China
Responsible supply chain management and ethical purchasing

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Serena Lillywhite
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Abstract
As China continues its economic development and integration with the global economy, pressure is building to ensure international enterprises embrace responsible supply chain management and contribute to improved labour and environmental conditions. Despite China’s reputation for having a poor regulatory framework, China’s labour law is more comprehensive than that of many OECD countries. What is lacking is an adequate system of implementation. This paper draws on the experiences of an Australian non-government organisation (NGO) in dealing with the Chinese optical industry to consider the important question of corporate social responsibility in China. It includes:

• experiences of the Brotherhood of St Laurence managing a supply chain in China
• understanding corporate social responsibility in China
• understanding China’s regulatory environment and labour laws
• challenges and opportunities of responsible supply chain management
• ethical business in action—practical advice for business managers.

Introduction
China is an increasingly significant producer of most manufactured goods for the global economy. With membership of the World Trade Organization, the negotiation of an increasing number of Free Trade Agreements and the phasing out of quota protection agreements, this trend is set to continue. China’s capacity to provide a seeming endless supply of cheap and compliant labour is considered the single most important factor contributing to China’s strong economy and astonishing capacity to attract foreign direct investment. In the Asia Pacific region, approximately 80 per cent of foreign direct investment (FDI) goes to China. In 2004, FDI inflows to China reached almost USD60 billion, making China the world’s largest recipient of FDI (Ryan 2004).

Corporate social responsibility (CSR) is increasingly being regarded as part of the global business landscape, an indicator of corporate citizenship, good governance and a risk management strategy. However, supply chain management rarely gives recognition to labour rights and environmental standards: rather, attention is focused on logistics such as price, quality control, sourcing, distribution and marketing.

Corporate social responsibility must include responsible supply chain management and investment practices that promote labour standards, particularly in developing countries such as China that may not have a well-developed regulatory environment. Enterprises, industry associations, home and host governments, non government organisations and trade unions are well-placed, and indeed have a responsibility, to collaboratively promote labour rights as an integral component of responsible supply chain management and sustainable foreign direct investment. Increasingly, albeit slowly, the business community is acknowledging the global responsibilities of transnational enterprises, including the complex issue of supply chain management in developing countries.

Voluntary mechanisms such as the OECD Guidelines for Multinational Enterprises have been developed as a framework to assist enterprises meet their responsibilities. The OECD Guidelines are the most important international instrument that exists for business, and are unique in that they have the support of business, trade union and non government organisation (NGO) communities. Complex supply chain and subcontracting arrangements make application of the Guidelines more difficult, but encourage greater corporate accountability and transparency.

Corporate social responsibility in China

The global trend towards corporate social responsibility is evident in China. It is being influenced by a number of factors: pressure from NGOs and trade unions, initiatives by some global brands to improve factory conditions as part of a risk management strategy; the development of multilateral mechanisms (such as the OECD Guidelines for Multinational Enterprises), and the development of China’s regulatory framework (labour law, trade union laws and occupational health and safety law). Gaining a competitive advantage and ensuring the reputation of global brands is not tarnished is the dominant driver of CSR developments in China, and indeed in many industrialised economies. A commitment to decent working conditions and the protection of labour rights is rarely what motivates CSR initiatives.

Codes of conduct, monitoring and compliance

Corporate social responsibility processes are most commonly implemented through corporate codes of conduct, certification instruments such as SA 8000, and, to a lesser extent, multi-stakeholder initiatives such as the Ethical Trading Initiative (UK), the Fair Labor Association (USA) and the Fair Wear Foundation (Netherlands). There are also industry-specific standards (for example in the textile and apparel industry) and multilateral mechanisms such as the OECD Guidelines for Multinational Enterprises, the Global Reporting Initiative, and the UN Global Compact. In addition to the national laws and international standards, corporate codes and certification standards are important in promoting core labour standards (particularly where national laws are inadequate or poorly regulated), and in identifying some problems and compliance issues. However, codes too often represent a shallow attempt to understand the real issues in transnational supply chain management or to apply long-term sustainable efforts to promote fair and decent working conditions. Codes of conduct do not necessarily ensure acceptable factory and labour conditions. They are often developed at a distance, without involvement and commitment from both workers and managers. They are frequently poorly promoted and understood within factories, and workers are usually not given an opportunity to comment freely and without reprisal on their operation in the workplace.

