Trust Issues in Supply Chain Management

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ABSTRACT

When corporate boundaries become blurred, as they are in contemporary supply chain management, distinctive ethical issues arise. In a traditional market situation, agreement with another company to charge a fixed amount is considered to be collusion or price fixing and to be both illegal and unethical. In a supply chain context, agreements that a supplier charge a fixed amount are essential for vendor managed inventory. Such agreements are not illegal and not regarded as unethical. What is the ethical basis for this difference?

SUPPLY CHAINS

A traditional supply chain involves three entities: A supplier, the business, and the customer. Traditionally, the business needs some supplies in order to produce or have available items it expects to sell to the customer. Traditionally, several suppliers compete to supply the business with these items, usually on price, availability, and quality. Price is usually negotiated and, although a good past history with a supplier may provide an advantage, the business regards itself as constrained only by its interests, not those of the supplier, in awarding subsequent orders. Indeed, in a competitive economy, the relation of the business to the supplier is parallel to the relation of the customer to the business. Customers, after all, have no obligation whatever to continue purchasing from the same business. It is up to the business to satisfy the needs of the customer better than other businesses. This normally involves doing better in competition on price, quality, and availability.

Ethics in the traditional situation mainly involves honesty on the part of the three parties involved in the supply chain. Misrepresenting the items one is competing on is a traditional way of taking unfair advantage. Also, if a supplier agrees to price or availability and then backs out, the ethical implications of reneging are clear. Similarly if the business misrepresents quality to a customer, it is not likely to get repeat business. And the customer must pay for the merchandise.

I.T. has dramatically changed the way in which the supply chain can be managed. Wal-Mart in particular has been a leader in using I.T. to produce a more efficient supply chain. (Foley & Mahmood 1994, 7-8) In effect, suppliers are chosen on a long-term basis and given the responsibility for managing the business' inventory of that item. The business forgoes the ability to obtain lower prices through negotiating on an order-by-order basis with different suppliers. But it directly negotiates its own inventory levels with the supplier, and the supplier competes long-term on being able to maintain those levels. Clearly this sort of arrangement is advantageous with high- and steady-volume items. The business has only the inventory it needs to meet customer demands, and there is no slack caused by internal processing. The ability to have the right inventory levels may more than make up for small cost savings. And both supplier and business need to share an accurate and reliable inventory management system enabled by I.T.

But the ethical situation changes. Rather than the supplier and the business pursuing their own interest and interacting through competition, a whole new layer of trust is added. The interests of the supplier become embedded in the interests of the business. Similarly, the interests of the business become embedded in the interests of the supplier. The supplier can no longer be concerned with maximizing quantity in its own interest--it must now be concerned directly with the proper inventory level for that item for the business. And the business must recognize that the supplier has forgone the chance for extra profit in the interests of a stable long-term arrangement.

The ECR (Efficient Consumer Response) model developed in the 1990s and adopted by a number of supermarket chains includes CRP (continuous replenishment) which requires supermarket and suppliers to enter into a long-term net-price agreement. Only then is it possible for the supplier to manage store inventories directly. In the case of the Texas grocery chain H.E. Butt, it was necessary for both the chain and the suppliers participating in CRP to come to see the situation as long-term potential win-win as opposed to short-term win-lose. A "non-antagonistic" mindset was required. (Clark and Croson 1995, 8)

Some commentators argue that such arrangements are unlikely to be stable precisely because competitive profit maximization and mutual trust agreements are incompatible. (Cox 2004, 410) Other commentators note that supply chain efficiencies require the development of trust and that the requisite trust requires more than formal contract conditions, but is "developed on the basis of personal contacts and confidence in performance." (Claro & Claro, 2004, 411) A standard text on the management of I.T. notes that "For [successful sharing of corporate information], the partner firms must . . . have a high level of trust in each other." (Frenzel and Frenzel 2004, 503) I believe both sets of commentators are pointing to the same difficulty: To obtain the cooperative benefit of supply chain efficiency, both business and supplier have to acknowledge that cooperative benefits take priority over their own individual interests. The agreement is in fact an ethical one and supported not by sanctions but by mutual recognition of a principle higher than individual interest. It is, in effect, a small-scale social contract. The problem is the stability of such an arrangement in the context of a profit-maximizing market economy. In the context of a competitive market economy, sanctions for violating such cooperative agreements can only be supplied by market forces. In effect, if a supplier or the business is unhappy, it can take its business elsewhere. If the business or supplier is a corporation rather than an owner, any possible additional ethical persuasion is simply not available. Impact on the bottom line is the only relevant consideration. Therefore, long-term agreements with suppliers to manage inventory for mutual benefit need to be viewed cautiously, especially by the less powerful party in such agreements.

