to business support – are delivered cross-border. Mode 3 includes Foreign Direct Investment (FDI) and represents the largest mode of service delivery. Traditionally, FDI has been seen positively and governments have actively tried to attract investment from abroad and for that reason legal limitations are fewer, particularly in manufacturing. However, the idea that all FDI is positive has been challenged and EU legislation such as the EU FDI Screening Regulation or the Foreign Subsidy Instrument – see chapter 5 – have put limits to FDI. Mode 2 (consumption abroad) is relatively small and includes tourism for which the EU is unlikely to pursue restrictions. Mode 4 (temporary stay in another country to supply services) is also relatively small but it is a mode where EU-wide restrictions are easier to apply, and these restrictions have a direct impact on bilateral trade. Restriction on mode 4 could include measures to reduce the number of working visas for professionals that support the delivery and installation of goods like a sophisticated machine or services like a large IT project. The recent EU sanctions on Russia as a result of Russia's invasion of Ukraine includes restrictions in the provision of services (see Box 2.1).

Across sectors, financial services and transport are two sectors where the EU could apply restrictions. This is because these two sectors represent a significant part of a country's economy and because market commitments at the multilateral and bilateral level are relatively modest so the EU could restrict market access without violating international rules. Restrictions in these sectors could include limitations on financial transfer, loans, the ability to open a branch, as well as restrictions in the transportation of goods and passengers.

[147] Articles in the Updated Enforcement Regulation and the Anti-Coercion Instrument argue that the EU has the exclusive competence as per Article 207 of the Treaty of the Functioning of the European Union.

8.2.2 The EU's ability to act on Intellectual Property Rights (IPRs)

Expanding the scope of the Enforcement Regulation beyond goods and services, and including Intellectual Property Rights (IPRs), demonstrates not only their importance for the EU economy as whole, but also where trade policy is headed in the near future. It is estimated that 45% of the EU's total economic activity is generated by industries which rely on IPR. Likewise, these sectors provide almost 39% of total EU employment.[148] Over the last two decades the volume of annual investments in IPRs has increased by 87%. This trend has been persistent in sectors where EU business are world leaders such as clothing, luxury goods and pharmaceuticals.

However, the ability and competence of the European Commission to act on IPRs are limited both by existing EU law covering IPRs and international treaties on IPRs that the EU and EU member states have signed. And this is not only the case when it comes to the updated enforcement regulation for trade disputes, but the same considerations are relevant for IPR aspects of the Anti-Coercion Instrument.

Take for example the case of EU law on IPRs which deals with copyright (covering literary works, films, and music) as well as industrial property rights (covering patents, trademarks, designs, and geographical indications).[149] Table 8.2 provides an overview of the main legal instruments on trademarks, industrial designs, and geographical indicators in the EU.

TABLE 8.2: MAIN LEGAL INSTRUMENTS IN THE EU

Trademarks	▪ European Union Trademark Regulation (EUTMR) ▪ Directive approximating the laws of the Member States relating to trademarks
Industrial Designs	▪ Community Designs Regulation (CDR) ▪ Directive on the legal protection of designs
Geographical indicators	▪ Agricultural products and foodstuffs Regulation ▪ Wines regulation ▪ Spirits drinks regulation ▪ Aromatised wines regulations

There are no existing provisions in these relevant legal instruments for a revocation of a right for political motivations. For example, the EU trademark law only contains provisions which deal with revocations and cancellations where there is a counter claim that invalidates the application of an EU trademark. And the same is true for legal instruments covering

[148] Erixon, F. et al, 2022. The Benefits of Intellectual Property Rights in EU Free Trade Agreements. Accessed at: https://ecipe.org/wp-content/uploads/2022/01/OP0122_Paper.pdf

[149] A geographical indication is a sign that is used in some products, indicating that they have a specific geographical origin and possess qualities that are due to that origin. They are typically used for agricultural products, wines, spirits, and handicrafts. It is important to note that geographical indications are the term that is used in the TRIPS agreement. In other treaties, this type of IP takes a different name. For instance, "Appellation of Origin" is used in the Lisbon Agreement for the Protection of Appellations of Origin and in the Geneva Act of the Lisbon Agreement on Appellations of Origin and Geographical Indications. See: https://www.wipo.int/geo_indications/en/

other types of IPRs in the EU. This affects the EU's ability to reduce or interfere with the moral right that comes with intellectual property protection – for instance by demanding the EUIPO to invalidate trademarks held by companies with jurisdiction in a country the EU seek redressive or retaliatory measures against. The legal instruments of EU law on IPRs do not provide the European Commission with the ability to act under Article 207[150] of the TFEU in such circumstances. It may be possible that the EU could take sanctions measures that would include the moral aspects of IPRs, but that would then have to be decided on the legal basis of the Common Foreign and Security Policy.

There are areas where the EU does have competence under Article 207 of the TFEU, and this is the case when it comes to trade-related aspects of IPRs. However, also here the ability of the EU is limited both by multilateral as well as bilateral and regional agreements that include provisions on IPRs and for which the EU is a member.

At the multilateral level, the EU takes an active participation in the global efforts to protect and enforce Intellectual Property Rights as a member of both the World Trade Organisation (WTO) and the World Intellectual Property Organisation (WIPO). At the WTO, the agreement that governs IPRs is the Agreement on Trade-Related Aspects of Intellectual Property Rights.[151] Since intellectual property takes many forms, the TRIPS agreement looks at several kinds of property rights and how to protect them under a single legal framework. Most of these measures were taken and upgraded from past international agreements, such as the Paris Convention for the Protection of Industrial Policy and the Berne Convention for the Protection of Literary and Artistic Works.

These treaty obligations are important for informing what measures the EU can take. As a member of the WTO and signatory of the TRIPs agreement, the EU is committed to principles of equal treatment and non-discrimination to other WTO members. Certainly, some exceptions are foreseen regarding the suspension of the rights or concessions of intellectual property, but they are pretty specific and not applicable in this context. Even if the EU has competence to act, these commitments under the WTO limit its ability to do so.

The EU's ability to act is also limited by its treaty obligations as a member of WIPO. WIPO administers a total of 26 treaties on intellectual property, including the WIPO convention, which are grouped into three categories. The first category relates to intellectual property protection. These treaties define basic standards for intellectual

[150] European Commission, 2022. Consolidated version of the Treaty on the Functioning of the European Union — Art. 207. Accessed at: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E207:en:HTML

[151] WTO, 2022. TRIPS — Trade-Related Aspects of Intellectual Property Rights. Accessed at: https://www.wto.org/english/tratop_e/trips_e/trips_e.htm

property protection. Examples of this first group are the Beijing Treaty on Audiovisual Performances (2012) and the Singapore Treaty on the Law of Trademarks (1994). The second category of treaties is known as 'the global protection system' as it ensures that one international registration will have an effect in any of the relevant signatory states, which simplifies and reduces the cost of making individual applications. The main treaties that fall in this category are the Hague Agreement Concerning the International Registration of Industrial Designs (1925), the Madrid Agreement Concerning the International Registration of Marks (1989), and the Lisbon Agreement for the Protection of Appellations of Origin (2015). Lastly, the third category of treaties provide systems that organize and classify information concerning inventions, trademarks, and industrial designs. These examples illustrate that there is a variety of IPR conventions that underpin both the WIPO convention itself and the WTO TRIPs, and these conventions are of importance for the measures that the EU can take. Also note that WIPO offers an Arbitration and Mediation Centre as an alternative dispute resolution. This avenue of dispute resolution can be considered by the EU to solve disputes before activating trade defence measures on IPRs.

In addition to these multilateral treaty obligations, the EU has to act in conformity with existing regional and bilateral treaty obligations. The EU has adopted a revised strategy of the Intellectual Property Rights in Third Countries, and has concluded a series of bilateral and regional trade agreements which include IPR chapters.

