
Counter corruption in your supply chain in China

Secure your supply chain, and protect your reputation

Executive summary

The report is also available at: www.ethicalcorp.com/China

Ethical Corporation Institute

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Contents

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Foreword	3
Executive summary	4
Introduction	6
Section 1: Regulatory environment	8
1.1 Relevant legislation	8
1.1.1 Customs laws	8
1.1.2 Laws on the Inspection of Commodity Imports and Exports.....	9
1.1.3 Customs measures	9
1.1.4 Criminal Law	9
1.1.5 NPC’s supplementary provisions	9
1.1.6 Company law	9
1.1.7 Addition to the Company Law	10
1.1.8 NBCP	10
1.1.9 UNCAC	10
1.2 Multinational corporations and corruption mitigation.....	10
Section 2: Chinese supplier relations	11
2.1 Official measures to counter corruption in the supply chain.....	11
2.2 Corporate measures	12
Section 3: Case studies	15
3.1 Corporate supply chain challenges and strategies	15
3.2 Case study 1: Japanese branded consumer-goods manufacturer	15
3.3 Case study 2: European mining company.....	16
3.4 Case study 3: Fortune 500 US IT company.....	16
Section 4: Concluding analysis	18
Appendices	
Appendix A: Methodology	19
Appendix B: References.....	19
Appendix C: Corporate questionnaire and responses	20

Foreword

If you are involved in compliance and affect the ethical performance of your corporate operations in China, then this report is for you.

Companies that effectively remove corruption risks from their operations understand that corruption can occur at any point in a supply chain. Several companies have had to deal with supply chain corruption very publicly. These include Fronterra (milk), Nestle (baby formula), DuPont (non-stick pans), Procter & Gamble (cosmetics), Johnson & Johnson (baby foods), Kraft (GM ingredients), Lipton (tea), Smith Kline & French (anti-inflammatory drugs), Colgate (toothpaste) and Haagen-Dazs (ice-cream).

The Ethical Corporation Institute was interested in speaking with the major multinational companies in

China and revealing the most pertinent and most common supply chain risks encountered. Our interviewees did more than disclose their corruption risks; they have shared their winning strategies for countering corruption in China.

Proactive companies look beyond compliance and auditing.

Attentive companies implement internal anti-corruption policies, detail risks in a CSR report, monitor regulatory trends, make commissions and fees transparent, introduce supplier ethics management (SEM) programmes and produce integrity due diligence reports on potential partner companies.

We hope that you can incorporate some of these lessons into your supply chain in China.

Ethical Corporation Institute

Executive summary

The findings of this Ethical Corporation Institute briefing underline the significance of China's emergence as the "world's workshop" over the past three decades since former leader Deng Xiaoping's Opening Up and Reform commenced. The findings also underline the importance of the country's developing supply chain infrastructure, an increasingly critical aspect of western multinational operations as the process of expanding out from China's tertiary cities – notably Beijing, Shanghai, Shenzhen and Guangzhou – and into the country's so-called tier two and three cities (ie those large cities in the hinterland).

Interviewees, all working for multinational corporations with significant China-based operations, point to the Chinese government's massive investment in major construction and infrastructure projects, primarily along the coastal regions where investment has been concentrated. These key centres of investment can be defined as: first, the Pearl river delta (PRD) encompassing southern China's Guangdong province bordering the Hong Kong Special Adminis-

trative Region (SAR) and Macao SAR; second, the Yangtze River Delta (YRD) extending from the municipality of Shanghai into Zhejiang and Jiangsu provinces and; third, the Beijing-Tianjin Corridor (BTC) encompassing the region extending from the capital to Tianjin on the Bohai Gulf coast.

The Chinese government believes that the pace and scale of this investment has been matched only by surging levels of foreign direct investment (FDI) – at least until the second half of 2008. At this point FDI inflows noticeably began to slow in line with the onset of recession in North America and western Europe – as more multinational corporations established mainland China businesses or developed and expanded existing operations.

Multinational corporations (from the US and the EU but also, it should be noted, significantly from Taiwan, Hong Kong, Japan, South Korea and Singapore) have contributed to China's manufacturing base, which has subsequently grown rapidly on the back of cheap land, affordable, plentiful (and adequately educated) labour and generally high levels of product

quality. These factors – together with the unfulfilled potential of China's domestic consumer market to become the world's largest – have further attracted multinational corporations to source ever-increasing volumes of products to the mainland to support a growing domestic customer base, expanding foreign retail operations and their own manufacturing subsidiaries and affiliates.

