

**Moral Purpose, Economic Incentive and Global Trade—Why New
Business Models Are Needed**

by

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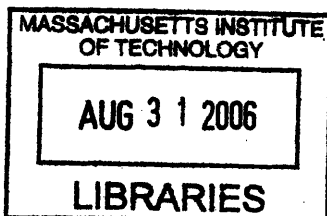
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ABSTRACT

Globalization has occurred in various forms over the past century, yet only recently has it become daily news. This evolving process has created numerous underlying tensions that are not well understood. While western society has tried to address these tensions, it has sometimes mishandled them. In this thesis, we examine one such area; the belief that globalization creates opportunities for significant labor exploitation and why it is necessary, in the absence of government regulation and enforcement, to set social codes for companies sourcing products in developing countries in order to prevent this mistreatment.

The thesis examines whether these codes are actually effective in accomplishing their stated objective of improving social conditions and if not, what plan could better accomplish this goal. It is divided into five chapters; the first is a review of five central globalization trends that frame the social code discussion. The second and third chapters look at the negative publicity that exposed labor problems overseas and assesses whether any of the known global actors care enough to cure the problems. Starting with the historical development of multi-stakeholder initiatives (MSIs) set up as a response to these problems, we then examine the codes they promulgated.

In the fourth and fifth chapters, we discuss why the codes are less effective than desired. The analysis is focused on the alignment and misalignment of institutional and organizational incentives in three areas: business model design, supply-chain management, and capital-market development.

While acknowledging the impressive social good accomplished by the MSI's, we argue that moral purpose by itself is difficult to impose across a wide range of institutions and cultures. Using more dynamic business models, companies and MSIs can create the right incentives to eliminate exploitive practices. Finally, we look at how creating such a virtuous cycle can have a profound positive impact on global trade and encourage governments to regulate. While modifying business models will prove daunting for many companies, there is ample economic justification to do so.

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Preface

I originally undertook this thesis to explore if consumers have any significant desire to drive change in the marketplace. Specifically, I was interested in learning if consumers would search for and ultimately choose a product because it had a label that certified the social and environmental conditions under which the product was manufactured (like the Good Housekeeping seal of approval my mother used to search for). Would there be enough demand for labeled products to induce other manufacturers to alter their social and environmental practices? Having been involved in two industries where the vast majority of the manufacturing jobs were transferred to lower cost countries, I wondered if consumers ever thought, or more importantly acted upon issues such as jobs or externalities caused by industry changes. Did they care about how products were made or were they driven primarily by other considerations such as price?

I learned quickly that consumers, at least for the time being and in any significant numbers, are not prepared to create large change in the marketplace. Because consumers were not prepared to instill change, my thesis then evolved into a study of whether and how better social and environmental practices can be brought to global capitalism. In the absence of consumer demand, will business self-regulate to improve social and environmental practices or is leverage needed to get business to change? What form does this leverage take and can business use it as a catalyst for better performance?

I learned that there are many who are trying to bring better practices to capitalism, in particular to those who work in developing countries. I am particularly impressed by local

entrepreneurs, who overcome tremendous difficulties to build a business that will create prosperity for many, and by the non-profit workers who try to also achieve the same goal through different means. Of course, as you shall see in the thesis, there are also those that exploit many for personal benefit.

However, my experiences in interviewing entrepreneurs are more benign. It is through these interviews that I realized that trust, mutual dependency and cooperation are significantly underrated as factors in development, in both business and as a society. This thesis seeks to address this issue by demonstrating how incentives that encourage trust and cooperation also lead to better economic performance. I have known many of these entrepreneurs through business experience. I am grateful for their honesty and where necessary have changed certain names to protect their confidence.

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Introduction

“The root of the difficulty is an attitude of mind that has never really died out in this world—nor perhaps even diminished greatly since the days of the pharaohs—a willingness to sacrifice human values to other objectives.”—John Gardner¹

Devaraj is a diligent, hard-working and well-respected Indian entrepreneur. His company, Charankattu Coir Mills (CCM), inherited from his father, manufactures coir products that are produced from the fibers of the coconut palms that fill the southwestern Indian province of Kerala. While he directly employs 175 workers to weave and finish his company’s door mats, rugs and geo-textiles, he depends on a larger Keralan cottage industry that employs 400,000 people² to harvest the coconuts, ret the fiber, spin and twist the yarn and supplement his small weaving capacity.

His door mats and rugs are sold throughout the world by some of the largest mail-order houses, department stores and home center chains; he is also the largest exporter of coir geo-textiles to Japan. Devaraj has known this business his entire life. Though now close to 50, he took over the business when his father passed away while Devaraj was still in college. He is the third generation to work in the business; his grandfather had started the business as a supplier to the British trading firms that controlled the coir industry until Indian independence in 1947. Though his grandfather was not allowed to sell internationally until independence, the export-led doormat industry has existed in Kerala for well over 100 years.

¹ Gardner, J. W. (1981). Self-renewal : the individual and the innovative society. New York, Norton.

² Coir Board of India. "Coir Board Schemes." from <http://coirboard.nic.in/index.htm>.

In many ways, not much has changed. There is little mechanization in the manufacture of a coir doormat; manual labor is the dominant means for accomplishing everything. Coir is the hairy brown outer part of the coconut. The only way to remove this durable fiber is to let the coconut sit in pools of salt water for 3-6 months, through a process called retting. While buyers visit factories like Devaraj's, few see the viscous retting pools dotting the areas adjacent to the local canal system that signs in Alleppey fondly advertise as "the Venice of the East". Thousands of workers gather the fallen coconuts from the millions of palm trees that give Kerala its lush, paradisiacal look; the coconuts are brought to central stations where they are placed in the retting pools.

When the fiber has begun to separate from the husk, the coconuts are then taken to individuals who remove all the fiber. The fiber removal, by far the dustiest of the processes, is the only stage that was moderately improved by mechanization. During the thirties, the British invented a static spinning disk that the wet coconut is thrown against separating the fiber. Once separated, the fiber is laid out to dry in the sun, although during the monsoon this process may be delayed. The dry fiber is gathered by another group of individuals and spun into yarn at home on wooden spinning frames. Indian coir has a very short staple length, is very coarse and thus, according to Indian manufacturers does not lend itself to machine spinning, although the Sri Lankan coir industry--four hundred miles away—uses primarily mechanized spinning equipment.

Once the yarn is spun, more individuals gather it up and take it home to weave doormats on wooden frame looms. Even when most exporters, as did Devaraj, branched out into coir carpets and rugs in the 1940's and geo-textiles in the 90's, they chose to weave these very-wide products on hand looms, as they still do today. Devaraj's company buys

doormats for export from the cottage trade, using his employees to only trim or print on the mats, but weaves rugs and much of the geo-textiles mainly with his employees. To satisfy his needs, Devaraj buys from 50 subcontractors that employ an average of 10 people each; he estimates that they supply him with 80% of their production so it can be presumed that Devaraj employs another 400 people indirectly³.

The cottage industry, with its army of workers, is overseen by a government organization, the Coir Board and an affiliate organization, the Coir Industrial Relations Committee (CIRC) which sets minimum wages, working standards and offers certain benefits, though it is not known for rigid enforcement⁴. Devaraj, his father and their predecessors have relied upon this supply chain for years in their effort to grow their business. It served them well with Devaraj winning multiple awards from the Coir Board for his exporting prowess.

Yet in 2003, Devaraj's company became the first firm in the coir-industry world-wide to become certified by a New York-based NGO, Social Accountability International (SAI), for managing its business according to social and labor standards (SA 8000) promulgated by SAI. When asked why he did this in addition to the ISO 9001 and 14001 certificates his company has, Devaraj responded that he hoped it would help him become credible in the eyes of potential European and US customers.

Devaraj's decision to follow social standards issued half a world away, by an organization in a highly developed country, speaks to the paradoxes that surround globalization. Why would a company that had not altered its supply chain in over half a

³ Devaraj (2006). Personal Interviews With Devaraj, Jan-Feb 2006. Hannover, Boston.

⁴ Ibid.

century expect to get new business, not by product innovation, but by complying with foreign social standards, especially since it was already certified in quality processes? How possibly could any organization certify social compliance in an industry where 90% of the work is done by independent contractors in a home work environment with loosely enforced regulation?

The coir doormat industry is a very small part of the globalization story, but it is a good place to start because it has been a global business since its inception and has changed very little, if any, over the last century. We shall continue to revisit Devaraj and Kerala in the following pages for exactly the same reasons.

The fact that Western customers now care about how doormats are made, when they didn't for so many years, is the starting point for this thesis. We shall look at the intersection of global trade—in this case, the business of manufacturing products in low-cost developing countries—with moral purpose—the belief that globalization creates opportunities for significant exploitation and why it is necessary, in the absence of government regulation and enforcement, to set social and other codes for companies sourcing products in developing countries in order to prevent this exploitation. These codes have evolved independently and while there are presently initiatives toward some degree of standardization; multiple organizations are promoting different codes they believe help improve or will solve globalization's social challenges.

Overview

This thesis will examine whether these codes are actually effective in accomplishing their stated objective of improving social conditions and if not, what plan could better

accomplish this goal. It is divided into five chapters; the first is a review of five central globalization trends that will help frame the social code discussion. The second chapter looks at the negative publicity that exposed labor problems overseas and assesses whether any of the known global actors care enough to cure the problems. This review allows us to better understand why and how present social codes came into existence.

The third chapter analyzes the current social codes and labels created by the multi-stakeholder initiatives (MSI's) as a response to the negative publicity (such as SA 8000). We see if these social codes help correct the conditions that engendered the publicity. Through research and interviews with these stakeholders, we examine the incentives that these codes create and determine whether the incentives will get the desired results. The analysis is focused on the alignment and misalignment of institutional and organizational incentives in three areas: business model design, supply-chain management, and capital-market development.

In the fourth and fifth chapter, we discuss why the codes are less effective than desired, how to improve them and ultimately how to create an environment where they will naturally evolve into a priority for governmental regulation and enforcement. We show that the business models employed by many companies coupled with the reactive nature of the social codes create negative incentives, lack of cooperation and mistrust that cannot overcome the historical tensions presented in section one.

While acknowledging the impressive social good accomplished by the MSI's, we argue that moral purpose by itself is difficult to impose across a wide range of institutions and cultures. Though consumers could theoretically support social labeling initiatives and drive change, they have shown little interest for the time being other than the small success

of the 'Fair Trade' program. Though business may not ultimately be able to self-regulate; with the support and pressure of the other stakeholders, business is best positioned to take the lead. Using more dynamic business models, companies can create the right incentives to eliminate exploitive practices. Finally, we look at how creating such a virtuous cycle can have a profound positive impact on global trade, and while modifying business models will prove daunting for many companies, there is ample economic justification to do so.

Chapter One—Five Central Globalization Trends

Industrialization, De-Industrialization and the Virtuous Cycle

As evidenced by the small coir industry and contrary to the comments in the popular press, globalization is not a new phenomenon. In many ways, the recent period of globalization is not even the most dramatic. Richard Baldwin and Philippe Martin have analyzed the two major waves of globalization that have occurred in the industrialized era⁵ and found significant similarities and differences. These periods—1870-1914 and 1960 to the present—are notable for de-industrialization in one area and industrialization in another, “The late 20th century globalization wave started with a very large North-South income gap and it de-industrialized the North while industrializing the South (or some parts of it). The first globalization wave industrialized the North, de-industrialized the South and produced enormous income divergence between groups of nations that were not initially very far apart”⁶

Citing studies by Fernand Braudel, Simon Kuznets and K. Chauduri, Baldwin and Martin argue that Europeans perceived China and parts of India to be much more developed

⁵ Baldwin, R. E. and P. Martin (1999). Two Waves of Globalisation: Superficial Similarities, Fundamental Differences. NBER Working Paper 6904. Cambridge, MA, National Bureau of Economic Research: 1-32.

⁶ Ibid.

than Europe in the 18th century⁷. India's cotton and China's silk industries were world leaders and formed the basis for early trade, "Clearly, civilizations that invented gunpowder, paper and oceanic navigation aids were by no means primitive societies just waiting for Europe to develop."⁸

Though they do not address the significant policy effects of colonization and attribute Southern decline to market forces, Baldwin and Martin give an excellent description of the first wave of globalization as a virtuous cycle for the North, "Higher income leads to a larger local market in the North and this in turn attracts relatively more investment to the North. Of course, the higher investment rate leads to a growing market-size gap and the cycle restarts. The spiral is boosted by the localized nature of technological spillovers. Namely, Northern industry and innovators benefit proportionally more than the South from increasing industrialization in the North. As the North experiences this stylized Industrial revolution, Southern industry rapidly disappears in the face of competition from Northern exports. In a self-generating process, the North specializes in industry and the South in primary goods."⁹

As the South lost its industry and the colonial powers reinforced the primacy of Northern manufactures through policy and regulation, the southern colonies became dependent on their European masters for economic growth. The European colonizers left varied states of infrastructure in their colonies after the rush to independence following World War II, and more importantly, they left strong seeds of mistrust. Experiments in

⁷ Ibid.

⁸ Ibid.

⁹ Ibid.

socialism and communism dotted the ex-colonies as newly formed and newly freed countries tried to create prosperity in their own way.

The failure of these political/economic systems to achieve their stated goals, as evidenced by the falling of the Berlin Wall and the Chinese communists' embrace of its "Reform and Opening Policy" gave way to market forces and the global trading system we have today. The acceleration of this change has surprised many observers. Though economic growth and prosperity has continued in the developed world, the rapid industrialization of the south and the relocation of significant manufacturing there has given some in the developed world the same sinking sense the South had during the first wave of globalization.

The virtuous cycle that had propelled the North to develop has now moved to the South, Baldwin and Martin continue:

"As industrial investment rises in the South, income rises, spurring local investment, and Southern industrialization and income growth. Now it is the Southern countries turn to step on the virtuous industrialization-income growth spiral. Northern industry suffers to some extent from the new competition. The North experiences some de-industrialization and tends to specialize more in services. In this last stage, the two regions converge towards even income and industrialization levels."¹⁰

While Baldwin and Martin project that the income convergence is the result of the relocated virtuous cycle, many in the developed world are now beginning to wonder whether income convergence actually means incomes shrinking in the North while concomitantly rising in the South. The notions of "Northern industry suffers to some extent" and "the North....tends to specialize in services" are observations that have not been quantified yet. Is

¹⁰ Ibid.

it possible that a virtuous cycle in one area requires a vicious cycle in another as actually occurred in the first wave of globalization? What are the repercussions of income convergence? And finally, is the Southern mistrust created by colonization and its concomitant North-South income divide disappearing as incomes converge or will the mistrust shift to the North?

Manufactures, Tariffs and Protectionism

The fact that significant trade occurred between countries during both waves of globalization is hardly surprising. What may be surprising is that much of the North's development, including the U.S., came during periods of high tariffs and substantial protectionism. While it is true that Great Britain, at the height of its empire, was the bulwark of the global free trade movement, the European continent and the US maintained protectionist development strategies primarily through high tariffs¹¹. This strategy was continued by Japan after World War II with excellent results.

Paul Bairoch states, "This fallacy is almost a dogma among neoclassical economists and can be expressed in the following terms: 'Free trade is the rule, protectionism is the exception' ... The truth is that, historically, free trade is the exception and protectionism the rule..."¹²

U.S. tariffs averaged in excess of 40% of dutiable imports from 1875-1913. By comparison, in the period from 1875-1913, the average tariff on manufactured goods in

¹¹ Ibid.

¹² Bairoch, P. (1995). Economics and World History. Chicago, University of Chicago Press.

France was 20%, Germany 10%, Spain 25% and only in the UK was it zero.¹³ Trade began to liberalize with the signing of the General Agreement on Tariffs and Trade (GATT) in 1948.

By 1996, the tariffs in the US had been reduced to an average of 5-7%, except for clothing that was covered by separate trade agreements with duties of 19%, and agricultural products (not including grains) at 38%.¹⁴ The European Union (EU) and Japan had similar tariff structures with some small variations. Echoing Bairoch's point, tariffs in the developing world were approximately double those of the developed world.

Baldwin and Martin reference trade economist Ed Leamer's work on breaking the second wave of globalization into two distinct periods that have completely different ramifications. During the first period from 1950-1979, most of global trade was between developed countries; however during the most recent period, "trade liberalization and rapid industrialization changed the nature of the Third World's participation in the world trading system. In short, they became exporters of industrial goods, especially labor-intensive industrial goods. This matters, according to Leamer and Wood, since these goods compete more directly with goods produced in the developed countries."¹⁵ In 1980, manufactured goods comprised only 15% of the South's exports to the North. Only nine years later, manufactured goods were at 53% of the South's exports and by 2000, they had increased to 59%.¹⁶

¹³ Baldwin, R. E. and P. Martin (1999). *Two Waves of Globalisation: Superficial Similarities, Fundamental Differences*. NBER Working Paper 6904. Cambridge, MA, National Bureau of Economic Research: 1-32.

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ UNCTAD (2005). *UNCTAD Handbook of Statistics*. Geneva.

The developing world's rapid industrialization was beginning to displace Northern workers by 1995 and the process has continued to accelerate. In the ten years ending in Sept. 2005, the U.S. textile and apparel industry has lost 57% of its jobs, the electrical engineering industry 27%, the paper products industry 23% and the computer industry 20%.¹⁷ Germany, with its more rigid work rules, has seen unemployment increase to 4.6 million workers, a 150% increase since 1990.¹⁸

Given conventional wisdom today, the irony the data shows is that under protectionist tariffs, development occurred and industrial jobs grew. Whether this could be maintained in a developed economy is a point of debate, but the tensions created by the job losses overseas contribute to the environment of accelerating mistrust between labor in developed countries and labor in developing countries.

GATT, MFA and China's Entry into the WTO

As protectionism accelerated during the world-wide depression of the 1930's, the trading system devolved into a bilateral system.¹⁹ Best evidenced by the creation of the Japanese 'Greater East Asia Co-Prosperity Sphere', countries tried to dominate regional markets, in place of larger ambitions. The British focused on trade with their colonies and the U.S. focused inwardly, leading to the isolationism that prefaced the Second World War.

¹⁷ Hornig, F. and W. Wagner (2005). Dueling Titans. Spiegel special 7: 142-146.

¹⁸ Hawranek, D., A. Jung, et al. (2005). Survival of the Fittest. Spiegel special: 62-69.

¹⁹ Baldwin, R. E. and P. Martin (1999). Two Waves of Globalisation: Superficial Similarities, Fundamental Differences. NBER Working Paper 6904. Cambridge, MA, National Bureau of Economic Research: 1-32.

While it is widely accepted that the Japanese inability to access natural resources in South-east Asia precipitated their attack on Pearl Harbor, the lack of German economic expansion through trade also played a role in Hitler's decision to attack neighboring states.

Out of the destruction of World War II, the Generalized System on Tariffs and Trade (GATT) was born in 1947. GATT was an effort to start liberalizing trade multi-laterally as opposed to the bi-lateral trade that led to the war.²⁰ Another seven rounds of negotiation, ending with the Uruguay round in 1994, yielded significant tariff liberalizations and more importantly, led to the formation of the World Trade Organization (WTO).

Yet, within the context of this paper, we are actually more interested in what happened with negotiations on tariffs concerning textiles and apparel. Given the high-labor factor in textiles, the entrenched-industry interests, the large employment in developed countries and the low barrier to entry by low-cost countries, these negotiations were much more contentious and yielded side agreements that created major market distortions that are just being remedied for the first time in 2006.

Given the strong political leverage of the industry, the Multi-Fiber Agreement (MFA) was signed in 1974 allowing countries to impose quotas on textile and apparel imports. These quotas forced developing countries to specialize in niche markets to receive available quota and served to lull scale players in the developed world into a false sense of security.

Significantly, the MFA and the varying quota system were renegotiated every four years, theoretically giving time to the developed countries to assess how to ultimately open these markets.²¹ In reality, these renegotiations led to changing country and product quotas

²⁰ Ibid.

²¹ Shelton, R. and K. Wachter (2005). "Effects of global sourcing on textiles and apparel." Journal of Fashion Marketing and Management 9(3): 318-329.

and the development of the sourcing agent. Agents, such as Li & Fung, and William E. Connor Company, started in Hong Kong by selling sourcing services that took advantage of the quota system. In a simple example, they would buy cotton fabric from Hong Kong, where there might be quota, and ship it to Korea to be cut and sewn, because the quota for sewn products was full in Hong Kong.

Twenty years later in 1994, the MFA signatories agreed to the Agreement on Textiles and Clothing (ATC), which phased out the quotas of the MFA over ten years until they were to end completely in 2005. During this time, the developed world's textile and apparel industry continued to suffer job losses. As part of an effort to save jobs, the US created two acts that complicated the already confusing quotas of the MFA.

