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P A P E R S

**CAMBODIA
BLAZES A
NEW PATH TO
ECONOMIC
GROWTH AND
JOB CREATION**

Sandra Polaski

**Trade, Equity, and
Development Project**



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A UNIQUE AND SUCCESSFUL INTERNATIONAL POLICY EXPERIMENT has been under way in Cambodia for the last six years. In the country's export apparel factories, working conditions and labor rights are monitored by inspectors from the International Labor Organization (ILO), an international public organization.¹ The results of the inspections are published in credible, highly transparent reports that describe in detail whether the factories are in compliance with national labor laws and internationally agreed basic labor rights.² These reports are published on the Internet, and a range of Cambodian and international actors use them. The U.S. government uses the reports as a key input for decisions under an innovative scheme that allows Cambodian firms to sell more apparel in the U.S. market if they improve working conditions and respect workers' rights. Private retail apparel firms that buy from Cambodian factories also use the reports. These buyers, conscious of their brand reputations, use the reliable information they find in the reports to steer orders toward compliant factories and away from noncompliant ones.

The Cambodian experiment combines roles for local and international actors in previously untried ways. It relies on a combination of private self-regulation with limited but essential interventions by governments and international organizations. The experiment warrants attention by policy makers elsewhere around the world for two reasons. First, it introduces new policy tools that can help to maximize societal benefits from global production systems. These novel instruments now have an established record of effectiveness that can be studied by those who wish to adopt similar approaches. Second, the project combines elements of voluntary corporate self-regulation with key public interventions. The public interventions—at both national and international levels—corrected deficiencies that typically arise in purely voluntary corporate self-regulation. The resulting system changed the incentives facing private actors, effectively aligning their interests more closely with public objectives. As policy makers search for effective ways to improve the governance of increasingly global production systems and to realize more of the potential of private self-regulatory efforts, the Cambodia experiment offers new and successful methods that can be replicated, as well as important analytical lessons.

This paper begins with a brief description of the Cambodia project and its economic and historical context. It then discusses the novel elements involved in the experiment and describes the key public interventions. Next, it analyzes their impact on the private sector, tracing the changes in incentives faced by firms and resulting changes in corporate behavior. It then looks at practical outcomes in Cambodian factories. A discussion of the costs and benefits of the project follows, including an assessment of its cost-efficiency and the distribution of burdens and benefits. A final section addresses the issue of replicability and improvements that might be made in future applications of these new policy tools.

GENESIS OF THE PROJECT

Cambodia is one of the least developed countries in the world. It entered the modern global economy late because of war and civil strife from the 1960s through the 1980s. As the country stabilized in the 1990s, it sought to play catch up in its economic development. One important strategy was to transform a handful of state-owned textile and apparel factories into an export industry and attract foreign investment into the sector, in order to earn foreign exchange and create new jobs for the underemployed Cambodian workforce. The apparel industry requires relatively low levels of investment and limited skills on the part of workers. It is usually the first step in the process of industrialization. Cambodia was eager to take it.

The global apparel trading system has been governed for over forty years by a system of quotas that set limits on the textile and apparel products from any one country that can be sold in large, affluent markets like those of the United States and the European Union (EU).³ Because Cambodia was a latecomer to the apparel industry, it was not a party to that system and therefore had no quotas. It was free to sell into the U.S. and EU markets, but at the same time those countries were free to limit or cut off market access at will, in the absence of negotiated agreements. Despite that risk, willing investors from China, South Korea, Taiwan, and other East Asian economies bought, leased, or built apparel factories in Cambodia. Buyers from the United States and Europe also arrived, in part to circumvent the limits they faced on their imports from other countries under the global quota system.

The infant apparel industry in Cambodia grew rapidly. From virtually nil in 1994, apparel exports had grown to almost half a billion dollars in value by 1998.⁴ The share going to the United States increased rapidly, to the point that in 1998 the domestic U.S. textile and apparel industries called for imports from the country to be constrained. The U.S. government concurred and initiated negotiations with Cambodia to bring it under the quota system.

Meanwhile, in Cambodia the burgeoning workforce in the factories became increasingly discontent with conditions. The workers turned for help to labor unions, many affiliated with political parties. Demonstrations and strikes became increasingly common. In June 1998, supportive labor groups in the United States petitioned the U.S. government to review alleged abuses of workers' rights in Cambodia's apparel factories.

These converging issues formed the backdrop for the quota negotiations. They came at a time when the U.S. government was increasingly interested in linking trade privileges with support for labor rights.⁵ U.S. and Cambodian negotiators worked out a three-year textile trade agreement for the 1999–2001 period that established quota limits on the twelve largest categories of apparel exports. However, in a unique step, they agreed that if the Cambodian government achieved substantial compliance by the apparel factories with national labor laws and internationally agreed labor rights, the new quotas would be increased on an annual basis.⁶ The parties agreed to consult twice each year during the three-year agreement to identify the key challenges involved in meeting that overall goal. These consultations established practical goals for each semiannual period, which were then used as benchmarks to determine whether to grant the quota increase for the subsequent year.

Both parties recognized that a reliable source of information on the actual practices and conditions in the factories would be needed for the quota determination. The capacity of the Cambodian government to inspect private firms and enforce national labor laws was extremely weak.

It was tacitly acknowledged that reporting by Cambodian government inspectors was not credible as a basis for the quota decisions. (This issue is discussed in depth below.) Alternatively, private for-profit and not-for-profit monitoring groups existed, but none were deemed to have sufficient credibility to provide the basis for a significant public decision that would have broad economic impacts. To fill the gap, the two countries turned to the ILO, the arm of the UN system responsible for setting international labor standards and supervising compliance. The ILO has an elaborate, if bureaucratic, supervisory system that is oriented toward reviewing the conduct of governments, both through periodic examinations of their compliance with ratified labor conventions and in response to complaints raised by labor unions and others.⁷ The organization had never monitored the private sector directly and had never engaged in on-the-ground inspection of workplaces. The request from the United States and Cambodia to take up a new role evoked a cautious response from ILO Director General Juan Somavia and provoked debate within the ILO bureaucracy and governing body.⁸ After a deliberative process, Somavia decided that the ILO should accept the request and begin monitoring Cambodia's export apparel factories because the project was supported by the two member states involved. The monitoring proposal also had the backing of employers and labor unions in the target country.

