



## OECD ROUNDTABLE ON CORPORATE RESPONSIBILITY

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## **Pursuing corporate responsibility in China—experiences of a small enterprise in the optical industry.**

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This paper is divided into three parts. First, I want to give a brief overview of the experiences the Brotherhood of St Laurence has had in attempting to responsibly manage the transnational supply chain of its commercial enterprise—Mod-Style—in China. Second, I will describe the barriers and some of the opportunities we have encountered. Finally, I will identify what governments can and should do in efforts to pursue corporate responsibility and improved compliance with labour and environmental standards.

### **1. Experiences of an Australian NGO managing a supply chain in China.**

#### ***1.1 Introduction***

The Brotherhood of St Laurence (BSL) is an Australian community organisation with a vision of promoting social justice and a whole of society framework for a poverty-free Australia. The Brotherhood is building relationships with business that are based on social entrepreneurship rather than welfare.

In 2000, the BSL gained ownership of a commercial enterprise, Mod-Style. Mod-Style is a small company employing 17 staff, which imports and wholesales optical frames to Australia’s independent optical retailers. In 2001-02 the company imported 152,000 optical frames, with a turnover of AUD5 million. Most of the production occurs in China, where currently 90 per cent of the world’s optical frames are manufactured, primarily for the US and European markets.

The BSL accepted ownership of the company on the basis that it would investigate the ethical implications of owning a company which sourced goods from China and elsewhere. Profits were quarantined for two years, and used to fund a thorough investigation of the supply chain, the conditions of production workers, the barriers to improvements in these conditions and some creative responses to the issues.

The BSL is committed to the core labour standards of the ILO, and other statements of principle set out in the OECD Guidelines for Multinational Enterprises and the UN's Global Compact. The investigation into Mod-Style was conducted in this context.

## ***1.2 Mapping the supply chain***

### *Identifying the factories*

Mod-Style has 23 suppliers based in China, Korea, Japan and Italy. There are 13 suppliers in China, most of which are wholly Hong Kong owned family businesses, with the well-educated and business astute second generation significantly involved in managing the operations. These factories have adapted technologies and processes from Europe and Japan and created highly competitive operations in global markets.

The BSL has invested considerable time and resources to understand the realities—an undertaking which would be difficult for many small or medium enterprises. Even arranging visits can be complicated and time-consuming and requires an understanding of Chinese business culture. Seven of the 13 factories have been visited, all based in the industrial zone of Dongguan, Shenzhen, southern China. These factories vary in size from 150 workers to 4500. Mod-Style's largest Chinese supplier, (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. Mod-Style's business, however, accounts for less than 2 per cent of this factory's annual production and so has limited consumer influence.

### *Customer profile and subcontracting relationships*

Prior to China joining the WTO, the Hong Kong owned optical factories based in China were producing only for the export market. The final customers include some of the large global brands such as Gucci, Timberland, DKNY, Esprit, Disney, and Calvin Klein, as well as smaller importers like Mod-Style. However, many customers deal with the factories through complex indirect arrangements. For example, many contract with the three or four trading houses with offices in Hong Kong, which have considerable control over the global optical industry.

Other sub-contracting arrangements in the industry are also complex and virtually impossible to map. Raw materials and components are imported from other countries (for example, metal and acetate [plastic] come from Italy; Germany and Japan, screws are from Switzerland; lenses are from the USA, Thailand and Vietnam; colouring and screen prints from Italy) and wire comes from domestic Chinese suppliers. The smaller factories often outsource production processes such as electroplating and injection moulding, and little is known about these conditions or relationships by the BSL.

### *Understanding the workforce*

The majority (80 per cent) of workers at factories visited are young women aged 17-25 years who have migrated from surrounding rural provinces to work in the burgeoning industrial districts. Generally speaking, they appear to have a relatively low level of education. Most are employed in repetitive, low-skilled jobs with only about 10 per cent of the production process requiring technical expertise. Staff turnover is high, with most workers staying with a factory for one to two years.

### ***1.3 Understanding the labour and environmental conditions***

The BSL experience has shown that factories and their processes vary in terms of conditions for workers, compliance with labour and environmental standards, and managerial style, even within the relatively small number of Mod-Style suppliers studied by the BSL. 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 excessive overtime without appropriate remuneration. Some factories have a commitment to occupational health and safety (OH&S), while others place restrictions on water usage and toilet breaks. All workers migrating from rural areas are in a vulnerable position because of their temporary residential and employment status.