The creation of the Caribbean Basin Initiative in 1983 and the African Growth and Opportunity Act (AGOA) in 2000, coupled with North American Free Trade Agreement in 1994, all encouraged the cutting and sewing of garments to take place in low cost countries, utilizing fabric woven in the United States. Equally distorting to the market mechanism was the fact that the knowledge and capital for many of these apparel factories came from the same Asian companies that could not export from their own factories due to quota restrictions. An example of this distortion is that in the Asian-owned apparel sector in the small African nation of Lesotho, employment jumped from 15,000 in 2000 to 55,000 in 2004.²²

While it is true that higher labor costs had a significant impact on the developed worlds' textile and apparel industry, the quota system distorted the marketplace in so many ways that they focused on the wrong areas for growth; the only exception to this being the

²² Field, A. M. (2005). Winter of Discontent. Journal of Commerce. New York: 1.

Northern Italian textile cluster that has survived and prospered by steering away from scale production. This trend coupled with the sophisticated supply chains of the Asian agent system led to the lack of any desire by retail customers to be involved in sourcing and forced most of them to use agents to buy apparel.

Ultimately, despite all of the protectionist agreements, there are essentially no significant clothing operations in Japan and the U.S.—87% of clothes in Japan are imported and 89% in the US.²³ In a sense, the agreements did serve to phase out industry job reductions in the developed world, yet it left a legacy of strong distortion in what countries are producing what, a sort of mutated textile and apparel eco-system.

Compounding these sourcing efforts initially, China signed the ATC in 2001 and stood to gain significantly by the end of tariffs in 2004. As it stands now, China has substantially increased their exports to the US and Europe and as result, has agreed to keep exports to a specific increase until 2008, when all restrictions will be removed. For the first time, the world faces essentially free trade in textiles and apparel. Like football players stepping on Astroturf for the first time, this is a new field requiring an altered strategy for the players involved.

Capital Market Development

As with manufacture trade, investment and capital flowed freely in both waves of globalization. Baldwin and Martin state, “While there are several distinguishing features of the late 20th century financial globalization, many of its elements resemble the wave of

²³ Shelton, R. and K. Wachter (2005). "Effects of global sourcing on textiles and apparel." Journal of Fashion Marketing and Management 9(3): 318-329.

globalization that ended in 1914. Indeed, the only real debate among informed observers is whether we have returned to 1914-levels of financial integration (Sachs and Warner, 1995²⁴), or have yet to reach those levels (Zevin 1989²⁵).”²⁶

As an example, considering average current accounts as a percent of GDP, the capital flow in the UK of 2.6% in the period 1989-1996 is the same as 1919-1926 and less than the 4.6% from 1870-1913; likewise the 1.2% of the US is just above the 1.0% of 1890-1913²⁷—a time when most people perceive the United States’ development as being solely internal. The major disparity between these capital flows is the duration of their investment period, “This difference is that capital mobility at the end of the 19th century seems relatively more important for long-term than for short-term capital flows.”²⁸

As bi-lateral trade grew in the period before World War I and during the depression, capital markets also retrenched significantly. The gold standard was abandoned and governments moved to control access to financial markets. Rajan and Zingales describe the period, “With their ability to turn on or turn off finance, governments obtained extraordinary power over private business. In addition, they intervened more directly by nationalizing industrial firms or by setting-up government-sponsored cartels. In parts, these actions

²⁴ Sachs, J. and A. Warner (1995). Economic reform and the process of global integration. Brookings Papers on Economic Activity. Washington, D.C., Brookings Institution.

²⁵ Zevin, R. (1992). Are world financial markets more open. Financial Openness and National Autonomy. J. Schor and T. Banuri. Oxford, Oxford University Press.

²⁶ Baldwin, R. E. and P. Martin (1999). Two Waves of Globalisation: Superficial Similarities, Fundamental Differences. NBER Working Paper 6904. Cambridge, MA, National Bureau of Economic Research: 1-32.

²⁷ Ibid.

²⁸ Ibid.

reflected a distrust of the market; in part, they reflected the inadequacies of past government policies.”²⁹

After World War II, the financial markets opened very slowly. Given that the major task for most developed countries was reconstruction, limitations on banking and investment remained strong. In the last twenty years, however, loosening of capital markets has accelerated. The ability of pension and endowment funds to invest in private equity markets coupled with the full repeal of the Glass Steagall Act, allowed for more aggressive financial options and brought capital liquidity, in many forms, to a much larger audience.

Rajan and Zingales write about the threat of incumbents and capital markets and the point is especially relevant to our thesis subject, “When the financial system is underdeveloped, a small group of financiers can control whatever limited access there is to credit. Ironically, the less financiers do to broaden access, the greater is their individual power...Many of the evils of capitalism—the tyranny of capital over labor, the excessive concentration of industry, the unequal distribution of income in favor of the owners of capital, the relative lack of opportunity for the poor—can be attributed, in some if not substantial measure, to the underdevelopment of finance.”³⁰

Rajan and Zingales continue with a description of a Vietnamese investor in a closed stock market who would face ruin in a major downturn because they would have no opportunity to diversify away their risk. They contrast this example with an American investor in Vietnam, who would not be hurt by this downturn because of their risk diversification. Their point is that if Vietnam allowed an open capital market, then the

²⁹ Rajan, R. and L. Zingales (2004). Saving capitalism from the capitalists : unleashing the power of financial markets to create wealth and spread opportunity. Princeton, Princeton University Press.

³⁰ Ibid.

American investments would reduce the Vietnamese risk premium allowing for significantly less expensive cost of financing for the Vietnamese company and hence more investment.³¹

Allowing for open markets is one thing but creating the institutions to support them is another. Foreign investors need assurances that the information they are receiving is trustworthy; otherwise they will demand a large discount. As markets develop, companies increase transparency and the more accurate earnings estimates will push their stock prices up. As prices rise, there are more incentives to deliver better information to investors.³²

Likewise, corporate governance will also change as markets open up. As Rajan and Zingales had pointed out, closed or small capital markets favor incumbents and in the developing countries of the world, this is definitely the case. Most public companies in democratic developing countries are actually controlled by families or a group of closely related investors. Most of these companies and certainly those in China have close ties to the government, with some of them partly or wholly owned by the government.

Capital market development now forms a strong tension between incumbents and newcomers. Though not all of these newcomers are foreign, there is certainly a strong belief that developed-country investors will tear apart developing countries' financial markets, if allowed. Hence there is a strong demand for market control, which as a byproduct tolerates poor institutional development and allows efforts for more economic and social transparency into companies to falter.

³¹ Ibid.

³² Ibid.

Income Distribution Trends and Inequality Perceptions

“In the globalized society, the split between the upper half of the income distribution and the lower half in America increases. While globalization brings us this extra prosperity, it also brings us extra uncertainty, tension, and greater inequality. In America it leads to a cowed workforce”--Paul Samuelson³³

As lower tariffs and the end of protectionism subject companies to intense competition, labor in the developed world has been through the most volatile period since the end of World War II. As shown previously, job losses by industry have been significant. These losses, which started with the primarily semi-skilled or unskilled occupations, have now moved into the skilled workforce. Outsourcing and offshoring are now widely accepted business tactics in the developed world, no matter what level of education the workforce may have.

Faced with risk of losing their jobs to lower paying countries, U.S. and European workers have become more productive. However, a recent study by Ian Dew-Becker and Robert Gordon³⁴ demonstrates that “over the period 1966-2001, as well as over 1997-2001, only the top 10 percent of the income distribution enjoyed a growth rate of real wage and salary income equal to or above the average rate of economy-wide productivity growth.”³⁵ Equally important Dew-Becker and Gordon show that half of the income gains went to the top 10%.

³³ Hornig, F. and A. Jung (2005). "The market has no heart"--Interview with Paul Samuelson. Spiegel special 7: 142-146.

³⁴ Dew-Becker, I. and R. J. Gordon (2005). Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income. NBER Working Paper Series. Cambridge, National Bureau of Economic Research: 1-86.

³⁵ Ibid.

Using data compiled by Mishel et al³⁶, Dew-Becker and Gordon describe the rapid increase in compensation for CEO's in major US corporations, "The ratio of CEO pay to average worker pay increased from 27 in 1973 to 300 in the year 2000, then fell to 237 as a result of the stock market crash. Including both cash and equity compensation, the 1989-2000 increase in CEO compensation grew 342 % as compared to 5.8% for the median hourly wage."³⁷ As the US moved to a Republican-majority in Congress, labor lost its ability to promote income equality through legislation or even taxation. Though the corporate scandals at the turn of the century drew significant attention to corporate governance issues, equality in pay has stayed in the background.

The ability of management to appropriate a significant percentage of profits has increased dramatically in the last 10 years. Dew-Becker and Gordon refer to a study by Bebchuk and Grinstein³⁸ that shows that the compensation of the top 5 executives of 1500 large U.S. public companies (S&P 500, Mid-Cap 400 and the Small-Cap 600) companies grew over 150% as a percentage of the company's earnings from 1993-2002. Compared to a sample size of 20,000 companies, these executives earned 5% of the companies' earnings in 1993-95 increasing to 12.8% in the period 2000-02.³⁹

³⁶ Mishel, L., J. Bernstein, et al. (2005). The State of Working America 2004/2005. Ithaca, Cornell University Press.

³⁷ Dew-Becker, I. and R. J. Gordon (2005). Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income. NBER Working Paper Series. Cambridge, National Bureau of Economic Research: 1-86.

³⁸ Bebchuk, L. and Y. Grinstein (2005). The Growth of Executive Pay. NBER Working Papers Series. Cambridge, National Bureau of Economic Research.

³⁹ Dew-Becker, I. and R. J. Gordon (2005). Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income. NBER Working Paper Series. Cambridge, National Bureau of Economic Research: 1-86.

By comparison, CEO's of comparable companies in Europe and Japan earn approximately one-third of US pay.⁴⁰ Moreover, CEO's in non-U.S. advanced countries earn total compensation 19.9 times greater than the average hourly pay, which is less than 50% of the multiple for US manufacturing companies and 12% of the multiple for large U.S. company CEO's in 2003.⁴¹ But even though the CEO multiple is considerably less in Europe, CEO pay has still risen significantly with respect to wage-earners; for example in Germany, CEO pay has risen 89% from 1997-2003, while wages have increased only 1.4%.⁴²

Income inequality is a tension that has yet to be acknowledged, let alone addressed. The frustration that comes with increased productivity without increased pay will come to the surface at some time. With respect to this phenomenon, we are particularly interested in the fact that employees will no longer feel their incentives are aligned with top management and will lose their trust in their leaders and employers. The leaders' ability to lead change will be hampered by taunts of hypocrisy and the status quo will prevail.

Why are the trends central?

Table 1 below briefly outlines how the previously mentioned trends create certain tensions that we will see throughout our discussion of social codes. As we look at whether global actors care, we can see these tensions played out in all of their responses. When we

⁴⁰ Mishel, L., J. Bernstein, et al. (2005). The State of Working America 2004/2005. Ithaca, Cornell University Press.

⁴¹ Ibid.

⁴² Bohringer, C., D. Deckstein, et al. (2005). The German Job Roulette. Spiegel special. 7: 40-50.

examine incentives created by social codes, we shall see these same tensions again and when we finally arrive at our conclusion, we shall see how these tensions can be changed into better incentives that reinforce rather than fight the trends.

Table 1 Tensions Created by Globalization Trends

Globalization Trend	Tensions Created
Industrialization, De-Industrialization and the Virtuous Circle	Rapid development in the South favors virtuous cycle there. Developed countries' economies and social structure under attack as jobs leave. Expectations of social support diminish as affected companies and countries cut pension plans, health and other benefits. Northern labor becomes suspicious of South's intent
Manufactures, Tariffs and Protectionism	Increased levels of outsourcing improve manufacturing skill base in South. Job losses grow and skill base in North evaporates. Developing countries use selective protectionist measures to encourage faster growth while developed countries try to force high-cost standards onto developing ones
GATT, MFA and China's Entry into the WTO	Distorted incentives have created intense competition among countries. Developing countries will try to keep low cost of labor as a comparative advantage and choose to overlook labor and social issues. Threat of no quotas on Chinese goods reinforces previous issue. Labor in developed countries look for Chinese dumping practices fostering more mistrust
Capital Market Development	Developing capital markets allow for rapid capital inflows and outflows prompting charges of speculation by developing countries. Incumbents in developing economies rush to sell shares of newly privatized companies and export capital from domestic investment. Politicians look to capitalize on same trend and force closer link with business.
Income Distribution Trends and Inequality Perceptions	Uneven income distribution discourages workers in developed countries leading to push back on free trade issues. Consumers and employees lose faith in managers; see system as hypocritical and abandon corporate social responsibility efforts. Developed countries' consumers overspend to keep up and severe recession follows

Chapter Two—Labor Problems Overseas; Does Anyone Care?

Signs of Friction and Negative Publicity

As decreasing tariffs accelerated competition, companies aggressively looked for lower-cost sources. Since many companies chose to use agents or sub-contractors for their overseas purchases, they believed they were essentially immune to concerns about labor and social conditions in the source countries. This feeling of security probably existed because most companies had always done some degree of overseas sourcing and had never suffered negative repercussions. Yet as labor tensions increased in the US and other developed countries, it became a matter of time before someone would notice the working conditions overseas.

Labor, government and industry, tried initially to keep American garment manufacturing onshore by financing a positive marketing campaign to convince consumers that “Made in the USA” was an important label and worth shopping for. Roger Milliken’s effort with the “Crafted with Pride in the USA” in the 1980’s and Wal-Mart’s declaration that it would sell as much American product as possible met with little success. Studies on the “Made in the USA” campaign show that just 11% of consumers only buy clothes made in the U.S.⁴³ Consumers were more interested in fashion, quality and price.

⁴³ Dickson, M. A. (2001). "Utility of No Sweat Labels for Apparel Consumers: Profiling Label Users and Predicting Their Purchases." *The Journal of Consumer Affairs* 35(1): 96-118.

Andrew Ross, labor scholar and anti-sweatshop activist, describes the next step in the chain of events, as well as his belief why it occurred, “In the 1980’s, Nike was able to move its factories from South Korea and Taiwan to Indonesia, China, Thailand and Vietnam to exploit lower wages, but the comparative advantage means nothing if consumers are not willing to pay \$125 for a shoe assembled for seventy or eighty cents. If consumer abhorrence for sweatshops has a decisive impact on sales patterns, all is lost...Accordingly, the leading edge of activism shifted away from labeling (Made in the USA), toward the high-end publicity strategy of targeting the image of large, well-known companies.”⁴⁴

Jeff Ballinger’s research on Indonesian labor conditions in the late 1980’s⁴⁵ and his subsequent article in *Harper’s* magazine⁴⁶ in 1992 implied that Nike’s subcontractors were exploiting their labor force. The National Labor Committee (NLC), founded by three union presidents, began to target other garment producers about working conditions in their source factories. The Gap was targeted in a 1995 NLC campaign that highlighted conditions in Central American maquiladoras.⁴⁷ As a result of a speaking tour organized by the NLC and picked up by national correspondents, the Gap reached an agreement with the NLC whereby social codes of conduct would be translated into Spanish (or the source country language) and outside monitors would be permitted to inspect for labor and safety violations.⁴⁸ Through the media, this was the first time the general public were made aware of codes and

⁴⁴ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

⁴⁵ Ibid.

⁴⁶ Ballinger, J. (1992). The New Free-Trade Heel: Nike's Profit's Jump on the Back of Asia's Workers. Harper's Magazine: 46-48.

⁴⁷ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

⁴⁸ Ibid.

monitoring in overseas factories, although Levi Strauss had actually issued workplace codes of conduct in 1991.⁴⁹

In 1996, the NLC exposed conditions in a Honduran factory producing clothes for a Kathie Lee Gifford licensed-collection sold at Wal-Mart. Facing considerable scrutiny and with the help of a New York publicist, Kathie Lee required that all factories producing her line had to be independently monitored for labor violations, forcing Wal-Mart to join companies issuing codes of conduct.⁵⁰

'Sweating', the Labor Movement, and Labor's Reaction

Not all exploitation was in the developing world. The garment industry has always had labor challenges, as Ross points out in his history of the term 'sweating', "In the nineteenth century, the term *sweating* referred to the system of subcontract, which, in contrast to the integrated and supervised factory system, consisted of farming out of work by competing manufacturers to competing contractors. The small contractors 'sweated' as much labor as they could out of immigrant workers. Sweating was indigenous to garment production because of its division of labor, separating the craft processes of design, marking and cutting, from the labor-intensive sewing and finishing, and organized around a three-tier system of small producers—the inside shop, the contractor, and the home. In this industry on

⁴⁹ Freeman, R. B. (1998). *What Role for Labor Standards in the Global Economy*. Cambridge, MA: 1-36.

⁵⁰ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

wheels, neither the jobber nor the manufacturer nor the contractor was responsible for one other's conduct; each could blame others for flagrant abuses of the system.”⁵¹

In many ways, the history of the textile and apparel trades is the history of the labor movement. Unfortunately, like much social change, it required tragedy to raise awareness of the issues at hand. The Uprising of 20,000, the Great Revolt of 1910 and the Triangle Shirtwaist Factory fire in 1911, where many workers fell to their death from the eighth floor as a result of exit doors being locked, led to the development of collective bargaining, new safety regulations and the eventual introduction of worker's compensation laws. Ross defines this gain as the labor-capital social contract, “Organized labor learned that management would make big concessions in return for uninterrupted production, while the manufacturers found a way for labor to accept their coming creed of scientific management and industrial efficiency.”⁵²

The International Ladies' Garment Workers' Union (ILGWU), the organizer of the 1910 revolt, had its share of volatility throughout the first half of the 20th century. It was however, instrumental in fostering unions in other industries that employed immigrants such as the auto and steel industries. Ultimately, The ILGWU reflected the continued migration of the garment industry offshore and its membership continued to shrink, until it merged with the Amalgamated Clothing and Textile Workers' Union (ACTWU) to form the Union of Needletrades, Industries and Textile Employees (UNITE) in 1995.

UNITE continued to lobby for enforcement of labor conditions and under the sympathetic ear of the Clinton Administration, Secretary of Labor Robert Reich started again

⁵¹ Ibid.

⁵² Ibid.

to inspect domestic garment producers. In 1995, Department of Labor (DOL) inspectors caught a California producer, who had used nominal slave labor in the form of undocumented workers locked up 24 hours a day, to sew garments for large American retailers.⁵³

Working with UNITE, the White House convened a presidential task force, the Apparel Industry Partnership (AIP), to set workplace (which have since been expanded and referred to as social) codes. The AIP was the start of multi-stakeholder initiatives; in addition to UNITE, its members were a diverse group that included the Interfaith Center on Corporate Responsibility, Lawyers Committee for Human Rights, the National Consumers League, the Retail, Wholesale and Department Store Union and industry representatives from well-known retailers such as L.L. Bean, Patagonia, Liz Claiborne, Phillips Van Heusen and Nike.⁵⁴ The AIP ultimately gave rise to the Fair Labor Association (FLA), which we will examine in the next chapter.

UNITE also supported grass-root student movements that became the next outspoken critics of the global apparel industry. The group, United Students against Sweatshops (USAS), lobbied college administrations to develop codes of conduct for factories that produced university licensed apparel. USAS believed that industry involvement in the FLA compromised their independence and encouraged their respective universities to join the Workers Rights Consortium (WRC—which will also be discussed in the next chapter).

⁵³ Ibid.

⁵⁴ Ibid.

Labor, in conjunction with the students and other human rights organizations continue to expose workplace conditions.⁵⁵

While we will examine the social codes of conduct in depth later in this thesis, the question we ask at this point: Is the fact that social conditions overseas could be found in the U.S., with its tighter laws and enforcement, an indication that either there are unscrupulous operators in both locations or perhaps that the supply chain operations of the hyper-competitive retail trade had evolved into more of a demand chain with a differing and completely new set of expectations?

Are Global Standards Necessary or Discriminatory?

“You cannot expect a low-income, low-productivity country to have the amenities that America enjoys. It’s unfair to expect labor and environmental standards as strict as ours. That is unrealistic. I grew up in a steel town, in Gary, Indiana. That was a long time ago, almost 90 years. If a worker’s leg got caught by the hot molten steel, they didn’t even stop work. You can see how things have improved over the years, and that will happen in China too.”—Paul Samuelson⁵⁶

As campaigners called for improved social and environmental standards in developing countries, the issue took on significant political overtones. Leaders in the developing world argued that standards imposed by the developed world were essentially protectionist in nature. Citing the fact that labor movements were instrumental in exposing working conditions overseas, developing countries (and their companies) stated that labor’s intent was to drive up their cost thereby keeping the jobs in the developed world. This debate

⁵⁵ Ibid.

⁵⁶ Hornig, F. and A. Jung (2005). "The market has no heart"--Interview with Paul Samuelson. Spiegel special 7: 142-146.

has been framed by the media, depending on which side they take, as either the race to the bottom or the race to the top. Steven Suranovic describes it according to fairness arguments, “Advocates of standards agreements seem more likely to use moral justifications arising out of the golden rule fairness principle especially when condemning the purported harm caused to individuals as a result of current policies. They also more often use inequality and discrimination arguments. Opponents of standards agreements are more likely to use sovereignty and rule of law agreements. Also, since many opponents of these types of agreements are economists, they tend to assess the extended costs and benefits of standards and support those policies that are most efficient.”⁵⁷

Andrew Ross is clearly in the first camp, “Labor rights are not privileges that carry a price tag, and poverty does not preclude entitlement to them. There is no reason why core labor standards (recognized by the ILO--International Labour Organization) should be subject to a costs-benefit analysis. In any case, whatever increased costs are incurred from observing these rights should not be borne by host nations, but by the multinational firms that reap vast profits from the sweatshop system”⁵⁸

Jagdish Bhagwati, the free-trade supporting economist is just as clearly in the second camp, “The developing countries cannot then be blamed for worrying that the recent escalation of support for such a (Social) Clause in the WTO in major OECD countries derives instead from the desire of labour unions to protect their jobs by protecting the industries that face competition from the poor countries. They fear that the moral arguments

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Suranovic, S. (2002). "International Labour and Environmental Standards: Is This Fair Trade." The World Economy 25: 231-245.

