OECD Working Papers on International Investment 1999/03

Rules for the Global Economy: Synergies Between Voluntary and Binding Approaches

Kathryn Gordon

https://dx.doi.org/10.1787/044824660786

OECD

DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS

WORKING PAPERS ON INTERNATIONAL INVESTMENT
Number 1999/3

Rules for the Global Economy: Synergies between Voluntary and Binding Approaches

Kathryn Gordon

First issued: November 1999
Last revised: October 2000

Comments are welcome and should be sent to Kathryn Gordon (kathryn.gordon@oecd.org; tel: 33-1 45 24 98 42). *The views expressed in this document are the authors' and are not necessarily shared by the OECD.*

Rules for the Global Economy:
Synergies between Voluntary and Binding Approaches

Abstract

This paper explores the differences, similarities and synergies between voluntary and binding approaches to international rules. Voluntary efforts to ensure that firms adhere to appropriate standards of business conduct have been an important recent development in international business. These efforts have included the publication of codes of conduct describing the nature of a firm's commitments in such areas as environment, labour, product safety and bribery as well as implementation of specialised management systems designed to help firms honour these commitments. Yet, some NGOs and labour unions question the credibility of these efforts and wonder whether initiatives that do not have the force of law can ever be effective.

This paper notes that all approaches to the social control of business organisations -- voluntary and legally binding -- have distinctive shortcomings. These include problems of: credibility arising from imperfect monitoring and enforcement; capture of the control machinery by vested interests; inertia and inflexibility. For this reason, the problem facing would-be designers of global rules is not to choose between voluntary and binding approaches, but to find a judicious combination of the two approaches that is well adapted to the control problem at hand.

The paper also emphasises the strong similarities and synergies that exist between firms' voluntary efforts and any system of binding rules that might eventually emerge. The similarities arise because the effectiveness of both voluntary and binding systems depends on the same intangible resources -- consensus and expertise. Businesses' voluntary efforts to observe appropriate standards have strong synergies with attempts to build binding systems of rules because they provide a mechanism by which the necessary intangible resources can be accumulated. In this sense, the voluntary efforts currently being undertaken by firms, in collaboration with NGOs and governments, may serve as precursors to more formal systems of rules. In most cases, however, the accumulation of these intangible assets is necessarily a slow and painstaking process. The creation of global rules that are not underpinned by the global intangible resources that will make these rules effective are not likely to be successful.

TABLE OF CONTENTS

Rules for the Global Economy:
Synergies between Voluntary and Binding Approaches

I. Introduction

The public debate surrounding globalisation has engendered calls for international standards for business conduct in sensitive areas such as labour relations, human rights, environment and bribery and corruption. In this paper, a "standard" is defined as a norm that describes desirable outcomes (e.g. toxic emissions below a certain level, no use of forced labour) or norms for appropriate business behaviour (e.g. record-keeping practices, procedures for handling hazardous materials). Generally, the term standard also implies that a certain acceptance or consensus surrounds the norms -- that is, a standard is something that is agreed upon and that, in some sense, serves to co-ordinate or harmonise behaviour for an agreed purpose.

As globalisation has moved forward, a recurrent theme in public discussions has been the absence of standards or the incompatibility of standards governing this process. Thus, labour unions fear that multinational enterprises can undermine labour regulations and social protections developed over decades in many OECD countries by moving production facilities into locations with less labour-friendly policies. Other concerns cover a wide range of public policy areas: environmental protection, bribery and corruption, consumer welfare, competition and the creation and diffusion of technology. There is clearly a demand in some quarters for global standards in these areas. However, it is also clear from the differing perspectives of business, labour, NGOs and from geographical differences in opinion, that there is little consensus on what these standards should be.

Views also differ on which institutional settings are most appropriate for housing these standards. Some policy makers and analysts favour embedding such standards in binding rules of the game involving government-directed enforcement mechanisms. But other analysts (for example, Sally, 1994) note that we are far from having global governments and rules writing capacities and that, for now, most international business is more or less embedded in a number of supranational, national or sub-national systems of political control. Under these circumstances, the business community itself and some NGOs support "grass-roots" movements -- they applaud voluntary initiatives undertaken by the individual businesses or business associations, working in co-operation with NGOs and governments. These aim to control standards of business conduct in many areas that are central to the debate on globalisation. The purpose of this paper is to evaluate the strengths and weaknesses of these two approaches (and their possible synergies) and to explore their implications for public policy.

The widespread disagreement on the content and institutional setting for global standards underscores the need to return to fundamentals in the debate. The challenge of building rules and institutions "from scratch" places a premium on understanding the fundamental building blocks of systems of rules. This paper aims to make a contribution to this understanding by returning to first principles. Its approach to the analysis of the control of business organisations emphasises the intangible assets or resources that underpin any system of regulatory or social control of organisations. It starts from the premise that many of the essential ingredients of any system of rules -- those that determine whether or not the system is effective -- are invisible to the eye. They cannot be read about in law books, written down explicitly in contracts or international agreements or discerned by examining the enforcement apparatus. These intangibles include the cultural resources (ie. part of what is sometimes called "social capital"), and the expertise (human capital) that support this control.

