

**TESTIMONY SUBMITTED TO
THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES**

**“THE WORLD BANK’S APPROACH TO CORE LABOR
STANDARDS AND EMPLOYMENT CREATION:
RECENT DEVELOPMENTS”**

BY

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The World Bank Group has recently taken several steps that have a significant impact on core labor standards, work place practices or employment creation. In my testimony I would like to call the Committee's attention to four key examples, three positive and one negative.

1. International Finance Corporation Adoption of Performance Standard on Labor

The most positive recent development was a step taken by the International Finance Corporation (IFC), which is the arm of the World Bank Group that lends to private firms in developing countries. In February 2006, the IFC adopted a new set of performance standards. These performance standards lay out requirements that must be observed by all firms that borrow from the IFC. The new standards adopted in 2006 included a labor performance standard, Performance Standard 2 or PS2, which for the first time required that the private firms borrowing from the IFC must comply with all core labor standards and certain other good workplace practices. The text of PS 2 is attached to this document.

The adoption of PS2 was an important step for the IFC and it also has a bearing on broader practices. It paved the way for the recent adoption by the main World Bank body of a new requirement that core labor standards be respected by firms that seek procurement contracts funded by the Bank, discussed below. It also led to the adoption of a new standard by the Equator Banks requiring borrowers to respect core labor standards and follow other good workplace practices. The Equator Banks are a group of leading commercial banks that decided earlier to adhere to a set of principles on environmental practices called the "Equator Principles". After the IFC's promulgation of PS2, the Equator Banks adopted the same standard. Together the IFC and these banks account for over 80% of international private sector project finance in developing countries, so the impact is potentially very large.

The IFC is now in the process of implementing PS2. The organization's Environment and Social Development Department, which shepherded the development of the standard, has been assigned the task of operationalizing the new standard, although loan officers ultimately have responsibility for implementation. The department provided initial training to loan officers to help them understand and apply the standard to all new loans. The department must also implement a process for ongoing oversight of the performance of borrowers and for prompt remediation where problems arise.

The department has made a very professional and serious effort to operationalize the standard. At the same time, it must be recognized that respect for core labor standards was not part of the culture of the IFC or the reward system for loan officers. The effective and full implementation of PS2 will require a significant change in the institution's orientation toward workers' rights and workplace practices. It will require continuing capacity building by the Environment and Social Development Department, adequate resources for the task, and the support of IFC leadership.

This positive work deserves the support, attention and encouragement of the Committee and the U.S. Executive Director.

2. World Bank Policy on Core Labor Standards

As mentioned, the World Bank recently revised its “Standard Bidding Document for Procurement of Works” to require that core labor standards be respected by the Bank’s contractors. This will apply primarily to the infrastructure projects funded by the Bank. Implementation has not yet started. The Bank will undoubtedly face a steep learning curve in implementing this new requirement, as core labor standards have not been part of its procurement activities in the past and because respect for these standards is still contested in some parts of the Bank. It will be important that the leadership of the Bank and its governing body pay close attention to progress on implementation to ensure that the new requirement is fully operationalized. It would be advisable for the Bank to learn from its sister institution, the IFC, which has now accumulated at least some experience to share.

The Committee and the U.S. Executive Director should track the progress of the effort.

The World Bank more generally has not adopted a consistent stance of promoting core labor standards.

3. Doing Business Report 2008

The Doing Business Report is perhaps the most glaring example of inconsistency by the World Bank in promoting good workplace practices and respect for workers’ rights.

The annual Doing Business Report ranks countries according to how “business friendly” they are. The rankings are used both inside and outside the Bank in decisions about investment. The report covers a number of appropriate topics, such as the ease of establishing and operating a business, including licensing and registration requirements, and access to credit in financial markets. It also deals with the topic “Employing workers”. This is an area where the approach taken in the report is seriously off track in terms of good policy and specifically in terms of creating employment and promoting good labor practices.

The section on “Employing workers” creates an index of what it calls the “Rigidity of Employment”. This index is made up of three components, labeled “difficulty of hiring”, “rigidity of hours”, and “difficulty of firing”. A perfect score for a country means that it is a good place to do business in terms of employment matters. A low ranking suggests that investors should avoid the country and that the government should change its labor laws and labor market policy. I will comment briefly on each element of the index and its impact on employment and workers in the real world.

