



**BETTER WORK**

## Better Work Discussion Paper Series: No. 5

### Does Better Labour Standard Compliance Pay? Linking Labour Standard Compliance and Supplier Competitiveness

Chikako Oka

March 2012



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**DOES BETTER LABOUR STANDARD COMPLIANCE PAY?**

**LINKING LABOUR STANDARD COMPLIANCE AND SUPPLIER COMPETITIVENESS**

**Chikako Oka**

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March 2012

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## **Abstract**

Faced with growing demands for responsibility in global supply chains, multinational companies are increasingly regulating labour and other conditions of their suppliers through codes of conduct and monitoring. While research in this area has been expanding rapidly, the link between labour standard compliance and competitiveness of supplier firms remains unexplored. This paper seeks to fill the gap by examining whether the supplier's level of labour compliance affects its likelihood of attracting and retaining buyers. Based on original survey and panel data from Cambodia's garment sector, the paper shows that better labour standard compliance is a necessary condition for producing for reputation-conscious buyers but not a sufficient condition for attracting them. Other criteria such as price, quality, and delivery time are driving buyers' sourcing decisions. Nevertheless, producing for a certain buyer type and respecting certain labour standards increases the supplier's likelihood of retaining buyers, which is critical to the supplier's competitiveness.

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## I. INTRODUCTION

In the past decade, the focus of the debate concerning labour standards appears to have shifted from the desirability to the efficacy of various forms of labour regulation, notably private and non-governmental schemes in global supply chains (Sabel et al., 2001; Elliot and Freeman, 2003; Weil 2005; Barrientos and Smith, 2007; Locke et al. 2007). While the burgeoning literature has examined various means by which labour conditions can be improved in global supply chains, the link between labour standard compliance and competitiveness of supplier firms has received little attention.

The lack of research in this area is partly explained by the fact that scholars studying the subject tended to focus on the plight of workers toiling under dismal conditions and various means to regulate unscrupulous firms rather than ways to motivate firms to improve labour conditions (e.g. Esbenshade, 2004; Seidman, 2008). Another reason behind the dearth of studies linking labour standards and competitiveness lies in the difficulties in accessing the firm-level data on working conditions and productivity in global supply chains. Considering that many supplier firms still view labour standard compliance solely as a cost, it is of great importance to examine whether and to what extent improving labour conditions can also help enhance supplier competitiveness.

This paper looks at the nexus between labour standard compliance of supplier firms and their potential for attracting and retaining buyers. For supplier firms to survive and prosper, it is important to attract and retain buyers, in particular those that give sufficient margins and continuous orders. In the apparel industry, buyers are increasingly concentrated and competition among suppliers all over the world has intensified, putting constant downward pressures on price (Hurley and Miller, 2005). Moreover, as the industry is marked by seasonal volatility, lack of orders during low seasons could be detrimental to the survival of supplier firms. Having a long-term relationship with buyers can help smooth out these risks. The question then is whether and to what extent better compliance increases the supplier's chance of attracting and retaining such buyers.

To shed light on these issues, this study uses two sets of data. First is a self-designed survey of 14 major buyers conducted by the author in 2008 that asked detailed questions regarding the process and mechanism of controlling labour standard compliance of suppliers. Second, firm-level data of nearly 400 firms in Cambodia's garment sector from 2006 to 2010 was obtained from Better Factories Cambodia (BFC), operated by the International Labour Organization (ILO). BFC has been monitoring Cambodia's garment export factories since 2001 with a view to encouraging continuous improvement.<sup>1</sup> One of the unique features of the program is that BFC monitors can access to virtually all exporting garment factories in the country as the Cambodian government requires all garment factories seeking export licenses to submit to BFC monitoring. Such unprecedented access and comprehensive data give an excellent opportunity to explore the link between labour standard compliance and competitiveness of supplier firms.

The next section considers the nexus between labour standard compliance and firm performance. Section III discusses the result of the buyer survey to understand how buyers try to ensure the level of labour standard compliance in their supplier factories. Section IV builds a conceptual framework to understand how buyer types may influence the process of attracting and retaining buyers. Section V describes the data and measures while Section VI discusses the regression results. The last section concludes that labour standard compliance and competitiveness of supplier firms appear to be linked in a rather nuanced and subtle manner.

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<sup>1</sup>More information about Better Factories Cambodia can be found on their website: <http://www.betterfactories.org>

## II. LABOUR STANDARD COMPLIANCE AND FIRM PERFORMANCE

Labour standard compliance can potentially affect the supplier firm's performance both negatively and positively. Supplier firms often grumble about the cost of compliance negatively affecting their bottom-line and their claim is not without evidence. Based on firm-level survey data from 16 developing countries, Maskus et al. (2005) showed that the investment cost to comply with various technical standards (e.g. safety, environment) imposed by importing countries significantly increased start-up and production costs. This is likely to apply to labour standards as well. Stigzelius and Mark-Herbert (2009) found that Indian garment manufacturers that implemented SA8000, a workplace and human rights standards developed by Social Accountability International, faced increased labour and investment cost as they were obliged to reduce overtime and improve facilities.

If buyers enforcing their codes of conduct pay for the cost of compliance by offering compliant suppliers premium prices or increased orders, suppliers can recover the cost of compliance. In reality, however, such burden sharing practice is almost non-existent in the global apparel industry (Locke et al., 2009). Ruwanpura and Wrigley (2011) find that high levels of labour standard compliance among Sri Lanka's apparel manufacturers are neither rewarded through higher prices nor offered guaranteed business.

