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# ▶ Getting Beyond Tier 1: Using a systems approach to improve working conditions in global supply chains

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## ▶ Summary

Engaging with suppliers beyond tier one is particularly challenging. But it is vital, as the biggest social and environmental risks often lie hidden further down the supply chain. The ILO Lab has been using a systems approach to understand how to better

reach small and medium enterprises at scale, in a way that builds both capacities *and* incentives to improve working conditions. This brief outlines why a systems approach is important and what the Lab has learned.

## ▶ 1. Introduction

Modern corporate supply chains are increasingly complex. The process of transforming raw materials into a finished retail product involves many steps, specialisations and spans a number of countries. When a company's supply chain has thousands of suppliers, it presents a major challenge to ensure sustainable practices throughout the chain – particularly in terms of ensuring decent working conditions of freedom, equity, security and human dignity.

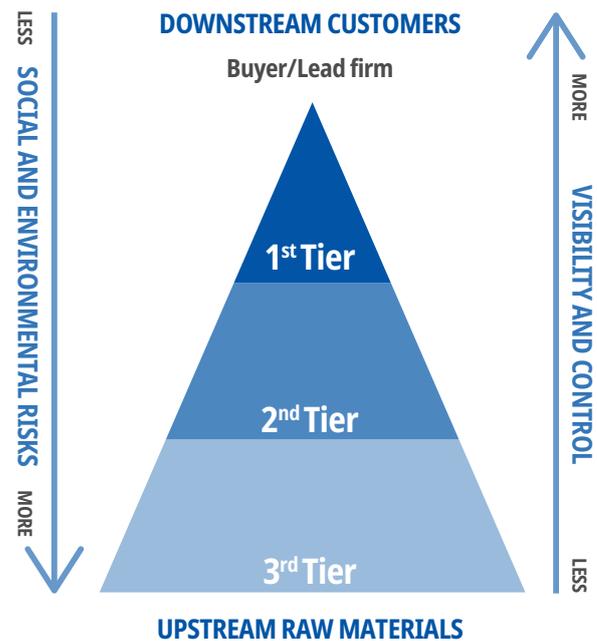
By definition, buyers have a direct contractual relationship with their vendors or Tier 1 suppliers, but not with the many subcontracted service providers and sub-tier suppliers below them, many of which are SMEs<sup>1</sup>. This creates issues of traceability, transparency and influence – limiting the ability of any one lead firm to cascade desired corporate codes of conduct throughout a loose network of supplier enterprises.

The more upstream suppliers are in the supply chain, the less oversight and control buyers have over them, as depicted in Figure 1. But this is also where the worst labour conditions are often found - in hidden, hard-to-reach SME suppliers who can also present a business continuity challenge: Research shows more than a third of all supply chain disruptions are the result of problems with indirect suppliers<sup>2</sup>. As the adage goes, supply chains are only as strong as their weakest link.

1 Synonyms for sub-tier suppliers include lower tier suppliers, supplier's suppliers, indirect suppliers, subcontractors, upstream suppliers.

2 <https://www.cips.org/supply-management/news/2011/november/beware-of-risk-at-lower-tier-suppliers/>

Figure 1. The inverse relationship between supply chain social risks and visibility



- ▶ 65 percent of procurement leaders have limited or no visibility beyond their tier one suppliers
- ▶ Only 6 percent of procurement leaders say they have full transparency of their entire supply chain
- ▶ 40 percent of all supply chain disruptions result from issues below immediate vendors
- ▶ SMEs make up 90 percent of worldwide businesses, and employ two-thirds of the global workforce

**Sources:** Deloitte Annual Global Chief Procurement Officer survey (2017), the Business Continuity Institute and the ILO report on 'SMEs and decent and productive employment creation'

A whole-of-chain lens is especially important at a time when companies are held accountable for labour violations anywhere in the production process. Simply put, companies cannot look deeply enough into their supply chain nowadays. A lack of decent working conditions can expose companies to significant risks and reputational damage.

### Box 1. What is a global supply chain?

The term "supply chain" refers to the organization of activities required to produce goods or services and take them to consumers through various phases of development, production and delivery. Global and regional supply chains involve cross-border organization. A supply chain perspective usually considers the process of bringing products and services to markets from the point of view of a main buyer or lead firm.

The terms supply chain and value chain are often used interchangeably. Value chains describe how value is created from the conception of a product or service to its final consumption, including the different stages of input supply, design, production, distribution and retail. The term value chain is often used with a developmental connotation, addressing issues of value capture and distribution across the chain.

