OECD OCDE

OECD ROUNDTABLE ON CORPORATE RESPONSIBLITY

"Supply Chains and the OECD Guidelines for Multinational Enterprises"

OECD Headquarters, Paris, 19 June 2002

BIAC* Discussion Paper on Supply Chain Management

"Encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the Guidelines."

– OECD Guidelines, 2000

"It is recognized that there are practical limitations to the ability of enterprises to influence the conduct of their business partners...Established or direct business relationships are the major object of this recommendation."

– Commentary on General Policies

"The Guidelines are not a substitute for, nor do they override, applicable law. They represent standards of behavior supplemental to applicable law."

– Statement of the Chairman of the OECD Ministerial, June 2000

Introduction:

The extent to which businesses engaged in global commerce adhere to labor and environmental standards is primarily an issue of national governance rather than supply chain management. In countries where laws governing anti-competitive business practices, environmental protection and labor standards are effectively enforced, companies can rely on government oversight to ensure that their suppliers are, at a minimum, in compliance with local law. However, in countries where such laws exist but are not effectively enforced, the question of whether suppliers meet these legal requirements or not is much more difficult to determine. In the short term, business can help to address this situation through voluntary efforts and in partnership with governments and others.

The ability of companies to respond to this issue varies greatly by sector, location, contract terms, and type of products or services being provided. Most customer-supplier interaction is focused on production issues of product design, performance, cost and quality. More recently, an increasing number of companies have begun to voluntarily monitor the activities of direct suppliers in other areas, including those covered by the OECD *Guidelines for Multinational Enterprises*. However, it is

* Business and Industry Advisory Committee to the OECD.

clear that this type of engagement is voluntary and is not possible in all situations, even with respect to direct suppliers, due to the complexity of the supply chain, the sheer number of suppliers, or a limited ability to influence suppliers' behavior.

As corporate responsibility covers a wide range of issues and is affected by the actions of many different actors, companies implementing corporate responsibility programs must prioritize both among the various issues to be addressed and the relevant audience, including employees, local communities, and suppliers. Any discussion of the supply chain in the context of corporate responsibility must recognize that other issues or activities may take priority depending upon the specific situation of each company. This discussion paper presents BIAC's views on these issues and the degree to which the OECD *Guidelines* can serve as a reference point for all companies in the supply chain.

An Overview of Supply Chain Management:

A supply chain is a network of facilities and distribution channels that encompasses the procurement of materials, production and assembly, and delivery of product or service to the customer. Included in each of these functions is the management of inventory and returns of product or material to suppliers, both of which are influenced by promotional and sales activities. The complexity of the supply chain and the business relationship between the various components varies greatly from industry to industry and company to company. Supply chains range from fully vertically integrated, where a single company owns an entire process of production, to those where each stage of the chain operates independently.

The industrial and logistical co-operation between manufacturers and their business partners has intensified continuously over the last decades. "Suppliers" are no longer restricted to traditional component suppliers. Suppliers have become complex (technical) solution partners ranging from large multinational companies often larger and more "global" than the manufacturers to small but nevertheless very competitive design and engineering firms.

In many areas, industrial and consumer markets have become more fragmented, with more customized products targeted to a narrower customer base. Supply chain systems require co-operation on a worldwide basis, although the "global market" is still characterized by many local and regional differences. In some industrializing countries, products are assembled with local components due to customs savings or local content requirements. As a consequence, an increasing number of manufacturers have moved beyond setting and controlling product quality standards for their up-stream and down-stream business partners and have begun to include environmental aspects of production processes in their requirements.

Supply chain management has been the focus of aggressive initiatives in many industries over the last decade to improve operational efficiencies, shorten product development cycles, increase product variety, improve quality and customer satisfaction, and better link the supply chain with demand and sales forecasts. Information technology plays a critical role in the integration of the supply chain, improving knowledge along the chain and increasing control of supply operations. However, there are clearly limits to such integration, and companies must be careful not to interfere with the independent management of their business partners since such partners will know best what is feasible and cost-effective for their business.

The OECD Guidelines refer particularly to suppliers and sub-contractors, that is, parties up the supply chain. This reflects the logic that some companies may be in a commercial position to encourage some direct suppliers and sub-contractors. The same does not necessarily hold true of customers or others down the supply chain, especially if national law prohibits a refusal to deal with any customer in many circumstances.

The Role of Government:

Government implementation and enforcement of national laws and regulations are essential for creating competitive markets, protecting the environment, and safeguarding individual rights. Most countries around the world have laws governing these issues in place, but in some countries a lack of resources and an inadequate institutional infrastructure inhibits the ability of countries to effectively enforce these laws. The only long-term solution to such failures is for governments to create an enabling environment for investment-led domestic growth that will create the resource base necessary to implement and enforce the law on all companies, regardless of size or nationality of ownership.