In most bilateral or regional agreements negotiated by the EU, there are chapters and disciplines for IPRs that go beyond existing commitments in the TRIPs agreement and are often referred to as TRIPs+ commitments. For instance, the EU-Canada Comprehensive Economic Trade Agreement (CETA) covers broader aspects of IPRs.[152] The CETA IP chapter not only takes up provisions from previous multilateral agreements, but also outlines procedures to protect against intellectual property violations and defines areas where both parties can cooperate further. The key point here is that these bilateral and regional treaty obligations also have to be taken into account by the EU and can thus further limit its ability to act, also when it comes to trade-related aspects of IPRs where the EU has competence and where Article 207 does apply.

Another general problem concerns the international nature of protected intellectual property. The intellectual property is separated from the actual product and often from the seller of a product: the intellectual property content of a product is often a combination of several different owners. For instance, while the seller of a product owns its trademark, it does not necessarily own the other intellectual property – the

[152] European Commission, 2022. CETA chapter by chapter. Accessed at: https://ec.europa.eu/trade/policy/in-focus/ceta/ceta-chapter-by-chapter/

copyrights, patents, designs, or the GIs of the same product. The denial of treaty-based intellectual property protection for one country may easily hurt owners of intellectual property in other countries.[153]

Furthermore, another issue related to the EU intellectual property system itself is that efforts to create a unified system to provide better protection of intellectual property have fallen short. This has to do in large respect because the EU's intellectual property system remains too fragmented, as some European patents such as pharmaceuticals are only protected at a national level, and sometimes subjected to expensive national validation procedures and parallel litigation in multiple EU countries. This point is substantial to understand the limitations to suspend tariff concessions or benefits on trade-related aspects uniformly at the EU level. It remains vague how the instrument will work on a general level.

The inclusion of services and intellectual property rights is not straightforward. In principle, the entire scope of services outlined in the GATS is likely to be subject to the regulation, including cross-border trade, consumption abroad, commercial presence, and presence of natural persons. Similarly, all trade-related aspects of intellectual property rights covered in the WTO TRIPS agreement should be covered, as well as those types of intellectual property rights included in bilateral or regional trade agreements to which the EU is a party if those agreements are relevant for the activation of the new Enforcement Regulation. But the important point is that context and scope are key for a determination on whether the EU has the competence to act under article 207 regarding trade in services and specific aspects of IPRs, and to what extent its ability to act is limited by existing multilateral, regional or bilateral treaty obligations.

8.3 How will the Updated Enforcement Regulation work?

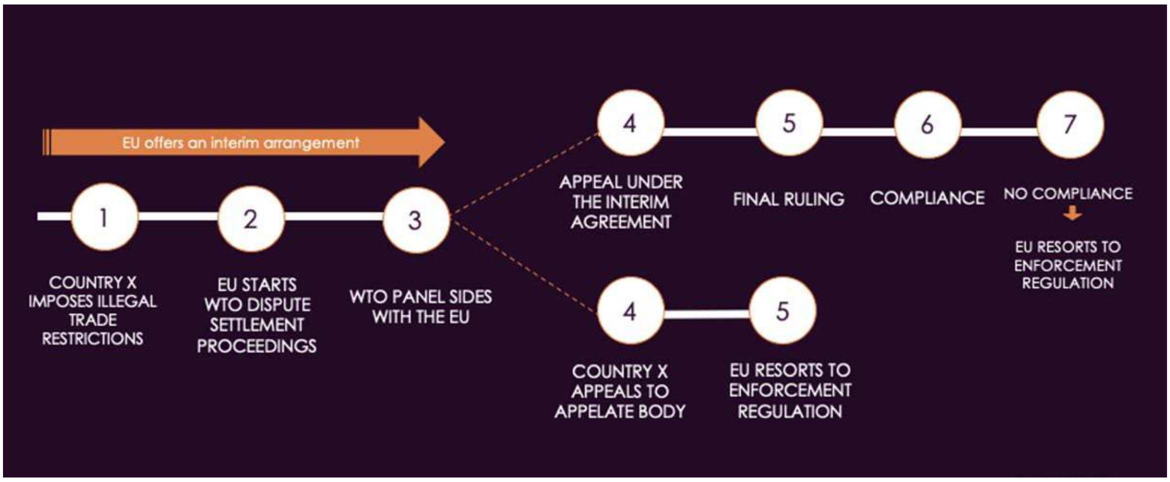
The revised Trade Enforcement Regulation entered into force in February 2021, and it will be reviewed by the Commission within a year after entry. Henceforth, and until the situation at the Appellate Body is solved, the Enforcement Regulation will ensure the coherent application of the enforcement mechanism in trade disputes, as well as the EU's suspension of concessions or adoption of countermeasures. So far, the EU has only explained what the procedural route for cases brought at the WTO would be. Hence, it is still unclear how the Enforcement Regulation would be applied in a specific bilateral or regional agreement.

For instance, in cases brought to the WTO, the procedure will be the following. First, if a country X imposes an illegal trade restriction, the EU will start the WTO's dispute

[153] Commission officials seem uncertain about how measures in services and IPRs could be taken under the Updated Enforcement Regulation. This was not part of the Commission's proposal and was effectively added by the European Parliament. The Parliament observed that services and IPRs are important parts of international law and hence should be part of a package of enforcement policies. However, it did not propose methods for how measures in services and IPRs would be taken in practice.

settlement procedures. Then, if the WTO panel sides with the EU, there would be two routes for which the case could be appealed. Since the EU is among the members who have joined the Multiparty Interim Appeal Arbitration Agreement (MPIA), country X could appeal to the paralyzed WTO appellate body, or if country X is among the 24 members which have joined the MPIA, it could appeal under this interim agreement. In the event that the appeal is taken to the MPIA, this mechanism will determine the final ruling and its compliance. However, if country X does not comply with this ruling, the EU will have the right to implement countermeasures based on the Enforcement Regulation. Finally, if country X is not a member of the MPIA and appeals to a paralysed Appellate Body in the WTO, the EU will resort to the Enforcement Regulation, in order to implement the appropriate countermeasures or suspend concessions to country X.

FIGURE 8.1: PATHWAYS FOR THE EU ENFORCEMENT REGULATION



Source: WTO.

When the EU resorts to the Enforcement Regulation, the Commission will make a proposal for what countermeasures to take. It may also decide not to take a countermeasure. Before the countermeasures are approved by member states, the targeted country will be consulted.

8.4 The EU's ability to act

While the new regulation gives stronger powers to the EU to act in trade policy, it also raises issues about the European Union's unilateral approach. It is possible that countries that are targeted would challenge the incompatibility of the Enforcement Regulation with EU obligations under the WTO rules that determine the procedures for the Dispute Settlement Understanding and establishes the rules for redressive action.

Currently, there are five disputes in which the involved parties have agreed procedures for arbitration under article 25 of the Dispute Settlement Understanding (DSU) – which allows for the alternative MPIA route. But only one of those (Colombia – AD Duties on French Fries [DS591]) involves the European Union, as a complainant. This does not mean that these are the only ongoing disputes involving the EU, but rather those that have acknowledged the MPIA as the appeal body. Certainly, there will be more uncertainty about EU action in those disputes that may arise and cannot use the MPIA, or in those cases that are currently under appeal at the paralyzed WTO Appellate Body. This is the case of a complaint against Turkey (DS583) related to violations of technology transfer requirements, and which is unresolved.

This case illustrates one of the major complexities in the Enforcement Regulation: its inclusion of trade in services (GATS) and intellectual property rights (the TRIPS agreement). The case against Turkey concerns IPRs. Moreover, in the latest report from the European Commission on the protection and enforcement of intellectual priority rights in third countries,[154] a list of "priority" countries was established. These countries were ranked in 3 different categories, depending on the scale and persistence of problems of IRP protection and enforcement.

From that list, only 4 out of 13 countries have joined the MPIA,[155] which means that in the event of a future trade dispute with one of the "red flag" countries, there is only the WTO route for dispute settlement. The main concern for IPR violations is China, but it is among the countries which have agreed to pursue arbitration under article 25 of the DSU. The next group of priority countries are India, Russia and Turkey, but since none of them have joined the MPIA the EU may have to go to the Enforcement Regulation to manage those disputes.