Notwithstanding such lack of support from buyers, the cost of compliance may be offset by positive effects of better working conditions and respect for human rights through higher productivity. According to the human capital theory, workers require investment and maintenance just as physical capital (Becker, 1975). Hence, firms can improve performance through investing in employees and encouraging them to acquire knowledge and skills. Moreover, better treatment of workers should motivate employees and make them more loyal and cooperative, contributing to productivity (Pheffer, 2007).

Growing empirical studies suggest that human resource innovations (e.g. selection, incentives, training, job enrichment, participation, teamwork, job security etc.) have positive impacts on firm performance (e.g. Ichinowski et al., 1997; Shaw, 2006). Factory managers may well see productivity-enhancing effects of complying with labour standards



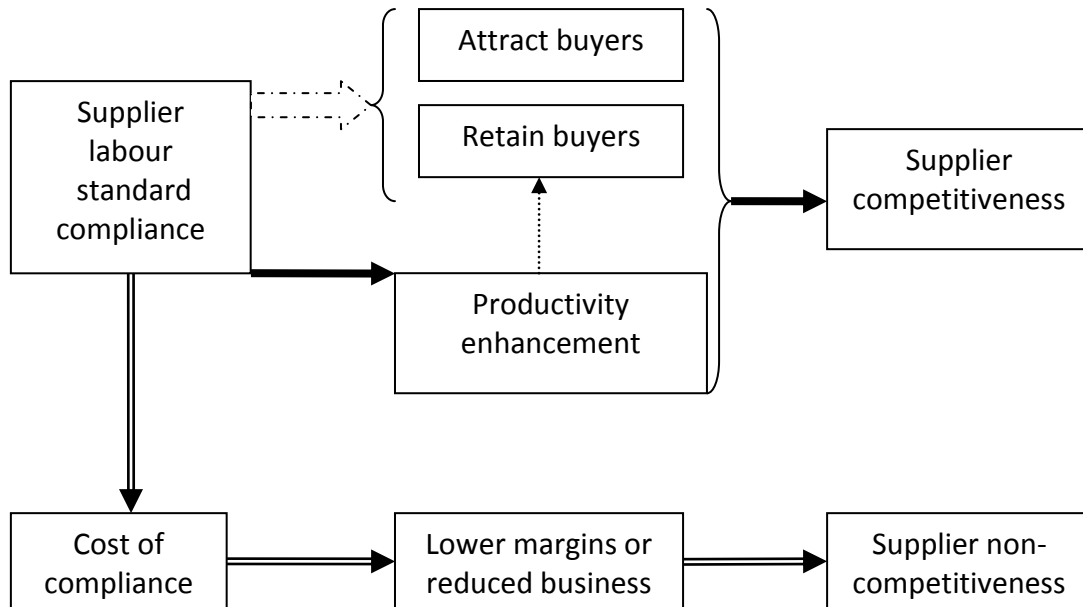
through increased worker motivation and consistent effort or other efficiency gains. Locke and Romis (2007) showed that a garment factory that trained and empowered workers had higher productivity than the other otherwise similar factory through a matched pair case study in Mexico. Robertson et al. (2011) argue that such efficiency gains from HR innovations may well be behind the broad-based progress in labour standard compliance in Cambodia's garment sector.

There is potentially another channel by which labour standards and competitiveness of supplier firms may be linked and yet overlooked: attracting and retaining buyers. We can think of at least two ways in which compliant suppliers may attract and retain buyers. First, buyers may prefer sourcing from better compliant suppliers to safeguard their reputation. Those buyers that derive most of their profits from branding are dependent on image and social legitimacy, which can be easily tarnished by negative publicity surrounding dismal working conditions and child labour in their supply chains. Hence, those reputation-conscious buyers are more likely to carefully select and monitor their suppliers to minimize potential problems and to safeguard their reputation (Oka, 2010a).

Second, buyers may also be attracted to compliant suppliers for reasons other than labour standard compliance per se. If indeed better compliance helps improve productivity, buyers should be attracted to those productive suppliers that can offer better quality for competitive prices. Hence, more compliant suppliers can potentially attract and retain buyers *directly* through reputation concerns and *indirectly* through productivity gains.

Figure 1 summarizes the potential channels linking the supplier's labour standard compliance and competitiveness. To achieve compliance, supplier firms are likely to incur cost, which is not compensated by their buyers. This would translate to reduced margins for suppliers if they avoid passing the cost of compliance on to buyers. If they do, their prices become less competitive and they are likely to lose business. Either way, the cost of compliance negatively affects supplier competitiveness. On the other hand, better compliance can help improve productivity, which would enable the supplier firm to offer better quality products for competitive prices, leading to increased business. Moreover, compliant firms may be in a better position to attract and retain buyers than less compliant firms because of reputation concerns of their buyers.

**Figure 1. Potential channels linking labor standard compliance and competitiveness of supplier firms**



While there is growing literature exploring the link between buyers and labour conditions of supplier firms, there has been no systematic study yet that looks specifically at how the supplier’s labour compliance may affect its likelihood of attracting and retaining buyers. Existing research has focused on particular brands and whether and how brands can encourage their suppliers to improve labour conditions (Frenkel and Scott, 2002; Locke and Romis 2007; Locke et al. 2007). Oka (2010a) shows factories producing for reputation-conscious buyers systematically outperform other factories with regard to labour standard compliance in Cambodia’s garment sector. Robertson et al. (2011) corroborated the findings across various labour standards. Yet, they did not assess whether and how labour standard compliance may affect buyer variables, which is the focus of this paper.