INNOVATIVE FEATURES OF THE PROJECT

Two key innovations of this project are identified above: (1) the creation of a trade agreement that provides positive market access incentives as a reward for improved labor conditions; and (2) the inauguration of a new role in international governance for an international agency. These innovations are highly significant policy instruments, valuable both for the results obtained in Cambodia and as new options for policy makers elsewhere. The following section discusses each innovation in detail.

The linkage between trade and labor rights had been discussed at least since the early twentieth century, but the first practical applications date from the 1980s. Those early policy experiments arose under the global system of special trade preferences for developing countries.⁹ Wealthy nations were permitted to extend extra market access privileges to poorer countries without violating international trade agreements that normally preclude differential treatment of trading partners.¹⁰ In 1984, the United States made the additional trade preferences conditional on a developing country's respect for the labor rights of its own workers. The United States undertook a second type of trade-labor linkage in 1993 when it persuaded Mexico and Canada, its partners in a free trade agreement (the North American Free Trade Agreement, or NAFTA), to include labor provisions in a side deal.¹¹ This side agreement included commitments by the trading partners to enforce their own labor laws, with the possibility of a fine or loss of trade benefits for failure to carry out that commitment.

The link between labor rights and trade in both the unilateral preference programs and the negotiated side agreement operated primarily as negative incentives. Trade privileges already granted could be withdrawn for a subsequent failure to comply with labor obligations. The U.S.–Cambodia Textile Agreement, by contrast, created a prospective positive incentive that would be granted annually for progress in the previous period. The positive incentive approach had the potential to elicit ongoing improvements in performance in order to qualify for a greater quota bonus in the subsequent year. The effectiveness of the potential reward was enhanced by the close temporal connection between the behavior of firms and the government in one year and the rewards that

would flow from good behavior during the following year. As it turned out, the U.S. government decided to award a 9 percent increase in quotas during 2000 and 9 percent again in 2001. The parties were pleased with their experiment and agreed to extend the trade pact for three additional years (2002–2004). Quota bonuses of 9 percent, 12 percent, and 14 percent were awarded for those years, respectively.

The second major innovation in the Cambodian experiment is the novel role for the ILO. To make the quota decisions, the United States needed credible and timely information on actual labor conditions in Cambodian apparel factories. The Cambodian government was not an effective source of such information because, as noted above, it had been engaged in civil strife or outright war for much of the last thirty years and is still struggling to establish full rule of law. The state is generally weak and faces severe resource constraints. Civil servants, including labor inspectors, are woefully underpaid. As a result, it is difficult to attract and hold competent inspectors. The average wage of a civil servant is the equivalent of \$28 a month.¹² By contrast, the minimum wage in the apparel industry in Cambodia is \$45 a month, and average monthly wages in the sector are about \$61.¹³ The salaries of government inspectors do not provide an acceptable minimum standard of living, by a wide margin, and therefore second and third jobs that compete for inspectors' time are the norm, not the exception. Taking bribes from employers is also common, with unscrupulous employers offering cash to inspectors who agree not to report violations of labor laws. Under these circumstances, the strengthening of the government's labor inspection system was a goal to be pursued over the medium and long term, but it was not a reliable source of information for the immediate purposes of the U.S.–Cambodia Textile Agreement. At the same time, a growing apparel sector was creating additional jobs and profits and was thus part of the solution to the constraints on government capacity, as it increased the tax base and resources for essential government functions. So while building public capacity to inspect workplaces and enforce laws was desirable, a short-term solution was needed to fill the information gap.

It was theoretically possible to engage private actors to monitor the worksites. Over the course of the 1990s, the creation of corporate codes of conduct and the need to monitor their implementation led to the emergence of an array of private monitoring groups. They ranged from for-profit accounting organizations such as KPMG and PWC and specialized for-profit auditing groups like Intertek Testing Service, to nonprofit social auditing groups such as Verité and nonprofit multistakeholder groups like the Ethical Trading Initiative, Social Accountability International, and the Fair Labor Association. None of these groups, however, had established credibility at an international level and among the diverse groups affected by the textile agreement, including employers, investors, buyers, labor unions, and governments. The entire field of social auditing is still at an early, experimental stage, with no clear leader or widely accepted methodology.

In the absence of either national public capacity or satisfactory international private capacity, the two governments faced the challenge of finding an agent to supply a necessary but missing function: internationally credible workplace inspection and reporting of results. Although the ILO lacked specific experience in factory monitoring, it possessed an established record of neutrality and expertise in labor standards. The ILO had been established by the Treaty of Versailles in 1919 and was the oldest agency in what would become the UN system. Over the years, it had gained extensive experience in evaluating labor rights in countries at all levels of development. As global economic integration accelerated in the 1990s, labor markets became increasingly integrated as well, causing greater competition between workers of different nations and greater scrutiny of labor conditions in

distant workplaces. Rich country governments felt increasing pressure from constituents to maintain labor conditions and standards at home while improving working conditions abroad. It seems only natural that government policy makers, grappling for means to address these new challenges, would turn to the ILO to play new roles. For most of the 1990s, however, the new roles envisioned were only in the public sphere, including such functions as technical assistance and capacity building for ministries of labor in the developing world. The unprecedented U.S.–Cambodia agreement, with its requirement for reliable, timely, and credible information about actual factory conditions, was a policy breakthrough that pushed the ILO to move beyond its traditional public sphere. Arguably, this foray into the private domain may augment the ILO’s relevance, as global production systems increasingly elude the control of national labor ministries and labor inspectorates.

KEY PUBLIC INTERVENTIONS

The policy experiment was put in place through two formal agreements: the textile agreement between the United States and Cambodia that began January 1, 1999, and an agreement between the ILO, the Cambodian government, and the Cambodian garment manufacturers to launch the monitoring initiative, signed on May 4, 2000.¹⁴ The two agreements operated independently but in complementary ways. The potential quota bonus under the textile agreement created an incentive for the Cambodian government and the factory owners to improve labor conditions in order to obtain economically valuable increases in U.S. apparel market access. The ILO monitoring program provided critical information for decisions on whether to award the bonus. Nonetheless, there were still shortcomings in the arrangement launched by these two agreements that might have greatly limited its effectiveness. A pivotal shortcoming was that the ILO monitoring program, as created, specified that participation by factories would be voluntary. But the quota bonus was awarded to the country as a whole, based on overall performance. The voluntary nature of participation meant that information would be incomplete, and perhaps unrepresentative, if some factories chose not to participate. Further, it created a perverse incentive for firms to stay out of the monitoring program, because those factories that did participate would bear the burden of improvement, while nonparticipating firms could share the increased bonus without the increased costs of better labor practices (a “free-rider” problem, in economic terms). The Government of Cambodia quickly recognized the potential distortion this introduced. It remedied this shortcoming in the plan design by issuing a regulation (*prakas* in Khmer) that limited the availability of export quota to the United States to those firms that participated in the monitoring program.¹⁵ This resulted in full participation, since all firms wanted access to the U.S. market, and allowed the ILO monitors to generate information on the entire sector.