The “difficulty of hiring” index gives perfect scores to countries that allow the use of fixed term—that is, temporary—contracts for workers hired to perform permanent tasks, with no limitations whatsoever. It gives the worst score to countries that limit the use of temporary contracts for permanent work to less than three years. It should be noted that temporary contracts are widely used—and abused—in many developing countries, notably parts of Latin America, to avoid putting employees on regular employment rolls, despite the fact that they are doing work that is integral to the operation of the firm and that the firm considers permanent.

These contracts keep the affected workers in a precarious economic position, not knowing whether they will be employed at the end of the contracts, which often run for as short a period as three months. In some cases, use of temporary contracts means that the worker will not qualify for regular employment benefits including medical insurance and pensions. It discourages both the employee and the firm from investing in the temporary worker’s training and skills because of the uncertainty of continued employment. It discourages workers from joining labor organizations or union organizing campaigns because of fear that their contracts will not be renewed. These effects are not consistent with the goal of creating employment and promoting core labor standards. Nor are they consistent with good labor market practices that encourage investment in human capital.

The “difficulty of hiring” index also discourages the effective use of minimum wage legislation and encourages very low minimum wages if they are set at all by governments. Despite extensive research showing that carefully established minimum wage policy can effectively alleviate poverty and improve income distribution without discouraging employment, the Doing Business team ignores that research and appears to assume that minimum wages should not be used or should be set at extremely low levels. It assigns a perfect score to countries that set the minimum wage at less than 25% of the average value added per worker. Minimum wages are used in many countries to provide a lower bound to the distribution of value added between labor and capital. In its’ recent *World Economic Outlook 2007*, the IMF found a worldwide increase in capital’s share of GDP and decrease in labor’s share, especially marked in developing countries. The Doing Business Report encourages countries to set minimum wage rules that allow firms to capture the largest possible share of output. This is what used to be called “sweating”, that is, extracting labor for the lowest possible wage, rather than encouraging increased productivity based on worker motivation, investment in workers’ skills and technology.

The “rigidity of hours” index implicitly advocates the rolling back of any restrictions on hours worked, with a perfect score assigned to countries that allow 50 hour weeks at least part of the year and limit vacation time. Countries that establish what we in the US came to believe were sensible limits, such as the forty hour work week, are considered bad places to do business, according to this index. In a world where unemployment and underemployment are major economic and social problems in most developing countries, the idea that workers already on payrolls should be worked to the maximum rather than encouraging firms to hire more workers by keeping work time to a reasonable level goes in the wrong direction.

The “difficulty of firing” index rates countries as bad places to do business that require advance notice of termination or layoff or that require the options of retraining or alternative placement be considered instead of layoff. On other hand, Doing Business gives a perfect score to countries that have no restrictions on layoffs, no advance notice requirements, no obligation to consider the options of retraining or alternative placement, and allow no priority in the layoff process for considerations such as seniority or preserving balance in the composition of the workforce. The index lists the “firing cost” in each country, which amounts to the cost of advance notice and severance pay. This must be understood in the context that in most developing countries there is no unemployment insurance. Severance pay is the only buffer for households that lose the income of their wage earners. To imply that this buffer should be eliminated by countries without unemployment insurance endorses an approach of shifting all economic risks from firms to households. This approach represents an extremist view of the balance between firm and household interests; it should not be implicitly or explicitly foisted on developing countries.

The “Employing workers” section was even worse in the past, when it anointed policies that were directly at odds with ILO conventions. However it is still seriously off track. It ignores extensive contemporary research on labor market policies. To the extent that Doing Business references any empirical evidence rather than relying on what appears to be an ideologically pre-determined preference for labor market deregulation, it relies only on labor market research that lies at one extreme of the spectrum of such research. It favors an approach to labor market policy that shifts all risk from firms to workers and households and encourages countries to prioritize the short-term interests of firms over all other economic interests. This is at odds with the more sensible and mainstream approach that encourages governments to balance the interests of all economic actors and to take social and long-term interests into account. As development policy it is short-sighted and ignores lessons widely learned in already-developed countries. At worst it encourages countries to adopt policies that will hurt their employment generation and worsen income distribution and poverty levels.