⁵⁸ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

are produced to justify restrictions on such trade since they are so effective in the public domain. In short, the ‘white man’s burden’ is being exploited to secure the ‘white man’s gain’. Or, to use another metaphor, ‘blue protectionism’ is breaking out, masking behind a moral face.”⁵⁹

As Suranovic suggests, Ross and Bhagwati use different frameworks to support their side. Certainly Bhagwati refers to the negative publicity generated by the labor activists as ‘so effective in the public domain’ and since he doesn’t believe that standards should be mandated, does not mention their costs. Ross, however, also states that developing countries should not have to pay these costs as they should be absorbed by foreign companies operating overseas. This idea may seem impractical given the current sourcing environment but we shall revisit it when we discuss business models in Chapter Four. The subject of global standards, and in particular implementation if they were to exist, is intrinsically tied to the protectionist tensions of globalization and any solution must pay careful attention to mitigate the friction, not make it worse.

What about the WTO, ILO or Country Regulation?

The difficulty in getting an agreement on what role for standards has been borne out by the history of the ILO. The ILO was formed as a result of the Treaty of Versailles in 1919. Christopher McCrudden and Anne Davies describe its function succinctly, “The ILO was given a broad mandate: to establish international labor standards in the form of Conventions,

⁵⁹ Bhagwati, J. (1995). "Trade Liberalisation and 'Fair Trade' demands: Addressing the Environmental and Labour Standards Issues." *The World Economy* 18: 745-759.

to persuade states to join these Conventions and to resolve disputes concerning their implementation.”⁶⁰ It was a seemingly simple task that has not been completed 86 years later.

After the end of World War II, the ILO was to work with the International Trade Organization (ITO) to link labor standards and trade. When the ITO failed and GATT was created on a supposedly temporary basis, there were no longer any labor linkages.⁶¹ This discussion has ensued and was placed again on the negotiating table with the formation of the WTO. The debate got louder and the distance between the developed and developing world grew larger.

Ultimately, the WTO pushed the matter back to the ILO, stating that labor standards were a labor issue and ultimately belonged with ILO.⁶² The ILO responded with a two-pronged strategy; first they would adopt a core set of labor standards, which by virtue of membership all countries should be committed to and surprisingly, second they should introduce a labeling program that would identify products that were produced in locations that adopted these standards.⁶³

The ILO adopted the core labor standards and issued a Declaration to this effect in 1998. It did not adopt the labeling program in yet another failure to agree on standards, “However, the attempt to link these to a labeling scheme was not accepted by the main decision-making body of the ILO, in large part because of the opposition of developing

⁶⁰ McCrudden, C. and A. Davies (2000). "A Perspective on Trade and Labor Rights." Journal of International Economic Law 3(1): 43-62.

⁶¹ Ibid.

⁶² Ibid.

⁶³ Ibid.

countries, the same countries which had been so adamant that the ILO was the place to deal with these issues.”⁶⁴

The ILO 1998 Declaration covers the following four areas⁶⁵:

- Freedom of association and the right to collective bargaining
- The elimination of forced and compulsory labor
- The abolition of child labor
- The elimination of discrimination in the workplace

Ultimately, society is the determinant of what kinds of behaviors are acceptable and what are not. As the history of the ILGWU points out, many times citizens must agitate before politicians propose, pass and enforce legislation. The development of social standards has taken a long time and is still very much a dynamic process. While international bodies, such as the ILO, have accumulated the knowledge of the many labor struggles that have taken place in the developed world, it has no jurisdiction over countries and can only hope that countries will abide by the ILO conventions.

In reality, many developing countries actually have labor laws; China and India being good examples. The problem is in the enforcement. As the example of Devaraj shows, a country’s desire to provide work in a competitive world and enforcement of labor laws are not always compatible. While history shows, along with Paul Samuelson’s quote, that as living standards rise, governments take more interest in enforcing standards, it will be awhile

⁶⁴ Ibid.

⁶⁵ ILO. (2006). "ILO Declaration on Fundamental Principles and Rights At Work." from <http://www.ilo.org/dyn/declaris/DECLARATIONWEB.INDEXPAGE>.

before developing countries can be expected to enforce anything remotely close to the standards in the developed world.

Do Consumers Care?

“The market has neither a heart nor a brain; it just does what it does.”—Paul Samuelson⁶⁶

When Ross discussed having companies absorb the costs of higher standards, he also mentioned consumers, “Even if the costs were passed on to the consumers (a more practical assumption), there is a reasonable expectation that they could be absorbed without much pain.”⁶⁷ Richard Freeman, to the same point, states, “Demand for standards is a legitimate demand based on the willingness of consumers to pay more for products made under decent conditions.”⁶⁸ Certainly in a market-based economy, consumer choice affects profoundly the behavior of producers. If a consumer says no, then either the manufacturer finds another consumer, changes the product, or goes bankrupt. If as Freeman asks, consumers are willing to pay for higher standards, then certainly there would be higher standards. But the question is: are they willing to pay? Or to that matter, are they even willing to search and make a choice?

⁶⁶ Hornig, F. and A. Jung (2005). “The market has no heart”—Interview with Paul Samuelson. *Spiegel special* 7: 142-146.

⁶⁷ Ross, A. (2004). *Low pay, high profile : the global push for fair labor*. New York, New Press : Distributed by W. W. Norton.

⁶⁸ Freeman, R. B. (1998). *What Role for Labor Standards in the Global Economy*. Cambridge, MA: 1-36.

Consumers have been the primary beneficiaries of globalization. Inflation has been dramatically reduced in the developed world; one of the primary drivers of this phenomenon is the continuing and significant decline in the price of manufactured goods. Whether driven by technological improvements, productivity gains or low-cost labor, the price of acquiring material happiness has dropped significantly.

Research shows that while the majority of consumers are delighted to enjoy this benefit, they have raised little concern about the tensions caused by globalization. A survey conducted by the largest British independent market research firm MORI (Market and Opinion Research International) in 2003 highlights the potential misperceptions that may exist in the public mind about consumers. MORI found that three-quarters of the British population (74%) would be influenced in their purchasing decisions by more information on a company's ethical and social behavior. The key word is influenced because ultimately MORI identifies only 15% of the population to be CSR activists, those that would be inclined to act on this information as opposed to be merely influenced.⁶⁹

Likewise, other MORI surveys confirm the same or even smaller amounts of consumers that would be classified as ethical, "In general terms, we find that the propensity for consumers to be concerned about these issues still far outstrips ethical consumer behavior....Looking at past consumer behavior, only one in seven (14 per cent) report they have chosen a product in the last year because of a company's ethical reputation and one in six (17 per cent) say they have boycotted a product on ethical grounds."⁷⁰ Interestingly enough, the same research also show that 29 per cent have bought a product because of an

⁶⁹ MORI. (2003). "Ethical Companies." from <http://www.mori.com/polls/2003/mori-csr.shtml>.

⁷⁰ Worcester, R. and J. Dawkins (2005). Surveying Ethical and Environmental Attitudes. The Ethical Consumer R. Harrison, T. Newholm and D. Shaw. London ; Thousand Oaks, SAGE: 189-203.

established charitable link in the last year.”⁷¹ Finally, a study that MORI conducted in 2000 for the Co-operative bank showed that only 5 per cent of the British population makes purchases based solely on ethical criteria.⁷²

In a 2000 U.S. survey of potential buyers of a “No Sweat” label, Marsha Dickson found similar results to the MORI studies, “Last, the empirical findings of the study were of reasonable magnitude. Only 16 percent of the sample was included in the potential No Sweat market segment. Nearly half of the sample showed no indication whatsoever that they would use the label and another 36 percent clearly placed higher priority on price. Certainly, if social desirability were biasing results, there would be a far greater number of respondents indicating they would use the label.”⁷³ In a 2005 article that profiled ethical apparel consumers, Dickson states, “The large proportion of consumers unwilling to sacrifice their own product needs for price, quality, color and fiber content is not surprising and similar to findings from previous research. For most consumers considering an apparel purchase, ethical attributes of a product take a back seat to product features.”⁷⁴

While it is apparent that currently there are not significant numbers of consumers to reward companies for insisting on high standards throughout their supply chain, consumers have been much more likely to boycott companies that behave poorly. This is evidenced by

⁷¹ Ibid.

⁷² Ibid.

⁷³ Dickson, M. A. (2001). "Utility of No Sweat Labels for Apparel Consumers: Profiling Label Users and Predicting Their Purchases." The Journal of Consumer Affairs 35(1): 96-118.

⁷⁴ Dickson, M. A. (2005). Identifying and Profiling Apparel Label Users. The Ethical Consumer R. Harrison, T. Newholm and D. Shaw. London ; Thousand Oaks, SAGE: 155-170.

the choice of activists to seek negative publicity for brand-focused companies, such as the GAP, Nike etc.

In particular, boycotts have the benefit that they do not need to be successful to be effective. Rob Harrison cites Craig Smith's research on the subject, "He described boycott effectiveness as attaining a reduction of sales as the boycotted product, and distinguished it from boycott success, which is the achievement of the boycott's political objectives."⁷⁵

Harrison displays in the same article a table showing 37 successful consumer boycotts since 1986, ranging from Gillette and Avon stopping animal testing to Shell's disposal of the Brent Spar platform on land to John Lewis ending employee shooting trips.⁷⁶ What is remarkable about this table is that not one successful boycott is listed for a producer exploiting labor conditions in developing countries.

Whether this indicates that consumers are not sensitive to this issue raises another question; do consumers get enough information to understand the problem? Or equally important, do consumers believe that their decision will have any effect on something they think is beyond their control? The decision to not buy something is easier than choosing what product to buy. In a boycott, that producer or product is clearly delineated by the boycott organizer. We shall look at the reactions of companies to the negative publicity they received in another section, but it can be assumed that part of their decision in how to respond was to prevent a boycott that would do more damage to their brand.

The difference between positive choice and a negative decision is directly related to information. Sir Robert Worcester, the founder of MORI, writes; "Currently, therefore,

⁷⁵ Clouder, S. and R. Harrison Ibid. The Effectiveness of Ethical Consumer Behavior: 89-102.

⁷⁶ Ibid.

messages about companies' ethical behavior are largely not getting through to consumers. Top-of-mind awareness of companies' contributions to society remains fairly low... This underlines the potential impact of engaging a company's customers and (not least) its employees in ethical programmes so that their informal communication networks can be used to spread the word. In particular, employees tend to be perceived by external stakeholders as particularly credible commentators on a company's activities...⁷⁷

Socially Responsible Investors, Transparency and the GRI

In contrast to consumers, investors have long tried to gather information about companies' behaviors. Religious groups have been sensitive to their investments since the 1920's; the Pioneer Fund opened in 1928 and since 1950 has screened stocks on behalf of Christian investors to exclude those that are involved in gambling, alcohol and tobacco.⁷⁸ It was the advent of the Pax Fund in 1971 and the formation of the Interfaith Center for Corporate Responsibility in 1976 that started the socially responsible investment (SRI) movement. With \$639 billion in assets in 1995 and more than \$2.29 trillion in assets in 2005, the SRI movement has now become an industry⁷⁹.

There are three areas of social investing: socially screened mutual funds and separate accounts, shareholder advocacy investors and community investing. By far the largest

⁷⁷ Worcester, R. and J. Dawkins Ibid. Surveying Ethical and Environmental Attitudes: 189-203.

⁷⁸ Social Investment Forum (2006). 2005 Report on Socially Responsible Investing Trends in the United States: A 10-Year Review. Washington, D.C., Social Investment Forum: 1-66.

⁷⁹ Ibid.

amount, \$1.7 trillion, is dedicated to screening⁸⁰. Of this \$1.7 trillion, \$200 billion is invested through mutual funds and the balance, \$1.5 trillion, through institutional investors, primarily public pension plans. Screened funds use both exclusive and inclusive screens, where exclusive indicates that the fund will exclude investments because of certain unacceptable behaviors and inclusive indicates that the fund will include companies for certain desirable behavior. Funds will generally screen for 2-4 screens with the seven most important by asset size reflected in the Table 2 below.⁸¹

Table 2 Social Screening by Asset Size

Social Screening by Institutional Investor	Assets (\$Billion)
Tobacco	810
MacBride Principles	295
Human Rights	255
Environment	150
Equal Employment	140
Community Relations	130
Labor Relations	130

Shareholder advocates are classified as investors that file one or more shareholder resolutions on social issues. Shareholder advocacy assets total \$700 billion and are a mix of socially screened funds and institutional investors who do not screen⁸². In 2005, these investors filed 348 corporate resolutions, of which 177 were voted on and 98 were withdrawn.⁸³

⁸⁰ Ibid.

⁸¹ Ibid.

⁸² Ibid.

⁸³ Ibid.

With respect to our thesis topic, global labor standards through social codes; twenty-five resolutions were proposed in 2005, eight were withdrawn and fourteen were voted on. The average votes cast in favor of these resolutions was 11.4%.⁸⁴ Given the results of the shareholder votes, it can be assumed that the level of interest of stockholders in global standards is not that different of consumers. Likewise, judging by the ranking of screens, labor relations are also a relatively low priority for institutional investors.

Though it appears that investors will not force companies to improve labor standards, they have built significant momentum in the form of getting companies to at least report their behavior. Since SRI investment firms spend so much effort screening for sometimes intangible behavior, they have strongly advocated social and environmental reporting. Sometimes referred to as ‘triple bottom line accounting’, SRI investors have financed a non-profit group, the Global Reporting Initiative, to build standards that will allow a common framework for reporting.

Moreover, the environmental lobby and the recent highlighting of energy issues have pushed the topic of sustainability reporting to the forefront of SRI interest. Of the twenty-five highest votes received by shareholder resolutions put forth by shareholder advocates, eight of them, all receiving more than 30% votes, concerned enacting sustainability or GRI reporting⁸⁵.

The effort to seek greater corporate transparency may be driven partially by the ethical lapses of business leaders over the last ten years, yet there is also a sincere desire to have companies at least report behavior that they may be slowly trying to change. Whether GRI

⁸⁴ Ibid.

⁸⁵ Ibid.

reporting may be considered good publicity or brand enhancement is certainly subject to debate, it seems destined to grow and will fit into our thesis in the next chapter as we look at social codes.

The Purpose of a Corporation

It is difficult to examine companies' responses to globalization without first exploring why corporations exist in the first place. There are no right answers to the question but it can be asserted that corporations are a creation of society and society did have a particular reason for corporations. In a capitalistic society, corporations exist to create and distribute economic benefit. In societies that promote competition, it is fair to say that only those corporations that are able to maximize their benefit while minimizing their resources utilized are the ones that survive.

However, irrespective of what business philosophers and economists may argue, ultimately companies serve the purpose of their owners. Certainly publicly traded companies offer far more transparency than private companies, yet in reality, one would still be hard pressed to find more than a few companies that maximize profit. Can companies with corporate jets and idyllic retreats claim to maximize profits?

Many public companies are actually controlled through two classes of stock—one that trades and one that doesn't. In the case of companies that are involved in labor problems overseas; two of the most prominent targets of activists, the Gap and Nike are both thoroughly controlled by their founder and their families. At the Gap, Donald Fisher and his

family own 31% of the outstanding shares⁸⁶. Philip Knight has even stronger control at Nike; he owns 23% of the outstanding shares and 92% of the voting stock⁸⁷. Certainly their concentrated ownership has served the financial interests of the company and their public shareholders, but they can also implement change at their companies through control in a much easier fashion than if the owners are primarily diversified financial investors. There is no risk of a hostile takeover of these companies, just the risk that the value will decrease.

Does this mean they are responsible for labor problems? Not necessarily, as like any company they have many stakeholders—it is however reasonable to say that they have wide discretion about how their companies pursue policies. Concentrated ownership interests can also be found in many other American apparel and footwear brands, including Columbia, Timberland, Kenneth Cole, Patagonia and Levi-Strauss.

Companies' Efforts and Reputational Risk

Of all the actors we have discussed so far, it is natural that companies come last. In many ways, they are the obvious choice to impose standards throughout their supply chain, yet it is only when they perceived themselves at risk that they chose to act. Like Andrew Ross's description of 'sweating', companies that purchased products overseas initially took the "we aren't responsible for our suppliers" defense. The history of their responses is essentially the history of their decision to do everything, but take ownership of the problem.

⁸⁶ Yahoo Finance. (2006). "Gap Inc. Ownership." from <http://finance.yahoo.com/q/mh?s=GPS>.

⁸⁷ Patterson, A. (2006). "Phil Knight's Not Diversified." from <http://www.fool.com/news/commentary/2006/commentary06020305.htm>.

Nike, the Gap, and every company involved in negative publicity has moved to estimate the reputational risk they have and to mitigate it. Generally, they have chosen to do this through multi-stakeholder partnerships. The rapid proliferation of non-governmental organizations (NGOs) in developing countries allows for a different perspective in source countries and companies have aligned with them to help monitor and assess labor conditions at the factory level. While these partnerships will be discussed in the next chapter, the focus here is on why haven't companies chosen to absorb manufacturing or create stronger partnerships as they might if they had a failing supplier in a developed country.

Looking at this issue a different way, developed countries do legislate to force social change. An example of this would be certain set asides for minority or woman owned businesses. Many times companies will issue long term contracts, buy preferred stock or generally set up long term incentives to encourage these companies to flourish. Yet these same companies have done nothing to encourage better behavior overseas. Why have they not done this?

As we can see previously, there is little incentive to do so directly. Companies have quantified the risk to their reputations (or brands) and determined that they can afford to be conservative in their reactions. They have sensed that consumers may care, but only to a relatively small extent; SRI investors may screen for these traits, but will only sell their stock—very few will play active governance roles and file shareholder motions; developing countries are competing for employment and will be slow to legislate and enforce standards; the ILO and WTO will be unsuccessful in reaching consensus on trade and labor linkages; the only threat is the negative publicity generated by primarily Western NGOs and labor

organizations. While some may question the true motivation of organized labor, the result is the same—at least someone is watching.

As companies moved closer to partnering with multiple stakeholders overseas because they believed it was the lowest cost way or perhaps, best way forward; they moved more aggressively in the developed world to capitalize on the growing corporate social responsibility (CSR) movement. Like GRI reporting, companies believed that greater transparency into their operations and exposure to the companies' good deeds would help give capitalism and the company a better image, "But a more fundamental question remains: what is CSR? Increasingly CSR is defined as a corporations' willingness to engage with stakeholders on the social and environmental impacts of its business and to make fundamental improvements as a result of the engagement. CSR has become the sign of good management"⁸⁸ Hannah Jones, the vice-president of corporate responsibility at Nike reinforces this definition, "We're moving away from just risk management to an understanding that corporate responsibility can contribute to the bottom line of innovation and operational efficiencies."⁸⁹

Nike's progression from worrying solely about reputational risk to trying to build capacity along the supply chain evolved from the work of MSI groups involved with 'social codes'. The question Hannah Jones' comment raises is will this be any more effective than before?

⁸⁸ Biello, D. (2005). CSR: three little letters that just might change the world. Supplement to the New York Times. New York.

⁸⁹ Ibid.

Chapter Three—Multiple Stakeholders and Social Codes

Evolution of Codes and Labels

While company codes of conduct have been in force for more than fifteen years, multi-stakeholder social code initiatives (MSIs) can be dated to 1996 and the Clinton Administration's formation of the Apparel Industry Partnership (AIP). Company codes of conduct are essentially written documents that embody many or most of the ILO core conventions on labor and incorporate better environmental and safety practices. They are voluntary in the sense that local legislation and/or enforcement may not obligate this behavior. The document becomes a commitment between the supplier and the company;⁹⁰ the supplier *voluntarily* agrees to behave according to the code and the company represents to its customers and other interested parties that its vendors are behaving likewise. We italicize *voluntarily* because most companies make acceptance of the code a precondition for receiving future orders.

In a short period of time, company codes of conduct by themselves were difficult to enforce. As we have seen previously, companies did not see any significant demand or reason for immediate change. Resultantly they determined it was in their best interest to work

⁹⁰ Social Accountability International and ITGLWF. (2006). "Codes of Conduct." Retrieved March 20, 2006, from <http://www.itglwf.org/pdf/CodesofConduct-pp33-42.pdf>.