The relationship between national laws and the Guidelines' recommendations are also very relevant to the discussion of corporate responsibility, as conformance with applicable laws and regulations is the most basic responsibilities of individuals and companies alike. Almost all codes of conduct and company policies include legal compliance as an obligation and state that compliance with host country law is the minimum level of performance acceptable. Indeed, even the performance level against which most private auditors measure suppliers' facilities is usually based on national law. Furthermore, the scope for voluntary initiatives in respect of direct suppliers and sub-contractors is limited in the presence of a comprehensive democratic legal framework.

The Guidelines, of course, go beyond national laws, "providing voluntary principles and standards for responsible business conduct *consistent with applicable laws (emphasis added).* In the absence of such laws, e.g., freedom of association, how is a global company to use these voluntary principles in guiding its own internal corporate responsibility programs and procedures? Should it advocate for freedom of association in countries where it is prohibited?

Promoting Principles for Corporate Conduct:

Many companies have developed internal policies or codes of conduct that integrate social and environmental aspects into their business plans. In doing so, companies have found that they can discover areas of strategic advantage, and improve their management systems. Integrating such aspects into performance objectives has also helped businesses focus on a central issue for every enterprise: improving the lives of the people involved in its business operations. Improved performance in these areas is frequently cited as generating intangible assets, such as employee commitment and customer brand loyalty, that may lead to improved financial performance.

Companies have also found benefits from doing business with suppliers and sub-contractors who embrace high standards of business conduct and who demonstrate commitment to those standards through their business practices. At a minimum, business partners are expected to be in compliance with all relevant laws and regulations, particularly given the potential risks to the companies' public reputation. Companies in several industries, with a manageable number of direct suppliers and sub-contractors, promote corporate responsibility objectives with those business partners. Before committing to a contract, a growing number of companies ask their suppliers and sub-contractors to commit to terms regarding their legal, environmental and employment standards. Such voluntary initiatives by companies have been very useful in supporting a business culture that minimizes corruption and encourages full compliance with all relevant laws and regulations. But not all companies have the means or capacity to do so.

Practical Limitations of Influencing the Supply Chain:

Yet, in the United States, it has been calculated that worldwide, some 80,000 factories employing millions of workers feed the appetite for consumer goods.[1] Some argue there are tens of thousands more than that. One large U.S. retailer alone buys from more than 20,000 factories worldwide. It is evident that not all enterprises can promote and monitor observance of corporate responsibility objectives throughout their supply chains. They quickly run into logistical and financial requirements that far exceed their capacity. An enterprise's ability to promote corporate responsibility principles, like those outlined in the OECD Guidelines, will depend on the industry in which it operates, the quantity of suppliers, the structure and complexity of the supply chain, and the market position of the enterprise. Some examples of the business relationships that limit an enterprise's ability to promote implementation of principles of corporate conduct include:

- Companies that purchase commodities as raw material for their products buy such goods in middle markets, and not from the farms or factories that produce the goods. Commodity markets have hundreds or thousands of small producers feeding into it, making it virtually impossible to identify the supply chain.

- Some companies' purchases represent a small portion of a particular supplier's output, leaving the customer with very limited influence over the supplier's operations. In such cases, the customers may be able to communicate its policy, but will find it difficult to demand observance. In addition, a supplier with several contracts may find that they are being asked to subscribe to multiple different competing corporate responsibility initiatives. And in markets with a monopolistic or oligopolistic structure, the supplier is in a strong position to disregard the promotion of codes of conduct by its clients.

- Companies in some sectors have thousands of suppliers and supply chains that are both complex and deep. These enterprises may be able to communicate corporate responsibility principles to a limited number of suppliers with which they have direct relations, but cannot feasibly communicate them to all indirect suppliers deeper in the supply chain. One U.S. footwear and apparel company that applies its code of conduct throughout its supply chain has more than 750 suppliers in 52 countries, which is small relative to comparable firms in the industry.[2]

- Many businesses rely on short-term contracts with suppliers and change suppliers frequently. In such businesses, promoting corporate conduct activities along the supply chain would lead to costly frictions.

---

[1] Vickery, Tom. "Global Sourcing: Not Just Ethical, but Economical." Reuters, 1 April 2002.

[2] Ruggie, John Gerard. "The Theory and Practice of Learning Networks: Corporate Responsibility and the Global Compact." JCC 5, Spring 2002.

- In all sectors of government procurement or suppliers owned by government (e.g. public utilities) it can be extremely difficult if not impossible for private companies to promote codes of conduct or to alter the practices of suppliers.