### III. BUYER SURVEY RESULTS

To better understand how buyers try to monitor and control the level of supplier compliance, the author conducted a buyer survey on 9-10 October 2008 in Phnom Penh, Cambodia during the Buyers Forum, a bi-annual event where major buyer representatives gather to exchange views with other buyers and stakeholders and to build consensus. In

total, 14 responses from compliance staff were collected, of which 9 BFC member buyers, 4 non-BFC buyers, and 1 sourcing agent.<sup>2</sup> These 13 buyers account for 45 percent of Cambodia's garment export value.

This survey complements the Cambodia Buyer Survey conducted in 2004 by Foreign Investment Advisory Service (FIAS), which sought to gauge the importance of labour standard issues in buyers' sourcing decisions.<sup>3</sup> The survey targeted senior sourcing staff from 15 of the largest US and EU buyers accounting for about 45 percent of Cambodia's garment exports. One of the key results of the FIAS survey was that labour standards figured prominently in buyers' decisions in selecting a country to source from, although it had to be balanced with traditional sourcing criteria such as price, quality, and delivery time. This survey complements the FIAS survey by asking detailed questions regarding the process and mechanism of controlling the level of labour standard compliance in supplier firms.

Buyer responses reported in Table 1 show that all of the surveyed buyers check compliance levels of their potential supplier factories before placing orders and rate compliance performance of existing supplier factories, showing buyers' great attention to labour standard issues. Almost all the buyers use the compliance rating to identify poor performers rather than good performers, confirming that buyers tend to use sticks rather than carrots to reduce labour standard violations in their supply chains. This is consistent with others' findings that suppliers' better compliance is not rewarded by buyers through increased orders (Ruwanpura and Wrigley, 2011).

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<sup>2</sup> With the assistance of ILO-BFC, the author distributed questionnaires to 16 participating buyer representatives, of which 12 returned completed forms during the forum. Subsequently, the author contacted 15 other buyers who did not participate in the forum, of which 2 completed the questionnaire on-line.

<sup>3</sup> FIAS is a joint facility of the International Finance Corporation (IFC) and the World Bank. The FIAS Buyer survey results can be found here: <http://www.betterfactories.org/content/documents/Cambodia%20Corporate%20Social%20Responsibility.pdf>

**Table 1. Responses to the buyer survey regarding labour standard compliance of supplier factories**

Survey Questions	Number	Valid	Missing
<u>1. Compliance Check</u>			
Does your company check compliance levels of factories before placing orders?		14	0
Yes	12		
Partially Yes	2		
No	0		
<u>2. Compliance Rating</u>			
2-a. Does your company rate compliance performance of supplier factories?	14	0	
Yes	14		
No	0		
2-b. If yes to above, how does your company use the rating? (multiple answers possible)		13	1
To identify poor performers and encourage them to improve	13		
To identify very poor performers and reduce/cancel orders	3		
To identify good performers and reward them with more orders	2		
<u>3. Monitoring Procedure</u>			
Which procedure, if any, does your company use to ensure an acceptable level of compliance at supplier factories? (multiple answers possible)		13	1
Zero Tolerance	6		
Three Strikes	6		
Continuous Improvement	7		
<u>4. Warning</u>			
4-a. How often does your company issue warnings to supplier factories in Cambodia that certain non-compliance leads to cancellation of orders?		13	1
Often	1		
Sometimes	6		
Rarely	5		
Never	1		
4-b. If yes to above, regarding which issues? (multiple answers possible)		9	5
Child labour, Forced labour	5		
Wage	4		
Contract	3		
Overtime, Disputes/Strikes, FoA, Welfare	2		
Leave, Safety & Health, Discrimination	1		
<u>5. Cancellation of Orders</u>			
Has your company ever cancelled orders because of compliance problems in Cambodia?		14	0
Yes	4		
No	10		

As for the monitoring procedure, all the surveyed buyers have some kind of procedure to ensure an acceptable level of compliance. “Zero tolerance” means that

violations of certain standards, often fundamental issues such as child labour lead to immediate cancellation of orders. “Three strikes” suggests that factories are required to achieve an acceptable level of compliance in three audits, or they lose orders. “Continuous improvement” indicates that buyers work closely with factories to solve problems on a continuous basis. Some buyers combine different procedures.

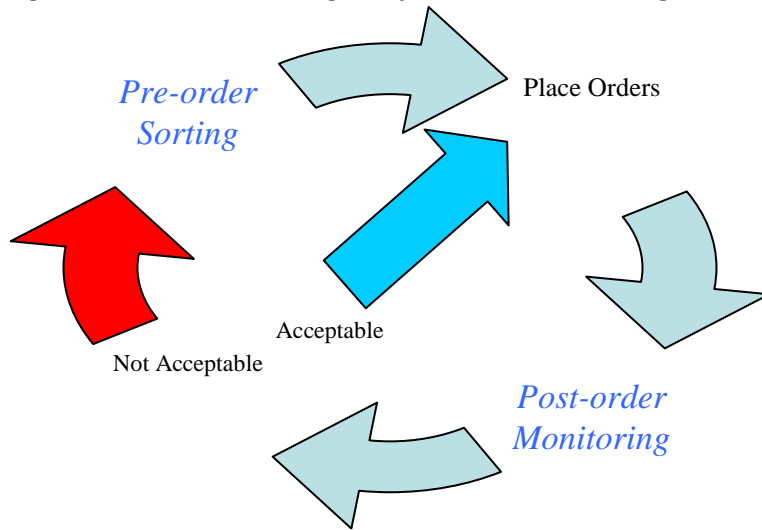
The surveyed buyers occasionally issue warnings to supplier factories that certain non-compliance leads to cancellation of orders and such warnings mainly concerned child labour, forced (or involuntary) labour, wage and contract issues. Nonetheless, cancellation of orders due to non-compliance is a rare event. Only four buyers have ever resorted to this option, of which one buyer temporarily withheld orders in Cambodia. This lack of consequences in the event of violations is not specific to Cambodia. Locke et al. (2009: 326) call it “an open secret” that very few buyers exit supplier factories because of non-compliance with the codes of conduct.

