

Fuest, Clemens; Di Fabio, Udo; Felbermayr, Gabriel

Research Report

Free enterprise and state control: Annual bulletin of the advisory board of the Foundation for Family Businesses

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Phone: +49 (0) 89 / 12 76 400 02

Fax: +49 (0) 89 / 12 76 400 09

E-mail: info@familienunternehmen.de

www.familienunternehmen.de

Prepared by:

Prof. Dr Dr h.c. Clemens Fuest

President of the ifo Institute –

Leibniz Institute for Economic Research at the University of Munich

Prof. Dr Dr Udo Di Fabio

Professor of Public Law,

Rheinische Friedrich-Wilhelms-University, Bonn

Prof. Gabriel Felbermayr, PhD

Director of the Austrian Institute of Economic Research (WIFO),

Vienna

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Good intentions do not always have good outcomes

The coronavirus pandemic led to a large number of government interventions and directive measures, including long unseen restrictions on fundamental rights as well as enormous aid packages to stabilise the economy.

The situation recalled the financial crisis a good ten years ago, when government help was needed to stabilise banks and assure investor confidence in the future. However, now it is time to return to a system that allows people to take responsibility for themselves and protects individual freedoms.

Yet what we observe is a growing mistrust of market forces. Redistribution by the government, active industrial policy and excessive climate protection bureaucracy are all enjoying high popularity ratings. In particular, many young people seem to long for a caring and interventionist state, with economic players in chains. Their objections are aimed not only at major corporations, but often also at family businesses, even though responsibility and foresight, regional identity and innovative strength are part of the DNA of family enterprises.

The Advisory Board of the Foundation for Family Businesses has taken a closer look at this trend towards faith in the state. The authors consider the efficiency of government intervention on the basis of various examples and investigate whether the same objectives could not be better met with different means and at lower cost.

They do not doubt the politically defined need for action in this context, whether in environmental and climate protection, when dealing with human rights, on the global market for chips or healthcare products or in public services; they merely discuss the choice of means and identify market economy alternatives.

Their conclusions sound alarming. In the Annual Bulletin of the Advisory Board of the Foundation for Family Businesses, these researchers warn of considerable losses in prosperity as a result of neo-interventionism. Their

plea: government intervention must remain balanced. Not all good intentions translate into good actions. Micromanagement of businesses causes overload without meeting the intended objectives.

Government action is undoubtedly required, for example in regulating the financial industry or preventing the loss of biodiversity. But Prof. Clemens Fuest, President of the ifo Institute, believes it would be wrong for government to direct capital flows or corporate investment decisions. Price signals are the great strength of the market economy, thus government intervention must be combined with the use of market economic processes.

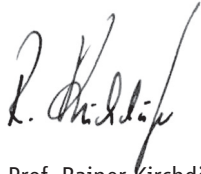
Prof. Udo Di Fabio, a former member of Germany's Constitutional Court, highlights the problems of government intervention in the market, such as the government-imposed minimum wage, the expansion of co-determination, or the planned taxonomy of the European Commission. He argues that the principle of free collective bargaining and the protection of property would suffer, the market as a discovery process would be disabled to some extent and the elasticity of economic transformation lost. Care also needs to be taken when particular interests, for example those of non-governmental organisations, undermine the formation of democratic will.

Prof. Gabriel Felbermayr, Head of the Austrian Institute of Economic Research (WIFO), looks at the EU's planned supply chain due diligence legislation as an example of a neo-interventionist approach. Efforts to force companies to maintain perfect observation of thousands of suppliers in remote countries are unrealistic. This legislation will lead to higher import costs for German companies, shorter supply chains, and a deterioration in the international division of labour.

The invisible hand of the market does not always hold sway in Germany. There is justifiably no completely free

competition; instead, the social market economy aims to achieve balance and justice. Government intervenes if the market fails or macroeconomic crises get out of

hand. But there is a limit. Neo-interventionism is stifling lively entrepreneurship – and thus our country's prosperity.

A handwritten signature in black ink, appearing to read 'R. Kirhdörfer', written in a cursive style.

Prof. Rainer Kirhdörfer

Chair of the Advisory Board and

Executive Board member of the Foundation for Family Businesses

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Prepared by Prof. Dr Dr h.c. Clemens Fuest

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Economic policy beyond the coronavirus crisis: the emergence of neo-interventionism

Prepared by Prof. Dr Dr h.c. Clemens Fuest

I. Introduction

The role of governments in the economy has long been a focus of debates about the economy and economic policy. These debates run in cycles: in the 1960s, there was great optimism about the possibility of managing the economy through government action and ensuring greater security and less inequality in income distribution with a growing welfare state. The oil price shocks and a rise in government debt, unemployment and inflation in the 1970s brought disillusionment. In the 1980s and 1990s, politicians advocating market liberalism, such as Ronald Reagan and Margaret Thatcher, captured the economic and political zeitgeist, with the collapse of the communist centrally planned economies in 1989 seeming to confirm this attitude.

However, the global financial crisis which erupted in 2008 encouraged critics of liberal market economies, giving fresh impetus to demands for greater government control of the economy – and these trends have increased significantly in recent years. The UK weekly “The Economist”, for instance, made increasing calls for more government interventions the subject of its leader on 15 January 2022: “Beware the bossy state!”

The newly emerging trend towards government interventionism was previously described in Fuest (2020a), where it was termed “neo-interventionism” and defined as follows: neo-interventionism “has the following characteristics: firstly, there is low confidence in the ability of markets, pricing mechanisms and competition to solve economic problems. Instead, government institutions are thought able to achieve better results through directing intervention in economic activity. Secondly, neo-interventionism is associated with the perception

that economic incentives do not play a central role in making economic decisions. This results, thirdly, in the theory that the government can use price regulation, social transfers or taxes to redistribute income without having to fear major evasive responses or harmful side effects.”¹ Proponents of neo-interventionist ideas often define their positions as distinct from positions of market liberalism, which are often referred to collectively as neoliberalism.

The implementation of neo-interventionist positions in economic policy holds considerable risks for economic prosperity. By the same token, some government intervention and regulation is an important prerequisite for creating and maintaining prosperity. For this reason it is important to distinguish useful from harmful government intervention, which normally entails detailed analysis of the individual areas of economic policy.

This article is primarily aimed at explaining the phenomenon of neo-interventionism, discussing reasons for its growing influence, and analysing how government’s role in the economy has evolved and how it should develop in the future. It is structured as follows: the next section discusses the dichotomy between neo-interventionism and neoliberalism. Section III explains the reasons for the emergence of neo-interventionism. Section IV uses a number of indicators to investigate how the role of the state in the economy has changed in recent decades. Section V discusses the implications of the coronavirus crisis for future government action. Section VI describes some areas of politics where neo-interventionist tendencies have emerged or have already become prevalent. The conclusions are presented in section VII.

1 Fuest (2020a), p. 16 [our translation].

II. Neo-interventionism versus neoliberalism

As mentioned already, neo-interventionism can be considered the opposite of neoliberalism, if you understand neoliberalism as an attitude that tends to take a critical view of government intervention in the economic process and prefers to trust market forces. In recent years, “neoliberalism” has increasingly been used in the public debate as a kind of collective term for the causes of all sorts of actual or perceived economic, social and environmental problems. Examples include economic crises, income and wealth inequality, child labour, unemployment, stagnating wages, deficiencies of the social, healthcare and education system, tax evasion, economic power in the hands of monopolies and cartels, exercise of political power by large corporations and wealthy individuals, or excessive cuts in government expenses to contain government debt.

The association of these problems with the term neoliberalism suggests that they are attributable to the fact that markets and individual economic freedoms have too much room for manoeuvre. That bears little relation to the actual causes, which are much more complex. Nevertheless, those who use the term in this way ultimately pursue the aim of discrediting the market economy and advocating neo-interventionist political agendas.

From a historical perspective, to link the term neoliberalism to the radical ideas of the market economy is to turn the facts on their head. Neoliberalism is a school of thought of the 1920s and 1930s in which economists, social scientists and philosophers tried to develop a society based on individual freedoms and markets, but intended to remedy the shortcomings of the *laissez-faire* approach that had characterised traditional liberalism. Historically therefore, neoliberalism is a theory that believes in *more* government intervention than earlier versions of liberalism. Neoliberal thinking came into being in different places, independently of each other. Many of those involved met at the Walter Lippmann

Colloquium, a conference held in Paris in 1938. Its delegates included economists such as Friedrich von Hayek, Jacques Rueff, Wilhelm Röpke and Ludwig von Mises as well as the sociologist Alexander Rüstow, the political scientist Raymond Aron and the philosopher Louis Rougier. Walter Lippmann was an American writer and political commentator. This conference is often referred to as the birthplace of neoliberalism. Some of the delegates were famous liberal thinkers, while others had ideas that we would today associate with social democracy. After the Second World War, many of the delegates joined the Mont Pèlerin Society, which became an important forum for the development of liberal theories.²

Today, the term neoliberalism tends to be associated with economic policies that gained influence in the United States and the United Kingdom in the 1980s and were represented by politicians such as Ronald Reagan and Margaret Thatcher. A definition of neoliberalism based on this variant can be found in Harvey (2007, p. 2). He defines modern neoliberalism as “a theory of political economic practices that propose that human well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets, and free trade. The role of the state is to create and preserve an institutional framework appropriate to such practices. ... Furthermore, if markets do not exist (in areas such as land, water, education, health care, social security, or environmental pollution) then they must be created, by state action if necessary. But beyond these tasks the state should not venture. State interventions in markets (once created) must be kept to a bare minimum because, according to the theory, the state cannot possibly possess enough information to second-guess market signals (prices) and because powerful interest groups will inevitably distort and bias government interventions ... for their own benefit.”

² See Plickert (2008) and Kolev (2013).

Key elements of this “modern” concept of neoliberalism are therefore the preservation of individual freedoms within an institutional framework that protects private property rights and competition, but also implies private responsibility for individual actions and limits the extent to which individuals can rely on the state to help them if they get into financial difficulties.

Other variants of neoliberalism can be found in *ordo* economics and modern welfare theory. In both cases, the theory of market failure plays a key role, according to which government intervention is only justified if there is market failure and intervention will actually result in improvements.

III. What are the origins of neo-interventionism?

Neo-interventionism, understood to be a political orientation that favours increased government intervention in the economic process and seeks to keep market processes at bay, has gained in popularity in recent years, not only in politics and the media, but in some cases even among researchers, who have contributed forcefully to the public debate. The economist Maria Mazzucato, for example, refers in her books to the “entrepreneurial state” and “mission-oriented economic policy”, emphasising in this context the role of government investment programmes and industrial policy innovation initiatives.³ With his works on income and wealth inequality, the French economist Thomas Piketty (2014) has attracted a lot of attention, especially in the United States. He calls for an expansion of government redistribution. Nobel laureate Joseph Stiglitz has for years demanded more active government policies and more government regulation and redistribution.⁴

These theories are controversial, but have considerable influence on current economic policy debates. This has less to do with the arguments presented as such, which are not new, and more to do with various economic and political developments, which ensure that ideas and demands like these increasingly fall on fertile soil. Let us examine this more closely.

1. Macroeconomic crises and the renaissance of stabilisation policy

Cyclical fluctuations are part and parcel of economic development. However, sharp economic downturns may have a considerable negative impact on the economy, taking the form, for example, of self-reinforcing downward spirals, with production outages turning out to be significantly worse than they need to be. In addition, hysteresis effects may arise in which economic downturns lead to permanent damage, for example by preventing young people from starting professional training or a career. Such developments may have serious economic, social and political consequences. An example is the traumatic experience during the global economic crisis of the 1930s. For this reason, the stabilisation of the economy – especially support for economic activity in a recession – has traditionally been regarded as an important task of government.

How successful government-led stabilisation policy can be in smoothing cyclical fluctuations and exercising macroeconomic control of the economy is, however, the subject of debate. In this context, it is important to distinguish between automatic stabilisers and discretionary stabilisation measures. The control system, in combination with social security systems such as unemployment insurance, has a stabilising effect that is deemed “automatic” because it kicks in without politicians having to take action in a crisis. In the case of discretionary

3 See Mazzucato (2013, 2021).

4 See Stiglitz (2021).

stabilisation policy, governments actively intervene in economic development, for instance by launching economic programmes. Whereas the effectiveness of automatic stabilisers is largely uncontroversial, the debate on discretionary economic policy is more contentious. On the one hand, the economic situation is difficult to diagnose and the implementation of economic policy entails a time lag; thus, economic support measures may arrive at the wrong time. On the other, there are political economic cycles during which governments attempt to stimulate the economy ahead of elections, regardless of whether that makes macroeconomic sense.

The 1970s and early 1980s were turbulent, with two oil shocks and rising inflation and unemployment, but starting in the 1990s, the global economy enjoyed an extended period of relative stability. Although there were occasional upheavals, such as the Mexico crisis of 1994 (also referred to as the peso or tequila crisis), the financial and economic crisis in East and Southeast Asia in 1997 and 1998, or the bursting of the dotcom bubble in 2001, the impression was created in the years up to 2008 that efforts to avoid major cyclical fluctuations were increasingly successful. Figure 1 illustrates that the fluctuations in economic growth in the period between the early 1990s and the global financial crisis were significantly smaller than before or afterward. There was talk of the Great Moderation.⁵ Governments' stabilisation policies seemed to focus mainly on not creating any economic volatility of their own.

The period of the Great Moderation ended abruptly in 2008, when the global financial crisis, which had started mainly in the United States, plunged the world's economy into a deep recession. Government stabilisation policy experienced a comeback during this crisis. This continued during the European sovereign debt

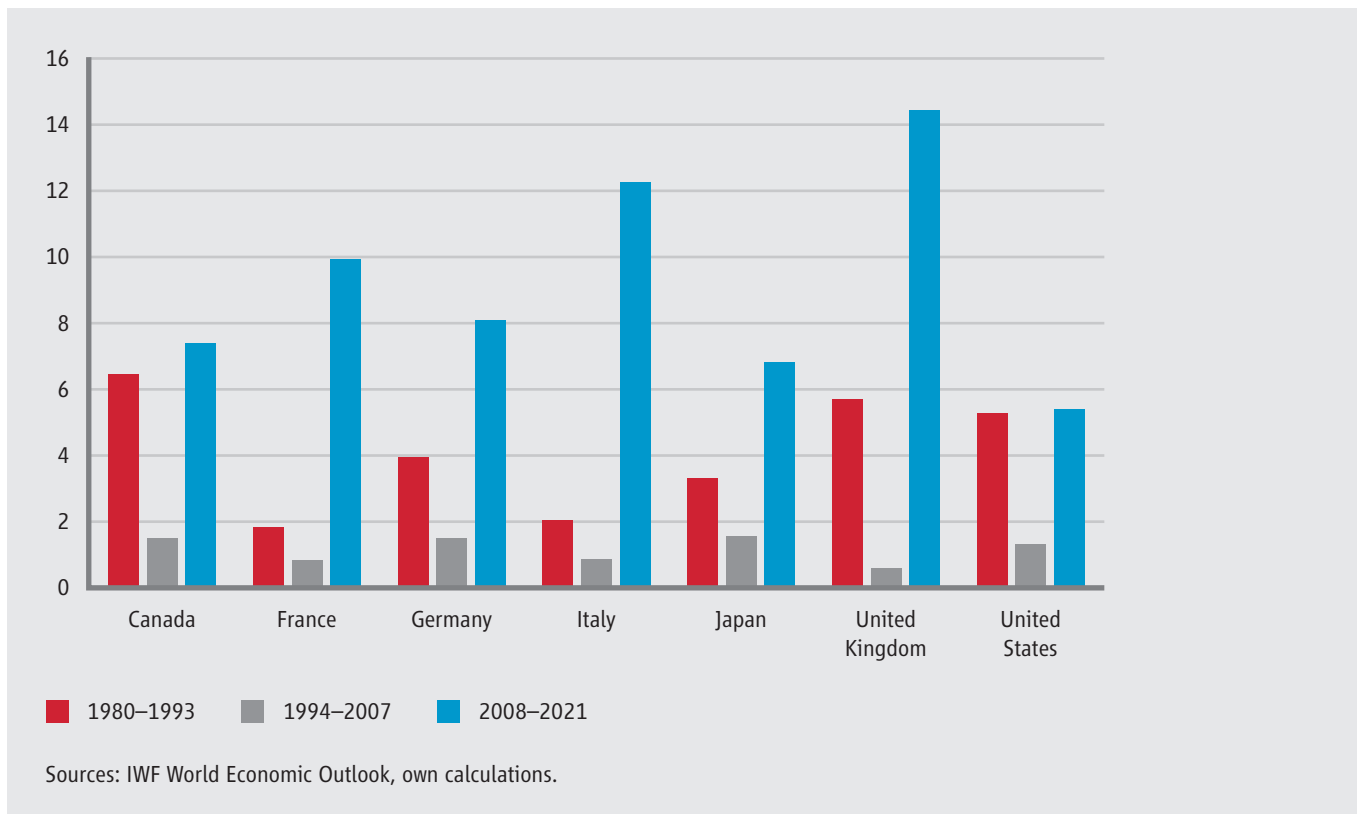
crisis, although the circumstances were somewhat different: highly indebted countries, which were particularly hard hit by the crisis, accused creditor countries of leaving them too little scope to implement an anti-cyclical fiscal policy, which they said was necessary to overcome the crisis.

The outbreak of the coronavirus crisis in the winter of 2020 brought about the next massive economic downturn, and once again, government intervention was required to stabilise the economy. In a pandemic, the idea is to provide aid to cover the period in which the risk of infection makes social consumption impossible rather than to stimulate macroeconomic demand directly. Government intervention is nevertheless required to avert wider economic damage.

Only a decade apart, the global economy was thus shaken by its two deepest crises since the Second World War. Extensive government intervention was required in both cases to stabilise the economy. Against the backdrop of these crises, government seems reliable and strong, the private sector volatile and weak by comparison. That may explain why many people believe that the state should play a stronger role in the economy. However, it is easy to overlook that measures required in major crises may be counterproductive in normal times – similar to medical treatment that saves the lives of seriously ill people but would be harmful if administered to healthy people. Another factor is that, in the fiscal policy debates especially in Europe, there are frequent calls on the government to stimulate the economy through debt-financed programmes even in times of more or less normal economic performance and in situations in which weak growth is primarily attributable to structural rather than economic causes.

5 The term Great Moderation was introduced by Stock and Watson (2002).

Figure 1: G7 countries: fluctuations in real GDP growth (variance)



2. The global financial crisis and bank bailouts

The global financial crisis promoted interventionist ideas in part by triggering a recession that made government intervention necessary to stabilise the financial system and the wider economy, but it also created the impression that the prevailing economic system was suffering from a fundamental design flaw. In the financial sector, at any rate, high profits were generated for years that benefited managers and owners of banks as well as other financial market players. These profits were only possible by taking high risks. When the financial crisis hit, causing banks to suffer huge losses that brought them to the brink of collapse, billions of euros in public funds were used to stabilise the financial system.⁶

It is both unsurprising and entirely justified that the population was angry that profits had been privatised and losses nationalised on a grand scale, and that the

consequences of the crisis for the real economy led to job losses in sectors that were not responsible for the crisis. The financial crisis was seen not only as the manifestation of misconduct by the elite, but also of fundamental design flaws in the market economic order.

The public debate often lost sight of the fact that the combination of lax banking regulation, especially insufficient capital requirements for banks, and implied government bailout guarantees were the central causes of the crisis. Part of the market economic order is that profit opportunities and liability risks lie in the same hands, but this link had been broken in the financial sector. However, this is the exception rather than the norm; in other sectors, but especially in small and medium-sized companies and family businesses, the owners' liability for losses is one of the fundamental principles of doing business, and is guaranteed by adequate capitalisation. In the financial crisis, it was

⁶ See for example Sinn (2010).

therefore the departure from general market economic conditions rather than an “unfettered” market economy that led to the crisis. The problem was not the absence of regulation, but the incorrectly designed regulation of the financial sector and the predicament of the banking sector, which forced governments to take supportive measures. That did not change the fact that the financial crisis shook confidence in the market economy and led to calls for greater government supervision and regulation.

3. The debate about income and wealth distribution

Already seething criticism of trends in the distribution of income and wealth was strengthened significantly by the impression that the financial crisis enriched financially very well-off groups at the expense of taxpayers and therefore of “normal citizens”. Figure 2 provides an overview of the trend in inequality of disposable incomes since 1995 for selected countries. In the United States, income inequality was already higher in 1995 than in all other economies under review, except the UK. The income gap in the United States has widened since then, while it has stagnated in the UK. Sweden had the lowest income inequality in 1995, although it has increased considerably since then, reaching approximately the same level as Germany or France today.