Multinational enterprises (MNEs) are at the forefront of the globalisation process and the problems of controlling them are one of the central concerns in the debate on globalisation. By their very nature these enterprises' operations straddle a variety of social, economic and regulatory contexts. As stated by Sally (1994), MNEs are "embedded in networks of relations with a number of important external actors, not only governments. These networks manifest marked differences between nations and regions, with differential implications for production and managerial relations within the firm, public policy choices and the constellation of MNE-government relationships". Indeed, MNEs are a diverse lot. Their operations cover the entire spectrum of economic activity -- primary production, industry and manufacturing, services --- and many small- and medium- sized enterprises now have "global reach". MNEs also respond to a variety of "publics" -- consumers, NGOs, regulators and the general public in both host and home countries. Given this rich diversity of circumstances, the problem of control of the activities of multinational enterprises is a particularly complex one.

Further adding to the complexity are firms' own voluntary efforts to define and respect a given standard of business conduct. These efforts often begin with a written expression of commitment in various areas -- sometimes called a "code of corporate conduct". Frequently these codes are accompanied by the implementation of special management systems designed to help firms honour their commitments in their day-to-day operations. New disclosure and public communications practices have evolved in step with these efforts. Drawing on various sources in the literatures on international business, regulation and law enforcement, this paper, argues that, while they may not be perfect control systems, voluntary efforts have made important contributions to building up the intangible assets -- social consensus and expertise -- that are required to make any kind of social control possible. In this sense they are complementary to and synergistic with binding systems of rules.

The layout of this paper is as follows:

- Section II discusses and analyses voluntary efforts to improve corporate conduct.

- Section III looks at the similarities and differences between binding and voluntary approaches to global rules writings. It begins in Section III.a with a look at their differences, viewed in terms of the distinctive design, credibility and enforcement challenges facing public and private standards. Section III.b examines the roles of social consensus ("Consensus, consent and voluntary compliance") and of expertise ("Expertise: the human capital and the social control of organisations").

- Section IV explores the implications of this analysis for public policy in relation to international standards.

II. Voluntary approaches to international standards for business conduct: The state of play

Voluntary efforts to control the ethical dimensions of business behaviour have been one of the most important developments in international business during the last fifteen years. These efforts include the issuance of ethics statements, codes of corporate conduct and the implementation of accompanying management systems. A code of corporate conduct is an expression of commitment to observe a particular norm for business conduct -- the code, in effect, describes this norm and communicates it to one or more audiences (the general public, employees, suppliers or other business partners). A study of 246 codes of conduct (Gordon and Miyake 1999) finds that the codes discuss a vast array of ethical issues. These include environmental issues ranging from recycling to hazardous materials, employment issues ranging from child labour to discrimination, bribery and corruption, competitive practices, insider trading,

transparency and consultation with local communities and protection of indigenous rights. Studies have shown that the majority of large corporations have such codes[1]. Governments, business associations, inter-governmental organisations and non-governmental organisations have also issued codes.

Notwithstanding the intense activity in this field, scepticism persists about how significant these efforts are. For example, some elements of the NGO community are suspicious of the corporate codes movement, fearing "industry will pay lip service to codes, but may not change its behaviour where profits are at issue[2]". The academic literature, some of which is reviewed below, largely concurs with the view that voluntary efforts to improve business conduct will encounter enforcement and, therefore, credibility problems (but it also notes that similar problems occur in public regulation). However, the literature also recognises the strengths of voluntary efforts and the weaknesses that are known to exist in public regulation.

Business surveys shed light on how managers see the market forces pushing firms in the direction of responsible corporate behaviour (see KPMG 1999 and Arthur Andersen 2000). The Arthur Andersen survey shows that the desire to protect or improve reputation is the most common factor influencing the development of business ethics activities among major UK companies and that such activities are more common among "heavily branded" companies. The second most important factor cited was adherence to corporate governance guidelines and in particular the need for robust internal controls to manage business risk, including legal non-compliance and litigation risks. The third factor cited was the importance of values in guiding organisational behaviour. Firms are, by definition, institutional settings in which individual people work -- that is, they are essentially a group of individuals linked by more-or-less shared objectives, a corporate culture and a business, legal and social environment. Far from being ethically neutral actors, these individuals bring their own values and ethics to work with them and businesses have found that such programmes can be an effective way of raising morale and cementing employee loyalty and can help them compete in tight labour markets. The survey suggests that businesses consider stakeholder pressure to be a relatively minor influence on their ethical activities (far less significant than the first three).

These surveys also shed light on how companies go about writing corporate codes. Although outside instruments are not often referred to in the codes (OECD 1998), companies often consult the codes of other firms in similar industries as well as declarations and statements issued by such international organisations as the International Labour Office and the United Nations. Codes issued by NGOs (especially the environmental code, CERES) and several business association codes (e.g. the ICC Business Charter for Sustainable Development and the Canadian Chemical Producers' Responsible Care Initiative) are also influential. Many of the firms in the consultations viewed their corporate codes as being dynamic entities that must be (and are) frequently revised to ensure that they are staying up with, among other things, industry practices and benchmarks. More than half of the firms in the UK survey made their codes available upon request to the public and consultation with NGO -- basically seeking advice and feedback -- is becoming more common. Through this process of imitation and mutual influence the codes movement appears to provide a mechanism by which ideas can be shared and through which a consensus might eventually form among some of the key actors in this process.