A second potential shortcoming was that the monitoring program required reports on conditions in factories but left unclear whether the information would be provided in aggregate form or would identify conditions in individual factories by name. As the monitoring program began, this issue remained unresolved. After discussions with all parties, the ILO decided to issue reports that aggregated results in the first instance. These “synthesis reports” would give a profile of problems in the sector without naming individual firms. However, after time was allowed for remediation of any problems found, the ILO monitors would reinspect each factory for compliance. Factories that had not remedied violations of national labor laws or international labor rights found on the first visit

would be identified by name in a subsequent report. This decision established a level of transparency regarding factory conditions that was significantly higher than information provided by any private monitoring programs that currently exist.

These two seemingly small public interventions—one by the Cambodian government to make factory participation in the monitoring program a requirement for receiving quota allotments and the other by the ILO to provide full transparency of monitoring results—together created a situation that was unprecedented in the realm of global corporate regulation and self-regulation. Once the monitoring and reporting system became fully functional, the two interventions resulted in the provision of a high level of information—to all concerned actors—regarding labor conditions and legal compliance in the entire Cambodian apparel sector.

PRIVATE SECTOR RESPONSE

The transparency and comprehensive nature of the monitoring system changed the incentives facing private actors, including both the factories producing garments and the international apparel firms buying from them. The latter now knew the range of conditions in both their existing supplier firms and all other garment firms in the country. This enabled them to select partner firms with full knowledge of whether the factories complied with national and international minimum requirements. Under conditions of transparency, the factory owners now had multiple incentives to come into compliance with laws and improve working conditions. They stood to gain increased market access to the United States through the quota bonus system. They also faced peer pressure from other firms, whose own quota bonus would be at risk if other factories failed to comply. At the same time, international buyers who were concerned about working conditions and their brand reputations now were able to choose between supplier factories on the basis of good information about their practices. Compliant firms began to advertise their good records as an advantage in attracting buyers, and noncompliant firms found themselves losing orders.

Good information is a prerequisite for any well-functioning market.¹⁶ The Cambodian experiment marks the first time that credible information about labor conditions in a developing country's workplaces has been widely accessible to actors at the local and international levels, in both the private and public sectors. The experiment provides an unprecedented opportunity to witness the effects on market participants' behavior. As noted above, the first effect was to align the incentives facing private firms with Cambodia's twin public objectives of achieving better labor conditions while winning more market access to the United States. A second effect, operating purely between private actors, was the shifting of orders to compliant firms. Although the public incentive of quota increases was more readily apparent, the private incentive for firms to improve their labor standards to attract reputation-conscious buyers was very significant as well, perhaps dominant in some cases. This can be seen by examining the evolution of apparel exports over the period of the experiment. From 1999 through 2002, apparel exports from Cambodia to the United States of items that were covered by quotas increased by 44.8 percent, from a value of \$433 million in 1999 to \$627 million in 2002. Over the same period, exports of garments that were not covered by the quotas increased by 302 percent, albeit from a smaller base of \$83 million in 1999 to \$334 million in 2002.¹⁷ This pattern indicates that buyers were attracted to place orders with factories that were seen as compliant with labor norms

A NOTE ON THE FUTURE

The quota system will be phased out at the end of 2004 for all members of the WTO. Cambodia plans to position itself as a safe-haven for buyers who care about their reputation. This decision represents a consensus between the government and the private sector that improving labor standards has had practical, tangible value in the marketplace. It also reflects recognition that this market niche may be the only one available to a country like Cambodia that cannot compete with countries like China on cost, quality, speed to market, and other traditional factors. Although Cambodia must also perform on an acceptable level with respect to those factors, its one outstanding competitive advantage lies in mitigating buyers' reputation risk.

even when they were making decisions on items that were not restricted by quota and thus would not benefit from the quota increases. Collectively, these buyer decisions shifted the composition of Cambodia's apparel exports over the course of the experiment. In 1999, only 19 percent of exports were of nonquota items, whereas by 2002, 53 percent of exports were not under quotas.

This experience has led the Cambodian government and the country's apparel manufacturers to conclude that the value of good labor standards and transparency will survive the end of the entire global quota system on January 1, 2005, when the U.S.–Cambodia quota bonus system will no longer provide an incentive.¹⁸ In 2003, the Cambodian government asked the ILO to continue the monitoring program for another three years, which will run beyond the end of the quota system. Both the government and the manufacturers have contributed funds for the program, augmented by continuing financial support from the U.S. government.

The economic basis for this strategy can be understood as a risk mitigation or insurance function. The ILO monitoring and reporting system provides a form of reputation risk insurance to global apparel retailers who source their goods in Cambodia. Although labor conditions are still far from perfect in the country's apparel factories, as discussed below, ILO inspections reveal any serious abuses, with attendant pressure on the firms to correct the problems. If the firms fail to do so, buyers can quickly shift orders to other factories with better practices. The ILO produces detailed monitoring reports for each factory that form the basis of the public reports discussed above. These detailed reports are provided to the individual factories soon after the monitoring visit, to allow them to begin remediation. Many international buyers now routinely require their suppliers to share those reports when they are received, rather than waiting for the periodic public reports issued by the ILO. In addition to providing information about any abuses, the reports allow buyers to reinforce the motivation of factory managers to remedy the problems quickly. Factories that are seen as making good efforts to tackle deficiencies are often rewarded and assisted in those efforts by their buyers.

