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EU Trade Policy in Light of the New Industrial Strategy for Europe

EU trade policy, which is essential to a prosperous European economy and industry, has an important role to play in tackling the major challenges of our times relating to worsening geo-economic and trade tensions, enduring global sustainability issues and a deteriorating multilateral order. The attempt to surmount these issues requires the adoption of a non-protectionist and peaceful approach to the benefit of the EU industries, consumers and citizens, and more generally, the world.

In this respect, the European Commission recently released a Trade Policy Review that responds to these numerous challenges by promoting an open, sustainable and assertive trade policy. This policy is in line with

the EU's fundamental treaty commitment to free and fair trade¹ as well as the overarching green and digital transitions as supported by the EU New Industrial Strategy. In this respect, open strategic autonomy becomes the new horizon towards which the EU trade policy is directed. It is aimed at balancing the benefits of trade openness and competitiveness with strengthened resilience, sustainability, a more assertive stance towards unfair trade practices, and rules-based cooperation.

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1 In the Treaty of the European Union, the EU commits itself to contribute to the sustainable development of the Earth, free and fair trade, as well as to the observance and development of international law, including the principles of the United Nations Charter (Article 3(5) of the TEU).

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The EU trade policy's new model of open strategic autonomy should be generally understood and implemented as uniquely supportive of emerging or new forms of trade openness rather than as a buttress for protectionism. These forms of trade openness should therefore essentially be founded on and contribute to sustainability, fair conditions of competition and a level playing field, security and predictability, multilateral trade cooperation to the greatest extent possible, and legal and economic grounds.

Sustainable trade

Trade and sustainability must be compatible, even though they are not necessarily so automatically. In this respect, diverse EU policies may contribute to sustainable trade, including EU environmental and social policies, as well as EU trade policy whose main perspective relates currently to its Trade and Sustainable Development (TSD) chapters in its new generation free trade agreements (FTAs).

Domestic environmental and social policies are generally considered first-best policies to correct market failures, while trade policies are generally qualified as “blunt and rarely, if ever, efficient when addressing market failures” (Mavroidis, 2016, 414). EU trade policy should therefore be applied for sustainable trade purposes only to the extent that it improves the impact of international trade on the environmental or social realities. This transition towards a more sustainable economy and trade creates new market opportunities and increases employment.

Furthermore, EU trade policy should contribute to sustainable trade through concrete, measurable and direct instruments addressed primarily or at least ultimately to companies, being the core actors in this transition towards sustainability.

Against this background, the following specific trade policy instruments should be adopted by order of preference:

1. trade liberalisation in environmental goods at the multilateral level
2. mandatory EU system of due diligence with international private certification
3. one-topic sustainability agreements
4. improved EU free trade agreements in terms of both substance and enforcement.

Trade liberalisation in environmental goods at the multilateral level

Trade liberalisation in environmentally related goods (EGs) at the multilateral level represents the first-best trade policy option to contribute to sustainable trade in

facilitating the access – at lower cost – to EGs. On the one hand, as shown by the OECD (2019a) set of trade and environmental indicators, international trade in EGs has more than doubled over the period 2003-2016. This growth may relate in part to domestic environmental policies (Sauvage, 2014). On the other hand, Shapiro (2020) shows that in most countries, import tariffs and non-tariff barriers are substantially lower on dirty (more upstream) than on clean (more downstream) industries. The limitation of greater protections for clean industries could help address climate change and increase welfare.

Trade liberalisation in environmental goods and services would be best approached in a holistic manner at the World Trade Organization (WTO) by reviving the currently suspended Environmental Goods Agreement (EGA) negotiations. The latter should proceed on a plurilateral agreement's basis, cover the majority of international trade in EGs and be extended to include developing countries. The targeting of the elimination of tariffs on EGs would benefit all WTO members on a most-favoured-nation basis.

As the EGA represents a paradigm shift by integrating the environmental policy purpose in the international trade agenda, its scope should first cover the most obvious EGs that directly contribute to climate change mitigation in a measurable way, that already greatly benefit from domestic environmental policies, and for which consensus by participating WTO members may be more easily found. The scope of the EGA should then be incrementally extended to progressively cover all EGs of a value chain based on a periodic review mechanism.

Mandatory EU system of due diligence with international private certification

The European Commission is expected to release a proposal for a directive on mandatory corporate due diligence later this year, which is a welcome initiative. Compared to voluntary due diligence and reporting systems, mandatory due diligence requirements may contribute to the reduction of adverse human rights and environmental impacts of businesses' activities and supply chains in a more positive way, thereby rendering them more resilient (European Commission, 2020a).