These figures can be assessed in different ways. Especially in the United States, there is an increasingly critical debate about the high and still increasing level of inequality. The same applies to the UK. Income inequality levels are lower in France and Germany and have been stable since 2008. However, there are complaints even in these countries that, for instance, increases in income inequality have not been reversed since 1995 or that wealth is very unequally distributed by international standards, even if incomes are not.⁷

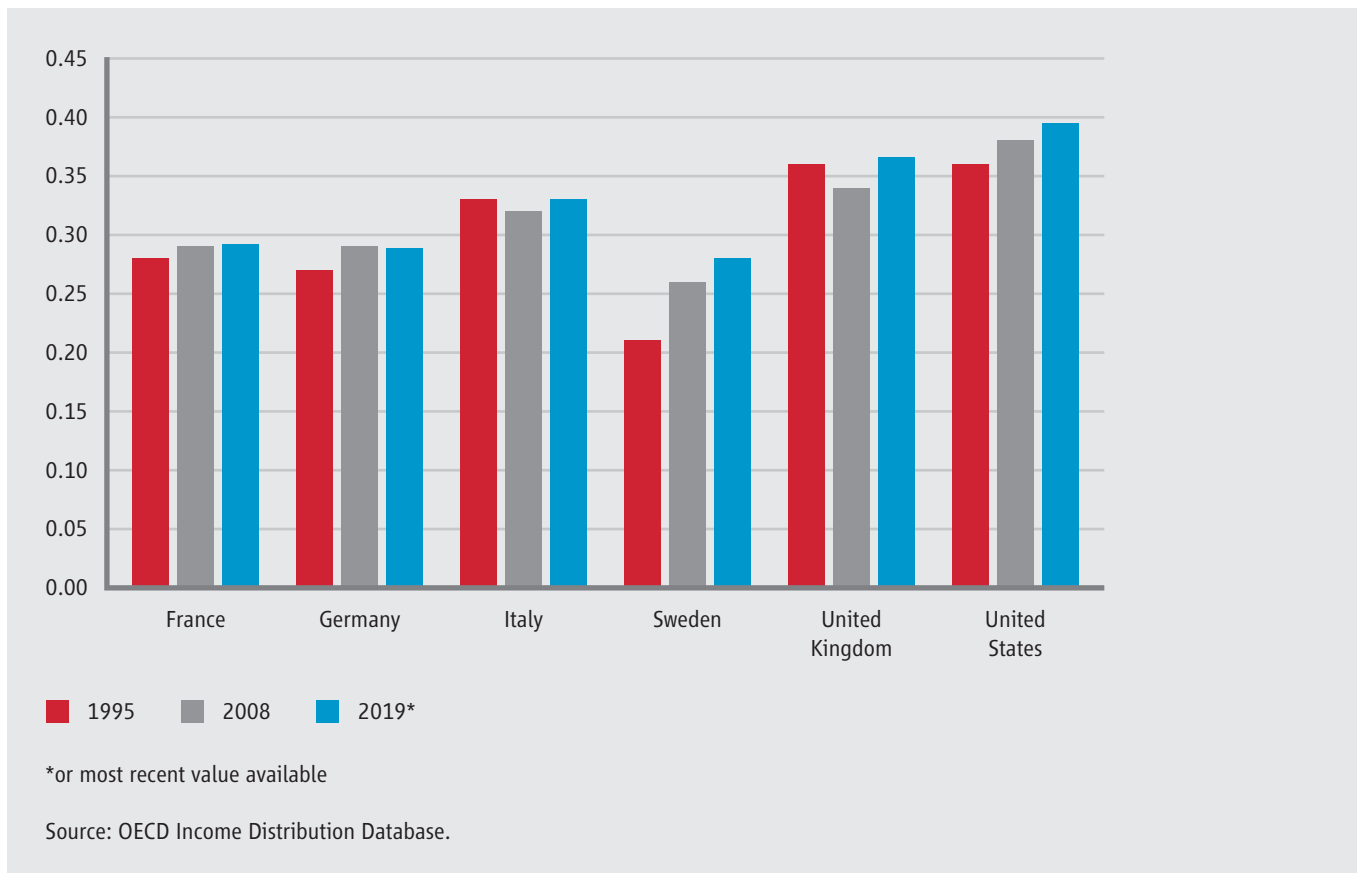
Sometimes the criticism is also levelled at income distribution trends *before* taxes and transfers. This applies, for instance, to the debate about the low-pay sector in Germany. One of the objectives pursued by the labour market reforms under the Agenda 2010 was to combat unemployment by facilitating employment in low-paid jobs and giving those employees transfers to boost their incomes. It is exactly these top-up payments that are today criticised for being morally reprehensible because they benefit employers at the expense of the general public. That was a key argument for the introduction of the statutory minimum wage. In the run-up to Germany’s parliamentary elections in 2021, this debate was expanded by the issue of whether full-time employment would result in an adequate old-age pension, leading to calls to raise the minimum wage to 12 euros per hour. This policy is based on the belief that politicians can and should set distribution results through direct market intervention rather than waiting to correct them subsequently through taxes and transfers.

What is more, especially in Europe, perceived income distribution is more unequal than actual income distribution in many countries, including Germany.⁸ These systematic misjudgements have consequences for the public debate and political decision-making. One example is a representative survey conducted in Germany in 2014, in which 59 percent of respondents said that income and wealth were not fairly distributed in Germany.

7 When comparing wealth distribution, assets held in the form of pension entitlements are normally left out of consideration, which distorts the results, see for example Fuest (2021).

8 See Niehues (2016).

Figure 2: Disposable income inequality (Gini coefficient)



4. Environmental destruction and global warming

From an economic perspective, environmental destruction and global warming are caused by externalities, i.e. by the fact that individual cost-benefit calculations are not aligned with those of macroeconomic costs and benefits. There is consensus about the significance of environmental protection and the risks posed by global warming. More controversial is the debate about the instruments to be used in pursuing the objectives of environmental and climate protection. In principle, market-based instruments such as taxes or tradable emission certificates are available for this purpose. These instruments have the advantage of enabling environmental objectives to be met at minimal cost.

Despite this advantage, reservations about the use of

these instruments are wide-spread. These reservations are traceable to the notion that, as in a planned economy, the government should specify directly which sectors and companies make what contributions to environmental protection objectives and what technologies are used in this process. Examples are calls for a ban on combustion engines, political targets for expanding the use of renewable energies, or a requirement to install solar systems on all roofs, or at least on all commercial buildings. Planned economic thinking is even more prominent in the area of green financial market regulation; under the taxonomy for sustainable finance, economic activities are classified in the context of political negotiations according to whether or not they are to be considered sustainable. Environmental protection plays an important role in this regard. Capital flows will then be directed so that they increasingly benefit the selected activities.⁹

⁹ See Fuest (2020 et al).

The trend towards interventionist environmental and climate policies is rooted to a degree in the belief held by many environmental movements and the associated political powers that planned economic action organised by government will deliver results, whereas they have little confidence in market economic systems.¹⁰

5. Low interest rates and scope for government debt

The global decline in interest rates – especially on government bonds – has led to a situation where budget constraints on the public purse are taken less and less seriously in the fiscal policy debate. Low interest rates combined with a monetary policy of purchasing large quantities of government bonds create the impression that there are no limits on the public sector’s financial room for manoeuvre.

This fails to take account of a number of important factors. The financing of budget deficits by the central banks will reach its limits when inflation returns – and trends suggest that this may be happening at present. There is no guarantee that interest rates will remain permanently low. Even if inflation and interest rates were to remain low in the medium term, the use of resources by the government means that they are no longer available for use in the private sector. This is not a problem as long as there are enough underutilised resources – that is, as long as there is high unemployment and companies have spare capacity. However, the economic situation being experienced in many countries is different. Especially in areas where there are frequent calls for higher government expenditure, for instance on construction or digitalisation projects, capacities are often fully utilised and cannot be increased without major effort. In those scenarios, growing government expenditure displaces private spending, and from a macroeconomic perspective, this is only an advantage

if government expenditure is more productive than private expenditure.

6. The rise of China – proof of the success of interventionist economic policy?

Internationally, China’s rise in recent decades is undoubtedly one of the most spectacular economic developments in the world. This rise can be attributed to its market economic reforms and the resulting opening to international trade and foreign investments. Even so, government control continues to play a central role in the Chinese economy, and industrial policy strategies such as “Made in China 2025” and initiatives with major infrastructure investments, such as the New Silk Road project, elicit concern as well as admiration from Western industrialised countries: the economic catch-up process attracts admiration, but the prospect that China could technologically overtake and ultimately dominate the West is cause for concern. This debate is reminiscent of the discussions about Japan’s economic rise in the 1970s and 1980s.

In response to China’s expansion, there are frequent calls for Germany or Europe to develop an industrial policy strategy of its own under which the sectors and technologies of the future are subsidised by the government. There is no doubt that government support for science and technology plays an important role in innovation and economic growth, and this support can be justified by the positive external effects of these activities, even in an economic system strictly based on market economic principles. What is controversial is whether, and if so, to what extent government should intervene in business investment decisions in order to pursue industrial policy objectives. This course of action can easily overlook that growth, innovation and productivity gains in China are not driven by the still influential state-owned enterprises, but primarily by

10 Thus we find, for example, the following statement in the resolutions of the 55th Federal Congress of the German Green Youth: “It is obvious that the much vaunted market forces can ensure neither compliance with the Paris Agreement nor good working conditions: this is why the public sector has to use its scope for action to create many well-paid public-sector jobs in social welfare, which includes the mobility sector”, *ibid*, p. 3 [our translation].

private companies. It remains to be seen whether industrial policy initiatives such as “Made in China 2025” will ultimately be successful and what role targeted investment control by the government will play in this process. Even if they deliver success, this does not necessarily mean that the government’s investment control

will work under the conditions of Western economic systems. To present China as proof of the success of interventionist economic policy is just as unconvincing as the notion that industrialised Western states need stronger investment control by government in order to stand up to China.

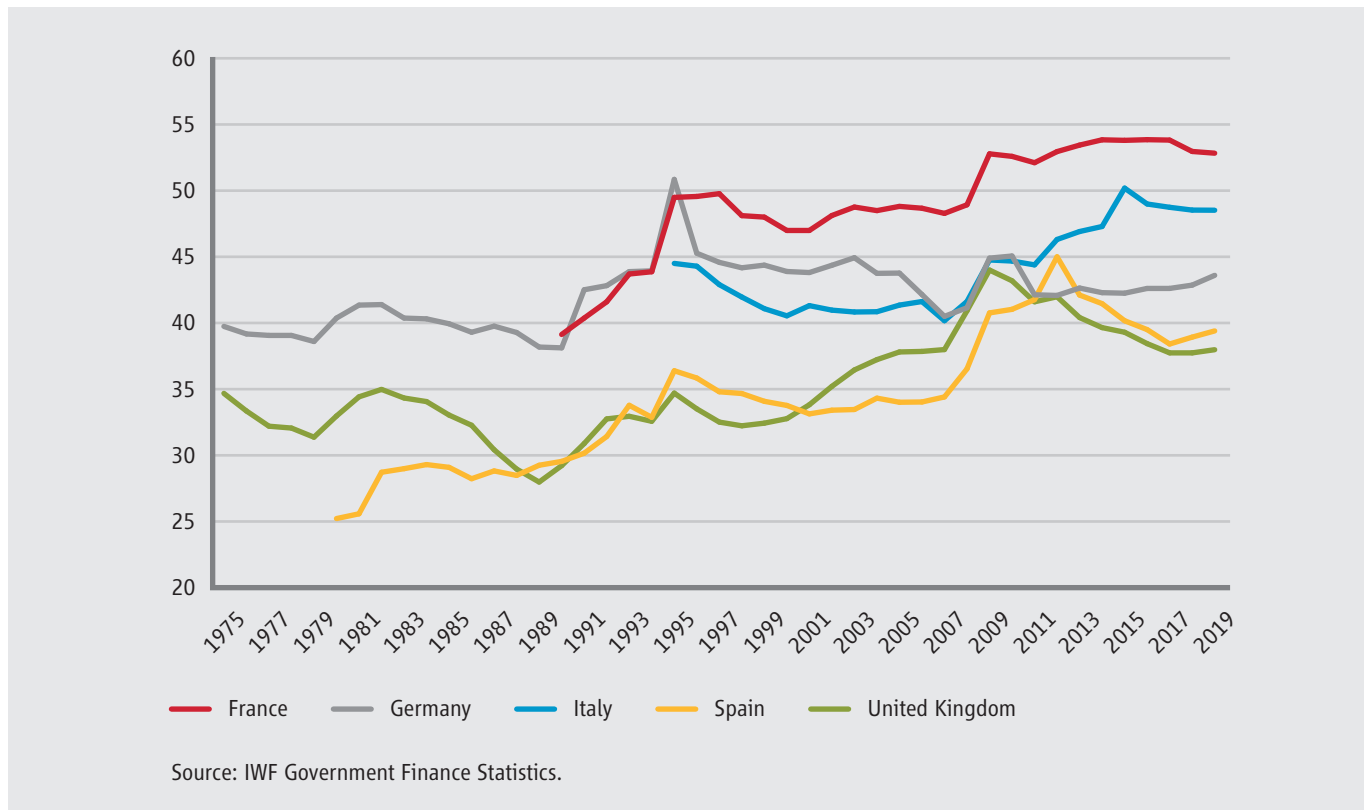
IV. How has the role of the state in the economy changed in recent years?

It is difficult to measure the state’s influence because it is complex and multidimensional. Let us look at the development of some key indicators of state influence in the economy.

expenditure minus interest expenditure; that is, only the government expenditure used to finance public services for the population is taken into account; interest is excluded because it is not used to finance government services. Of course government’s interest expenditure nonetheless has to be financed through tax and is therefore linked to government intervention.

Figure 3 illustrates the changes in government expenditure for five major economies in the period from 1975 to 2019. It shows primary expenditure, i.e. total

Figure 3: Government expenditure, 1975 to 2019 (primary expenditure in percent of GDP)



In all countries under review, the share of economic output attributable to primary government expenditure has risen markedly since 1975 – the start of the

data available here. This is particularly true of France, Italy and Spain. The UK and Germany have recorded a smaller increase, with considerable fluctuations in

between. However, since the mid-1990s, Germany's primary expenditure ratio has been largely stable, while it has risen in other countries over the same period. To some extent, these figures reflect growth differences since the global financial crisis, during which Germany performed better than other countries.

Figure 4 shows the development of social expenditure, the largest government expenditure item overall and the most important driver of increased government expenditure. A key reason for the rise in social expenditure is demographic change, which is driving up the cost of healthcare services and pensions. It would therefore be wrong to claim that it was growing government intervention in market activities that led to increasing government expenditure, especially in the past two decades. At the same time, it is obvious that politicians will have to find solutions for demographic change that limit the growth in social expenditure; otherwise, there is a risk of excessive demand on government finances.

When it comes to government intervention in economic activities, it is even more difficult to measure government regulation. The OECD has designed a comprehensive indicator for this purpose whose development in a number of countries is presented in Figure 5.

The OECD indicator for regulatory intensity is based on six sub-indicators that capture and aggregate government restrictions on market access and competition on the one hand and market distortion caused by direct government action, e.g. companies in public ownership, on the other. The method of calculating the OECD regulatory indicator has, however, changed in the meantime, with the result that the data for 2018 can be compared across countries, but not to figures from earlier years.

The data presented here paints a clear picture: regulatory intensity decreased in the period under review – in part because within the EU, there is a trend to reduce national market access restrictions.

A more comprehensive indicator for measuring government intervention in the economy is the Index of Economic Freedom published by the Heritage Foundation. It measures government influence on the economy from the related restrictions on individual freedom, and includes regulation as well as government expenditure and taxes.

Figure 4: Development of social expenditure, 1995 to 2019 (in percent of GDP)

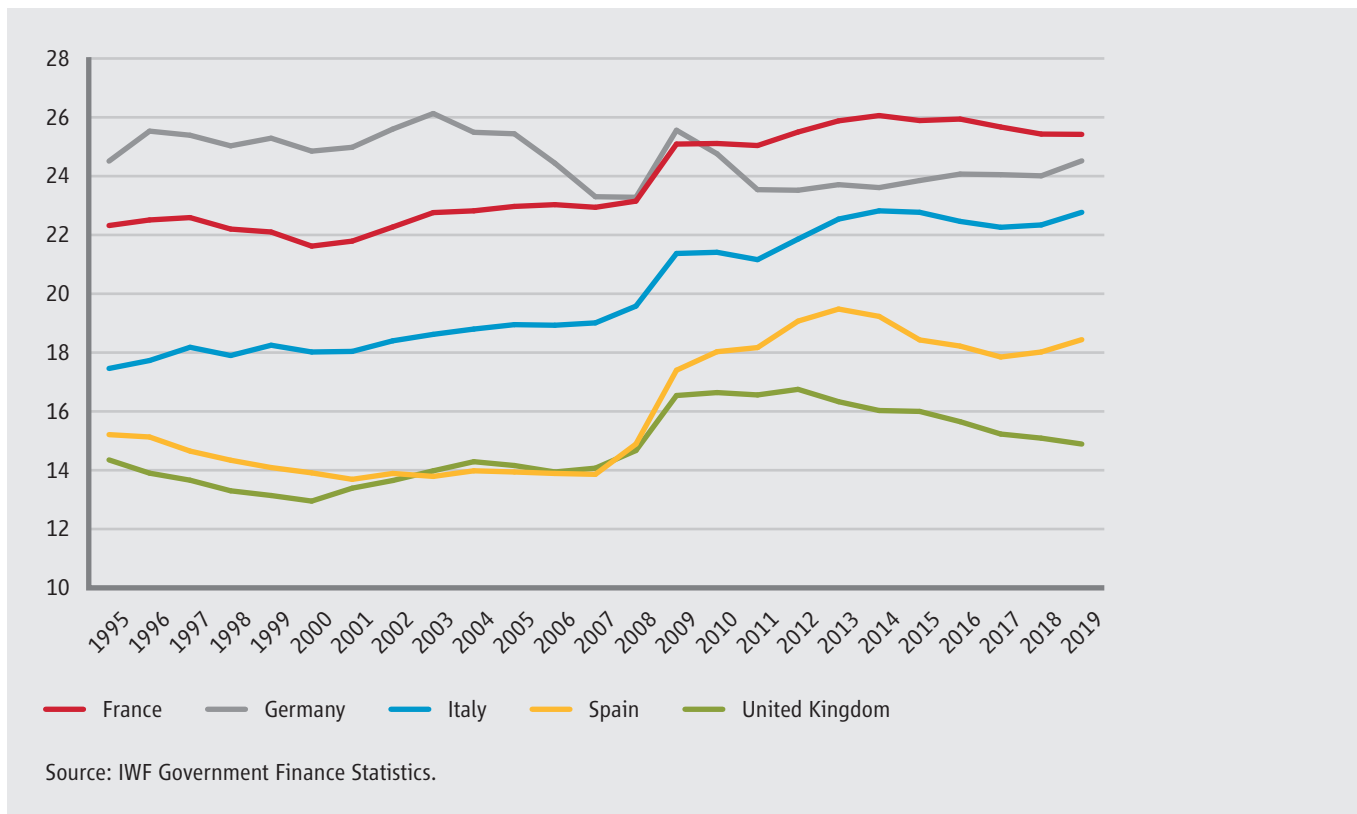


Figure 5: Product market regulatory intensity, 1998 to 2018 (OECD indicator)