Most apparel buyers have their own internal codes of conduct and undertake factory compliance inspections themselves or contract with for-profit or not-for-profit monitoring agencies to do so. However, none of these efforts have the credibility or transparency of the ILO system. Purely self-regulatory schemes may suffice to assure buyers that their suppliers are not violating laws or codes of conduct, but they have little credibility with the public and other interested actors. The skepticism of other actors is founded on the potential conflict of interest between the firm's incentive to cut

costs and its desire to avoid reputation risk. This perceived conflict of interest is compounded by the lack of transparency of private sector self-monitoring efforts, creating a potentially large credibility gap. A respected third party such as the ILO, whose governance structure includes governments and worker representatives as well as employer organizations, has interests in the monitoring process that broadly correspond to the combined interests of the workers, managers, and governments covered by this monitoring scheme. The high level of transparency that the ILO adopted in its reporting further enhances the credibility of results, because the specificity of the reports allows for challenges by any individual or organization that holds information to the contrary. This operates as a reality check and reinforcement of the credibility of the ILO. It is hard to imagine a self-regulatory scheme achieving this level of credibility. Apparel buyers have demonstrated the commercial value of the combination of reputation protection, good labor practices, and transparent information by directing increased orders to compliant Cambodian factories.

The policy experiment also changed the incentives facing labor unions, in and outside of Cambodia. The Cambodian unions that existed as the apparel industry started to grow were mainly extensions of political parties. Although such unions' concerns undoubtedly included the interests of workers they represented, their primary loyalty was to the political party with which they were affiliated. Union conduct in the factories was influenced by the likely impact on the government, with ruling party-affiliated unions less likely to cause embarrassment than opposition-affiliated unions. The political affiliation of the factory owners was also a factor under these circumstances, leading to potential conflicts of interest on the part of unions. As the quota bonus system and ILO monitoring gradually took hold, the Cambodian unions were confronted with a changing set of incentives. Both government- and opposition-affiliated unions, as well as the independent unions that began to emerge, now had to factor into their strategies the desirability of achieving increases in quota that would translate into more jobs. This shift in incentives served to moderate the tendency to pursue purely political goals, and led unions to place more emphasis on the viability of firms and therefore the jobs of workers. It also opened up an entirely new source of information, namely the ILO reports, and a new source of leverage to achieve improvements in working conditions: apparel buyers' desire for compliance by their supplier factories.

The Cambodian unions had allies in the international labor movement and especially in the American Federation of Labor–Congress of Industrial Organizations (AFL–CIO) and the U.S. textile and apparel union, UNITE HERE. These unions had supported the creation of the quota bonus system and the ILO monitoring project in principle, although they were critical of many details of the plans. The AFL–CIO established an office in Phnom Penh in 2001 to help train Cambodian unions in organizing and collective bargaining skills. Historically, the apparel quota system had the potential to divide unions in different countries, as the impulse for protection of a union's own members would pull in the opposite direction from international labor solidarity. In this case, as the U.S. unions became involved with the Cambodian unions on a face-to-face basis and helped them in their development, the impulse toward solidarity increasingly came to dominate. The local–international alliance that resulted has played a constructive role, both in Cambodia, through the tripartite (government, employer, and labor) body that oversees the ILO monitoring program and in the United States, where the views of labor unions, as well as other interested stakeholders, are sought by the government in deliberations over quota increases.

RESULTS IN THE FACTORIES

The impact of the quota bonus and monitoring program has been positive for employment and working conditions in Cambodia's apparel sector, by all available measures. At the most basic level, the increase in quota and the sourcing decisions of reputation-conscious buyers have been key factors in the very large increase in output and employment in the sector. In 1998, before the textile agreement took effect, apparel factories employed about 80,000 workers. At the end of 2003, apparel employment stood at 220,000.¹⁹ These jobs make up the major share of scarce formal sector employment and are among the highest paid jobs in the country for low-skilled workers. The overwhelming majority of employees in the sector are young women. To put the desirability of these jobs in context, the minimum monthly wage in the sector (\$45) is greater than the entire average monthly household income in rural areas (\$40).²⁰ As noted above, average monthly apparel wages are higher than the legal minimum, at about \$61.

A second measure of the impact of the experiment can be found in the ILO monitoring reports. Eight reports have been issued as of mid-2004. Each report covers a group of factories that were visited by the ILO monitors. The details of compliance or noncompliance by that group of factories with each of 156 items on a checklist are reported, in an aggregated form. The ILO then allows those factories a period of several months to remedy the problems, while it goes on to visit a different group of factories. Later, it revisits each group, noting which recommendations (called "suggestions" in the ILO reports) have been acted upon and which have not been remedied. In a subsequent report, the ILO publishes the findings of these repeat visits, this time identifying by name each factory that has complied—or not—with each suggestion. By mid-2004, virtually all factories in the sector had been visited at least once, and most had been revisited an additional one or more times.

The reports show that on their first visit, ILO monitors typically found a mixed pattern of compliance and noncompliance by factories.²¹ Compliance was good in three key areas of basic labor rights: There was no forced labor, few instances of child labor, and little gender discrimination, although isolated cases of sexual harassment were found. However, widespread problems were found involving underpayment of wages and excessive hours or forced overtime. Violations of health and safety laws were common, including both minor and more serious infractions. Problems with freedom of association—the right to form unions and bargain collectively—were found in a relatively small number of factories, although the violations found in those instances were often very serious.