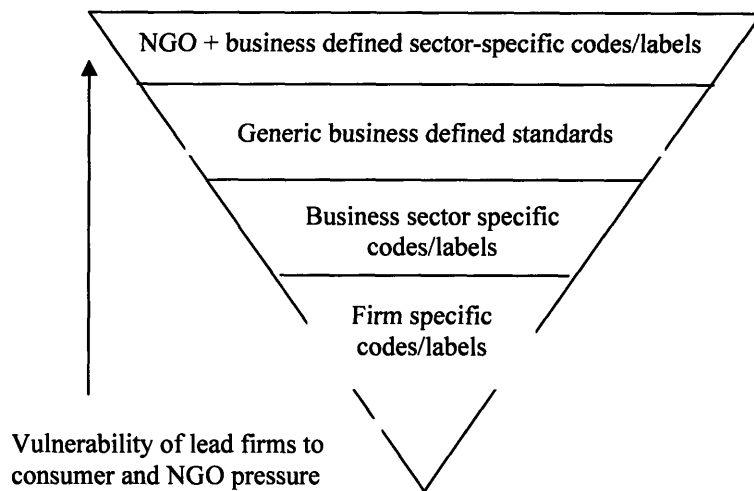
with the other stakeholders, as opposed to taking more definitive action on their own, to accomplish the objective of improved working conditions; “According to Sean Ansett, Senior Manager for Global Partnerships for Gap Inc, his company has learned through the process of trying to go it alone on implementing its code how important collaboration among companies and with stakeholders is in achieving effective implementation.”⁹¹ Effective implementation in this context refers to ensuring codes are complied with, but it may also mean that the Gap was still receiving negative publicity over its suppliers and found that working with potential adversaries may have been a better business strategy.

Khalid Nadvi and Frank Waltring in a 2002 paper have traced the development of social codes and placed them into five distinct generations.⁹² Nadvi and Waltring have diagrammed this evolution (Figure 1 following) with company codes as the origin and multi stakeholder partnerships expanding only as consumer and NGO pressures increased. As we have seen, there are not convincing arguments that consumer pressure was this strong but it is reasonable to assume a company’s perception of potential reputational risk is a valid substitute for consumer pressure.⁹³

⁹¹ Maquila Solidarity Network. (2003). "Codes Memo: Number 16." Retrieved March 20, 2006, from <http://www.maquilasolidarity.org/resources/codes/memo16.htm>.

⁹² Nadvi, K. and F. Waltring (2002). Making Sense of Global Standards. Duisberg, Gerhards-Mercator-Universitat Duisberg: 1-46.

⁹³ Ibid.



Source: Nadvi and Waltring

Figure 1 Code Development as Pressure Increases

Figure 1 portrays well the Gap’s thinking as well as many other developed country buyers. As company codes became difficult to enforce for a variety of reasons, it was natural that trade associations or industry groups would cooperate to set their own codes and enforcement provisions. Nadvi and Waltring’s five generations are delineated in Table 3 below⁹⁴ that shows sector codes as the next generation. Because legitimacy became a larger issue, new generation of codes were developed, including the International Standards Organization that developed environmental standards but stayed away from social standards.

When the Clinton Administration began to crack down on domestic labor problems and NGOs and labor groups continued to expose overseas practices, companies moved quickly to form multi stakeholder initiatives. These organizations, which are the major actors today, have promulgated the fifth-generation codes highlighted by Nadvi and Waltring and

⁹⁴ Ibid.

Table 3 Different Generations of Global Social and Environmental Standards

Generation	Examples / Contents	Actors involved	Key drivers	Influence in international trade	Certification
1st generation Company codes of conduct	e.g. Nike, Reebok, Karstadt, etc.: Self-obligations of TNCs on the firm and supplier level, internal formulation and implementation	TNCs and their suppliers	TNCs as lead firms of supply chains	Existence of a large number of firm codes, focused on some brand name companies in consumer near sectors and in buyer-driven chains	1 st party-self monitoring; setting process easy, legitimacy weak
2nd generation Business-defined sector codes and labels	ICC, Eco-tex, AVE: Sector specific Codes and labels formulated and implemented by enterprise associations	Enterprise associations, Chambers, suppliers	Enterprise associations	Sporadic, but with more comprehensive influence according to the sector approach	2 nd party monitoring through associated sector association: setting quiet easy, still weak legitimacy
3rd generation Business-defined international standards	ISO 14000: Environmental management standards (using the model of ISO 9000)	ISO, national standardization bodies, business mainly from industrialized countries	Business	Not necessary, but gets increasing influence especially in natural resource intensive sector	3 rd party monitoring thorough market based certification bodies, setting more difficult. Legitimacy high
4th generation Business & NGO defined sector-specific codes and labels	Transfair, FSC, Rugmark, etc.: NGO fostered sector specific codes and labels, formulated and implemented mainly through NGO and business partnership with independent monitoring procedures and civil society participation	NGOs, religious associations, solidarity groups, minority groups, unions, large retailers,	NGOs	Gain increasing importance according to new strategies of NGOs and retailers	3 rd party monitoring through certification bodies or NGOs (setting difficult, keeping legitimacy requires constant negotiation
5th generation Tripartite defined generic social standards	SA 8000, FLA, ETI: Tripartite social minimum standards to harmonize the diverse numbers of codes and to increase legitimacy, and transparency	social NGOs, unions, TNCs (buyers and producers), certification bodies	Public Sector NGOs	Increasing influence despite disagreements between special actors involved in forming standards	3 rd party monitoring through certification bodies

Source: Nadvi & Waltring⁹⁵

⁹⁵ Ibid.

are the primary ones that we will examine to determine their effectiveness; the exceptions being ‘Fair Trade’ , which is listed as a fourth-generation code and the most recent initiative—the Business Social Compliance Initiative (BSCI), put forth in 2003 by an industry association, the Foreign Trade Association in Brussels that could be classified as second-generation.

Brief History of the MSI Initiatives

To help in understanding the effectiveness of MSIs, we shall use the balance of this chapter to describe a brief history of five MSI’s, three American and two European. We shall also look at joint efforts to start an information clearinghouse and to standardize the varying codes. This history is critical because the founders and benefactors ultimately determine what the desired outcome of the MSI is and what incentive structure gets set up to accomplish this outcome.

Internal vs. External Monitoring

Much of what we shall see about the MSIs relates to monitoring. Internal monitoring occurs when just single source codes of conduct are issued, for example a plant or a company that issues a code will also use their own employees to monitor compliance. This happens primarily in the developed world where regulation is enforced through government efforts. Compliance penalties and/or potential litigation can be large and companies have a very high incentive to ensure compliance. Companies use codes to set the bar higher than the law, accomplishing hopefully two things: a positive goal, better performance, whether it is safety,

environmental etc. and a defensive goal, creating a precedent that can be utilized in case of compliance failure that the company was using its best efforts. In the case of social codes overseas, where there is no governmental enforcement and as the comment by the Gap points out, internal monitoring quickly became problematic.

External monitoring uses third-party monitors and has its own source of problems. These problems form a bigger part of the differences between MSIs and will be reflected in a separate table along with governance, financing, budgets and other issues in the next section. Dara O'Rourke outlines the issue, "These external monitoring systems differ in key procedures for auditing (who conducts the monitoring and how), certification (whether a factory or a brand is certified), and reporting (what is publicly disclosed)."⁹⁶

US Origin

Fair Labor Association (FLA)

The Fair Labor Association (FLA) is the oldest of the American initiatives and is the only one that is the direct result of government involvement. Given the labor pressure on the Clinton Administration on both the 'sweatshops overseas' issue and 'jobs at home' issue, the administration convened the previously described Apparel Industry Partnership (AIP) in 1996. The FLA's main purpose was to establish monitoring and verification standards for the

⁹⁶ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

codes of conduct approved by the AIP.⁹⁷ Dara O'Rourke refers to the FLA as "both the oldest and most controversial of current initiatives to establish monitoring and verification".⁹⁸

As we have seen in the previous chapter, the AIP, perhaps because it was convened by a democratic administration, was unique because it involved so many diverse players. However, the many goals of the participants could ultimately not be aligned and the FLA was accused of following industry's lead and not paying enough attention to the demands of the labor and inter-faith groups.⁹⁹

Andrew Ross writes about the AIP and the formation of the FLA, "Elaine Bernard, director of Harvard's Trade Union Studies Program, suggested that the agreements merely gave the 'good housekeeping seal of approval to a 'kinder, gentler' sweatshop.' The result was an impasse that led to the withdrawal of the labor and interfaith groups from the partnership. The AIP's monitoring arm, the FLA, was set up without their participation and immediately garnered the reputation of being a corporate front"¹⁰⁰

The FLA has responded to this criticism and has changed the way it monitors and discloses information. Presently, it externally monitors five percent of its participating companies' factories, publishes audit findings and remediation plans.¹⁰¹ O'Rourke views the FLA as advancing "market pressures by creating a supply chain policing system involving

⁹⁷ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

⁹⁸ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." The Policy Studies Journal 31(1): 1-29.

⁹⁹ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

¹⁰⁰ Ibid.

¹⁰¹ Maquila Solidarity Network. (2005). "Codes Memo: Number 19." Retrieved March 20, 2006, from <http://www.maquilasolidarity.org/resources/codes/pdf/codesmemo19.pdf>.

multiple stakeholders. This advances a kind of ‘collaborative regulation’ or ‘regulated regulation’ (Ayres and Braithwaite, 1992¹⁰²; Teubner, 1983¹⁰³) that depends on top-level commitment to the code from a brand or retailer, both internal and external monitoring of suppliers, and participation of NGOs in providing legitimacy to the system.”¹⁰⁴ The FLA presently has fifteen participating companies, including well-known brands such as Adidas-Salomon, Nike, Patagonia, Nordstrom and Reebok which agree to implement the FLA workplace code of conduct throughout their global supply chains. The FLA also has thirteen ‘Category B’ participants that agree to maintain FLA standards in factories that produce products for FLA affiliated colleges and universities.¹⁰⁵

Worker Rights Consortium (WRC)

The Worker Rights Consortium was formed in April 2000, partially as a reaction to the large industry involvement in the FLA¹⁰⁶. The USAS together with UNITE, the American Federation of Labor-Congress of Industrial Organizations (AFL-CIO) and a variety of human rights, labor and religious organizations wanted an initiative that would consider labor rights

¹⁰² Ayres, I. and J. Braithwaite (1992). Responsive Regulation: Transcending the deregulation debate. Oxford, Oxford University Press.

¹⁰³ Teubner, G. (1983). "Substantive and reflexive elements in modern law." Law and Society Review 17: 239-285.

¹⁰⁴ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." The Policy Studies Journal 31(1): 1-29.

¹⁰⁵ Fair Labor Association. (2006). "Participating Companies." Retrieved March 24, 2006, from <http://www.fairlabor.org/2005report/companies/participating/index.html>.

¹⁰⁶ Ross, A. (2004). Low pay, high profile : the global push for fair labor. New York, New Press : Distributed by W.W. Norton.

before industry rights. The WRC has found most of its traction on university campuses and essentially focuses on the collegiate licensing trade.

It was initially controversial because it mandated that all licensees must disclose factory locations. This created significant dissension between licensor and manufacturer, resulting in Nike canceling its contracts with Brown University and the University of Michigan over the issue and Phil Knight withdrawing a \$30 million gift to the University of Oregon.¹⁰⁷

Unlike the FLA, the WRC has a bottoms-up approach. It encourages workers' complaints and then uses local human right NGOs to investigate them. In this sense it hopes to build worker entitlement and create confidence that workers can monitor their own workplace.¹⁰⁸ In the WRC's own words, "The WRC's independence is a crucial asset to the organization and to affiliate colleges and universities. This independence allows the WRC to get information from workers and worker advocates about factory conditions that other monitors cannot obtain and to assist factories and licensees in communicating with workers and their representatives to resolve problems and disputes; enhances the credibility of the WRC's reports; and enables colleges and universities to report that their licensees' supply chains are subject to investigative review by an organization that operates entirely independently of the licensees."¹⁰⁹

O'Rourke addresses the potential detractions of the WRC model, "Opponents have accused the WRC of representing a 'gotcha' model of monitoring, more focused on

¹⁰⁷ Ibid.

¹⁰⁸ Ibid.

¹⁰⁹ Worker Rights Consortium. (2006). "How Does the WRC Relate to Licensee Corporations." Retrieved March 24, 2006, from http://www.workersrights.org/about_faq.asp.

identifying problems and embarrassing firms than on resolving problems.”¹¹⁰ He views this as “a ‘fire alarm’ model of regulation (McCubbins and Schwartz, 1984¹¹¹) that focuses on creating new mechanisms of accountability for both firms and government agencies by gathering information from workers and local organizations and then helping them organize to win demands.”¹¹² Presently, the WRC has 152 affiliated colleges and universities.¹¹³

WRC Designated Suppliers Program

At the end of 2005, the WRC put forth a new program, the Designated Suppliers Program (DSP), as the best way forward to enforce WRC’s code of conduct. The DSP states that DSP factories will operate at a higher level, “In addition to the respect for the standards currently embodied in university codes of conduct, these factories will be required to meet two additional standards: demonstrable respect for rights of association—as evidenced by the presence of a legitimate, representative union or other representative employee body—and the payment of a living wage.”¹¹⁴

The DSP further mandates that licensees will source 25% of their production from DSP factories the first year, 50% after two years and 75% after three years. At this point, university members will decide whether there is more value in moving to 100% production in DSP facilities or have some “production occurring outside of the sphere of the Designated

¹¹⁰ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

¹¹¹ McCubbins, M. and T. Schwartz (1984). "Congressional oversight overlooked: Police patrols versus fire alarms." *American Journal of Political Science* 28: 165-79.

¹¹² O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

¹¹³ Worker Rights Consortium. (2006). "WRC Affiliated Colleges and Universities." Retrieved March 24, 2006, from <http://www.workersrights.org/as.asp>.

¹¹⁴ United Students Against Sweatshops (2006). Designated Suppliers Program. Washington DC, USAS: 1-5.

Suppliers Program in order to maintain a broader influence on the apparel industry at large.”¹¹⁵

The advent of the DSP has caused confusion among WRC members and provoked criticism from other code initiatives. Based on concern from its members, the WRC board issued a clarifying statement in January 2006, “To clarify, the WRC Board stated support for the DSP as ‘the most effective way forward to achieve sustainable compliance’ and ‘recommended’ that affiliated colleges and universities adopt the program. This is a recommendation; it is not a mandate or requirement for affiliation with the WRC.”¹¹⁶

The FLA has also raised issues concerning the DSP’s position on freedom of association.¹¹⁷ In particular, an area of concern is China, where many of the licensed products are produced and has inconsistent laws concerning freedom of association. As the FLA has a large affiliated university program, this protest may be a strategic effort to lure new members. However, some key members of the WRC, such as Duke University, where 200 students occupied the President’s office in 1998, are happy with the direction of the DSP, “Jim Wilkerson, Duke’s director of trademark licensing, said the USAS proposal is ‘feasible and doable’ and ‘support is likely’”.¹¹⁸

Social Accountability International (SAI)

¹¹⁵ Ibid.

¹¹⁶ Worker Rights Consortium. (2006). "WRC Statement Concerning the Board's Resolution about the Designated Suppliers Program." Retrieved March 26, 2006, from http://www.workersrights.org/DSP/WRC_DSP_Statement_3-2-06.pdf.

¹¹⁷ Barenberg, M. (2006). FLA Comments on Proposed Designated Supplier Program--Freedom of Association Issues, Columbia Law School: 1-16.

¹¹⁸ Appelbaum, R. and P. Dreier (2005). Students Confront Sweatshops. *The Nation*. November 28, 2005.

SAI is a successor organization to the Council on Economic Priorities Accreditation Agency (CEPAA), which was founded in 1969. CEPAA created the SA 8000 code of conduct in 1998 modeled after the ISO 9000 code used for ensuring standard quality control practices. CEPAA changed its name in 2000 to SAI, reflecting the growing popularity of SA 8000.¹¹⁹

SA 8000, the code under which Devaraj is certified, is administered by a board made up of labor, industry and NGOs. SA 8000 is a process-based system and is supposedly self-selecting, though many companies mandate its use by suppliers. Like the ISO 9000, factories are certified and not brands or companies. It requires that factories pay a 'living or basic needs wage', a definition that is still the subject of much discussion. As evidenced by Devaraj's decision, SAI hopes that factories will willingly choose to be certified in the hope that developed world buyers will be attracted to them.¹²⁰

Like the other standards, SAI has its critics that state that an audit based on one day a year visit is hardly comprehensive.¹²¹ Many member companies cite SA 8000 as an excellent example because it is an enabling system; managers must take responsibility for their own factories and by extensive training will build capacity among the staff. We shall discuss this further in the next section.

O'Rourke calls SAI an example of 'privatized regulation', "These initiatives certify that management systems are in place to guarantee acceptable performance in individual factories...SAI tap into the motivations of individual factories seeking to connect into

¹¹⁹ NEIS Original Ink. (2001). "Who's Who in Codes of Conduct." Retrieved March 19, 2006, from <http://www.newecon.org/CodesofConduct1-02-01.html>.

¹²⁰ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

¹²¹ Ibid.

socially concerned (and presumably high-value) buyers, as factories are audited only if they ask (and pay) for the evaluation. These systems involve an advanced form of ‘privatized regulation’ (Knill and Lehmkuhl, 2002¹²²; Utting, 2002¹²³).”¹²⁴

SAI does not use NGOs to certify factories, but rather refers interested parties to testing services such as those used for ISO certifications. These testing services, such as UL or TUV, issue the certificates based on SAI’s authorization. SAI claims that “SA8000 is widely accepted as the most viable and comprehensive international ethical workplace management system available.”¹²⁵ SAI members include companies such as the GAP, Chiquita Brands, and Timberland, labor unions that represent 15 million workers and NGO’s such as Amnesty International and CARE. Presently SAI has 710 certified factories in forty-seven countries of which Italy accounts for 233 or 30% of the total. India is next with 104, China 99 and Brazil 73. These four countries account for 72% of the total factory certifications.¹²⁶

¹²² Knill, C. and D. Lehmkuhl (2002). "Private actors and the state: Internationalization and changing patterns of governance." *Governance* 15(1): 44-63.

¹²³ Utting, P. (2002). Regulating business via multistakeholder initiatives: A preliminary assessment. *Voluntary Approaches to Corporate Responsibility*. P. Utting. Geneva, United Nations Non-Governmental Liason Service: 61-130.

¹²⁴ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

¹²⁵ Social Accountability International. (2006). "About Us." Retrieved March 25, 2006, from <http://www.sa-intl.org/index.cfm?fuseaction=Page.viewPage&pageId=472>.

¹²⁶ Ibid.

EU Origin

Ethical Trading Initiative (ETI)

A visit to ETI's offices close to the financial center of London can help illustrate the tremendous leverage small organizations can exert. Founded in 1998 with government funding, ETI presently has a budget of about \$1.8 million, of which 40% is a UK government grant and 60% is paid by members, consisting of companies, labor unions and NGOs.

The offices, located on the second floor of a small walk-up building in a pedestrian way close to Gray's Inn are not something one would expect of an organization whose members represent \$180 billion in annual purchases. ETI has a 'base code' similar to the other code issuing organizations (see Appendix I); expects its members to implement the code along their supply chain but does not monitor, audit or certify their compliance.

Dan Rees, director of ETI, describes their mission as "developing good practices and building capacity along the supply chain."¹²⁷ Similar to the GRI, members are expected annually to report their compliance with the ETI base code, as well as their non-compliance challenges. ETI puts on conferences and seminars where the stakeholders, including suppliers in the developing countries attend, with the goal of furthering best practices. They run pilot programs in partnership with their members in multiple countries and pass on the results to their members. Unlike most of the other MSI's, they also work on problems in the developed world. They were instrumental in getting legislation to license temporary labor providers in the UK (what the British descriptively refer to as 'gangmasters').¹²⁸

¹²⁷ Rees, D. (2006). Interview with Dan Rees, Director ETI. London.

¹²⁸ ETI (2004). Ethical Trade Initiative 2003/2004 Annual Report. London, Ethical Trade Initiative.

ETI prints an extensive library of reports and has commissioned a study into supply chain conflicts that documents specific inconsistent practices of developed world buyers.¹²⁹ ETI has earned credibility with its various stakeholders because it is a learning and teaching organization; it makes no representation that its member companies comply but implies that there is a reasonable level of trust in their discussions with members to move an ethical trading agenda along. They are instrumental in formulating joint standards, which will be discussed later.

Critics find transparency lacking at ETI and contend that any non-compliance should be reported to the general public and not to just member organizations.¹³⁰ They also charge that ETI will be left behind because of its lack of enforceable standards, "The strength of the ETI's experimental "learning by doing" approach has been its ability to explore alternative methods of monitoring and remediation at a time when there are no easy answers to the code implementation dilemma. At the same time, ETI's seeming inability to move beyond the learning stage could ultimately lead to self-regulation by better educated companies, in the absence of any permanent institutional enforcement mechanisms."¹³¹

Presently ETI has thirty seven corporate members including Inditex (Zara), the GAP, Sainsbury's, Tesco and Marks and Spencer; its union members include the International

¹²⁹ Acona (2004). *Buying your way into trouble*. London, Acona Limited
Insight Investment: 1-38.

¹³⁰ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

¹³¹ Maquila Solidarity Network. (2003). "Codes Memo: Number 13." Retrieved March 25, 2006, from <http://www.maquilasolidarity.org/resources/codes/memo13.htm>.