Monitoring, compliance and enforcement of codes are complex and problematic. Inspections tend to be ad hoc and are not necessarily undertaken by personnel skilled enough to identify falsified information (LARIC 2000). In isolation, codes cannot be relied on to protect workers’ rights or promote worker empowerment, nor should they be seen as alternative to national labour laws or a substitute for government ratification of international labour standards. Codes of conduct can, however, be a useful first step in harnessing an enterprise’s commitment to CSR, particularly when accompanied by a meaningful and independent process of monitoring and compliance.

Corporate responsibility and competitive advantages

The Brotherhood of St Laurence research in China has confirmed that whilst CSR is not well understood by most Chinese, some factory managers are increasingly interested in how a business can be more responsible, particularly in highly competitive sectors such as the optical industry. These managers are becoming aware that corporate responsibility and improved compliance with corporate codes, national laws and international standards could be harnessed as a competitive advantage. Improved compliance is already resulting in certain factories being more attractive to large brand name customers who can use evidence of compliance to demonstrate a commitment to CSR in a global context. This provides benefits for the factory through increased production contracts, benefits for the transnational’s reputation for improved supply chain management and corporate responsibility and benefits for the factory workers who enjoy improved labour conditions. There is significant scope for foreign enterprises to pursue innovative mechanisms and introduce ethical purchasing practices. Competitive advantage is the driving force rather than the promotion of labour rights, and this may be a response to current international thinking.
Training and education
Training and education are increasingly a part of the global CSR landscape. Tracking the increased commitment to CSR and improved implementation of national laws in China shows a slow but steady transition from an emphasis on codes of conduct and monitoring to the introduction of a variety of training programs and projects. Many of these developments have been experimental or occurred in an ad hoc manner. However, the great concern at present is the lack of capacity to deliver meaningful, effective and sustainable programs that offer real benefits to workers and contribute to cultural and workplace changes.

China’s regulatory environment and labour law
China has a complex regulatory environment. Chinese labour law sets standards and rules that are as high as those in most OECD countries, although the extent to which they are implemented and influence behaviour in the factories is another matter. There is a gap between the practice as described by Department of Labour and All China Federation of Trade Unions (ACFTU) officials and some foreign enterprises and factory managers and what actually occurs.

The Chinese legal system and culture do not provide strong institutional support for compliance with domestic law. Chinese labour law is complex, made more so by provincial adaptations and exceptions in special economic zones.

China is not a country with a strong civil society. The ACFTU is not particularly effective in protecting workers’ rights, independent NGOs have very little space in which to operate and there are few consumer protection mechanisms. Workers are often not well informed of their rights and the weakness of China’s legal institutions means also that workers are reluctant to take steps to secure their legal entitlements, although this is gradually changing with the establishment of legal aid centres and support services in some cities. Still, factories are under no real pressure from Chinese society to reform and comply with labour law. Missed opportunities are most evident with regard to wages, hours of work, social security entitlements and overtime payments. Within the optical industry, the practices of not paying legal minimum wages and appropriate overtime and bonus payments, and of imposing arbitrary fines and deductions, force many workers to choose a factory where they are able to work illegal amounts of overtime in order to survive (Lillywhite 2004).

Case study: doing business in China from a small business perspective
The Brotherhood of St Laurence (BSL) is an Australian NGO with a vision of promoting social justice and a whole of society framework for a poverty-free Australia. In 2000, the BSL gained ownership of a small business, Mod-Style, which imports and wholesales optical frames for Australia’s independent optical retailers. In 2003–04, the company imported 146,000 optical frames and had a turnover of almost AUD5 million. Much of the production occurs in China, where 90 per cent of the world's optical frames are currently manufactured. For example, the Chinese city of Wenzhou produces 750 million sunglasses a year, amounting to half of China’s total production (Ryan 2004).