The unbalanced and counterproductive approach to employment and labor market policy in the Doing Business Report cannot be ignored. It is used as an input to country level planning, poverty reduction strategies and loans by other parts of the World Bank Group. It is also used by private firms as a basis for decisions on where to invest. I believe that the “Employing workers” index should be removed entirely from the Doing Business Report until the Bank can come to terms with the wide array of labor market and social issues that are involved. I suggest that the Committee should instruct the U.S. Executive Director to work to eliminate this section until the Bank staff is able to provide an approach that can be approved by the Bank’s governing body, which can bring to bear the experiences of the member governments in dealing with the economic, social and political complexity of labor market issues.

4. The “Better Work” Program of the IFC and the ILO

One recent initiative that deserves attention and support is the recently launched “Better Work Program”. This is a joint project operated by the IFC and ILO that is designed to improve labor practices and productivity in global supply chains. The program will monitor workplaces in participating countries to determine whether national labor laws and core labor standards are observed. It will report the results of that monitoring and provide advice and assistance to the firms to improve their compliance.

The new program draws on experience gained by the ILO in a successful policy experiment in Cambodia. The ILO conducts ongoing monitoring of conditions in the apparel factories there and publishes the results in highly transparent reports that detail compliance or non-compliance by each factory with national labor laws and internationally agreed basic labor rights. Until the end of 2004, these reports were used by the US government as a key input for decisions under an innovative scheme that allowed increased access to the US market in response to improved working conditions and labor practices. An important element of the experiment that was largely unanticipated but has proven critical to its ongoing success is the use of the ILO reports by private foreign firms that buy from Cambodian producers. These buyers, conscious of their brand reputations, use the reports to determine whether their supplier firms comply with labor standards. The buyer then encourage remediation of problems, and if factories repeatedly fail to improve, the buyers shift orders to firms that run businesses able to comply with the national laws and core labor standards. The net effect has been to upgrade the quality of the industry while increasing apparel production, exports and employment very substantially. A fuller description and analysis of the Cambodian project is attached.

The new joint program of the IFC and ILO will draw on these lessons to achieve improvement in workplaces that produce for global supply chains elsewhere. Discussions are underway with the governments, private sectors and labor unions of Jordan, Vietnam and Lesotho to establish programs that draw on the lessons of the Cambodian success. This program will require external financial assistance and deserves the attention and support of the Committee and the U.S. Executive Director.

Conclusion

These four undertakings indicate both that progress is being made in moving the World Bank Group to address core labor standards and to improve workplace conditions, but that some serious problems remain and much more needs to be done. The active oversight of this Committee can contribute to further improvements.

Introduction

1. Performance Standard 2 recognizes that the pursuit of economic growth through employment creation and income generation should be balanced with protection for basic rights of workers. For any business, the workforce is a valuable asset, and a sound worker-management relationship is a key ingredient to the sustainability of the enterprise. Failure to establish and foster a sound worker-management relationship can undermine worker commitment and retention, and can jeopardize a project. Conversely, through a constructive worker-management relationship, and by treating the workers fairly and providing them with safe and healthy working conditions, clients may create tangible benefits, such as enhancement of the efficiency and productivity of their operations.
2. The requirements set out in this Performance Standard have been in part guided by a number of international conventions negotiated through the International Labour Organization (ILO) and the United Nations (UN).¹

Objectives

- To establish, maintain and improve the worker-management relationship
- To promote the fair treatment, non-discrimination and equal opportunity of workers, and compliance with national labor and employment laws
- To protect the workforce by addressing child labor and forced labor
- To promote safe and healthy working conditions, and to protect and promote the health of workers

Scope of Application

3. The applicability of this Performance Standard is established during the Social and Environmental Assessment process, while implementation of the actions necessary to meet the requirements of this Performance Standard is managed through the client's Social and Environmental Management System. The assessment and management system requirements are outlined in Performance Standard 1.
4. Throughout this Performance Standard, the term "workers" is used to refer to employees of the client, as well as to certain types of non-employee workers described in paragraph 17. The application of this Performance Standard will vary depending on the type of workers, as follows:
 - **Employees:** All the requirements of this Performance Standard, except for the requirements under paragraphs 17 and 18, apply
 - **Non-Employee Workers:** The requirements of paragraph 17 apply
5. Supply chain² issues are addressed in paragraph 18.