In sum, the buyer survey results show that major buyers concerned about labor conditions in their supplier firms try to control the level of compliance through *pre-order sorting* and *post-order monitoring*.<sup>4</sup> As shown in Figure 2, buyers check the compliance level of their potential suppliers before placing orders and select suppliers based on their criteria (pre-order sorting). When factories do not pass an initial audit, most buyers require them to provide a corrective action plan and submit themselves for follow-up visits. Once the compliance level is deemed acceptable and orders are placed, supplier factories will be regularly monitored to ascertain whether suppliers continue to satisfy the required standards (post-order monitoring).

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<sup>4</sup> In the context of regulating the US garment industry, Weil and Mallo (2007: 807) distinguish between the sorting effect, where manufacturers seek to match themselves with better complying contractors *ex ante* and the direct effect, where manufacturers try to make their contractors more compliant through monitoring.

**Figure 2. Pre-order sorting and post-order monitoring**



If the supplier factory continues to satisfy the buyer in terms of compliance as well as other criteria (e.g. price, quality, delivery), the factory continues to receive orders. Otherwise, in theory, the factory will lose orders and need to go through the pre-order sorting process again. In reality, however, once orders have been placed, except for egregious violations, labour compliance rarely affects buyers' sourcing decisions, as confirmed by the survey. Non-compliance with codes of conduct is often overlooked partly because buyers' compliance staff has less influence than sourcing colleagues when they decide whether or not to continue buying from a non-compliant factory (Locke et al. 2009). There is also a switching cost associated with changes in suppliers. Hence, buyers have more leverage *before* placing orders in influencing supplier behaviour and selecting more compliant suppliers than *after* placing orders.

One of the limitations of this buyer survey is a small and non-representative sample. Given that most respondents are BFC members and participants in the Buyers' Forum, these buyers are likely to be more concerned about labour conditions in their supply chains than the average buyers sourcing from Cambodia. Thus, the survey responses are likely to be biased toward buyers' active involvement. Second, this type of surveys asking buyers how they implement codes of conduct is unlikely to be able to distinguish between policies and actual practices, which are often decoupled. These limitations notwithstanding, the survey highlights that i) even those buyers concerned about suppliers' labour conditions

rarely reward compliant suppliers through increased orders and ii) that these buyers rarely terminate orders because of non-compliance.

#### **IV. CONCEPTUAL FRAMEWORK**

The process of attracting and retaining buyers can be conceptualized in three stages: (i) mode of transaction, (ii) sorting, and (iii) relationship formation. First, given a combination of sourcing criteria (price, quality, delivery time, as well as labour and other standards), buyers decide whether to transact directly with their supplier firms or indirectly through sourcing agents (in some cases, buyers use both channels). Second, buyers or agents select supplier firms based on their sourcing criteria. Third, once the buyer and the supplier enters a business relationship, the duration can vary from one season to a number of years, depending on the extent to which the supplier continues to satisfy the buyer's needs.

The process of attracting and retaining buyers is likely to differ depending on the type of buyers a supplier is dealing with. Buyer types in the apparel industry can be broadly classified into two types: *specialty retailers* and *mass merchandisers*. Specialty retailers specialize in certain apparel products and target certain market segments (e.g. H&M, Nike) whereas mass merchandisers offer a variety of products including non-apparel products and appeal to the mass market (e.g. Target, Wal-Mart). The two buyer types differ notably in terms of product categories. Products can be broadly classified as *functional products* that have long product life cycles such as basic clothing and *innovative products* that have short life cycles such as fashion apparel (Lee, 2002). Specialty retailers tend to specialize in innovative products while mass merchandisers tend to focus on basic functional products and this has important implications for quality requirements, nature and duration of relationships, and profit margins for suppliers.

In the first stage, buyers choose the mode of transaction based on the level of standards required. According to Transaction Cost Economics, when a transaction requires a higher degree of asset specificity, or non-transferable investment in one's partner, this raises switching cost and the risk of opportunism in the absence of safeguards (Williamson,

1975 & 1985). Thus, buyers requiring stringent quality and labour standards are likely to prefer vertical integration (*hierarchy*) than arms'-lengths relationships (*market*). Nonetheless, growth of global outsourcing in labour-intensive industries like apparel has made vertical integration less viable as firms started to source from contractors around the world. Hence, the middle ground between *hierarchy* and *market*, namely strategic alliances have become popular as a good compromise, which Williamson (1991) call *hybrid*.

On the one hand, buyers can better control supplier opportunism (i.e. in this case non-compliance with required standards such as codes of conduct) through direct transactions with suppliers than through indirect transactions via sourcing agents. On the other hand, sourcing agents can quickly find the cheapest suppliers that satisfy the buyer's conditions. Given the relative advantages, buyers that require stringent standards tend to prefer direct transactions while buyers with more emphasis on price and quantity prefer using sourcing agents (Oka, 2010b). Accordingly, specialty retailers with rigorous standard requirements are likely to prefer a direct relationship with suppliers while mass merchandisers with emphasis on price and quantity are likely to transact indirectly through sourcing agents.