Thus, the codes movement provides a channel through which ideas about what companies should commit to and how they should implement their commitments can be aired and debated. Is there any evidence that firms are arriving at a consensus on these commitments? Looking at the content of the codes, consensus can be defined as near unanimity that the commitment is worth mentioning in the codes (which would be evidence of a *de facto* standard of commitment). Gordon and Miyake (1999) look at the codes issued by firms in narrowly defined sectors, such as the branded apparel industry. In relation to this industry, there appears to be broad (but not unanimous) agreement that firms need to commit publicly in a certain number of ethics areas (e.g. to reasonable working environments, no discrimination). Complete

consensus -- meaning that all the apparel codes make public commitments in this area -- applies to only one issue, child labour. Consensus within the apparel codes does not extend to other issues of human rights in the workplace (only about half of these firms making public commitments on freedom of association, for example). Likewise, the codes dealing with bribery show considerable diversity in the concepts they use and the scope of commitments they make. Differences extend to the definition of a bribe and parties to bribery (see Gordon and Miyake 2000).

The growth of consensus on the types of enforcement techniques that are appropriate for different problems of business conduct is very much in evidence. "Compliance with law" and "continual improvement" are now core concepts used in implementing environmental and labour standards. These concepts and the management practices that flow from them are an extremely important addition to enforcement practices in the business community that would not have been widely accepted 15 years ago. Other enforcement efforts associated with voluntary initiatives also show evidence of consensus building. An examination of the bribery codes shows that record keeping, compliance offices and whistle-blowing facilities are the preferred implementation tools used in business' fight against bribery (Gordon and Miyake 2000). Other organisations (e.g. the International Chamber Commerce) are contributing to this view by publishing enforcement recommendations for bribery that advocate the use of such management tools. While whistle-blowing facilities were initially considered for the apparel industry (Liubicic 1998), they are not used in the industry, which focuses instead on internal or external monitoring. Gordon and Miyake (1999) show that only one apparel industry code mentions whistle-blowing out of 32 codes. Thus, the code movement and associated sharing of experiences in enforcement appear to be facilitating agreement and standardisation of compliance measures. It will be argued below that this consensus and knowledge building -- on the nature of commitments and on enforcement techniques -- will be crucial for the success of any system of global standards, regardless of whether they remain voluntary or whether they eventually become binding.

Also important are some of the "institutional building blocks" that support these commitments. These consist of standardised management systems and related supports (e.g. consultants and auditing services) that aim to help companies ensure that they comply with the law and that they continually improve their performance. The standards define practices in the area of training and education, document control, operational control, auditing and corrective action, monitoring and evaluation, preventative action and record keeping. Perhaps the most influential initiative of this type is the standardised environmental management system, ISO 14001. SA 8000 for labour standards and ECS 2000 in business ethics[3] are other important standards. These are designed to assist companies in putting in place effective management systems for achieving environmental and social goals. As will be discussed below, these voluntary management systems are already receiving official recognition, as they are integrated into public compliance and enforcement programmes. These systems -- and the knowledge and expertise that underpins them -- are also likely to a critical input to enforcing any binding system of global standards that might eventually emerge.

It would be a mistake to view these voluntary efforts as developing independently of public policy. Many of them are clearly shaped by the public policy framework in which they are issued. This influence can take several forms:

> *Blending public regulation with voluntary private initiatives*. The tendency to blend voluntary and binding components has been called "co-regulation" in the OECD and is one of the major trends in regulatory reform in the OECD (Gunningham and Rees 1998). An excellent example of this is the European Union's emerging regulatory framework for the environment. EMAS' recognition of ISO 14000 as an implementing standard for its Eco-Management and Audit Scheme (EMAS) is an excellent example. This recognition gave a big push to firms' adoption of

ISO 14001, which is, of course, also a management standard that they could use to honour voluntary commitments that go beyond compliance with law.

Corporate law enforcement and litigation. Several governments have integrated private management systems into their public law enforcement strategies (notably, Australia, Canada and the United States). Many of the North American codes are clearly defensive responses designed to manage litigation risks (Gordon and Miyake 1999).

Contribution of expertise. Governments have contributed their expertise to the voluntary movement on a number of occasions. For example, they participated in technical committees that have defined voluntary standards (e.g. the ISO 14000 series of standards). They have contributed to the international organisations that have contributed to the intellectual foundations for the codes (e.g. the International Labour Organisation on labour and the OECD on bribery).

Moral suasion. Governments have used their extremely influential positions with firms to promote their own visions of responsible business conduct. Several OECD governments have issued model codes and a number of sector specific initiatives have been supported by them (e.g. the United Kingdom, the European Commission and Canada in sustainable development, United States in the apparel industry).

III. Voluntary and binding behavioural norms: similarities and differences

This section compares voluntary and binding approaches to setting international standards for business conduct. Its main contribution is the recognition of the complementarities and synergies between the two approaches. Some analyses emphasise the differences between these approaches and, indeed, the differences are important (Section III.a). However, it is easy to exaggerate them and Section III.b explores their similarities and synergies. These derive from the fact that both systems draw on the same intangible resources -- Consensus and Expertise.

III. a. Differences between binding laws and voluntary standards

Uniformity and consistency. Formal codified and enforced law tends to have the advantage of relative consistency and uniformity of standard (see, for example, Webb and Morrison 1996). In contrast, actors in voluntary systems sometimes (but not always) have trouble defining and achieving uniform standards. Other than this the codes showed great diversity in coverage of issues, with only half of the codes making commitments to fundamental human rights in the workplace, such as freedom of association. This diversity of commitment might stem from differing circumstances of the apparel firms, but it could also signal that different firms apply different standards.