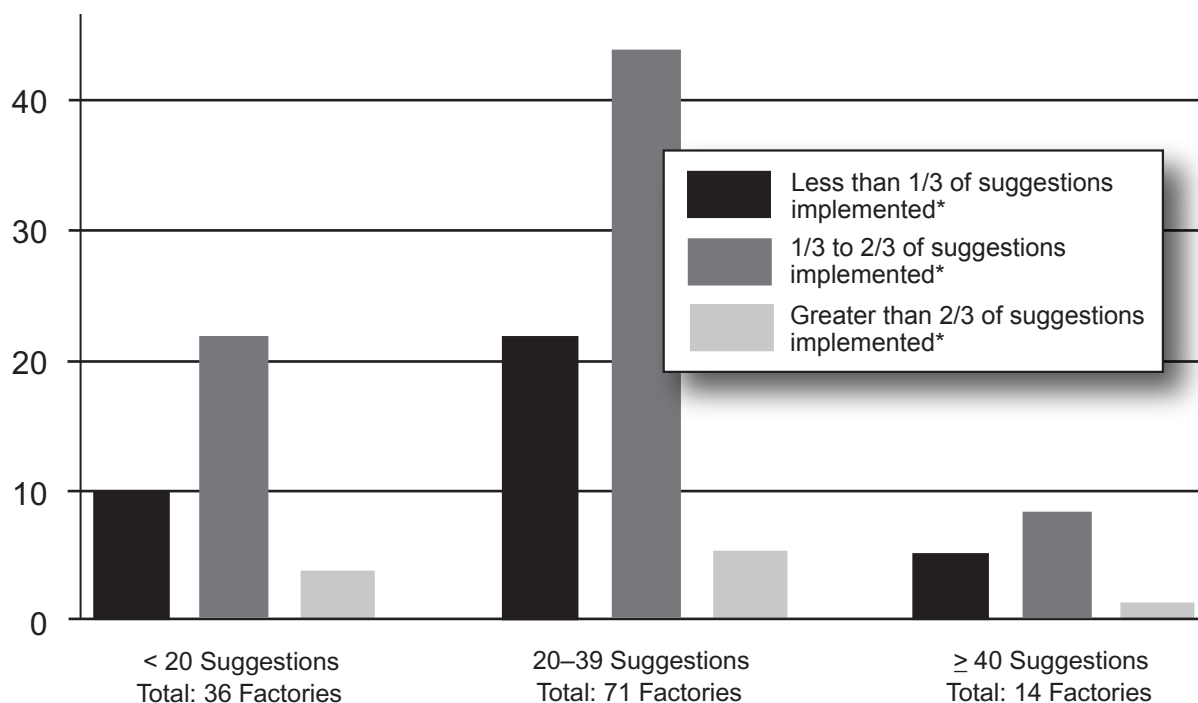
The pattern of initial findings was somewhat encouraging. The near-absence of child labor was a positive discovery, because child labor can impose damaging costs on the child's development and that of the country. It also poses a particularly strong threat to buyers' reputations in a world of instant communications and consumer sensitivity to such abuses. Before the advent of the ILO monitoring project, a British Broadcasting Corporation (BBC) program had presented two ostensibly underage workers in a factory that supplied apparel products to Nike. Although many knowledgeable observers questioned the accuracy of the program, Nike ended its contracts with the factory and left Cambodia. After the ILO began its monitoring program and issued its first report, Nike returned to place orders in Cambodia once again, demonstrating the value of the ILO's credibility to global firms. Although Nike had internal monitoring mechanisms in place before the BBC report, the company knew that its own internal findings would not be credible enough to counter the damaging

report. The ILO’s findings, by contrast, commanded global respect. Similarly, the finding that discrimination was not a widespread problem was welcome.

The problems that the ILO did find on initial inspections were nonetheless serious and follow the pattern of problems found in factories in many parts of the global production system, particularly those in developing countries with a surplus supply of labor and weak rule of law. Underpayment of wages owed, failure by employers to pay the legally required minimum wage, and excessive hours of work, often mandatory, were found in many factories. These problems directly undermine the economic or physical well-being of workers. Health and safety problems were also common, although serious violations were more limited. Repression of unions, although occurring in a limited number of factories, denied affected workers the ability to address problems with wages and hours directly, through their own organized capability. At the same time, anti-union behavior by employers undermines a key channel through which workers are able to experience and participate in democratic institutions and activity.

The ILO monitors made detailed suggestions to each factory to correct the deficiencies that were identified. The first three groups of factories were subsequently reinspected. (The final group is currently being reinspected, and results will be available later this year.) Among the factories that have been reinspected, some progress was made by the great majority of factories in implementing the suggestions for improvement. Sixty-one percent of the reinspected factories had implemented

FIGURE 1. Reinspected Factories: Response to ILO Suggestions



* Includes suggestions partly implemented or in the process of being implemented.

Source: Tabulation of ILO Third, Fifth, and Eighth Synthesis Reports on the Working Conditions Situation in Cambodia’s Garment Sector

between one-third and two-thirds of the ILO's suggested corrections, while an additional 8.2 percent of factories had implemented more than two-thirds of the recommendations. A small group of factories came into full compliance with the ILO recommendations. Due to the sheer volume of practices reviewed by the monitors (156 items on the checklist) and the number of suggestions for improvement, it can be difficult to see the patterns in the ILO reports. Figure 1 is an attempt to quantify the results, through a schematic that groups the responsiveness of factories that have been reinspected to ILO recommendations. The factories are sorted into three categories: those with relatively few deficiencies on the first inspection (fewer than 20 of the 156 items required improvement), those with 20–39 deficiencies, and those with 40 or more deficiencies. For each group, the figure presents the percentage of problems that were corrected between the first and second visits (less than one-third, one-third to two-thirds, or greater than two-thirds of suggestions implemented).

A different way of quantifying the results is to review the types of workplace deficiencies separately. A review was done of the problems and subsequent factory responses for the issues of wage payments, hours of work, safety and health, and freedom of association. The table below summarizes results for the same group of factories (those that have been reinspected to date).

TABLE 1. Factory Remediation of Specific Labor Problems

	Factories with no suggestions (perfect)	Factories fully compliant (on 2nd inspection)	Factories with mixed compliancy	Factories with zero compliancy
Wages	8	27	79	7
Hours	21	31	26	43
Safety & Health	0	0	117	4
Freedom of Association	2	22	67	30
Total	31	80	189	84

Source: Tabulation of ILO Third, Fifth, and Eighth Synthesis Reports on the Working Conditions Situation in Cambodia's Garment Sector

It is clear from the table that the greatest progress was made in payment of wages. Almost 95 percent of factories had adopted some or all of the ILO's recommendations. With regard to health and safety problems, some violations were remedied by 95 percent of firms, although none were in full compliance with the law and ILO suggestions. Forty-one percent of factories were in full compliance with legal hours of work and overtime requirements or had fully remedied problems found on the first inspection, while 33 percent of factories had not remedied any of the problems. About 76 percent of factories had remedied some or all problems with freedom of association identified by the ILO, while the other 24 percent had failed to correct any of the problems in this area that the ILO had identified.

The ILO project provides a source of useful and reliable information both about initial conditions in the factories and progress on remediation of problems. The progress seen in the reports and the

figures above are noteworthy. Although it is regrettable that some factories have been unresponsive in one or more areas, it is remarkable that so many factories have made rapid changes and corrections to practices that routinely confront apparel workers in many countries.