The EU-wide mandatory due diligence system should be based on an obligation of conduct in the form of a context-based legal standard of care, according to which undertakings have to adopt all objectively necessary and sufficient measures to identify, prevent and mitigate the most severe or likely adverse corporate-related impacts on human rights and the environment throughout the supply chains. In this respect, the applicable standard of care

should vary according to the size and means of the undertakings, as well as to their sector of activity and the context of operations, in order to guarantee the effectiveness of the due diligence system as well as legal certainty.

The EU mandatory due diligence requirements should be applicable to all EU undertakings and non-EU undertakings that operate in the internal market in order to foster both a European and a global level playing field. Access to the EU internal market should be conditioned or be made more tariff advantageous (e.g. based on a future WTO EGA) based on compliance with the due diligence obligations.

Beyond an appropriate standard of care, the effectiveness of the EU mandatory due diligence system also depends on its consistent and coordinated monitoring and enforcement by the European Commission and the EU member states. As this will entail significant costs (European Commission, 2020a, 22), it is important to review the compliance with the mandatory due diligence requirements. This could be done through reference to internationally recognised private conformity assessment systems based on internationally recognised standards (e.g. international product-related standards, including standards related to conformity assessment, developed by the International Organization for Standardization).

The EU-wide cross-sectoral due diligence system should thereby also contribute to the further development of international private standards and conformity assessment systems into a private world agreement, that would in turn support other relevant international treaties (e.g. UN Treaty of Business and Human Rights; WTO TBT-plus and SPS-plus agreements).

One-topic sustainability agreements

The EU should privilege the development of dedicated sustainability agreements with its trading partners with a wider multilateral perspective. The unique example in this respect is the Agreement on Climate Change, Trade and Sustainability (ACCTS) between Costa Rica, Fiji, Iceland, New Zealand, Norway and Switzerland.

Improved EU FTAs in terms of both substance and enforcement

To enhance the effectiveness of the TSD chapters in the EU's FTAs, they need to comprise more concrete and targeted rules on various sustainable trade-related topics, beyond the currently covered areas. These rules should all be legally binding. Flexibility is necessary due to the ambition of the TSD commitments; however, they should

vary according to the EU's trading partner in order to ensure the continued conclusion of FTAs with future EU's trading partners that are not necessarily like-minded.

The TSD chapters in the new generation of the EU's FTAs are limited in the effectiveness of their enforcement. The appointment of a Chief Trade Enforcement Officer and the establishment of a Single Entry Point therefore represent worthwhile initiatives. The specific dispute settlement mechanisms based on a panel of experts should still be rendered more operational, notably in providing for economic or trade sanctions in case of non-compliance, which should be made contingent upon a 'competitiveness test' (e.g. Article 9.4 of the level playing field chapter under the Trade and Cooperation Agreement between the EU and the UK).

Fair trade

Europe's traditional openness to trade and investment firmly underpins its economic competitiveness and resilience (European Commission, 2020b, 4). In this respect, foreign investment in the EU economy has become increasingly more important over the last ten years. In this respect, foreign investment in the EU economy has become increasingly important over the last ten years. This may be explained by the rise in value chain production (OECD, 2013). Related trends point to the greater prominence of new foreign direct investment (FDI) providers with more investment from emerging economies and state-owned enterprises, as well as the growing presence of "offshore investors" (European Commission, 2019).

This increasing openness towards foreign investments represents a great economic opportunity for Europe. It may, however, also raise concerns about certain foreign investments and other trade practices, which may represent important challenges to public security and the level playing field in the EU's Single Market. On the one hand, foreign direct investments in the EU internal market have increasingly concerned foreign investors with close ties to their home governments that strategically target European companies involved in the development of critical technologies or in critical infrastructures (e.g., energy). Other critical assets that could be strategically targeted by FDIs relate to critical inputs, or access to sensitive information. These trends and potential risks relating to FDIs warrant a more comprehensive approach at the EU level given the operation of firms over several EU member states, the importance of the proper functioning of the Single Market, and the necessity of a greater leverage over foreign countries.

On the other hand, with the generally low tariff levels, subsidies are being increasingly used by governments in

both high-income and emerging economies as a substitute for protection (Evenett, 2019; Hoekman and Nelson, 2020). Most importantly, the increase in value-chain-based production and trade that is highly correlated with an expansion in FDIs (OECD, 2013) is expected to limit the incentives to use traditional trade policy instruments such as tariffs, and to increase the incentives to use subsidies (Hoekman, 2016). However, subsidies will generally have spillover effects on trade that may even be intended so. While subsidies are presumed to be first-best instruments to address market failures implying positive spillover effects, they may also be adopted based on other rationales, such as an industrial policy-driven objective, that can imply negative cross-border spillover effects. More specifically, in a value chain world, negative spillovers can and will occur (Hoekman, 2016). Against this background, foreign subsidies can, through their negative effects, distort the competition and challenge the level playing field in the EU's Single Market. Indeed, the EU State aid rules, that are aimed at preserving such a LPF in the internal market, are solely applicable to subsidies provided by EU member states. Moreover, in this context of increasing importance of subsidisation and global value chains, the WTO legal disciplines on subsidies have to be adjusted and extended to cover services and investments. However, this endeavour is expected to be a long-term exercise.