Flexibility and responsiveness to changing circumstances. Of course, the other side of the non-uniformity problem posed by voluntary corporate control systems is their flexibility or their ability to adapt to the circumstances of individual firms or to the particular requirements of a sector or location (Ayres and Braithwaite, 1992). Voluntary efforts often have the advantage of flexibility and adaptability to changes in structural conditions over time. This tends to lower what economists call the dead-weight costs (i.e. the value of lost output) of the codes (relative to those associated with more rigid rules).

In contrast, public law making or enforcement functions may far removed from the processes that society is attempting to control. As a result, they may not have the information needed to design high quality laws or to enforce them effectively (that is, with due concern for individual circumstances). In addition, both the legislative process and the enforcement apparatus may be subject to considerable inertia. As a result, the system of rules and enforcement can quickly get out of alignment with the underlying structural conditions, especially in fast moving sectors. A study of regulatory systems in the OECD (OECD 1997) characterises them as containing "enormous inventories of rules and formalities that have survived without any serious examination for years or even decades."

Effectiveness and cost of monitoring and enforcement. There is no clear "winner" in the comparison between binding and voluntary systems in this area. In some cases private monitoring and enforcement is known to be as good as public monitoring, while in others it is clearly inferior (Purchase 1996). Imperfect monitoring and enforcement gives rise to the so-called "free rider" problem. The free rider can benefit without paying or can impose costs on others without compensation. For example, a firm might use the label of a private quality control association without actually adhering to the norms established by the organisation -- thus, it benefits from the scheme without paying any of its costs. The free rider problem -- that firms say they are observing high standards, but do not -- is one of the main reasons for public doubts about the credibility of voluntary efforts.

However, most government policies, including regulation, also have credibility problems -- indeed, policy credibility is one of the most basic issues addressed in public policy analysis (see Kydland and Prescott (1977) for a discussion of credibility problems in such diverse areas as fiscal and monetary policy and zoning). In the labelling scheme just described, the free riding problem stems from imperfect monitoring (are firms really respecting the quality standards?). Clearly, public labelling schemes pose the same monitoring problems.

As noted in the discussion of corporate codes, firms and NGOs are aware of these enforcement problems and have been busy trying to address them by building private monitoring and enforcement capacity. Efforts include establishing norms for record keeping, developing specialised training programmes, refining the use of whistle-blowing facilities and developing external monitoring services, including formal audits. As noted above, public policy has, in some cases, promoted these efforts by "assimilating" them into public enforcement systems.

Capture of the legislative process or of the enforcement apparatus by vested interests. Although regulatory economics often looks at regulation as if it were governed by the benevolent objective of serving public needs, practical experience shows that this is often not the case (see Gonenc et al. for a discussion of OECD experience with regulation). One weakness of systems that are designed and/or enforced by governments is their susceptibility to capture by interests groups (for example, Peltzman (1976) and Stigler (1971)). The scope for such capture is increased when information asymmetries make it difficult for civil society to hold regulators accountable (Laffont and Tirole, 1993). As a result, the quality of the written law and enforcement may suffer as the regulatory apparatus is captured by the more politically well-connected actors and made to serve their interests. Voluntary corporate efforts may be subject to influence by vested interests as well. For example, the private firms that audit corporate performance in labour and the environment have occasionally acted like vested interests in private international standards-setting fora such as ISO. However, the voluntary movement is less susceptible to vested interests because its decision-making apparatus tends to be less centralised than in government-led binding systems.

III.b. Synergies between voluntary and binding standards: The accumulation of consensus and expertise

At a very basic level, the similarities between voluntary and binding systems stem from the fact that both must be designed, monitored and enforced. In both voluntary and binding systems, these three functions draw on the same intangible assets or resources. The first of these is the agreement or consensus on what rules ought to be (norms, formal and informal, and the acceptance they have is often called social capital). The second resource is the expertise or specialised human capital that is required to make both binding and voluntary rules operative. This section discusses the similarities and differences between binding and voluntary systems of rules, first in relation to consensus (or agreement) and second in relation to expertise.

Consensus, consent and voluntary compliance

In the economics literature, it is understood that informal conventions and norms are a pervasive feature of any transactions system. They have facilitated commerce throughout economic history and are a feature of all transaction frameworks, from barter economies to the sophisticated markets of advanced industrial societies. Some economists (e.g. North 1990) argue that advanced economies -- even with their tendency to formalise rules in law and transactions in contracts -- rely heavily on informal norms and conventions. This is because it is rarely possible to account for all contingencies when writing formal rules or contracts -- this is the notion of the "infeasibility of complete long term contracting" (see Williamson, 1996, for a discussion of this issue in the context of organisational governance). The informal norms tend to come into play when actors respond to events that have not been described *ex ante* in law or contract.

These informal norms are essential inputs into the transactions process -- the economic literature uses the term "social capital" to refer to these unwritten but widely held beliefs and norms (see, for example, Coleman (1990), Slemrod (1998), Stiglitz (1999) and Nahapiet and Ghoshal (1998)). Generally, these are seen as complementary to formal legal codes -- they may facilitate contract enforcement (by allowing contracts to be drawn up with less detailed treatment of contingencies and by lowering the amount that must be spent on third party enforcement). However, since social capital tends to be very much bound to culture and to legal traditions, it tends to be specific to nations or regions -- "global social capital" is, at least for now, fairly underdeveloped.

