Abstract No. 002-0001:

Safeguarding CSR in Global Supply Chains:
- The Governance of Codes of Conduct in Buyer-Supplier Relationships

Second World Conference on POM and 15th Annual POM Conference, Cancun, Mexico, April 30 - May 3, 2004

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Summary

In the wake of globalisation, companies are becoming increasingly aware of the social and environmental aspects of international production. Companies of today not only have to be profitable, they also have to be good corporate citizens. In response to the increasing societal pressure, many companies adopt the concept of corporate social responsibility (CSR) by introducing codes of conduct that are expected to ensure socially responsible business practises throughout the chain – from supplier of raw materials to final end-users.

However, there are several challenges to the management and control of codes of conduct in global supply chains. Active commitment is a precondition for the successful
implementation of the codes, but the incentive to comply with the codes does not necessarily extend to all the actors in the chain. Moreover, it is difficult to enforce codes of conduct in global supply chains, because the involved companies are separated geographically, economically, legally, culturally and politically. In consequence, introducing codes of conduct in global supply chains raises a series of agency problems that may result in non-compliance.

Realising that non-compliance can have severe consequences for the initiator (due to consumer sanctions, negative press, capital loss, government interventions, damaged brand etc.), the article wants to discuss how the interests of the actors in a supply chain are aligned with the terms of the codes. The article will focus on a simple buyer-supplier relationship. Based on agency theory, this article will introduce number of safeguards/protective mechanisms that may protect the initiator against non-compliance.

**Keywords:**

Corporate Social Responsibility (CSR), Agency theory, governance, safeguarding, protective mechanisms, trust/opportunism, reputation effects.
1.1 Introduction: CSR in Global Supply Chains

Practitioners and scholars alike are increasingly aware that doing the right thing is not just a matter of being profitable. The ethics of business activities are becoming increasingly important, and more and more companies are evaluated on their ability to meet - not only the customers’ needs - but also the various needs of employees, NGOs, representatives of the local community and other interest groups. Even though many companies still leave the question of CSR to philosophical minds, more companies are beginning to realise that they can no longer ignore the moral obligations placed on them by society.

The globalisation of economic activities has undoubtedly affected this development. Even though the concept is still the subject of much controversy, few deny the fact that many companies today are engaged in international business activities. When part of the production process is outsourced to companies in different geographic, cultural and institutional settings, differences in social and environmental standards are uncovered. Moreover, it is increasingly evident that companies can exploit these differences by moving their production facilities to countries with low social and environmental standards (the so-called ‘industrial flight’ hypothesis) (Hansen 1995; Schary & Skjøtt-Larsen 2001). However, even though companies might gain short-term benefits from the lowering of social and environmental standards, public criticism can damage the company’s as well as the industry’s legitimacy in society and thus have a negative effect on sales, market shares and stock prices. Over the years, numerous companies have been criticised for violation of union rights, use of child labour, dangerous working conditions, discrimination etc. in their facilities abroad (see e.g. Iannuzzi, 2002; King & Lenox, 2000; Zyglidopoulos, 2002; Kapstein, 2001; Cannon, 1994; McCall 1998).

In response to this development, an increasing number of companies embrace the language of CSR, and international organisations as well as business associations and standardisation organisations have been involved in the development of standards, labelling
schemes and reporting systems that address the social and environmental aspects of production (Kapstein, 2001; Utting, 2000; Kolk & van Tulder, 2001). Moreover, especially a large number of multinational companies have introduced codes of conducts, i.e. sets of written principles, guidelines or standards intended to improve CSR in the whole value chain. The World Bank estimates that there are some 1,000 codes in existence today.

Due to the international division of labour, the management and control of the codes cannot be limited to the individual firm. Compliance with the codes will depend on the actions of all parties involved in the supply chain. So far, most research has addressed the question of whether the various CSR initiatives are reliable - from the perspective of the various interest groups in society (e.g. unions, NGOs, government, customers) (Utting, 2000; Haufler, 2001; Jenkins, 2001). Much less has been done to investigate how companies devoted to CSR can safeguard themselves from non-compliance in the supply chain. The question is how the company can be certain that the other companies in the chain will fulfil the obligations stated in the codes? Non-compliance constitutes a serious threat to companies that have promoted themselves as socially responsible by developing codes of conduct. One thing is to be socially irresponsible; another is to be a socially irresponsible liar. Not only can the customers sanction socially irresponsible business practices, a bad reputation might also affect the relationships with other stakeholders (Haufler, 2001; Ackerstein & Lemon, 1999). For instance, the initiator might face government intervention, difficulties in attracting new investors and business partners, negative press and activism by grassroots (NGOs).

Therefore, the initiator has a strong incentive to ensure that the other companies in the supply chain comply with the codes of conduct. In order to prevent non-compliance, an agreement must be made between the companies in which promises, rights and obligations in relation to social responsibility are allocated between them (cf. Koch, 1995). The challenge is
to design an agreement that makes the all companies in the supply chain act in accordance with the codes (cf. Jensen & Meckling, 1976; Prendergast, 1999; Petersen, 1993).ii

Based on a simple buyer (principal) – supplier (agent) relationship, the article will discuss some of the basic principal-agent problems arising from the implementing of codes of conduct in global supply chains. Moreover, the article will present a number of safeguards/protective mechanisms on which the company can perhaps rely when designing an agreement with the other companies in the chain.