The Cambodia experiment also gave rise to progress in the factories through channels other than the ILO monitoring program. Significant benefits arose from collaboration between the Cambodian and U.S. governments to fill gaps in Cambodia's regulatory regime that had hindered the implementation of labor law. The Cambodian labor law, which was drafted with the assistance of the ILO and adopted in 1997, is a modern law incorporating all of the basic international norms. Nonetheless, the law left many institutional and procedural lacunae that were meant to be filled through regulatory *prakas*. Few of these regulations had been enacted, and the resulting procedural gaps included such basic matters as the method for a union to establish its status as the legitimate representative of workers in a factory and to gain the legal right to engage in collective bargaining with the employer. Another missing regulation involved the creation of an arbitration council, which was foreseen in the law as a venue to resolve workplace disputes without the need for strikes or lockouts by private sector actors or for intervention by government inspectors and courts. These gaps came to be a major focus of the semiannual meetings between the Cambodian and U.S. governments. Progress on drafting and issuing the most essential *prakas* sometimes served as a benchmark to be used by the United States in judging whether to award a quota bonus.²² In drafting the procedural regulations, the United States assisted the Cambodian government when invited to do so, and further help was sought from the ILO. Draft *prakas* were reviewed with employers' organizations and trade unions for further modification before being enacted. Gradually, procedures were put in place that allowed for orderly determination of worker, employer, and union rights and obligations.²³ An arbitration council *prakas* was issued, and the council was established with further assistance from the ILO. The arbitration council is now functioning and commands wide respect from employers, trade unions, and workers in the private sector. Twenty-eight cases were arbitrated in the council's first ten months of existence, with 85 percent of the disputes resolved.²⁴ Thus, the twice-yearly labor consultations mandated by the textile agreement provided an impetus and contributed to the articulation of procedures and institutions that extended the rule of law and improved dispute settlement in Cambodia. These mechanisms are likely to have positive spillover effects on the broader political and economic system. Lessons from other developing countries suggest that nations that create institutions to successfully resolve distributional conflicts enjoy stronger and steadier growth than those that do not.²⁵

BENEFITS AND COSTS

Some of the benefits of the quota bonus and monitoring experiment are direct, quantifiable, and substantial. For example, the quota bonus itself constitutes a clear benefit to the Cambodian economy, apparel firms, and workers. In 2002, the value of the quota bonus was \$56.4 million (calculated by multiplying the 9 percent quota bonus for that year times the share of exports under quota, valued at \$627 million).²⁶ By the same calculation, about 13,000 jobs were created by the increased exports that year, and workers earned total wages of \$9.5 million in those jobs. Quota-dependent jobs and earnings increased further in subsequent years, as the quota bonus was raised to 12 percent in 2003 and 14 percent in 2004.²⁷

Other benefits of the Cambodia experiment are less easily quantified but nonetheless substantial. For example, the monitoring system contributed to the growth of nonquota apparel exports, as brand-name buyers who operated in Cambodia because of quotas in the first instance also increased orders for nonquota categories because of the significant lowering of reputation risk as a result of the monitoring. As noted above, growth of nonquota exports has been even greater than that of exports under quota. How much of the growth in nonquota categories is attributable to the reduced premium for reputation risk is difficult to quantify.

Overall, Cambodia was the first least developed country in the world to achieve over \$1 billion in yearly exports, with apparel accounting for 80 percent of the total. Apparel exports now constitute about 36 percent of Cambodia's overall gross domestic product. Increased earnings by apparel firms and workers strengthen the private sector economy and also translate in increased tax revenue for the government, which desperately needs resources to finance infrastructure, education, health care, and law enforcement. Increased spending in these areas is essential to sustained economic and social development for the future.

The ILO monitoring program confers direct benefits on Cambodian apparel workers. They are now more likely to be paid the wages to which they are entitled under law, to receive appropriate overtime pay and bonuses, to work in safer and healthier workplaces that pose less risk to their well-being, and to enjoy freedom of association, with the attendant possibility of increasing wages and benefits through their collective bargaining strength.

The cost of the program has been surprisingly modest. The initial three-year monitoring project was funded at \$1.4 million. The U.S. and Cambodia governments contributed \$1 million and \$200,000, respectively, and the Garment Manufacturers Association of Cambodia contributed \$200,000. Spread over three years, with an average of 200,000 workers in the sector, the annual cost per worker was \$2.33, and the average annual cost per factory was \$2,333. These costs compare very favorably to voluntary private monitoring schemes in the region, where the cost of factory inspections and certification that a factory conforms to a buyer's code of conduct can range as high as \$10,000.²⁸ The U.S. government subsequently provided an additional contribution of \$675,000 to the project, after judging that the project lacked sufficient personnel at senior levels to allow it to maintain its ambitious monitoring schedule while responding to additional demands for support and services from various Cambodian stakeholders. Even with the supplemental funds, the cost per worker was \$3.46 on an annual basis, or about \$3,500 per factory. The parties agreed in late 2003 to renew funding for two additional years, at comparable levels.

The program was cost effective primarily because the eight monitors were hired locally, at salaries that were quite attractive by Cambodian standards, but very economical by international standards. The project director, an ILO expert with substantial international experience, trained the local monitors and exercised oversight to ensure that the monitoring met international norms. The local monitors were carefully selected and generally have been praised by all parties.²⁹ Because the local monitors were paid at levels that were attractive in Cambodia, they were less vulnerable to the temptation of bribes or other forms of corruption faced by low-paid government labor inspectors. Indeed, the incentive to stay employed by the ILO was strong and offset any blandishments they might have been offered. Even with the addition of an assistant project director, who is paid, like the project director, at international pay scales, the overall composition of salaries in the project made it possible to carry out activities at an internationally credible level of competence while paying salaries

at the local level. One reason for the high costs of many private monitoring programs is that auditors are typically paid at international salary or consultant levels and are flown in for inspections from distant locations, with attendant travel, housing, and per diem costs.

The cost-effectiveness of the local hires was further enhanced by equally important but intangible contributions. The local hires spoke Khmer and thus were easily able to communicate with both employers and workers. As local residents, they were well positioned to meet with workers and unions away from the workplace if necessary. By contrast, private auditors who are not locally based may have difficulty communicating with workers. Even where language is not a barrier, they may not inspire adequate confidence among workers to persuade the latter to communicate freely about deficiencies in their employer's practices, particularly if the only contact is in the workplace where workers may feel intimidated.

The distribution of costs of the Cambodia program was less than optimal in one respect. International buyers, who gained substantial economic benefit from the project, did not contribute directly to the costs of the project. In effect, the project provided reputation risk insurance for the buyers without requiring that they pay a premium. It is hypothetically possible that canny factory owners were able to negotiate better prices for goods produced under conditions that posed less risk to buyers' reputations, although given the competitiveness of the global apparel sector, that is doubtful.