This social capital -- that is widespread agreement on how things ought to be done -- is also an essential element of effective law enforcement. Law enforcement is often thought of as a process in which governments invest resources in monitoring and deterrence, thereby establishing an incentive system that shapes decisions to comply with law or to be unlawful. In return for their investment, societies receive a certain amount of compliance. A simple "deterrence" approach to a binding law would typically be based on the following assumptions: 1. Legal statutes can unambiguously define misbehaviour; 2. All actors are fully informed utility maximisers (that is, they are *homo economicus* observed in an enforcement context); 3. Legal punishment provides the primary (indeed only) incentive for compliance; 4. Enforcement agencies optimally detect and punish misbehaviour, given available resources (Scholz 1997). Thus, the operative assumptions are that "good and evil" can be easily identified and codified and external (government) enforcers can be relied upon to uphold the "good", while the actors covered by the laws are naturally inclined to do " bad" if it is in their economic interest.

The "deterrence" model undoubtedly provides useful insights, but enforcement studies show that it does not come close to providing a full explanation of real-world compliance. For example, Slemrod (1998) reports on studies of compliance with income tax laws in the United States. These show that people pay far more in income taxes than can be explained by a rational calculation balancing the monetary benefits of evasion against its expected monetary costs based on reasonable guesses of the amounts of

possible fines and of the probability of getting caught. In fact, people appear to pay their income taxes for a number of reasons, many of which have nothing to do with tax enforcement; they may believe it is the right thing to do (personal conviction) or their friends and family may pressure them to do so (peer pressure). These motivations are quite similar to those underlying voluntary instruments.

This way of thinking about compliance with binding laws -- that is, that much compliance is in fact voluntary -- takes us into much deeper waters than many economists are accustomed to navigating. Nevertheless, there is a growing recognition that, underpinning the more visible features of any effective legal system (law codes, punishment practices, the particulars of the enforcement apparatus), is a critical mass of agreement and consent by the people being governed by the law. Indeed, without this agreement and implied consent, many laws would be prohibitively costly to enforce using methods that are acceptable to democratic societies[4].

Obviously, the recognition of roles played by voluntary compliance and of the importance of culture and belief in the functioning of binding legal systems blurs the distinction between voluntary and binding systems. It emphasises the importance of the content and "user acceptance" of behavioural norms, be they voluntary or legally binding. It also sheds light on the processes that govern the effectiveness of both voluntary and binding attempts to control business conduct. Market pressures and profit motives that promote high standards of corporate conduct may be important for some firms and in some industries (e.g. forces operating through consumer pressures and firms' desire to maintain reputation as a business asset). But other forces are also at work. Corporate compliance with high behavioural standards -- voluntary or binding -- must also be understand in terms of the social milieu that exists within a firm. Within this milieu, the various stakeholders draw on their cultural "resources" (values and beliefs) -- those that underpin their activities with the firm -- thereby shaping corporate conduct in all areas, including corporate ethics[5]. Likewise, the social milieu that surrounds the firm is important in providing external pressure for compliance with a given standard[6].

Seen in this light, the voluntary efforts to raise standards of business conduct have a lot in common with formal regulation or rules because they both draw on the same intangible resources -- consensus and consent. Consider the example of child labour. Gordon and Miyake (1999) show that a considerable amount of consensus appears to exist in relation to this issue. Child labour outcomes are also determined by other institutions (education systems, social and family welfare services) in the OECD and in other countries as well. It is interesting to note that child labour is common in certain activities, even in the OECD. OECD farm families often draw extensively on their children's labour. In some OECD countries, children deliver newspapers or mind younger children and this is considered acceptable, even beneficial, for the children involved. However, in these OECD countries, social norms exist that, in effect, draw the line between types of child labour that are socially acceptable and types that are not. These norms support proscriptions against child labour and lower their enforcement costs. Thus, most residents of most OECD countries would be shocked to see a child working in a factory or any other formal workplace. Indeed, it is so socially unacceptable that most employers in advanced OECD countries would not even consider employing a child or underaged individual, either because they personally believe it is unethical or due to peer pressure.

This broadly supportive social environment lowers the cost of enforcing formal child labour laws. As in the example of income tax compliance discussed above, much of the compliance with child labour laws that is observed in the OECD is, in effect, voluntary -- it is not a response to fears that labour inspectors might impose penalties. Thus, in most OECD countries, enforcement of child labour laws in routine work environments is not costly, leaving enforcement and child welfare officials free to concentrate on a limited number of areas that present specialised enforcement problems (e.g. the sexual exploitation of children). This is an example of how social capital of a particular type plays a key role in facilitating the

enforcement of law. The example also shows that voluntary efforts to raise standards draw on the same cultural resources as formal standards.

Of course, there are major differences between legally binding laws and voluntary norms. This way of looking at things suggests an area of caution for policy makers in the international arena. The first relates to the hazards of trying to impose formal rules when the social consensus supporting them does not exist. At the present time, political demands for global standards in labour and the environment appear to be fairly strong in many OECD countries. These would attempt to impose standards even in countries where social agreement with the standards is not widespread. This could give rise to situations where laws exist on the rulebooks but are prohibitively costly to enforce. As a result, they are basically ignored or are selectively enforced (a potentially dangerous outcome if it leads to excessive discretion in law enforcement[7]). Indeed, the machinery of enforcement in an situation where a critical mass of actors has no intention of complying with a law can be counterproductive, sometimes forcing activities underground and inadvertently causing more harm than good[8].