1.2 Theoretical Perspective

Two perspectives within economic organisation theory have received a lot of attention over the past 20-30 years: - The transaction cost theory and the P-A theory/agency theory (Petersen, 1993; Greve, 2000). Where transaction cost theory tries to explain why some activities are performed within a hierarchy while others are carried out in the market, the central question in agency theory is how a principal ensures that the agent acts in accordance with the principal’s goals – in a situation characterised by asymmetric information and uncertainty (Bregn, 1998).iii The article is predominantly based on insights from agency theory. However, a number of related theories (most notably transaction cost theory) and alternative perspectives (most notably network theory) will be introduced.

Even though agency theory is often associated with the study of the owner[s]-manager relationship (Eisenhardt, 1989; Walsh & Seward, 2001), it is applicable to most cooperative efforts in which it is difficult for the principal to monitor the work of the agent. The basic idea behind agency theory is to provide the agent with incentives to act in accordance with the principal’s interests (Eisenhardt, 1989; Dees, 1992; Koch, 1995; Petersen, 1993). Agency theory is based on some of the following assumptions:
• **Methodological individualism.** Agency theory (as well as new institutional economics in general) is based on a methodological individualism in which social phenomena are seen as the products of activities and states of individuals (Hodgson, 1998; Fay, 1996). For instance, Jensen & Meckling (1976, p. 311) characterise the firm as a “(...) *nexus of a set of contracting relationships among individuals* (...)”. Agency theory begins and ends with the relationship between two or more individuals (see also Arrow, 1984; Dees, 1992).

• **Bounded rationality, self-interest and opportunism.** Agency theory is based on the theory of bounded rationality according to which individuals are rational by intention, but only to a certain degree. (Bregn, 1998; Eisenhardt, 1989). The individual does not know everything about everything but only something about something. As Ostrom (1993, p. 45) notes: “*Information search is costly, and the information-generating capabilities of human beings are limited. Individuals therefore often must make choices based on incomplete knowledge of all possible alternatives and their likely outcomes*”. Moreover, agency theory sees the individual as a self-interested creature and addresses the problem of opportunism, i.e. the promotion of self-interest under false pretensions (Dees, 1992; Koch, 1995; O’Donnell, 2000). With regard to the latter, it is not expected that all individuals are opportunistic, but that some are, and that it is difficult and costly to separate the opportunistic actors from the non-opportunistic ones (Williamson & Ouchi, 1981). The implications of opportunism will be discussed later.

• **Information asymmetry.** It is expected that there is an information asymmetry between the principal and the agent. The agent holds private information about his or her “true type” (Dees, 1992). Moreover, it is costly and time consuming to get information about the agent’s behaviour. Otherwise, it would be easy to monitor the agent and disclose non-compliance with an agreement. Agency theory is concerned only with the principal’s lack of information about the agent’s action (Mikkelsen, 1994).
• **Risk.** As a point of departure, agency theory considers individuals to be risk-averse (Arrow, 1984; Eisenhardt, 1989). Otherwise, there would be little reason why the principal and the agent should bother making an agreement. If agents were risk neutral, all risk in co-operative arrangements could simply be imposed upon them (Arrow, 1984).

• **Uncertainty.** It would also be easy to design a contract if there was always a clear connection between the agent’s behaviour and the observable outcome. It would be based solely on outcome-related rewards. Uncertainty arises because of information asymmetry, opportunism, and because there is no clear-cut connection between the agent’s behaviour and the outcome (Dees, 1992; Arrow, 1984; Williamson, 1984).

• **Conflict of interest.** Agency problems are only relevant when there is conflict of interest between the principal and the agent and it is difficult and costly to monitor the behaviour of the latter (Eisenhardt, 1989; Ouchi, 1996; Hill & Jones, 1992). On the other hand, there must also be some basis for co-operation. Co-operation is only interesting if there is some potential for a fruitful exchange of values between the parties. If two parties anticipate a gap between contributions and compensations in the initial phase, the co-operation will never be implemented (Ouchi, 1996; Milgrom & Roberts, 1992).

In short, there are two ways to ensure that the agent acts in accordance with the principal’s interests - monitor actions or reward outcomes (Eisenhardt, 1985, 1989; Petersen, 1993; O’Donnell, 2000).

Monitoring can be seen as a mechanism used by the principal to obtain information about the actions of the agent, whereas rewards are outcome-based, financial incentives (cf. O’Donnell, 2000). However, both alternatives are associated with costs that depend on the characteristics of the activity (the complexity of the assignment, the ability to monitor the agents, the correspondence between outcome and the agents behaviour etc.). In relation to
codes of conduct, the agency costs might involve e.g. the time spent on reaching an agreement with the suppliers, monitoring compliance and revising the contracts.