In the second stage of supplier sorting, buyers or agents select suppliers based on their sourcing criteria. While mass merchandisers are more demanding in terms of price, specialty retailers tend to place more weight on quality and delivery time. In addition to these traditional sourcing criteria, buyers increasingly demand their suppliers to satisfy labour, environmental, and other standards. As shown earlier in the buyer survey, most buyers check the level of labour standard of candidate suppliers.

In the third stage of relationship formation, buyers requiring more stringent standards are likely to favour a long-term relationship for the same reason they prefer a direct transaction: better controlling supplier opportunism through repeated transactions. Switching cost is higher especially for those buyers who select their suppliers carefully and invest in the relationship. On the other hand, the supplier's relationship with mass merchandisers is likely to be shorter as mass merchandisers often rely on agents to pick suppliers from one season to another, making it difficult to form a long-term relationship.



Profit margins also vary with buyer types. The gaps in margins are partly explained by product types as functional products have lower profit margins than innovative products (Lee, 2002). Moreover, mass merchandisers can use their market power to drive down supplier margins. For instance, studies have shown that suppliers of Wal-Mart had lower profit margins compared to other suppliers (Bloom and Perry, 2001; Mottner and Smith, 2009). This is confirmed by field-based interviews conducted by the author as one manager of a factory supplying Nike said that they would not consider producing for Wal-Mart as margins would be too low.

In sum, the supplier's likelihood of attracting and retaining is likely to be moderated by buyer types as they have different requirements and preferences. Given the stringent standards required, specialty retailers are likely to be harder to attract than mass merchandisers. On the other hand, once a business relationship starts, specialty retailers are likely to stay longer in the relationship than mass merchandisers, who tend to switch suppliers more frequently. Moreover, specialty retailers give better profit margins than mass merchandisers.

## **V. DATA AND MEASURES**

This section operationalizes concepts to answer the following questions: (i) Are pre-order selection criteria different between specialty retailers and mass merchandisers? (ii) Do better complying factories (i.e. violating fewer labour standards) attract more reputation-conscious buyers? (iii) Are compliant factories better able to retain buyers?

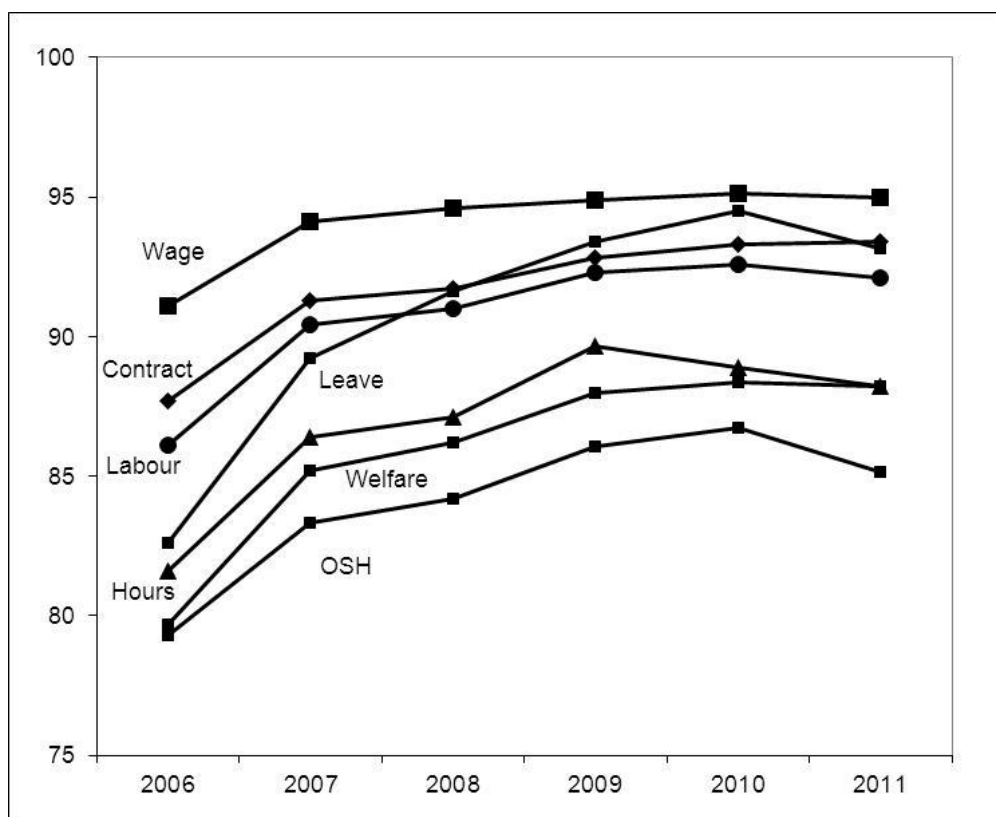
The data for this study draw on the firm-level data collected by ILO BFC. Pairs of BFC monitors conduct un-announced visits of all exporting garment factories every 8 months on average. While monitoring started in 2001, the data have been systematically stored only since December 2005. Thus, this study covers the data from December 2005 to December 2010. During this period, 1868 factory inspections were conducted for a total of 396 factories. In addition to the compliance data, BFC collects information on firm characteristics such as the number of employees, unions, country of ownership, as well as the name of buyers sourcing from the factories.