The BSL accepted ownership of Mod-Style on the basis that it would investigate the ethical implications of owning a company that sourced goods from China. Profits were quarantined for two years, and used to fund a thorough investigation of the supply chain, the conditions of the workers, the barriers to improvements in these conditions, compliance with China's labour law and an assessment of global trends in CSR in China. This involved extensive discussions with factory owners in China and their representatives in Hong Kong, the Hong Kong Optical Manufacturers’ Association, brand name customers who use the same suppliers in China, and NGOs based in Hong Kong and Australia. This work is ongoing.

The BSL experience in attempting to responsibly manage the supply chain of its commercial enterprise illustrates the complex opportunities and challenges facing enterprises and governments that are committed to responsible trade and investment practices. The research confirms that no
single organisation has all the answers, particularly with regard to ensuring labour rights are part of negotiations and practices. The best results are achieved through innovative incremental progress and global collaboration among enterprises, trade unions, industry associations, NGOs and governments.

**Mapping the Mod-Style supply chain in China**

**Identifying the factories**

Investigating the supply chain has involved identifying and regularly visiting factories that supply Mod-Style, developing an understanding of the customer profile and subcontracting relationships of the factories and understanding the workforce. The BSL has invested considerable time and resources to understand the business and labour rights issues in China—an undertaking which, while difficult for many small or medium sized enterprises, needs to be done to promote labour rights as an integral component of trade and investment.

Mod-Style has in China approximately 20 suppliers, the majority of which are wholly Hong Kong owned family businesses, with the well-educated and astute second generation significantly involved in managing the operations. Those factories with 1500 workers or more have clearly appropriated the benefits of FDI, adapted technologies and processes from Europe and Japan and created highly competitive operations in global markets. For example, one of Mod-Style’s suppliers (also one of the largest producers for the global market) has 4500 workers, 20 production lines, and a monthly production capacity of 1.1 million optical frames. It is listed on the Hong Kong stock exchange and has a market value of more than USD50 million (Frost 2002). This company is setting standards that help demonstrate that not all production facilities in China are ‘sweatshops’. In other respects, however, it cannot be said that the Chinese workers have achieved ‘decent work’, in the sense understood by the International Labour Organization.

The BSL is facing new challenges as it attempts to identify new suppliers, and assess conditions in factories manufacturing global brands that are imported and distributed in Australia by Mod-Style. It is time-consuming to persuade licensing agents to be transparent about where goods are manufactured.

**Customer profile and subcontracting relationships**

The Hong Kong owned optical factories based in China are producing for both the export and domestic markets. The final customers include most of the large global brands; however, many of these larger customers have no idea which factories are producing their products or the conditions under which they are being made. They rely on complex licensing arrangements with trading houses and agents that do not necessarily share the stated values and business practices of the brand name company. This lack of transparency is, in some cases, a calculated risk management strategy to minimise damage to company reputations in the event of labour rights and environmental concerns. It can also be interpreted as an enterprise’s failure to accept their corporate responsibility for the global dimension of their business, or a choice made because they consider China ‘just too hard’ and the less they know about it the better. Regardless of what influences each company’s practices, BSL experience has confirmed that as production networks become more complex, the factory becomes more remote, and ‘arms-length’ relationships result in further difficulties in influencing workers conditions and implementing desired business values.

The size of the factories in China influences not only working conditions but also the complexity of sub-contracting arrangements. The smaller factories often outsource production processes such as electroplating and injection moulding, which then need to be monitored separately. Our research has also shown that those factories that produce cheaper products than their competitors often do so through compromising the labour standards and neglecting the necessary investment in capital equipment and facilities that would ensure occupational health and safety.