8.5 The potential impact of the Updated Enforcement Regulation

The new Enforcement Regulation attempts to fill a gap in the dispute settlement mechanism at the WTO caused by the crisis in the Appellate Body. In essence, the new Enforcement Regulation will impact trade, investment, and procurement in the same way that Appellate Body decisions did.

The specific amount of trade, investment, and procurement affected by the new Enforcement Regulation, however, will differ on a case-to-case basis. Similar to the ACI (see chapter 2),

[154] European Parliament, 2021, Report on the protection and enforcement of intellectual property rights in third countries, Staff Working Document (2021) 97 Final. Accessed at: https://trade.ec.europa.eu/doclib/docs/2021/april/tradoc_159553.pdf

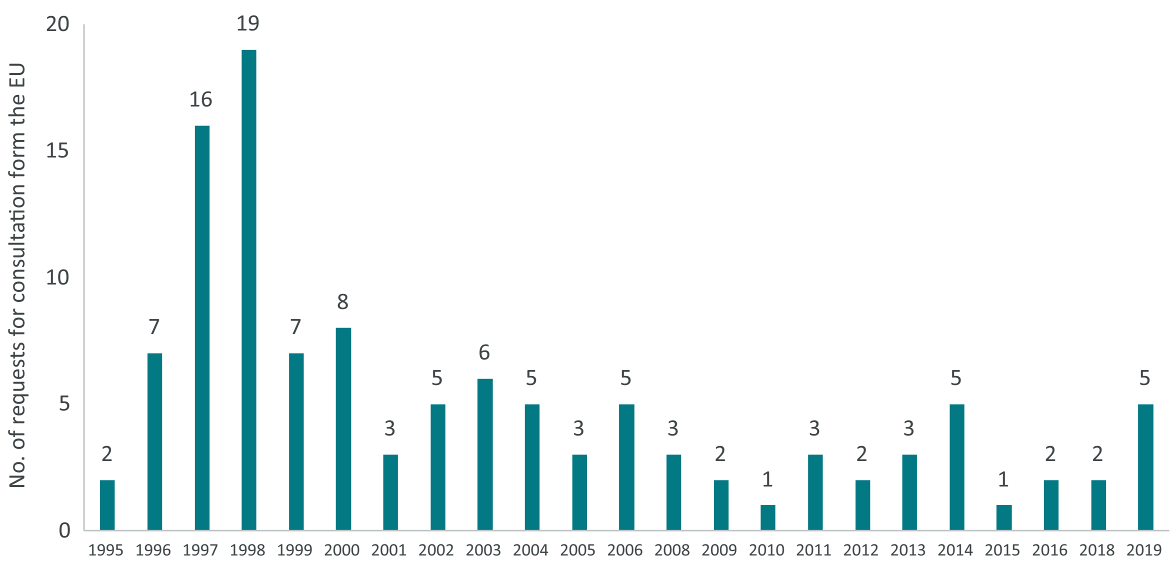
[155] China, Brazil, Ecuador and Ukraine.

Article 4[156] of the updated regulation requires countermeasures to be equal – not exceeding the nullification/impairment of EU's commercial interests. Based on this like-for-like approach the potential impact of the new Enforcement Regulation will be more targeted in combatting trade coercion and non-cooperation.

8.5.1 The EU as a user of the dispute resolution mechanism

Since the new Enforcement Regulation will be applicable to cases that have been blocked at the WTO for resolution, a good indication of the amount of economic flows that will be impacted by the regulation is the number of complaints made by the EU at the WTO Dispute Settlement Body. The EU has been a frequent user of the WTO dispute settlement mechanism. Since its inception in January 1995, there have been a total of 598 requests for consultations as of 31st December 2020. Out of these, the EU was responsible for 115 of the requests, i.e., close to 20%. Figure 8.2 shows the number of complaints from the EU per year since 1995. The highest number of requests were in 1998, but since the 2000s the number of requests have averaged close to 3 per year.

FIGURE 8.2: NUMBER OF REQUESTS FOR CONSULTATIONS MADE BY THE EU PER YEAR (1995-2019)



Source: WTO.

An even better indicator of the trade flows impacted by the new Enforcement Regulation is the number of cases brought by the EU that reached the Appellate Body. The working of the WTO dispute settlement mechanism is such that disputes are initiated through a formal

[156] European Commission, 2021, Regulation concerning the exercise of the Union's rights for the application and enforcement of international trade rules, EU (654/2014), Art 4. Accessed at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0167&-from=EN

request for consultations, whereby the complaining member invites the member whose measures are being challenged to discuss the disputed matter. As mentioned before, between 1995 and 2020, the EU requested for 115 consultations. If through the consultations, the member countries are unable to resolve the dispute, the complainant can request the establishment of a panel to review the complaint. In the period between 1995 and 2020, 58 of the consultation requests led to the establishment of a panel.

The panel then comes out with the ruling and either party associated with the complaint can register an appeal if they do not agree with the panel's ruling. From the total number of EU complaints, 39 appellate body reports were implemented. Between 1995 and 2020, therefore, close to 27% of the consultation requests were forwarded to the Appellate Body in the form of a notified appeal. Since the new Enforcement Regulation accounts for the cases that should have been brought to the WTO Appellate Body before it stopped operating, we could extrapolate that 27% of the EU's trade disputes could be addressed by the new Enforcement Regulation.

The EU, however, is also part of the Multiparty Interim Appeal Arbitration Agreement (MPIA). In reality, some EU dispute cases will also go through the MPIA, while the rest could be subject to the new Enforcement Regulation. Even the ones that do go through the MPIA, in cases where there is no compliance with the final ruling, will also become a target of the new Enforcement Regulation. A more precise estimate of the trade and investment flows affected by the new regulation will therefore be slightly lower than the 27% estimated above, in order to take account of the MPIA.

Countries most often at the receiving end of the EU complaint include the United States, India, Argentina, and China. Table 8.1 shows the number of cases and percentage share of countries against which the EU has filed complaints. The United States accounted for 31% of the total EU cases, leading by a large margin. It was followed by India (9.5%), Argentina (7%), and China (6%). Out of these however, only 15 of the cases against the United States were taken to the Appellate Body, and 2 against Korea, Russia, and Argentina. Russia and Argentina have also been more recent targets of EU complaints going to the Appellate Body, whereas there have been continuous cases against the United States over the entire period.

TABLE 8.3: EU CASES BY COUNTRY AND STAGE OF DISPUTE SETTLEMENT (1995 AND 2020)

Countries	Request for Consultation	Appeal Notified
United States	31	15
India	11	1
Argentina	8	2
China	7	1
Japan	6	1
Canada	5	1
Russia	5	2
Mexico	4	0
Korea	4	2
Brazil	3	1
Indonesia	3	0
Thailand	2	1

Source: WTO.

In terms of sectors, the EU has had the greatest number of cases against different countries in the automotive sector. This includes cases on auto parts, cars, commercial aircrafts, and certain vessels. And this is not a new phenomenon. EU cases concerning automotive are spread out throughout the period. The automotive sector is followed by the alcoholic beverages sector. EU cases in this sector have targeted countries such as Chile, Korea, India, Philippines, and Colombia. These have also been happening throughout the period between 1995 and 2020. Other prominent sectors have been the telecoms sector, especially in terms of telecom procurement rules (but they were more popular in the 1990s), the textiles and apparels sector including leather and hides, and the agricultural sector which includes meat and dairy products specifically. EU cases against the United States in recent times have mostly concerned steel tariffs and anti-dumping duties.

The new Enforcement Regulation also has provisions for cases involving trade in services and intellectual property rights. Between 1995 and 2010, the WTO dispute settlement system handled 42 cases on intellectual property rights, and 30 cases on GATS. Although these cases represent a small percentage of the total number of cases taken up with the WTO dispute settlement mechanism, the inclusion of these provisions in the new Enforcement Regulation might be for futureproofing. The Appellate Body crisis might take time to be resolved. Recognizing this, and taking into account the changing nature of trade, i.e., the increasing importance of trade in services and intellectual property, has led to the EU including these new provisions in the amendment of the regulation. There were 5 EU cases on intellectual property rights, and 2 cases on trade in services between 1995 and 2020. China had one case in each category. Other countries targeted in this regard included India, Canada, US, Turkey, and Russia.