Textile, Garment and Leather Workers' Federation and International Confederation of Free Trade Unions; its NGO members include Oxfam and Christian Aid.¹³²

Business Social Compliance Initiative (BSCI)

BSCI is the most recent initiative for codes of conduct and as mentioned previously is a reversion to a sector initiative. BSCI is not a tripartite (company, labor and NGO) organization like SAI and ETI, nor a bipartite organization like FLA or the WRC; it is solely an industry initiative. Its objective is to get member's suppliers up to SA 8000 standards or equivalent 'best practice'.¹³³ Auditing is done by SAI's accredited auditors.

BSCI has developed a database of suppliers and audit findings and shares this with its members only. A BSCI member, Heinz-Dieter Koeppel comments on the expense of SAI certification and the reason for BSCI, "The most important reason for creating BSCI was to avoid multiple auditing and because we believe a sectoral approach is the only way to bring about sustainability and rapid change."¹³⁴

Critics of BSCI have commented on their industry focus and have pointed out that industry is again afraid to deal with other stakeholders such as labor and NGOs. Dan Rees of ETI thinks it is good that companies can share supplier data but is afraid that BSCI may

¹³² Ethical Trade Initiative. (2006). "Members of the Ethical Trading Initiative." Retrieved March 25, 2006, from <http://www.ethicaltrade.org/Z/abteti/who/memb/list.shtml#ngo>.

¹³³ BSCI. (2006). "Business Social Compliance Initiative--An Initiative of the Foreign Trade Association." Retrieved March 25, 2006, from <http://www.bsci-eu.org/content.php?page=BsciMonitoring>.

¹³⁴ Maquila Solidarity Network. (2005). "Codes Memo: Number 19." Retrieved March 20, 2006, from <http://www.maquilasolidarity.org/resources/codes/pdf/codesmemo19.pdf>.

become the lowest common denominator for enforcing codes of conduct.¹³⁵ Another comment by Koeppel strengthens this fear, “as the name—Business Social Compliance Initiative—indicates, we are business driven.”¹³⁶

Maquila Solidarity Network, a Canadian NGO which reports regularly on developments in codes of conduct sums up BSCI, “In many respects, the BSCI represents a step forward for large European retailers. It commits member companies to a common code of conduct that is largely based on ILO conventions. It also facilitates sharing of information on audit findings among retailers, thereby limiting duplication of factory audits. However, the BSCI is clearly an industry-controlled, self-regulatory initiative, and one that offers little access to information or influence to workers or other stakeholders.”¹³⁷ There are fifty-four members of BSCI including most of the large European retailers, such as Otto, Inditex, C & A, Karstadt and de Bijenkorf.¹³⁸ It is noticeable for its lack of large French retailers.

Information Clearinghouses

Fair Factories Clearinghouse (FFC)

Reebok, in conjunction with the trade group, the National Retail Federation, and large department stores such as Federated Merchandising Group and the Hudson Bay Company,

¹³⁵ Rees, D. (2006). Interview with Dan Rees, Director ETI. London.

¹³⁶ Maquila Solidarity Network. (2005). "Codes Memo: Number 19." Retrieved March 20, 2006, from <http://www.maquilasolidarity.org/resources/codes/pdf/codesmemo19.pdf>.

¹³⁷ Ibid.

¹³⁸ BSCI. (2006). "Business Social Compliance Initiative--An Initiative of the Foreign Trade Association." Retrieved March 25, 2006, from <http://www.bsci-eu.org/content.php?page=BsciMonitoring>.

have formed the FFC to act as a clearinghouse for social audit information.¹³⁹ It is similar to the industry movement that formed BSCI in the sense that retailers and brands were frustrated by the duplication of efforts to audit factories. Like BSCI, information sharing is entirely voluntary and no proprietary information will be released to the general public.

According to the FFC, “The objectives of the FFC are to:

- Improve the availability, comprehensiveness and standardization of factory social compliance audits through the use of a global data management system to track workplace conditions.
- Facilitate the exchange of information concerning factory social compliance audits from internal and external reports without requiring adherence to a particular social compliance audit standard.
- Eliminate the duplication of audits through the sharing of social compliance information.
- Advance and promote education and knowledge about the current status of workplace conditions and steps that companies can take to improve workplace conditions.”¹⁴⁰

The FFC aims to accomplish its objectives in two phases; phase one will allow companies to use the FFC database software to monitor their compliance activities and phase two will allow for the voluntary sharing of proprietary information. A benefit of

¹³⁹ Fair Factories Clearinghouse. (2006). "Governance." Retrieved March 26, 2006, from <http://www.fairfactories.org/governance.htm>.

¹⁴⁰ Fair Factories Clearinghouse. (2006). "About." Retrieved March 26, 2006, from <http://www.fairfactories.org/about.htm>.

the clearinghouse is to allow companies to find better conforming suppliers and to notify other participants of compliance issues with existing suppliers.

Initiatives to Social Code Standardization

Joint Initiative on Corporate Accountability and Workers' Rights (Jo-In)

As companies continue to take their own efforts to share information, the MSIs have also moved to do the same. In the spring of 2003, the ETI joined with three other previously described MSIs, the FLA, SAI and the WRC along with two other European MSIs, the Clean Clothes Consortium (CCC) and Fair Wear Foundation (FWF) to form the 'Joint Initiative on Corporate Accountability and Workers' Rights' or 'Jo-In'.

The members of Jo-In reached a consensus on a common code of labor practice in 2005 that will be used in pilot project in Turkey.¹⁴¹ The draft Jo-In code along with the other MSI positions is presented as a table in Appendix I. The objective of the trial project, according to Jo-In is:

1. "To maximize the effectiveness and the impact of the multi-stakeholder organizations by ensuring that resources are directed as efficiently as possible to improving the lives of workers and their families.
2. To explore possibilities for closer cooperation between the multi-stakeholder organizations and ensure that resources are directed as efficiently as possible through shared learning.

¹⁴¹ Maquila Solidarity Network. (2005). "Codes Memo: Number 19." Retrieved March 20, 2006, from <http://www.maquilasolidarity.org/resources/codes/pdf/codesmemo19.pdf>.

3. To assess in what manner voluntary codes of labour practice and various approaches to their implementation can best contribute to better workplace conditions.”¹⁴²

The biggest challenge facing Jo-In is reconciling the various approaches each MSI has to actually implementing the codes of conduct. The ETI has been instrumental in getting Jo-In this far because it is viewed as a learning organization; the challenges are ahead as implementation is actually the heart of the matter.

¹⁴² Joint Initiative on Corporate Accountability and Workers' Rights (2005). Project Design, Joint Initiative on Corporate Accountability and Workers' Rights: 1-8.

Chapter Four—Efficacy and Incentives of Codes and Labels

Devaraj and SA 8000

Before we look at the efficacy of the multi-stakeholder initiatives, let us return to Devaraj and his decision to become SA 8000 certified. As we have seen in the design of SA 8000, it is very similar to the process for the ISO quality certifications. Devaraj had received his ISO 9001 in 1999 and ISO 14001 in 2002; he believed it was a logical step to apply for the SA 8000 certification. He used the same certification body as he did for the quality certifications and it took him eight months to be certified receiving his SA 8000 in 2003.

As we had previously mentioned, Devaraj believed that the SA 8000 would allow him to appear credible in the eyes of potential American and European buyers; he did not believe it would make a difference to his existing customers. He has been monitored for social codes by his existing buyers since 2000 and by 3 different firms; all related to the buyers' agents in India. He has not had any compliance issues. As part of his SA 8000 certification, he did have to make one concession; he placed an additional 2% of his direct employees pay into a Provident Fund to meet the SA 8000 'basic need' standard.

To diversify his dependence on fiber and labor from Kerala, Devaraj opened a facility in the adjoining state of Tamil Nadu. He primarily makes geo-textiles for his Japanese customer here and the facility is not SA 8000 certified. Yet he has excellent labor relations, his employees are paid a living wage and he believes he produces better products in his Tamil factory. He ascribes most of this success to his relationship with his Japanese

customer. Moreover, he contrasts this relationship with those of his Western customers that demand SA 8000 certification in his Kerala plant.

In his geo-textile business, Devaraj has what he calls a “mutual dependency” relationship with his supplier.¹⁴³ He is the Japanese company’s major supplier who is trusted with the buyer’s intellectual property and in turn he agrees to not sell another Japanese importer. He licenses all the Japanese patents at no cost and the Japanese regularly train his employees spending weeks if necessary. The Japanese test all of his products; paying for their cost and sharing all of the test reports without threatening to take away the business.

Devaraj has a three year exclusive contract with the Japanese buyer. Based on this, he expands his plant, trains his workers, invests in new equipment and develops new products knowing that he has an economic reason to do so. The Japanese pay him when he ships his merchandise and have offered to help finance development efforts. He receives constant sales updates from his buyer and while they are not real-time, they are sufficient for Devaraj to plan his workload and raw material purchasing appropriately. He feels comfortably asking for projections and knows that his buyer will inform him if sales projections vary.

Contrasted with the Japanese company, Devaraj states his Western buyers offer no contract, no sales information, no exclusivity and short-notice order changes. Devaraj states that he uses his own employees in Tamil Nadu for the Japanese customer because he can plan his production schedule. In Kerala, he uses the cottage markets as much as he can to meet the demands of his SA 8000-requiring customers. He prefers not to do this and while he states it

¹⁴³ Devaraj (2006). Personal Interviews With Devaraj, Jan-Feb 2006. Hannover, Boston.

is not to avoid audits, he does say that the SA 8000 auditors let him pick two out of the fifty subcontractors he uses for its audit purposes.¹⁴⁴

Devaraj views his Japanese buyers as a partner and his European and American buyers as customers. The Japanese buyers work hard to build trust; the others work equally hard to create uncertainty. In Devaraj's mind, his goal is to minimize uncertainty. Having a business in a developing country creates enough uncertainty; he doesn't want more from his customers. Absent the 2% pay to the Provident fund, he feels his uncertified Tamil plant employees perform as well, if not better than his certified Kerala ones and are perhaps even happier. He further states that if he could have the same kind of transparency he has with his Japanese buyer, he would be happy to install a profit-sharing plan or higher compensation in Kerala, in place of SA 8000 requirements.¹⁴⁵

How effective are Codes and Labels?

Based on Devaraj's example, it is easy to say that the social codes may not be as effective as desired. Yet, the multi-stakeholder initiatives have helped to make codes of conduct a significant issue in the sourcing community. Certainly, thousands of workers have improved their lives because of the work of the MSIs. The challenge in this area is that much of the data is anecdotal, like Devaraj's. There is no methodology and no significant research that quantitatively documents the success of MSIs.

¹⁴⁴ Ibid.

¹⁴⁵ Ibid.

Given the lack of clear data, one way to examine the effectiveness of the MSIs is to judge by what the stakeholders are saying. Neil Kearney, General Secretary of the ITGLWF, in a 2003 speech, states, “A decade later and the situation has been transformed. A recent report suggested that there are now more than 10,000 corporate codes of conduct in existence. Some are good, the vast majority not worth the paper they are written on. Manufacturers, retailers, brand names, almost every type of enterprise have scrambled to put in place an umbrella of security in the form of a corporate code of conduct. A great many of these are general in nature and meaningless in practice, in reality a public relations exercise and very frequently a fig leaf for continued exploitation...The use of corporate codes of conduct, including multi-stakeholder codes is often haphazard and half-hearted. Far too many companies appear to see codes merely as a test that has to be passed. Thus all effort goes into convincing the auditors to issue a certificate and these efforts exhaust the company’s ability to continue improvement after the certificate has been granted. True, there probably have been some improvements in the application of health and safety standards and there well may have been a reduction in child labor in certified plants.”¹⁴⁶

Kearney continues, addressing specifically the issue of effectiveness, “In reality, nearly a decade of work in applying corporate codes of conduct has produced very limited improvements in working conditions in the textile, clothing and footwear industries. This must pose the question as to whether the effort being expended on voluntary initiatives is worthwhile and whether the emphasis should now switch elsewhere.”¹⁴⁷

¹⁴⁶ Kearney, N. (2003). Codes of Conduct: Clean-up or Cover-up? International Conference on European Social Regulation, Paris.

¹⁴⁷ Ibid.

Johannes Merck, Vice-President of the \$18 Billion Otto Group, in a talk to the SAI 2005 conference addresses the same issue, “Having one’s own internal monitoring system is fine. However, it’s not especially effective either...As a result we had suppliers reporting that they had to deal with more than 50 audits a year—audits that their customers—in other words companies like Otto—had carried out. Just imagine the amount of time and money that was wasted—quite apart from the loss of goodwill...Audits create transparency. However, they change little...Unfortunately, even though we have successfully combined our buying potential, we frequently find that many suppliers do not really work at implementing the corrective action plans between audits. Average improvement rates of 30% are clearly insufficient. Without expert support, smaller businesses in particular are often unable to meet the requirements at all...”¹⁴⁸ Merck, in the same speech, did discuss how working with SAI increased “social compliance” to 65% of suppliers upon re-audit. These results highlight the challenges of codes—65% compliance after training and upon a one day audit; like most of the data, it is sparse and there is no mention of duration, improved productivity, higher profitability or most measures one would expect from improved labor conditions.

Finally, reinforcing the tensions inherent in ‘voluntary multi-stakeholder initiatives’, Merck states, “For this reason, we will need more cooperation. In this regard, I would make the following point. It would be helpful if the NGOs would target above all those who do nothing at all in the field of social standards or ‘free riders’. A company such as Otto and many others are represented here today needs critical voices. This is absolutely clear! But we

¹⁴⁸ Merck, J. (2005). Speech at SAI Conference. Social Accountability International September 2005 Conference, New York, N.Y.

also need positive support from the public.”¹⁴⁹ It appears that Otto would like other drivers to facilitate social standards, such as consumers, but is also getting tired of the NGOs pointing out their shortcomings.

The Financial Times in a November 2005 article sees it the same way—companies must preserve their reputation, “Faced with increasingly complex risks in their global supply chains, some of the world’s largest companies are seeking strength in numbers. Industries from electronics to chocolate-making and toys to jewellery are learning to collaborate on labour and environmental standards, hoping to minimize the risks to their reputation. ‘There is safety in numbers’, says David Logan, a consultant who has advised Gap, Marks and Spencer, Cadbury Schweppes and other companies on child labour issues and socially responsible sourcing. ‘It deflects the attacks on singular brands. By pooling experience, companies start to get on the front foot instead of being on the back foot’”¹⁵⁰

After ten years of work, there is still a large learning curve going on with MSIs and much of it, from the companies’ perspective is still based on limiting risk. Why are companies like Otto not getting the credit they seek for their efforts? Is there a point when companies will no longer worry about their reputation and what is it?

On the first question, Alex Nicholls and Charlotte Opal answer it indirectly by talking about the challenges Nike faces, “Indeed a lack of power and information has been a common defence in corporate supply chain scandals: Nike’s main defence when exposed as a buyer of sweatshop-produced goods was that this criticism be directed at the manufacturers

¹⁴⁹ Ibid.

¹⁵⁰ Maitland, A. (2005). Industries seek safety in numbers. Financial Times. London. FT Responsible Business- November 28, 2005

of the goods rather than Nike as the corporate buyer. The fact that consumers remained unimpressed by such an argument is significant as it rests on a perception of Nike's power and information very different from that presented by the company itself."¹⁵¹ As we have seen, consumers are more likely to penalize companies than reward them. The information and transparency Nicholls and Opal refer to are the same transparency arguments MSIs are grappling with today. Yet, will there ever be enough information or is that a false goal?

Peter Utting of the United Nations Research Institute for Social Development (UNRISD), in addressing the role of MSIs at a speech at a conference in Brussels in November 2005, talks to the additional problems of scale and legitimacy. On scale, he shows the following table and states that, "The fourth problem (sic) relates to scale. There is so much talk about CSR that we sometimes get the impression that most of the business or corporate community is participating actively in this agenda. This is far from being the case. When looking at the figures, we need to bear in mind that there are about 70,000 TNCs, 700,000 TNC affiliates, and millions of small and medium sized enterprises supplying TNCs and large northern retailers.

Approximately 4,000-5,000 companies are thought to produce company reports. About 700 companies claim to use some of the GRI guidelines, and only 68 claim to use them systematically. By far the largest certification initiative in the CSR arena, ISO 14001 certification for environmental management, has been adopted by 90,000 entities. SA8000

¹⁵¹ Nicholls, A. and C. Opal (2005). Fair Trade: Market Driven Ethical Consumption. Thousand Oaks, CA, Sage Publications.

certification related to labour standards has been adopted by 700. Other data are provided in the table.”¹⁵²

Table 4 Utting--Number of Companies Utilizing MSI Codes

TOTAL TNCs = 69,727 TNC AFFILIATES = 690,391 ^a

SUPPLIERS OF TNCs and NORTHERN RETAILERS = SEVERAL MILLION ^b

Multi-stakeholder Initiative	Entities	As of
ISO 14001 Certification	90,569 ^c	December 2004
Global Reporting Initiative		
- using GRI guidelines	707	August 2005
- in accordance with GRI guidelines ^c	68	August 2005
United Nations Global Compact	2339 ^e	Nov 2005
Forest Stewardship Council	731 ^f	July 2005
Marine Stewardship Council	12 ^g	March 2005
Partnerships for Sustainable Development	308 ^h	August 2005
SA 8000	710 ⁱ	Sept 2005
Ethical Trading Initiative	38 ^j	Dec 2004
Fair Labor Association	16	Nov 2005

- a. UNCTAD World Investment Report 2005.
- b. In the garments industry alone, there are estimated to be 250,000 export factories worldwide (AccountAbility et al., 2005).
- c. Refers to certified entities, some of which may not be companies.
- d. This category implies a higher level of commitment to the initiative’s norms and guidelines.
- e. Refers to participating companies, of which 98 are in Fortune’s Global 500.
- f. Forest management and chain of custody certificates.
- g. Certified fisheries. Another 17 fisheries are currently undergoing full assessment and 40 are engaged in the programme.
- h. Partnerships registered on the CSD Database.
- i. Refers to facilities.
- j. Also includes the Ethical Tea Partnership, an association that comprises 18 tea packers.

Source: Peter Utting¹⁵³

¹⁵² Utting, P. (2005). Responsible Sourcing: Improving Global Supply Chains Managemet. European Commission DG Employment, Brussels, Belgium.

¹⁵³ Ibid.

On Merck's second question, he surmises that even if the MSIs are successful, it raises a whole different issue, "This brings us to the question of the legitimacy of non-governmental organizations or multi-stakeholder initiatives which may marginalize the participation of certain stakeholders, not only from developing countries but also trade unions, in their decision-making and governance structures; and that, unlike trade unions, do not have a membership base. There is also the concern that largely unaccountable non-governmental or private organizations are encroaching in the public arena of standard setting and governance."¹⁵⁴

Perhaps Merck should be asking different questions. Voluntary initiatives occur because there is a perceived void in society. In the case of social codes, the void is clear lack of legislation, regulation and enforcement that exist in developing countries. O'Rourke refers to "outsourcing regulation".¹⁵⁵ Would Merck be better off asking when will countries take responsibility for regulating and enforcing working conditions or 'insourcing regulation'? Can voluntary social codes and their sponsor be termed successful once this occurs?

Certainly, MSIs should be proud of all they have accomplished. Yet companies need to ask themselves if there is something else they should be doing in addition to the work of the MSIs that will bring regulation back to where it belongs. We argue that there is and that companies need to be doing more, not only because it will help improve labor conditions, but more importantly, because their business models will be threatened by the changes we referred to in Chapter One. Business has a unique opportunity to do good by doing well, as opposed to the proverbial 'doing well by doing good'. We shall begin to examine this

¹⁵⁴ Ibid.

¹⁵⁵ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

opportunity by looking at the incentives set up under the MSIs. However first, we will have a brief look at another voluntary initiative, Fair Trade, so that we can compare their incentives with the social code MSIs.

‘Fair Trade’ and Market Access

As we have seen so far, all of the multi-stakeholder initiatives are voluntary; in the absence of governmental regulation and enforcement, consumer demand, investors’ interest and companies’ direct and specific actions, MSIs are serving to help impose positive change upon the workplace. Fair Trade is one initiative with a similar objective that can make a legitimate claim to being consumer-led and hence market driven.

We had originally considered examining other initiatives, particularly sustainability ones such as the Forest Stewardship Council and the Marine Stewardship Council, which also work through labeling and consumer demand. However, we found that the Fair Trade movement may be more comparable in the sense that in addition to market access and profit appropriation issues, it works to build capacity in developing countries.