For more information, see the ILO Guide on [Value Chain Development for Decent Work](#)

## ▶ 2. A systems approach

Many corporate responsibility, compliance and capacity building initiatives have focused on Tier 1 suppliers. However, buyers also need to avoid creating 'islands of privilege' where just a few high-performers stand out in a sea of sub-standard suppliers. As noted in an ILO research report: "Most SMEs in the second tier and further down are excluded from the benefits of good practices that may be advantageous for first tier suppliers....There is little evidence that the supportive practices used by lead firms for their first tier suppliers can be expected to flow down through their own SME subcontractors"<sup>3</sup>.

Individual SME suppliers may face a variety of labour issues, but the reason why these problems exist in the first place can mostly be found at the sectoral or national level, with many suppliers operating in countries or regions with weak or unenforced labour laws or different norms about what constitutes acceptable business practice. The challenges are therefore not only supplier-specific but felt at a system-level, creating risks across entire industries.

Such systemic problems require systemic solutions. Many of these issues may seem intractable, but concerted - and increasingly, collective - action can shift the status quo and bring about concrete social and business benefits. However, this requires a new approach, one that moves beyond individual suppliers to consider the wider 'system' in which suppliers exist.

A systems approach recognises that no enterprises exist in isolation: Rather, their performance is deeply connected to that of a web of other actors, from service providers to buyers, as well as to a range of supporting

<sup>3</sup> ILO Good Procurement Practices and SMEs in Global Supply Chains

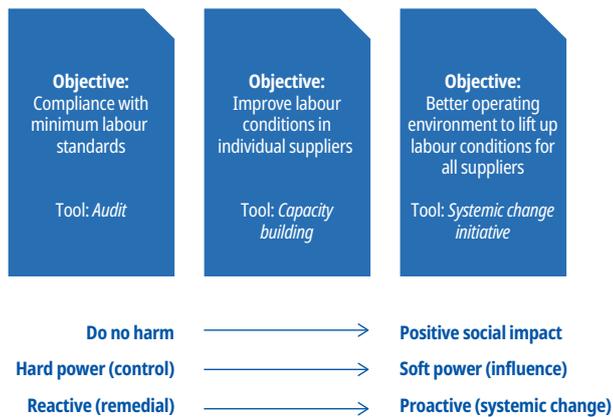


functions such as access to technology, finance and know-how<sup>4</sup>. A supplier may wish to adopt a better business practice but is constrained in what it can do to improve, based on the incentives and capacities that exist in the system. For example, training suppliers on good workplace practices will not lead to improved performance if buyers always submit rush orders leading to excessive overtime; or if suppliers cannot access an affordable form of finance to upgrade out-dated and dangerous machinery.

At its core, a systems approach seeks to address the underlying reasons why a problem exists, and not just treat its symptoms (see Box 2). It recognises that lasting and large-scale change comes from addressing the root causes of an issue. This means paying attention to both the capacity and incentives for change; and removing constraints at the industry-level, rather than just for a small sub-set of enterprises.

System-level interventions by lead firms and external partners are strategic; they aim to find leverage points for change in the system to improve conditions for all suppliers – as a rising tide lifts all boats – rather than having to go ‘directly’ to work with each and every supplier. A systemic change initiative therefore provides another way to complement existing approaches, such as audits and capacity building programmes, as shown in Figure 2.

**Figure 2. Levers of action for lead firms and supporting organisations**



4 Kramer, Mark R., and Marc W. Pfitzer. "The Ecosystem of Shared Value." Harvard Business Review 94, no. 10 (October 2016)