WAL-MART

Wal-Mart's treatment of its suppliers is an interesting example; it is not only a corporation, it is by far the largest company on the planet. Its strategy is to compete entirely on the basis of low prices. (Wal-Mart's slogan is "Low Prices--Always.") So perhaps it is not surprising that it does not seem to have great concern for the well-being of its suppliers. As Charles Fishman points out, ". . . the real story of Wal-Mart . . . is the pressure the biggest retailer relentlessly applies to its suppliers in the name of bringing us 'everyday low prices.'" (Fishman 2003, 68-9) Fishman notes that Wal-Mart's 21,000 suppliers are constantly being required to lower their prices. He claims that, rather than being constrained by cooperative agreements with suppliers, Wal-Mart uses its size and power to achieve its own strategic ends. Wal-Mart spokesperson Melissa Berryhill disagrees: "The fact is Wal-Mart, perhaps like no other retailer, seeks to establish collaborative and mutually beneficial agreements with suppliers." (Fishman 2003, 71)

One should also note that in its supplier agreement, Wal-Mart bans the use of bribes or any other sort of kickback. It also strongly encourages its suppliers not to discriminate for employment not only on such traditional grounds as race and religion, but also on sexual orientation. (Wal-Mart [Supplier] Requirements 2005)

Because of its size, many suppliers have little choice but to deal with Wal-Mart on its own terms. Those terms are quite ethical in a traditional supplier context--it does not cheat suppliers, keeps its word, pays bills promptly--but it is willing to drive such suppliers as Vlasic Pickles into bankruptcy and Huffy Bicycle into years of losses. Few suppliers are even willing to talk about their experience with Wal-Mart

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for fear of being frozen out. Wal-Mart has cashed in on additional threats such as moving production offshore, for example to China. (Fishman 2003, 71-4)

There is no question about the supply chain efficiency Wal-Mart has been able to gain. Because of its size, it can set and enforce standards for suppliers, for example requiring RFID identification on products from many of its suppliers by 2006. Again, in a vendor-managed inventory system, the additional burden for supplying RFID tags falls on suppliers and many commentators feel it will be excessive.[b] (Thomas 2003, Handfield 2004) Rob Handfield notes that smaller suppliers still have little choice and recommends forming a supplier consortium to gain some bargaining power with Wal-Mart. (Handfield 2004, 2)

To get a clear view of the ethics of this situation, we need to recognize that corporations are not ethical individuals. A properly functioning for-profit corporation obeys the principle of maximizing shareholder profits. Period. This is not an ethical judgement about corporations, but rather an observation about their nature. To the extent a supplier becomes the "captive" of a large corporation, there is no room for trust. Therefore, insofar as a supplier enters into a managed inventory agreement with a large corporation, it should not depend upon trust. Rather, the supplier must be able to enforce its side of the agreement without depending on the good will of the corporation.

Is it unethical for Wal-Mart to make agreements with its suppliers and then squeeze those suppliers? This is a misleading question because a corporation is not a person. It is a legal creation with some, but not all, of the properties of a person. So we need to consider the ethics of dealing with powerful entities which are not bound by personal ethical considerations.

DEALING ETHICALLY WITH CORPORATIONS

Even though the corporation is a legal construct and thus cannot act either ethically or unethically, it is constructed out of individuals who can and should be ethical. So the appropriate way of conducting ethical dealings with corporations is through individuals.[c] For small non-corporate business, there is no distinction: The (small) company is the owner or owners and these individuals are ethically responsible for what the company does.[d] But corporations are not individuals. Normally corporations respond only to that which is "real" for them, namely effects on profit and loss. Thus the futility of issuing public statements about unethical corporate behavior. Corporations will not become ethical agents through discussion of any kind, because they cannot become individual ethical agents.

So too with Wal-Mart. Because the violation of trust involved is not an issue which is likely to garner wider public sympathy, the suppliers are on their own to negotiate conditions protecting their own interests. Perhaps a supplier's association parallel to a labor union might be in order, as Rob Handfield suggests. (Handfield 2004) But such an association would likely be as much anathema to Wal-Mart as labor unions themselves. One of the things that corporations protect closely is their own power.

In the case of the "squeezed" suppliers for Wal-Mart, one way to avoid getting "squeezed" would be if possible not to let Wal-Mart gain the lion's share of one's business for a particular product line. Otherwise demands for lower prices (a central part of Wal-Mart's strategy) will have to be agreed to.

It look as though, although Wal-Mart is sensitive to traditional ethical considerations in the supplier relationship--not cheating suppliers, keeping its word, paying bills promptly--it may not have fully recognized the ethical implications of converting the supply chain. In effect, it continues to treat suppliers as hands-off partners free to take their business elsewhere. And Wal-Mart can continue to do so as long as they maintain their overwhelmingly dominant position in retailing.