Agency theory also makes a distinction between opportunism before (ex ante) and after (ex post) an agreement. Ex ante opportunism (also known as hidden information or adverse selection) is caused by the fact that only the agent has thorough knowledge of his or her true type. In consequence, the principal might choose the wrong type of agent to perform the task. Ex post opportunism (also referred to as hidden action or moral hazard) occurs, because it is difficult for the principal to determine whether the agent complies with the terms of the agreement. Moreover, the principal may find it difficult to sanction the agent if he or she violates the contracts (see e.g. Arrow, 1984; Dees, 1992; Greve, 2000; Milgrom & Roberts, 1992; Petersen 1993).

**1.3 Opportunism, CSR and Codes of Conduct**

Agency theory is useful in analysing different ways to govern principal-agent relationships. This also applies to the governance of CSR initiatives, including codes of conduct. It is generally acknowledged that opportunism poses a threat in inter-firm relationships (see e.g. Das & Rahmann, 2000, O’Donnell, 2000). Therefore, opportunistic motives and behaviour is of crucial interest to companies integrated in global supply chains. Not only are transactions carried out in different organisations, they are also separated culturally, institutionally, geographically, politically etc. As the globalisation of the economy escalates, it becomes increasingly important to develop means that can be used in the governance of transactions between companies in an international environment.

Implementation of codes of conduct requires some kind of motivation and commitment. In supply chains, however, it is not enough that the initiating company is dedicated to social and environmental issues. The company must persuade the other organisations in the supply chain to act socially responsible too. In a buyer-supplier relationship, this might be difficult if, for
example, a supplier shows no interest in CSR or the buyer holds limited bargaining power against the supplier. Assuming that the buyer and the supplier do not share the same interest, there is a risk that the supplier will neglect social responsibilities.

Opportunism in relation to codes of conduct and other CSR standards arises due to the fact that these initiatives can be costly and time consuming (See e.g. Sinding, 2000; Walley & Whitehead, 1994; Kapstein, 2001; Kolk, 2000; Utting, 2000). Actually, if CSR was always the optimal solution in terms of profitability, there would probably be no CSR debate. All companies would automatically adopt the highest social and environmental standards in order to boost profit. However, this is not always the case, and some suppliers therefore have an economic incentive to lower social and environmental standards in order to achieve economical gains. Moreover, the potential benefits of introducing codes of conduct might be unevenly distributed among the companies in the supply chain. For instance, the goodwill generated by social responsibility is often associated with a brand held by only one of the companies in the chain. This company will receive the full benefits of introducing a code of conduct. The rest of the companies in the chain will have to share the indirect benefits, e.g. new deliveries. If these companies furthermore have to bear the costs of implementing CSR, there is a potential conflict of interest between the companies in the chain. This increases the risk of opportunistic actions.

If it was possible to develop contracts that included all contingencies (Greve, 2000; Milgrom & Roberts 1992, p. 127), these problems could be dealt with. However, codes of conducts as well as many other contracts are incomplete – very incomplete, actually. When a code of conduct is not formulated in a complete, enforceable contract, it becomes difficult to verify whether the supplier has actually complied with it, and the buyer may become the subject of opportunism (Eisenhardt, 1989).
In relation to codes of conduct, there is also a remarkable lack of effective monitoring systems. Only a minority of firms with codes of conduct actually mention monitoring in relation to the implementation, and the majority of these use internal systems (Kolk et al. 1999; Kolk & van Tulder, 2001; OECD, 2000; Utting, 2000).

To sum up, a principal-agent situation arises when a company introduces a code of conduct in a global supply chain and the incomplete character of the codes causes the risk from non-compliance to increase. The potential opportunism of the suppliers may have different faces. According to agency theory, a distinction can be made between ex ante and ex post opportunism.

**Ex ante (before agreement):**

Companies throughout the supply chain have to be involved in the implementation of the codes of conduct. To the extent that compliance with the codes requires improvements of existing practises in the chain, an initiator has two options: 1) persuade or command the other companies in the chain to carry out the necessary improvements; 2) replace companies performing poorly in the social and environmental field with new ones who already comply with the codes. Negotiations are likely to take place before the decision is made. During these negotiations, a number of conditions may put the initiator of the code at risk. In a buyer-supplier(s) relationship (where the former is the initiator of the code of conduct), the supplier has a better knowledge of his/her past behaviour and future plans. If this information does not serve the buyer’s interest, the supplier might try to hide it (Arrow, 1984). The hidden information in relation to social and environmental issues may find expression in different ways:
• The supplier guarantees that the products and services are carried out in a socially
responsible manner by exaggerating the social and environmental performance. By
convincing the buyer that the company already complies with the codes, the supplier can
avoid necessary improvements and still get deliveries from the buyer. This is especially
the case if the supplier discovers that comprehensive compliance mechanisms are unlikely
to be implemented. The opposite situation might also occur, if the buyer expresses a
willingness to defray at least part of the costs associated with social and environmental
improvements in the supply chain.