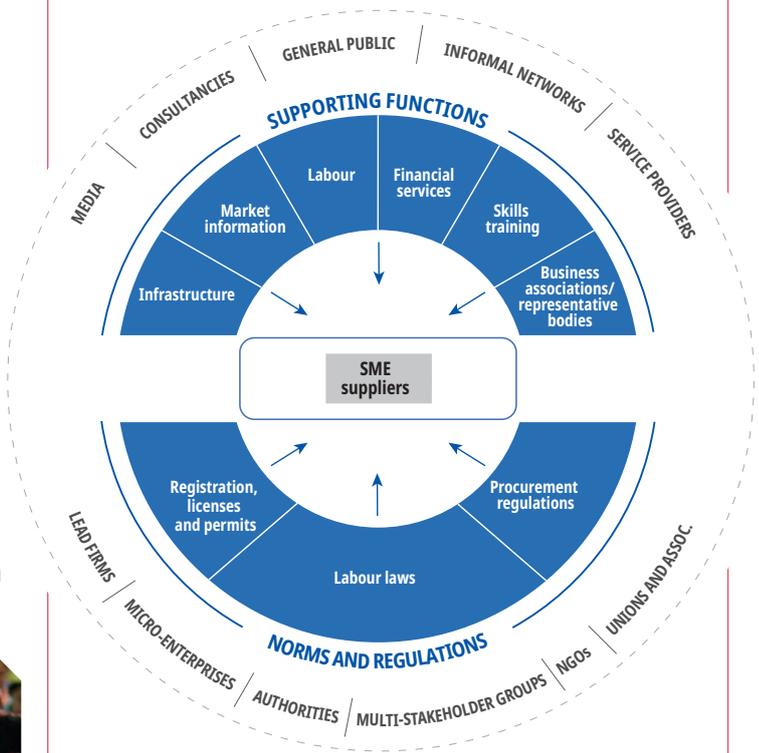
**Box 2. What is a systems approach?**

Systems thinking is prominent in literature on supply chain resilience. This recognises the impossibility of isolating the supply chain from other global systems because pressures or threats that have a bearing resilience often arise from outside the supply chain<sup>5</sup>. One popular approach to help navigate the inherent complexity of supply chains is known as market systems development (MSD).

The aim of MSD is systemic change, which has been defined as the goal to: ‘Shift the conditions that are holding the problem in place’<sup>6</sup>. These conditions can be thought of along a continuum from things that are tangible and more easily tracked (such as policies and resource flows); to semi-explicit conditions such as relationships, connections and power dynamics – through to implicit changes in the mental models underpinning actor behaviours<sup>7</sup>.

Market systems development provides a way conceptualising the landscape in which suppliers operate. This covers:

- ▶ The *operating environment*, considering the wide range of organisations that impact SME operations e.g. competitors, financial institutions, trade associations, regulators and government agencies
- ▶ *Business services* (known as supporting functions), whose availability, accessibility and affordability have a direct influence on how SME suppliers behave and perform
- ▶ The *normative and regulatory environment*, both existing policies and how (or if) they are enforced, as well as the social norms that guide day-to-day attitudes and conduct



For more information on MSD and decent work, see the Lab’s policy brief: [A Systemic Approach to Creating More and Better Jobs](#).

5 “Supply chain resilience: definition, review and theoretical foundations for further study” by Benjamin R. Tukamuhabwa, Mark Stevenson, Jerry Busby & Marta Zorzini

6 The Water of Systems Change: [https://www.fsg.org/publications/water\\_of\\_systems\\_change](https://www.fsg.org/publications/water_of_systems_change)

7 This typology of system-level changes from The Water of Systems Change aligns with the language commonly used in the MSD approach, as codified in the Operational Guide to the Making Markets Work for the Poor Approach.



*“Many of the salient human rights issues such as human trafficking and fair wages... require systemic changes and need to be addressed collaboratively through engagement with the larger community”*

*Unilever Human Rights Report, 2015*

### ▶ 3. What we learned

Over the past five years, the ILO Lab has run a number of studies to use a systems approach to better understand and start to improve decent working conditions in global supply chains. Through this work, we have picked up three key lessons which are highlighted below and brought to life through two examples from the garments and auto-parts chains in Asia (Case 1 and 2).

**A systems approach is analysis-led.** Instead of being reactive and responding to labour violations when they arise (most likely because of media or NGO attention), strengthening systems is about being pro-active in helping suppliers innovate and develop successful, socially responsible business models – building on the practices outlined in the ILO [MNE Declaration](#). To do this, companies need to first get a view of their entire supply chain to identify the material labour issues. They then need to develop a wider and deeper view of their supplier-base, including by understanding the system-level dynamics at work in the supplier landscape - as outlined earlier in Box 2. However, there are often significant information gaps - and many global buyers do not know their lower-tier suppliers or where their raw material inputs are sourced from. The first step is to plug these gaps to build supply chain visibility.