So what is an individual to do when faced with a corporation conducting itself in a manner that would be unethical for an individual? I.T. professional codes of ethics envision such possibilities: The ACM (Association of Computing Machinery) Code mentions the professional responsibility of assessing the social consequences of systems and possible whistle-blowing if management does not act to mitigate dangerous consequences. Your choice may be to comply with unethical orders or to quit. There may be an opportunity to be a whistle-blower, but in spite of legal protections, this course of action usually costs the whistle-blower a fair amount. An individual may be fortunate enough to be able to cause the unethical behavior to change within the company without damaging his or her own prospects in the company. But one can hardly count on this happening.

What, then, are your ethical obligations against a corporation which is acting contrary to ethical standards? The relevant ethical consideration is that, in theory, whatever you ultimately do, higher level principles have to be acknowledged by what you do.[e] The critical point is that even if reasons of interest make it difficult or impossible for you or to do what you believe is ethical, it is still necessary for you to acknowledge your own ethical principles in what you do. It is easy to see why. If the fact that others are not behaving well was a sufficient reason for you not to behave well, the situation could never improve.

For example, if your corporation is making substandard hardware, your ethical responsibilities differ depending on whether you have the ability to influence the strategy of the company. If you do have influence, then ethically you are required to use it. If, however, the company is unwilling to change (its market niche may be to produce substandard equipment until word gets around), you need to consider leaving. If, for other reasons (family obligations), it is not possible to leave, you still need to continue to make your position known. If you do not have influence, it may be harder for you to make your position known, but ethically you still need to try. The critical point is that ethically you must acknowledge your own ethical principles in what you do.

The trust situations we considered involve mutually beneficial agreements or understandings between companies, instead of individuals. The ethical question is how to handle such situations when such agreements or understandings are violated. When there is a great disparity in the size and power of the two companies, as is the case with many of Wal-Mart's suppliers, there may be no viable ethical trust arrangement. Hobbes (1651), one of the first social contract theorists, noted that social contracts are possible only between parties of roughly equal powers. In Wal-Mart's case, it can simply order suppliers to obey its wishes. As Fishman notes, Wal-Mart suppliers are even reticent to talk about their experience with Wal-Mart for fear of retribution. (Fishman 2003, 71-4) Just as with the individual, the disruption to one's business caused by making waves may be more than one is ethically required to do.

In the case of long-term mutually beneficial inventory arrangements or outsourcing arrangements with a corporation, any additional stability can only come from appeal to the interests of the corporation--its own survival and its efficiency in producing more profits. Corporations are indeed sensitive to damage to their reputations. They usually want to be thought of as responsible citizens. But not because they are participants in a social contract they have a commitment to uphold, but because it is "good public relations." In this respect, corporations could be seen as at Kohlberg's Stage Three, Conformity, with a goal of "looking good" for others.[f] (Stage 6 is the most developed ethically.) Extensive corporate philanthropy tends to be justified in this way. But it is ultimately for the sake of the bottom line. It is more important for corporations to be *seen* as caring and responsible, for example, for the environment, than for them to *be* caring and responsible. (Since they are not individuals, it is far from obvious that they actually *could* be caring or uncaring.) For the ethical individual, it does not matter whether anyone *knows* that he or she has done the right thing. But for the corporation, being *thought* to be ethical is the whole point.[g]

So appealing to possible damage to a corporation's reputation can be a good strategy. It may be that, if indeed Wal-Mart imposed a restriction on the percentage of business a supplier can do with them, it could be for reasons of reputation as well as possible impacts on the bottom line. But we cannot expect corporations to behave as ethical individuals would behave. So trust arrangements such as agreements for vendor managed inventory have a built-in source of instability which, given current institutions, are simply part of the environment.

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ENDNOTES

[a] A part of the material in this paper is from Schultz 2006. Its use for this conference is with the permission of Idea Press.

[b] *RFID Gazette* 2006 claims the rollout is not going that well. Less than 10% of Wal-Mart's 6,600 stores are RFID equipped. And suppliers have little incentive to pay the $9,000 average cost of conversion to RFID.

[c] The individual top executives of Enron were punished for ethical violations, but the corporation itself can be punished only by bankruptcy or closing its doors.

[d] My thanks to Major Johnson for this point.

[e] See Schultz 2006 Chapter 2, "The Rational Basis of Ethics"

[f] See Schultz 2006 Chapter 1, "Determining Right and Wrong."

[g] This discussion echoes Plato's in the opening discussion of his *Republic.* (Plato. 360 BCE, 357a-367e)

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