The more serious limitation of applying corporate responsibility through the supply chain, however, may be its inability to reach the vast majority of people in the world who produce goods for local consumption or work outside the formal economy. For these people, attempts to enforce local law through the global supply chain would bring little or no benefit. As stated above, the only real solution that will reach this majority of the world's people is the implementation and effective enforcement of national laws.

Supply Chain Management and Control:

Some enterprises have voluntarily opted to engage in more extensive reviews of their suppliers performance in certain areas deemed of importance by the company in order to match the supplier's values with the company's. Some companies have established monitoring and assessment mechanisms that may lead to cancelled contracts if a supplier is found to be in continuous violation of certain corporate responsibility objectives, such as the use of child labor or forced labor. Many enterprises have committed to assisting suppliers to meet the enterprises' objectives through training programs on labor and environmental standards and helping them to understand the bottom-line benefits of observing such standards.

Yet, the costly nature of monitoring suppliers' observance of a code of conduct or corporate responsibility objectives may be an obstacle for most enterprises. For example, after reports of poor working conditions and abuse of labor standards in one supplier in Central America, a U.S. apparel retailer decided to establish a group of local union, religious and academic leaders as independent monitors to meet regularly with workers to hear complaints, investigate problems and look over the books of this supplier. The retailer spends $10,000 a year for the independent monitors at the supplier, which is owned by investors from a third country, and thousands more for management time to arbitrate disputes and for its own company monitors to recheck facts on the ground. For this enterprise to duplicate these intensive efforts at each of the 4,000 independent factories with which it contracts would cost the equivalent of 4.5 percent of its annual profit of $877 million in 2000.[3] Many companies find that they must rely on suppliers to monitor themselves and pursue corporate responsibility objectives out of their own self-interest.

There are a handful of multinational enterprises that have set up mechanisms for independent, external auditing of supplier's observance of corporate responsibility objectives. However, it is not economically or logistically feasible for all enterprises to monitor and audit all their suppliers. The best way to monitor and audit the social and environmental performance of all firms is for national governments to implement and enforce national laws and regulations that protect workers and the environment. These examples reinforce the fact that the monitoring and auditing costs will lead to competitive disadvantages if the monitoring and auditing of the supply change is primarily focused on developing countries.

The way companies communicate their commitment to corporate responsibility and relationship with their suppliers also varies from enterprise to enterprise. While some companies make their

---

3 Kaufman, Leslie and David Gonzalez. "Labor Standards Clash with Global Reality." New York Times. 24 April 2001.

corporate responsibility policies very public and/or subscribe to outside corporate responsibility initiatives, others develop their corporate responsibility policies and programs internally and disseminate the policies throughout the enterprise without making them widely available outside the firm. Different public reporting approaches are also used, including issuing corporate responsibility-specific reports, incorporating corporate responsibility into annual reports, posting information on company Web sites, and/or publicizing corporate responsibility practices through business associations. Some companies also use the processes to develop such reports as a means to promote greater transparency and interaction with shareholders and others.

The OECD Guidelines provide companies with guidance as to principles of corporate conduct to integrate into their management systems. The Guidelines do not call on companies to monitor, audit or report on their efforts to promote principles of corporate conduct, but instead leave these decisions to companies to determine what course of action best fits the business reality and the local context.

The Way Forward:

The complexity of this discussion points to the fact that efforts by companies to promote voluntarily corporate initiatives through supply chains should not divert attention from the primary means for promoting environmental and social protections: the implementation and enforcement of national laws and regulations. Competitive markets depend on governments to set a level playing field and to establish appropriate rules in areas such as corporate governance, financial disclosure, bribery and corruption, truth in advertising and product safety. Regulatory frameworks for environmental protection and labor rights are also essential aspects of the government's role in protecting the broader social interests. Indeed, the most basic responsibility of all actors in society, including business, is to respect and uphold the rule of law. Global improvements of labor and environmental conditions have to be seen as a long-term project.

In countries or regions with ineffective domestic governance, corporate responsibility initiatives may be used to promote good business practices, but should not be seen as a long-term solution. The OECD Guidelines, themselves, are not meant to substitute for national laws. Private entities cannot and must not replace governments with open and transparent rule-making processes.

Business generally agrees that the best way to promote improved labor and environmental standards in a direct supplier or subcontractor is to convince them that it is in their interest to improve standards and conditions and will have a positive effect on their bottom line. Companies work with their supply chains to promote corporate responsibility principles, because they believe in doing business with suppliers and sub-contractors who embrace high standards of ethical business behavior and who demonstrate commitment to those standards through their business practices. Leading by example will be more successful in the long run.