Outsourcing

Buying responsibly from Chinese supply chains

As product safety scandals rock US toymakers, Prakash Sethi offers a blueprint for plugging the ethical gaps in China

No-one with any experience of working with or observing China's phenomenal economic growth and transformation into a global manufacturing juggernaut should have been surprised by the recent spate of contaminated and unsafe products coming out of the country's factories and exported to all parts of the world.

These include unsafe toys, children's clothes, blankets, toothpaste and pet food, to name a few. It must be a case of self-induced mass amnesia that led major importers in the industrially advanced economies to claim that it was not their systems that had failed. Instead, commentators and politicians, in the US generally, blamed China's authorities for insufficient policing of their own laws and Chinese suppliers for producing sub-standard products.

The signs of systematic breakdown of China's regulatory regime have been all too apparent in reported incidents of frequent mining accidents, air, water and ground pollution, and a pall of smog over the skyline of its major metropolises. Western buyers have been equally aware of the sweatshop-like working conditions in factories where young workers routinely put in seven-day, 72-hour weeks and are often short-changed in the payment of regular and overtime wages. In fact, China's own people have been the worst affected by the negative side-effects of fast-paced development, where economic output and employment have trumped all other concerns, such as worker health and safety, economic well-being, and environmental protection.

This problem is not confined to China. But the symptoms are most pronounced in China because of the scale of manufacturing in the country and the authorities' failure to plan for "negative externalities" to worker and public health and safety. In a larger sense, China is indicative of the prevailing business model under modern globalisation where capital mobility and labour immobility force poorer countries to keep labour costs close to subsistence levels while ignoring all harmful effects of unfettered production on individuals and society-at-large.

These are the pre-conditions of future calamities waiting to happen, of which China's case is an early warning system. It would be a terrible mistake to assume that these problems are unique to China. They are present – to a greater or lesser degree – in all emerging economies that have followed or intend to follow the Chinese model of economic growth. Globalisation-induced competition among emerging economies for foreign investment, and the unrelenting pressure by foreign multinationals to seek lower costs, leave these countries with no choice but to keep their labour costs low and spare the multinational companies from bearing their fair share of external costs.

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Low costs

It is only a matter of time before more cases of unsafe products and abusive working conditions are discovered in places such as India, Pakistan, Bangladesh, Vietnam, Cambodia and Indonesia. They will also be found with equal certainty in other poorer countries as they struggle to seek their share of economic nirvana in competition with the first-tier emerging economies of China and India. And in this effort, a large number of foreign buyers are only

too happy to oblige by constantly moving their buying power to the lowest labour cost countries.

Let us now examine the role of two major players whose conduct has affected the quality and safety of products made in China: the Chinese suppliers themselves, and the foreign brands that buy their products.

Chinese manufacturers are generally under-capitalised and operate with razor-thin margins to meet the constant demands of foreign buyers for ever-lower unit costs. Under-capitalisation and thin margins prevent them from acquiring more modern equipment that would facilitate greater economies of scale and improved product quality. Instead, they use older machines with high maintenance costs. Their workers are also relatively young and untrained. Many of these companies are family-owned or privately controlled and are oriented towards seeking shorter payback periods and higher rates of return on invested capital. Worker turnover is quite high, which makes for high training costs and low worker productivity.

In the past, these manufacturers could constantly reduce costs by pressuring their workers into working longer hours and at minimum wage rates. Unfortunately for local manufacturers, labour costs have been rising. In part, this is because of pressure from global brands wanting to ensure that products are sourced "ethically". However, brands calling on suppliers to improve wages and working conditions have rarely noted how their demands increase the cost structure of local manufacturers.