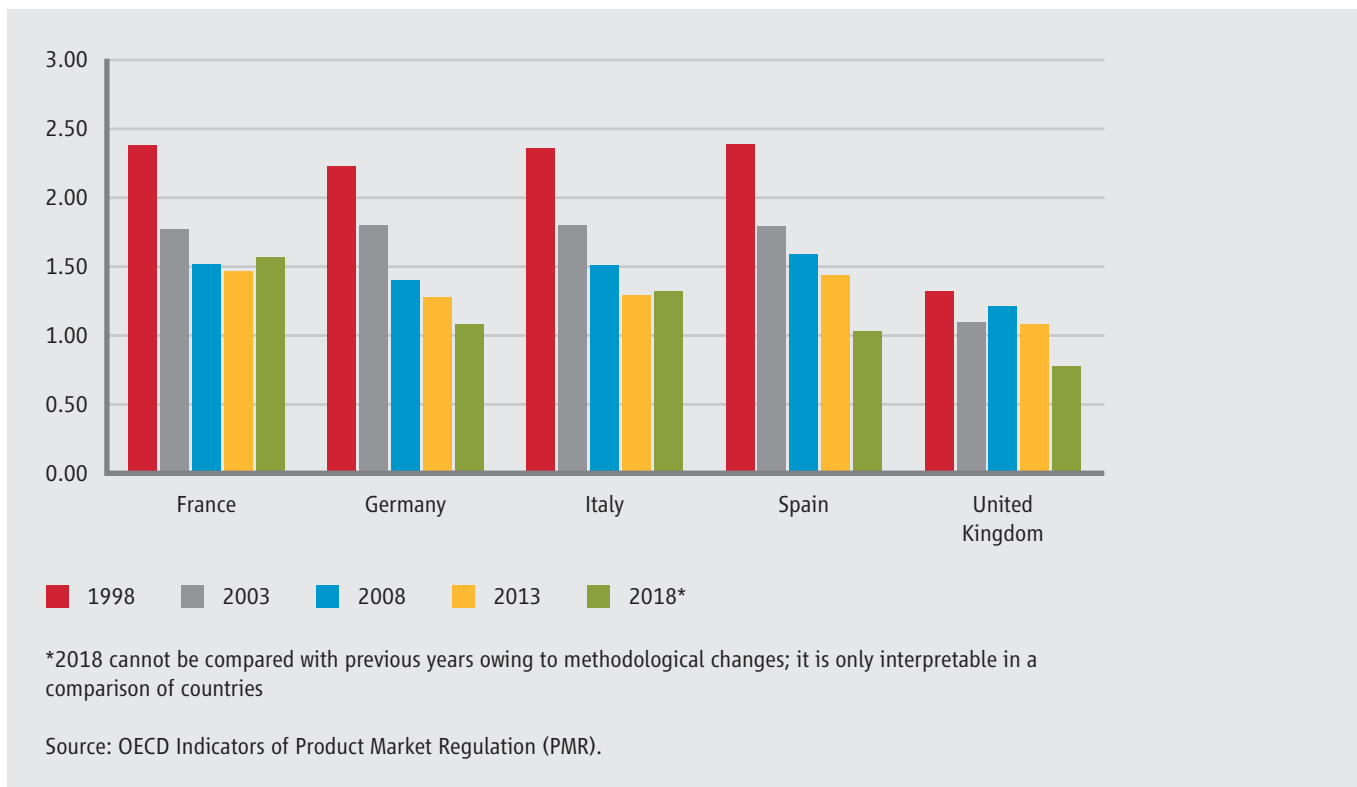
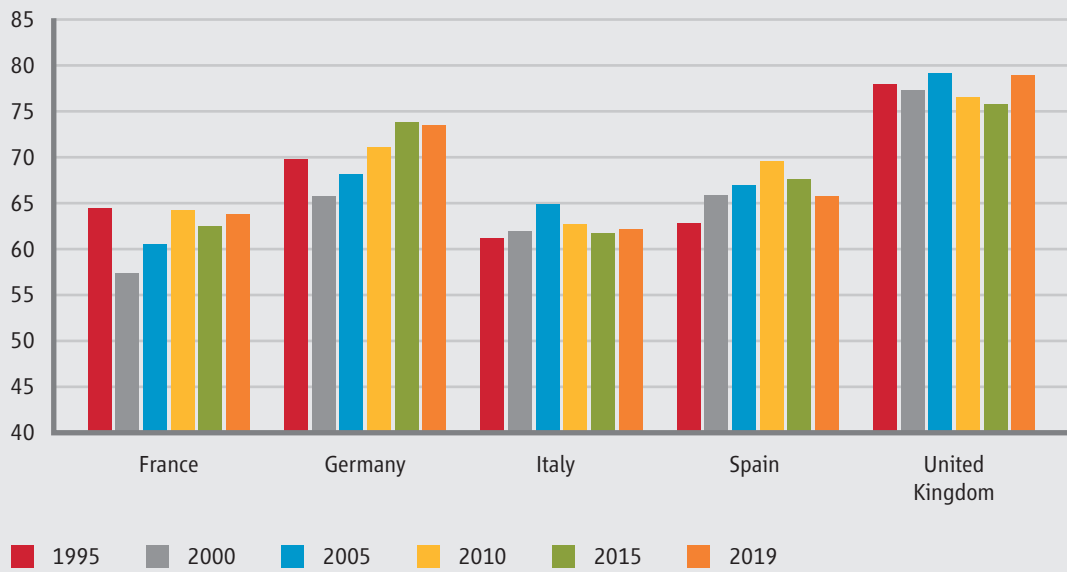


Figure 6: Index of Economic Freedom, 1995 to 2019 (Heritage Foundation Index)



Source: Heritage Foundation.

This graph presents a mixed picture. Greater economic freedom has been recorded in Germany and especially in the UK than in France, Italy and Spain, although the trend is not clear. While the index value for Germany increased, at least until 2025, no specific trend can be detected in other countries.

Overall, the indicators observed here show neither that government intervention in markets, at least before the coronavirus pandemic, increased to any significant extent, nor that the government was stepping back, as is

claimed from time to time, citing supposedly neoliberal policies.

During the coronavirus crisis, government intervention in economic activity expanded considerably. Given the seriousness and particular nature of the crisis, that is neither surprising nor problematic. The crisis has nevertheless had a considerable influence on the debate about future government action, as well as direct economic consequences for the role of the state in the economy, as is explained in the section below.

V. Consequences of the coronavirus pandemic for the role of the state in the economy

Will governments' role in the economy change following the coronavirus pandemic, and if so, how? During the crisis, governments did a lot to protect the economy by supporting employment relationships and companies. This led to rising budget deficits and an extremely expansionary monetary policy. In addition, governments imposed tight restrictions on individual freedoms. Overall, there was a massive increase in government intervention during the pandemic.

Some people argue that governments should continue to play a more active role, even after the pandemic, at least for an extended phase of economic recovery. In his book on politics after the pandemic, Gerbaudo (2021, p. 250) claims, for example, that "the public has accepted the need for greater government intervention more readily than was considered necessary given the impending climate emergency" [our translation].

This could be countered by saying that the weaknesses and inadequacies of governments' reactions to the pandemic reflect fundamental efficiency problems in the public sector. In his book on crisis management in Germany, Schularick (2021) talks of the "demystified state", permitting the conclusion that it would be counterproductive to devote more resources to it. A counterargument here could be that the efficiency problems are the result of inadequate funding, and taxes and levies would have to be raised to overcome them. The causes of the problems may also be of an institutional nature, which would indicate that appropriate reforms are needed. For example, the impression was created during the crisis that, although the federal and state governments coordinated their decisions, responsibilities tended to be blurred in the process and some necessary measures were not implemented. That would argue in favour of reorganising the distribution of tasks between the federal and state governments in Germany. Lastly, the point could also be made that the crisis situation was so special and unique that there are few lessons to be learned for the future of government action. None of this changes the fact that citizens and voters judge the actions of the government during the crisis, and the impressions they gain will influence their trust in government institutions and therefore the scope of the future role of the public sector. For this reason it may be interesting to examine how citizens' confidence in government changed in the course of the pandemic.¹¹

1. Citizens' satisfaction with their government during the crisis and confidence in state institutions

Survey data is available to measure the population's confidence in government and other institutions or organisations, although it has to be borne in mind that the results of such surveys vary and are heavily influenced by current circumstances. Figure 7 illustrates the results of Eurobarometer surveys on how citizens' confidence in national and EU institutions has changed over

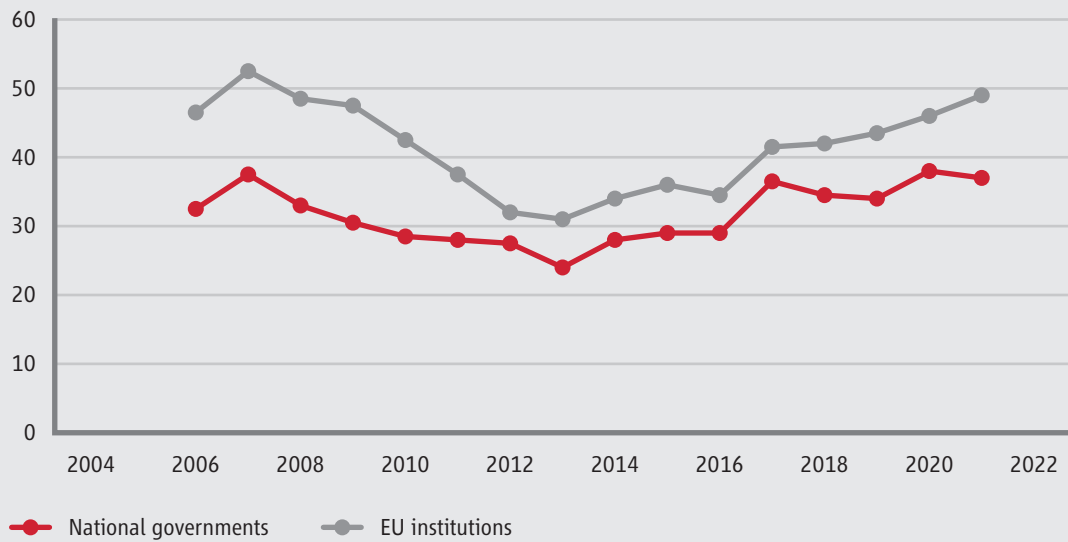
time. It covers the period from 2006 to 2021, which includes the financial crisis, the eurozone sovereign debt crisis and the coronavirus crisis.

Figure 7 shows that trust in national, and even more so in European, institutions declined sharply, especially during the eurozone sovereign debt crisis, but has gradually recovered from its low in 2013. It is not surprising that trust in political institutions and decision-makers suffers when the economic situation is bad, and recovers when the situation improves. Yet it became apparent during the European sovereign debt crisis that the eurozone's institutions failed to deliver what was expected of them. It is remarkable, however, that during the coronavirus crisis a similar collapse in trust has so far not materialised; in fact, the data indicates that trust in European institutions has even increased. One reason for this must surely be that, during the European sovereign debt crisis, the main concerns were the inefficient functioning of the institutions and the sometimes bitter and polemic conflicts being fought among member states. During the coronavirus crisis, there was less focus on the European political level, and the member states avoided conflict and showed solidarity, for example by creating the joint NextGenerationEU recovery plan. There are other surveys, however, that arrive at less encouraging results, as we will explain below.

Other studies measure citizens' approval ratings for the actions of their government over time and by conducting survey experiments. Herrera et al. (2020) use high-frequency survey data for this purpose, with a data set covering the period between January and July 2020. The data confirms that there was a *rally-around-the-flag* effect in the early part of the pandemic, i.e. a tendency for citizens to show solidarity with their national government in times of crisis. But in countries with high infection numbers whose governments did not succeed in containing the pandemic, support for politicians soon waned.

¹¹ See EEAG (2022) for more on the following.

Figure 7: Trends in confidence in national and European institutions, 2006 to 2021



Sources: Eurobarometer, own calculations: the table shows the average confidence values for each year. Survey question: For each of the following institutions, are you likely to have confidence in them or not have confidence in them?

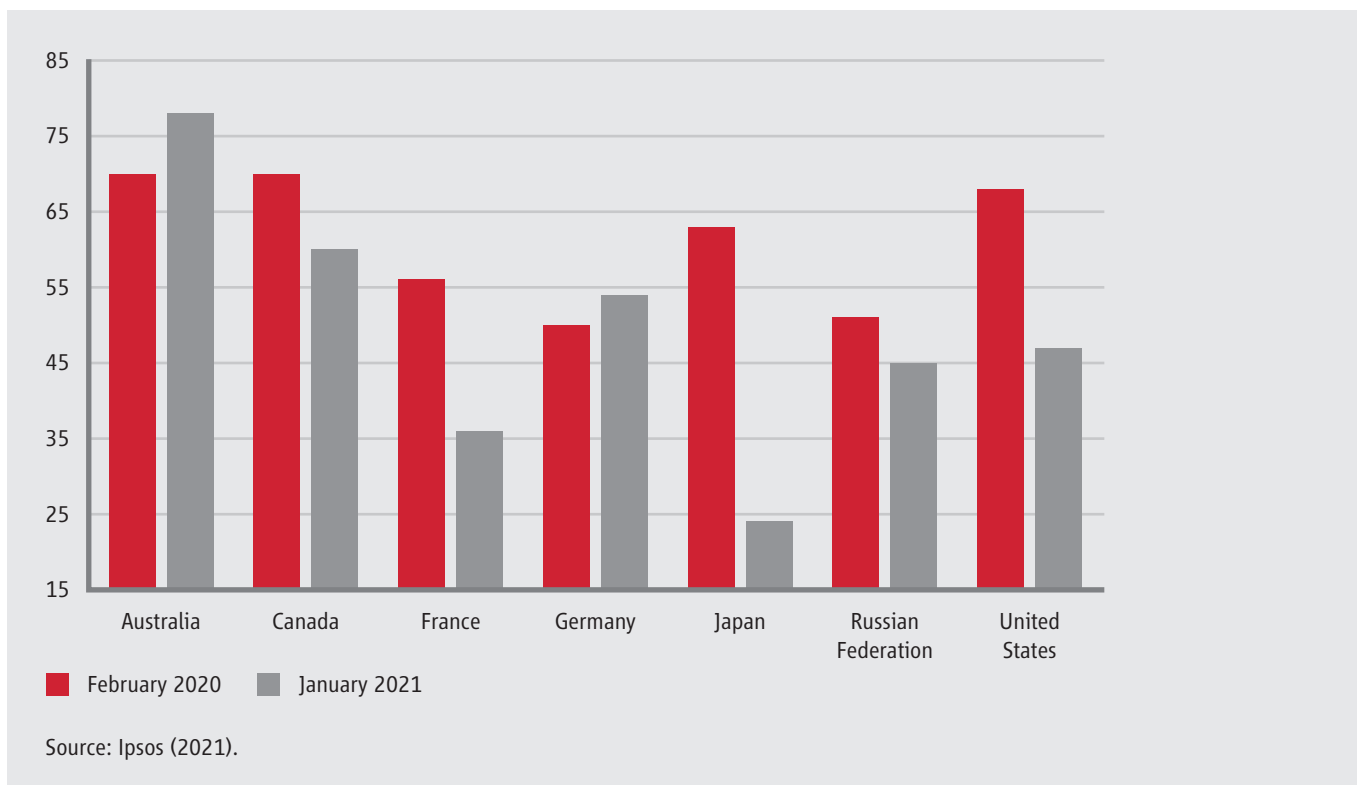
Since then, there have been further studies tracking trust in government over longer periods. Figure 8 shows results gathered by Ipsos (2021) in the course of two surveys. The first was conducted in February 2020, when the pandemic had just started in Europe. The second dates from January 2021, when those surveyed already had an idea of how their governments had dealt with the first and a large part of the second wave of the pandemic. The results are quite revealing. Australia is the only country that recorded a significant increase in the proportion of respondents who are confident that their government is dealing with the crisis effectively. In Germany, there was a small increase, which is at least an indication that confidence did not decline. But in all other countries, confidence declined, in some cases dramatically so. This data creates the impression that trust in government action during the coronavirus crisis tended to wane.

The data in Figure 8 underscores that the impression made by governments on their citizens during the crisis varies considerably between countries, and studies that take a more in-depth look at the different dimensions of crisis management confirm this. Figure 9 summarises

the results of a survey study conducted by Lazarus et al. (2020), which covers various dimensions of government's crisis management. Those participating in the survey were asked, for example, whether they thought their government had provided accurate information about the pandemic, whether they had received medical, financial and other aid, whether they believed that the government had protected households at risk, etcetera. The responses were combined into a covid score which can take values between zero and 100, with 100 indicating the highest possible level of satisfaction.

It is important to note that the survey was conducted in June 2020, i.e. after the first wave of infections and before further waves and subsequent vaccination campaigns. As Lazarus et al. (2020) demonstrate, the results correlate closely with the number of covid-related deaths and the general level of trust in the government.

Figure 8: Trust in the coronavirus crisis management of governments, 2020 and 2021

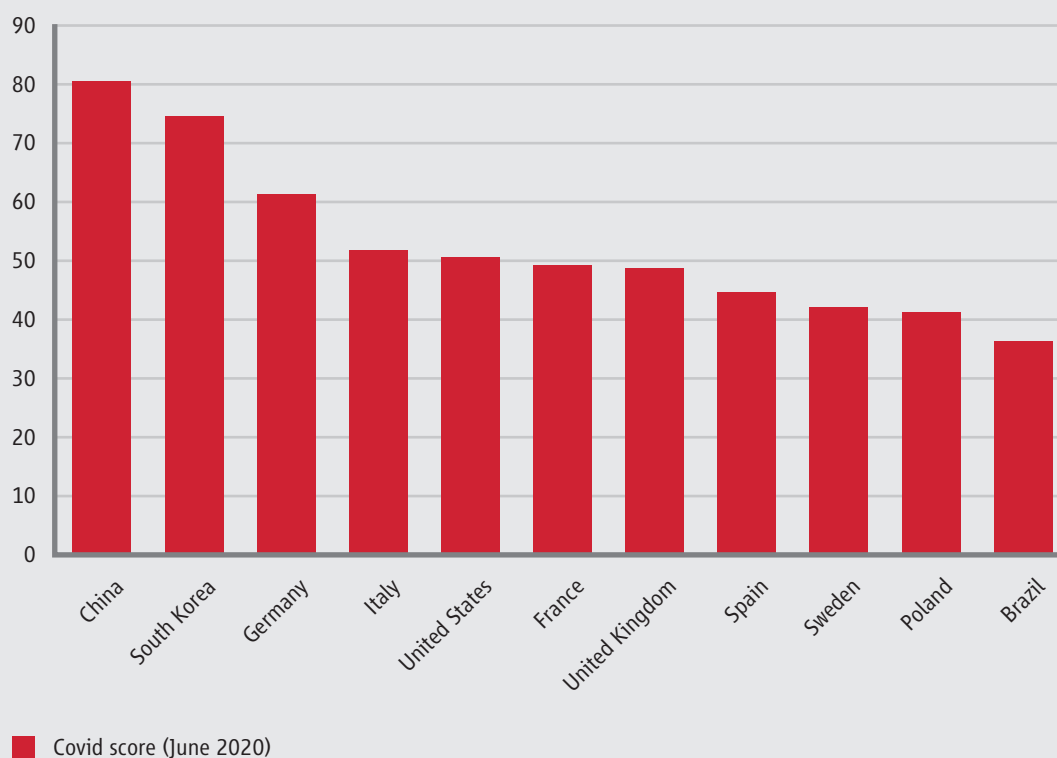


Gianmarco et al. (2020a) report on the results of a survey that was likewise conducted in June 2020 to assess the impact of the crisis on socio-political attitudes in Italy, Spain, Germany and the Netherlands. The results show that the trust of citizens in each other as well as their trust in institutions, support for the EU and for a welfare state financed by taxes declined as a result of the crisis. But the authors also found a *rally-around-the-flag* effect in favour of the governments in power and growing confidence in scientific expertise. At the same time, populist positions were losing ground. This could point to rising demand for skills in political leadership. In Gianmarco et al. (2020b), the authors arrive at the following conclusion:

“In this sense, a new fault line in the political arena may be opening up, confronting the increased demand for simple policy solutions of the past two decades with the complex, nuanced, and competent approaches demanded by the future.”

It should, however, once again be emphasised that this survey dates from June 2020, a relatively early phase of the pandemic. Changes in the levels of confidence in governments and ultimately also demand for government services depend on the perception of government actions over the entire course of the crisis.

Figure 9: Citizens' satisfaction with their national government's management of the coronavirus crisis (Covid score, June 2020)



Source: Lazarus et al. (2020).

2. Consequences of the crisis for the role of the state in the economy

In addition to these changes in how the state is perceived by its citizens, the crisis has created a number of economic facts that will influence the future role of the state in the economy. The first thing to note is the significant rise in government debt, which curtails the scope for government action in that fewer resources are available for providing public services. At the same time, there is increasing pressure to raise taxes and levies. Fiscal pressure is also reducing the scope for redistribution (Ayaz et al. (2021)).

A second important change is the loss of education and training services, which is particularly serious in a time when digitalisation has accelerated because of the pandemic and is driving structural change. There is a need for action in education policy in order to compensate

for the deficiencies that have arisen. However, changes made to education and training to adapt it to this transformation will also require room for greater corporate engagement, including family businesses, which are already closely integrated with occupational training systems.

Overall, citizens rate the services provided by government institutions in various countries during the coronavirus crisis very differently, as the data explained in the previous section shows. It certainly cannot be said that there has been an erosion of trust or a failure of the state, at least not across the board. There is, however, no indication either of renewed, increased demand among the population for a greater government role in the economy beyond the period of crisis. In many countries, including Germany, shortcomings became apparent in specific areas and were also observed by citizens, for example in the digitalisation of the public

administration, health authorities and schools. Yet there is some evidence of the demystification of populist

politicians and a growing demand for skills and for policies based on scientific insights.

VI. Future developments and risks of neo-interventionism to economic prosperity

As the coronavirus pandemic recedes, other economic and financial policy issues will come back into focus, especially energy and climate policies, trade policy, industrial policy as well as social, labour market and housing policies. That interventionist ideas play a prominent part in current debates has less to do with the effects of the coronavirus crisis and more to do with the developments that preceded it, which are described in section III. These policy areas face the risk that considerable economic damage will be done if neo-interventionist ideas prevail. Let us examine this more closely.

1. Risks of neo-interventionism to economic prosperity

When considered from the viewpoint of economic theory, the benchmark for assessing economic policy concepts is found in welfare economics, including the theory of market failure and public choice theory, which deals with problems associated with state failure. Ultimately, the solution to problems of economic policy is to choose the best among different imperfect institutional arrangements. From an economic perspective, there is no doubt that government intervention is necessary to achieve efficient results or avert damage in certain areas, for example in environmental policy. What is decisive, however, is the choice of instruments used.

There is sometimes a misconception that criticism of interventionist action is directed against all forms of government intervention or rules and prohibitions in general. That is misleading: even in a “night-watchman state”, i.e. a state that limits its role to fulfilling elementary public tasks, such as internal and external security and the protection of private property, it is part of the state’s responsibilities rigorously to enforce certain prohibitions, such as the protection of private

property. Anyone who unlawfully appropriates or damages the property of a third party will not only have to compensate the owner for the loss or damage, but may also face criminal consequences. This represents massive government intervention.