Expertise: human capital and the social control of organisations

Another model of corporate misconduct is that it is not so much the result of wilful, premeditated misconduct as of error, ignorance or innate human limitations (which give rise to "bounded rationality[9]"). In addition to accounting for the risk and uncertainties inherent in most human activities, this approach recognises that corporate actors have only limited amounts of the information, knowledge and resources needed to control outcomes. Here, misconduct can occur even when the parties to the misconduct face major financial penalties in the event of say, an accident, and when they all share a strong personal conviction that misconduct should be avoided. In occupational safety, for example, the level of fines have been shown to have no influence on safety outcomes (because employees are already fully convinced of the need to avoid accidents), but the level and type of inspection is known to be highly influential on outcomes (Gunningham and Rees, 1997). Another example is airline safety, where major firms are known to share the safety goals of formal legislation and, indeed, often engage in significant over-compliance with safety-related law and regulation. However, this is a sector where major problems are relatively infrequent (so that vigilance can be worn down by routine) and where safety dispositions form a system, making it difficult for any single actor to identify emerging problems. In this context, safety procedures must be both technical (including technical monitoring of suppliers and business partners) and behavioural (controlling the "human-machine interface") and there is often significant uncertainty or ambiguity in what constitutes misconduct or in recognising it in a real world setting.

Viewed from this perspective, rules systems (binding or voluntary) serve the function of defining and encoding society's risk tolerance and enforcement is designed to ensure that firms are operating within these tolerances. Rules are attempts by societies to keep "within reasonable bounds the risk of social harms arising from inevitable corporate mistakes" -- that is, their focus is "error correction" or prevention (Scholz 1997) in a context of risk and uncertainty[10]. Rules writing and compliance in this setting is quite different than under the deterrence model described above. First of all, explicit rules -- in the form of codified laws -- may be impossible to write because of the large number of contingencies that would have to be built in to them. In such cases, much of the *de facto* definition of standards occurs in administrative or enforcement agencies or services (public or private).

Enforcement also plays a different role under models of bounded rationality than under the pure deterrence model. Differences of opinion on what constitutes responsible practice may occur, but the organisation being monitored probably shares the same objectives as the monitoring agency (as a result, the two parties to the monitoring process have less of a "cat and mouse" relationship than under the pure deterrence model). Under bounded rationality, one of the main effects of monitoring or inspection is to identify and focus attention on compliance problems. This creates a role for specialised, external

monitoring services -- which may be public or private -- whose main role is to enlist or reinvigorate support among the regulated, to heighten awareness of problems and to supply expertise and advice (Gunningham and Rees (1997) and Ayres and Braithwaite (1992)).

Thus, this second way of looking at corporate conduct (or misconduct) emphasises the key role played by another intangible resource -- expertise -- in determining the effectiveness of systems of rules. The voluntary and binding systems of rules are similar in this sense because they draw on the same sets of expertise. This would include knowledge about record systems, training programmes, preventative and remedial measures, production procedures and manuals, all of which are needed regardless of whether the standard is voluntary or binding. A crucial aspect of this expertise is the mastery of "idiosyncratic information" (Williamson 1996) -- including knowledge of local or sectoral circumstances and of how general standards or principles need to be adapted to these circumstances. As noted above, firms' voluntary efforts in such areas as labour, environment and bribery appear to be associated with the build-up of expertise that will probably prove to be useful to systems of binding rules that might eventually emerge in the same areas. This human capital accumulation has occurred in a number of institutional settings: internal services or departments formed within the firms trying to raise their standards; specialised for-profit firms that sell services (e.g. consulting, auditing, accreditation) to these firms; and in NGOs wishing to influence these efforts.

V. Assessment

The policy implications of the above analysis are as follows:

People who dismiss voluntary rules may be unaware of the serious problems that accompany government-enforced rules. Public suspicions of voluntary efforts undertaken by businesses and NGOs may be based on a somewhat unrealistic view of the alternative -- public regulation. No system of social control of companies is perfect and many, including a large number of public schemes, are highly imperfect.

Voluntary efforts to respect a given standard in many areas of corporate conduct can serve as precursors to binding, formal rules in these same areas. This is because firms' voluntary efforts contribute to the intangible resources that will, in any case, be necessary to support any binding rules that may emerge. As noted above, firms have started a process of dialogue that may gradually lead to consensus on the part of some major actors. Their efforts have also contributed to the build-up of expertise that currently help them comply with their legal and ethical commitments and that in the future could help them comply with any global standards that might eventually be developed. Governments and NGOs, by collaborating with firms on these efforts, have also played important and varied roles in the accumulation of these intangible assets.

Just as most OECD systems of regulation have developed over many decades, putting global systems in place will take time. Binding and voluntary (but widely complied with) global standards could facilitate international trade and investment in a variety of ways (e.g. by eliminating competitive distortions arising from lack of uniform standards). However, the process of developing them is inevitably a painstaking one since it requires the accumulation of the required "social capital" (consensus and expertise) on a global scale.

During the lengthy process of building a system of global rules, voluntary codes assume an important role as the only de facto system; but binding approaches still have much to offer. In many policy areas, we are only at the start of what promises to be an arduous task of building a meaningful set of global standards. In the meantime, voluntary codes and associated

management supports will have to do much of the "work" in terms of defining *de facto* global standards. As the business community itself often points out, these voluntary efforts can only be, at best, a highly imperfect substitute for a uniform, appropriate policy framework supported them -- there is a need to reap the benefits of synergies between voluntary and binding approaches. Such a framework would have to include not just international standards, but also supporting domestic institutions (e.g. school systems, public sector reforms, better corporate governance systems, and improved enforcement capacity).