Developed world standards demanded here

False assumptions

Squeezed by rival exporters and foreign pressure to keep costs down, local manufacturers have sought other means to stay in business. A relative neglect of product quality and use of sub-standard materials is one manifestation of this situation. Although, when taken individually, the negative impact of micro-decisions in sacrificing product quality and compromising product safety may be small, their cumulative effect in the context of many companies making similar choices is quite large and leads to tragic macro consequences. These cost pressures are most severe at the lower end of the technology-product spectrum, such as toys, inexpensive clothes, shoes, common toiletries and food items.

Foreign multinationals are equally caught in the tyranny of micro-decisions of their own making. In their drive to seeking ever lower costs, they assume that they can control the most critical element of the new supply chain – product integrity and quality assurance. This assumption is based on their extensive experience in maintaining product quality in their home countries and their insistence on demanding similar standards in the importing countries, which are more stringent than those prevailing in the importing country.

Recent events have proved these assertions wrong. Here, organisational inertia and cultural arrogance have also played a critical role. In imposing their more stringent standards, global brands have wrongly assumed that there exists a baseline of common standards that suppliers would follow in the interest of keeping their long-term relationships with their major customers. This has turned out not to be the case. There are large differences in societal expectations of the so-called common standards. A highly fragmented system of secondary and tertiary contractors – all pressured to deliver goods while keeping prices low – finds it all too easy to forego the promise of an uncertain tomorrow in the interest of a predictable today.

It is interesting to note that the brand with the most stringent supplier standards and greater transparency, US toymaker Mattel, has been the subject of most recalls [see box]. In contrast, companies whose products are invariably made in the same or similar types of factories as those used by Mattel have managed to escape public scrutiny. These companies have quietly withdrawn only those products where specific consumer complaints have been received.

A new approach

At present, it is apparent that it is not only the Chinese, but also the western governments, and notably the regulatory agencies in the US – ie the Food and Drug Administration and Consumer

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The world's production line

Product Safety Commission – that cannot be counted upon to prevent unsafe and harmful products from entering the global supply chain. And the evidence suggests this situation is unlikely to improve significantly any time soon.

We must, therefore, search for an alternative approach that would somehow a) minimise the need for government-imposed regulatory regimes; b) leave the responsibility for product safety and quality assurance on the shoulders of the importers; c) create a system of incentives that would align the economic interests of both the Chinese companies and western buyers; and, d) make all parties bear their fair share of the cost of negative externalities by minimising the "free rider" problem and thus assuring that those who benefit from the system must bear the cost of negative externalities.

It's China for now

We should also recognise that for the foreseeable future there is no viable alternative to keeping major manufacturing operations in China. The country has developed both the necessary infrastructure and resource-integration capabilities that simply cannot be duplicated by any other country. Under these circumstances, the only companies that would opt for moving out are likely to be the ones who are seeking countries that are in the pre-development stage with little or no socio-economic infrastructure and political governance structure.

Therefore, from the global development perspective, the most viable alternative under the current circumstances would be to create a more human and environmentally friendly system of globalisation and international trade with its central focus on China. Rather than focusing on achieving lowest cost under all circumstances, this system is intended to improve the operational and environmental efficiencies within China. The model can then be exported to other developing countries as they move up the supply chain to becoming major producers.

This system can best be described as a "closed loop cluster". In one sense, this is not a new system and its earlier versions can be found in the American Wild West when the wagon train – confronted by outlaws – would circle the wagons and become a self-contained entity with a focus on repelling the unwanted intruders. In contemporary times, this practice could be seen as like a military base where all necessary products and vital functions are performed under controlled conditions and sealed off from the outside world. Another variant of the system could be seen in a Japanese industrial setting that aims at maximising efficiencies through just-in-time manufacturing where all parts suppliers and service providers are close to a mother plant, such as a car factory.

In a similar fashion, our closed loop cluster (CLC) would require that most of the necessities of the "clusters" are produced within its own borders. Entry from outside sources is minimised and tightly controlled to reduce the risk of contamination and unwarranted intrusion into the system. In the case of toys and other similar products, the CLC would require a number of large buyers and their manufacturing partners to create a self-sufficient system where the volume of products required would be

large enough that all primary and tertiary needs of the product manufacturing could be satisfied by the companies within the cluster. The limited number of products and materials coming from outside the cluster would be subjected to maximum control and inspection.