Neo-interventionism poses a risk to economic prosperity because it shapes government intervention in such a way that the objectives pursued are not achieved at all, or only at a cost that exceeds what is unavoidable. At issue is often not “more or less government”; in many cases, the issue is whether and how government intervention is combined with the use of market economic processes, whether different government measures are consistent and coordinated, and whether the government has the knowledge required to ensure that the planned market interventions will in fact increase economic prosperity or that other stated objectives are met at minimal cost. We provide a few examples to illustrate this below.

2. Choice of instruments in environmental and climate policy

A number of different instruments are used in environmental policy in order to internalise external effects or to limit or prohibit activities of individual economic entities if they cause harm to others. Interventionism is not harmful if it specifies environmental objectives, such as the target of limiting carbon emissions to a certain volume. These kinds of targets will always be controversial, but from an economic policy perspective, the decisive criterion is what instruments are used to achieve these targets. In order to meet a set emissions target while keeping the economic cost to a minimum, it makes sense to charge a standard price for the carbon emissions of all sectors, for example, with a system for

trading emission certificates. If the private-sector players gear their action to the price of these certificates and avoid emissions whenever the cost of avoidance is lower than the price of an emission certificate, the consequence is that emissions are avoided where this can be done at the lowest cost without government or anyone else having to know in which areas of the economy the cost of avoidance is lowest.

Interventionist environmental policy, by contrast, specifies where and how emissions must be reduced by directly intervening in private business decisions.¹² Examples of these kinds of interventions are a ban on combustion engines for motor vehicles, which is currently being debated, a requirement to install solar systems on every roof, or the government's instruction to phase out the use of coal as a fuel in power generation. The impact of interventionist measures in climate policy also depends on the overall design of the environmental policy toolbox. In the EU, for example, the transport and building sectors are currently excluded from the European system for trading CO₂ certificates, although coal-fired power stations are not. In this situation, the intervention of a ban on combustion engines is certainly not an efficient climate policy instrument – efficient would be to integrate transportation into the emissions trading system. Even if other drive systems are available and in fact reduce carbon emissions, there will at least be some contribution to climate change mitigation. The government's instruction to switch off coal-fired power stations, by contrast, does not make any contribution to climate change mitigation if the power generation sector is already included in certificate trading.

All of this does not mean that price alone is always enough to achieve environmental and climate objectives in the best possible way, but additional intervention – such as where the carbon price is not effective – must be well considered and coordinated with the price of carbon emissions. Improved thermal insulation of

buildings, for example, reduces heating costs for tenants. If, however, rent regulation means that these costs cannot be fully recovered through rentals and therefore have to be partially borne by landlords, rising carbon prices will not provide any incentive to insulate buildings to the correct extent, because landlords would incur high costs without benefiting from thermal insulation. If there is no will to change this rent regulation, it may make sense to provide additional financial incentives for landlords to invest in thermal insulation.

Another example of harmful interventionism in environmental policy is the limitation of particulate emissions in inner cities by imposing driving bans on diesel vehicles. An intelligent use of market mechanisms would lead to better results. Instead of blanket bans, flexible toll systems should be used, with toll charges rising when particulate pollution increases. The result is that only those vehicles will enter the city centre for which not doing so would entail high costs. For example, craftsmen delivering windows to a construction site will hardly be able to do without their van. Restaurant clients or people attending a cultural event, on the other hand, will switch to public transport even at lower toll charges, because this will result in lower costs for them. Blanket driving bans have the major disadvantage of not considering that they have different consequences for different motorists. This makes compliance with emission limits for particulate pollution more expensive for the economy as a whole than is unavoidable.¹³

3. EU sustainable finance taxonomy

A particularly obvious example of neo-interventionism is the EU sustainable finance taxonomy. It is part of the EU's Sustainable Finance Action Plan (European Commission (2021)), which in turn belongs to the EU's agenda on climate change mitigation and sustainable economic activities within the meaning of the Sustainable Development Goals of the United Nations. In

¹² See Fuest (2020a) for more on the following.

¹³ See Fuest (2020a).

principle, the EU Action Plan covers three sustainability dimensions: environmental, social and governance. To date, however, the legislation has focused on the first criterion, environmental sustainability, pursuing a number of different environmental objectives, including climate change mitigation, climate change adaptation, sustainable use of lakes and oceans, protection of biodiversity and many more (TEG, 2019).

The EU taxonomy aims to direct capital flows into parts of the economy whose activities can be considered “sustainable”. In an economic system based on market economic principles, i.e. a system that is not managed by central planning, it is unusual to attempt to compile a catalogue of all economic activities intended to have preferential access to financing. This project is causing a number of serious problems.

Firstly, given the diverse nature and fast pace of economic change, attempts to create a list of all economic activities that meaningfully represents the part of the economy that is sustainable are not likely to succeed.

Secondly, the political negotiation process is highly susceptible to being influenced by special interests. It is doubtful whether incentives in the political process, which tend to be guided by short-term election cycles, can ever be suitable for promoting sustainability in the economy as a whole.

Thirdly, it is significantly more expedient in areas where private business activities conflict with sustainability objectives for reasons of market failure – such as external effects – to address the causes of market failure directly.

Fourthly, there are complex balancing and transitional problems in the area of environmental protection alone. Wind turbines are in conflict with bird protection. Modern diesel engines and gas turbines can make important contributions to climate change mitigation, at least for a transitional period. Arms manufacturers are not normally seen as models of sustainable economic activity, but the EU’s security can hardly be ensured without a

dedicated defence industry. Classifying these activities into sustainable or not sustainable does not do the facts justice. The point is rather to find the right balance for these activities. This ultimately requires the use of price signals and the cause-based allocation of costs and income of economic activities.

Fifthly, there is a lack of coordination with other climate policy instruments, such as trading in CO₂ emission certificates. Sixthly, there is a risk that certification and monitoring processes implemented to ensure compliance with regulations and standards in the classification of economic activities will lead to high costs and efforts.

One of the strengths of the market economy, and ultimately one of the pillars of prosperity, is that capital markets decide on the basis of price signals which activities receive capital flows. To disable part of this fundamental function of the capital markets or distort them by imposing a political administration and control process, as is envisaged with the taxonomy, may lead to massive reductions in efficiency and prosperity. This could be countered by arguing that the taxonomy is merely aimed at informing capital market participants and will not necessarily have any directive effect, but this view of the matter is not convincing. There are already signs that there will be political intervention on the basis of the taxonomy in banking and financial market regulation and supervision as well as in monetary policy in the refinancing of banks, and this will result in political control of capital flows.

4. Property market: rent regulation, rent caps, expropriation

The property market is a classic example of interventionist economic policy. At issue is not the government’s redirection of resources, but the pursuit of redistribution targets by intervening in market prices, even going as far as expropriation. Rent regulation is widely used. Its aim is to redistribute funds from landlords to tenants. This is questionable in itself, because redistribution should in fact be based on individual economic

performance. Although it can be assumed that, commercial leases aside, landlords have higher average incomes than tenants, this certainly does not apply in each and every case. Even in cases where this is true, the redistribution effect is diffused by the fact that differences in economic performance between landlords are not taken into account. A more important aspect is, however, that rent regulation has harmful side effects that lead to negative distribution and efficiency effects.

The impact of regulation on supply plays a key role in this regard. The most important criticism levelled at rent regulation is that it causes the supply of rental housing to fall, thus exacerbating the housing shortage. As explained earlier, it is typical of neo-interventionist concepts to assume implicitly or explicitly that there is a low incidence of chain reactions as a result of government-induced price changes. In the case of rent caps, this would mean that the supply of housing would not decline. This can be justified by arguing that the stock of available housing is a given and can, in any case, not be changed in the short term. This is not a convincing argument for a number of reasons. Firstly, harm would be done by even a medium-term decline in the stock of property available for rent as a result of falling housing construction and cuts in maintenance investments. Secondly, the argument neglects the effect on the use of existing housing stock. Rental flats can be converted into owner-occupied flats. Politicians like to respond to such developments with follow-up intervention in the form of restrictions on these types of conversions, but this makes it even less attractive to build rental properties in the first place. Rental flats can be used by their owners themselves. Another effect of rent caps is that existing tenants keep their flats for longer, even when the space becomes too large for them, for example once children grow up and leave home.

Empirical studies on rent regulation show that these effects really occur. Rent caps in Berlin are a very good case in point. As Dolls et al. (2021) demonstrate, offers

of rental flats in that segment of the market subject to the rent cap declined significantly immediately after regulation was introduced, i.e. the rent cap made the housing shortage worse. Similar outcomes have been documented for rent regulation in other countries.¹⁴ We must realise that, from a politico-economic perspective, the rent cap is primarily aimed at redistributing funds in favour of tenants who already have housing, as they make up a large proportion of the electorate. The negative consequences for those looking for housing are accepted in the process.

While the rent cap was being rolled out, a debate started in some political quarters in Berlin on expropriating large private residential property companies – a debate that has intensified since the Federal Constitutional Court declared the rent cap unconstitutional. This kind of expropriation and transfer into state ownership would obviously not make any difference to the number of available residential units in the short term, but in the medium term, the negative effects on private housing construction would reduce the supply of housing. The ultimate aim here is to turn an important sector of the economy from one organised according to market economic principles into a government-run sector. From a politico-economic perspective, this gives existing tenants the opportunity to improve their financial position, initially at the expense of the property owners, and in the long term to the detriment of the community of taxpayers in order to keep rentals low. From a macroeconomic viewpoint, this kind of nationalisation of the production of mainly private goods will mean a considerable loss of prosperity.

5. Foreign trade

There have been repeated calls for government control measures in foreign trade policy to remedy actual or perceived problems. After the outbreak of the coronavirus pandemic, there were disruptions and stoppages affecting large parts of foreign trade. At the same time,

¹⁴ See for example Diamond et al. (2019).

there was a sharp rise in demand for medical products such as face masks, disinfectants, certain medications and ventilation equipment. In many cases, these goods were only manufactured abroad, often in Asia. Many countries responded to the emergency by intervening in the market and initially securing supplies for the domestic population.

As a result there are frequent calls to reduce the dependency on imports for medical goods. The French government, for example, submitted a plan for repatriating the healthcare industry.¹⁵

Foreign trade frictions are, however, not limited to healthcare products; international trade as a whole was disrupted when the coronavirus crisis broke out. An important factor here was that national borders were closed not only to people, but also to the transportation of goods, even though imports and exports of goods are associated with substantially fewer risks than the entry or exit of people. After these disruptions in the early phase of the pandemic had led to a collapse in international trade and industrial production, most countries changed their policies and kept their borders largely open, at least for the movement of goods. Despite this, there have repeatedly been disruptions to trade, for example because the authorities respond to local Covid-19 outbreaks by closing ports and other logistical facilities.

Since the summer of 2021, an increasing number of industrial companies are affected by problems with the supply of intermediate goods and input products. Shortages were first noticed in the supply of semiconductors and then spread to a wide range of input products. The problems were caused not only by the closure of borders or ports ordered by governments, but also by coordination problems in container shipping and a global pandemic-induced shift of demand away from services to goods. This overwhelmed existing production

and transport capacities, which can only be adapted to a limited extent.

Since many companies, especially in Germany's strongly export-focused industry, are closely integrated into international value chains, disruptions in these value chains quickly have far-reaching consequences for industrial production. Another factor is that warehousing has been reduced in many instances in recent decades to cut the costs associated with tied-up capital.

Against this backdrop, there are increasing calls to shorten international value chains and aim for a higher degree of self-sufficiency, not necessarily at the national level, but in Europe at least. The debate over the lessons to be learned from the crisis-induced trade frictions is both useful and necessary in principle. At the same time there is a risk that very different problems will be mixed up and interventionist action taken by government will do damage. It is the task of companies to adjust their value chains where necessary in the light of experience gathered during the crisis and, for example, to readjust the ratio of cost savings through just-in-time supply structures to reserves to cushion any disruption. In this process, greater resilience does not necessarily mean a shift of production sites to Germany or Europe, but in many cases requires greater international diversification – and it is questionable whether government intervention is necessary and useful here. Whatever the case, a government-controlled shortening of international value chains would have far-reaching consequences, especially for the German economy, which relies heavily on exports.¹⁶ If imports were to be replaced by government-subsidised domestic production, other countries would respond by taking appropriate protectionist measures.

It is no doubt correct for the government to review geostrategically relevant dependencies – for example

15 Ministère de l'Économie, des Finances et de la Relance, Le plan d'action pour la relocalisation des industries de santé en France, *économie.gouv.fr*, 18 June 2020, <https://www.economie.gouv.fr/plan-daction-pour-relocalisation-industries-sante-en-france> [as at: 1 Feb. 2022].

16 See Flach et al. (2020).

on semiconductor production in Taiwan, as private companies will not take government's overall geostrategic interests into account in their decision-making. Yet whether the government-sponsored and managed establishment of semiconductor plants in Europe is the right answer has to be the result of comprehensive analysis of mutual strategic dependencies, rather than a review of the semiconductor sector in isolation.

Government is also right to take precautions against health risks. But that does not necessarily mean that

VII. Conclusions

Neo-interventionism in economic policy holds considerable risks for economic prosperity. After the global financial crisis, the coronavirus pandemic is the second serious crisis to have shaken the global economy in the past 15 years. Both crises required emergency measures to be taken by government to avert major loss or damage. It is just as important, however, to scale back emergency measures once the crises have been overcome. One of the lessons learned from the financial crisis is that some regulations need to be more restrictive in the financial sector, especially capital requirements for banks, but stronger active control of the economy by government is not necessary. It is becoming increasingly clear that global environmental problems, such as climate change and loss of biodiversity, require government action, but government intervention in this area should be appropriate.

Criticism of neo-interventionist economic policy strategies is not levelled at government intervention per

self-sufficiency ought to be sought for the production of healthcare products. Greater supply security can also be achieved through cooperation and suitable agreements to provide mutual assistance in the case of health risks, at least at the European level, but ideally more widely. As with other goods, it will often be more expedient to diversify supply sources than to convert to domestic production.

se. These strategies are necessary, for example, in the form of strict limits on carbon emissions, in the protection of biodiversity or in regulating financial markets and banks, in promoting fundamental research, in infrastructure development and in many other areas. Criticism is directed at an excessively interventionist choice of instruments, which often comes with government-controlled resource allocation to certain sectors or locations that does not take market signals into account, or at government that is prescriptive in its selection of technical solutions. The challenge is to arrive at an appropriate combination of market solutions and government regulation that allows the attainment of overarching social objectives, such as a high level of prosperity, broad participation in this prosperity, and sustainability.

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Interventionism and the constitution: How much state intervention is compatible with entrepreneurial freedom?

Prepared by Prof. Dr. Dr. Udo Di Fabio

I. Interventionism as a trend-indicating term

Interventionism and neo-interventionism are terms that originate not in the legal world but in political debate and academic discourse. Like terms such as neoliberalism or neo-protectionism, they are used to indicate a trend, to highlight or discuss the trajectory of economic policy. The slippery nature of such vocabulary, which often means different things to different people, is exemplified by the concept of neoliberalism. Originally coined by economists, it bore little relation – at least in the German tradition represented by figures such as Walter Eucken¹ or Alfred Müller-Armack² – to current notions of neoliberalism held particularly by its detractors.³ Their paradigm of the social market economy did not advocate unbridled capitalism, nor did it regard the market as an entirely self-regulating institutional order.⁴ Instead, ordoliberalism sought to provide the market economy (based on private property and freedom of contract) with a well conceived legal framework set by the state – the aim being to maintain the smooth operation of the market, to enable a free society and to put the market economy at the service of the people as a constitutionally protected space in which they could

shape their own lives and pursue their interests.

In the United States, however, Friedrich August von Hayek, and most of all the monetarist Milton Friedman (an influential figure in the economic policies of President Ronald Reagan and the British prime minister Margaret Thatcher), gave neoliberalism another face, which has come to shape its international image. This form of neoliberalism regarded itself in particular as a counter to what its proponents saw as welfare state interventionism that had emerged with Roosevelt's New Deal. That interventionism, they believed, was guilty of paralysing the economy, increasing inflation, fuelling government debt and often failing to (efficiently) meet social policy objectives. As early as 1946, Milton Friedman and George Stigler sought to demonstrate that rent control reduced the supply of affordable housing rather than increasing it as intended.⁵ The debate between neoliberalism (in the American understanding) and state interventionism thus appears stuck in a constitutionally indistinct zone, a domain of normative indifference.

II. Economic constitution: the traditional dogma of the German Basic Law's neutrality towards economic policy

Case law right from the early days of the Federal Constitutional Court emphasised the neutrality in economic policy of the Basic Law (Grundgesetz), the constitution of the

Federal Republic of Germany. The court's decision on the Investment Aid Act (Investitionshilfegesetz) in 1954⁶ gave rise to the following dictum, still frequently cited today:

1 Viktor J. Vanberg, *The Freiburg School: Walter Eucken and Ordoliberalism*, *Freiburger Diskussionspapiere zur Ordnungsökonomik*, no. 04/11, 2011, accessed at https://www.econstor.eu/bitstream/10419/4343/1/04_11bw.pdf, on 7 February 2022.

2 Alfred Müller-Armack, *Wirtschaftsordnung und Wirtschaftspolitik*, second edition 1976, pp. 78 et seq.

3 On this term and the history of the idea: Thomas Biebricher, *The Political Theory of Neoliberalism*, 2019, pp. 11 et seq.

4 Eugen Buß, *Lehrbuch der Wirtschaftssoziologie*, 2019, pp. 177 et seq.

5 Milton Friedman/George J. Stigler, *Roofs or Ceilings? The Current Housing Problem*, New York 1946, see the summary, pp. 21 et seq.

6 BVerfGE 4, 7 et seq.

“The Basic Law guarantees neither the neutrality of the executive or legislature in matters of economic policy nor a ‘social market economy’ managed only by market-compatible means. The ‘neutrality in economic policy’ of the Basic Law lies solely in the fact that the constitution has not explicitly decided upon a particular economic system. This enables the legislature to follow whatever economic policy it regards as appropriate, provided it adheres to the Basic Law.”⁷

From this judgement, and based in particular on Article 15 of the Basic Law (known as the socialisation clause), some even concluded that the court had given a green light to wholesale nationalisation and public ownership of the economy and thus that a socialist economy with strong elements of state planning could be compatible with the constitution. Wolfgang Abendroth, for example, an early Marxist interpreter of the Basic Law, took the view that the state could socialise productive assets and plan the economy. At the other end of the spectrum, the influential Hans Carl Nipperdey, professor of civil law and the first president of the Federal Labour Court, argued that the freedoms protected by the Basic Law were incompatible with anything other than a market economy, albeit one that the government needed to balance against social cohesion by correcting it accordingly.⁸ With its judgement in a case concerning the Co-determination Act (*Mitbestimmungsgesetz*) in 1979, the Federal Constitutional Court accepted the principle of interventionism (in the sense of partial political control of the economy) but balanced it with basic rights. Notably, the court considered this issue in relation to the epistemology of state planning – the question of what policymakers are able to know and what they need to know in order to sensibly direct the economy.

“The Codetermination Act results in material changes to the economic order. It differs through its far-reaching content from other laws directing the economy, but shares with them its relatedness to matters subject to more rapid change than other areas characterised by relatively greater stability.”⁹

The inherent difference between political and administrative decision-making processes on the one hand and the processes of market-based exchange on the other result in insurmountable complexity whenever the former seek to direct the latter. State direction of the economy is possible and, when it takes the form of well-designed incentives, can even be to the benefit of market forces. However, where political and legal measures result in the bureaucratic micromanagement of behaviour and infringe on entrepreneurship and innovation, a loss of efficiency follows. If, as in the planned economies of the former Eastern Bloc, the market as an institution is practically eliminated and replaced by politically determined targets for investment, production and distribution, this can only result in an enormously inefficient system.

Following German reunification in 1990 and the implosion of the socialist planned economies in the Eastern Bloc, this increasingly became the dominant view. Intervention in property ownership, in investment and pricing was not considered unconstitutional per se, but had to be more closely weighed up against its impact on basic economic rights. This more market-friendly balance was also related in significant part to the project of European integration, since the basis for the internal market and for overcoming national protectionism was closely bound up in EU primary law with basic freedoms and the principle of the open market economy (Art. 119 et seq., 127 TFEU) or social market economy (Art. 3 TEU), rendering it incompatible with state planning.

7 BVerfGE 4, 7 (17 et seq.) [our translation]; similarly 50, 290 (336 et seq.).

8 Taking stock of the case law of the Federal Constitutional Court: *Hans-Jürgen Papier*, *Grundgesetz und Wirtschaftsverfassung*, WM 2009, pp. 1869 et seq.; see also *Udo Di Fabio*, *Industriepolitik und Grundgesetz*, in: *Di Fabio/Felbermayr/Fuest/Windthorst*, *Industriepolitik in Deutschland und der EU*, *Jahresheft des Wissenschaftlichen Beirates der Stiftung Familienunternehmen*, 2020, p. 1 (10 et seq.).

9 BVerfGE 50, 290 (333) [our translation].

III. A return to heavier intervention

1. The pendulum swings from neoliberalism to neo-interventionism

Economic policies have a tendency to fall in and out of favour as periods of heavy political intervention alternate with liberalisation and state withdrawal from the market. Today, after an era of deregulation and market opening, the pendulum is clearly swinging back in the opposite direction. Deeper economic intervention is again being advocated, either as a contemporary interpretation of the social market economy (in the shape of an eco-social market economy) or as a modern-day Great Transformation.¹⁰ On the left of the political spectrum, there is a desire to give socialism another try, this time through transformative economic democracy in which the law would turn employees into co-owners, giving them the power to decide what is produced and how,¹¹ or through an environmentally motivated reform to laws on private property. In constitutional terms, the effect of this is to extend the primacy of politics over the economy to such a degree that basic rights – especially basic economic rights – appear marginalised in the face of the dominance of “citizen lawmaking”.