## COMPLIANCE MEASURES

BFC monitors assess nearly 400 checklist items of labour standards, which are based on the Cambodian labour law and the international core labour standards. These are grouped into the following categories: contracts, wages, hours, leave, welfare, occupational safety and health (OSH), labour relations, and fundamental rights. Given that monitored standards for hours and leave are few and that they measure similar issues (i.e. the number of hours/days worked), they are combined together to form one category, hours-leave. Similarly, welfare is joined with OSH to form OSH-welfare, as welfare has only few monitored standards and the majority of them are closely related to OSH (e.g. drinking water and toilets). Fundamental rights need to be treated separately since violation of fundamental rights occurs only rarely, but one incidence of non-compliance has serious implications. Hence, non-compliance of fundamental rights is measured by a binary variable (whether or not violation occurred) rather than a continuous variable (how many violations occurred).

As for monitoring procedures, un-announced visits span an entire day. The process includes on-site inspection, meetings with human resource managers, union leaders, and shop stewards as well as interviews with workers. Monitors collect copies of pay slips and hour records for verification. BFC monitors assess each checklist item and determine whether a factory complies with a specified standard or not. Figure 3 shows the evolution of compliance rates, where a 100 indicates a full compliance for the category. While we can observe overall progress across issue areas, some violations remain stubbornly common, notably excessive overtime.

**Figure 3. Evolution of compliance rates by issue category**



### BUYER VARIABLES

As monitoring is industry-wide, compliance and basic firm characteristic data are available for all exporting garment factories, but this is not the case for buyer variables. As of now, 22 buyers have joined BFC, which make up more than half of Cambodia’s garment export volume. As others have not joined, however, BFC does not possess complete information about which buyer is sourcing from which factory. Moreover, some buyers joined BFC later, making it difficult to analyse their relationship with suppliers over time. To circumvent this problem, this study limits the analysis to seven specialty retailers and three mass merchandisers, who have been BFC members since 2006.

All of the buyers included in the sample are globally famous buyers who have invested in corporate social responsibility efforts, so I call them reputation-conscious buyers. But, the degree of reputation-consciousness is likely to vary. For instance, while all of them joined BFC at the outset, not all of them have joined other highly regarded multi-stakeholder initiatives such as the Fair Labor Association (FLA) and the Ethical Trading

Initiative (ETI).<sup>5</sup> Buyers join these initiatives to show their commitment to better working conditions and to safeguard their reputation, so the membership signals a high degree of reputation-consciousness. In fact, all the seven specialty retailers are members of either the FLA or the ETI while none of the three mass merchandisers are.

To evaluate the compliance pattern of suppliers producing for different buyer types, the following buyer dummies have been created. A specialty retailer dummy takes the value of one if the observation belongs to a supplier producing for an original BFC buyer classified as a specialty retailer, and zero otherwise. A mass merchandiser dummy is created in the similar manner. There is some overlap, suggesting that some factories produce for both types of buyers. As for the duration of buyer-supplier relationship, it is considered “long” when the relationship lasted at least from 2006 to 2010, covering the entire period of this study.

To measure the levels of labour compliance required by different buyer types, it is important to separate pre-order sorting effect from post-order monitoring effect. Specifically, observations where a supplier entered into a business relationship with a buyer for the first time have been labelled as “new” supplier observations.<sup>6</sup> Figure 4 shows the average compliance rate of new suppliers by buyer types. It shows that new suppliers of specialty retailers have better overall compliance rate than new suppliers of mass merchandisers. Moreover, both types outperform suppliers of other buyers who were not original BFC members. This confirms the assumption that reputation-conscious buyers, specialty retailers in particular choose more compliant suppliers than other buyer types.

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<sup>5</sup> See Oka (2010a) for discussion on the FLA and the ETI.

<sup>6</sup> As there is no buyer information prior to 2006, those suppliers that already produced for the original BFC buyers in 2006 are considered as pre-existing suppliers.

**Figure 4. Average compliance rates of new suppliers by buyer types**

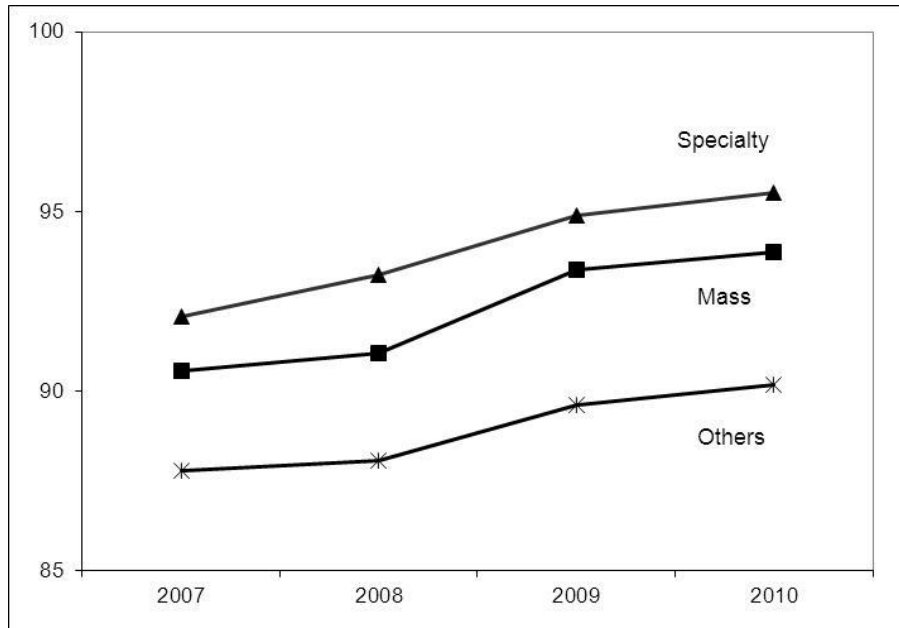


Table 2 provides the summary statistics regarding the number of non-compliance items for different buyer and supplier variables. We can observe that fewer numbers of violations are reported for suppliers of specialty retailers (27.3) than those of mass merchandisers (32) but the latter is still better than the full sample average (37.9). New suppliers of specialty retailers violate fewer items (23.5) than the average, which is not surprising as newer factories tend to be more compliant. 55 percent of observations belonging to the suppliers of specialty retailers are in long-term relationships, compared to 23 percent for the suppliers of mass merchandisers, confirming the different preferences of buyers. Generally, suppliers in long-term relationship have fewer violations than the average.