There are, however, two major differences between our CLC and other examples of clusters described above. An important element of this cluster is to create trust among suppliers and buyers and thus reduce transaction costs involved in managing contractual relationships. The system creates almost total dependence among the member companies where individual success cannot be separated from the group's success. The companies within the cluster would have no incentive to cheat the system because the cost and risk of being thrown out of the cluster would be disastrous.

Such a system, however, has the danger of becoming coercive and anti-social because it controls supply and thus manages demand and manipulates prices in the market. This is where the second distinction of our CLC comes into being and makes the system viable and socially acceptable. As a self-governing system, the CLC reduces competition among the participants, which would call for greater regulation and oversight on the part of the government to prevent abuse of market power.

From China to a mall near you

Case study: Mattel

The tyranny of micro-decisions on the part of foreign manufacturers and their tragic macro consequences can be seen in the controversies following the recent large-scale recall of toys by Mattel. The toymaker recalled 18 million products in August alone, because of loose magnets that posed a choking risk to children.

Mattel had previously earned a reputation for maintaining among the most stringent industry standards in product safety and quality assurance. It had instituted global manufacturing standards to protect wages, working hours, and health and safety standards of the workers employed in vendor plants that made its toys. The company also required vendors' compliance with its principles, to be monitored by an independent third party and its findings made public.

This course of action was not followed by other major toy companies, which felt that they could better control their costs by keeping such information away from critical public scrutiny. Had every company been equally transparent, it would have been all but impossible for the local vendors to compromise quality and safety standards for fear of losing business. It would have also minimised the "free rider" problem by preventing the less scrupulous foreign buyers to exploit the situation under the cloak of secrecy.

In recalling its products, Mattel followed a policy of maximum safety that would be the normal course of action in similar situations in industrially advanced countries. When Mattel discovered safety hazards in one batch of toys, it did not limit its recall to that particular batch and instead recalled all toys manufactured under similar conditions. This action was based on the assumption that since Mattel could not be assured that all other toys would be defect-free, the most prudent course of action was to recall all toys in those categories. For this action, Mattel was criticised both by other companies in the industry and the Chinese government for over-reacting to the situation and thus causing unnecessary panic among the consumers and hurting China's reputation.

Therefore, as a self-regulatory mechanism, the cluster would only be acceptable to the regulatory regimes and society at large if it could demonstrate that the system was more efficient in reducing externalities and also paying the cost of negative externalities that must be borne by the production system.

Therefore, such a CLC would have as its essential feature a voluntary code of conduct that would be subscribed to by all members, would be subject to independent external monitoring and compliance assurance, and its findings made fully transparent and available to the public. The code of conduct would also provide a mechanism by which member companies would a) minimise the creation of negative externalities, and b) when it is not possible, to devise means of sharing the cost of such externalities by the member companies in a fair and equitable manner. Such a course of action is possible because the CLC would prevent "free riders" from joining the cluster.

We can envisage such CLCs being created by different industry groups and even multiple clusters within single industries where different groups of companies may have different reasons to join a CLC. The cumulative effect of these clusters would be that negative externalities would be absorbed by the companies through a variety of approaches best suited to the member companies in each CLC. Thus we would have the benefit of minimising negative externalities, eliminating the free rider problem, and provide the market with good products and services because of the manner in which CLC codes of conduct are implemented in a fully transparent manner. ■

Dr S Prakesh Sethi is a professor at Baruch College, the City University of New York. He is also president of the International Center for Corporate Accountability, a non-profit teaching and research organisation based in New York. Dr Sethi is currently working on a book: "Outsourcing in China: Where Good Ethics Should Have Been Good Business, but Wasn't".