**Understanding the workforce**

The workforce in the optical industry is representative of much of the manufacturing sector in southern China. The majority of workers are young women aged 17–25 years who have migrated from surrounding rural provinces to work in the burgeoning industrial districts. Their primary aim is
to earn as much money as possible and send most of it home. Generally, they appear to have a relatively low level of education and not to be well informed about their labour rights. Most are employed in repetitive, low-skilled jobs. Staff turnover is high, with most workers staying at a factory for only one to two years.

An interesting development in 2004 was the astonishing reporting by China’s Ministry of Labour and Social Welfare of a shortfall of 2 million migrant workers for the Guandong region (The Economist 2004). Reasons are not hard to find, with the Ministry disclosing that average migrant worker salaries in the manufacturing sector have risen by only 68 Yuan in the past 12 years. To this can be added the harsh working conditions in Guandong, the opening of new industrial zones elsewhere in China, a rise in agricultural salaries, and workers choosing to stay closer to home where the salaries are not as high but the hours of work are less. Reported labour shortages could potentially reduce China’s key competitive advantage: an endless supply of cheap labour. Economists suggest that foreign companies will be affected by rapid increase in suppliers’ factory wages, fuelling inflation and raising the price of Chinese-made goods (Harney 2004). According to The Economist, this tightening of the labour market has also coincided with a sharp increase in the number of industrial disputes. Chinese officials have responded to current labour shortages and recruitment difficulties enterprises in Shenzhen face by implementing new minimum wage standards (effective 1 July 2005) that will be the highest in China (Frost 2005).

Understanding labour and environmental conditions

Environmental standards and physical conditions

The BSL experience has shown that not all factories are the ‘sweatshops’ often attributed to China. Factories and their processes vary in terms of conditions for workers, compliance with labour and environmental standards, and managerial style, as they do in Australia. For example, some factories meet their obligations and provide social security contributions on behalf of workers, but have a heavy security presence and an arbitrary system of fines and deductions. Other factories provide state-of-the-art facilities and architect-designed plants, yet expect workers to undertake excessive overtime without appropriate remuneration. In pursuing CSR, it is necessary to recognise that the physical conditions of a factory can be misleading and divert attention from other poor labour conditions, and that currently all workers migrating from rural areas are in a vulnerable position because of their temporary residential and employment status.

Environmental standards and physical conditions vary significantly among factories in China. In the optical industry, the larger factories, which undertake electroplating on site, have sophisticated equipment, ventilation and waste management. Indeed, worse conditions have been witnessed in Australian electroplating facilities. As observed during BSL research visits, all factories appeared to collect, and in some cases treat, wastewater before sending it to an outside plant for further processing. Some factories had acetate dust collection bags, and in one case acetate shavings were sold for recycling into personal goods such as combs and toothbrushes. Chemicals and paints were generally well labelled and stored, and most larger factories had a chemical inventory. The situation was different, however, in the smaller optical factories which had not invested as heavily in the equipment and processes to meet environmental standards.

The physical conditions of the factories also presented a complex picture. Generally, they were better than anticipated, particularly in terms of occupational health and safety (OH&S) standards. Most of the factories visited were clean and well-lit, with adequate heating and cooling. Dust masks were often provided (though not always worn), and some factories had specialised ‘hands-free’ machines to reduce finger injuries. The overall impression is that these optical factories provide better facilities and working conditions than usually reported in the toy, footwear, textile and apparel industries.

In other respects, however, it cannot be said that Chinese workers have achieved decent work and reasonable living conditions. For example, worker accommodation was often spartan and dehumanising. In the worst cases limitations were placed on water usage and time allowed for toilet breaks, and workers received glucose injections to overcome fatigue as a result of long working hours (Lillywhite 2005). Large, clean new factories do not guarantee good working conditions and can often mask serious human rights abuses.
Labour standards

Significant human and labour rights issues exist in the factories visited to date, particularly with regard to wages, hours, and social security entitlements. In these key conditions there were evident breaches of Chinese labour law. Managerial regimes are strictly hierarchical and at times repressive. It is often difficult for workers to raise grievances and have disputes resolved without risking reprisal. Fines and disciplinary action are common, and in some factories workers appeared despondent. The BSL research found that overall workers are compliant and in reality do not participate in the co-determination of their workplaces in any meaningful way.