#### *Environmental standards*

Environmental standards vary significantly among the factories studied. Generally speaking, the larger factories, which undertake electroplating on site, had sophisticated equipment, ventilation and waste management. All factories appeared to collect, and in some cases treat, wastewater before it was sent to an outside plant for further processing. Some factories had acetate dust collection bags, and in one case all acetate shavings are sold for recycling into personal goods such as combs and toothbrushes. Chemicals and paints are, for the most part, well labelled and stored, and most of the larger factories had a chemical inventory. The smaller optical factories, however, did not appear to invest as heavily in the capital equipment and processes necessary to ensure compliance with environmental standards.

#### *Physical conditions*

The physical conditions of the seven 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 are well lit with adequate heating and cooling. Dust masks are often provided (though not always worn), and some factories have specialised 'hands-free' machines to reduce finger injuries. The overall impression, confirmed by local NGOs such as the Asia Monitor Resource Centre in Hong Kong, is that these factories provide better facilities and working conditions than reported in the toy, footwear, textile and apparel industries.

In other respects, however, it cannot be said that the Chinese workers have achieved 'decent work', in the sense understood by the ILO. For example, worker accommodation is often spartan and dehumanising. In the worst cases limitations are placed on water usage and time allowed for toilet breaks. Large, clean new factories do not guarantee reasonable working conditions and can often mask serious human rights abuses.

### *Labour standards*

Significant human and labour rights issues exist, 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. For example, it is difficult for workers to raise grievances and have disputes resolved without risking reprisal. Fines and disciplinary action are common, and in some factories workers appear despondent. Overall, workers are compliant and in reality do not participate in the co-determination of their workplaces in any meaningful way. Freedom of association is not possible, as the only legal trade union is the All China Federation of Trade Unions. There was no evidence of collective bargaining, and conditions were set by unilateral management decisions. In this regard individual firms have little or no capacity to bring about change in China.

#### ***1.4 National law, codes of conduct and global reporting***

The factories which supply Mod-Style exist in a complex regulatory environment. Chinese labour law sets standards and rules, which 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, discussed below. In addition to the national laws, there are requirements of large customers, in the form of corporate codes of conduct or certification with reporting instruments such as SA 8000 and ISO standards.

Whilst important in contributing to the promotion of core labour standards (particularly where national laws are inadequate or poorly regulated), in our experience, codes too often represent a shallow attempt to understand the real difficulties in transnational supply chain management. They do not provide an accurate representation of conditions, workers are usually not consulted or given an opportunity to comment freely and without reprisal on their operation, and inspections are ad hoc and not necessarily undertaken by skilled personnel. In addition, some codes ignore the reality of Chinese labour relations by claiming that the principle of freedom of association is adhered to. In isolation, codes cannot be relied on to protect workers' rights or promote worker empowerment.

The attitude of factory management towards the efforts of the BSL to understand and improve workers conditions varied. We found it was necessary to develop relationships with managers over time, and then to focus on those most receptive to our approaches. A single approach from a distance would achieve nothing. Among some managers there is interest in processes that may result in improved relationships, better management practices and enhanced competitiveness. Managers are interested in how a business can be both ethical and competitive, as the optical industry is highly competitive and often price is the only differentiation. There is interest in how corporate responsibility and improved compliance could be turned into a competitive advantage.

## **2. Barriers to positive change**

The BSL has explored what can be done to give effect to the ILO core labour standards and the OECD Guidelines, as well as generally to improve the circumstances of the Chinese workers producing for Mod-Style. A number of key barriers stand in the way of achieving change.

### *Enterprise capacity*

A key problem for the individual firm pursuing ethical trading practices lies in the nature of the core labour standards themselves. The ILO core labour standards are statements of principle, policy and practice addressed to States. It is necessary for an enterprise to then translate these principles into a form which can be applied in individual workplaces. For example, it is not within the capacity of Mod-Style to achieve freedom of association in China. Most of the core conventions require practical interpretation and implementation in keeping with the ‘spirit’ of the principle. This is best pursued through incremental and pragmatic steps in light of what is possible.

Core labour standards are ‘big picture’ issues and it is all the more difficult for enterprises to support compliance as many factory managers in China—and indeed in many OECD 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*

It is important to recognise that corporate responsibility amongst supply chains is a very complex issue. The conceptual and ethical task of dealing with Chinese factories is difficult for the small firm, even one committed to doing everything possible to operate 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.

To demonstrate this complexity, 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?