“Decisions on whether, what, how and where goods are produced and by whom do not only affect equity holders but, in the case of major companies, large parts of society. Economic democracy means, then, that stakeholders – i.e. not only a company’s employees – have the same influence in decisions with widespread impacts on whether, what, when, where and how production takes place

and, importantly, that they do so autonomously, i.e. without this being determined by the coercive laws of competition.”¹²

In reality, however, even the older case law of the Federal Constitutional Court, let alone such neo-socialist arguments, today appears anachronistic and backward-looking in the context of the EU legal order. As Matthias Ruffert writes:

“Art. 3 (3) subpara. 1 TEU speaks of a highly competitive social market economy. This finds its expression principally in the internal market, and the Charter of Fundamental Rights provides essential guarantees for a free economic order: freedom to choose an occupation, freedom to conduct a business, right to property. The agricultural sector, conceived along planned economy lines, remains a foreign body amid a market-compliant industrial policy.”¹³

Other influences are of far greater importance to the growing openness to neo-interventionism than socialist plans to turn employees into owners. These include the climate policy transformation agenda, social and ethical standards such as environmental, social, and corporate governance (ESG) criteria (these are not only aimed at climate neutrality and environmental sustainability but are also part of the political drive for more diversity¹⁴) and a new industrial and digital policy driven by shifts in geopolitical power relations.

10 The Great Transformation is a vision by the Marxist economic theorist Karl Polanyi which aims for fundamental social change; see for example *Claus Thomasberger*, *Der Vordenker Karl Polanyi: Die große Transformation und die Marktgesellschaft*, in: *Ökologisches Wirtschaften* 1.2016 (31), pp. 30 et seq.

11 *Heinz Bierbaum*, *Wirtschaftsdemokratie – von der Mitbestimmung zur sozialistischen Transformation*, in: Alex Demirović (ed.), *Wirtschaftsdemokratie neu denken, Dokumentation einer Tagung der Rosa Luxemburg-Stiftung*, 2018, p. 12 (16 et seq.).

12 *Andreas Fisahn*, *Wirtschaftsdemokratie – verfassungsrechtliche Schranken und Möglichkeiten*, in: Alex Demirović (ed.), *Wirtschaftsdemokratie neu denken, Dokumentation einer Tagung der Rosa Luxemburg-Stiftung*, 2018, p. 42 (44) [our translation].

13 *Matthias Ruffert*, in: Christian Calliess/Matthias Ruffert (eds.), *EUV/AEUV mit Europäischer Grundrechtecharta, Kommentar*, sixth edition 2022, Art. 3 EUV marginal note 25 [our translation]. The cogency of this assumption is also confirmed by *Andreas Fisahn*, op. cit. pp. 60 et seq.

14 *Nicola Cucari/Salvatore Esposito De Falco/Beatrice Orlando*, *Diversity of Board of Directors and Environmental Social Governance: Evidence from Italian Listed Companies*, in: *Corporate Social Responsibility and Environmental Management*, vol. 25 (2018), pp. 209 et seq.

2. Environmental interventionism

Reorienting major economies towards the goal of climate neutrality is an ambitious and – in terms of its importance and complexity – extraordinary task. Emissions trading (the original and still commonplace regulatory approach to this challenge) aims to achieve this through market mechanisms by assigning a price to collective environmental goods – in this case through the issuance of CO₂ emissions permits. While market-based, this is not a pure market system, since the number of such emission allowances is rationed by a cap that is gradually reduced over time. The trading of emission allowances enables the market to efficiently allocate the reduced total volume of emissions of an industry without the need for detailed decisions on planning and allocation by the state.

Similarly, carbon taxes are designed by putting a price on CO₂ to disincentivise companies from putting fossil fuels into circulation. These strategies based on pricing and rationing contrast with general targets such as “Fit for 55”¹⁵ or, even more notably, with the setting of countries’ residual carbon budgets to avoid exceeding the global warming limits of 1.5 or 2 degrees Celsius advocated by climate scientists (IPCC).¹⁶ Section 4 of the Federal Climate Change Act (Bundesklimaschutzgesetz) of 2021 sets targets that, while not reminiscent in style of the old-fashioned planned economy, nevertheless slip back into the bureaucratic approach to economic governance. The old, politically determined targets of five-year plans are history, having largely failed except for a few flagship projects. Today’s targets are not about production levels or performance standards;

they are prevention and reduction targets. Yet they may prove equally difficult to achieve, as interdependencies, unexpected events or underestimated implications throw them off course. This environmentally motivated approach which, via its effect on individual sectors, ultimately encompasses the whole economy, is laid out, for example, in Section 4 (6) sentence 1 of the Federal Climate Change Act, which empowers the government to enact statutory instruments:

“By means of a statutory instrument, the Federal Government shall set the permissible annual emission budgets for the individual sectors, decreasing annually in basically regular increments, in 2024 for the years 2031 to 2040 and in 2034 for the years 2041 to 2045. These annual emission budgets must be consistent with the achievement of the national climate targets of this Act, with the annual mitigation targets referred to in the sixth and seventh sentences of subsection (1) above and with the requirements of European Union legislation. In this context, it shall be assured that significant reductions in greenhouse gases are achieved in each sector. The permissible annual emission budgets shall apply unless a divergent provision is made on the basis of section 4 subsection (7) below.”¹⁷

Pointing out the neo-interventionist tendencies resulting from the determined reduction in harmful greenhouse gas emissions – decided unanimously by EU countries – is intended not as criticism but simply as an important observation, particularly in light of the stricter targets resulting from the Federal Constitutional Court’s decision of 24 March 2021.¹⁸ The “targeted

15 The 27 EU Member States have committed to making Europe the first climate-neutral continent by 2050. To this end, they have agreed to reduce emissions by at least 55 percent by 2030 compared with 1990 levels. See the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM/2021/550 final.

16 In this respect, see Section 3 (2) of the Federal Climate Change Act (2021), under which greenhouse gas emissions are to be reduced to such an extent by the year 2045 that net greenhouse gas neutrality is achieved. From 2050, the intention is even to achieve negative greenhouse gas emissions. Section 4 provides for a system for setting residual emission budgets to be adjusted using statutory instruments.

17 Translation provided by the Language Service of the Federal Ministry for the Environment, Nature Conservation and Nuclear Safety, accessible at https://www.gesetze-im-internet.de/englisch_ksg/englisch_ksg.html, accessed: 20 April 2022.

18 BVerfG, Order of the First Senate of the Court (Beschluss des Ersten Senats), 24 March 2021 – 1 BvR 2656/18.

support for sustainable economic sectors and businesses” and the “conversion of unsustainable industries”¹⁹ which ultimately amount to a transformation of the economy’s entire energy metabolism are a departure from the models of welfare state intervention seen in the past. The reduction targets set by climate policy have little prospect of success without intensive intervention in market activity given that they refer to a whole cascade of controlling measures, including the setting of minimum prices, mitigations and offsets, disclosure and reporting obligations, monitoring systems and rationing measures.

To implement the targets, policymakers have at their disposal a traditional toolbox of regulatory law – for example, emission limits on fleet consumption²⁰ for newly registered vehicles, a ban on combustion engines in motor vehicles²¹ or a stop to coal-fired power generation. These policies leave little room for market solutions. They also result in an entanglement of different layers of regulation. For example, when an emissions trading system at European level for electricity generation is combined with national responsibility for energy policy, this causes the market-based rationing of emissions to undermine the market-based procedure of discovery and potentially removes essential elasticity from the economic transition. Even policy at EU level alone lacks coherence here, as it (perhaps counterproductively) combines carbon pricing, which is designed to allow economic and technological innovation to decide the future, with interventionist fleet consumption targets for new vehicles.²²

In fact, both types of intervention – regulation on the one hand and pricing or rationing strategies on the

other – are dirigiste approaches, especially if they pursue rigorously defined carbon reduction targets. Section 4 of the National Emissions Trading System for Fuel Emissions Act (Brennstoffemissionshandelsgesetz, BEHG) enables the German government to set annual limits and targets, and the companies monitored under the Act are required by Section 6 to submit a monitoring plan for identifying fuel emissions and to report them in accordance with Section 7 (1). Once established, such mechanisms have a tendency to quickly multiply in scale and scope to encompass ever more areas, particularly when, as is becoming increasingly apparent, the need for regulation is growing.

The new interventionist drift is set to intensify in future as state intervention, primarily for climate protection purposes, becomes ever more necessary. For one thing, with rapid economic growth in developing and highly populated countries, a further rise in global CO₂ is likely to occur despite good intentions and new technological solutions. Increases in harmful emissions in China, India, Russia or Africa will rapidly deplete the residual carbon budget available to developed countries, including in Europe, which have traditionally been heavy emitters, and will inevitably lead to more restrictive measures. In addition, new needs that are not entirely evident today will also result in new regulation designed to encourage certain behaviour or, more particularly, to mitigate undesired effects. Examples include anti-carbon leakage measures on businesses, which prevent them from moving abroad to avoid emissions standards,²³ or the payment of climate bonuses to private households.

Another example is the call from the German government for minimum retail prices for agricultural products

19 Deutsche Kommission Justitia et Pax, Arbeit in einer nachhaltigen Wirtschaft – Die sozial-ökologische Transformation aus arbeitspolitischer Perspektive, 2021, p. 21 [our translation].

20 Regulation (EU) 2019/631.

21 By 2030, under the European Commission’s “Fit for 55” Package, annual emissions of new vehicles must be at least 55% lower than in 2021. By 2035, the reduction compared with 2021 levels must be 100%: from that year on, newly registered vehicles must emit zero CO₂ in operation.

22 Clemens Fuest, Neodirigism, ifo Viewpoint 214, 10 February 2020, p. 1.

23 Proposal by the European Commission dated 14 July 2021 for a Carbon Border Adjustment Mechanism/CBAM, accessible at: https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_3661, accessed: 7 February 2022.

or the issue of vouchers to help poorer segments of society afford essential goods when (perhaps overdue) improvements to animal welfare rules result in higher food prices.²⁴ It is likely that the environmental transformation, like the still unresolved crises in the financial and fiscal system, will increase the overall requirement for social intervention. Rent caps or initiatives to nationalise large housing companies, as in Berlin, are certainly a response to the need for affordable housing, but their approach embodies the dirigiste tendencies of an interventionist policy that dispenses with market mechanisms altogether instead of simply mitigating or modifying them.²⁵ Calls for companies or the government to charge different energy prices depending on users' social circumstances are also a neo-interventionist response to state-induced energy price rises.²⁶

By definition, the degree of market intervention is intensified, including from a constitutional rights perspective, if the state's policies disable or materially influence the basic pricing mechanism. Heavy market intervention also exists when the state not only imposes constraints – e.g. safety, environmental or health requirements – but also sets strict guidelines for the production of goods and services. Political decisions to steer investment in a certain direction are also interventionist in this sense, especially if they involve key parts of the financial system.

In this context, the taxonomy issued by the European Commission in a delegated act is an important tool

for steering investment and its funding. Based on the Taxonomy Regulation of 18 June 2020,²⁷ the Commission has issued a delegated act to detail its climate objectives.²⁸ The delegated act on six environmental objectives (sustainable use and protection of water and marine resources, circular economy, pollution prevention and control, protection, restoration of biodiversity and ecosystems, climate change mitigation and climate change adaptation) was prepared based on a report by the Platform on Sustainable Finance. Sustainable finance as defined by the taxonomy must promote at least one of the six objectives. Given its inclusion of nuclear power and gas-fired electricity generation, the taxonomy may serve more to enhance information for the financial sector rather than to redirect financial flows on a large scale. Nevertheless, drawing a political distinction between good and bad investments is an interventionist approach and has the potential to be expanded to other objectives or to be tightened further. Here too, in light of the European Green Deal, it is likely that the global increase in CO₂ emissions will rapidly intensify the pressure to act and that private investment will find itself increasingly called upon to fund the transition to a climate-neutral economy.

3. The interweaving of state and NGO power

Large listed companies looking to increase their value are well advised to adhere to ESG or compliance rules,²⁹ and compliance may also be encouraged or compelled by national law. The state can incentivise businesses

24 See such a proposal in an argument against minimum prices in food retail in *Dennis Rickert*, *Nachhaltige Landwirtschaft nicht durch Mindestpreise im Einzelhandel*, FAZ no. 30, 5 February 2022, p. 20.

25 *Clemens Fuest*, *Neodirigism*, ifo Viewpoint 214, 10 February 2020, p. 1 (2).

26 On corresponding expectations from organisational pedagogy: *Martin Gibson-Kunze/Holger Backhaus-Maul/Johanna Mierendorff*, *Die soziale Verantwortung von Energieunternehmen in der öffentlichen Grundversorgung. Ein Vergleich privatwirtschaftlicher und kommunaler Energieunternehmen im Umgang mit einkommensarmen Haushalten*, in: *Claudia Fahrenwald/Nicolas Engel/Andreas Schröer* (eds.), *Organisation und Verantwortung*, 2020, pp. 305 et seq.

27 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, accessible at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32020R0852>, accessed: 7 February 2022

28 With the taxonomy, the EU Action Plan on Financing Sustainable Growth aims to harmonise the definition of sustainable investment throughout Europe.

29 *Yiwei Li/Mengfeng Gong/Xiu-Ye Zhang/Lenny Koh*, *The impact of environmental, social, and governance disclosure on firm value: The role of CEO power*, in: *The British Accounting Review*, vol. 50 (2018), pp. 60 et seq.; *Bryan W. Husted/José Milton de Sousa-Filho*, *The impact of sustainability governance, country stakeholder orientation, and country risk on environmental, social, and governance performance*, in: *Journal of Cleaner Production*, vol. 155 (2017), pp. 93 et seq.

to bind themselves voluntarily to such rules, which sometimes reach deep into investment decisions, the choice of business relationships or the composition of corporate bodies and the internal organisational structure.³⁰ Rules such as ESG criteria or finance directives have often come into being under the influence of NGOs, which today wield considerable power in setting and monitoring the direction of corporate policy and investment decisions.³¹ This has created a strong interventionist network. In Western democracies, NGOs are regarded not only as legitimate civil society associations but often as key representatives of the common good in their relevant area of expertise. This means that they sometimes receive government funding in order to pursue public goals.

This role in representing the common good should not, however, be overstated, and is not without cause for concern in the context of a representative system of democracy and the division of powers. NGOs regularly pursue their own ends, sometimes in competition with each other and not always in symmetry with the relationship between states and their interests.³² A conceptual, coherent political prioritisation of different objectives is, by its nature, beyond the capability of NGOs, and remains the prerogative of parliamentary politics, legitimised by democratic elections.

In constitutional terms, the democratic state may support the positive impact of NGOs, which can change economies for the better, but should not leave itself at the mercy of their interests. Rather, the state is responsible for ensuring both that public goals are met and that they are implemented transparently. Where

government vacates this role, constitutional rights may be threatened by the exercise of non-state but nevertheless political power.³³ Economic power, of course, can confer political influence, which is why political parties, for example, are publicly accountable for the donations they receive (Art. 21 (1) sentence 4 of the Basic Law). Likewise, rules initiated and overseen by NGOs, often established across borders, must not be allowed to result without scrutiny in new forms of corporative interventionism, or at least not without sufficient democratic checks and balances.

4. Industrial policy old and new

Traditional industrial policy may make a rather antiquated impression when compared with the new strategies of climate policy transformation. However, this area of economic policy activity should not be ignored as a phenomenon of a new interventionism. Both national industrial strategies and their European counterparts are increasingly responding to external developments and are identifying threats to competitiveness as well as the emergence of problematic dependencies in supply chains and the international division of labour. At issue are the development of artificial intelligence and the role of digital platforms, but also the question of autonomy in an increasingly fraught geopolitical environment. In connection with the draft of an EU Chips Act, for example, Thierry Breton, the Commissioner for the Internal Market, has called for efforts to make the EU more independent in chip manufacture:

30 See for example Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, which aims to more closely orient banks' strategy and risk management on the ESG/CSR criteria.

31 To examine the influence of NGOs on rule-setting multi-stakeholders, distinctions are drawn between four types of NGO power: symbolic, cognitive, social and monitoring power; for more detail, see *Magnus Boström/Kristina Tamm Hallström*, NGO Power in Global Social and Environmental Standard-Setting, in: *Global Environmental Politics*, vol. 10 (2010), pp. 36 et seq.

32 Research points out that NGOs are not necessarily a homogeneous group and that there are clashes of interests and asymmetries of power and representation. This means that NGOs do not inevitably contribute to more democratic and legitimate international environmental policy: *Tanja Brühl/Marika Gereke*, Der Beitrag von Non-State Actors zum Schutz der Umwelt: Eine kritische Analyse der Rolle von NGOs in der Klimapolitik, in: *Zeitschrift für Außen- und Sicherheitspolitik* (2015), pp. 677 et seq.

33 *Udo Di Fabio*, *Herrschaft und Gesellschaft*, Studienausgabe 2019, pp. 103 et seq.

“We must regularly monitor our industrial supply chains, anticipate possible future disruptions, and ensure the resilience of our entire supply chain including design, production, packaging, equipment and suppliers such as producers of wafers. We must also support the development of European fabrication plants – ‘mega fabs’ – able to produce in high volume the most advanced (towards 2nm and below) and energy-efficient semiconductors.”³⁴

The aim of this project is for the state to initiate the building of new megafactories, mobilising 45 billion euros to restore a heavyweight presence for Europe in the world of chip manufacture.³⁵ Alongside new

semiconductor factories, it provides for export bans in the event of crisis, modelled on the US Defense Production Act. The problem, however, with squeezing out private initiative through state investment is that this involves planning for an existing or predicted demand that may not materialise in future. Moreover, the state faces a higher risk than market-oriented businesses of poor profitability, which can then trigger further political intervention. In this case, for example, there is the risk that trade restrictions will be contemplated should it become clear that major production sites for end products (and thus the demand for chips) are set to remain in Asia.³⁶

IV. EU law and the German economic constitution in sync: the market as an institutional condition for economic self-determination

The law – and German constitutional law to a greater extent than EU law – is not well equipped to handle this neo-interventionist trend. In the case of Union law, the idea of the open market and curbs on protectionism is written into its very DNA. It was only thanks to this idea that the European project succeeded in banishing the political antagonisms driven by the economic rivalry of individual nations. The internal market, fair competition, the basic freedoms and the social market economy are thus the foundations of a successful integration and have been anchored in the treaties since the beginning.³⁷ If, in the face of changing political circumstances and a more defensive position (be it real or perceived), a very different political programme is emerging, this raises the question of its relationship with the legal configuration of an open and highly competitive market economy.

The importance of a closer normative evaluation of

neo-interventionist measures relates to EU law and German constitutional law alike. In reality, there is no serious disagreement between the German and European economic constitutions: the freedoms guaranteed under the Basic Law extend in an elementary way to the economic space: occupational freedom (Art. 12 of the Basic Law), the right to property (Art. 14), freedom of association (Art. 9 (3)) and, not least, private autonomy and freedom of contract (Art. 2 (1)) provide a system of guarantees in which the economy can develop and regulate itself without state interference. These freedoms are guaranteed so that individuals can obtain the goods and services that satisfy their wishes and needs without being dependent on the goodwill of politicians. Businesses and entrepreneurship are not foreign bodies in a romantically painted association of free individuals but essential intermediaries in any efficient organisation of the economy. This efficient organisation, in turn, necessarily relies on market relationships; otherwise,

34 https://ec.europa.eu/commission/commissioners/2019-2024/breton/blog/how-european-chips-act-will-put-europe-back-tech-race_en, accessed: 7 February 2022.

35 Hendrik Kafsack/Stephan Finsterbusch, Die große Chip-Wette, FAS no. 5, 6 February 2022, p. 17.

36 Hendrik Kafsack/Stephan Finsterbusch, Die große Chip-Wette, FAS no. 5, 6 February 2022, p. 17.

37 Rainer Freriks/Ulrich Widmaier, Die Veränderung der Strategie ökonomischer Akteure im Prozess der Entstehung eines europäischen Binnenmarktes, in: Roland Czada/Susanne Lütz (eds.), Die politische Konstitution von Märkten, 2000, pp. 107 et seq.

political allocation would inevitably have to replace the price mechanism in coordinating supply and demand.

The market is simultaneously an institutional precondition for, and a product of, private autonomy and economic freedom. Since the work of Adam Smith we know that the interplay of supply and demand serves not only to coordinate private interests but also to allocate resources efficiently, lifting output and productivity through a competitive process in which the common good is increased without the need for politically determined plans or targets.³⁸ In relation to the market, private property has also stood since Roman law specifically for individual control over assets and wealth, an institutional prerequisite for individuals to take responsibility for securing their own livelihoods and to plan the resources they need to shape their lives.