As demand has increased, so Chinese manufacturers have modernised production, kept labour costs down (though it should be noted that wage rates began to rise more sharply in 2008) and so beaten the global competition through a combination of low costs and high quality.

However, the pace and scale of this growth has inevitably raised substantial and varied opportunities for corruption within the supply chain, while China's inexperience of ethical and anti-corruption compliance regulations make the task even more difficult to tackle. For more details on ethical and anti-corruption compliance see ECI's report *Anti-Corruption, Ethics and Compliance in China* – February 2009.

Corruption – be it bribery, kickbacks, product substitution, misappropriation, fraud and/or other financial crimes – clearly remains a challenge for multinational corporations and their local Chinese joint-venture (JV) partners alike.

Interviewees for this briefing unanimously believe that the arrival of the global economic downturn is forcing multinational corporations in developed countries to revise their global strategies, with the impact being felt in developing markets where goods and materials are frequently sourced and the supply chain based. In the current international economic climate all supply chains are increasingly vulnerable to risk, though China remains somewhat insulated from the worst effects of the worldwide recession.

Yet, despite this, the crisis has undermined some of the basic precepts required for ethical and legal outsourcing. Many companies are finding that they must now quickly mitigate the possible increase in corruption and other risks as the impact of global trade disruption becomes more acute. China itself is somewhat at risk from weakening export growth –

China's exports were down 17.5% year-on-year in January 2009, while imports fell by 43.1%, according to China's official state statistician, the National Bureau of Statistics (NBS). Tens of thousands of export-oriented companies in southern China – already under pressure before the onset of the global financial crisis – have already been forced into bankruptcy by plummeting export demand, rising labour, land, energy and commodity costs and the tougher enforcement of environmental and labour laws following the introduction of China's significantly more stringent labour laws in 2008.¹ As economic pressures on local suppliers and other external partners increase, some executives believe that the tendency to resort to corruption – be it in securing deals, maintaining relationships or just topping up levels of personal income – has the potential to increase in the current period of uncertainty.

Against this backdrop of economic recession, increased pressure on both exporters and importers and credit crunch this briefing yields three key findings.

First, the problems of corruption facing China's supply chain – and its overall business environment – will not disappear overnight, despite tremendous efforts by the authorities from Beijing down to provincial level to crack down on infringers and to create a robust regulatory environment.

Second, such is the size of China and the relative concentration of foreign investment and economic development in certain key regions that corruption issues relating to the supply chain and general business standards vary substantially. Those coastal regions that benefited first and for longest from inflows of FDI, for example, tend to have far higher standards of integrity and transparency than inland and more remote provinces which have less experience of economic reform and foreign investment.

Third, it has emerged from ECI research that one of the best ways to mitigate corruption-related risk in the supply chain is to set up and maintain effective in-house programmes which actively implement compliance codes and evaluate supply chain partners based on ethical and compliance criteria.

¹ For more on this subject see Harney, Alexandra (2008) *The China Price: The True Cost of Chinese Competitive Advantage* (Penguin).

Introduction

China's emergence over the past three decades as the world's chief manufacturer and sourcing base for multinational corporations is virtually unprecedented. The pace and scale of this growth from such a low base and with few established regulations has created an economic environment where corruption and bribery have been able to flourish, particularly given China's opaque operating environment, weak legal enforcement record and its reliance on relationships (known as *guanxi*) in commercial transactions.

Despite the operational challenges, China's growing prominence as a global sourcing centre has prompted multinational corporations continuously to redesign their sourcing and manufacturing systems on the mainland, thereby creating some of the most effective and cost-efficient supply chain systems in existence – and increasing multinational corporations' dependence on the China component of their business. US technology giant IBM even opened its first supply chain innovation centre in Beijing in March 2008. The centre's remit is to integrate and transform the company's global supply chain capabilities.¹ Despite the appearance of so-called "China + 1" policies of diversification of production and sourcing to other developing economies China retains the lion's share of orders and FDI.

With so many supply chain operations moving to China, the need for effective controls has increased both on the part of the central government and the multinational corporations themselves – particularly in the wake of food safety and product quality concerns which have become more frequent over the past two years.² Yet supply chain issues extend into numerous areas: labour practices; local quality control and inspection; shipping freight costs; environmental issues; intellectual property (IP) and copyright issues; and, crucially, supply chain security.