Fair Trade started as a movement to help Eastern European economies recover from the devastating effects of World War II. The Oxford Committee for Famine Relief (Oxfam) was originally set up in 1942 to help get food and medical supplies through blockades in Greece. After the war was over, Oxfam “enlarged its objectives to include the ‘relief of suffering in consequence of the war’”¹⁵⁶ During the 1960’s, Oxfam expanded their operating territory to include developing countries. During this period Oxfam opened retail shops

¹⁵⁶ Nicholls, A. and C. Opal (2005). Fair Trade: Market Driven Ethical Consumption. Thousand Oaks, CA, Sage Publications.

throughout the United Kingdom that were staffed by volunteers and sold handicrafts from projects they were funding in the developing countries. Presently Oxfam has 750 retail shops staffed by 22,000 volunteers in the UK.¹⁵⁷

In 1991, Oxfam founded CaféDirect, a coffee importer that bought directly from small producers and co-operatives and in 1992 helped set up the Fairtrade Foundation, which controls the use of the 'Fair Trade' mark in the UK.¹⁵⁸ Though Oxfam had a much higher profile, the Fair Trade mark was actually created in 1988 by the Max Havelaar Foundation, a Dutch organization that championed the rights of Javanese coffee farmers.¹⁵⁹

Contrary to the social code initiatives, Fair Trade is based on labeling. There are still multiple Fair Trade organizations, though the most widely known and accepted is the Fair Trade Labeling Organization (FLO) which pools certification and marketing resources for the developed world. TransFair USA is the US member of the FLO and monitors US importers, manufacturers and distributors.¹⁶⁰ Interestingly, Fair Trade has moved away from its handicrafts and textile roots and into the commodities trade. Mainly, this is because the FLO has been unable to certify its 'fair trade' origins and given its limited resources, it has chosen industries that are easier to certify.¹⁶¹

¹⁵⁷ Oxfam. (2006). "History of Oxfam." Retrieved March 26, 2006, from http://www.oxfam.org.uk/about_us/history/history4.htm.

¹⁵⁸ Ibid.

¹⁵⁹ Nicholls, A. and C. Opal (2005). Fair Trade: Market Driven Ethical Consumption. Thousand Oaks, CA, Sage Publications.

¹⁶⁰ TransFair USA. (2006). "What is Fair Trade Certification." Retrieved March 26, 2006, from <http://www.transfairusa.org/content/about/certification.php>.

¹⁶¹ Nicholls, A. and C. Opal (2005). Fair Trade: Market Driven Ethical Consumption. Thousand Oaks, CA, Sage Publications.

As stated by Alex Nicholls and Charlotte Opal, “Fair Trade has three interlinked aims: to alleviate extreme poverty through trade; to empower smallholder farmers and farm workers to use trade relationships as a means of enhancing their social capital, and to support the wider campaign for global trade reform and trade justice. Crucially, Fair Trade addresses these objectives through a market-driven commercial model, rather than by charity or a developmental aid mechanism. This approach is ultimately more sustainable and empowers producers to develop livelihoods that avoid dependency.”¹⁶²

Fair Trade hopes to accomplish these objectives through four “basic principles:

- Direct purchasing from producers
- Transparent and long-term trading partnerships
- Agreed minimum prices
- Focus on development and technical assistance via the payment to suppliers of an agreed social premium”¹⁶³

A big component of Fair Trade’s business model is disintermediation; in essence it seeks to cut out the middleman. In the case of most commodities, this is the local wholesaler/exporter that buys from the small plantations and then exports the product overseas. Fair Trade recognizes that small producers face such challenges as market access, market information including pricing and quality, access to credits and financial markets, weak domestic institutions and high switching costs in the face of poor market information. They encourage producers that are not capable of standing alone to join or form cooperatives.

¹⁶² Ibid.

¹⁶³ Ibid.

Once a producer cooperative or estate is chosen, Fair Trade importers are obligated to encourage the economic growth of the producer in three ways: they should enter into a contract of at least 6 months to a year, agree to pay a 'floor price' for the commodity where the floor price is defined as the cost of production + cost of living + cost of complying with Fair Trade standards or market price (whichever is higher); finally importers must also pay a 'social premium' on top of the floor or market price. The social premium is to be spent by the grower community on social development projects.¹⁶⁴ Fair Trade importers also may pay for products ahead of shipment, if requested to by the growers.

Critics contend that the Fair Trade movement is getting appropriated by the large retailers. Supermarkets such as Tesco and Whole Foods and specialists like Starbucks sell a large amount of Fair Trade product at a significant price premium. While they pay producers the floor price, they do not share any of the price premiums they receive. Supporters contend that this is okay because the producers are benefiting, but the ethical specialists that supported the growth of the Fair Trade movement are beginning to feel marginalized and are pushing for Fair Trade remaining with smaller retailers.

Fair Trade products have enjoyed reasonable market acceptance. Sales of all Fair Trade labeled products reached \$900M in 2003 and are projected to reach \$1.8B in 2007.¹⁶⁵

What is the Incentive Design?

¹⁶⁴ Ibid.

¹⁶⁵ Ibid.

In the following section, we will examine the incentives that these voluntary initiatives create. We will accomplish this with the help of a series of five tables. Table 5 gives an overview of the initiatives; it covers the main institutional areas that can be indicative of the MSIs incentive setup. Tables 6, 7 and 8 examine the incentives as they relate to different components of the MSIs' social codes and how these incentives affect the buyer-supplier relationship. Table 9 shows how the present incentive structure reinforces the tensions we identified in the first chapter.

In the next chapter, we will use this information to show that though the MSIs are well intended, they do not create enough incentives to be successful in achieving their desired results. Finally we will conclude with what needs to change in order to have a better outcome.

MSI's and Institutional Structure

Table 5 highlights that all of these organizations work with extremely limited budgets. It is to their credit that they are able to have the impact they do. The small budgets alone signify the low level of interest the industry players have. Taken as a total and discounting for government grants and BSCI, for which we have no figures, the total annual industry investment in the code organizations is \$4.6M. Certainly these investments are magnified by industry's own investment in 3rd party monitoring and self-monitoring, yet they are still extremely small.

Though they have representation on the boards, there is no senior management represented among the members. The industry representatives generally have titles such as

social compliance manger or vice-president, social responsibility. Given the potential modeling effects these organizations could have, these two areas alone show that industry's priority is not necessarily here.

Table 5 MSIs' Institutional Structures

	FLA	SAI	WRC	ETI	BSCI	Fair Trade (FLO)
Governance	16 member board consisting of 6 industry reps, 6 NGOs, 3 university reps, 1 independent chairperson	7 member board consisting of 1 counsel, 1 staff, 1 member of advisory board, 2 NGOs and 2 independent	15 member board consisting of 5 university reps, 5 independent labor experts, 5 USAS reps	10 member board, consisting of 3 industry reps, 3 labor, 3 NGO reps and 1 independent chair	N/A but assumed to be industry and trade associations that form FTA	11 member board consisting of 5 Fair Trade labeling organizations, 4 producers, 1 NGO and 1 industry
Budget and Financing (\$)	2004-\$1.8M of which \$1.4M member fees and \$400K IEM fees	2004-\$2.1M of which \$1.1M service revenue, \$700K government grant, \$200K donation, \$100K misc	2004-\$950K of which \$550K government grants and 400K fees	2004-\$1.8M of which \$800K from UK government, \$900K from member and \$100K conferences	N/A	2004- \$2.1M of which \$1.1 from labeling orgs and \$1.1M from external grants
Monitoring	Yes; companies must use internal monitoring and external monitoring, allowing for external auditors to inspect at least 30% of factories over 3 years. FLA chooses factories for inspections	Factories self-select for certification, which is performed by outside auditor. Must be recertified every 2 years. Factories choose sub-contractors for inspection	Inspects based upon complaints from workforce or local NGO, will also inspect factories with no prior experience and has significant collegiate apparel business	Self-monitoring, members need to report annually on compliance with ETI base code	Encourages compliance with SA 8000	Yes; FLO inspects growers and also conducts audits to ensure floor prices are met

	FLA	SAI	WRC	ETI	BSCI	Fair Trade (FLO)
Certification or Labeling	No	No	No, but starting DSP program to encourage using certified factories	No	No	Yes
Incentive to Buyer	Lowers reputational risk	Lowers reputational risk	Lowers reputational risk	Lowers reputational risk	Lowers reputational risk	Allows for Pricing Premium
Disincentive to Buyer	None	None	None	None	None	None
Incentives to Supplier	Keeps business See table for further rewards below	Keeps business There is some capacity-building as management is responsible for SA 8000 process	Keeps business Though DSP may lead to more business if accepted by licensors	None. Capacity building through pilot projects and conferences.	Similar to SAI	Floor Price, Social Premium, Long Term Contract etc. See Table below
Disincentives to Supplier	Lose business	Lose business	Lose business	Lose business	Lose business	Lose business
Incentive to Labor	Better working conditions along ILO code	Better working conditions along ILO code, living wage, some training	Better working conditions along ILO code	Better working conditions along ILO code	Better working conditions along ILO code	Better working conditions along ILO code, higher wages, training, social premium for community
Disincentives to Labor	Creates tension with employer, because of high stakes	Creates tension with employer, because of high stakes	Creates tension with employer, because of high stakes	Creates tension with employer, because of high stakes	Creates tension with employer, because of high stakes	None
Measure of Effectiveness	% of factories complying with audit	Number of certification holders	Number of factories on DSP list	None, learning organization	None	Sales
Transparency	Restricted	Restricted	Public	Public	Restricted	Public/Restricted

Sources: Organizational Websites, Dara O'Rourke¹⁶⁶, Nicholls et al¹⁶⁷

¹⁶⁶ O'Rourke, D. (2003). "Outsourcing Regulation: Analyzing Nongovernmental Systems of Labor Standards and Monitoring." *The Policy Studies Journal* 31(1): 1-29.

¹⁶⁷ Nicholls, A. and C. Opal (2005). *Fair Trade: Market Driven Ethical Consumption*. Thousand Oaks, CA, Sage Publications.

Like many non-profits, most of the incentives can be traced to their funding sources and even the WRC, with no industry funding, is still subject to the direction of its university benefactors, witnessed by the clarification of DSP responsibilities. Likewise, given that the objective of all of the codes, with the exception of ETI, is compliance, the only reward is to the industry benefactors, namely reducing their own reputational risk. Though most code organizations are moving towards capacity building, there is no inherent reward structure built into the code compliance structure for suppliers. The only disincentive is to the supplier, which is loss of business. Again, the industry has no disincentive and even in the face of adverse publicity can claim that they are using best efforts as demonstrated by their commitment to their respective MSI.

Incentive Alignment in Three Areas

Business-Model Design

Knowing that the MSI structure reinforces the benefactor's goals, we should look next at how most of these companies operate. With the exception of Inditex, almost all of the MSI industry members have business models that revolve around low fixed asset or no fixed asset investment in supply chain operations. They can be seen as investing in their core competency of brand management, and/or retailing and outsourcing everything else.¹⁶⁸

¹⁶⁸ Walters, D., M. Halliday, et al. (2002). "Added value, enterprise value and competitive advantage." Management Decision 40(9): 823-833.

Conceptually, this is about flexibility and certainly the MFA regime encouraged this behavior.

Given the changing landscape, it still appears at least through the lens of the MSIs that the outsourcing relationship is very traditional. As part of compliance with the codes there is no added incentive in terms of investment, preferential terms or better financing. Much of this may be because such relationships are vested in the supplier-buyer discussions and not public information. However, very little data exists and certainly the code organizations are not holding any rewards out to its supplier base for code compliance.

A key part of this model does favor the MSIs and that is organizations with a large investment in brands have large risk of reputational loss. Yet given the cooperative nature of the MSIs, they have helped foster the mitigation value that industry feels comfortable with. As stated previously, in the absence of general consumer interest and limited investor activity, industry has calculated the value of reputational risk and invested accordingly to reduce or eliminate it. Certainly, as evidenced by the table below, there are no rewards inherent in MSI structure that would signify willingness on behalf of industry to change their business model over the issue of social standards.

Fair Trade, by definition, is an exception to this and this is one reason why it is included in this survey. Fair Trade is all about business model change and the reward structure indicates how it intends to achieve this goal. Even with equity investment, Fair Trade encourages a different model; in this case it facilitates the investment of growing cooperatives in upstream marketing companies, such Day Chocolate Company.¹⁶⁹

¹⁶⁹ Nicholls, A. and C. Opal (2005). Fair Trade: Market Driven Ethical Consumption. Thousand Oaks, CA, Sage Publications.

Table 6 Incentives Created by Compliance that reinforce or Might Change Business Model

If Supplier Complies, The Following Rewards Are Offered	FLA	SAI	WRC	ETI	BSCI	Fair Trade (FLO)
Long Term Contract	None	None	None	None	None	Yes
Pricing Premium	None	None	None	None	None	Yes
Equity Investment	None	None	None	None	None	Some, usually upwards
Advance Payment	None	None	None	None	None	Yes
Preferential Supplier	None	None	None, with DSP potential, yes	None	None	Yes
Exclusivities	None	None	None	None	None	Yes
Training	None	None	None	None	None	Yes
Expansion Opportunities	None	None	None	None	None	Yes
Access to Senior Management	None	None	None	None	None	Yes

The Spanish retailer, Inditex, which is sometimes better known by the name of its major subsidiary, Zara, is another example of a different business model. Perhaps because it started as a manufacturer, Zara manufactures 50% of its products in its own factories. It uses a small pool of outside suppliers, 400, to supply its other needs.¹⁷⁰ Its relationships with this pool vary greatly. For 40% of its fabrics, which is traditionally a bottleneck in apparel production, Zara buys from an Inditex-owned subsidiary. For dyestuff, Zara buys from a part-owned producer accounting for 20% of the producers business. Zara buys the rest of its fabric from the supplier pool, but accounts for no more than 4% of sales at any single vendor. This allows Zara to marry flexibility with price.¹⁷¹

We shall talk about Zara more in the next chapter, but it serves as another counterpoint when examining Table 6.

¹⁷⁰ Ferdows, K., M. Lewis, et al. (2003). "Zara." Supply Chain Forum 4(2): 62-67.

¹⁷¹ Ibid.

Supply Chain Considerations

Based on the business model that most of the code partners utilize, supply chain considerations play a great role. In this regard, the MSIs offer no incentives or differentiation along the supply chain. Again this information may be embedded in the buyer-seller relationship but it is certainly not a part of the incentive system offered by anybody other than Fair Trade. While there is a growing movement among MSIs to address buyer issues, such as ETI's initiative with a commissioned study on buying practices;¹⁷² buyers behavior and its corresponding effect are not addressed as part of compliance issues. This makes sense given that the buyers are funding the MSIs. Certain buyers are beginning to re-examine their practices but this is a new area.

Most of the proponents of the outsourcing model have focused on the claims to efficiency. Hau Lee refutes this conventional wisdom, "As time went by, I observed one fundamental problem that most companies and experts seemed to ignore: *Ceteris paribus*, companies whose supply chains became more efficient and cost-effective didn't gain a sustainable advantage over their rivals. In fact the performance of those supply chains steadily deteriorated. For instance, despite the increased efficiency of many companies' supply chains, the percentage of products that were marked down in the United States rose

¹⁷² Acona (2004). *Buying your way into trouble*. London, Acona Limited
Insight Investment: 1-38.

from less than 10% in 1980 to more than 30% in 2000, and surveys show that consumer satisfaction with product availability fell sharply during the same period.”¹⁷³

Lee places supply chains in four different categories: efficient supply chains, risk-hedging supply chains, responsive supply chains and agile supply chains¹⁷⁴.

		Demand Uncertainty	
		Low (Functional Products)	High (Innovative Products)
Low (Stable Process)		<i>Efficient Supply Chain</i>	<i>Responsive Supply Chain</i>
High (Evolving Process)		<i>Risk Hedging Supply Chain</i>	<i>Agile Supply Chain</i>

Figure 2 Supply Chain Demand/Process Matrix (Source: Lee¹⁷⁵)

Lee states that different products require different supply chain structures. If we were to overlay some of the products that that are purchased by the industry members of the MSI, the matrix would look like the following:

¹⁷³ Lee, H. (2004). "The Triple -A Supply Chain." Harvard Business Review(October 2004): 102-112.

¹⁷⁴ Lee, H. (2002). "Aligning Supply Chain Strategies with Product Uncertainties." California Management Review 44(3): 105-119.

¹⁷⁵ Ibid.

		Demand Uncertainty	
		Low (Functional Products)	High (Innovative Products)
Low (Stable Process)		<i>Grocery products, basic apparel, basic home textiles, basic shoes</i>	<i>Fashion apparel, fashion shoes, home textiles</i>
High (Evolving Process)		<i>Certain food products, natural textiles dependent upon growing seasons</i>	<i>Performance shoes, performance outerwear, textiles incorporating electronics</i>

Figure 3 Demand/Process Matrix with Code-Related Products

For example, products such as basic apparel and shoes will benefit from efficient supply chains that will take advantage of scale, optimization techniques and have constant information flowing in both directions.¹⁷⁶ Generally these facilities would be modern and somewhat capital intensive. Products such as seasonal food and natural products dependent upon growing seasons should have risk-sharing built in with perhaps inventory pooling or guaranteed safety stocks to stabilize supply. Fashion products require mass-customization techniques and flexible manufacturing cells. Performance products require the best attributes of the two previous structures.¹⁷⁷ Lee demonstrates that each of these structures requires different strategies that have three goals in mind, agility, adaptability and alignment¹⁷⁸.

¹⁷⁶ Ibid.

¹⁷⁷ Ibid.

¹⁷⁸ Lee, H. (2004). "The Triple -A Supply Chain." Harvard Business Review(October 2004): 102-112.

Table 7 Incentives along the Supply Chain Created by Code Compliance

If Supplier Complies, The Following Rewards Are Offered	FLA	SAI	WRC	ETI	BSCI	Fair Trade (FLO)
<i>Information-Sharing</i>						
Forecasting	None	None	None	None	None	Yes
Delivery Dates	None	None	None	None	None	Yes
Desired Inventory	None	None	None	None	None	None
Point of Sale Data	None	None	None	None	None	Yes
Seasonal Demand	None	None	None	None	None	Yes
Regional Demand	None	None	None	None	None	None
Promotional Events	None	None	None	None	None	None
Scheduling Changes	None	None	None	None	None	Yes
Inventory Holding Costs	None	None	None	None	None	Yes
<i>Joint Decision Making</i>						
Consultation on Pricing	None	None	None	None	None	Yes
Product Mix	None	None	None	None	None	Yes
Optimal Order Quantity	None	None	None	None	None	Yes
Availability Level	None	None	None	None	None	Yes
Resolution of Order Exceptions	None	None	None	None	None	Yes
Inventory Levels	None	None	None	None	None	Yes
Promotional Events	None	None	None	None	None	None
<i>Incentives Are Shared On</i>						
Reduced Inventory Costs	None	None	None	None	None	None
Delivery Guarantees for Peaks	None	None	None	None	None	Yes
Allowance for Defects	None	None	None	None	None	None
Training Costs	None	None	None	None	None	Yes
Markdowns/Advertising	None	None	None	None	None	None
Order Changes	None	None	None	None	None	Yes

Getting to this point requires tremendous collaboration along the supply chain.

Simatupang and Sridharan have tried to find ways to measure these efforts that might result in a meaningful collaboration index.¹⁷⁹ Though we will not use the index, we will utilize the methodology; the authors break down collaboration into three components: information sharing, decision synchronization or joint decision making and incentive alignment.¹⁸⁰ All of these areas then break down into specific questions about particular strategies. We have used

¹⁷⁹ Simatupang, T. and R. Sridharan (2005). "The collaboration index: a measure for supply chain collaboration." *International Journal of Physical Distribution & Logistics Management* 35(1): 44-62.

¹⁸⁰ Ibid.

their specific areas as a basis to see if the MSI codes encourage or create rewards for any discussion in these areas. The results are reflected in table 7.

Capital Market Development

Compliance with codes also offers the supplier little capital development opportunities. While again there may be financial investment between buyers and sellers, it is certainly not stated as a benefit of compliance. The MSIs' efforts to encourage transparency in the case of compliance issues are a start, but it does not spill over into financial transparency. SAI encourages managers to take the lead in SA 8000 compliance but the internal incentives within the company may be skewed to push the manager to cover-up. Financial transparency helps build systems that encourage capital development.

Given the poor credit markets in most developing countries, access to developed country financing can have a significant impact for suppliers. John McMillan and Christopher Woodruff discuss one of the limitations of a developing countries' firm's growth, "...although firms can for a while grow incrementally by investing their retained earnings, they reach a point where, to take advantage of economies of scale, they must make big discrete jumps in their investments. Having a long delayed return, such investments are unlikely to be made on the basis of ongoing relationships."¹⁸¹

Equity investment can encourage long term expansion and productivity improvements. Certainly, by not encouraging transparency, buyers will rarely find the

¹⁸¹ McMillan, J. and C. Woodruff (2002). "The Central Role of Entrepreneurs in Transition Economies." *Journal of Economic Perspectives* 16(3): 153-170.

transparency they desire if they were to consider a stronger financial relationship with their supplier.

Table 8 Incentives to Help Capital Development Created by Code Compliance

If Supplier Complies, The Following Rewards Are Offered	FLA	SAI	WRC	ETI	BSCI	Fair Trade (FLO)
Encourage Financial Transparency	None	None	None	None	None	Yes
Equity Investment Opportunities	None	None	None	None	None	Yes
Preferred Stock	None	None	None	None	None	Yes
Options in Buyers Stock	None	None	None	None	None	Yes
Financial Advice	None	None	None	None	None	Yes
Honest Broker in Consolidation Efforts	None	None	None	None	None	Yes
Participation in Debt Offering	None	None	None	None	None	Yes
Long Term Financing	None	None	None	None	None	Yes

Incentives Created by MSIs Unintentionally Reinforce Globalization Tensions

As we can see from the above tables, successful compliance with the social codes does not bring great rewards to suppliers other than the right to retain or bid for new business. This is very much a top-down model that developed country businesses have tried to move away from with their own domestic suppliers. While this paper does not examine

how industry treats developed country suppliers, it would not be difficult to conclude that some of the wrong incentives are set up in these relationships also.