8.5.2 The EU imports affected by the Updated Enforcement Regulation

The amount of EU imports affected by the regulation will depend on two factors:

1. The number of dispute cases that are stuck in a gridlock at the Appellate Body and cases where there is no compliance with the ruling of the MPIA.
2. The amount of EU trade and investment impaired by the trade measures of the country against which the complaint has been lodged.

This is because the enforcement follows a like-for-like approach and at the same time only targets dispute cases where no resolution has been received and won't be for a long time.

To understand the amount of trade that might be affected by the new Enforcement Regulation, we look at previous cases that the EU took to the WTO dispute settlement body and analyze the amount of EU trade that was impacted from the trade measures undertaken by the partner country. Table 8.2 shows these figures for five EU cases. For instance, Indonesia banned exports of certain raw materials for the development of its own industries. The EU requested a consultation in 2016. The value of trade of the relevant products between Indonesia and EU before the ban and the consultations was close to €1.2 million. Similarly, countries such as Colombia and the United States imposed anti-dumping duties on EU exports of frozen fries, olives, and spirits. These were all contested by the EU in the WTO dispute resolution body. For all of the cases listed below, a panel has been established, but no further steps have yet been taken to resolve the issue.

TABLE 8.4: EU COMPLAINTS AT THE DSM, COUNTRIES AND IMPORT VALUES AFFECTED.

Case	Country Affected	Type of Trade Affected	Amount of Trade Affected
WT/DS592/4	Indonesia	Raw Materials (Nickel)	€1.2 million (2014)
WT/DS591/3	Colombia	Frozen Fries	€22.5 million (2017)
WT/DS582/11	India	ICT Products	€13.2 billion (2017)
WT/DS577/8	United States	Olives	€0.05 million (2016)
WT/DS502/6	Colombia	Spirits	€7.7 million (2014)

Source: WTO Dispute Settlement, UNCOMTRADE. Authors' calculations.

All these cases are instructive for the new Enforcement Regulation, since when it is introduced, the EU will have the flexibility to choose its retaliation instrument on a case-by-case basis, responding in an equal and proportional manner. Therefore, by being able to establish how much of EU trade is usually affected in its complaints to the WTO, it gives us an idea of the trade consequences when the new enforcement regulation is applied. These complaints differ in the kind of sectors and the amount of trade they impact. Sectors vary from agriculture to ICT products, while the value of imports vary from €1.2 million to €13.2 billion.

8.6 The risk of retaliation

The nature of the Updated Enforcement Regulation makes it a target for retaliation. This is because the regulation itself targets disputed cases without waiting for a resolution. This is bound to heighten the dispute. Retaliation could take place in two ways. Countries can either retaliate with their own measures against the EU enforcement regulation measures or announce their own measures against the EU cases also pending at the WTO Appellate Body.

Between 1995 and 2020 there were 91 cases against the EU at the WTO. Out of these 17 made it to the Appellate Body. Partner countries facing EU measures under the new Enforcement Regulation could easily establish their own enforcement regulation under which they could target the EU. These countries include Indonesia, United States, China, Russia, Argentina, Brazil, and Canada.

The EU is also the leading proponent of the MPIA, and thus will endeavor to solve most of its trade disputes through the established mechanism. However, countries outside of this mechanism, that are hurt by EU measures, could very well respond with their own countermeasures. For instance, India, United States, Argentina, and Russia are not part of the MPIA. Given the large number of EU complaints against these countries in the past, there is a risk of retaliation outside of this mechanism from these countries.

Moreover, given the flexibilities of the regulation, the instrument can also be treated as a political tool. The EU will have the freedom to choose the cases where it will respond with trade measures. This could risk further complaints and retaliation from partner countries. This will depend on how the EU determines the cases to be targeted by the enforcement regulation. There is already a distinction in how the EU approves cases on services and IPR, and cases on trade in goods. The more cumbersome this process is, the greater the risks that the instrument will be politicised.

9. DEFORESTATION INITIATIVE

9.1 What is the Deforestation Initiative?

The global level of deforestation remains high, with significant environmental, economic and social impacts as a result of it for the EU and beyond. More than 1.6 billion people are estimated to be directly dependent on forest resources for their livelihood and forests are the home of 80% of global terrestrial biodiversity. Each year, deforestation accounts for more greenhouse emissions than the EU economy in total.[157] However, the EU remains a major importer of forest-risk commodities (FRCs), such as meat/beef, maize/corn, soy, cocoa, coffee, palm oil, rubber, timber, wood, food and feed as well as bioenergy feedstock.[158]

To address this situation, the European Commission stated in its communication on the European Green Deal in December 2019 that it would "take measures, both regulatory and otherwise, to promote imported products and value chains that do not involve deforestation and forest degradation". In January 2020, the European Parliament urged the Commission in a resolution to present "a proposal for a European legal framework based on due diligence to ensure sustainable and deforestation-free supply chains for products placed on the EU market, with a particular focus on tackling the main drivers of imported deforestation and instead encouraging imports that do not create deforestation abroad".[159] In October 2020, the ENVI Committee of the European Parliament urged in its legislative-initiative report that an EU legal framework should include mandatory requirements for due diligence, reporting, disclosure and third-party involvement for companies, as well as penalties in case of non-compliance and access to justice for victims of a breach of these duties.[160]

In November 2021, the European Commission then proposed a new regulation on deforestation-free products. The proposed new rules would guarantee that the products that EU citizens buy, use, and consume on the EU market do not contribute to global deforestation and forest degradation. The proposed regulation would target six commodities: coffee, cocoa, cattle, palm oil, soy and wood, as well as derived products including leather, oil cakes and chocolate. The proposal must be approved by the European Parliament and EU member countries. The European Parliament is expected to drive a hard bargain and advocate for a more ambitious package.

[157] COWI A/S, 2018, Feasibility study on options to step up EU action against deforestation, European Commission. Accessed at: https://ec.europa.eu/environment/forests/pdf/KH0418199ENN2.pdf

[158] COWI A/S, 2018, Feasibility study on options to step up EU action against deforestation, European Commission. Accessed at: https://ec.europa.eu/environment/forests/pdf/KH0418199ENN2.pdf

[159] European Parliament, Legislative Train Schedule An EU legal framework to halt and reverse EU-driven global deforestation. Accessed at: https://www.europarl.europa.eu/legislative-train/theme-environment-public-health-and-food-safety-envi/file-eu-driven-global-deforestation

[160] European Parliament, 2020, An EU legal framework to halt and reverse EU-driven global deforestation. Accessed at: https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2020/2006(INL)

9.2 Legal basis, subsidiarity, and proportionality

EU law provides a legal basis for the deforestation initiative as it requires the Union environmental policy to aim at a high level of protection and also requires the EU to contribute to developing international measures that preserve and improve the quality of the environment and the sustainable management of global natural resources.[161]

According to the new proposal of the European Commission from November 2021, EU competence to act in the area of deforestation and forest degradation stems from the articles of the Treaty on the Functioning of the European Union (TFEU) related to the protection of the environment According to Article 191 (1) TFEU.[162] Regarding the principle of subsidiarity, the European Commission argues that action at Union level would be more effective than at national level as it would prevent possible adverse impact on the functioning of the internal market and on trade aspects. Notably, it argues that without a harmonised approach, measures restricting internal trade would be taken by several Member States which would disrupt the functioning of the internal market.[163] When it comes to proportionality, the European Commission argues that monetised benefits would clearly offset costs and that the proposed regulation is "in line with the gravity and urgency of the problem it aims to tackle".