**Systems change is a long-term play.** System change addresses the root causes of negative practices, which in turn requires long-term investments. This is not about quick fixes to ‘paper over the cracks’ of a deeper problem. Instead of just providing protective equipment



to workers operating dangerous machinery or training a few suppliers, it means eliminating the risk in the first place by improving industry-wide access to safer machinery or catalysing behaviour changes. Systemic constraints cannot be resolved overnight and require time, patience and commitment to overcome. Progress takes place incrementally rather than in an instant – which requires looking beyond quarterly reporting towards long-term value creation and relationship-building with suppliers and sourcing locations.

**A systems approach needs to be part of business strategy.** The ultimate aim for any lead firm will be to create competitive advantage. A systemic approach works where commercial performance and social progress depends on suppliers’ ability to lift-up their labour standards – recognising the interdependence between business and societal outcomes. The essence of strategy is making choices<sup>8</sup>. Companies cannot overcome every constraint – many of which might be unfeasible or too numerous to address – but instead focus on a strategic portfolio of interventions which, taken together, can positively transform the operating environment for suppliers<sup>9</sup>.

**A systems lens is critical for transformational change.** Efforts to build the business case for suppliers to improve working conditions in many global supply chains have focused on demonstrating the ‘returns’, but not on the investment and risks side of the equation. Given that in many industries, slim supplier margins can easily be eroded, there are questions about how receptive the majority of enterprises will be to the opportunity argument. Instead, the carrot of efficiency improvements needs to go hand-in-hand with industry-wide upgrading strategies, particularly for those suppliers who deploy a ‘cost control’ and survival-based business model.

<sup>8</sup> Mark Kramer, Shared Value Leadership Summit, 2018

<sup>9</sup> Some types of labour issue may not be suited to being addressed through a systemic approach, and need to be solved through public action alone.

## CASE 1

### Systemic constraints in Asia's Garment Export Industry

Export-oriented apparel production is the quintessential global value chain. Different stages of production - as raw materials are transformed into retail products - are carried out in different countries, involving complex and fast-changing buyer demands and drawing on diverse industries such as agriculture and textiles. The cotton may come from Pakistan, the buttons from Indonesia, the fabric from Vietnam - and it is all assembled in Bangladesh.

The global value chain structure helps link local producers to international markets, facilitating knowledge spillover and the development of new skills for workers. For emerging economies, garments are considered a gateway to globalised manufacturing exports. The sector is also a critical absorber of low-skilled labour: On average, garment production accounts for half of manufacturing employment in the main clothing exporting countries in Asia. For poor labourers, it is often the most attractive industry after agriculture.

However, working conditions in Asia's factories remain a key concern. The sector has received significant international attention, in large part due to a series of high-profile media stories concerning industrial disasters and serious labour violations. The nature of the modern garment industry —relying on labour-intensive inputs with short lead times—carries a high risk of human rights and environmental violations.

Numerous initiatives have been launched by governments and development agencies to try and promote a more sustainable garment industry, including through 'top-down' policy channels, 'bottom-up' interventions on the factory floor, and 'outside-in' campaigns seeking to leverage public and consumer pressure.

The Lab carried out an [analysis](#) of the garment supply chain in Asia - focusing on Vietnam and Indonesia - to understand the dynamics of value addition and the market incentives to provide better working conditions. The report identified system-level constraints needing to be overcome to improve conditions in SME suppliers:

- ▶ *Equitable access to finance.* Foreign investment can facilitate knowledge spillovers in the long-term, but it can create closed networks in the short-term, which limit opportunities for domestic upgrading. Local suppliers need access to growth capital, but often face significantly greater challenges to accessing affordable credit than their foreign-invested counterparts. This constrains working capital and creates a risk averse attitude towards investing in working conditions.
- ▶ *Slow-to-adapt skills systems.* Garment production has long been a low-skilled, low-paid, labour-intensive industry - and the source of Asia's comparative advantage in production. High staff turnover rates are generally accepted as a 'cost of doing business' as labour supply has historically been plentiful, but in some countries the emergence of other more attractive sectors such as electronics is creating new pressures on factories. Skills upgrading will be vital as the industry modernises and many of the traditional entry-level jobs, held mostly by women, might be lost. The use of intelligent technologies - the so-called Fourth Industrial Revolution - means that many workers will no longer be required to control machines. Increasing buyer demands for full-service production emphasise the importance of up-skilling the workforce. However, vocational training is not widely demanded, it can be poorly linked to industry needs, and the quality of training supply is generally low. Professional recruitment services are not developed, and the medium-term market capacity to absorb skilled workers is uncertain.

