Ethics at the Other End of the Supply Chain

John Hooker
Tepper School of Business
Carnegie Mellon University

January 2013
To appear in *Ethisphere Magazine*

In September of 2012, fire swept through a low-wage clothing factory in Karachi, Pakistan, killing at least 212 workers. Scarcely two months later, at least 112 died in a garment factory blaze outside Dhaka, Bangladesh. Both factories suffered from multiple safety hazards, including locked or insufficient exits. These are not isolated events. A shoe factory in Lahore, Pakistan, burned just hours before the Karachi disaster, killing 25. Even as I write this, there are reports of seven deaths in another Bangladeshi factory fire, where the sole emergency exit was locked.

These factories originated supply chains with Western companies at the receiving end. The German discount retailer KiK owned up to being the primary customer for the Karachi factory. It agreed to pay families compensation of US$1930 per death. Journalists found evidence in the ashes that Wal-Mart, Disney and Sears sourced from the Dhaka factory, although they were reluctant to confirm it. Wal-Mart said it had already found the factory to be “high-risk” and stopped sourcing from it. Disney claimed that none of its licensees had been permitted to make Disney brands at the factory for at least a year. Sears said it had no idea it was sourcing from the factory.

It is often hard to know, much less control, what happens at the far end of a supply chain. How can a company make sure its suppliers are ethical? In the Bangladeshi case, for example, Wal-Mart placed the order with a New York City company now known as Success Apparel, which subcontracted to Simco Bangladesh Ltd, which send the order to Tuba Group, which passed it along to Tazreen Fashions, which operated the Dhaka plant. Simco's chairman said that he tried to rescind the order when he learned that Tuba had diverted it from its own Wal-Mart compliant plant to Tazreen, but to no avail. Meanwhile, disaster struck at the Tazreen plant.

The south Asian fires are eerily reminiscent of the famous 1911 Triangle Shirtwaist Factory fire in New York City, which killed 146 garment workers, primarily young immigrants. Following common practice at the time, managers had locked the exit doors to prevent pilferage. The parallel with the Triangle fire teaches two lessons, one of which we should heed, and one of which we should ignore.

The first lesson is that business can lose its ethical moorings in new economic times, for which traditional norms may be inadequate. The Triangle Company saw a rapidly growing new market and an influx of cheap immigrant labor, and it exploited the situation. It is not as though Americans viewed industrial deaths as acceptable. The public reacted to the disaster with horror. But business norms had not evolved fast enough to deal with the new industrial environment, and reforms were necessary.

Something like this has been going on in emerging economies. The rise of outsourcing in developed economies provides a rapidly growing market—if the price is right—while migration from the hinterland provides limitless cheap labor. There is a race to the bottom as entrepreneurs try to underbid each other for huge foreign contracts. It is a very different environment from the one in which the country's traditional business norms developed.

The second lesson, the one we should ignore, is the way that reform was carried out after the Triangle incident. Public outrage and labor activism led to 60 new State laws regulating exits, fireproofing, fire extinguishers, eating and sanitary facilities, and working hours. Similar regulations have since become part of the working environment in the United States. All of this makes perfect sense for the U.S. situation, and it may seem that the same road to success should be followed everywhere.

However, other countries have different business cultures that may necessitate different ways of enforcing norms. In simplest terms, Europe and North America organize business around rules and contracts, while much of the world organizes business around relationships. In one case, you trust the system, and in the other, you trust the person. Naturally, it is not all black and white, because rules and relationships play a role in both settings. Nonetheless, there is a difference in emphasis.

When a supply chain stretches from one type of culture to the other (as many do), there is a mismatch somewhere along that chain. This can cause problems when contractual specifications for quality and labor standards don't make it across the cultural divide. This is nicely illustrated by another supply chain fiasco, this one involving a Chinese supplier. Although it received a good deal of publicity at the time, the complete story is rarely told.