REPLICABILITY

The Cambodian policy experiment comprised a multiplicity of elements that were combined in mutually reinforcing ways. The combination could not be recreated in exactly the same configuration elsewhere, because the phaseout of apparel quotas will eliminate the quota bonus incentive. However, many elements of this successful project are separable and replicable. Policy makers in other countries should consider adopting some of the essential components and applying them in new configurations in other situations. The purpose of this section is to identify the most important of the distinct components and the key characteristics that made each component successful, as a contribution to efforts to replicate these innovations in other circumstances.

Positive Incentives

An important innovation in Cambodia was the manner in which trade privileges were linked with improved labor rights. Labor provisions had previously been included in trade agreements and trade preference programs by the United States, but prior to the U.S.–Cambodia Textile Agreement such provisions operated as a negative incentive. In those arrangements, trade privileges were granted to the trading partner with the condition that they could later be revoked if labor conditions subsequently deteriorated, governments failed to improve severe problems, or new violations were discovered. In negotiating terms, the privileges were “front-loaded.”

By contrast, the U.S.–Cambodia Textile Agreement created a positive incentive that operated prospectively. The additional market access (quota increase) was not granted until the Cambodian government and employers met preestablished benchmarks of progress in labor conditions and compliance with law. The improvement in labor standards had to be demonstrated first, and then the commercial reward followed.

The difference in impact of positive and negative incentives can be substantial. Looked at from the perspective of the grantee, a positive incentive system requires real changes in behavior in order to access the desired market reward. Under a negative incentive system, continuing improvement in labor standards may be less likely once the desired market access has been granted. Unless the parties establish clear benchmarks and timetables for the withdrawal of benefits in case progress stalls, the deterrent effect of a general (and vague) conditionality may be discounted by the recipient. From the perspective of the grantor, a positive incentive creates a clear and immediate link between achieving desired improvements in labor conditions and the expansion of market access. This may make the trade-off more politically popular—and therefore sustainable—within the grantor’s body politic. By contrast, it may be politically unappealing to employ a negative incentive, because revoking privileges already granted can disrupt ongoing economic activities. (The prospective character of the benefits in the Cambodia agreement meant that the U.S. government did not risk disrupting existing market relations by a failure to grant additional benefits.) Partly as a consequence of these political considerations, negative incentives are typically employed only in cases of egregious misconduct. This can limit the efficacy of such systems to achieve sustained progress on labor rights and conditions.

In this case, innovation went beyond the substitution of positive for negative incentives. The positive incentives were structured in a way that required progress in each annual period to gain a quota increase for the following year. The repetitive nature of the exercise elicited more progress than a one-time qualifying period could have achieved. At the same time, it allowed modest, feasible steps to be taken and rewarded rapidly, as part of the repeated annual exercise. This aspect of the program design is particularly important, because many of the labor problems encountered in developing countries are difficult to solve in one stroke.

Policy makers would be wise to look for opportunities to link prospective trade, investment, and other benefits to progress on labor rights, given the marked and rapid progress achieved in Cambodia.

Goal Setting

The semiannual consultations between the two governments proved to be an important mechanism for harnessing the positive incentives to practical goals. Benchmarks were set that could be achieved in a six- to twelve-month period. The goals included both structural elements, such as the issuance of necessary regulations and creation of institutions, and the remediation of specific, egregious problems in particular factories. In many cases, achieving the goals required action by both the government and private firms. Once the ILO monitoring reports became available, an overall goal in each period was the demonstration by the factories that had been inspected of progress in remedying identified problems.

The specificity of goals meant that all actors understood what was expected. The fact that the short-term goals were agreed in consultations between the two governments provided implicit ownership by both sides of the benchmarks for the period. The challenge faced by the parties was to identify goals that were sufficiently ambitious to contribute to significant and sustained progress in labor rights and condition—and thus to merit the commercial rewards—while recognizing the constraints on Cambodian actors and not setting unrealistically ambitious goals.

Policy makers seeking to replicate this approach should include a frequent consultative process and give thought to including all affected actors in the consultations.

ILO Monitoring

As noted above, the Cambodia monitoring program marked the first time that the ILO had inspected factories or directly monitored private sector behavior. The organization proceeded in a careful, deliberative manner, which slowed the development of the program somewhat but allowed it to build consensus among relevant actors at each step. It gained experience through an iterative process of inspections and a problem solving approach to issues that arose. This careful process was an important factor in the success the monitoring program has enjoyed in Cambodia.

Getting the price of monitors right was another important contribution. By combining the skills of internationally experienced staff at the leadership level with those of local staff who were subsequently trained to ILO standards, costs were kept low without sacrificing quality and credibility.

The experience has also built a strong new capacity within the ILO that is highly relevant to the needs of its constituencies elsewhere. As countries struggle to balance economic and social policies—and to advance trade while promoting acceptable levels of labor standards—the ILO could be called on to use its newly developed skills to monitor and provide credible information in a wide range of situations. Such an invitation could come from governments, and it is likely that the ILO would act only if the governments involved explicitly requested its participation. However, the private sector could also initiate ideas and projects involving the ILO and then solicit their governments to endorse or join the project. Such an approach is currently being studied by a consortium of private firms and nongovernmental organizations in Central America and the United States.

Transparency

If there is one aspect of the Cambodia monitoring program that can be singled out as indispensable to its success, it is the high level of transparency that the ILO provided through its reports. As discussed above, this transparency allowed governments, firms, trade unions, and other interested parties to use the information that was generated. The reports served a multiplicity of purposes in the hands of different actors and reinforced the common interests that they shared. Any future role for the ILO should replicate at least this level of transparency.

The question arises whether private auditing groups could substitute for the ILO and provide a similar degree of transparency and credibility. Currently, no private sector group has attempted this level of transparency. Those groups that do publish the results of monitoring have been unwilling to identify the specific factories inspected and the findings, both positive and negative, in those factories. Some multistakeholder monitoring groups, such as the Fair Labor Association, have improved their transparency in recent years. However, even the groups that are relatively more transparent still aggregate information for large groups of factories or for regions of the world. Without specific information on a factory and its performance, outside actors are not in a position to act on the information. In addition, the credibility of reporting is undermined and a useful check on accuracy is lost if workers or others who might possess conflicting information about a particular firm's behavior are not able to identify firms in the reports. The reputation risk to factories and buyers is not effectively mitigated by reports that lack credibility and neutrality, and so this important function is not available. Particularly in countries where there are widespread derelictions from national laws and international norms, an aggregated approach to monitoring and reporting has little

value. Unless private monitoring groups begin to report more detailed information, by factory, to all relevant actors, it is unlikely that they will improve the functioning of markets and generate the progress on overall performance that was achieved by the ILO in Cambodia.