9.3 How does the Deforestation Initiative work?

The new proposal by the European Commission would set mandatory due diligence rules for companies placing relevant commodities on the EU market and would include a benchmarking system used by the European Commission to assess countries and their level of risk of deforestation and forest degradation driven by the commodities. The benchmarking system would be accompanied by a list of contravening operators and would be tiered, categorising countries in three categories: low, standard and high risk. Obligations for operators and member states authorities would vary according to the risk levels. The new regulation also includes a definition of what deforestation-free means, according to a definition by the FAO. Another envisaged element is a progressive product scope to be regularly reviewed and updated.[164] In addition, a deforestation-free

[161] Article 191 (2) and Article 21(2.f) of the Treaty on the Functioning of the European Union. Accessed at: https://www.europarl.europa.eu/RegData/etudes/STUD/2020/654174/EPRS_STU(2020)654174_EN.pdf

[162] In the article, "preserving, protecting, and improving the quality of the environment, protecting human health, prudent and rational utilisation of natural resources, promoting measures to deal with regional or worldwide environmental problems, and in particular combatting climate change" are defined as objectives of the Union policy on the environment.

[163] European Commission, 2021, Proposal for a regulation of the European Parliament and of the Council on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010. https://ec.europa.eu/environment/system/files/2021-11/COM_2021_706_1_EN_ACT_part1_v6.pdf

[164] European Commission, 2021, Proposal for a regulation of the European Parliament and of the Council on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010. p. 17.

label would be awarded to commodities deemed not to have been produced on forest land converted to agricultural use after December 31, 2020.

More specifically, the processes under the new proposed regulation would work as follows. Companies would report to national authorities that the products they place on the EU market conform with the rules. A digital system would provide authorities in member states with the relevant information about the commodities, such as geographic coordinates and country of production. The country benchmarking system by the European Commission would then determine the deforestation risk. In addition, the authorities in Member states will carry out inspections and report their enforcing activities to the European Commission. In case of infringements, authorities make use of penalties ranging from "fines, the confiscation of the relevant commodities and products as well as the confiscation of revenues, the suspension or prohibition of relevant economic activities and the exclusion from public procurement processes for the operators and traders that violate the regulation."[165]

In turn, companies aiming to place such products on the EU market would themselves be asked to collect relevant information about their products, exercise mandatory due diligence and evaluate the risks in their supply chains. They would also need to take mitigation measures such as using satellite monitoring tools, field audits, capacity building of suppliers or isotope testing to check the origin of the product. Companies failing to provide accurate information could face fines of up to 4 per cent of their annual turnover.[166]

Finally, the European Commission expects that producing countries improve forest governance and create socio-economic opportunities notably through Forest Partnerships. For this, they would benefit from EU support and funding to adapt to the measures.

9.4 The EU's ability to act

Due diligence legislation for FRC products would be compatible with the WTO rules and the bilateral and regional trade agreements of the EU. General exceptions are foreseen in WTO legislation allowing unilateral trade restrictions under Article XX of the GATT and Article XXI of the GATS. Specific provisions aim to protect the adoption or enforcement of necessary measures to protect human life, animal or plant life or health (XX.b GATT and XIV.b GATS) relating to the conservation of exhaustible natural resources (XX.g GATT). However, some of the measures that the EU could take on due diligence could be considered discriminatory based on MFN, national treatment clauses or due to the imposition of

[165] European Commission, 2021, Proposal for a regulation of the European Parliament and of the Council on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010. p. 17.

[166] Mehreen Khan, 2021, Brussels seeks to curb deforestation with food import ban, Financial Times. Accessed at https://www.ft.com/content/545b5d8d-13c7-4ed8-93a7-96ae3d1a378e

additional non-tariff restrictions. As a result, any due diligence process implemented by the EU should be transparent and live up to highest standards of accountability. If they do, measures are likely to be WTO compliant.

In addition, mandatory certification requirements could be associated with higher initial costs to obtain the certificates. It is therefore crucial that any future legal framework on mandatory certification by the EU is carefully designed in order to take these potential challenges into account.

9.5 The potential impact of the Deforestation Initiative

In principle, the instrument has the potential to cover all EU imports of FRCs. For example, the EU is one of the main importers of palm oil, soy, rubber, beef, maize, cocoa, and coffee which are associated to deforestation. The EU also accounts for 7-10% of global consumption of crops and livestock linked to deforestation.[167]

A European added value assessment analysed the effects of four different policy options on imports of the following FRCs: palm oil, soy, beef, maize, rapeseed, and sugar crops, as well as to food products and biofuels containing them. The four policy options include mandatory due diligence for forest-risk supply chains (option 1), mandatory certification standards for forest-risk commodities (option 2), a combination of policy options 1 and 2 (option 3), as well as mandatory labelling of food products containing forest-risk commodities (option 4).[168] Overall, the assessment finds that up to 2030 all policy options analysed "show a negative economic impact in terms of GDP and employment. However, at EU level the size of the GDP and employment impacts is less than 0.01%, compared to the baseline. In all cases, the final prices of FRCs in the EU increase by less than 2%".[169] However, many more import flows that could be associated with deforestation or forest degradation could be impacted. The scope of this impact would, however, depend on more clear and binding definitions of these terms at EU level.

For a more detailed overview of the impact of due diligence legislation on EU imports see section 6.5.1 which includes an assessment of EU imports of timber before and after the EU Timber regulation entered into force and found that there is no significant change in trade after the introduction of the regulation. In addition, section 6.5.2 discusses different sub-options of how due diligence can be implemented and finds that the cost impact of mandatory due diligence is likely to differ according to different product groups and the

[167] European Parliament, Legislative Train Schedule: An EU legal framework to halt and reverse EU-driven deforestation. Accessed at: https://www.europarl.europa.eu/legislative-train/theme-environment-public-health-and-food-safety-envi/file-eu-driven-global-deforestation

[168] Aleksandra Heflich, 2020, An EU legal framework to halt and reverse EU-driven global deforestation, European Added Value Assessment. Accessed at: https://www.europarl.europa.eu/RegData/etudes/STUD/2020/654174/EPRS_STU(2020)654174_EN.pdf

[169] Aleksandra Heflich, 2020, An EU legal framework to halt and reverse EU-driven global deforestation, European Added Value Assessment. Accessed at: https://www.europarl.europa.eu/RegData/etudes/STUD/2020/654174/EPRS_STU(2020)654174_EN.pdf

complexity of related supply chains. This, in turn, can also be relevant for the impact of due diligence provisions when it comes to different FRCs.

Regarding a potential reaction by third countries, it is also possible that the new policy instrument could lead to a certain trade diversion effect as it incentivises foreign exporters to direct more sustainably produced goods to the EU, while they re-direct more non-sustainably produced goods to other countries.[170]

According to the impact assessment conducted by the European Commission regarding the new regulation proposed in November 2021, legally binding options (like deforestation-free requirement, mandatory due diligence, etc.) would be more effective than voluntary measures.[171] The six products covered in the scope of the new proposed regulation account for around 19 per cent of commodity imports into the EU. Overall, the new rules are expected to reduce greenhouse gas emissions and biodiversity loss and through that are expected to have a positive impact on local communities, including indigenous peoples. The European Commission expects that producers implementing more sustainable production practices will gain share in the EU market and see increased competitiveness compared to operators sourcing from 'high-risk' countries. The related costs would result from the complexity of supply chains and setting up of related due diligence systems. However, the legislation would only focus on deforestation and forest degradation, but not on the import of commodities produced on other converted natural ecosystems, such as savannahs and peatlands. An expansion of the scope would only be subject to an assessment after two years, and then every five years thereafter.