• The supplier overstates the problems in complying with the codes in order to gain extra
time. Suppliers will often have some time to comply with the social and environmental
requirements in the code of conduct. By overstating existing problems the supplier might
delay the implementation of the code.

• The supplier withholds information about prior and ongoing lawsuits, consumer boycotts,
strikes, public sanctions etc. A “baggage” of unethical behaviour will damage the
reputation of the supplier and have a negative influence on the negotiations with the buyer
(cf. Haufler, 2001; Hopkins, 1997). For instance, a buyer trying to implement a code of
conduct will probably not rely on suppliers who have been condemned for violations of
human rights and environmental regulation. Even though various kinds of screening might
uncover the supplier’s track record, it does not in itself safeguard the principal from
opportunism (Milgrom & Roberts, 1992). Future action cannot always be inferred from
past behaviour.

Interestingly, the supplier’s private information can be disadvantageous even to the supplier
(ibid. p. 154). For instance, suppliers with high social and environmental performance have a
strong incentive to reveal this information, because it makes them attractive to buyers
interested in CSR issues. However, buyers might not consider suppliers as the most reliable sources of information when it comes to the evaluation of their own performance. Therefore, they will be sceptical towards (private) information that cannot be verified by third parties.

**Ex post (after agreement)**

Ex post opportunism is the intentional or unintentional violation of an agreement¹. Ex post opportunism in relation to CSR presents itself in one of the following versions or in a combination of them:

- The supplier delays necessary investments in social and environmental improvement by referring to unforeseen events and difficulties in implementation.
- The supplier intentionally ignores the terms of the agreement, e.g. by using child labour, violating union rights, neglecting dangerous working conditions and ignoring environmental responsibilities. The supplier may estimate the disclosure of non-compliance to be only a remote possibility. This is an option, especially if the chain consists of many suppliers. The costs of monitoring are likely to increase when the supply chain is diffused, i.e. when it contains many companies, and no one holds more than a fraction of the group’s total resources (Hill & Jones, 1992). In this situation, no one will be able to bear all the costs associated with a thorough monitoring of code compliance in the whole chain.
- If the supplier is an important alliance partner to the buyer, the supplier can use the bargaining power as a means to obstruct enforcement of the codes. The supplier can also *hold up* the buyer if the latter has invested substantial resources in the business relationship. Hold-up problems arise in situations where a party is forced to accept a
worsening of the effective terms of the relationship once it has sunk an investment (Milgrom & Roberts, 1992).

• The supplier unintentionally ignores the terms of the agreement. If the supplier is completely indifferent to social and environmental issues, a laissez faire leader will not take any steps to improve the working environment and external environment unless outsiders, e.g. buyers or regulatory authorities, demand it.

• The supplier violates the codes indirectly by outsourcing the most polluting and dangerous tasks to sub-suppliers who are not covered by the codes of conduct.

• The supplier misleads the buyer by withholding relevant information about the social and environmental performance. This kind of manipulation is especially an option if the code of conduct is not sufficiently monitored.

• The supplier impedes access to the production facilities and thereby obstructs the monitoring of code compliance.

• Misinterpretation. The incomplete character of most codes of conduct leaves room for interpretations. The supplier’s interpretation of code compliance might differ from that of the buyer.

In some buyer-supplier relationships it is rather easy to assess whether the supplier has delivered the right quantity to the right place, at the right price and in due time. It would be advantageous to use outcome-based payment in these relationships. However, some quality aspects of the production process - including social and environmental issues- are difficult to evaluate ex post. Very often, socially responsible products and services do not differ from irresponsible ones. It is difficult to determine, for instance, whether a product has been made with or without the use of child labour. Without comprehensive monitoring and efficient safeguards, such violations of the codes of conduct are likely to go undetected.
1.4 Safeguarding/Protective Mechanisms

As the above indicates, the implementation of codes of conduct is associated with a number of potential problems. Not all suppliers act this way, of course (cf. Williamson & Ouchi, 1981), but some might – which makes it relevant to discuss how the buyer can be safeguarded against non-compliance with the codes.

Safeguards, or protective mechanisms, are basically means to ensure that an agent fulfils his or her obligations according to the agreement (Koch, 1995)\(^v\). Safeguarding includes elements of different theories, but the purpose of this article is not to give a detailed presentation of the different positions, nor to engage in the dogmatic discussions between them. Instead the article wants to discuss how safeguards can ensure compliance with codes of conduct in global supply chains.

The safeguards/protective mechanisms dealt with in this article are as follows:

- Direct sanctions
- Goal congruence
- Third party intervention
- Trust
- Reputation effects

The classification is inspired by the work of Koch (1995) and (1997). This classification is by no means held to be definitive. The different types of safeguards are interrelated and depend upon perspective and interest. Some of them could probably be both united and split up. However, I will argue that the five types of safeguards are fairly representative of the means that are relevant to companies implementing codes of conduct in global supply chains.
1.4.1 Direct Sanctions

Contracts, whether complete or incomplete, are of little use if it is not possible to enforce them. Nonetheless, codes of conduct often do not entail any description of how non-compliance is to be monitored or what the consequences of non-compliance are (see e.g. Kolk et al. 1999). In consequence, it is rather unclear what sanctions are open to a buyer when a supplier’s non-compliance with the code is disclosed.