In the absence of negotiated solutions at the multilateral level, the EU initiatives relating to the recent EU framework regulation for the screening of FDIs in critical assets that may affect the security or public order (Regulation (EU) 2019/452, 2019) and the European Commission's (2021a) proposal on foreign subsidies should be supported. This more assertive legal stance by the EU is genuinely aimed at contributing to fair conditions of competition and a level playing field in the Single Market as well as public security, beyond any form of protectionism, based on legally predictable rules founded in economics.

The EU FDI screening regulation

The EU regulation for screening of foreign direct investments establishes a framework for the screening by member states of FDIs into the EU on the grounds of security or public order and for a mechanism for cooperation and information sharing. Despite its contribution to enhanced legal certainty and transparency, the EU FDI screening regulation provides for an incomplete and imperfect system at the EU level that may compromise the achievement of a properly functioning and open Single Market.

On the one hand, the EU FDI screening regulation relies essentially on national proceedings that are typically confidential. The EU-wide cooperation and information-sharing

mechanism also shows limited transparency in some respects. Furthermore, investors may still continue to face multiple parallel national (formal and informal) investment screening proceedings within the Single Market. Against this background, the European Commission should propose, as part of its five-year review, the establishment of an EU-wide investment screening mechanism on grounds of security or public order with respect to at least projects or sectors of Union interest based on the EU's exclusive competence regarding the common commercial policy.²

On the other hand, despite the list of factors on critical assets and foreign investors provided for in the EU FDI screening regulation, there is a risk that national investment screening authorities expand the interpretation on security and public issues in order to cover other hidden issues, in particular economic issues. To overcome this risk, the EU should adopt complementary legislative instruments founded in economics and make full use of its competition policy³ with the objective of ensuring fair conditions of competition and a level playing field in the Single Market.

European Commission's proposal on foreign subsidies

The recent European Commission's (2021b) proposal for a regulation on foreign subsidies distorting the internal market aims at establishing new rules with respect to subsidies received from third countries by undertakings active in the EU. In this respect, it emphasises and targets the distortive effects that foreign subsidies may cause in the EU Single Market. As mentioned above, this can in fact be the case. The European Commission's proposal proceeds on the basis of indicators to identify the distortive effects of foreign subsidies on the internal market and it importantly mentions the relevance of the purpose of the foreign subsidy. The latter translates itself however in the determination of the potential positive effects of the subsidy. In that regard, we observe that the balancing test in the proposal has become wider, less specific and gives broad discretionary power to the Commission, compared to the EU interest test in the White Paper (European Commission, 2020b). This lack of specificity with the ensuing risk that the European Commission does not recognise positive effects of foreign subsidies clearly creates legal uncertainty and may dissuade companies and operators from investing in the Single Market at the expense of its competitiveness. Instead of contributing to fair competition in the internal market, the proposal risks promoting protectionism. Against this background, the European Commission should base its actions on the theory of economic policy

² Article 3(1)(e) TFEU.

³ See e.g. Case T-102/96 Gencor Ltd v Commission of the European Communities [1999] ECR II-759.

and develop guidance or further rules providing for safe harbours regarding foreign subsidies. More generally, the regulation on foreign subsidies and its application should not be more restrictive than the State aid rules applicable to EU member states. Importantly, all necessary measures should be taken to ensure WTO compliance with the proposal.

Multilateral trade

Major challenges that our world is facing would be best addressed through solutions negotiated at the multilateral level, and importantly at the WTO, even if they require strenuous medium- to long-term efforts. The General Agreement on Tariffs and Trade (GATT) and the WTO have indeed proven to be indispensable to the operation of the global economy, ensuring openness and development, as well as security and predictability to the multilateral trading system. They have thereby also contributed to peace-keeping.

For these reasons, it is of the utmost importance to restore and improve the multilateral rules-based trading system through the modernisation of its rules and the reform of its dispute settlement system. In this respect, it is important to note that the EU strongly supports the reform of the WTO, as evidenced by the Annex to the Trade Policy Review “Reforming the WTO: Towards a sustainable and effective multilateral trading system” (European Commission, 2021c).