Table 9 Global Trends & Tensions Reinforced by Social Codes

Globalization Trend	Tensions Created	Social Codes Reinforce or Reduce Tension
Industrialization, De-Industrialization and the Virtuous Circle	Rapid development in the South favors virtuous cycle there. Developed countries' economies and social structure under attack as jobs leave. Expectations of social support diminish as affected companies and countries cut pension plans, health and other benefits. Northern labor becomes suspicious of South's intent	Social Codes reinforce tension as suppliers question integrity of buyer demands without adequate rewards. Codes come across as patronizing with monitoring and enforcement provisions.
Manufactures, Tariffs and Protectionism	Increased levels of outsourcing improve manufacturing skill base in South. Job losses grow and skill base in North evaporates. Developing countries use selective protectionist measures to encourage faster growth while developed countries try to force high-cost standards onto developing ones	Same as above, with standards reinforcing notion of higher costs. No capacity building, efforts to foster consolidation or cooperation, investment, technology transfer, training lead reinforce notion of exploitation.
GATT, MFA and China's Entry into the WTO	Distorted incentives have created intense competition among countries. Developing countries will try to keep low cost of labor as a comparative advantage and choose to overlook labor and social issues. Threat of no quotas on Chinese goods reinforces previous issue. Labor in developed countries look for Chinese dumping practices fostering more mistrust	Same as above with companies choosing to play countries against one another to keep costs low. No investment in training, infrastructure to give country confidence in building institutions (Cambodia may be exception with US/ILO project)
Capital Market Development	Developing capital markets allow for rapid capital inflows and outflows prompting charges of speculation by developing countries. Incumbents in developing economies rush to sell shares of newly privatized companies and export capital from domestic investment. Politicians look to capitalize on same trend and force closer link with business.	No investment or long term contracts encourage owners to harvest profits and not re-invest or invest elsewhere (Devaraj in Tamil Nadu). Politicians also expect payoffs and without transparency practice is silently encouraged. Resentment of labor vs. owner as incumbents keep out newcomers
Income Distribution Trends and Inequality Perceptions	Uneven income distribution discourages workers in developed countries leading to push back on free trade issues. Consumers and employees lose faith in managers; see system as hypocritical and abandon corporate social responsibility efforts. Developed countries' consumers overspend to keep up and severe recession follows	Consumers see through potential hypocrisy of codes and do not see equality. Affects consumers to be in developing countries and those now in developed countries. Consumers do not choose on ethics and inequality will lead to large changes that will affect globalization on both sides.

More importantly, these incentives build upon the already existing tensions we saw in the first chapter. Whether social codes, in and of themselves, could overcome historical tensions is not likely. The point is that in order for voluntary initiatives to create change, the incentives must be strong enough to reduce tension so that change can occur. If industry can grow quickly such that government realizes it has to strengthen institutions to support growth and retain investment, then the incentives have been successful; if the incentive structure encourages harvesting of profits and discourages long term investment, then developing countries will still focus on economic growth and not institutional development and concomitant regulation. Likewise, demands for standard enforcement without rewards will be perceived as patronizing and reinforce feelings of incipient protectionism.

Table 9 reviews how social codes reinforce globalization tensions. In the next and final chapter we shall see how offering the right incentives for social code compliance will help these tensions be reduced.

Chapter Five—Social Codes and Labels Will Become More Effective with New Business Models

Bad Business Model Design Only Leaves Room for Negative Incentive

As we saw in the previous chapter, the MSIs offer very little reward for supplier compliance, other than the ability to remain a supplier. Most likely, there are private incentives in particular buyer-seller relationships, but there is little data on these relationships and they are certainly not formalized into any of the policies of the MSIs. Fair Trade is the exception to this because it offers incentives in many places and while not large, does demonstrate that voluntary initiatives can lead to a different business model, particularly if the initiative gains traction with consumers.

In the case of social codes, the MSIs actually reinforce the models that existed during the time of the Multi Fiber Agreement. These models are predicated on low fixed-asset investment and high brand investment. They are designed to purposely create tension along the supply chain in order to induce competition among suppliers for the lowest cost. There is no transparency along the supply chain because lack of information creates fear for loss of business and encourages lower prices. The supply chains in this model are notable for their lack of trust and cooperation. All of these behaviors have negative impact upon working conditions, which the voluntary initiatives are supposed to be improving.

While long hours are the norm in any growing enterprise, there is more than ample data to show that productivity diminishes significantly after 55-60 hours per week. Yet productivity gains are not important to buyers in this business model because suppliers can

be replaced. Certainly the distorted incentives of the quota period did not encourage investment, but the changing landscape now should favor consolidation and skill-building.

It is acceptable wisdom to say that voluntary initiatives cannot change business models, but we have seen an example of one, Fair Trade, that can create at least a new model. However, given that the majority of the MSIs' benefactors still favor their present business models does not give the MSIs much ability to encourage change. All of the MSIs in this thesis have done a tremendous job of helping to improve conditions given their extremely small budgets. They do not have the charter to mandate change in the way their members conduct business and even if they desired one, their members would not allow it to happen. From the companies' point of the view, MSIs are very much a voluntary initiative.

Businesses, while sincere in their efforts to improve conditions, have still made social standards a low priority and are participating more out of fear of reputational loss than because improved conditions will create better products and ultimately, more highly developed economies and a larger pool of potential customers. MSIs have become unintended allies in this effort because they lack the ability to force change in the way businesses operate. Certainly, companies could allocate much larger resources to this task if they determined it was a significant priority. Inditex, while not allocating more money to MSIs chooses to own and operate much of their supply chain in high wage Spain. This is a decision to choose better standards for the right reason; the company gets the flexibility it desires and the state enforces the working standards.

Why Changing Incentives along the Supply Chain is Insufficient by Itself

In many ways, the MSIs would have the easiest time changing the incentives along the supply chain. ETI is already trying to do this by raising awareness of how buyer behavior affects suppliers and SAI is trying to encourage more management involvement through the SA 8000 process. To the same extent, the efforts to have buyers reveal their source factories and sub-contractors also begin to bring understanding to the instrumental role un-monitored sub-contractors play in most supply chains.

More information builds trust and this effort is necessary to improve conditions. It is however not sufficient. The nature of the MSI businesses differ greatly and as Lee showed, their supply chain should vary accordingly. In most cases, the companies should have different supply chain structure for different ranges of products. To enable complete information-sharing, joint decision making and incentive alignment, most companies have to change their business model. Inditex is a good example of a company that utilizes different supply chain structures, but will also search for a low cost supplier. It is also not perfect and is sometimes subject to challenges about working conditions in sub-contractor's plants.

In April 2005, the Spectrum Sweater factory in Savar, Bangladesh collapsed killing seventy-nine workers. When buyers from the factory were contacted by the Clean Clothes Campaign, a European MSI, only Inditex immediately pledged to help the victims.¹⁸² The other buyers were members of the BSCI who issued a statement "pledging that they would

¹⁸² Clean Clothes Campaign. (2005). "Spectrum Update: New info & demands." Retrieved March 31, 2006, from <http://www.cleanclothes.org/news/05-04-24.htm>.

send representatives to Dhaka in the first week of May to get more clarity on the situation.”¹⁸³

Does this response imply that Inditex is a better company? Not necessarily, however, it could easily imply that Inditex may have more flexibility in the way it responds because it has a different business model. The BSCI members have to exercise caution because they know that implicating themselves in the Spectrum collapse implicates them in every sourcing decision they make.

While it is premature to look at every developing country as a potential market, many MSI participants do not see the modeling potential that changing business models may have. Do Toyota Motor’s investments in the US mitigate complaints about Japanese competition? Initially, they did not but as the landscape changed they have been pointed out as an example of the way foreign investment should be made. There is little discussion about unfair Japanese competition any more. Likewise, Toyota has thousands of employees in the US; they are now the best word of mouth for the company and its products. Can an efficient and agile supply chain create these incentives? Not by itself, investment and involvement are much better signaling techniques.

Why Change will not be Consumer Led for at Least Ten More Years

Certainly, consumer-driven change could have the largest impact not only on social codes, but on almost any ‘voluntary initiative’. The fact remains however that consumers are not presently driving market change. The evidence we presented for apparel also translate to

¹⁸³ Ibid.

sustainability initiatives. In a paper assessing the affects of ecolabels, Tom Rotherham argues that consumers may not even be the best way forward, “It is perhaps unlikely that consumers will remain the primary focus of ecolabelling in the future, in view of evidence that private and public procurement policies have been important elements in the success of ecolabelling programmes, as well as the fact that other market actors can provide more consistent and more diverse incentives for producers. From a logistical perspective, the argument that the consumer may not be the main focus of ecolabelling is also compelling; by negotiating with the five main coffee buyers, it is possible to interact with 50% of the total coffee market. A single supermarket chain, Tesco, represents one-eighth of all consumer retail spending in the UK.”¹⁸⁴

Fair Trade is a useful counterpoint in this thesis, not only because it sets up better incentives than the code MSIs, but because it has received consumer and corresponding market acceptance. Yet, even at projected 2007 sales of \$1.8B, Fair Trade cannot be used as a model for the worldwide \$900B textile trade. Consumers will ultimately respond to social and sustainability issues in larger numbers; the question is when and how will we get to a critical mass. Certainly, as previously mentioned, most research indicates this will not happen for another ten to fifteen years, if then.

One thing the research does point out is that perhaps the best way to do this is through modeling behavior. Like the Toyota example, employees are a simple, but very effective way to communicate company beliefs to others. Worcester and Dawkins address employees as perhaps the best way forward for communicating ethics, “In particular, employees tend to be perceived by external stakeholders as particularly credible commentators on a company’s

¹⁸⁴ Rotherham, T. (2004). *The Trade and Environmental Effects of Ecolabels: Assessment and Response*. Geneva, Switzerland, United Nations Environmental Programme: 1-44.

activities; for example, the majority of the British public say that when hearing about a company's contribution to society and the environment, they would be more likely to believe the word of someone who worked for that company brochure or advert... Therefore, in the communication of ethical issues to consumers, the influence of informal communication networks should not be underestimated. There is a propensity for customers, employees and other stakeholders to act as advocates of those companies they perceive as ethical, and conversely to act as saboteurs of those companies they perceive as unethical."¹⁸⁵

Given the sheer number of employees that work in the industries MSIs focus on, the signaling and modeling potential is enormous; both at the developed country end and at the sourcing start. The long term potential of having well-treated and respected employees can go a long way in helping to build a brand in potentially underdeveloped but large markets. However, this potential cannot occur in the present environment where management is incited to harvest profits and not reinvest in future long-term growth. While the low capital intensity of many of the industries reinforces harvesting, the end of the MFA regime will finally allow for best-practice companies to consolidate and grow without fear of bumping into quota limits.

The alignment of employee interest with company interests can also be reflected in the growing disparity between worker pay and management pay. This tension can only be reduced by example and if it cannot be solved in the developed world it has little chance of being solved in developing countries. While the rightful provenance of this charter may

¹⁸⁵ Worcester, R. and J. Dawkins (2005). Surveying Ethical and Environmental Attitudes. The Ethical Consumer
R. Harrison, T. Newholm and D. Shaw. London ; Thousand Oaks, SAGE: 189-203.

belong with government and taxation policy, certainly aligning incentives throughout an organization will provide better results.

Dan Rees of ETI addressed this issue when asked about corporate senior management involvement with ETI, “The people care about what we do, but the company does not.”¹⁸⁶ Certainly, the voice of the company is its leadership and it is reasonable to question how committed senior management is to the MSIs mission. This statement also reflects on the investment companies make in the MSIs. Employees will listen to what managers say, but ultimately will follow where the company spends its money.

If consumers are going to begin to drive market change, aligning incentives at the employee-level throughout the supply chain may be the best way to get them motivated to make purchasing decisions based on ethical and sustainability issues in addition to the normal decision parameters.

How Stakeholders Need to Focus on Economic Justification

Business, which is the financial driver of the MSIs, has a much larger stake in the success of social codes than they may immediately think. Judging by their investment levels and lack of senior management involvement, business views social-code voluntary initiatives as a mitigation tool with some learning to be gained. What they need to realize is that the business and social environment in developing countries is extremely dynamic and they may be underestimating certain opportunities.

¹⁸⁶ Rees, D. (2006). Interview with Dan Rees, Director ETI. London.

MSIs need to play a much larger role in this by not only focusing on buyer behavior, but on buyer economics. Given the evidence of so much merchandise being sold on markdown, does it make sense for traditional retailers to continue their same practices?

Marks & Spencer (M&S) is a good example of a traditional retailer that has shifted most of its sourcing from domestic supply to overseas. M & S prided itself on its relationships with its suppliers; it was one of four companies selected for inclusion in I.D. Lewis' book, *The Connected Corporation—how leading companies win through customer-supplier relationships*.¹⁸⁷ Keith Blois comments, "...Lewis selected four companies who in the early 1990s were recognized as international leaders in the management of customer-supplier relationships. One of these companies was M&S where, with the support of Sir Richard Greenbury (for M&S was very proud of the way it managed its relationships with suppliers), Lewis interviewed managers at a variety of levels in the organization and met with several of their suppliers. According to Greenbury, over some 70 years ago, M&S had developed a special relationship with all its suppliers. A fundamental feature was that M&S expected to carry on doing business with a supplier season after season, year after year."¹⁸⁸

When M&S decided to move offshore, it selected their best British suppliers and encouraged them to also move with them. "Rather than abandon these relationships, we picked our best British suppliers and asked them to work with us in setting up lower cost, responsibly managed operations overseas. Some of these are owned and managed by our UK suppliers; others are established through shared equity agreements between UK

¹⁸⁷ Lewis, I. D. (1995). *The Connected Corporation--How Leading Companies Win through Customer-Supplier Relationships*. New York, The Free Press.

¹⁸⁸ Blois, K. (2003). ""Is It Commercially Irresponsible to Trust?"" *Journal of Business Ethics* 45(3): 183-193.

manufacturers and local suppliers, with significant input from trained UK management to ensure responsible working conditions as well as quality of product.”¹⁸⁹

While M&S has had its share of recent corporate challenges; the commitment of senior management and their willingness to be fully committed to their suppliers demonstrate how they view their supply chain. M&S is a member of ETI, yet it will yield better results than other members because the company realizes the considerable economic value of a good supply chain.

MSIs can serve as catalysts with members such as M&S, because M&S translates their learning into superior financial performance along the supply chain. Nike’s failure to notice the lifestyle shoe phenomenon has cost the company perhaps in excess of \$200M of lost revenue. John Shanley, a financial analyst recently commented, “Several large retailers, he said, have warned of stagnant European demand for Nike's premium footwear lines "due to both shopper resistance to higher-priced athletic footwear and a strong consumer movement towards lifestyle footwear styles," which have proved successful at competitors such as Puma and Adidas-Salomon. Shanley warned that Nike has lost market share in Japan to Adidas as consumers gravitate towards more "lifestyle" shoes, while a high level of promotions have hurt margins.”¹⁹⁰ Part of Nike’s failure to respond quicker has been attributed to its dependence on partnerships on performance shoes and nowhere else. Is there economic justification for them to reconsider their business model?

¹⁸⁹ Johnson, M. (2004). "Marks & Spencer Implements an Ethical Sourcing Program for Its Global Supply Chain." Journal of Organizational Excellence 23(2): 3-16.

¹⁹⁰ Portland Business Journal (2006). Nike downgraded; stock falls. Portland Business Journal. Portland, Oregon. March 7, 2006.

MSIs and their stakeholders have built an excellent information gathering system. While industry is starting to appropriate this hard-earned information for its own through renewing sector initiatives and clearinghouses, MSIs still can serve to help facilitate, first training and ultimately, consolidations of complying suppliers. They can serve to help suppliers think about outside capital, sell minority interests and otherwise prepare better performing companies for eventual market flotation. All of these events increase organizational transparency and will produce better conditions as companies seek to attract talented employees.

To accomplish this task, MSIs should consider diversifying their funding sources as they move more into capacity-building and away from just monitoring and compliance. MSIs will be well served by this diversification because it will give them more leverage with both buyers and suppliers. Moreover, if MSIs are to change their perception as agents of supplier compliance into true capacity-building organizations, they must have more funding and different funding sources. If MSIs can assume this role, then they will have not only the proverbial stick, but the carrot as well.

Risk of Commodization by Outsourcing Increases as Fragmentation Decreases

Another way to look at economic justification for changing business models is to understand the phenomenon Clayton Christensen noticed in the technology field. Christensen realized that continuing efforts to outsource production ultimately led to the risk of

commodization by the manufacturer.¹⁹¹ Lee Kuan Yew discusses this with respect to China, “They are learning. They have learned from the Americans; from M&A, takeovers and mergers. They know that if they try to sell their computers under a Chinese brand, it will take them decades in America. But if they buy IBM, they can inject their technology and low cost into IBM’s brand name, and gain much faster access to the market.”¹⁹²

Li & Fung, one of the agents that prospered under the MFA regime, has drastically altered their business model and is a compelling example of the risk certain companies will face by commodization. In the last few years, Li & Fung has bought or licensed well know brands in the developed world and is now controlling the production, logistics and actually manages the inventory of these brands for retailers. They are still one step removed from the customer and may choose to remain this way, though it would certainly be easy enough to do so.

Esprit Holdings is another example, although one that took a tortuous route, of a supplier taking over the brand. Its problems with family control and management well documented, the company was at one point operated separately in three continents. Ultimately, the European and Asian operating divisions bought the original US Company; though it has not been that successful in the US to date, Esprit has sales in excess of \$3B annually.

While Li & Fung has not purchased their suppliers and we have no data that their supply chain is more social code compliant than others, their model should be perceived as a threat to developed country retailers and brands at some point. If retailers and brands

¹⁹¹ Christensen, C. M. and M. E. Raynor (2003). The innovator's solution : creating and sustaining successful growth. Boston, Mass., Harvard Business School Press.

¹⁹² Hoyng, H. and A. Lorenz (2005). "It's stupid to be afraid". Spiegel special 7: 142-146.

continue to focus on their present business model, they will continue to lose leverage as suppliers build power through consolidation in the post-MFA world. As family control of well-known brands enters generational-transfer issues, suppliers will be poised to take advantage of buying opportunities as they see fit. While the market leverage still continues for buyers, suppliers will begin to exert more power as the era of quota shopping disappears. The danger to existing players is not vertical integration itself, but the premise that integration will start from the bottom up.

How a Newly Fixed Playing Field Requires New Models

MSIs are by design voluntary and as we have seen, they do not have a clear mandate to force business to change operating models or for that matter even their behavior. Given this, can MSIs be more effective at improving social conditions and if so, how can they do it? Likewise, companies, whose business models have been based on sticking to core competencies, such as building brands, marketing and merchandising, are not prepared for a world that has become less fluid than previously. What should companies do? Are the goals of the MSIs and its business stakeholders similar enough to actually get governments to take on regulation?

Setting up the right incentives for both MSIs and companies is very possible if companies are willing to reassess how they have operated in the past. As the MFA regime ends, companies need to realize that their old business models with the emphasis on only an efficient supply chain and inherent low cost advantages will need to be replaced. Companies that move to invest in key suppliers will build more flexibility in a world where scale is no

longer the advantage it was. This is not to imply that business should vertically integrate or even take control of suppliers but rather adopt a portfolio theory that has been previously applied to the venture world.

The investment can come in many forms. As we have seen with Inditex, this can be majority or minority owned suppliers or as with Marks & Spencer, this can be through no equity investment but issuance of long term contracts and willingness to open up the supply chain to joint decision making. This is the example Devaraj preferred. Long term interest through equity or contracts signals that both the buyer and supplier has placed their trust in the relationship and are willing to align their incentives.

MSIs can help to identify potential partners or even form investment groups for non-competing members that can serve as an investment vehicle. The resulting required transparency will get buyers to again open their supply chain decision making. Through this method, buyers can build supply chain expertise in all four areas of Lee's matrix giving them flexibility and scale, while allowing them to hedge their risk.

Likewise, investment will require management involvement on the buyer's behalf, giving both the supplier access to new skills and likewise building expertise in the buyer's organization. It can provide for a training ground for young buyers and managers and better internationalize the operation.

Why New Models Will Work and Drive Social Improvement

“For all the complaints of factory owners, though, the situation has a silver lining for the members of the world's largest labor force. Economists say the shortages are spurring

companies to improve labor conditions and to more aggressively recruit workers with incentives and benefits.”¹⁹³ *The New York Times*, April 3, 2006

In this era of globalization, most countries seek rapid economic development. As such, they have put aside most of their regulation and enforcement efforts to ensure the country’s competitiveness. By direct investment in a country’s suppliers, buyers are signaling that they are willing to take a risk that the country will strengthen their institutions to support business. This is the critical factor that is missing in all of social code work. Ultimately, the government will need to take responsibility for those activities that rightfully belong to it. No business or MSI can play this role.