The ultimate and fastest way to enforce a contract is to terminate it in case of non-compliance. However, this exit strategy has certain limitations. Most importantly, the principal’s ability to terminate an agreement depends on the bargaining power of each party in the relationship. Exit is only applicable as a safeguard if it is a credible threat. Hence, if the supplier’s products and services are of vital importance to the buyer (buyer-dependence), the threat of exit has little effect. In the opposite case, if indeed the future of the supplier depends on continuous co-operation with the buyer (supplier-dependence), the supplier has a strong incentive to honour the terms of a code of conduct (Helper, 1990; Buvik & Reve, 2002).

The opportunity for direct sanctions can be improved by introducing some kind of bonding, i.e. money that is forfeited in the event of non-compliance (Milgrom & Roberts, 1992). In this context, however, the applicability of this safeguard is limited simply because codes of conduct do not have an expiry date. It will be difficult to determine when the bonds should be repaid. A less radical way is to neither pay nor return deliveries that do not comply with the codes of conduct. If an organic product is found to contain pesticides, for instance, the buyer can withhold both payment and product. However, the legitimacy of such sanctions might have to be settled by the legal system (as I shall return to later). This may involve a number of difficulties since non-compliance is not always as visible as in the case of pesticides. Moreover, even though the buyer is able to detect non-compliance, third parties might be unable to verify this claim.
In summary, direct sanctions can be an efficient safeguard against non-compliance with codes of conduct, and it is recommended that codes of conduct include an explicit description of legitimate sanctions. This will both serve as an indication of commitment to the codes of conduct and as a warning for potentially opportunistic suppliers. However, the applicability of direct sanctions depends on the characteristics of the buyer-supplier relationship. Therefore, the buyer would do well to envisage more subtle means to alleviate the fear of opportunism. Moving beyond the scope of institutional economics, buyer-supplier dialogue during the planning and implementation process can be an important element in this process (see next section).

1.4.2 Goal Congruence

Without a conflict of interest between the principal and the agent, opportunism is unlikely to occur. The basic idea of agency theory is to incite the agent to act in accordance with the principal’s interest. Moral hazard as well as adverse selection presupposes some kind of goal incongruence (Koch, 1995; Milgrom & Roberts, 1992; Dees, 1992).

In relation to codes of conduct, the risk of non-compliance increases with the goal incongruence between the buyer and supplier. Goal incongruence between buyer and supplier can have many causes, but the costs of complying with the codes are likely to be one of them. If the implementation of the codes imposes costs on the supplier, it is reasonable to consider safeguards that promote goal congruence in the relationship.

Higher levels of goal congruence in buyer-supplier relationship can be achieved in numerous ways: 1) the buyer can compensate the supplier for costs associated with code compliance. For instance, the buyer and supplier can make joint investments in environment friendly machinery; 2) The buyer can reward the supplier for complying with the codes. The supplier could, for example, get an exclusive right to deliver products and services to the buyer. However, as mentioned earlier, outcome based rewards have certain limitations; 3) the
parties can undertake joint investments in transaction specific assets which will commit both of them to the relationship; 4) by referring to the strategic potentials of CSR, the buyer can convince the supplier that they will both be better off in the future if they implement the codes; 5) the buyer can involve the supplier in the planning and implementation of the codes of conduct, and thereby stimulate commitment and goal congruence.

With regard to the latter, the use of non-economic incentives to increase commitment is normally beyond the scope of standard agency theory. Nonetheless, it should be noted that if it is possible, no matter by what means, to create commitment to the codes of conduct, compliance is more likely to be accomplished. If the codes of conducts are implemented through a top-down approach in which the suppliers have little influence on the terms, it might be difficult to ensure commitment to the project. A bottom up/voice approach in which both buyer and supplier are involved in the whole process, however, might be an important element in the successful implementation of codes of conduct (cf. Helper, 1990; Schary & Skjøtt-Larsen, 2001).

In conclusion, creating goal congruence is one of the main tasks in establishing efficient safeguards that secures the buyer against non-compliance. Especially in global supply chains where monitoring is complicated – and costly. Higher levels of goal congruence can be achieved through financial and non-financial means. It should be noted, however, that the level of goal congruence between buyer and supplier changes in the course of time (Koch, 1995).

Moreover, the societal expectations to the companies develop across time and these changes must be reflected in the codes. Therefore, goal congruence is not established once and for all. It requires continuous interrelation between buyer and supplier and must continually respond to the changing social demands in the environment.
1.4.3 Third party intervention

Even though the principal has reason to believe that the agent has violated the contract, the resolution of the conflict is often in the hands of third parties, e.g. courts and arbitrators. The normal legal system is probably one of the most important protective mechanisms in this regard. The normal legal system can be defined as: “(...) the regulatory body that can impose sanctions on the parties to a transaction in order to force them to fulfil their obligations” (Koch, 1995, p. 4). However, there are a number of limitations to ability of the legal system to ensure compliance with codes of conduct in global supply chains. For instance, it is difficult for the legal system to impose sanctions on agents, unless they fail to comply with existing laws. However, codes of conduct goes beyond the legal requirements. In consequence, non-compliance with codes does not necessarily mean non-compliance with national laws.