9.6 The risk of retaliation

Third countries could also decide to retaliate against the EU by defining certain EU exports as FRCs and introducing similar measures. However, the EU is not among the main exporters of global FRCs, and the impact of such retaliation would likely be limited.[172] For more information on the risk of retaliation regarding the EU's Corporate Sustainability Due Diligence legislation in general see chapter 6. As illustrated by an agreement reached at COP26 in November 2021 with more than 130 world leaders representing over 90% of the planet's forests committing to end and reverse deforestation by 2030, it is possible that other countries may increasingly impose similar measures to limit trade in FRCs independently of the EU deforestation initiative.[173]

[170] Aleksandra Heflich, 2020, An EU legal framework to halt and reverse EU-driven global deforestation, European Added Value Assessment. Accessed at: https://www.europarl.europa.eu/RegData/etudes/STUD/2020/654174/EPRS_STU(2020)654174_EN.pdf

[171] Trade Yearbook, 2020, Executive Summary: The state of forest-risk supply chains. Accessed at: http://resources.trase.earth/documents/Trase_Yearbook_Executive_Summary_2_July_2020.pdf

[172] Trade Yearbook, 2020, Executive Summary: The state of forest-risk supply chains. Accessed at: http://resources.trase.earth/documents/Trase_Yearbook_Executive_Summary_2_July_2020.pdf

[173] UN Climate Change Conference UK 2021, Glasgow Leader's Declaration on Forests and Land Use, Accessed at: https://ukcop26.org/glasgow-leaders-declaration-on-forests-and-land-use/

10. CONCLUSION

The global economy is going through a turbulent period. Developments over the past decade like the rise of China and climate change have changed traditional dynamics in international trade – and, lately, the Covid-19 pandemic has unleashed concerns in Europe and elsewhere about countries being too dependent on other countries for the supply of critical goods and technologies; a concern that Russia's war against Ukraine has laid bare. In Brussels and some national capitals, the relative decline of Europe's share of the world economy has prompted policymakers to consider the region's place in the world and what the new patterns of global economic power mean for the EU. A growing chorus of voices consider Europe badly equipped for a new world of geopolitical frictions and declining relevance for global institutions that previously guarded the rules for trade and other forms of exchange. Consequently, the EU is currently in the process of building for itself an arsenal of new defensive trade instruments. These instruments have the capacity to radically change the way in which the EU trades and relates with the rest of the world.

Europe's assertiveness on trade policy has been heightened by its response to the Russian invasion of Ukraine. The sanctions that the EU unleashed against the Russian economy include some trade measures covered in this study. Restrictions on the provision of financial messaging services, export ban of dual-use goods, semiconductors, aircraft, spare parts, and related services, prohibition on investments, the use of euros, and closing Europe's air space or Europe's public procurement market are examples of these measures. However, this harsher geopolitical reality also requires new thinking about the effects that the measures presented in this study have on Europe's closer allies, including Ukraine.

In this context, this report has sought to better understand the design, workings, and implications of EU's new trade defence instruments. It takes an extensive look at the objectives of the instruments, their legality, proportionality, and subsidiarity, the working of the instruments and the division of labour between institutions, as well as their enforceability in conjunction with existing multilateral and bilateral rules affecting the EU. It also attempts to capture the impact and potential for retaliation for the EU and its partners as a result of the implementation of the instruments. The report, however, comes with a note of caution. In their current state, all instruments are at different stages of development. Some have been approved while others need to be negotiated by the co-legislators. The instruments have the potential for change and development, presenting a moving target for the writing of this report, which at this point offers a snapshot of the current status and implications instead of concrete results set in stone.

While each instrument varies in its specifics, there are some general findings that the instruments share. Firstly, the starting point for the creation of many of these instruments has been to prepare Europe to retaliate against coercion and unfair trade practices by partner countries. The primary example of this is the Anti-Coercion Instrument (ACI). But also measures such as the Foreign Subsidy Instrument (FSI), the Level Playing Field in the EU-UK Trade and Cooperation Agreement (LPF), the International Procurement Initiative (IPI), and the Enforcement Regulation, are all reactionary measures which will be put into effect when the EU faces unfair trade measures. For these instruments, there are also certain partner countries that are likely to be more targeted than others. For instance, the United States, China, Russia, the UK, and Turkey are likely to be on the receiving end of the instruments due to the significant volumes of trade and economic interdependence with the EU. But the instruments also target countries that either do not follow the same rules as the EU – like China, Russia, Turkey and in some cases the United States – or countries with which the EU wants to maintain the current level of competitiveness, like the UK.

This study sheds light on the areas where the instruments lack clarity, particularly in the implementation and design of the instrument – for instance, the decision-making hierarchy and the division of labour between the EU and the EU member states when measures are applied. The study identifies doubts on the compliance of the instruments with WTO rules and bilateral FTA provisions which should be resolved before the instruments are approved. Moreover, even though each instrument operates in different EU markets – some are specific to the procurement market, while some deal with mergers and acquisitions, and others with supply chains and standards – together these defensive trade policies make the EU more inward-looking, which could have negative consequences for the EU because EU is a larger supplier of goods and services than it is a buyer.

In analysing the impact of these instruments on the EU and its partners, the study also attempts to describe the regularity with which each instrument might be used. This is important since the frequency of use will determine the impact of the instruments. For instance, if the Anti-Coercion Instrument is used regularly for minor trade disruptions, it could have a larger effect on EU imports compared to when it is used more sparingly to counter coercive activities.

For some instruments, the frequency of their use is well defined, particularly for the ones which will become a regular requirement when trading with the EU, such as the Carbon Border Adjustment Mechanism, the Corporate Sustainability Due Diligence, and the Deforestation Initiative. In this regard, there are also some unique instruments such as the EU-UK Level Playing Field where the objectives are more overarching (they effect more than just trade) and they are similar to guiding principles on the functioning of trade with the EU. The frequency and objective of all the measures assessed in this study will become clearer as the instruments are further developed.

The EU has certain discretion in the application of some of these measures. This can be useful in the new geopolitical context if the costs of alienating your closer partners exceed the benefits. Some countries will complain at the lack of consistency in the application of the norms but ultimately it is up to the EU to decide in which countries it wants to apply the International Procurement Instrument, the Foreign Subsidy Instrument, the Updated Enforcement Regulation, or the Anti-Coercion Instrument. In contrast, other measures will apply to all EU trade partners in exactly the same way. Some of these measures like the Carbon Border Adjustment Mechanism, the Corporate Sustainability Due Diligence, and the Deforestation Initiative will impose costs to companies in the United States, Turkey, United Kingdom, and Ukraine, which may undermine other EU's geopolitical objectives.

Each instrument is relevant in its own context, and might not on its own seem to present a significant change to EU's trade policy. However, taken together these instruments have the potential to substantially change the Union's trade practices – and more so the measures that established new trade restrictions or costs (e.g., CBAM) than measures that are contingent and specific only to one country. In their totality, these measures would have the effect that Europe would produce more for itself and be less dependent on both exports and imports. This is a significant policy shift which may lead to a contradiction between an EU which talks about open trade and the importance of multilateralism, international norms and organisations while it builds an arsenal of defensive unilateral trade policy measures which will eventually be used to achieve its own autonomous goals.

While the implementation uses restrictions to the EU market as the main policy lever, the objective is not just about creating an equal playing field but also ensuring that the rest of the world follows EU rules. The EU's new policies go beyond the Brussels Effect as popularised by Anu Bradford in her book of the same name. Through the Brussels Effect, EU regulation was adopted indirectly – through the lobby of non-EU companies to non-EU governments – but this time the EU aims at regulating non-EU companies directly through EU policies. This regulation of non-EU companies is also being undertaken unilaterally by the EU, instead of in collaboration with partner countries. These interferences in partner country policies increase the risk of retaliation. Therefore, EU policies are not just defensive, but also risk increased protectionism and conflict through trade if used in a non-transparent way and if they are implemented in a way that is incompatible with WTO rules.