Freedom of association and collective bargaining will need to be considered if progress on the complex issue of human rights and business is to be made. In this regard, individual firms have little capacity to bring about change in China, as this is a complex matter of national law with local variations. However, several major footwear companies have been involved in a capacity building project which is encouraging worker participation through occupational health and safety committees (IGC 2002). Furthermore, one of these companies has been facilitating ACFTU elections within a factory, a significant first step in the process of ensuring workers participate in choosing their union representative. These examples demonstrate that progress is taking place in China, often at surprising speed; and there is scope for foreign enterprises to contribute, particularly if they possess ‘consumer clout’ and are serious about CSR.

Challenges and opportunities of responsible supply chain management

Opportunities for enterprises to make a difference

Despite the increased global awareness of corporate social responsibility, supply chain management is still primarily concerned with price, quality control, design, service, speed and reliability of delivery, and access to, and integration with, global markets and production networks. Supply chain management and offshore trading relationships are an important part of ensuring an organisation has a consistent approach to corporate responsibility that recognises the global dimensions. This includes supply chain management, and compliance with local labour and environmental laws or with international standards where laws in developing countries are not well developed or at odds with international best practice. In addition, companies that pursue ethical business practices abroad are well placed to appropriate the competitive advantages that flow from sustainable business and contribute to FDI for development. The issue of transparency and business integrity amongst supply chains and subcontractors remains an important consideration.

Enterprises interested in investing in China need to become familiar with the labour law. They need to make decisions about where they stand on issues such as: wages, hours, access to social security entitlements, and OH&S. This requires a good understanding of the working and living conditions of suppliers’ employees, opportunities to improve those conditions and mechanisms to monitor compliance.

Limitations to enterprise capacity

Exercising corporate responsibility in supply chain management and in purchasing policies does present significant challenges.

Core labour standards

While the International Labour Organization (ILO) core labour standards are the appropriate reference, they are addressed to nation states. The task for companies is to interpret the standards and find ways to apply these to their business practices. It is all the more difficult for enterprises to expect compliance with international standards as many factory managers in China—and indeed in other developed countries—do not see the links between labour rights and human rights, environmental standards and social justice.
**Complexity of the issue: conceptual and ethical considerations**

The conceptual and ethical task of dealing with Chinese factories is especially difficult for the small firm, even one committed to operating in an ethical manner. It requires time, resources and commitment. Specialist staff are needed with expertise and knowledge of the labour and environmental issues and regulatory environment of developing countries.

The BSL has recognised that there are no easy answers to the difficult questions raised by our work. For example:

- What is the best approach to ensure sustainability and an enduring culture of corporate responsibility amongst our supply chains? Can this realistically be achieved?
- Do we only deal with factories that are open to our approach of continuous improvement and withdraw from dealing with the bad ones?
- To what extent can we accept willingness to change as a basis for an ongoing relationship with a supplier, irrespective of the time frames for achieving real change?
- How do we determine the point at which conditions are just so bad that nothing is to be gained by our continued involvement with that factory?
- How do we honour the ILO principles to which we are committed where they are simply impossible in the non-complying state?
- In which areas should we concentrate our efforts in terms of improved compliance—wages, hours, social security entitlements or the less threatening area of occupational health and safety—and who should make this decision?
- Would dealing with fewer suppliers increase the capacity to bring about an improvement in individual factory conditions as production increases?

These questions, and others, need to be addressed by all responsible enterprises sourcing goods and services in China.

**Complexity of the law and ineffective regulation**

A system of law that ensures compliance is essential to protect workers' rights. However, the complexity of the Chinese legal system is, in itself, a limitation to enterprises pursuing CSR. Chinese labour law, whilst reasonably progressive, is diminished by poor implementation and enforcement. Enterprises investing in China need to work within the regulatory environment as best they can, and where possible, contribute to dialogue concerning simplification of the law. Enterprises need to become familiar with the Labour Law of the PRC and then decide where they stand on issues such as wages, hours, access to social security entitlements, OH&S, freedom of association, collective bargaining, and the role of the ACFTU. They need to determine criteria by which they will assess the social, environmental and economic impact of their FDI. This requires a good understanding of the working and living conditions amongst the suppliers, opportunities to improve those conditions and mechanisms to monitor compliance.