### *Complexity of the law and ineffective regulation*

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. Some factory managers have expressed frustration about the complexity of the regulations (and also the foreign company imposed codes of conduct) and the inability of the local departments of labour to assist with interpretation of the law. For example, social security entitlements (insurance and pensions) and bonus payments are an area that is extremely complex and difficult to understand. Local labour departments may prefer not to insist on compliance with laws—it is reported that staff have friends and relatives who manage factories, and financial contributions and kickbacks are a reality.

The weakness of the Chinese legal institutions means too that workers are reluctant to take steps to secure their legal entitlements, adding to a culture of avoidance of legislated standards. This is most evident with regard to social security and overtime. Factory managers and workers are required by law to contribute to pension and insurance funds managed by the local department of labour. Workers have little confidence they will ever be able to access these benefits, particularly as most are from rural provinces and are unclear how contributions will be transferred to their hometown for retirement. Another concern is how workers who often have only temporary residential status in Guangdong province can claim insurance benefits in the event of an industrial accident.

In addition, the practices of not paying legal minimum wages, 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. As a result, as some factories reduce the amount of overtime in order to comply with the law, it is becoming increasingly difficult to attract and keep skilled workers.

These are complex issues of national scope, and there is very little a small firm can do to ensure the guaranteed, full enforcement of all laws.

### *Costs of compliance*

In this highly competitive industry, cost and relationships are often the only differentiating factor. Improved compliance means operating costs will escalate and lead to higher unit costs for customers. The failure of enforcement and the tight competition means that managers believe they cannot afford to comply with local laws in the absence of any guarantee that competitors will do so. There is a fear of losing customers to less compliant factories or even other countries such as Vietnam and Indonesia. The issue of greatest concern to managers was meeting ongoing insurance and pension contributions. One-time costs such as building new dormitories to improve living conditions and allow for the employment of additional workers to reduce overtime were not seen as particularly onerous. The time spent in responding to codes of conduct was also cited as a cost.

### *Customer leverage*

The reality for many small or medium enterprises (SMEs) is that they have limited influence. Mod-Style, while a major player in the Australian optical industry, is a minor customer of most of the supplying factories in China. Despite the best intentions and commitment to core labour standards, the relatively small production gives us little authority. Attempts to gain leverage through global collaboration with larger brand name customers have been met with, at best, a lukewarm response.

### *Corporate governance and production networks*

Identifying and gaining access to brand name customers has in itself been problematic. It involves navigating global production networks that are often a maze of licensing arrangements shrouded in secrecy. Trading houses are responsible for managing the production of almost all the major optical brands, yet many are unwilling to acknowledge that the frames are being made in China. This lack of transparency and accountability has also hindered our efforts in global collaboration.

### *Industry associations*

Opportunities to engage with the appropriate industry association have been limited. The optical industry association is primarily interested in developing new markets and accessing new technology. To date they have not indicated any interest in contributing to improved industry-wide labour and environmental compliance: this is seen as the factory's responsibility.

## **2.1 Stakeholder dialogue: opportunities for enterprises**

Documenting the difficulties encountered provides insight into the reality of SMEs attempting to operate responsibly in China. Whilst it makes fairly bleak reading, it is important to recognise that opportunities for continuous improvement do exist. The BSL believes it is making progress towards its goal of understanding the optical production chains and taking steps to improve conditions for workers in the factories.

### *Model of Engagement*

A great deal of thought has gone into how this can be done consistently with the OECD Guidelines and other similar instruments. The BSL has developed a Model of Engagement, a creative response to the complex issue of supply chain management. It involves the undertaking of research, the establishment of 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. The Model of Engagement promotes education and training as the most appropriate mechanism to encourage worker empowerment and self-determination, and sustainable improvements to labour and environmental standards.

This model is a dynamic process that requires a commitment to continuous dialogue and establishing partnerships and alliances with all stakeholders. The BSL has adopted a non-confrontational approach in discussions with factories. We are confident that the most useful first step is to engage directly with workers in some way that benefits them and which will be acceptable to the local management. This latter qualification is essential to have any hope of success.

To this end, the BSL is proposing an occupational health and safety (OH&S) needs assessments involving workers and external technical expertise. This would create a forum in which BSL staff, local NGOs and technical consultants could engage directly with staff, as well as providing health and safety information. It is hoped it will begin the process of empowering staff by involving them in day to day operations, leading to appropriate education and training, and the establishment of OH&S committees with a minimum of 50 per cent worker membership.