This, of course, is not to say that the market should be treated as a sacred cow, completely off limits to political intervention, nor that it should serve as a model for

regulating every area of social life. But no one today could claim seriously that an individual, free and democratic society can exist without private property and a fundamentally open market. There is not and has never been a single example of such a society. The normative order embodied in the fundamental rights of the Basic Law, including economic rights and the corresponding welfare state mandate, thus rely on the market for their very existence, while at the same time institutionally guaranteeing the existence of the market. This means that the weight or intensity of an encroachment on these basic rights is dependent on the extent to which market relationships are affected by state regulation which reduces the freedom of individuals to make their own decisions. From the perspective of basic rights, economic intervention is particularly heavy when it disables or materially alters the elementary mechanism of supply and demand. The debate, often assumed dead, around the economic constitution should thus be revived here “in new form as the question of a particular benchmark for evaluating legislation on economic policy”.³⁹

V. Categorising economic intervention in terms of constitutional law

1. First level of intervention: protecting the open market and free competition

One of the necessary responses to the neo-interventionist trend would be a stronger constitutional recognition of the institutional role of the open market in enabling the exercise of individuals’ basic rights. The role of market relationships in the exercise of these rights has constitutional implications for the monitoring of market intervention.

If the state protects the market against monopolies and oligopolies, it may be interfering with the basic rights

of individual monopolists, but it is also protecting an institution that safeguards freedom and thus the individual rights of other market participants. It is true that the Basic Law, unlike EU primary law, provides no explicit institutional guarantee for open markets and fair competition.⁴⁰ However, the guarantees provided by individuals’ economic basic rights necessarily confer an institutional responsibility upon the state to protect open and socially accessible markets. Individuals would otherwise lack a functional space in which to exercise substantial economic freedoms, such as the freedom to choose an occupation, the right to property (Art. 12 and 14 of the Basic Law) and the freedom to conduct

38 On the timeliness of this fundamental economic insight in constitutional law: *Jens Kersten*, *Die Herstellung von Wettbewerb als Verwaltungsaufgabe*, VVDStRL 69 (2010), p. 288 (289).

39 *Reiner Schmidt*, *Staatliche Verantwortung für die Wirtschaft*, in: Josef Isensee/Paul Kirchhof (eds.), *Handbuch des Staatsrechts*, vol. IV, third edition 2006, Section 92, marginal number 26 [our translation].

40 *Jens Kersten*, *Herstellung von Wettbewerb als Verwaltungsaufgabe*, VVDStRL 69 (2010), p. 288 (293); *Reiner Schmidt*, *Staatliche Verantwortung für die Wirtschaft*, in: Josef Isensee/Paul Kirchhof (eds.), *Handbuch des Staatsrechts*, vol. IV, third edition 2006, Section 92, marginal number 26.

a business (Art. 12 of the Basic Law, Art. 16 of the Charter of Fundamental Rights). Regulatory policy that responds to monopolies with state price controls is thus not interventionist; on the contrary, it protects and promotes the market. Similarly, case law in relation to industrial disputes, which seeks to preserve parity and a level playing field, serves to protect wage negotiation processes. Freedom of association in this context (Art. 9 (3) of the Basic Law) practically and logically depends on the existence of the (labour) market.

The entire civil law framework – contract law, property law, company law or inheritance law, but also antitrust and state aid law – gives form to people’s individual autonomy, with legislation and the courts providing legal forms and categories – a protected and dependable set of rules or legal order – as a basis for the processes of market exchange. This, too, does not fit the description of interventionism unless the state places its political objectives at the heart of organised decision making – for example requiring companies’ supervisory boards to consist of an equal number of employee and shareholder representatives⁴¹ or to reflect policies on diversity or gender equality.⁴²

2. Second level of intervention: traditional regulatory limits to the freedom to choose an occupation or trade

Legislatures and courts do not limit themselves to tackling cartels and monopolies or to promoting fair, free market-based negotiation processes.⁴³ Legislation may also constrain market participants by steering or restricting their activity in order to promote politically defined objectives deemed to be for the common

good.⁴⁴ Regulatory law imposes clear limits on economic activity. Interference with basic rights in order to implement political objectives – for instance to realise the government’s social or environmental ambitions – is legitimate but requires justification. All intervention must be tested to ensure that it is appropriate, necessary and reasonable. The tests to be met here must be stricter than for those measures designed to open up or protect the market.

3. Third level of intervention: dirigiste market intervention

The term dirigiste in this context represents a third level of intervention in the market. The claim that individual measures or the cumulative effect of a set of measures are exerting a disproportionate impact on an industry or sector – substantially distorting market mechanisms or preventing economic actors from negotiating autonomously – is highly relevant in relation to basic rights. Interventionism, as a term indicating a trend, thus also serves from a constitutional law perspective to indicate potential problems and can be used for the purposes of legal analysis when measuring the degree of intervention in fundamental market mechanisms. A minimum wage set by the state, for example, is already interventionist in principle, but the concept of interventionism is even more valuable when it comes to assessing the proportionality of such measures. The higher the amount by which the minimum wage exceeds the wage paid under employment contracts or collective agreements, or the more it results from political calculation rather than impartial expertise, the heavier the degree of interventionism.

41 See BVerfGE 50, 290 et seq.

42 See for example the German law on equal participation of women and men in management positions in the private and public sectors (Gesetz für die gleichberechtigte Teilhabe von Frauen und Männern an Führungspositionen) of 24 April 2015, BGBl, no. 17, 30 April 2015. The European Commission and European Parliament have long called for a binding quota of 40 percent women on the supervisory boards of listed companies, see the Commission’s press release of 14 November 2012 (https://ec.europa.eu/commission/presscorner/detail/en/IP_12_1205), a proposal that was taken up again by the Commission President in January 2022.

43 *Jens Kersten*, Herstellung von Wettbewerb als Verwaltungsaufgabe, VVDStRL 69 (2010), p. 288 (290).

44 *Charlotte Kreuter-Kirchhof*, Wettbewerb im Zeitalter klimapolitisch motivierter Energiewende? in: Jürgen Kühling/Daniel Zimmer (eds.), *Neue Gemeinwohlherausforderungen – Konsequenzen für Wettbewerbsrecht und Regulierung*, 2020, pp. 89 et seq.

In collective labour law, for example, interventionism must be assumed if industry-wide applicability of collective agreements is not only imposed as originally intended in order to combat opportunism but also in areas where existing collective agreements cover only a tiny minority of companies. In such cases, the politically imposed obligation to pay the wage specified by the

collective agreement amounts to an unjustified interference in the freedom of association.⁴⁵ At this dirigiste level of intervention, greater weight must be attached to the restriction of individuals' basic rights in cases where the effective disabling of market mechanisms has diminished their opportunities to exercise their own freedoms through economic interaction.

VI. State-directed public service infrastructure

Evaluating state intervention becomes difficult in areas where the state directly provides public utilities and where private entities merely operate "under licence", i.e. partially under private law and in market form but nonetheless for the purposes of fulfilling the state's responsibilities. In healthcare, energy and water supply, for example, hybrid structures – located somewhere between private enterprise, public service provision and heavy state control – have long been commonplace. Though traditionally subject to strong political control, these areas do not present a constitutional problem. After all, doctors who treat patients under state health insurance, for example, have "voluntarily" entered a partially state-run profession. European law has put in place certain protections for public utilities, ultimately to reflect the different public service traditions of its member states during a period of determined deregulation and privatisation (the

neoliberal era).⁴⁶ Today, some areas are experiencing a trend towards remunicipalisation. This is a constitutionally unproblematic development, provided that the displacement of private players is based on trust, respects their rights and involves compensation where appropriate. Where the state directly provides public utilities, this does not constitute interventionism, as there is no private sector in such cases to direct. The nationalisation of housing companies in Berlin under Art. 15 of the Basic Law, if accompanied by fair, market-oriented compensation in accordance with Art. 14 (3) of the Basic Law, may be an unwise choice of economic policy, but it bears no direct relation to interventionism.

The nationalisation of industries nevertheless opens up another question, namely that of how large a public sector is compatible with a free society.

VII. Conclusion

We speak of dirigisme and interventionism where constitutional democracies intervene heavily in economic freedoms across individual industries, strongly interfere with or disable the price mechanism, impose legal requirements on investment and production or attach political objectives to the composition of corporate bodies. Such measures are not unconstitutional per

se and do not inevitably infringe principles of EU law such as the open, highly competitive market economy. Nevertheless, they are serious interventions in entrepreneurial freedom – the "freedom to conduct a business" explicitly recognised under Art. 16 of the EU Charter of Fundamental Rights. This freedom is particularly valuable where it has a personal impact, where corporate

45 *Felix Prokop*, Die Allgemeinverbindlicherklärung nach § 5 TVG – Eine verfassungsrechtliche Untersuchung der Änderungen durch das Tarifautonomiestärkungsgesetz 2014, 2017; *Thomas Lobinger*, Stärkung oder Verstaatlichung der Tarifautonomie? in: JZ 69 (2014), pp. 810 et seq.

46 See the volume by *Rudolf Hrbek/Martin Nettesheim (eds.)*: Europäische Union und mitgliedstaatliche Daseinsvorsorge, 2002; *Reiner Schmidt*, Die Liberalisierung der Daseinsvorsorge, in: Der Staat 42 (2003), pp. 225 et seq.

assets and entrepreneurial initiative are not the domain of anonymous institutional investors but have a very human face in the form of family businesses. Constitutional rights encompass many aspects of a thriving civil society, and entrepreneurs are an elementary part of this. Preserving entrepreneurial freedom of action

is not just a matter of constitutional rights; rather, it is also a concern central to a democratic society that seeks to shape freedom socially and environmentally in such a way that performance and innovative power are encouraged rather than lost.

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Can the government really do it better? Neo-interventionism as illustrated by the Supply Chain Due Diligence Act

Prepared by Prof. Gabriel Felbermayr, Ph.D. and Prof. Dr. Alexander Sandkamp¹

I. Introduction

Throughout the world, we are witnessing a new wave of state interventionism that is expressed in ever greater control and regulation of business activities. Germany's Act on Corporate Due Diligence Obligations in Supply Chains (Lieferkettensorgfaltspflichtengesetz, LkSG, hereinafter referred to as Supply Chain Due Diligence Act) and its forthcoming European counterpart are examples of this. Here we can see how seemingly ethical action can lead to undesirable side effects that prevent the desired positive effects from materialising in poorer countries as intended. The main reason for this is the interventionist approach of the legislation, which gives rise to costs that may lead to a decoupling of supply chains.

The Economist, a weekly publication in the UK, refers to a new era of "bossy interventionism" in which the state interferes with the finer details of running a business,² like passengers in the back seat of a car who constantly instruct the driver when and how strongly to brake or accelerate, without owning a licence or vehicle themselves.

This intensified neo-interventionism is the result of a mistrust – grown since the global economic and financial crisis of 2008/09 – of the regulatory premise that decentralised market activity, under the right institutional framework conditions, will produce economically and socio-politically desirable results. The coronavirus crisis has evidently strengthened this trend even further

– rather paradoxically (Ipsos, 2021), given that it has clearly demonstrated the limits of government action in most countries.

As a consequence, confidence in free enterprise seems to have been severely damaged. In many sections of society, there appears to be a new prevailing belief that companies will bend or even break the law and disregard all moral values in the pursuit of profit maximisation, if only they can do so unobserved. And many people allege that even seemingly rule-compliant behaviour will turn into socially undesirable behaviour if governments fail to tighten up their regulation decisively. Globalisation is portrayed as a danger that does more harm than good to societies and the environment unless the state has some control over it. But especially from a development perspective, it is clear that investments and business relationships with Western companies in poor countries can bring enormous benefits – for both sides (World Bank, 2020).

The international economic and financial crisis exposed fraudulent practices in the global financial sector, and the diesel scandal those of the German automotive industry; fundamental human and environmental rights are flouted in many emerging and developing countries. There is no denying these happenings, nor should they be glossed over. However, claiming that these shameful episodes are characteristic of the market economy and placing entrepreneurs under general suspicion would be

1 Prof. Gabriel Felbermayr, Ph.D. is director of the Austrian Institute of Economic Research (WIFO) and professor of economics at the Vienna University of Economics and Business (WU). Prof. Dr. Alexander Sandkamp is assistant professor of economics at Kiel University (CAU) and a fellow of the Kiel Institute for the World Economy (IfW).

2 The Economist, 15 January 2022, "Welcome to the Era of the Bossy State".

a complete distortion of the facts. Regulation founded on this kind of thinking will always be much more expensive and have stronger side effects than that which targets the true black sheep.

A recent study by the European Parliament Research Service on the planned supply chain legislation provides ample evidence of such distortion. As early as the introduction, the authors claim that the power and influence of multinational companies abroad “enables them to avoid liability for their harmful impacts on local communities either by hiding behind the ‘corporate veil’ (when they act through subsidiaries and companies they control) or by exploiting weak and poorly enforced domestic regulation in developing countries, or by abusing the international investors’ protection system (Zamfir 2020).”³ They go on to say that the development of global supply chains “has unintended harmful effects, such as when independent local suppliers enter into a race to the bottom to secure their share of the market.” The text links to Amnesty International’s website as evidence for these statements. Later on, the authors qualify this: “This does not mean however that the local impact of multinational companies is always harmful.”

But empirical evidence shows that the benefits of international value chains are not the exception. In fact, the opposite is true: on average, integrating suppliers from developing countries into the value chains of Western companies brings major economic and socio-political advantages for the global South: both technological and management know-how are transferred, and exporting suppliers pay better wages, offer more stable employment relationships and are more respectful of the environment. And as they are exporting to Europe, they are inevitably in the formal sector, where – unlike the informal sector – taxes are paid and standards are most likely to be met. All of this is well documented, especially in the manufacturing sector, where German family businesses tend to have their main areas of

activity. This statistical evidence does not mean that there are no serious exceptions – which must certainly be counteracted with adequate measures – but it shows very clearly that the general perception is distorted. If certain EU policies make it more difficult for suppliers from poor countries to participate in Western value chains, then the development benefits described are at risk of being diminished. This would be a disservice to the people in the global South. What may seem like a good and fair policy from an ethics of conviction perspective is unjustifiable from an ethics of responsibility perspective.

Germany’s new Supply Chain Due Diligence Act, which is due to come into force in 2023, is an example of a neo-interventionist approach. It obliges companies above a certain size to monitor whether their foreign suppliers comply with a list of standards, and to take remedial action if necessary. Companies that fail to monitor suppliers sufficiently are subject to fines. The act focuses mainly on human rights violations by direct suppliers and excludes liability claims. At the European level, the EU Commission presented a proposal for a new directive on 23 February 2022, which would be similar in structure to the German legislation but would go significantly further (European Commission 2022, European Parliament 2021).

If this directive works as intended, suppliers found guilty of misconduct will disappear from EU supply chains. However, the legislation ignores the economic costs, which go far beyond the mere costs of monitoring for EU buyers. An alternative approach of blacklisting “bad” suppliers through a central EU agency would be at least as effective in weeding out unlawful suppliers, but would entail lower costs for German companies and consequently have less of a negative impact on the development process.

The main problem with the Supply Chain Due Diligence

3 The text talks about multinational companies and refers to the OECD Guidelines applying to them. The OECD uses a very broad definition that includes all foreign activities.

Act is as follows: EU buyers are not able to observe the behaviour of suppliers in far-away countries perfectly. There will always be a degree of uncertainty. They may manage to reduce this uncertainty by investing in monitoring measures, but they cannot eliminate it entirely. It is therefore possible that, despite their best efforts, one of their suppliers from a developing country may violate a human right or an environmental standard. The German Supply Chain Due Diligence Act provides for substantial fines of up to 2 percent of a company's turnover if the regulatory authorities find that it has not fulfilled its "duty of care". This means the act exposes buyers to new risks when purchasing from foreign suppliers – risks that they cannot completely exclude. Rational companies will want to minimise these risks by concentrating their monitoring activities on fewer but larger suppliers and withdrawing from countries where it would be particularly difficult to monitor suppliers or where the likelihood of bad behaviour is high (for example, due to weak local institutions). Companies' actions will be determined not so much by the monitoring costs involved, but by the costs they would incur if they were to be rightly or wrongly accused of not having made sufficient efforts. As a consequence, even suppliers that do not violate any rights may be dropped from EU supply chains. Thus, the Supply Chain Due Diligence Act risks harming law-abiding suppliers as well, since they will not be able to prove that they are complying with the law without incurring additional costs. A law motivated by ethics of conviction would therefore prove to be highly problematic from the standpoint of ethics of responsibility.

To avoid this unwanted restructuring of global value chains (GVCs), it would be better to adopt an approach that confers the inspections and the associated costs on a government body so as to reduce the costs and risks facing EU companies. Instead of requiring every EU buyer to screen every single supplier, a central EU agency should take on the monitoring role and keep a blacklist of companies excluded from EU supply chains. This would avoid costly duplicate inspections. It would also minimise legal uncertainty, giving importers who

comply with the list peace of mind that they will not be penalised. They would have no incentives to adjust their supply chains – except, of course, to discontinue business relations with listed companies. Only companies found guilty of wrongdoing would thus be excluded from the EU value chains. This approach would expose companies to much less micro-control by the authorities, making it less interventionist in nature, and it would be preferable to the Supply Chain Due Diligence Act in terms of ethics of responsibility as well.

The German Supply Chain Due Diligence Act and its planned European counterpart are by no means the only examples of neo-interventionist approaches in foreign trade policy. The proposed Carbon Border Adjustment Mechanism also threatens to impose very tight bureaucratic monitoring on importers and thus cause high bureaucratic costs. In addition, the EU Commission is currently working on a new regulation on international public procurement, which – while motivated by the understandable desire to promote a reciprocal opening of the market in this area – is expected to result in very ad hoc and case-specific interventions in procurement processes. In today's globalised world, however, this will often also affect intermediate products from Germany – for example when German goods, services or construction work are ordered from abroad. Moreover, this could lead to retaliation by trading partners and thus pose a further threat to European and German companies.

However, the remainder of this paper will focus on presenting and analysing the German Supply Chain Due Diligence Act. Section II describes the act passed by the German Bundestag on 11 June 2021 and also addresses similar laws in other countries as well as current discussions at the EU level. To help assess the degree to which the German economy is affected, Section III outlines the importance of countries with problematic working conditions as suppliers for German companies. Section IV discusses the expected impact of the law, looking at the affected companies, the German economy as a whole and exporters in developing countries. In the

process, it also references current research findings in relation to the French supply chain law. Section V presents two alternative solutions that could play a role

in the context of a European directive, and Section VI draws a conclusion.

II. The German Supply Chain Due Diligence Act in detail

The German Act on Corporate Due Diligence Obligations in Supply Chains was passed by the Bundestag on 11 June 2021 (Bundestag 2021a).⁴ It will come into force on 1 January 2023, applying to all companies that are domiciled in Germany (head office or branch office) and employ more than 3,000 people.⁵ Companies with more than 1,000 employees will not be subject to the act until 1 January 2024 in order to give smaller companies more time to implement it. In total, the act affects 2,217 companies headquartered in Germany (Bundesregierung 2021), 634 of which are active in the manufacturing sector.⁶ Given that family businesses are generally small in size, with fewer than ten employees on average (Gottschalk et al. 2019), many of them will likely not fall directly under scope of the act. That said, quite a few of the 500 largest family businesses, which have an average of 5,000 employees in Germany (Gottschalk et al. 2019), will certainly be affected.

The act obliges the companies concerned to comply with certain standards for the protection of human and environmental rights, based on 13 international conventions (Bundesregierung 2021). Specifically, the standards prohibit the following:⁷

- The worst forms of child labour (slavery, prostitution, drug trafficking)
- Employment of a child below the minimum age
- Forced labour

- All forms of slavery
- Failure to comply with occupational health and safety obligations (under national law), in particular inadequate protective measures and safety standards
- Failure to respect freedom of association
- Unequal treatment in employment
- Withholding an adequate living wage
- Causing harmful soil change, water pollution or air pollution
- Unlawful eviction and unlawful taking of land
- Hiring of private security forces where there is a risk of torture, danger to life and limb or disregard for freedom of association
- Manufacture of mercury-added products in accordance with the Minamata Convention
- Use of mercury and mercury compounds within the meaning of the Minamata Convention
- Treatment of mercury waste contrary to the provisions of the Minamata Convention
- Production and use of chemicals contrary to the provisions of the Stockholm Convention
- Handling, collection, storage and disposal of waste in a manner that is not environmentally sound in accordance with the provisions of the POPs Convention
- Exports and imports of hazardous waste within the meaning of the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal

According to Stöbener de Mora and Noll (2021a: 1240),

4 The act is based on a legislative proposal by the Federal Government (Drucksache 19/28659) dated 19 April 2021 (Bundesregierung 2021), which was forwarded to the Bundestag in an amended version by the Committee on Labour and Social Affairs on 9 June 2021 (Drucksache 16/30505) (Bundestag 2021b).

5 In the original proposal, the act was only supposed to apply to companies whose head office is in Germany, but it was later extended to include branch offices in order to prevent distortions of competition.