NOTES

- ¹ The ILO is a specialized agency of the United Nations system.
- ² The member states of the ILO, currently 177 nations, have agreed that all workers have certain fundamental rights, regardless of the level of development of their country. These rights include freedom of association and the right to collective bargaining; freedom from forced labor; restrictions on employment of children and elimination of the worst forms of child labor; and freedom from discrimination in employment. ILO, *ILO Declaration on Fundamental Principles and Rights at Work* (Geneva: June 1998), available at <http://www.ilo.org>.
- ³ The quota system dates back to the 1960s and reflects the fact that these industries were important sources of exports, income, and jobs in many countries, both rich and poor. To address concerns of domestic industries and workers in rich countries, while allowing poor countries to grow out of poverty, a series of international agreements were negotiated over several decades that allocated shares of guaranteed access to rich country markets. As developing countries' capacity grew, they began to push for a phaseout of the system, and this was finally agreed in the negotiations that created the World Trade Organization in 1995. The quota system will be completely eliminated on January 1, 2005.
- ⁴ International Monetary Fund, "Cambodia: Selected Issues and Statistical Appendix," IMF Country Report No. 03/59 (Washington, D.C.: March 2003), p. 9.
- ⁵ The Clinton administration, particularly during its second term (1997–2001), was increasingly motivated to find means to resolve the tension between trade and labor issues. This tension had stymied progress on trade negotiations during the first Clinton term.
- ⁶ U.S.–Cambodia Bilateral Textile Agreement, available at http://199.88.185.106/tcc/data/commerce_html/TCC_2/Cambodiatextilebilat.html.
- ⁷ For a description of the ILO supervisory system, see <http://www.ilo.org/public/english/standards/norm/enforced/index.htm>.
- ⁸ The ILO is governed by a unique structure that includes the governments of the 177 member countries (controlling half of the votes in decisions), employers' organizations (one-quarter of votes) and labor unions (one-quarter of votes).
- ⁹ Such programs were permitted under the Generalized System of Preferences (GSP) of the General Agreement on Trade and Tariffs (GATT) and are also permitted under its successor, the World Trade Organization (WTO). Both the United States and the European Union created links between respect for labor rights and market access under their respective GSP regimes.
- ¹⁰ This principle is termed *most favored nation* treatment (MFN). It requires that all parties to a trade agreement be treated by any country party to the agreement as well as it treats its most favored trading partner.
- ¹¹ The North American Agreement on Labor Cooperation (NAALC) was agreed between Canada, Mexico, and the United States in August 1993. Available at <http://www.naalc.org>.
- ¹² All monetary figures in this paper are given in U.S. dollars. The Cambodian government is constrained from raising inspectors' salaries not only by a lack of resources but also by terms of loan agreements with the IMF that restrict the government's ability to raise salaries for public employees. IMF, IMF Country Report No. 03/59, p. 27.
- ¹³ IMF, IMF Country Report No. 03/59, p. 48.
- ¹⁴ Because of delays in launching the monitoring project, decisions on the quota increases for 2000 and 2001 were made without the benefit of information from the ILO monitoring project.
- ¹⁵ Prakas No. 108 MOC/M2001, Cambodian Ministry of Commerce, March 28, 2001.
- ¹⁶ The problem of imperfect information is a widely recognized impediment to well-functioning markets. See for example Joseph Stiglitz, "Information and the Change in the Paradigm in Economics," in *The Nobel Prizes 2001*, ed. Tore Frängsmyr (Stockholm: The Nobel Foundation, 2002), pp. 472–540.

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- ¹⁷ IMF, IMF Country Report No. 03/59, p. 9.
- ¹⁸ Sok Siphana, Secretary of State for Commerce, Royal Kingdom of Cambodia, speaking at the World Bank Group's International Conference on Public Policy for Corporate Social Responsibility, Country Session 1, October 8, 2003.
- ¹⁹ U.S. Embassy Phnom Penh, "US-Cambodia Bilateral Textile Agreement Quota Bonus Decisions for 2002," press release, December 3, 2003.
- ²⁰ IMF, IMF Country Report No. 03/59, p. 13.
- ²¹ ILO, *ILO Synthesis Reports on the Working Conditions Situation in Cambodia's Garment Sector* (Geneva: 2001–2004), available at <http://www.ilo.org/public/english/dialogue/ifpdial/publ/cambodia.htm>.
- ²² Prakas were discussed in public meetings between the U.S. and Cambodian governments on June 4, 2001, and November 30, 2001, in which the author served as chief spokesperson for the U.S. government delegation.
- ²³ For example, Prakas No. 305 established procedures to establish the representation status of unions. Issued by MOSALVY (Cambodian Ministry of Social Affairs, Labor, Vocational Training and Youth Rehabilitation), November 22, 2001.
- ²⁴ See Arbitration Council web site at http://www.arbitrationcouncil.org/eng_index.htm.
- ²⁵ See for example Dani Rodrik, "Institutions for High-Quality Growth: What They Are and How to Acquire Them," *Studies in Comparative International Development*, vol. 35, no. 3 (Fall 2000).
- ²⁶ IMF, IMF Country Report No. 03/59, p. 9.
- ²⁷ U.S. Embassy Phnom Penh, Cambodia, "U.S.-Cambodia Bilateral Textile Agreement Quota Bonus Decision for 2004," press release, December 3, 2003, available at <http://phnompenh.usembassy.gov/wwwwh0060.html>.
- ²⁸ Nguyen Manh Cuong, Deputy Director, International Cooperation Department, Ministry of Labor, Invalids and Social Affairs, Government of Viet Nam, speaking at the World Bank Group's International Conference on Public Policy for Corporate Social Responsibility, Country Session 1, October 8, 2003.
- ²⁹ International Labor Organization and U.S. Department of Labor, *Mid-term Evaluation Report of the Project "Ensuring that Working Conditions in the Textile and Apparel Sector in Cambodia Comply with Internationally-Recognized Core Labor Standards and the Cambodian Labor Law"* (Phnom Penh: February 2003).

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