Would-be designers of global rules in such areas as labour and the environment should learn from past experiences in regulation. Anyone wishing to write global rules would do well to draw lessons from past experiences in both domestic and international arenas. The international community has already attempted has been made to draw up a comprehensive set of standards (the Draft United Nations Code of Conduct on Trans-national Corporations negotiated in UNCTAD). This attempt was abandoned in 1994 after many years of negotiation. At the level of domestic regulation, OECD experience shows that well-designed, high-quality rules need to be adapted to the sector and the problem (e.g. rules systems prohibiting bribery pose different design problems than those promoting occupational safety). The necessary adaptations can be subtle and, clearly, the writing of high-quality rules requires expertise and adaptability to national and sectoral circumstances. This is a particular problem when, as is often the case, society's target or "desired behaviour" involves trade-offs between harms produced, costs imposed and economic activities foregone. Will negotiators have the necessary sectoral expertise and the knowledge of regional variations in regulatory requirements to write well-designed, flexible rules?

OECD systems of regulations and rules for businesses are often combinations of binding and voluntary measures and effective global standards are also likely to be hybrids. Viewed as a design problem for the social control of business, the challenge for designing rules and enforcement systems in support of global standards is not one of choosing between voluntary and binding systems. Rather, it involves finding a judicious combination of the two.

Intangible resources -- social consensus and expertise -- are the critical missing ingredients in the global rules system and public policy should first focus on developing these. Unfortunately, building intangible assets these is a laborious, time-consuming process. Consensus has to be built slowly through a laborious process of discussion, education and accumulation of experience. The corporate code movement provides a valuable institutional channel for consensus building and sharing of expertise. Expertise -- the human capital underpinning any system of rules -- must also be accumulated. Again, voluntary efforts to raise standards of business conduct have allowed firms and NGOs to accumulate compliance expertise[11].

In attempting to craft international rules, policy makers should avoid doing more harm than good. Rules that do not enjoy strong social consensus in the societies in which they are to be enforced are likely not to be enforced, making them rather meaningless. They could also inadvertently produce harmful effects -- they could lead to selective enforcement (which may promote corrupt law enforcement) or they could force certain activities underground (which could unintentionally encourage them by removing them from other social and economic controls).

Policy makers should pursue rules-writing initiatives that are accompanied by dialogue that helps build consensus, by research and monitoring that contribute to the accumulation of expertise and by pressures for continual improvement in both public and private governance. In other words, the quality of the process that surrounds any global rules-writing initiative will as important as the rules themselves. There are a number of examples of this type of high-quality

rules-writing exercises. The ILO, through its extensive research, field projects and country reviews, contributes to knowledge of regulatory problems. Furthermore, though ILO "rules" may be imperfectly adhered to, they provide a forum for well-informed dialog about problems and encourage countries to improve their performance. The OECD Working Group on Bribery is another example of a forum that combines rules writing with sharing of experiences among country experts and monitoring and outreach activities geared to improved performance.

Notes

1 A survey conducted by KPMG 1999 shows that a bout 85 per cent of Canadian companies have a code of conduct. A survey of international businesses conducted by Industrial Research Bureau for Control Risks Group in 1999 shows how many businesses had issued formal codes relating to bribery. 90 per cent of the US firms had such codes and 85 per cent of the Europeans had codes.

2 NGO concerns about the corporate codes movement are evident when one consults many of their web pages. This quote is taken from "Commerce with Conscious?" website www.ichrdd.ca. An article published ("Engineering of Consent: Uncovering Corporate PR Strategies") published on one website offers NGOs advice on how to "recognise manipulative strategies and distinguish them from industry behaviour which is truly indicative of change." www.icaap.org

3 See *ECS 2000* Ethics Compliance Management System Business Ethics Research Project June 30, 1999. Reitaku Center for Economic Studies, Reitaku University, Japan. The code is available on the ECS 2000 web page.

4 Slemrod notes that, if taxpayers ever decided that they were really not going to pay them anymore, taxation authorities could not enforce many types of tax (e.g. estate taxes). Those sources of tax revenue would not be viable without the implied consent of the taxpayers.

5 Conley and O'Barr (1997) adopt an anthropological approach in order to examine three types of corporate misconduct -- racial discrimination among salespeople, cartelisation and suppression and destruction of information relating to a public health hazard. Their study distinguishes between misconduct that is linked to broader cultural attributes and misconduct linked more specifically to corporate culture. Corporate culture refers to how management decisions such as hiring, compensation and promotion shape broader cultural attributes into a corporate culture that, in turn shapes incentives for misconduct. The study finds that the cultural basis of the three types of misconduct is quite different, with implications for enforcement (notably, who should be the target of enforcement efforts, firms or individuals).

6 The importance of developing this aspect of social capital -- that is, broad social acceptance of ways of doing things that support higher social and economic welfare is a new focus of development economics (see, for example, Stiglitz 1999).

7 Discretion in law enforcement is a feature of every system of state-enforced laws. However, when it becomes excessive, it can degrade law enforcement in a number of ways. First, it helps create an environment that is propitious for bribery of law enforcement officials. Second, discretion in enforcement can create an "organisational culture" in police and regulatory compliance services that, pushed to the extreme, is anti-democratic (i.e. too much discretion by law enforcers gives rise, in extreme cases, to a police state).