To grasp the potential of each of the instruments, the study provides an analysis of the legal basis, processes, and impacts, while also drawing out the interrelations and interactions between the different instruments. The study assesses eight measures which constitute the new EU defensive trade instruments. Below, we present a summary of each of the instruments and its assessment in terms of their *concrete measures* (are the measures clearly known and specific? Do we know how the instrument will work in terms of its specific measures?); *compatibility* (are the instrument in line with EU's international and bilateral obligation?) and the *potentially affected sectors* (What is the scope of the impact? Is the instrument directed at specific sectors only, and if so, are these clearly indicated?). Finally, our assessment also indicates whether the instruments are *discretionary or automatic.*

Anti-Coercion Instrument (ACI): the ACI follows a clear objective which is to deter and counteract coercive actions by third countries through the use of the EU's own trade defence arsenal. However, the broad definition of what constitutes coercion, its assessment on a case-by-case basis, as well as the broad scope of the countermeasures open the door for subjectivity in the application of the instrument. The EU will defend the WTO compatibility of ACI based on the national security exception. However, this does not mean that anything can be declared as a national security exception. Moreover, FTAs and other international conventions (e.g., on IPRs) will have a bearing on the EU's ability to apply the ACI, particularly in trade in services and trade-related aspects of IPR. Finally, retaliation is a likely scenario particularly if the EU overshoots in the size of its countermeasures.

ANTI-COERCION INSTRUMENT ASSESSMENT

Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
The measures include the suspension of tariff concessions, imposition of customs duties. and restrictions on the importation of goods, access to EU's public procurement, and suspensions in trade in services and trade-related aspects of intellectual property rights (IPRs). Other non-conventional measures can also be taken as demonstrated by the EU sanctions on Russia.	Depends on its final implementation.	All sectors can be subject to ACI. Trade in services and IPR are included but the EU may not always have the capacity to act due to existing obligations.	Discretionary.

International Procurement Instrument (IPI): the IPI will be used as a leverage to negotiate market access in procurement markets for EU firms and to restrict access to EU's procurement market for companies, goods, and services coming from countries where EU companies face restrictive or discriminatory measures. The objectives, legal basis, and workings of the instrument are clearly defined in the proposal for the instrument. The instrument is also compatible with the EU's international and bilateral commitments since the instrument only addresses non-covered procurement. However, the exact economic consequences of the instrument are difficult to judge given the case-by-case basis on which the instrument will be applied. There is also scope for retaliation from partner countries. Partner countries will be quick to point out that EU member states impose similar restrictions on their public procurement markets or that the EU's share of imports in procurement is relatively low. Partner countries may see the closing of their own procurement markets as an attractive retaliatory measure to the EU IPI which could end up creating additional barriers for the EU instead of providing increased market access.

INTERNATIONAL PROCUREMENT INSTRUMENT ASSESSMENT

Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
The IPI has two types of measures: score adjustments, which are penalties that procurement authorities have to apply to a company subject to the IPI; and the exclusion of tenders from a third country and sector subject to the IPI.	Compatible.	IPI applies to procurement above €5 million. All sectors in EU procurement can be subject to IPI.	Discretionary.

Carbon Border Adjustment Mechanism (CBAM): the objective of the CBAM is to avoid carbon leakage by adding a cost to certain carbon-intensive imports from countries with a different carbon-cost policy than the EU. There is enough clarity on the objective of the CBAM proposal and its legal basis. However, much remains to be decided to know how it is going to work in practice. The CBAM being a relatively novel global policy, it could also be contested at the WTO depending on the actual implementation of the instrument. For instance, since many producers of CBAM goods in third countries pay carbon taxes and other forms of non-direct levies for their direct carbon emissions, it would be unfair and WTO incompatible to exclude those from the CBAM. Moreover, there is scope for retaliation in many of the CBAM products that the EU is targeting. Even though EU's exports of CBAM products only account for very little of EU's total exports, the EU holds a significant market share in the global exports of many of these goods. However, retaliating against the EU CBAM can also lead to increased costs for partner countries since many of the CBAM goods from the EU add value to the final demand of the partner countries.

CARBON BORDER ADJUSTMENT MECHANISM ASSESSMENT

Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
A levy on imported products which value corresponds to the level of embedded carbon in the affected products.	Depends on its final implementation.	Cement electricity, fertilisers, iron and steel, and aluminium.	Automatic.

Foreign Subsidy Instrument (FSI): the Foreign Subsidy Instrument (FSI) addresses the distortive effects of foreign subsidies by investigating and redressing these effects. It impacts three different kinds of markets – M&A, international procurement, and the EU single market depending on the distortion caused by foreign subsidies. The foreign subsidy instrument is coherent in its objectives, legal basis, and the workings of the instrument. The instrument is also complementary to the EU's bilateral trade agreements as well as WTO rules. Retaliation against the FSI may arise as the EU kick-starts a more assertive industrial policy, providing subsidies to industries such as microelectronics and semi-conductors.

FOREIGN SUBSIDY INSTRUMENT ASSESSMENT

Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
The EU Commission can impose redressive measures such as reducing their market presence, refraining from certain investments, or repayment of the foreign subsidy to companies using foreign subsidies in mergers and acquisitions, public procurement, and other market situations in the EU.	Compatible.	All sectors can be subject to FSI. However, the sectors with a higher prevalence of foreign subsidiaries are more likely to be impacted by FSI.	Discretionary.

Corporate Sustainability Due Diligence: the due diligence instrument aims to identify, prevent, mitigate, and end adverse human rights and environmental impacts in companies' operations, subsidiaries, and value chains. The Directive requests companies to integrate due diligence to account for actual and potential adverse human rights and environmental impacts; identify these adverse impacts and take appropriate measures to prevent and mitigate them. Company's Directors are responsible for establishing and overseeing the due diligence actions in their firms as part of their duty of care. Victims of these adverse human and environmental impacts can make a civil liability claim before national courts for damages that could have been avoided with appropriate due diligence measures. Member states will be responsible for supervising the new rules and will be able to impose fines in case of non-compliance. This new system will add compliance costs and transition costs for EU and non-EU companies.

CORPORATE SUSTAINABILITY DUE DILIGENCE

Specific Measures	**Compatibility**	**Affected sectors**	**Discretionary or automatic**
Businesses need to integrate due diligence, identify adverse effects, and take measure to prevent or eliminate these effects.	Compatible.	All sectors can be subject to due diligence. Large EU and non-EU companies as well as smaller companies in high-risks sectors will be directly impacted by these new obligations. SMEs will be impacted indirectly as long as they are part of a larger supply chain.	Automatic.

Level Playing Field in the EU-UK Trade and Cooperation Agreement (LPF): the level playing field provisions under the EU-UK trade and cooperation agreement establish rules to safeguard fair competition between EU and British businesses. These rules are there to ensure that there is no regression from the current standards maintained between the EU and the UK which has the capacity to distort international trade and provide either of them with a more competitive edge. The LPF provisions in the agreement are detailed in their objective, legal basis, as well as their working. They have proper processes in place that each party must follow in the case of an alleged breach of their commitments. Moreover, as part of the EU-UK Trade and Cooperation Agreement, the LPF is in agreement with WTO rules and EU's other obligations to the UK. Well defined processes and mutual agreement on the LPF under the TCA limit the risk of retaliation.

LEVEL PLAYING FIELD IN THE EU-UK TRADE AND COOPERATION AGREEMENT ASSESSMENT

Specific Measures	**Compatibility**	**Affected sectors**	**Discretionary or automatic**
The provisions commit both parties to upholding high standards of protection on labour and the environment. The UK or the EU can impose redressive measures if the other changes its labour or environmental regulation to provide an unfair advantage to their companies.	Compatible. LPF falls under the EU-UK Trade and Cooperation Agreement (TCA).	All sectors can be subject to LPF.	Automatic.

Updated Enforcement Regulation for Trade Disputes: the amendments to the Enforcement Regulation (ER) grant the EU the right to action in response to a measure maintained by a country, and when the WTO dispute settlement mechanism is blocked for non-cooperative reasons by this country. The instrument obviously raises concerns about the EU's unilateral approach in resolving a trade dispute outside of the WTO, as well as its ability to include services and Intellectual Property Rights as a response. There is also lack of clarity in its working of how the regulation will be applied in EU's bilateral or regional agreements. The EU's unilateral approach also calls for increased risk of retaliation as the EU is working outside the rules established by the WTO without waiting for a resolution.

UPDATED ENFORCEMENT REGULATION FOR TRADE DISPUTES ASSESSMENT

Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
The EU can take countermeasures when there is a failure to implement a panel in the WTO because of paralysis in the Appellate Body or when a similar situation arises under other international trade agreement.	Not compatible.	All sectors can be subject to Updated Enforcement Regulation. Trade in services and IPR are included but the EU may not always have the capacity to act due to existing obligations.	Discretionary.