**Costs of compliance**

In highly competitive industries, product cost and relationships are often the only differentiating factors. Improved compliance means operating costs will increase and lead to higher unit costs for customers. Many factory managers believe they cannot afford to comply with local laws in the absence of any guarantee that competitors will also do so. There is a fear of losing customers to less compliant factories, or even to other countries such as Vietnam and Indonesia where labour is even cheaper, and the regulatory environment less well developed. In this regard, foreign enterprises have a responsibility to ensure production is not moved from factory to factory in search of the cheapest labour and least rigorous standards. They need to recognise that improved corporate responsibility amongst supply chains does involve some costs but other benefits in terms of sustainable business.

**Customer leverage**

The reality for many small or medium enterprises is that, on their own, they have limited influence. Negotiating improved supply chains requires time, resources and commitment. Specialist staff are needed with knowledge of the labour and environmental issues and the regulatory environment.
Even those enterprises such as Mod-Style with the best intentions and commitment to core labour standards, are small players by their. However, factory managers have, for the most part, appreciated the Mod-Style approach of direct dialogue to pursue corporate responsibility rather than arms-length directives and threats to cut production. Currently, some of the large enterprises are beginning to think about CSR in China; however, the significant number of small to medium enterprises investing in China also needs to be harnessed through global collaboration and industry-led initiatives.

Corporate governance and production networks
A further limitation for enterprises is the difficulties in navigating global production networks that are often a maze of licensing arrangements shrouded in secrecy. Trading houses are often responsible for managing the production and sourcing of various items in China, yet many are unwilling to acknowledge that they are being made in China. This lack of transparency and accountability hinders efforts to promote CSR amongst supply chains.

Industry associations
Industry associations and professional bodies do not necessarily prevent enterprises from exerting influence on ethical business practices, but they do not encourage corporate governance and transparency either. For the most part, they are primarily interested in developing new markets, sourcing new production techniques and meeting industry specific requirements. Protecting workers’ rights and environmental standards in China is not a high priority for these organisations in the optical industry.

Ethical business in action
There is no single answer or quick fix to ensure CSR amongst supply chains. What is required is customised responses to suit the needs of all stakeholders and the business and regulatory environment offshore, and the size of the enterprise in which investment occurs. Compliance with universal treaties and national laws to uphold basic labour rights and environmental standards should be the non-negotiable starting point. How enterprises then apply these conventions and statements, many of which are addressed to nation states, is the real challenge. It is necessary for an enterprise to then translate these principles into a form that can be applied in individual workplaces. This could include an emphasis on improved compliance with local law, occupational health and safety, education and training programs for workers and managers etc. All these are necessary incremental steps that will contribute to sustainable FDI and a more even distribution of the benefits and CSR.

The BSL has developed a process of engagement, in response to the complex issue of supply chain management. It involves a whole of organisation commitment to CSR, establishing an ethical sourcing strategy, undertaking research, implementing stakeholder dialogue and building long-term meaningful relationships with contractors and suppliers to discuss innovative ways to improve supply chain management and protect workers’ rights.

Organisations interested in responsible supply chain management need to ensure ethical business practices are embedded in the corporate culture. This will include:

- developing an ethical purchasing strategy
- mapping the supply chain
- undertaking research
- implementing ethical business practices
- operationalising codes of conduct and compliance mechanisms
- investing in independent monitoring and verification
- engaging in global collaboration
- investing in capacity building.
The Brotherhood of St Laurence Ethical Business Unit can provide advice and services on the above. For more information contact Serena Lillywhite, by e-mail <slillywhite@bsl.org.au>, or phone (+613) 9483 1379.

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