Moreover, enforcement of codes is difficult in countries with weak institutional structures. This is especially relevant to buyers engaged in global supply chains that involve Third World suppliers. Even if the legal system was able to settle conflicts between buyers and suppliers, the system would still face difficulties in determining whether the supplier has acted opportunistic or not. As mentioned earlier, codes of conduct are incomplete contracts. When buyer and supplier are unable to account for all contingencies and thus unable to formulate the codes of conduct in precise language, the resulting ambiguity of the agreement will leave room for conflicting interpretations of the terms. In consequence, both the buyer and the third party might be unable to prove that the agent has not complied with the agreement (Milgrom & Roberts, 1992).

Therefore, it is relevant to consider other third parties that could safeguard the buyers from non-compliance, e.g. industry organisations, certification auditors, external consultants, NGO’s or legal authorities (Kolk et al. 1999; Diller, 1999). From a contractual point of view, it is of little relevance whether the supplier is monitored by the buyer or by a third party.
However, third parties are sometimes especially competent to evaluate code compliance and, most important of all, they improve the reliability of the codes. Moreover, customers and other stakeholders might perceive third party monitoring as being more reliable and credible.

To sum up, third party intervention may serve two purposes. Most importantly, the monitoring of code compliance by third parties serves as a protective mechanism that can prevent violation of the codes. Moreover, third parties improve the credibility of the codes and signal commitment to the company’s stakeholders. In contrast to current practises in the business community, where most codes are monitored internally, third parties ought to play a more prominent role in the monitoring of codes of conduct.

1.4.4 Trust

All theories carry build-in assumptions, i.e. statements about the world that cannot be observed or tested (Neuman, 1997). With regard to the behavioural assumptions, trust vs. opportunism has been one of the major controversies between network theory and the institutional economics (see e.g. Ring & Ven, 1992; Podolny & Page 1998, p. 60-62; Granovetter, 1985). Agency theory and transaction costs theory alike are inclined to see opportunism as a central behavioural assumption, whereas network theory favours the concept of trust (Petersen, 1993; Williamson & Ouchi, 1981, Foss & Koch, 1996). However, institutional economists and network theorists seem to agree that economic agents are not in essence either opportunists or trustworthy (Schary & Skjøtt-Larsen, 2001; Williamson & Ouchi, 1981). One might question, then, whether opportunism/trust is a behavioural assumption or a variable that companies have to take into consideration when they engage in contractual relationships. Opportunism (lack of trust) and trust (lack of opportunism) are interrelated and all co-operative activities will include aspects of both.

A high degree of trust between buyer and supplier will be an effective safeguard that can reduce the costs from e.g. monitoring and performance evaluations5. The question is how the
buyer knows, which supplier to trust? Since it is difficult and costly to separate trustworthy agents from opportunists, agency theory seems to favour control over trust. However, agency theory and network theory nonetheless share the opinion that some kind of trust between the partners can develop in the course of time (Eisenhardt, 1989; Petersen, 1993; Johanson & Mattson, 1987; Podolny & Page, 1998). In general, it can be expected that a new buyer-supplier relationship will be characterised by a low level of trust. Trust is something the company must accept to rely on in a world of incomplete contracts. As the relationship evolves, however, the partners might begin to feel a moral obligation towards the cooperation. Trust emerges between the parties and, in consequence, the governance can be more relaxed (Buvik & Reve, 2002; Child, 1998; Ring & Ven, 1992). If a supplier could be trusted in past transactions, the basic argument seems to be, he or she is also likely to be trustworthy in future transactions. The cooperation can be seen as an ongoing screening process in which the principal and the agent gain knowledge of each other. In relation to codes of conduct, the buyers will often get a ‘record’ of experiences from working with the suppliers. Based on this information, the buyer will often have a pretty good idea which supplier to monitor most carefully (Granowetter, 1985).

In conclusion, long lasting relationships between buyers and suppliers ease the implementation and tend to reduce the need for thorough safeguarding (Diller, 1999). To monitor suppliers known traditionally to have been proactive in the implementation of social and environmental standards is a waste of time. In the planning and implementation of the codes, the buyer can use experiences from past transactions to target the monitoring of suppliers.

1.4.5 Reputation effects

Trust is related to reputation effects. Reputation is one of the main reasons why companies adopt codes of conduct in the first place. They want to persuade the customers that their
products and services are produced in a socially responsible way\textsuperscript{xii}. In a supply chain perspective, however, the company’s wish to be seen as socially responsible is not necessarily shared by the other actors in the chain. Therefore, compliance with codes will be affected by the actors’ interest in sustaining their reputations as reliable transaction partners.