Functioning WTO dispute settlement system

The restoration of a fully functioning WTO dispute settlement system, and in particular the Appellate Body, should be given priority on an independent basis as part of the WTO reform. It is crucial for the core existing WTO legal disciplines to be completely effective and modernised. Indeed, the WTO dispute settlement system has proven to be an essential element of the multilateral rules-based trading system. Its restoration will help promote its core characteristics relating to its binding nature, the independence of WTO adjudicators, as well as the WTO dispute settlement system’s fundamental contribution to the security and predictability of the multilateral trading system.

Some aspects of the WTO adjudicative system, however, deserve to be improved and clarified. First, the 90-day time limit for the issuance of Appellate Body reports, which was constantly exceeded by an average duration of 395 days in 2018 (WTO, 2020, 180), should be extended to a more realistic mandatory time period estimated at an average of six months; the possibility to extend beyond

this period should be rendered more difficult. In fact, the 90-day time limit imposed by US negotiators in 1993 was already widely criticised for being an unreasonably short time frame given the practices of other courts. Second, given the nature of WTO law and the claims, arguments and evidence provided by litigant parties, a certain number of panellists and Appellate Body members should be requested to have demonstrated expertise in economics, in particular econometrics (Mavroidis and Neven, 2017, 195). Third, the Appellate Body’s mandate limited to issues of law covered in the panel report and legal interpretations developed by the panel should be clarified. In this respect, an Understanding to Article 17.6 of the Dispute Settlement Understanding providing for general guidance as to the required degree(s) of correspondence between facts and law for the meaning and operation of domestic law to be subject to appellate review should be adopted. It should notably be determined according to the type of WTO covered agreement or legal obligation at stake, and the type of claim (*de facto* vs *de jure* cases) (Schaus, 2020).

International code of conduct on state-owned enterprises

In addition to the adjustment of the WTO rules to the climate and environmental challenges, an international code of conduct on state-owned enterprises should be adopted. In fact, state-owned enterprises (SOEs) are used in numerous countries, and they may sometimes create market-distortive effects. For instance, SOEs are quite present in the European economies (Amatori, 2017); and state-led economies generally heavily rely on SOEs that may have differing characteristics (Pelkmans and François, 2018).

Since the GATT 1947, WTO law comprises some disciplines regarding SOEs, including Article XVII of the GATT, which disciplines the behaviour of state trading enterprises (STEs) in their commercial activities. It should, however, be clarified and expanded with respect to its covered obligations. It provides, on the one hand, that STEs shall act in a non-discriminatory manner in their commercial activities, and, on the other hand, that STEs shall act solely in accordance with commercial considerations and shall afford the other enterprises adequate opportunity to compete for participation in their commercial activities. In the context of divergent WTO case law, these obligations should be understood as independent obligations (Mavroidis and Sapir, 2021). In fact, SOEs may contribute to market distortions based on behaviour that is not consistent with commercial considerations, while perfectly non-discriminatory. In this respect, an Understanding to Article XVII of the GATT based on the relevant disciplines

developed in the EU's FTAs (e.g. EU-Vietnam FTA) and beyond should be adopted.

Second, subsidies are also often granted through sometimes opaque systems of SOEs. Under the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement), a subsidy is established based notably on the existence of a financial contribution provided by a government or a public body, or by a private body entrusted or directed by the former. As such, the SCM Agreement should be clarified and reinforced through the development of an illustrative list of SOEs, annexed to the SCM Agreement that would *presumptively* qualify as public bodies (Mavroidis and Sapir, 2021) based on one or two criteria referred to in WTO case law with respect to the entity-based public body enquiry and typically included in the definition of SOEs in EU FTAs and beyond. This includes majority government ownership, governmental appointment of the majority of board members, governmental control over strategic decisions, the exercise of governmental functions, or the pursuance of government policies.

Conclusion

The EU trade policy, essential to a prosperous European economy and industry, can play an important role in tackling the major challenges of our times relating to sustainability and fair trade issues.

Solutions negotiated at the multilateral level, and importantly at the WTO, such as the trade liberalization in environmental goods, an international code of conduct on SOEs and improved WTO legal disciplines on subsidies, would most probably best address these challenges on a lasting basis. These negotiations will however require strenuous medium- to long-term efforts, that should also importantly encompass the restoration of the WTO dispute settlement system.

Therefore, the EU trade policy initiatives with respect to sustainable trade and fair trade are welcome to the extent they are effectively and genuinely aimed at achieving these goals and remain WTO-compliant. Additional actions should also be taken by the EU, such as sustainability agreements. Finally, further improvements are needed with respect to the EU's currently main sustainable trade perspective relating to its TSD chapters, and to the recent EU FDI Screening Regulation.

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