MSIs, utilizing their more diversified and larger funding base, however will find themselves as agents of change and development. More importantly, building up a local industry will allow for regulation demands to be made at the supplier level as suppliers look to create a level playing field. At the same time, labor and NGOs will continue to lobby for better conditions which may force the government to listen to its growing domestic industry. Developing countries have a huge need to encourage industry and this goal outweighs others, yet they have a large stake in maintaining foreign investment and if investments are made as opposed to buyer-supplier relationships, they will be more prone to act. Western companies have a track record of paying more and having better conditions in their overseas plants than domestic suppliers; wages in foreign subsidiaries or joint ventures in China are 35% higher than domestically owned enterprises.¹⁹⁴

¹⁹³ Barboza, D. (2006). Labor Shortage in China May Lead to Trade Shift. *New York Times*. New York.

¹⁹⁴ Lorenz, A. and W. Wagner (2005). Cheap and Cheerful? *Spiegel special* 7: 30-39.

If the gains from supply chain flexibility and transparency are to be achieved, a better trained and better paid workforce is mandatory. Conditions in successful companies that have incentives to reinvest are different than those where owners harvest profits, whether in Bangladesh, China or Massachusetts. In a recent editorial, the New York Times addresses the success of Chinese manufacturers, “China’s move up the textile ladder will produce the same difficult changes that other countries have experienced—among them persistent problems of what to do with the workers whose jobs leave. But workers in China are seeing their wages and benefits increase, and China’s progress bodes well for workers in poorer places like Cambodia, Bangladesh and Madagascar.”¹⁹⁵

By making commitments to partnerships, companies invest in suppliers through equity or long term contracts and suppliers will respond by having higher paid, better trained and motivated workers in a more responsible environment. Likewise, MSIs will be able to show that moving up the social code compliance ladder actually brings rewards and gets the source country one step closer to economic development and ultimately its own regulation of labor and environmental issues.

The Virtuous Cycle

“...it is the *justification* for right conduct by business leaders that should be the object of scholar’s attention rather than conscience, which varies from person to person” Douglas S. Sherwin¹⁹⁶

Now we can see how new incentives will reduce the larger globalization tensions identified in Chapter One. In Table 10, we list some of the potential incentives and potential

¹⁹⁵ New York Times Editorial (2006). Trading Up in China. The New York Times. New York. April 8, 2006.

¹⁹⁶ Sherwin, D. S. (1983). The Ethical Roots of the Business System. Harvard Business Review: 1-9.

business model changes we discussed previously and match them up against the trends. For each trend, we can see that changing the incentives reduces tensions between North and South, just as they reduce the tension between buyer and supplier. The key issue is that MSIs and business have to actively encourage economic development in developing countries. This is the most likely path to push regulation back into the hands of its rightful owner, the source country's government.

Table 10 New Business Models Reduce Globalization Tensions

Globalization Trend	Why Relevant
Industrialization, De-Industrialization and the Virtuous Circle	Rapid development in the South favors virtuous cycle there. Northern countries can participate if they a) are willing to invest and b) realize their indirect employees will be their future customers
Manufactures, Tariffs and Protectionism	Increased levels of outsourcing improve manufacturing skill base in South. Brand owners face high risk of being commoditized if they have no manufacturing knowledge as playing field becomes fixed. New business models need to be considered
GATT, MFA and China's Entry into the WTO	The playing field is soon to be fixed, distorted incentives under MFA and ATC now finished. Allows for disintermediation and investment possibilities
Capital Market Development	Developing capital markets allow for newcomers and force incumbents to open up. Transparency becomes desirable and reward structure favors equity ownership
Income Distribution Trends and Inequality Perceptions	Uneven income distribution does not encourage ethical behavior. Employees may want to do the right thing, but helpless without top management setting an example. Management needs to align interests and invest knowing there is strong economic justification.

Companies need to recognize the potential long term threats to their business models and see the long term economic opportunities, both at the consumer and commercial level, which exist in developing countries. MSIs need to state these issues and get members on track to potentially alter the way they operate. They need to also adapt their model to attract larger and more diverse funding sources which allow them the leverage they need.

Voluntary initiatives can serve to bring morals and change into the marketplace, but ultimately economic actors require economic justification to pursue these goals. Business has

always had and always will have challenges with morality, particularly in a world with many cultures and many goals. Yet economic development has a strong sense of continuity that can be forecast and well-managed businesses can see opportunities along this horizon. Of course, there is uncertainty but businesses' reluctance to change only increases uncertainty and reduces economic opportunities as we have seen.

MSIs that understand this phenomenon will be more effective because they will bring economic justification to the supplier level and not just compliance to buyers. There is truth to the virtuous cycle and businesses will see that they have more to gain by encouraging development than by imposing standards without concomitant rewards. The New York Times, in the same editorial as above is addressing the protectionist trend we identified, "All this speaks to how woefully misguided it is for members of Congress to respond to these pressures by trying to stop the flow of goods from China. The better off China is, the better of the rest of the world is—poor countries because they will get a shot at the jobs that leave China; rich countries because many more people over in China may finally be able to afford the expensive goods that are made in America."¹⁹⁷

The ability of companies to solve social issues is indeed limited; society's mandate for companies in a capitalistic world is ultimately to efficiently produce and distribute economic benefits. Yet companies that combine self-interest with an understanding of the inherent tensions of globalization will perform better when they align incentives throughout their organization and supply chain. Because the interests of management and labour, buyer and supplier, are aligned and because transparency is designed and built into a company's

¹⁹⁷ New York Times Editorial (2006). Trading Up in China. The New York Times. New York. April 8, 2006.

relationships and culture, capacity-building becomes second nature and economic gains follow.

Negative publicity and reputational risk are catalysts to start change; they are not a solution. NGO's that expose corporate bad behavior contribute to society but only to the extent that they or subsequent organizations help identify solutions. The ability to work with disparate groups is an essential skill critical to any organization's success. The MSIs we have examined have made great progress in this regard, but they will not be effective in bringing the goal of improved conditions to developing countries until these countries have enjoyed enough economic success that they have more to lose by not enforcing regulation than they have by shirking it.

Most of the MSI companies have CSR departments. These programs, while expedient for publicity reasons and yielding benefits that are still difficult to quantify, potentially mask real economic justification for looking at new business models; just as the MSIs unintentionally facilitated the traditional low fixed-asset investment business model of the brands and retailers.

The ability to create a market of consumers from the same society that assembled the company's product inexpensively builds trust for future corporate expansion. Global brands and retailers must recognize that setting up the right incentives will allow workers to feel good about the products they create. The assumption that Western brands will be well placed in developing countries because of their head start is misplaced. As development and the confidence it brings awaken nationalistic pride, Western brands will need the goodwill they created through their investments in their supply chains. As we have seen, employees may be

the best spokespeople for their companies and harsh memories of bad behavior will ultimately speak louder than all the negative publicity generated by watchful NGO's.

Finally, companies that change business models will profit now from improved and more flexible supply chains and profit later when their employees or partner's employees become consumers. Likewise, society benefits as economic development increases and governments strengthen their institutions and ultimately take on their rightful task of enforcing labor conditions. It is at this point that social code MSIs can claim success.

Appendix 1: Variation between draft Jo-In Code and Participating Codes of Conduct

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
Workplace Standards						
Child Labour ILO C138, C182 ILO R146,	Minimum age 15 or above compulsory school age	Minimum age 15 or above compulsory school age (C138).	No recruitment of a child (person less than 15 years) unless law stipulates higher	Minimum age 15; or 14 if country of manufacture allows; or age for completing compulsory education	Minimum age 15; or 14 if meets developing country exemption; or local minimum age if higher Not expose children or young workers to situations that are hazardous, unsafe, or unhealthy.	Minimum age 15; or 14 if consistent with ILO practice in developing countries
R190	Adequate transitional and economic assistance provided to any replaced child workers Not expose young workers under 18 to situations likely to jeopardise their health	Adequate transitional and economic assistance provided to any replaced child workers.	age for work or mandatory schooling unless law set at 14 in accordance with developing country provisions of C138. Adequate transitional and economic assistance provided to any replaced child workers			
Non- discrimination ILO C100,	No discrimination in hiring, remuneration,	Equality of opportunity and treatment	No discrimination in hiring, compensation, access to training,	No discrimination in hiring, salary, benefits,	No discrimination in hiring, compensation, access to training,	No discrimination in employment, including hiring,

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
C111, C183 ILO R90, R111	access to training, promotion, discipline, termination of employment or retirement based on race, colour, sex, religion, political opinion or affiliation, national extraction or social origin, caste, marital status, sexual orientation, trade union membership, disability or age. No interference with the exercise of the rights of workers to observe tenets or practices, or to meet needs relating to all of the above criteria. Equal remuneration, equal evaluation, and equal opportunities for	regardless of race, colour, sex, religion, political opinion, nationality, social origin or other distinguishing characteristic (C100 & C111)	promotion, termination or retirement based on race, caste, national origin, religion, age, disability, gender, marital status, sexual orientation, union membership or political affiliation.	advancement, discipline, termination or retirement, on basis of gender, race, religion, age, disability, sexual orientation, nationality, political opinion, or social or ethnic origin.	promotion, termination or retirement based on race, caste, national origin, religion, disability, gender, sexual orientation, union membership or political affiliation. No interference with the exercise of the rights of workers to observe tenets or practices, or to meet needs relating to all of the above criteria. Not allow behaviour, including gestures, language and physical contact, that is sexually coercive, threatening, abusive or exploitative.	salary, benefits, advancement, discipline, termination or retirement, on the basis of gender, race, religion, age, orientation, political opinion, or social or ethnic origin. Women's Rights: a. Women workers will receive equal remuneration, including benefits; equal treatment; equal evaluation of the quality of their work; and equal opportunity to fill all positions open to male workers. b. Pregnancy tests will not be a condition of employment, nor will they be demanded of employees. c. Workers who take maternity leave will not face dismissal nor threat of dismissal, loss of seniority or

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	<p>women The right of all individuals to make decisions concerning reproduction free of discrimination, coercion and violence Workers shall have all entitlements and protection provided in national law and practice with respect to maternity.</p>					<p>deduction of wages, and will be able to return to their former employment at the same rate of pay and benefits. d. Workers will not be forced or pressured to use contraception. e. Workers will not be exposed to hazards, including glues and solvents that may endanger their safety including their reproductive health. f. Licensees shall provide appropriate services and accommodation to women workers in connection with pregnancy.</p>
<p>Freedom of association and collective bargaining ILO C87, C98, C135, C154 ILO R143</p>	<p>Recognise & respect right of all workers to form or join trade unions of their choice and to bargain collectively</p>	<p>Recognize right of workers to join trade union and bargain collectively (C87 & C98) Workers'</p>	<p>Workers without distinction have right to join trade union of own choosing and bargain collectively. Workers'</p>	<p>Recognize right of workers to join trade union and bargain collectively Where the right is restricted by law,</p>	<p>Recognise & respect right of all workers to form or join trade unions of their choice and to bargain collectively</p>	<p>No employee shall be subject to harassment, intimidation or retaliation in their efforts to freely associate.</p>

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	<p>Recognise the trade union(s) of the workers' choice.</p> <p>Adoption of a positive approach towards the activities of trade unions and organisational activities of workers.</p> <p>Workers' representatives not discriminated against and have access to functions in workplace.</p>	<p>representatives not subject to discrimination & access to workplaces to carry out representative functions (C135 & C143)</p> <p>Employers adopt a positive approach to trade unions and positive attitude to their organizing activities.</p>	<p>representatives not discriminated against and have access to carry out functions in workplace.</p> <p>Employers adopt an open attitude to activities of trade unions and their organizational activities.</p> <p>Where right restricted by law, employer facilitates, and does not hinder, development of parallel means for independent and free association and bargaining</p>	<p>employer should not seek state assistance to prevent workers exercising right to FoA</p>	<p>Where right is restricted by law, employer facilities, parallel means for free association and bargaining.</p> <p>Workers' representatives not discriminated against and have access to carry out functions in workplace.</p>	
<p>Forced labour ILO C29, C105</p>	<p>No use of forced labour, including involuntary prison, indentured or bonded labour</p> <p>Workers shall not be</p>	<p>Employment is freely chosen.</p> <p>No use of forced, including bonded or prison, labour (C29 & C105).</p>	<p>Employment is freely chosen.</p> <p>No forced, bonded or involuntary prison labour.</p>	<p>No use of forced labour, prison labour, indentured labour, bonded labour or otherwise</p>	<p>Not engage in or support the use of forced labour, nor shall personnel be required to lodge 'deposits' or identity papers upon</p>	<p>No use of forced prison labor, indentured labor, bonded labor or other forced labor.</p>

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	<p>required to lodge 'deposits' or identity papers with their employer and shall be free to terminate their employment after reasonable notice.</p> <p>No restrictions on freedom of</p>	<p>Workers shall not be required to lodge "deposits" or identity papers with their employer.</p>	<p>Workers not required to lodge "deposits" or their identity papers with employer and are free to leave employer with reasonable notice.</p>		<p>commencing employment with the company.</p>	
Health and safety	<p>Safe and hygienic working environment – knowledge of industry and specific hazards.</p> <p>Take adequate steps to prevent accidents and injury, by minimising the causes of hazards</p>	<p>Safe and hygienic working environment. Promote best occupational health and safety – knowledge of industry and specific hazards.</p>	<p>Safe and hygienic working environment – knowledge of industry and specific hazards.</p> <p>Workers receive regular and recorded health and safety training.</p> <p>Access to clean</p>	<p>Safe and healthy working environment required. Standard also applies to employer operated facilities part from production facilities (e.g. housing)</p> <p>Take adequate steps to prevent accidents and injury, by</p>	<p>Safe and hygienic working environment – knowledge of industry and specific hazards.</p> <p>Take adequate steps to prevent accidents and injury, by minimising the causes of hazards</p>	<p>Safe and healthy working environment required to prevent accidents and injury to health.</p> <p>Ensure that its direct operations and those of subcontractors comply with all</p>

Draft Jo-In	CCC	ETI	FLA	SAI	WRC
<p>Not expose workers to hazards which may endanger reproductive health.</p> <p>Responsibility for health and safety assigned to senior management representative.</p> <p>All Workers shall receive regular and recorded health and safety training</p> <p>Establish systems to detect, avoid or respond to potential threats to the health and safety</p> <p>Access to clean facilities and portable water, and if appropriate, sanitary facilities for food storage.</p>		<p>facilities and portable water, and if appropriate, sanitary facilities for food storage.</p> <p>Accommodation, where provided, meet basic needs of workers.</p> <p>Responsibility for health and safety assigned to senior management representative.</p>	<p>minimising the causes of hazards</p>	<p>Responsibility for health and safety assigned to senior management representative.</p> <p>All Workers shall receive regular and recorded health and safety training</p> <p>Establish systems to detect, avoid or respond to potential threats to the health and safety</p> <p>Access to clean facilities and portable water, and if appropriate, sanitary facilities for food storage.</p> <p>Accommodation, where provided, meets basic needs of workers.</p>	<p>workplace safety & health regulations established by the national government where production facility is located, or with Title 29 CFR of the Federal Code of Regulations, enforced by Federal OSHA, whichever is more health protective.</p> <p>Ensure that its direct operations and subcontractors comply with all health and safety conventions of the International Labor Organization (ILO) ratified and adopted by the country in which the production facility is located.</p>

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	Accommodation, where provided, meets basic needs of workers.					
Wages	Workers shall have the right to a living wage. Wages shall always comply with all applicable laws, regulations and industry minimum standards and shall be sufficient to meet basic needs of workers and their families and provide some discretionary income. No deductions as disciplinary measure or for reasons not provided by national law except with permission of	Workers must be paid a living wage. Wages and benefits meet at least legal or industry minimum standards and be sufficient to provide some discretionary income. No deductions without express permission of worker concerned.	Living wage paid. Local minimum, national legal standards or industry benchmark standards whichever is higher. Workers provided with information about wages before enter into employment and about particulars of wages each time paid. No deductions as disciplinary measure or for reasons not provided by national law except with permission of worker. Disciplinary measures recorded.	Legal or prevailing industry wage, and meets basic needs / provide discretionary income.	Wages shall always comply with all applicable laws, regulations and industry minimum standards and shall be sufficient to meet basic needs of workers and their families and provide some discretionary income. No deductions as disciplinary measure or for reasons not provided by national law except with permission of worker. Workers provided with information about wages before entering into employment and	Legal minimum wage and benefits. WRC code requires pay a "living wage." Wages shall always comply with all applicable laws, regulations and industry minimum standards and shall be sufficient to meet basic needs of workers and their families.

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	<p>worker.</p> <p>Workers provided with information about wages before entering into employment and about particulars of wages each time paid.</p> <p>Remuneration either in cash or check form, in a manner convenient to workers.</p> <p>Wages paid on a regular and timely basis.</p>				<p>about particulars of wages each time paid.</p> <p>Remuneration either in cash or check form, in a manner convenient to workers.</p> <p>Wages paid on a regular and timely basis.</p>	

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
Hours of work ILO C131	Comply with national laws and benchmark industry standards, whichever offers greater protection. Maximum working hours per week not to exceed 48 hours on a regular basis; 1 day off in 7 Overtime voluntary and not exceed 12 hours per week, not demanded on regular basis and compensated at premium rate. Overtime voluntary and not exceed 12 hours per week, not demanded on regular basis and compensated at premium pay (if not defined, then at least one and one half of their regular hourly compensation rate)	Maximum hours per week not to exceed 48 hours; 1 day off in 7. Overtime voluntary and not exceed 12 hours a week, not demanded on regular basis and compensated at premium rate.	Comply with national laws and benchmark industry standards, whichever offers greater protection. Maximum hours per week not to exceed 48 hours on a regular basis; 1 day off in 7 Overtime voluntary and not exceed 12 hours per week, not demanded on regular basis and compensated at premium pay	Maximum hours per week not to exceed 48 hours; 1 day off in 7 Overtime voluntary and not exceed 12 hours a week, not demanded on regular basis and compensated at premium rate.	Maximum hours per week not to exceed 48 hours per week or (b) the limits of regular hours allowed by the law of the country of manufacture, and be entitled to at least one day off every seven day period, as well as holidays and vacations. Overtime not to exceed 48 hours; 1 day off in 7 plus holidays No restriction; premium pay	Not be required to work more than the lesser of (a) 48 hours per week or (b) the limits of regular hours allowed by the law of the country of manufacture, and be entitled to at least one day off every seven day period, as well as holidays and vacations. Overtime not to exceed 48 hours; 1 day off in 7 plus holidays No restriction; premium pay
Harassment and abuse	Every worker treated with dignity	Physical abuse, threats of physical	Physical abuse or discipline, threat of	No employee shall be subject to any	No corporate punishment, mental or	No employees shall be subject to any

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	and respect. Not engage in or support the use of corporal punishment, mental or physical coercion, threats of physical abuse, unusual punishment or discipline, sexual or other harassment, intimidation and verbal abuse.	abuse, unusual punishments or discipline, sexual and other harassment, and intimidation prohibited.	physical abuse, sexual or other harassment and verbal abuse or other forms of intimidation prohibited.	physical, sexual, psychological or verbal harassment or abuse	physical coercion or verbal abuse. No sexually coercive or exploitative behavior	physical, sexual psychological or verbal harassment or abuse. No corporal punishment
Employment relationship	Work performed must be on the basis of a recognized employment relationship established through national law and/or practice. Not avoid obligations under law through use of labour-only contracting, sub-	Not avoid obligations under law through use of labour-only contracting arrangements or apprenticeship schemes.	Work should be performed on basis of recognized employment relationship established through law and national practice. Not avoid obligations under law through use of labour-only contracting, subcontracting or home	-----	Not avoid obligations under law through use of labour-only Contracting or false apprenticeship schemes	-----

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
	contracting or home-working arrangements or apprenticeship schemes. Nor shall any such obligations be avoided through the excessive use of fixed-term contracts of employment.		working arrangements or apprenticeship schemes.			
Qualifiers	Provisions constitute minimum and not maximum standards or as the only conditions permitted to serve as the basis for any claim as to what standards or conditions of employment should be provided.	Provisions constitute minimum and not maximum standards. Companies expected to comply with national law, and /or apply provision that affords greater protection.	Companies should apply the higher standard (the Code of conduct or the applicable law of country) in case of difference or conflict.	When national and other applicable law, other requirements to which the company subscribes, and this standard address the same issue, that provision which is most stringent applies.	Companies should apply the higher standard (the Code of conduct or the applicable law of country) in case of difference or conflict	
Guidance on standards	Outcomes of workshop proceedings, pilots	Freedom of association and collective bargaining	FLA Monitoring Guidance and compliance	Guidance document 2005 Auditor Training and	Principles in founding document of the Consortium	

	Draft Jo-In	CCC	ETI	FLA	SAI	WRC
		and issue papers.	Guidance Document.	benchmarks.	SAI courses.	and opinion issued which articulates the de facto policy of the organization.

Source: Joint Initiative on Corporate Accountability and Workers Rights

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