Gaining permission for such activity is delicate and time-consuming. Once one session has been undertaken it is hoped that the experiences and learning can be applied to other factories.

#### *Applying the learning*

Enterprises have a role to play in documenting their experiences and making this information available to others. It is hoped that the knowledge gained by the BSL will assist other enterprises seeking to implement their own programs, and contribute to an environment of corporate responsibility.

#### *Consumer campaigns*

Enterprises might also contribute to consumer education and campaigns, so that products made in factories which have taken certain steps to improve conditions could eventually be specifically labelled, such as the 'No Sweat Shop Label' in the Australian textile industry. Such advertising and labelling would however need to take into account legal ramifications in the consumer country, and 'decent work' claims might be difficult to substantiate in contexts such as China.

## **2. Government intervention: the OECD Guidelines and China**

Implementation of the OECD Guidelines in non-adhering countries such as China is problematic. This paper has demonstrated that there are real limitations to the extent to which a small Australian importing company can achieve real change in its supply factories in China. Much of the work of attaining, for example, the ILO core labour standards must fall to governments, though there is a role for experienced enterprises and NGOs in advocating the appropriate action.

#### *Compliance with Chinese law and improved regulation*

Compliance with Chinese labour law and environmental standards must be a government priority. Improved regulation not just by the central government, but at a provincial government, county and Department of Labour level is required. Simplification of the law, enhanced skills for Department of Labour staff, and mechanisms to assist with interpretation and clarification of the law are all examples of how governments can assist.

#### *Institutional support to enterprises*

Global supply chains and arms-length contracting arrangements are barriers to the transparent application of instruments such as the OECD Guidelines. Governments could assist in providing greater institutional support to those enterprises seeking to do the right thing. The OECD or its member states could conduct a study of possible models and best practice which could be made available to the corporate sector. Governments can assist with the dissemination of information, NGO contacts, advice about best practice and mechanisms that promote application of the learnings.

Governments can assist firms, particularly SMEs, by ensuring they understand the realities of corporate responsibility amongst supply chains in developing countries. This involves understanding the culture, business and legal environment in which they operate, as well as appreciating why worker



empowerment and self-determination are important, and what issues are of greatest importance to workers in achieving decent and dignified work.

### *Corporate governance*

Government assistance to encourage multinational enterprises (MNEs) and SMEs of countries adhering to the OECD Guidelines to improve their transparency and accountability, particularly regarding their global production networks and licensing arrangements, would be beneficial. This would require in principle recognition that trading houses and indirect contractors are part of a corporate operation, either large or small. It will foster global collaboration for the industry and assist consumers to gain accurate information about the source of goods. For example, some well-known brands of Italian sunglasses labelled 'Made in Italy' are in fact produced in China, with only the finishing details done in Italy. Similarly, the contractual relationships along the supply chain could be disclosed, for example, in the annual reports of firms. This is consistent with the OECD Guidelines in terms of disclosure.

The principle should be that the State could contribute to greater transparency and accountability. The OECD, through the National Contact Points (NCPs), could undertake research into best practice in governance. Models may emerge which could result in improved global collaboration and a shared responsibility towards corporate responsibility, particularly in transnational supply chains.

### *Promoting corporate responsibility and ethical business.*

Corporate responsibility and the importance of labour and human rights in a properly functioning economic system could be promoted by governments through the provision of information to firms, trading houses, factory owners and managers, industry associations, importers, wholesalers and customers and workers. This may be best achieved through partnerships with NGOs, trade unions and appropriate business representatives and through the NCP network. It could also be pursued through the establishment of financial systems (subsidies and export credit regimes) that do not contradict the Guidelines. We have found that arguments about the competitive advantage of doing the right thing are most effective in the Chinese context.

In addition, governments could provide training and expertise to assist with marketing and management systems that promote ethical business practices and corporate responsibility as a competitive advantage.

### *Transfer of knowledge*

This involves education and training amongst workers, managers and government officials, and a transfer of knowledge, particularly about institutional strengthening of the legal sector and capacity building in factory management and financial systems. This might include assistance, for example, with establishing a social security system that meets the needs of an increasingly mobile labour market, and is consistent with the Guidelines.

The BSL experience with the optical frame industry in China highlights the challenges of improving labour and environmental practices in transnational supply chains. It has brought into focus the importance of engaging with all stakeholders and the role that enterprises and governments have to play in achieving better conditions for all workers and responsible corporate practices.