Lee Der Industrial Company was a major supplier of toys and other products to Western companies. By 2007, it had provided toys to Mattel and its subsidiary, Fisher-Price, for several years. However, Mattel discovered that the paint on some of the toys contained dangerous quantities of lead, and it recalled hundreds of thousands of toys. It was a period of multiple scandals involving Chinese suppliers, and the Chinese government revoked Lee Der's export license as part of a crackdown. Lee Der's head of operations, Zhang Shuhong, saw this as a fatal blow to the company. He had been completely devoted to the firm, even to the point of living in a small room in the factory to be close to his work. After urging his workers to look for other jobs, he hanged himself in a company warehouse.

My purpose is not necessarily to fault Mattel, which has been an industry leader in monitoring overseas suppliers. My point is that it is not enough to write specifications into supplier contracts, because at some point down the chain, business shifts to personal relationships. In China, this sort of trust relationship is known as *guanxi*, which normally develops between business partners over a period of years. A mere written agreement may not suffice, because expectations that are not built into the relationship may not be taken seriously. It is the opposite of Western business practice, where expectations must be written into the contract to be taken seriously. At some point in the supply chain, someone who works within the Western contractual system must develop *guanxi* with someone who works within the Confucian system, so that expectations are honored on both sides.

The Lee Der saga has an interesting twist that teaches a further lesson. This particular supply chain shifted to the relationship mode when Zhang sourced paint from a close friend, Liang Jiacheng, head of Dongxiong New Energy. Liang, however, was short of pigment for the paint and obtained it by going on the Internet. He found Dongguan Zhongxin Toner Powder Factory, which sold him lead-based pigments along with faked certification that they were lead-free. Liang failed to recognize the forgery and unwittingly sold poison paint to his friend Zhang. Unfortunately, Zhang didn't bother to perform quality tests on the paint, perhaps because he trusted his friend's integrity as much as the tests. The result was tragedy.

The supply chain therefore had two weak links. If a Western buyer had developed *guanxi* with Zhang, perhaps Zhang would have performed seemingly pointless quality tests to honor the relationship—particularly if the buyer emphasized his interest in following contractual specs and took care of Zhang's needs in return. This was the first weakness. The next link in the chain, the *guanxi* bond between Zhang and Liang, was appropriate for the cultural context and worked more or less as it should, even though Zhang may have (unjustifiably) felt betrayed. The next link, however, is where the chain broke. Liang apparently tried to adapt to the modern business environment by sourcing on the Internet, without the benefit of a personal relationship. The pigment seller felt no obligation to Liang and hoodwinked him. Liang's mistake was to use a Western mode of doing business in a cultural environment where it won't work.

It is tempting to make a similar mistake in a south Asian context. Pakistanis and Bangladeshis are as morally outraged by the factory fires as Americans were by the Triangle fire. But should they address the problem in an American fashion, with laws and regulations? A regulatory approach is not totally out of context, inasmuch as south Asian countries have quasi-Western legal systems, due to historical British influence, and a community of sophisticated legal professionals. However, a regulatory strategy alone is unlikely to do the job. The Dhaka plant, for example, had already been inspected by the Fire Service and Civil Defence Department of the Bangladesh government. The agency denied renewal of the plant's fire safety certification only a few months before the fire, due to safety violations. The plant nonetheless continued to operate in violation of the standards.

The Western mechanism of third-party certification can also play a role, but it, too, appears to be insufficient. Only a month before the Pakistani fire, Ali Enterprises received the prestigious SA8000 certification for its ill-fated Karachi plant. Certification is administered by Social Accountability International (SAI) and covers health, safety, child labor, and minimum wages. Unfortunately, the certification process itself can create the kind of supply chain problem it is designed to address. SAI farmed out the Pakistani inspection to the RINA Group, an Italian firm that works primarily in marine certification and apparently never inspected the Karachi factory. Instead, it telephoned a Karachi-based firm, RI&CA (Renaissance Inspection and Certification Agency), which sent out two inspectors who recommended certification of the unsafe factory. The Executive Director of SAI expressed dismay over the tragedy and vowed to track down what went wrong, but NGO certification of this sort can accomplish only so much.