**Table 2. Summary statistics of buyer and supplier variables**

	Number of compliance items	non-Number of Observations	of Share (%)
<u>Full Sample</u>	37.9	1959	100
<u>Limited Sample (suppliers of original BFC buyers)</u>			
Suppliers of specialty retailers			
All suppliers (average)	27.3	509	26.0
<i>of which</i>			
New suppliers	23.5	81	15.9
Long-term relationship	25.7	280	55.0
Suppliers of mass merchandisers			
All suppliers (average)	32	745	38.0
<i>of which</i>			
New suppliers	32.1	191	25.6
Long-term relationship	29	171	23.0

For regressions, other firm characteristics known to affect the level of compliance are also considered, namely the size and age of the firm, foreign ownership, and the number of unions in the establishment. The firm size is measured by the number of employees in the establishment. The age of the firm is measured by the number of monitoring visits by the ILO since 2001, given the lack of original data and the regular interval of monitoring visits.

## VI. REGRESSIONS

In order to assess whether better complying factories attract more reputation-conscious buyers, I estimate an Ordinary Least Square (OLS) with fixed effects. Fixed effects are appropriate as they use the time-series dimension of panel data to measure the expected change in the dependent variable given a unit change in an independent variable within cases (i.e. factory in this case). Moreover, fixed effects control for omitted or unobservable variables that differ among firms but remain stable over time, including firm strategy (Hsiao, 2003). Given the data limitation, the sample is limited to those factories that produced at least once for original BFC member buyers. To focus on the effect of non-

compliance items on buyer numbers (not the other way around), the non-compliance variables are lagged by one period. Standard errors are clustered on factory to take into account repeated factory observations.

Table 3 shows the results for the limited sample of factories producing for mass merchandisers and specialty retailers who are the original BFC members. Non-compliance items under Wage, Hours-Leave, and fundamental rights have expected negative signs while Contract, OSH-Welfare, Labour Relations have unexpected positive signs. The only category that reaches statistical significance is Hours-Leave ( $p < 0.05$ ). In other words, factories that violate fewer standards related to Hours-Leave tend to attract more reputation-conscious buyers in the following year. This may be because buyers like to source from factories that manage work scheduling well. On the other hand, factories that respect standards on hours and leave may feel they could increase their production capacity and try to attract more buyers to increase their capacity utilization. Nonetheless, lack of statistical significance, presence of unexpected signs and small R-squared prevent us from establishing a strong link between labour standard compliance of suppliers and buyer numbers.<sup>7</sup> The findings suggest that considerations other than labour standard compliance are driving buyers' sourcing decisions.

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<sup>7</sup> The limited buyer data are likely to underestimate the actual number of each factory is producing for. Hence, the result may be biased against finding a significant link.

**Table 3. Labour standard non-compliance and the number of original BFC buyers**

	# of Original BFC Buyers
<i>Number of non-compliance items under:</i>	
Contract (lagged)	0.024 (0.019)
Wage (lagged)	-0.009 (0.014)
Hours-Leave (lagged)	-0.029** (0.012)
OSH-Welfare (lagged)	0.002 (0.005)
Labour Relations (lagged)	0.006 (0.012)
Fundamental Rights (lagged)	-0.037 (0.100)
Size of factory (Log of total number of employees)	0.478**** (0.146)
Age of factory (Number of ILO monitor visits)	0.071* (0.038)
Year controls	Yes
Constant	-1.987* (1.053)
Number of observations	908
R-squared (within)	0.092
F-value	(12, 213) 4.35
Prob>F	0.000

Note: \* p<0.10, \*\* p<0.05, \*\*\* p<0.01, \*\*\*\*<0.001.  
Robust standard errors in the parentheses.

Next, to understand the characteristics of factories likely to retain buyers, I estimate a logit regression, where the dependent variable is a “long-term” dummy that takes the value of one when the buyer continues to source from the factory from 2006 to 2010. The sample is limited to the original BFC buyers because the duration of relationship for other buyers is unknown. Results reported in Table 4 show that the most significant predictors of long-term relationship are the size and age of factory ( $p<0.01$ ): larger and older factories tend to retain buyers longer. The size of the factory is likely to indicate the presence of firm network and firm capacity. The significance of age is not surprising given that newer factories could not be classified as long-term suppliers. The next most significant variable is the specialty retailer dummy ( $p<0.05$ ): factories producing for specialty retailers are much



more likely to retain buyers longer than the suppliers of mass merchandisers, controlling for factory characteristics and labour standard compliance levels. This is consistent with the assumption that reputation-conscious specialty retailers prefer long-term relationship to better control their suppliers, given the rigorous standards they require.