- ▶ *Shortfalls in public and private regulation.* Despite significant progress over the past decade, both regulation and 'beyond compliance' mechanisms are hindered by hidden sub-contracting and a lack of supply chain transparency. As a result, many sub-contractors and lower tier suppliers are 'sandwiched' between complying with labour standards, and meeting the time-pressured orders of international brands. Brand social responsibility teams are often structurally removed from the sourcing decision-makers in their company whose buying behaviour increases the risk of unauthorised sub-contracting.



## CASE 2

### Opportunities for Systemic Change in Thailand's Auto Parts Sector

Like in most modern global supply chains, few companies produce, distribute, and sell vehicles end-to-end. The car industry can be split into two separate but connected value chains: vehicle assembly and auto parts. Vehicle assembly firms make the final product, producing ready-for-retail light commercial vehicles, heavy-duty vehicles, buses and motorcycles. Supplying these companies are several tiers, ranging from raw material and component suppliers up to system suppliers and fully integrated production partners.

Some commentators predict that the global car industry could change more in the next 10 to 15 years than it has changed in the last 50 years. There are already significant transformations taking place, with the trend toward electric vehicles and the emergence of self-driving technology disrupting the industry's long-established order.

The Lab partnered with the ILO programme on [Responsible Supply Chains in Asia \(RSCA\)](#)<sup>10</sup> to carry out an analysis of the business practices in Thailand's auto parts sector - with a focus on decent work, and to identify opportunities for addressing them.

The report finds that in context of long-term stresses (e.g. electric vehicles) and shorter-term shocks (especially COVID-19), there may be an opportunity to re-think and re-set current paradigms. Here, responsible business can be framed as a way to create competitive advantage – and thus become a central feature for a sustainable business model success rather than an afterthought.

The report identified two potential avenues to explore:

#### Alternative models to subcontracted labour

One industry player observed that strong supply chains do not necessarily have low labour costs but low logistic costs. Many suppliers – particularly lower tier ones – are squeezed by downwards pressure on prices from buyers and upwards pressure on rising costs of raw materials. Their only way to control margins is through operational efficiency. But there are different pathways to productivity gains: By reducing input (labour and capital) while output (goods and services) remains constant; or by an increase in output while input remains constant. Both forms represent an improvement in productivity; but the latter is where business success does not come *at the expense* of investing in labour but instead often comes about precisely *because* of investment in staff re-skilling and in better working conditions.

Business models that treat labour as an asset not a liability may be better prepared to withstand future transformations or disruptions. In the context of COVID-19, a Morgan Stanley research report warned of



“cost headwinds” for companies that rely on low-wage workers<sup>11</sup>. Models that make job-eliminating innovations more attractive than those that create jobs, according to business theorist Clay Christensen, are based on an old-fashioned notion that capital is the scarcest resource. “The ability to attract talent”, he writes “and the processes and resolve to deploy it against growth opportunities, are far harder to come by than cash”.

#### Collaborating directly with lower tier suppliers

Applying supply chain risk management principles to just top-tier suppliers with the expectation that they will cascade to lower-tier suppliers is not realistic. The reality is that the lower-tier suppliers are critically important to the overall supply-chain functioning, and disruptions at these levels can quickly cause disturbances throughout the chain. Yet as one study noted: “suppliers are nearly bankrupt after nearly a decade of aggressive price cutting by their [buyer] customers. [Buyers] and suppliers need a better way of working together rather than more cuts in what suppliers are paid.”<sup>12</sup>

Greater collaboration between buyers and their lower-tier suppliers will be critically important to overall supply-chain functioning, both from the perspective of economic and social upgrading. Deloitte predicts the value chain structure is shifting from a traditional pyramid (brands at the apex controlling the customer relationships) to a more fluid ‘hub and spoke’ model, where the finished vehicle remains at the centre, surrounded by interconnected parts of a wheel: parts manufacturers, OEMs, IT suppliers, online players, telecom companies and device manufacturers. Multi-tier collaboration that works in a more “networked” or “circular” way, as opposed to linear supply chain, may become a ‘new normal’.

To access the full report please contact the RSCA programme [rsca@ilo.org](mailto:rsca@ilo.org) or visit their website at [www.ilo.org/rsca](http://www.ilo.org/rsca).

<sup>10</sup> This is a partnership between the EU, ILO and OECD, funded by the European Union.

<sup>11</sup> <https://impactalpha.com/three-ways-for-universal-owners-to-live-up-to-their-name/>

<sup>12</sup> World Automotive Industry: Challenges and Prospects (ILO)



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