6 These figures are based on data from 2017, made available in the 2018 Statistical Yearbook for Germany.

7 For more detailed information, see Bundesregierung (2021: 7 et seq.) and Bundesanzeiger (2021: 2959 et seq.).

however, these prohibitions leave “a worrying amount of room for interpretation”, which is likely to lead to legal uncertainty for the companies concerned. By contrast, the due diligence obligations to be fulfilled by affected companies are precisely defined and include, among other things, establishing a risk management system, performing an annual risk analysis and devising, implementing and regularly reviewing preventive and, if necessary, remedial measures. Corresponding reporting and documentation obligations apply, and a complaints procedure must also be established. Depending on whether suppliers are audited by external certification companies, costs for certification audits would also be incurred (Felbermayr et al. 2021b). Further costs could arise from the appointment of external consultants specialising in sustainability aspects (Stöbener de Mora and Noll 2021a).

The act covers “all steps in Germany and abroad that are necessary to produce the products and provide the services” (Bundesanzeiger 2021: 2961) and accordingly extends to the companies’ own business area as well as to their direct and indirect suppliers. However, the due diligence obligations are tiered. For example, companies do not have to conduct a detailed risk analysis for indirect suppliers; they are only obliged to take action if they obtain substantiated knowledge of human rights violations. Subsidiaries are considered part of the company’s own business area provided that the company exercises a “controlling influence” over them (Stöbener de Mora and Noll 2021a: 1241) – although here, too, a certain degree of legal uncertainty is to be expected with regard to the interpretation of this term. Financial services also fall within the scope of the business relationships concerned (ibid).

If companies fail to comply with their due diligence obligations, they could face financial penalties of up to 50,000 euros as well as administrative fines of “up to 2 per cent of the average annual turnover” (Bundesanzeiger 2021: 2967), which could be critical for some companies depending on their margins. In addition, companies can be excluded from public procurement.

There is no liability under civil law as had been contemplated for a while. However, non-governmental organisations are to be allowed to assert claims by affected parties (Stöbener de Mora and Noll 2021b). This only applies where a – not precisely defined – “outstandingly important protected legal position” is violated (ibid: 1287).

Overall, the Federal Government estimates (Bundesregierung 2021) that the Supply Chain Due Diligence Act will cost companies 109.7 million euros on introduction and 43.5 million euros per year in recurring costs. Accordingly, Felbermayr et al. (2021b) put the costs per company at a one-time amount of 49,481 euros and an annual amount of 19,621 euros. These are average values, as companies participate in international supply chains to varying degrees and international suppliers can be expected to incur higher compliance costs. Due to a higher number of supply relationships, downstream companies will be affected more strongly than upstream companies with their shorter supply chains (Felbermayr et al. 2021a). As most of the 500 largest family businesses are active in the manufacturing sector (Gottschalk et al. 2019), the Supply Chain Due Diligence Act may well cause some upheaval at these companies.

Supply chain laws in other countries

Germany is not the first European country to decide to pass supply chain legislation. France, for instance, introduced a due diligence law (“Loi de Vigilance”) as far back as 2017 (Verfassungsblog 2020, Kolev and Neligan 2021a), although it only applies to very large companies with more than 5,000 employees in France or 10,000 employees worldwide. Apart from the more generous application thresholds, the law is similarly ambitious as the German legislation. For example, companies are obliged to list possible risks concerning the violation of human rights. If human rights violations are identified, remedial action must be taken – and that applies to both direct and indirect suppliers.

Italy's supply chain legislation, on the other hand, focuses on potential human rights violations by Italian companies abroad. As such, Italian companies are required to implement programmes to ensure respect for human rights (ECCJ 2019).

The Netherlands passed a due diligence law in 2019 that focuses on combating child labour ("Wet Zorgplicht Kinderarbeid") (Allen and Overy 2020). This makes it narrower in scope than the German law. It is scheduled to come into force in 2022 and will apply both to Dutch companies and those that supply goods or services to Dutch end customers at least twice a year (Kolev and Neligan 2021a).

In Switzerland, a due diligence law recently fell through in a referendum because it failed to achieve the necessary majority vote across the 23 cantons (Brot für die Welt 2020). Norway has had due diligence legislation in place since 2021, requiring large companies to conduct a risk analysis with regard to human rights violations in accordance with the OECD Guidelines (Stöbener de Mora and Noll 2021b). Belgium and Austria are also planning to introduce due diligence laws (ibid).

The United Kingdom passed its Modern Slavery Act as early as 2015. It requires companies to eliminate all slavery and human trafficking from their operations (Legislation.gov.uk 2015). In 2019, the act was amended to include corresponding reporting requirements (Twobirds 2020). It applies to businesses with a turnover in the UK of more than 36 million pounds (and since 2019 also to public bodies with a budget of more than 36 million pounds). As far as environmental standards are concerned, the UK is currently working on a law governing the use of renewable resources in order to counteract illegal deforestation of rainforests (Gov.uk 2020).

Outside Europe, California, for example, introduced a due diligence law in 2012 that addresses slavery and human trafficking (State of California Department of Justice 2012). It affects companies in the retail and

manufacturing sectors with an annual turnover of more than 100 million US dollars.

In Australia, the Modern Slavery Act introduced in 2019 sets out the reporting obligations in relation to slavery, human trafficking and child labour for companies with a global turnover of more than 100 million Australian dollars (Legislation.gov.au 2018). Canada is working on a similar law as well (Stöbener de Mora and Noll 2021b). In the USA, the Dodd-Frank Act compels companies whose products contain certain metals to provide a corresponding certificate of origin (ibid).

Besides these individual national initiatives, there are also discussions on the introduction of EU legislation (European Parliament 2021a). In March 2021, the European Parliament adopted recommendations for the drafting of a directive on corporate due diligence. The European Commission intended to make a corresponding proposal for a directive in autumn 2021. That proposal was eventually published on 23 February 2022 (European Commission 2022) and turned out to be much broader in scope than the German Supply Chain Due Diligence Act.

For example, in comparison to the German act, the threshold from which companies are subject to the law is halved from 1,000 employees to 500 employees (provided they generate a minimum turnover of 150 million euros), which means that significantly more companies will be affected by the EU directive than by Germany's legislation. In addition, the directive defines high-impact sectors, where certain due diligence obligations will have to be fulfilled from a company size of at least 250 employees and a turnover of 40 million euros.

A major point of difference to the German draft is that companies are also directly responsible for their indirect suppliers and downstream companies – provided that a permanent supplier relationship exists, i.e. it is not just a one-off transaction. Under the German law, companies are only required to act on such suppliers if they obtain substantiated knowledge of human rights

violations. The EU directive also explicitly states that companies must develop and implement a strategy towards achieving the 1.5 degree target. And last but not least, the possibility of liability under civil law is explicitly included. This is not the case with the German law, although Germany does allow for legal action to be taken independently of the Supply Chain Due Diligence Act.

An EU regulation with due diligence obligations for certain metals came into force in January 2021, preventing

European companies from extracting these metals in conflict regions. Since 2013, the EU Timber Regulation has also imposed due diligence obligations with regard to illegal logging (Stöbener de Mora and Noll 2021b). In addition, the European Magnitsky Act (which is based on the US Magnitsky Act) allows sanctions to be imposed on individuals and institutions (including companies) if they are found to violate human rights (DOS 2020, European Parliament 2020, Atlantic Council 2020).

III. Degree to which the German economy is affected

In principle, human rights violations and environmental pollution can occur in any country, so it is hard to determine exactly how big the impact on the German economy will be. However, some supplier countries are particularly problematic as regards compliance with social and environmental standards. Determining the dependence of Germany's industry on these countries can therefore give a first clue to the impact of the German Supply Chain Due Diligence Act.

1. The ITUC score for measuring workers' rights

The ITUC score is used to classify individual countries in terms of their human rights situation. It is based on regular assessments of the general working conditions by the International Trade Union Confederation (ITUC).⁸ Factors that the indicator takes into account include freedom of association, free collective bargaining, the right to form trade unions and physical violence against workers (ITUC 2020). The ITUC score ranges from 1 (sporadic violations of workers' rights) to 5 (no guarantee of workers' rights). The special category 5+ is reserved for countries where workers' rights cannot be guaranteed due to a breakdown of the legal system. This article uses the 2020 classification, which covers 141 countries (ITUC 2020).

Although the ITUC score is a widely recognised indicator, it only covers certain aspects of the human and environmental rights addressed by the German Supply Chain Due Diligence Act. Other areas, such as child labour, are not considered. In fact, Felbermayr et al. (2021a) show that in a sample of particularly poor countries, the score correlates negatively with the proportion of working children (7 to 13 years), meaning that better labour protection is associated with an increased incidence of child labour. The dependencies calculated in this section therefore only represent the lower limit of the actual international linkages, because not all dimensions related to human and environmental standards can be taken into account.

2. Calculation of the international linkages of Germany's industry

Input-output tables from the OECD (OECD 2018) are used to calculate the dependence of Germany's industry on countries with high ITUC scores. These tables indicate the value of the intermediate products (in US dollars) that a given sector in a given country obtains from another sector in another country. This means the tables can be used to determine the value of the intermediate products purchased by Germany's industry

⁸ This article thus uses the same classification as Felbermayr et al. (2021a, b).

from individual supplier countries.⁹

As the tables only contain information on the flow of goods in 66 countries, not all countries with a high ITUC score are covered,¹⁰ which means that the values given are again a lower limit of the actual dependencies. For example, no input-output data is available for countries with an ITUC score of 5+.¹¹ In 2019, however, these countries were responsible for only 0.4 percent of Germany's total imports (Destatis 2021). Similarly, when it comes to countries with an ITUC score of 5, data is only available for 13 of the 32 countries in total. Those 13 countries were, however, responsible for 92 percent of German imports from this country category (Destatis 2021).

3. Importance of intermediate products from countries with a high ITUC score

Figure 1 shows the US dollar value of intermediate products sourced by Germany's industry from countries with an ITUC score of 5, i.e. those where workers' rights are not guaranteed, as well as the share of these countries in the total number of intermediate products used in Germany. The countries with the most serious violations of workers' rights are printed in bold.

In 2015, intermediate products totalling just under 76 billion US dollars came from countries in which workers' rights are not guaranteed. Taking into account the intermediate products originating from Germany itself, this corresponds to 2.6 percent of the total intermediate products used. If only imported intermediate products are considered, countries with an ITUC score of 5 account for 12.7 percent of the total intermediate products imported. According to the ITUC (2020), 0.9

percent of the total intermediate products used or 4.2 percent of imports come from the countries with the worst working conditions.

These percentages may seem relatively low. However, it is important to bear in mind that they are only average values for the German economy as a whole. While some industries source virtually no intermediate products from abroad, the shares in other industries are considerably higher. Germany's mechanical and plant engineering sector, for example, exhibits a particularly high level of international integration. In this sector, 4.2 percent of the total intermediate products used or 16.2 percent of the intermediate products imported come from countries with an ITUC score of 5 (Felbermayr et al. 2021b).

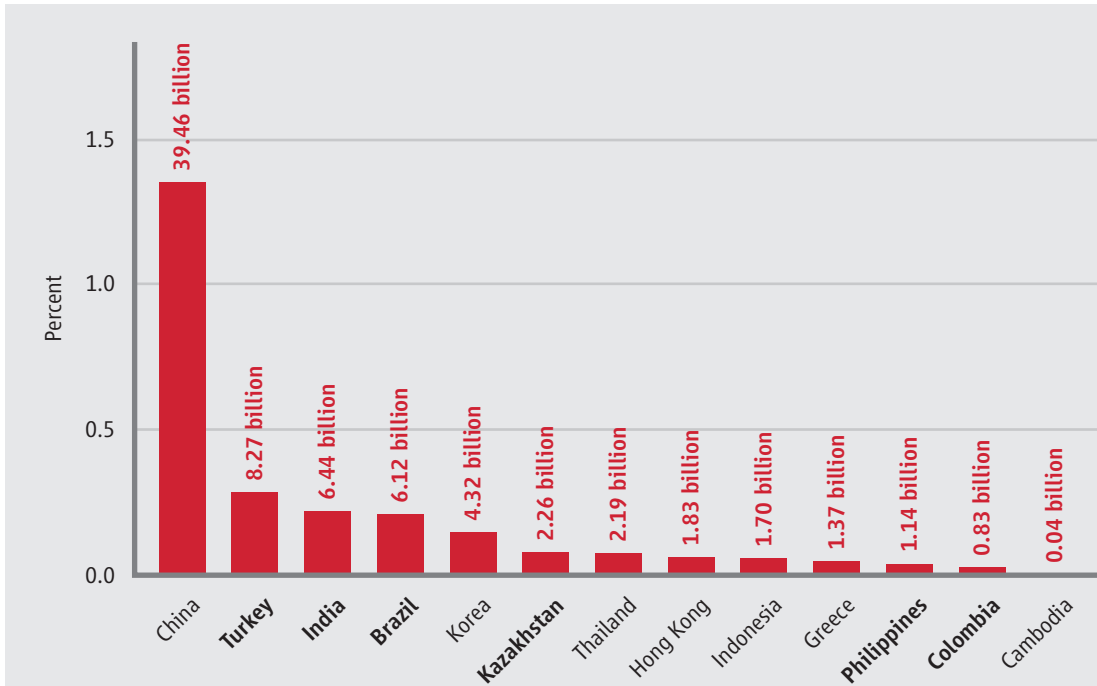
As evident from Figure 1, most of the intermediate products from countries with an ITUC score of 5 originate from China. In 2015, Germany's industry imported intermediate products worth almost 40 billion US dollars from China, which corresponds to a share of 1.4 percent of the total intermediate products used or 6.6 percent of the intermediate products imported. Next in line – with the share of total intermediate products used shown first and the share of imported intermediate products added in parentheses – are Turkey with 0.3 percent (1.4 percent), India with 0.2 percent (1.1 percent) and Brazil with 0.2 percent (1 percent). Here, too, the dependencies vary greatly across the individual industrial sectors. In the mechanical and plant engineering sector, for example, 2.7 percent of the total intermediate products used or 10.5 percent of imported intermediate products come from China (Felbermayr et al. 2021b). Looking at individual companies, the dependency is often even higher.

9 The most recent tables available refer to the year 2015. Assuming that the supplier structure in 2021 is comparable to that in 2015, the relative shares of the individual countries can be transferred accordingly. For a more detailed explanation of the methodology, see Felbermayr et al. (2015, 2020), for example.

10 Countries that are not covered have been grouped together as "Rest of the world" and considered accordingly in the calculation of the shares of total intermediate products used.

11 The nine countries with an ITUC score of 5+ are Burundi, Yemen, Libya, Palestine, Somalia, South Sudan, Sudan, Syria and the Central African Republic.

Figure 1: Share of intermediate products from countries with no guarantee of workers' rights (ITUC score 5)



Note: Values in USD. The countries with the most serious violations of workers' rights are printed in bold. No data is available for 19 countries with an ITUC (2020) score of 5. Greece's high score is attributable to the financial crisis, during which trade union rights were severely restricted (ITUC 2021a). Trade union rights are likewise restricted in South Korea (ITUC 2021b).

Sources: ITUC (2020) and ICIO tables from the OECD (2018).

Figure 2 shows the share of intermediate products from countries with systematic violations of workers' rights (ITUC score 4). In this category, the USA is the most important supplier country. Intermediate products worth almost 45 billion US dollars were imported from the USA in 2015, which corresponds to a share of 1.5 percent of the total intermediate products used or 7.5 percent of the intermediate products imported. Following far behind are Romania (0.2 percent of the total intermediate products used or 0.9 percent of imported intermediate products) as well as Malaysia and Vietnam (both with 0.08 percent and 0.4 percent in the respective categories).

In 2015, Germany's industry imported a total of almost 60 billion US dollars worth of intermediate products from countries where there are systematic violations of workers' rights. This corresponds to 2.1 percent of the total intermediate products used or 9.9 percent of

intermediate products imported. Looking at all countries with an ITUC score of 4 or 5, Germany's industry sources 4.7 percent of its total intermediate products or 22.6 percent of its imported intermediate products from countries with problematic working conditions. These shares also vary greatly across different industries.

A share of 4.7 percent of the total intermediate products used seems low at first glance. However, the value of the imported intermediate products does not give any indication of how important the individual foreign-sourced products are for the production process of a German company. It is possible, for example, that the value of an intermediate product sourced from China is low when measured in US dollars, but that the product is indispensable for a German company's production process. If such a German company is forced to end a business relationship owing to human rights violations and there are no substitutes in other countries, this may, in the

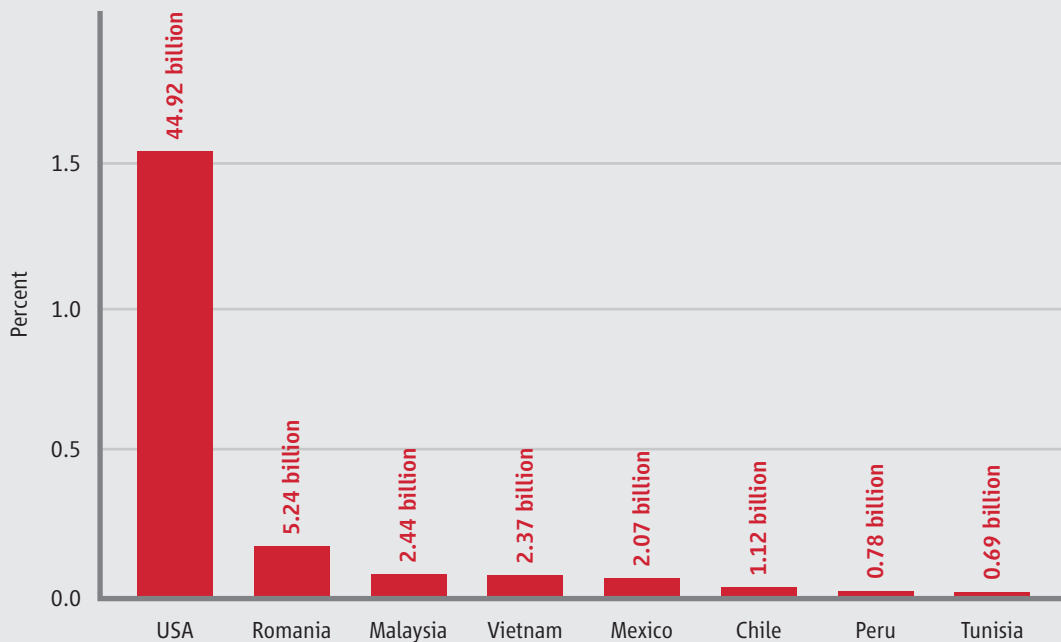
worst case, result in a production stop.

In other words, the 4.7 percent share of intermediate products from problematic countries could – if the worst came to the worst – result in 4.7 percent of German companies no longer being able to continue production if human rights violations were identified along the supply chain. The decisive factor here is the availability of close substitutes. In fact, only 0.5 percent of the goods imported into Germany in 2018 came from just one country (Flach et al. 2020). As many as 96.4 percent of all goods were imported from more than five countries. These figures indicate that German companies are fundamentally in a position to change suppliers should

they be forced to break off a supplier relationship because they have observed human rights violations.

By way of qualification, it must be mentioned that these percentages are based on an analysis of the six-digit product codes of the HS Nomenclature. However, products are actually classified using product codes with up to eight digits.¹² An intermediate product may therefore be produced in several countries according to its six-digit product code, but if we look at the situation more closely and distinguish products by their eight-digit product code, there may only be one country and, in the worst case, just one producer that manufactures exactly that product.

Figure 2: Share of intermediate products from countries with systematic violations of workers' rights (ITUC Score 4)



Note: Values in USD. No data is available for 33 countries with an ITUC (2020) score of 4. Input-output data from 2015.

Sources: ITUC (2020) and ICIO tables from the OECD (2018).

12 An example of a six-digit product code would be electric motors with a power of less than 37.5 W (product number 850110). But looking at the eight-digit level, a distinction is made between, for example, alternating current motors (85011093) and direct current motors (85011099), which are not readily substitutable.

4. The importance of indirect linkages

Since the German Supply Chain Due Diligence Act imposes greater responsibility on companies for their direct suppliers, the above analysis only takes into account those intermediate products that are sourced directly from abroad. If a German company only indirectly procures intermediate products from abroad, for example by purchasing intermediate products from Germany that were themselves produced using intermediate products from abroad, this is not taken into account.

However, an examination of these indirect intermediate products could become relevant in the context of European due diligence legislation, as that may also include heightened due diligence obligations with regard to indirect suppliers. The German Supply Chain Due Diligence Act only imposes limited due diligence obligations for indirect suppliers (Bundesregierung, 2021). An analysis of the importance of problematic countries that takes indirect intermediate products into account would go beyond the scope of this article, but is available for the German mechanical and plant engineering sector (Felbermayr et al. 2021b). The authors show that when such indirect integration is taken into account,

countries with at least systematic violations of workers' rights (ITUC scores 4 and 5) account for 12.9 percent of the total intermediate products used instead of just 6.5 percent. Especially China's share of all intermediate products used in the mechanical and plant engineering sector doubles from 2.7 percent to 5.8 percent. Whether the European due diligence legislation also extends to indirect suppliers will therefore be of great relevance to Germany's industry, as this would again significantly increase the number of supplier relationships that need to be monitored.

How then should the figures calculated in this section be interpreted? The fact that Germany's industry sources 4.7 percent of its total intermediate products from countries with problematic working conditions does not mean that all of these supplier relationships will actually have to be terminated due to human rights violations. Human rights violations may in fact also occur in countries with a lower ITUC score. Still, we can assume that supply relationships with these countries will at least require closer scrutiny. The next section will analyse how this affects even those companies that behave in an exemplary manner with regard to human and environmental rights.