These supply chain operations are increasingly the focus of multinational corporations. China's logistics industry enjoyed 26.2% year-on-year growth to \$10.7tn in 2007 alone, according to the China Federation of Logistics and Purchasing (CFLP).³ Amidst this rapid double digit growth are to be found increasing opportunities for massive financial gain by underpaid local government officials, entrepreneurs eager to amass personal fortunes as quickly as possible as well as regular employees seeking to "top up" their salaries. At the same time, multinational corporations are aware of a global trend towards regulatory compliance that increasingly encourages ethical business and global governance standards.

The challenge that corruption presents to multi-

national investors is considerable. Corruption in China has a long history. Local business culture is traditionally based on relationships and often involves running businesses in partnership with family or friends – making related-party transactions, soft lending and non-contractual agreements the norm rather than the exception. This tradition, together with the endemic bribery and gift-giving which are still a major part of relationship-based business in China, despite government attempts to limit the practices, increases the challenges for multinational corporations tasked with meeting global compliance standards.

From an operational perspective, for many multinational corporations, corruption in China is perceived to be part of the cost of doing business on the mainland. The trends identified in the World Bank and International Finance Corporate Enterprise Surveys 2003 (albeit a five-year-old document) still hold true: 73% of the companies surveyed reported that they expected to pay "facilitation payments" to get things done – a clear illustration of the extent of corruption. According to the same survey, the sectors most affected by corruption were construction, financial services and public sector procurement.

On the Logistics Perception Index, China ranks an impressive eighth, behind (amongst others) Singapore, the Netherlands, Germany, Sweden, Australia and Japan. It is noticeable that China beats Taiwan, Canada, Australia and the US.

Yet China appears to be getting at least something right when it comes to the supply chain environment. The WB's Logistics Perception Index (LPI) provides an indication of logistical efficiency amongst different countries around the world. First released in 2007, the LPI is based on seven key factors: 1) efficiency and effectiveness of the clearance process by customs, excise and other border control agencies; 2) quality of transport and information technology infrastructure for logistics; 3) ease and affordability of arranging shipments; 4) competence in the local logistics industry (transport operators, customs brokers, etc); 5) ability to track and trace shipments; 6) domestic logistics costs (local transportation, terminal handling, warehousing, etc); and vii) timeliness of shipments in terms of reaching their final destination.

On this seven-point scale, China ranks an impressive eighth, behind (amongst others) Singapore, the

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Netherlands and Japan. It is noticeable that China beats Taiwan, Canada, Australia and the US.⁴ In a sense this is not surprising as China has grown partially through becoming a major exporter and so therefore has needed to be efficient in terms of transportation and shipment to achieve this. Nevertheless it is a tribute to the advance of the last three decades.

Within logistics and supply chain efficiency, customs issues and border controls figure prominently. China's 15 close neighbours range from some of the world's largest countries (such as Russia and India) and historically its greatest enemies (Vietnam) to smaller central Asian republics (Kazakhstan, Kyrgyzstan, Tajikistan) and countries with troubled political and/or security environments (North Korea,

Afghanistan, Pakistan, Burma, Bhutan and Nepal).

Furthermore, China's border regions tend to be occupied by ethnic minority groups which often have more in common with the neighbouring country than with China itself: Xinjiang's Muslim ethnic minority Uighurs (who identify with their Islamic neighbours to the west and south); Mongolians; Tibetans; and a large number of smaller ethnic minorities that populate the more remote parts of southwest China's borders with Burma, Thailand, Laos and Vietnam. Inevitably, in the country's more remote regions away from the transparent, investment-friendly coastal regions and large cities, the problem of official corruption figures more prominently.

1 China Economic Review, IBM Launches Supply Chain Innovation Center, March 27 2008.

2 Though the 2008 Sanlu tainted milk scandal (where milk was tainted with melamine) made front page news globally a range of food safety and product quality concerns have hit the headlines in China and overseas in just about every sector from toys to toothpaste and pet food to yoghurt.

3 See China Economic Review, China's Revenues from Supply Chain Business Soars 26%, April 3 2008.

4 See China Economic Review, China is Very Logistically Efficient, January 25 2008.

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