The more fundamental solution is to plug into the system that makes south Asia work: a dense network of personal connections. People get things done by working through the extended family, friends of the family, and friends of trusted friends. It is safer to rely on someone whom Uncle Abdul knows and can vouch for. A trusted friend is unlikely to endanger your friendship by recommending someone who is undependable. It is not hard to access this network, because south Asians working in Western offices are almost certain to have extensive contacts back home. When sourcing from Bangladesh, India, or Pakistan, the best course is to follow these connections to responsible business people who can supply your needs. The resulting supply chain can avoid the kind of cultural mismatch that created problems for Mattel, because each party is connected to the next by a preexisting trust relationship.

If it is impossible reach a suitable supplier in this fashion, the grapevine can supply information about who in the industry has a reputation for ethical behavior. Personal character is important, and as in any part of the world, some people have more of it than others.

Constant monitoring of contractor and subcontractor activities is also key. One hears complaints that this simply isn't feasible, but it can happen if buyers constantly nurture their relationships with suppliers. Frequent association naturally leads to information sharing. In relationship-based business, if you don't stay personally on top of something, people may assume you don't really care about it, just as in a Western setting, people will assume you don't really care about something you don't bother to put into the contract.

Fierce price competition can force even well-intentioned managers at the far end of the chain to make safety compromises. Their very loyalty to their workers may oblige them to cut corners to stay in business. However, a widespread preference in the social network for ethical suppliers can relieve some of this pressure. Managers with good reputations, or with friends who are willing to recommend them as ethical suppliers, may have a better shot at finding customers.

Western buyers may protest that they themselves have cost pressures and must source from the cheapest possible manufacturers to stay competitive. They cannot afford the luxury of high-minded suppliers. Given the markups that one often sees in the apparel industry, this is not always a plausible excuse. But when it is true, Western business can think about getting its own ethical house in order.

The race to the bottom was curbed in Western countries by safety regulations, under which the market is less likely to penalize ethical firms. Perhaps it is time to view safety infractions by one's foreign suppliers with the same seriousness as those in home factories. The negative public image that results from sweatshops and factory fires abroad provides some incentive. But in view of continuing disasters, more effective measures at home may be necessary. They could relieve some of the pressure on emerging economies and help relationship-based business adjust to a world of outsourcing.

References

Julhas Alam, Wal-Mart, Disney clothes found in Bangladesh fire, Associated Press, 28 November 2012.

Vikas Bajaj, Fatal fire in Bangladesh highlights the dangers facing garment workers, *New York Times*, 25 November 2012.

David Barboza, Scandal and suicide in China: A dark side of toys, *New York Times*, 23 August 2007.

Farid Hossain, Reports: Exit locked at burned Bangladesh factory, Associated Press, 27 January 2013.

R. Duane Ireland, Robert E. Hoskisson, Michael A. Hitt, *Understanding Business Strategy: Concepts and Cases*, 2nd ed., Cengage Learning, 2008, pages C-152 to C-156.

Brad Kenney, How the Mattel fiasco really happened, *Industry Week Forums*, http://www.industryweek.com/blog/how-mattel-fiasco-really-happened, 6 September 2007, last accessed 30 January 2013.

Julfikar Ali Manik and Jim Yardley, Bangladesh factory, site of fire that trapped and killed 7, made European brands, *New York Times*, 27 January 2013.

Serajul Quadir, Burned Bangladesh factory was warned twice on fire safety, Reuters, 11 December 2012.

Declan Walsh and Steven Greenhouse, Inspectors certified Pakistani factory as safe before disaster, *New York Times*, 19 September 2012.

Declan Walsh and Steven Greenhouse, Certified safe, a factory in Karachi still quickly burned, *New York Times*, 7 December 2012.

Jonathan Watts, Boss in Chinese toy scandal kills himself, *The Guardian*, 13 August 2007.