The reputation of a supplier can be seen as a resource that influences future income (Koch, 1995; Bensaou & Anderson, 1999). If a supplier acts opportunistically, for instance, the buyer will probably not engage in future transactions. Moreover, the buyer might inform other companies that the supplier is an unreliable partner. On the other hand, establishing and maintaining a reputation as an honest and trustworthy person may be associated with costs (Ostrom et al. 1993). The supplier’s choice of action will depend on an individual evaluation of the costs and benefits of reliability.

In general, the value of a reputation depends on: “(...) the frequency of similar transactions, the horizon over which similar actions are expected to occur, and the transaction’s profitability” (Milgrom & Roberts 1992, p. 139). For instance, a supplier has a strong incentive to comply with the buyer’s codes of conduct if the buyer is a strategically important partner that can be expected to place a lot of orders in the future. In this case, reputation will serve as an efficient safeguard, because the supplier has a strong incentive to maintain a good relationship with the buyer\textsuperscript{xii}.

The strength of reputation as a protective mechanism also depends on the extent to which opportunism is likely to be detected and on the buyer’s ability to communicate incidents of supplier opportunism to other companies (Williamson, 1996; Koch, 1995). With regard to the latter, the costs of opportunism are heavier if the buyer holds a prominent position in the industry and is able to communicate the supplier’s violation of the code to other business partners. Therefore, reputation effects can be expected to be a stronger protective mechanism in networks with frequent interaction between the companies involved.
In conclusion, the applicability of reputation effects depends on the supplier’s overall interest in sustaining a good relationship to the buyer. Relying on this protective mechanism requires an analysis of the power structures in the relationship, the characteristics of the transactions, and the external environment.

### 1.5 Conclusion: Recommendations for Companies Implementing CSR in Global Supply Chains

In general, codes of conduct can be seen as a contract between the company and society. The company promises to fulfil its societal obligations as a corporate citizen by being profitable, law-abiding and ethical (cf. Carroll & Buchholtz, 2003). In a supply chain perspective, however, such a promise cannot be made without the active commitment of all actors involved. Codes of conduct serve as guiding principles for the behaviour throughout the supply chain. Especially when the codes of conduct are formulated in vague terms, the codes leave room for interpretation – and for opportunism. Moreover, the risk of opportunism will increase with the costs that the supplier has to bear in order to comply with the codes. If there are only few costs associated with implementing the codes, the need for safeguarding is limited. When the supplier’s expenses increase, safeguarding code compliance becomes highly relevant.

The previous sections of this article have discussed some of the problems that are associated with ensuring code compliance throughout the chain. Moreover, the article has presented some of the basic safeguards/protective mechanisms against supplier opportunism. These findings can be summarised into a number of general recommendations to companies implementing codes of conduct in global supply chains:

- Code compliance can seldom be achieved through outcome based rewards, simply because final products and services say very little about whether the supplier has acted in
accordance with the terms of the agreement. Therefore, alternative monitoring and enforcement procedures must be considered and included in the code of conduct.

- Implementing codes of conduct in global supply chains requires a screening of the involved suppliers. Especially new suppliers should be screened in order to prevent investments in relationships with socially irresponsible suppliers. Screening can be relaxed if the buyer has thorough knowledge of the supplier from past transactions. It is worth mentioning, however, that it is not always possible to predict future behaviour from past experiences.

- Direct sanction is a very effective safeguard if the buyer is the dominant partner in the business relationship (Unless non-compliance is very likely to go undetected, of course) (Koch, 1995). The governance of code implementation can be relaxed if the exchange relationship is very important to the supplier (cf. Hill & Jones, 1992). An analysis of the power structure and the resource dependency in the chain must be included in the planning of safeguard mechanisms. A description of legitimate direct sanctions should be included in the formulation of codes of conduct.

- Metaphorically speaking, direct sanction/exit is the stick whereas a bottom up/voice approach can be seen as the carrot (Helper, 1990). Codes of conduct are often implemented in a top-down way, but an increased involvement of the supplier in the planning and implementation of the codes might reduce the risk of opportunism because it aligns interests and establishes commitment to the initiative throughout the supply chain.

- Goal congruence can be achieved through joint investments and/or medium and long-term delivery contracts conditioned by code compliance. For instance, the buyer can support investments in social and environment friendly technology and offer training and technical assistance in social and environmental management.
• Trust can be an effective safeguard, especially in long-term relationships in which the buyer and the supplier have accumulated a thorough knowledge of each other. However, it is difficult to separate opportunistic and trustworthy suppliers, and therefore trust must be combined with other safeguards.

• Third party monitoring and enforcement can be an effective protective mechanism. Moreover, third party verification can be a means to improve the overall credibility of the codes. Codes of conduct are often met with some scepticism, and failure to ensure compliance with the codes might erode the overall credibility of the buyer’s voluntary initiative. In general, third party involvement can be recommended in the implementation of codes of conduct.