Deforestation Initiative: the instrument will use due diligence to ensure sustainable and deforestation-free supply chains for products placed on the EU market. Products such as coffee, cocoa, cattle, palm oil, soy, and wood, as well as derived products including leather, oil cakes and chocolate that are not certified as deforestation free will not be able to enter the EU. Environmental protection is supported by a clear legal basis in the EU and provides the initiative with a well-defined objective in line with its current climate and environment related policies. The proposal for the regulation also details the workings of the instrument. There is however scope for this measure to be considered discriminatory and a violation of the MFN and national treatment clauses, or due to the imposition of additional non-tariff restrictions. Moreover, mandatory certification could also be considered as hidden protectionism by the EU. This could lead to retaliation by affected countries.

DEFORESTATION INITIATIVE ASSESSMENT

Specific Measures	Compatibility	Affected sectors	Discretionary or automatic
Mandatory due diligence rules for companies and a benchmarking system used by the European Commission to assess countries' risk of deforestation and forest degradation driven by the commodities.	Depends on its final implementation.	Coffee, cocoa, cattle, palm oil, soy, and wood, as well as derived products including leather, oil cakes and chocolate.	Automatic.

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ANNEX

Annex 1: CBAM, HS codes selected (Annex 1 of the Proposal for establishing a carbon border adjustment mechanism on the 14th of July of 2021)

CEMENT CN CODE

CN code	Product description
252310	Cement clinkers
252321	White Portland cement, whether or not artificially coloured
252329	Other Portland cement
252390	Other hydraulic cements

ELECTRICITY CN CODE

CN code	Product description
271600	Electrical energy

FERTILISERS CN CODE

CN code	Product description
280800	Nitric acid, Sulphonitric Acid.
2814	Ammonia, anhydrous or in aqueous solution
28342100	Nitrates of potassium
3102	Mineral or chemical fertilisers, nitrogenous
3105	Mineral or chemical fertilisers containing two or three of the fertilising elements nitrogen, phosphorus and potassium; other fertilisers; goods of this chapter in tablets or similar forms or in packages of a gross weight not exceeding 10 kg - Except: 3105 60 00 – Mineral or chemical fertilisers containing the two fertilising elements phosphorus and potassium

IRON AND STEEL CN CODE

CN code	Product description
72	Iron and steel. Except: 7202 Ferro-alloys 7204; Ferrous waste and scrap; remelting scrap ingots and steel.
7301	Sheet piling of iron or steel, whether or not drilled, punched or made from assembled elements; welded angles, shapes and sections, of iron or steel
7302	Railway or tramway track construction material of iron or steel, the following: rails, check-rails and rack rails, switch blades, crossing frogs, point rods and other crossing pieces, sleepers (cross-ties), fish- plates, chairs, chair wedges, sole plates (base plates), rail clips, bedplates, ties and other material specialised for jointing or fixing rails
730300	Tubes, pipes and hollow profiles, of cast iron
7304	Tubes, pipes and hollow profiles, seamless, of iron (other than cast iron) or steel
7305	Other tubes and pipes (for example, welded, riveted or similarly closed), having circular cross-sections, the external diameter of which exceeds 406,4 mm, of iron or steel
7306	Other tubes, pipes and hollow profiles (for example, open seam or welded, riveted or similarly closed), of iron or steel
7307	Tube or pipe fittings (for example, couplings, elbows, sleeves), of iron or steel
7308	Structures (excluding prefabricated buildings of heading 9406) and parts of structures (for example, bridges and bridge-sections, lock- gates, towers, lattice masts, roofs, roofing frameworks, doors and windows and their frames and thresholds for doors, shutters, balustrades, pillars and columns), of iron or steel; plates, rods, angles, shapes, sections, tubes and the like, prepared for use in structures, of iron or steel
7309	Reservoirs, tanks, vats and similar containers for any material (other than compressed or liquefied gas), of iron or steel, of a capacity exceeding 300 l, whether or not lined or heat-insulated, but not fitted with mechanical or thermal equipment
7310	Tanks, casks, drums, cans, boxes and similar containers, for any material (other than compressed or liquefied gas), of iron or steel, of a capacity not exceeding 300 l, whether or not lined or heat-insulated, but not fitted with mechanical or thermal equipment
7311	Containers for compressed or liquefied gas, of iron or steel

ALUMINIUM CN CODES

CN code	Product description
7601	Unwrought Aluminium
7603	Aluminium powders and flakes
7604	Aluminium bars, rods and profiles
7605	Aluminium wire
7606	Aluminium plates, sheets and strip, of a thickness exceeding 0,2 mm
7607	Aluminium foil (whether or not printed or backed with paper, paper-board, plastics or similar backing materials) of a thickness (excluding any backing) not exceeding 0,2 mm
7608	Aluminium tubes and pipes
76090000	Aluminium tube or pipe fittings (for example, couplings, elbows, sleeves)

Annex 2: EU FTAs

TABLE 1: LIST OF COUNTRIES WITH WHOM THE EU HAS AN FTA

Albania	Ghana	Panama
Andorra	Greenland	Papua New Guinea
Anguilla	Grenada	Peru
Antigua and Barbuda	Guatemala	Pitcairn
Armenia	Guyana	Saint Helena
Aruba	Honduras	Saint Pierre and Miquelon
Bahamas	Iceland	Samoa
Barbados	Israel	San Marino
Belize	Jamaica	Serbia, FR (Serbia/Montenegro)
Bermuda	Japan	Seychelles
Bosnia and Herzegovina	Jordan	Singapore
Botswana	Korea, Rep.	Solomon Islands
British Indian Ocean Ter.	Lebanon	South Africa
British Virgin Islands	Lesotho	South Georgia and the South Sa
Cameroon	Liechtenstein	St. Kitts and Nevis
Canada	Madagascar	St. Lucia
Cayman Islands	Mauritius	St. Vincent and the Grenadines
Chile	Mexico	Suriname
Colombia	Moldova	Switzerland
Costa Rica	Montenegro	Syrian Arab Republic
Cote d'Ivoire	Montserrat	Trinidad and Tobago
Dominica	Morocco	Tunisia
Dominican Republic	Mozambique	Trinidad and Tobago
Ecuador	Namibia	Tunisia
Egypt	Netherlands Antilles	Turkey
El Salvador	New Caledonia	Turks and Caicos Isl.
Eswatini	Nicaragua	Ukraine
Faeroe Islands	North Macedonia	United Kingdom
Falkland Island	Norway	Vietnam
Fiji	Palestine	Wallis and Futura Isl.
French Polynesia	Georgia	Zimbabwe

Source: WTO.

TABLE 2: LIST OF COUNTRIES WITH WHOM THE EU HAS AN FTA WHICH INCLUDES PROVISIONS ON PUBLIC PROCUREMENT

Negotiated FTAs	Moldova
Andean Community	Singapore
Armenia	Switzerland
Canada	Ukraine
Central America	Vietnam
Chile	Under negotiation
Georgia	Australia
Iraq	Azerbaijan
Korea	Indonesia
Kazakhstan	New Zealand
Kyrgyzstan	Tunisia
Mercosur	Uzbekistan
Mexico	

Source: European Commission. Public procurement. Trade. European Commission. Last update 22 November 2019. Available at: https://ec.europa.eu/trade/policy/accessing-markets/public-procurement

TABLE 3: LIST OF MEMBER COUNTRIES OF THE WTO GOVERNMENT PROCUREMENT AGREEMENT

Armenia	Moldova
Australia	Montenegro
Canada	New Zealand
European Union	Norway
Hong Kong, China	Singapore
Iceland	Switzerland
Israel	Chinese Taipei
Japan	Ukraine
Republic of Korea	United Kingdom
Liechtenstein	United States

Source: WTO. Available at: https://www.wto.org/english/tratop_e/gproc_e/memobs_e.htm