**Table 4. Long-term relationship, buyer type, and labour standard non-compliance**

	Long Relationship	
Number of non-compliance items under:		
Contract	0.021 (0.06)	0.031 (0.06)
Wage	0.016 (0.06)	0.004 (0.05)
Hours-Leave	-0.007 (0.05)	-0.043 (0.05)
OSH-Welfare	-0.043** (0.02)	-0.048*** (0.02)
Labour Relations	0.033 (0.04)	0.031 (0.04)
Incidence of non-compliance with		
Fundamental rights (1=yes, 0=no)	-0.633** (0.32)	-0.563* (0.32)
Suppliers of specialty retailers (1=yes, 0=no)	1.015** (0.40)	
Suppliers of mass merchandisers (1=yes, 0=no)	0.202 (0.39)	
Size of factory (Log of total number of employees)	0.855*** (0.29)	1.161**** (0.28)
Age of factory (Number of ILO monitor visits)	0.226*** (0.07)	0.236**** (0.07)
Year controls	Yes	Yes
Constant	-0.725**** (2.20)	-0.873**** (2.15)
Number of observations	1061	1061
Pseudo R-squared	0.199	0.177
Prob > Chi squared	0.000	0.000

Note: \* p<0.10, \*\* p<0.05, \*\*\* p<0.01, \*\*\*\* p<0.001. Robust standard errors in the parentheses.

As for labour standard compliance, OSH-Welfare and fundamental rights are significant at p<0.05 level with expected negative signs, meaning factories with fewer violations under OSH-Welfare and no incidence of violation of fundamental rights tend to retain buyers for a

longer period. It is interesting to note that non-compliance with Hours-Leave, which was significant for attracting buyers, lacks significance for retaining buyers. On the other hand, non-compliance with OSH-Welfare and fundamental rights, which were not significant for attracting buyers, gain significance for retaining buyers. It suggests that factors that attract buyers may well be quite different from factors that retain them, which requires further research. Non-compliance with Contract, Wage, and Labour Relations have unexpected positive signs.

All in all, the regression results indicate a nuanced picture of how labour standard compliance may be related to supplier competitiveness. While non-compliance under Hours-Leave is found to significantly decrease buyer numbers, unexpected signs and lack of significance for other labour standards suggest that compliance is certainly not the only source of competitiveness and that non-compliance may well become a source of competitiveness in some cases. For instance, violations under Contract have unexpected signs for both attracting and retaining buyers though the association is not statistically significant. It is possible that factories abusing short-term contracts gain numerical flexibility and become more competitive than other compliant factories.

Nonetheless, those factories respectful of OSH-Welfare standards and fundamental rights are more likely to retain buyers. Moreover, it is important to note varying requirements and preference of different buyer types. New suppliers of reputation-conscious buyers, specialty retailers in particular, have much higher compliance levels than others. Suppliers of specialty retailers are significantly more likely to be in long-term relationships than those of mass merchandisers, after controlling for firm characteristics and labour standard compliance.

## **VII. CONCLUSION**

While the literature on labour standards in global supply chains has been growing, it has mostly focused on how to regulate suppliers through codes of conduct, monitoring, or other means, and few studies have examined whether and how better labour standard compliance might affect the competitiveness of supplier firms. While achieving compliance

is likely to incur cost, it may be offset by efficiency-enhancing effects of respecting labour standards and the possibility of attracting and retaining buyers. This paper has tried to shed light on the second lesser known aspect using the survey and firm-level data from Cambodia's garment sector.

The buyer survey results indicate that buyers do not reward better compliance and they verify the level of labour standard compliance before placing orders. Once orders have been placed, except for egregious violations of "zero-tolerance" issues such as child and forced labour, non-compliance rarely affects buyers' sourcing decisions. In short, the question of labour standard compliance appears to figure more prominently at the pre-order stage than the post-order stage.

The data analysis suggests that better labour standard compliance is a necessary condition for producing for reputation-conscious buyers but not a sufficient condition for attracting them as other criteria such as price, quality, and delivery time are driving buyers' sourcing decisions. Nevertheless, complying with OSH standards and respecting labour rights increases the supplier's likelihood of retaining buyers.

The data analysis has also shown diverging practices of different buyer types. Suppliers of reputation-conscious specialty retailers have better compliance performance than mass merchandisers, and they tend to retain buyers longer. This indicates specialty retailers' preference for rigorous selection and long-term relationships. In other words, better compliance is a necessary condition to produce for specialty retailers that give higher margins and favour long-term relationships. Nevertheless, it does not follow that attracting and retaining reputation-conscious specialty retailers is the best strategy for all suppliers as they have different firm strategies and resource constraints. Rather, the findings suggest that if suppliers look to upgrade their competencies and seek to attract such buyers, improving labour standard compliance is a necessity.

While the above findings are new, the result that better compliance does not automatically translate to more business is consistent with existing research showing that achieving compliance and obtaining certification has become a cost of doing business borne by suppliers (Ruwanpura and Wrigley, 2011; Stigzelius and Mark-Herbert, 2009).

There is scope for buyers to share the burden through offering long-term contracts or guarantees for stable orders, if not premium prices or increased orders.

One of the limitations of this paper is that the buyer information is not available for the full sample, reducing the scope of inquiry and the power of inference. Nonetheless, the study covers the majority of buyers in terms of export volume and the core message is unlikely to be affected by this. Another limitation relates to the lack of separation between the direct effect of buyers' labour standard requirements and the indirect effect of other requirements such as quality. The observed compliance level of the supplier is likely to reflect a combination of the two effects rather than the sole effect of the buyer selecting the supplier's level of labour standard compliance. Moreover, the direction of causality remains undetermined for relationship and compliance levels. Notwithstanding these caveats, this paper makes an important contribution to the literature on labour standards in global supply chains by investigating the link between labour standard compliance and competitiveness of supplier firms from the perspective of attracting and retaining buyers.

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