• Reliance on reputation effects depends on the costs and benefits of opportunistic behaviour. Reputation is a highly relevant safeguard when the supplier is dependent on future co-operation with the buyer, and/or the buyer can harm the supplier by communicating non-compliance to other relevant actors, e.g. in business networks. As with direct sanctions, the planning of code compliance mechanisms requires an analysis of the relationship with the suppliers in the chain.

Research in safeguarding/protective mechanisms is fragmented and often affected by internal disputes between different academic disciplines (most notably transaction cost theory and network theory). This article has tried to give an overview of some of the basic protective mechanisms that can safeguard the buyer against the supplier’s non-compliance with codes of conduct in global supply chains. However, it should be noted, that no single protective mechanism is superior to the others in every circumstance (Koch, 1995). Moreover, it is probably possible to identify further safeguards, to make new classifications and to elaborate existing ones. Systematic research in protection against opportunistic behaviour is highly
needed - not only in relation to the implementation of codes of conduct (cf. Das & Rahman, 1992). Opportunism occurs in all relationships between individuals, and thus safeguarding is relevant to the understanding of all aspects of the social and economic life.

**References**


Helper, S.: 1990, An Exit-Voice Analysis of Supplier Relations, Boston University, School of Management, Boston.


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i This definition is by no means universal (see e.g. Diller 1999, p. 102; Kolk et al. 1999, p. 151; Carroll & Buchholtz 2002, p. 232).

ii In agency theory, agreements are referred to as contracts whether they have a legal status or not. Contracts do not have to be a set of written statements and principles. They can be implicit and based on mutual understanding (Milgrom & Roberts 1992, p. 127).

iii Eisenhardt (1989, p. 59) makes a distinction between a predominantly descriptive (positivist agent theory) and a normative (the principal-agent research) agency theory. The positivist agent theory tries to describe why certain contractual relations arise. The other, more mathematical principal-agent research tries to determine the optimal contract between the principal and the agent (ibid. 1989, p. 60). However, even though there are some differences between the two perspectives, they both have the same units of analysis (the principal and the agent), share most of the basic human assumptions and address the same problems arising from goal incongruence, opportunism etc. Therefore, this article will not make a distinction between the two schools.

iv Perrow (1986, p. 227) and Dees (1992, p. 35) criticises agency theory for being predominantly concerned with agent opportunism. In relation to this article, opportunistic behaviour concerns the supplier’s violation of an agreement (Codes of Conduct) with a buyer. This does not imply, however, that buyer (principal) opportunism is without importance. However, this question should be analysed in another article.

v Three conditions must hold before it is relevant to discuss ex post opportunism 1) Conflict of interests to some degree, 2) Some rationale for cooperation between the principal and the agent, and 3) difficulties in determining whether the agent complies with the agreement and if not, enforce the terms of the agreement (Milgrom & Roberts 1992, p. 185).
Safeguarding, more or less synonymous with governance, is here defined as: ”(... the means by which order is accomplished in a relation in which potential conflict threatens to undo or upset opportunities to realize mutual gains” (Williamson 1998, p. 76). Moreover, safeguarding also bears similarities with the term deterrence, i.e. mechanisms that”(...) curb and control opportunistic behaviour” (Das & Rahman 2002, p. 90).

In general, if there were no costs associated with implementing CSR initiatives, most companies would adopt a socially responsible profile as a means to reduce the company’s risk. However, in real life situations, there are often real costs associated with CSR initiatives (cf. Utting 2000, p. 26; Walley & Whitehead 1994, p. 46; Kapstein 2001, p. 115).

However, even though the voice strategy is attractive to many academics, because it seems more constructive than the take-it-or-leave-it exit strategy, voice is not a panacea that can be applied to all business relationships. The voice strategy requires information, communication, and coordination between the buyer and the supplier, which will inevitably increase the transaction costs of the cooperation. These additional costs have to be compared with the benefits deriving from increased commitment and goal congruence (Helper 1990, p. 10).

According to Kapstein (2001), the reliability of third party monitoring can also be questioned. From a case study it was concluded that: ”(...)the auditors ignored hazardous chemical use, barriers to freedom of association and collective bargaining, violation of overtime and wage laws, and other infractions” (Kapstein 2001, p. 116).

In this article, trust is defined as: ”(...) the confidence of a person, group, or organization relating or transacting with another under conditions of some uncertainty that the other’s actions will be beneficial rather than detrimental to it” (Child 1998, p. 243-244).

In an investigation of 246 voluntary codes of conduct, it was concluded, that enhancement of the company’s reputation and stronger customer loyalty was a strong motivation for implementing codes (OECD 2000, p. 4). In an analysis of Swedish firms introducing ISO 14000, 88,5 percent of the companies considered “corporate image” as an important or very important motivation factor (Pokinska et al. 2003, p. 593).

Agency theory is based on the relationship between two individuals, but it worth mentioning that the costs and benefits of opportunism differ between individuals and organisations. An opportunistic individual might receive all benefits from opportunism, whereas the organisation as a whole has to bear at least part of the costs. Even though an organisation has an advantage in maintaining a good reputation, it does not eliminate the risk of individualistic opportunism, because organisations consist of individuals with diverging interests.