8 The Prohibition of the commercial production and sale of alcohol in the United States earlier in this century is a good example of the counterproductive effects of laws that attempt to proscribe the activities of a critical mass of people who are not at all in agreement. Studies show that Prohibition, in addition to giving a boost to organised crime, was also counterproductive in relation to its own objectives. This is because, once forced underground, retail trade in alcoholic beverages was no longer subject to the tax and business establishment controls that previously had kept its growth in check. As a result, it thrived under Prohibition.

9 The concept of bounded rationality recognises that human beings have finite cognitive capacities. As a result, they can only receive, process and react to finite amounts of information. Often workplace

situations require that employees process a large amount of information of various types and urgencies (e.g. about commercial activities, workplace safety, process and quality control). Bounded rationality says that, faced with such situation, they adopt "satisfying" strategies (e.g. rules of thumb such as first-in-first-out processing of tasks, ignoring certain types of information). These strategies may be necessary from a cognitive point of view, but are not necessarily optimal when judged according to other objectives (e.g. profit maximisation, public or occupational safety).

10 Scholz points out that the error correction perspective allows one to explain another empirical puzzle -- in addition to the tax compliance puzzle -- that arises from the enforcement literature. Empirical studies (e.g. of occupational safety) commonly show that increasing the probability of detection increases compliance, but that the size of punishment does not seem to matter.

11 This expertise has also been built up in the governments and inter-governmental organisations (notably the ILO) that have accompanied this process.

Bibliography

Arthur Andersen (2000) Ethical Concerns and Reputation Risk Management: A Study of Leading UK Companies.

Clague, Christopher (1993) "Rule obedience, organisational loyalty and economic development". *Journal of Institutional and Theoretical Economics*. Volume 149 Number 2. June.

Coleman, James (1990) *Foundations of Social Theory*. The Belknap Press of the Harvard University Press.

Conley, John and William O'Barr (1997). "Crime and custom in corporate society: A cultural perspective on corporate misconduct" *Law and Contemporary Problems* (Summer).

Gonenc, Rauf, Maria Maher and Giuseppe Nicoletti (2000) The implementation and the effects of regulatory reform: Past expereience and current issues" *Economics Department Working Papers* Number 251.

Gordon, Kathryn and Maiko Miyake (1999) "Deciphering Codes of Corporate Conduct: A Review of their contents" OECD Working Papers on International Investment Number 99-2.

_____ (2000) "Business approaches to combating bribery" in *No Longer Business as Usual*. OECD.

Gunningham, Neil and Joseph Rees (1997) "Self-regulation." *Law and Policy*. Volume 19. No. 4. October.

Gunningham, Neil (1996) "Codes of practice: The Australasian Experience". Executive summary published by Industry Canada. September.

KPMG (1999) *Ethics and Integrity: Business Ethics Survey*. http://audit.kpmg.ca/.

Kydland, F. and E. Prescott (1977) "Rules rather than discretion: the inconsistency of optimal plans" *Journal of Political Economy*, volume 85.

Laffont, Jean-Jacques and Jean Tirole (1993). *A Theory of Incentives in Procurement and Regulation* Cambridge Mass. MIT Press.

Liubicic, Robert (1998) "Corporate codes of conduct and product labelling schemes: the limits and possibilities of promoting labour rights through private initiatives". *Law and Policy in International Business.* Volume 30.

Nahapiet, Janine and Sumantra Ghoshal (1998) *Social capital, intellectual capital and the organisational advantage"*. *Academy of Management* Review. Volume 23. No. 2.

North, Douglass (1990) *Institutions, Institutional Change and Economic Performance*. Cambridge University Press. Cambridge.

Organisation for Economic Cooperation and Development. "Codes of Conduct: An Inventory" TD/TC/WP(98)74/FINAL.

Peltzman, S. (1976) "Toward a more general theory of regulation" Journal of Law and Economics, Volume 19, pp. 211-240.

Pfeffer, Jeffrey and Gerald Salancik (1978) *The External Control of Organisations: A Resource Dependence Perspective*. Harper & Row. New York.

Purchase, Bryne (1996) "The political economy of voluntary codes" Executive Summary Published by Industry Canada. September.

Reitaku Center for Economic Studies (1999) *ECS 2000 Ethics Compliance Management System* Business Ethics Research Project June 30, Reitaku University.

Sally, Razeen (1994) "Multinational enterprises, political economy and institutional theory: domestic imbeddedness in the context of internationalisaiton" *Review of International Political Economy* Spring. Volume 1, Number 1.

Scholz, John (1997) "Enforcement policy and corporate misconduct: the changing perspective of deterrence theory". *Law and Contemporary Problems*. Volume 253. Summer.

Stigler, (1971) "The economic theory of regulation" *Bell Journal of Economics*, Volume 2. Pages 3-21.

Stiglitz, Joseph (1999) "Participation and development: Perspectives from the comprehensive development paradigm." Unpublished conference paper. Seoul, Korea. February 27.

Slemrod, Joel (1998) "On voluntary compliance, voluntary taxes and social capital". *National Tax Journal*. Volume LI. No. 3. September.

Webb, Kernaghan and Andrew Morrison (1996) "Legal aspects of voluntary codes: In the shadow of the law" Executive Summary Published by Industry Canada. September.

Williamson, Oliver (1996) *The Mechanisms of Governance* Oxford University Press, New York: Oxford.