IV. Impact of the Supply Chain Due Diligence Act

This section examines the impact of the German Supply Chain Due Diligence Act on German companies, the German economy as a whole and on suppliers in developing countries. It also looks at an empirical study of the French supply chain law, from which we can draw conclusions about the potential impact of a German law.

As discussed in the previous section, human rights violations along the supply chain could lead to the termination of supply relationships. If no substitutes are available, an affected company's entire production process could, in the worst case, come to a standstill. This scenario is obviously an extreme case that will with luck be rare, but could become necessary in order to convincingly protect human rights in affected supplier

factories. However, a supply chain law will also have effects on companies and suppliers that behave in an exemplary manner with regard to human rights and environmental standards. These effects will be examined in more detail below.

1. Impact on affected companies in Germany

As already described in Section II, affected companies in Germany will incur both direct and indirect implementation costs as a result of the law. Both when the law is introduced and thereafter "once a year as well as on an ad hoc basis" (Bundesregierung 2021: 11), they will have to analyse and document human rights and environmental risks at their direct suppliers. The resulting

costs also extend to the suppliers themselves, as they too must comply with reporting and documentation obligations for their German trading partners and take this into account when purchasing or providing goods and services (Rudloff and Wiek 2020).

Ultimately, the Supply Chain Due Diligence Act will lead to rising import costs for German companies (Bown and Zhang 2019). Trade economists refer to this as a non-tariff trade barrier. Such a barrier increases trade costs and consequently reduces trade flows (Kinzius et al 2019). It is important to note that the costs are incurred per key account and independently of the amount of turnover, as each supplier must be audited separately and must fulfil its documentation obligations towards the German customer individually. The importing company in Germany can follow one of three adjustment strategies, which are briefly explained below.

1. Keep the existing procurement strategy

Many German companies will probably hold on to their procurement strategies and accept the higher costs caused by the reporting and documentation requirements as long as no human rights violations are found. Depending on the competitive situation, companies will either pass these costs on to end customers in the form of price increases or will have to accept lower margins. The latter may be the case in particular where German companies are in international competition with producers from other countries that are not subject to due diligence laws. European supply chain legislation would solve this problem, at least with regard to EU competitors.

2. Reduce the number of key accounts

If the costs per supplier relationship increase, additional costs could be minimised by reducing the number of suppliers to be audited. It is therefore likely that many companies will consolidate their supply chains and source each intermediate product from only one supplier. The decision to reduce the number of suppliers depends both on the direct costs associated with the risk analysis of individual suppliers and on the potential

costs that could be incurred in the form of administrative fines in the event of a due diligence violation. Although the German law only imposes a duty of care and not a duty to succeed, each additional supplier increases the risk that human rights violations will go unnoticed and result in fines.

Although such a strategy can reduce the costs arising from the legislation, it makes German companies more susceptible to production stoppages if supply bottlenecks at certain suppliers can no longer be compensated for by other suppliers. Furthermore, a dependence on individual suppliers would increase their market power, which could lead to higher prices for intermediate products and less favourable conditions from the point of view of German companies. The need to screen potential suppliers before entering into a business relationship (Stöbener de Mora and Noll 2021a) is moreover likely to cause a certain sluggishness and an accompanying dynamic inefficiency in German companies' procurement activities.

3. Relocate supply chains

A third option would be to recalibrate supply chains by relocating the production of intermediate products to the company's own operations, to Germany or other OECD countries. The advantage of such a relocation would be that compliance with human rights and environmental standards can be verified more easily and cost-effectively within one's own company than outside of it. This is especially true for suppliers in developing countries, where it is not only more costly to verify and document human rights compliance, but also more likely that human rights violations will occur in the first place (see Section III).

Higher labour costs in Germany and other OECD countries could be countered, at least in part, with a higher degree of automation, which would reduce employment levels. However, a regulation-induced relocation of value chains would also entail considerable costs for the companies concerned, as they would have to forego the advantages of international division of labour and

specialisation (Caliendo and Parro 2015, Eaton and Kortum 2002).

2. Other aspects of relevance for companies

If German companies are to successfully implement the Supply Chain Due Diligence Act, they naturally need the cooperation of their suppliers. However, there may be cases where suppliers refuse to comply with their documentation obligations vis-à-vis German customers or to contractually guarantee the required human rights and environmental standards along their own supply chains because they are either unwilling or unable to do so (Felbermayr et al. 2021a). Suppliers could also refuse to use only intermediate products from contractually specified manufacturers or even to disclose the names of their contractual partners at all (Stöbener de Mora and Noll 2021a).

The relative bargaining power of the partners is likely to play a significant role here. If the German company is an important customer, the supplier is likely to cooperate so as not to jeopardise the collaboration. If the German customer is relatively unimportant for the supplier and global demand for its products is high (for example, protective gloves during a pandemic), there is no incentive to cooperate. In the absence of substitutes, the German company concerned could, in the worst case, see its entire production process jeopardised.

The implementation of the Supply Chain Due Diligence Act is likely to be influenced not only by a German company's size relative to its supplier, but also by its absolute size. Large companies often already have an organisational structure for monitoring various non-financial obligations (Felbermayr et al. 2021b), and it could also be used for the reporting obligations under the Supply Chain Due Diligence Act. These synergy effects should at least lower the additional costs arising from the law.

Given that existing non-financial obligations apply primarily to listed companies, it is reasonable to assume

that these companies in particular will be able to benefit from already having appropriate structures in place. So while many of the 500 largest family businesses will be affected by the law due to their employee numbers (5,000 on average, Gottschalk et al. 2019), the listed ones among them are particularly likely to profit from synergy effects. However, since most family businesses are small or medium in size (family businesses represent 90 percent of the companies in Germany, but only generate 52 percent of total turnover, Gottschalk et al. 2019), we can assume that they – insofar as the act applies to them – are more likely to experience adjustment problems than other companies due to a lack of structures in the area of corporate governance.

On the other hand, smaller companies (fewer than 3,000 employees as of 2023 and fewer than 1,000 employees as of 2024) – and thus most family businesses – may benefit because they are not covered by the act. Nevertheless, these companies will be indirectly affected by the act if they supply larger companies that do fall under it (Felbermayr et al. 2021b), as direct suppliers of affected companies have to assure that they “comply with all relevant requirements and address them appropriately along the supply chain” (Bundesregierung 2021: 12).

Another important aspect of the German legislation is that the due diligence obligations only apply to direct suppliers. It is therefore difficult to imagine how heightened due diligence obligations that apply to indirect suppliers as well – as discussed at the EU level (European Parliament 2021a) – might be implemented in practice. The example of a microwave, whose production requires 1,500 direct and indirect suppliers (ZVEI 2020), illustrates how hard it would be for a company to monitor the entire supply chain. It is also often unclear where a supply chain actually begins (Görg et al. 2021).

3. Impact on the German economy

As explained in the previous section, it is to be expected that the Supply Chain Due Diligence Act will increase

the production costs of affected companies. It is initially irrelevant whether the companies accept the costs of monitoring suppliers to comply with their due diligence obligations or whether they shift some of the value creation to other countries or to their own operations, thereby sacrificing the advantages of the international division of labour. The increase in production costs reduces the competitiveness of directly affected companies and raises prices for consumers – a situation that could further fuel inflation, which is currently on the rise anyway (Felbermayr and Sandkamp 2021).

Intermediate products produced by affected companies are also likely to become more expensive, which in turn will have an impact on the competitiveness of downstream companies (Felbermayr et al. 2021a). In the worst case, this could negatively affect employment in Germany. Indeed, in a different context, various studies show that a rise in non-tariff trade barriers could sharply reduce real income in Germany (Felbermayr et al. 2020, 2021c, Eppinger et al. 2020, Sforza and Steininger 2020). For example, a state-enforced relocation of value chains back to Europe through a doubling of trade barriers reduces Germany's gross domestic product by up to 6.9 percent (Felbermayr et al. 2021c). Supply chain legislation is, of course, in no way equivalent to doubling trade barriers, but the mechanism is similar, so that negative effects on income can also be expected here, albeit to a much lesser extent.

Moreover, a reduction in the number of suppliers, as is to be expected as a result of the Supply Chain Due Diligence Act, would not only make affected companies more dependent on their remaining suppliers, but would also weaken the resilience of the German economy as a whole (Felbermayr et al. 2021a). If critical suppliers become unavailable due to lockdowns or natural disasters, for instance, the worst-case scenario would be that whole industry sectors suffer production stoppages. Against the backdrop of the COVID-19 pandemic, there are indeed efforts to make the German economy more crisis-proof. They will certainly include an increased degree of diversification in order to avoid dependencies

on individual suppliers (Felbermayr et al. 2020).

The German Supply Chain Due Diligence Act is likely to be counterproductive in this respect. The Trade Committee of the EU Parliament, referring to the planned EU legislation, recently stressed that “especially at this time no legislative initiatives of an economically inhibiting or damaging nature, such as those imposing higher administrative burdens or causing legal uncertainty, should be taken” (European Parliament 2021b: 73).

4. Impact on developing countries

The Supply Chain Due Diligence Act creates incentives for German companies to reduce the number of their suppliers in order to save on monitoring costs, which are incurred per key account. In addition, at least part of the supply chain is likely to be relocated back to Germany and other OECD countries, as the risk of human rights violations is lower and monitoring is easier and less costly due to better governance structures. The consequence would be both a reduction in international trade overall and a shift of trade away from developing countries and towards industrialised nations.

From the perspective of exporters in developing countries, the obligation to prepare documentation additionally constitutes a non-tariff trade barrier. This too will cause existing exporters' volume of exports to fall, possibly even to the point where they leave the export business altogether (Melitz 2003, Melitz and Ottaviano 2008). It is important to understand that this risk applies to all exporters in developing countries and not just to those that actually commit human rights violations. From a macroeconomic view, this mechanism leads to a loss of income and a decline in employment in developing countries.

Some might argue that a certain loss of income in Germany as well as in developing countries should be accepted in order to effectively protect human and environmental rights. However, a look at the economic literature indicates that such legislation could even

be counterproductive. By its very nature, the act only affects exporting companies, as a German law is not relevant to companies in developing countries that only serve the domestic market.

However, exporting companies differ greatly from those that do not export. On average, exporters pay higher wages (Bernard and Jensen 1995, Bernard et al. 2007) and employ workers with better qualifications (especially if they export to industrialised countries, Verhoogen, 2008). They also pay more attention to corporate social responsibility (Görg et al. 2017). Due diligence legislation with its natural emphasis on exporters is therefore a burden on precisely those companies that treat their employees better than average.

If these companies lose their export business, their employees will either become unemployed or find work in the informal sector, where human rights are often not even protected by local laws, however rudimentary they may be (Felbermayr et al. 2021a). If the company concerned leaves the export business and turns to the domestic market instead, there is also a risk that it will no longer feel bound by the human rights obligations it agreed to in order to export to Germany. In fact, the EU Commission mentions that the Better Factories Cambodia initiative may lead to an increase in child labour and employment outside controllable supply chains (EU Commission 2020:349). Moreover, due to lower incomes, people in developing countries are typically less willing to pay for high-quality goods. This means that fewer well-qualified employees are needed in production processes and the average pay of employees is likely to fall (Verhoogen, 2008).

Instead of turning to the domestic market, exporters could also focus on exporting to other countries with less stringent regulation when it comes to environmental standards and human rights. The effects would be similar to those of shifting business activities towards the domestic market. From a geo-economic perspective, shifting developing countries' trade away from Germany and Europe would further reduce their ability to exert influence, thus strengthening strategic rivals such as China.

On the other hand, one positive aspect for a number of developing countries could be that some German companies might decide to invest locally, as it would be easier to monitor compliance with human rights in their own companies. This could have a positive impact on employment. Kolev and Neligan (2021b) show that around 215,000 jobs in Africa depend on direct German investment (700,000 in Asia).

Politically, the Supply Chain Due Diligence Act could be considered patrimonial from the perspective of developing countries, since it effectively interferes with the right of self-determination of these countries without their prior agreement (Felbermayr et al. 2021a). As a result, German companies acting in accordance with the law could encounter reprisals in some countries (Stöbener de Mora and Noll 2021b).

5. Trade as an opportunity for developing countries

It is therefore to be expected that due diligence legislation will reduce German imports from developing countries and possibly even weaken human rights in the countries concerned. Conversely, the above mechanisms imply that if developing countries were to trade more, especially with Germany and other industrialised nations, this could make a positive contribution to the local human rights situation.

In fact, international trade in general and integration into global value chains in particular correlate positively with a country's per capita income (Ossa 2015, Ignatenko et al. 2019). Ossa (2015), for instance, found that in a sample of 50 countries, the median per capita income is 56 percent higher than in a world without trade. In addition, the more open a country is to international trade, the lower the prevalence of child labour, precarious female employment and poverty (Felbermayr et al. 2021a). The degree to which corruption is controlled and the rule of law is enforced correlates positively with the degree of openness (ibid.). Hence, greater integration of a country in global value chains not only

increases per capita income, but also has positive implications for local human rights and should therefore be pursued further.

6. Impact of the French supply chain law

It is of course not possible to empirically measure the impact of the German Supply Chain Due Diligence Act at this stage, as it will not enter into force until January 2023. However, as described in Section II, due diligence legislation is already in place in other countries, with the French supply chain law (in force since 2017) coming closest to the German law. An evaluation of the French law could therefore shed light on the most probable impact of the German Supply Chain Due Diligence Act.

In an as yet unpublished working paper, Kolev and Neligan (2021c) examine the impact of the French supply chain law on French trade. The authors show that France's imports have decreased as a result of the supply chain law. This is particularly true for imports from countries with low per capita incomes as well as former French colonies, most of which are developing countries. The results confirm existing findings in relevant literature that a due diligence law acts as a non-tariff trade barrier and reduces the implementing country's imports. That applies in particular to imports from developing countries, which have a higher average incidence of human rights violations and which are also more difficult to monitor.

V. Possible approaches at the EU level

The German Supply Chain Due Diligence Act has been passed and will come into force on 1 January 2023. However, in order to reduce distortions of competition and avoid circumvention effects, there is an urgent need for regulation at the EU level. A corresponding proposal for a directive was published by the EU Commission on 23 February 2022. As discussed in Section II, the European draft goes beyond the scope of the German Supply Chain Due Diligence Act in several respects. The heightened due diligence obligations for indirect suppliers in particular would be very difficult to implement for the companies concerned due to the reasons already mentioned. Felbermayr et al. (2021a, b) therefore discuss two possible alternatives to the due diligence law in its current form, which will be briefly outlined below.

1. Whitelist approach

One possible approach would be to use a whitelist (Caspary et al. 2021), i.e. an officially maintained list of companies with which European companies are allowed to maintain trade relations. An advantage of such a list over the German law would be a higher degree of legal certainty: the foreign exporters with which

European companies are allowed to trade would be precisely defined and European companies who only do business with exporters from the list would therefore not have to worry that they had breached their due diligence obligations. Due diligence with respect to indirect suppliers could also be addressed with such a list, as European companies would be obliged to act as soon as they discover that a non-listed company is part of their supply chain.

An additional advantage of such a list would be that European companies would no longer be obliged to conduct detailed audits of their suppliers, thus avoiding unnecessary multiple audits of the same supplier by several European partners. More importantly from the perspective of the European importer, there would be no monitoring costs per key account, which would eliminate the economically problematic incentive to reduce the number of suppliers. The negative effects on production costs and on the resilience of the economy as a whole would thus be reduced.

The main disadvantage would be the administrative effort involved in implementing such a solution: it

would be impossible to carry out central audits of all companies with which European firms trade directly or indirectly within a short period of time. Even long transition periods would probably not solve this problem. Moreover, a whitelist would represent a significant entry barrier for startup companies, as they would have to be certified before becoming involved in exports of goods or services to the EU. Last but not least, such a list would raise WTO concerns if it only applied to non-EU companies. European companies would therefore have to be certified accordingly, which would further increase the administrative burden.

2. Blacklist approach

A more realistic solution, and one favoured by Felbermayr et al. (2021a, b), would be a blacklist approach. This is an officially maintained list of companies with which trade relations are not allowed, whether direct or indirect. The advantages of such a list in terms of legal certainty and costs for European companies would be comparable to those of a whitelist. However, a blacklist would be much easier to implement, as it would no longer be necessary to explicitly audit all direct and indirect trading partners of EU companies. Instead, only companies suspected of violating human or environmental rights would have to be inspected, for example following a tip from a non-governmental organisation.

VI. Conclusions

The main argument put forward in support of introducing the Supply Chain Due Diligence Act is that not enough companies ensure that human rights are respected along their supply chains (as measured by compliance with the requirements of the National Action Plan (NAP) on Business and Human Rights in 2020). However, the economics literature presented in this paper clearly shows that the integration of developing countries in international value chains has actually contributed to improving the human rights situation locally – and could continue to do so. Intervention by means of the Supply Chain Due Diligence Act, though

Political responsibility would remain with the state and not be delegated to private companies. This kind of list would also provide a good basis for cooperation with other countries such as the USA, Switzerland or the United Kingdom, as existing lists could easily be exchanged.

An important point to ensure successful implementation is that companies suspected of committing or tolerating human rights violations are given the opportunity to express their standpoints before they are added to such a list. They must also have the opportunity to be removed from the list as soon as they no longer commit human rights violations. On the other hand, the EU Commission needs to be in a position to detect circumvention strategies by black sheep and to punish them appropriately.

The EU could follow existing list approaches in drawing up such a list. For instance, with its antidumping procedure, the EU already has a protective trade policy instrument in place that only imposes antidumping duties on certain companies (i.e. those that can be proven to export at dumping rates) and that has a corresponding grievance mechanism for falsely accused companies (Felbermayr and Sandkamp 2020, Sandkamp 2020). There are also similar blacklists in other areas, such as the aviation and fishing sectors, where certain airlines and ships are blacklisted (Felbermayr et al. 2021a).

well-intentioned, will not only curb this development, but in the worst case might even reverse it (at least partially).

This does not mean that the state should not work towards improving the human rights situation. However, not every intervention necessarily leads to an improvement; if ill-considered, it can even worsen the situation at the local level. As far as the already adopted German Due Diligence Act is concerned, the remaining legal uncertainty will have to be addressed through statutory instruments by the Federal Ministry of Labour

and Social Affairs and guidelines by the Federal Office of Economics and Export Control (Stöbener de Mora and Noll 2021a, b). At the European level, there should be a push for the introduction of a blacklist, as this offers the companies concerned greater legal certainty, minimises the costs of implementation and eliminates problematic incentives with respect to the supplier structure. In this way, human and environmental rights could be protected effectively.

The neo-interventionist approach of imposing tight regulation on companies is not suited to improving the global human rights and environmental situation. When international supply chains grow more expensive, they are at risk of becoming shorter – and that is not good for the development of the global South. There are more expedient approaches to making the world a better place.

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About the Advisory Board members



Prof. Udo Di Fabio is professor of public law at the University of Bonn and director of the Research College for Normative Foundations of Society (Forschungskolleg normative Gesellschaftsgrundlagen, FnG), Bonn. From 1999 to 2011, he served as a judge at the Second Senate of the German Federal Constitutional Court (Bundesverfassungsgericht). Prof. Di Fabio supports the research work of the Foundation for Family Businesses on constitutional issues.



Prof. Gabriel Felbermayr, Ph.D. is director of the Austrian Institute of Economic Research (WIFO) in Vienna and professor at the Vienna University of Economics and Business (WU). Until September 2021, he was president of the Kiel Institute for the World Economy. Previously, he headed the ifo Center for International Economics at the ifo Institute in Munich and since that time has been advising the Foundation for Family Businesses on trade policy issues.



Prof. Clemens Fuest is president of the ifo Institute and professor for economics and public finance at LMU Munich. As part of the Annual Monitor of the Foundation for Family Businesses, the ifo Institute and Foundation for Family Businesses survey family and non-family businesses on current issues relating to economic policy and the business world on an annual basis.



Prof. Rainer Kirchdörfer is a partner at the law firm Hennerkes, Kirchdörfer und Lorz in Stuttgart and honorary professor and head of the Chair of Family Business Law at Witten/Herdecke University. He is an honorary member of the Executive Board of the Foundation for Family Businesses and chairs the foundation's Advisory Board.



Prof. Hans-Werner Sinn is a constituent member of the Advisory Board of the Foundation for Family Businesses. As a former president of the ifo Institute and an outspoken economist, he contributes to debates on issues such as Germany as a business location, European financial policy, the relationship with the United States and the coronavirus pandemic.



Prof. Kay Windthorst holds the Chair of Public Law, Legal Doctrine and Legal Didactics and is managing director of the Research Centre for Family Businesses at the University of Bayreuth. He is also a former visiting professor in family business law at the University of Witten/Herdecke and at Altinbas University in Istanbul. His research focuses on governance and compliance in family businesses.



Foundation for Family Businesses

Stiftung Familienunternehmen

Prinzregentenstrasse 50

80538 Munich

Germany

Phone + 49 (0) 89 / 12 76 400 02

Fax + 49 (0) 89 / 12 76 400 09

E-mail info@familienunternehmen.de

www.familienunternehmen.de/en

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