¹ These conventions are:

ILO Convention 87 on Freedom of Association and Protection of the Right to Organize
ILO Convention 98 on the Right to Organize and Collective Bargaining
ILO Convention 29 on Forced Labor
ILO Convention 105 on the Abolition of Forced Labor
ILO Convention 138 on Minimum Age (of Employment)
ILO Convention 182 on the Worst Forms of Child Labor
ILO Convention 100 on Equal Remuneration
ILO Convention 111 on Discrimination (Employment and Occupation)
United Nations Convention on the Rights of the Child, Article 32.1

Requirements

Working Conditions and Management of Worker Relationship

Human Resources Policy

6. The client will adopt a human resources policy appropriate to its size and workforce that sets out its approach to managing employees consistent with the requirements of this Performance Standard. Under the policy, the client will provide employees with information regarding their rights under national labor and employment law, including their rights related to wages and benefits. This policy will be clear and understandable to employees and will be explained or made accessible to each employee upon taking employment.

Working Relationship

7. The client will document and communicate to all employees and workers directly contracted by the client their working conditions and terms of employment, including their entitlement to wages and any benefits.

Working Conditions and Terms of Employment

8. Where the client is a party to a collective bargaining agreement with a workers' organization, such agreement will be respected. Where such agreements do not exist, or do not address working conditions and terms of employment (such as wages and benefits, hours of work, overtime arrangements and overtime compensation, and leave for illness, maternity, vacation or holiday) the client will provide reasonable working conditions and terms of employment that, at a minimum, comply with national law.

Workers' Organizations

9. In countries where national law recognizes workers' rights to form and to join workers' organizations of their choosing without interference and to bargain collectively, the client will comply with national law. Where national law substantially restricts workers' organizations, the client will enable alternative means for workers to express their grievances and protect their rights regarding working conditions and terms of employment.

10. In either case described in paragraph 9, and where national law is silent, the client will not discourage workers from forming or joining workers' organizations of their choosing or from bargaining collectively, and will not discriminate or retaliate against workers who participate, or seek to participate, in such organizations and bargain collectively. Clients will engage with such worker representatives. Worker organizations are expected to fairly represent the workers in the workforce.

Non-Discrimination and Equal Opportunity

11. The client will not make employment decisions on the basis of personal characteristics unrelated to inherent job requirements. The client will base the employment relationship on the principle of equal opportunity and fair treatment, and will not discriminate with respect to aspects of the employment relationship, including recruitment and hiring, compensation (including wages and benefits), working conditions and terms of employment, access to training, promotion, termination of employment or retirement, and discipline. In countries where national law provides for non-discrimination in employment, the client will comply with national law. When national laws are silent on non-discrimination in employment, the client will meet this Performance Standard. Special measures of protection or assistance to remedy past discrimination or selection for a particular job based on the inherent requirements of the job will not be deemed discrimination.

² Supply chain refers to both labor and material inputs for the lifecycle of a good or service.

Retrenchment

12. The client will develop a plan to mitigate the adverse impacts of retrenchment on employees, if it anticipates the elimination of a significant number of jobs or a layoff of a significant number of employees. The plan will be based on the principle of non-discrimination and will reflect the client's consultation with employees, their organizations and, where appropriate, the government.

Grievance Mechanism

13. The client will provide a grievance mechanism for workers (and their organizations, where they exist) to raise reasonable workplace concerns. The client will inform the workers of the grievance mechanism at the time of hire, and make it easily accessible to them. The mechanism should involve an appropriate level of management and address concerns promptly, using an understandable and transparent process that provides feedback to those concerned, without any retribution. The mechanism should not impede access to other judicial or administrative remedies that might be available under law or through existing arbitration procedures, or substitute for grievance mechanisms provided through collective agreements.

Protecting the Work Force

Child Labor

14. The client will not employ children in a manner that is economically exploitative, or is likely to be hazardous or to interfere with the child's education, or to be harmful to the child's health or physical, mental, spiritual, moral, or social development. Where national laws have provisions for the employment of minors, the client will follow those laws applicable to the client. Children below the age of 18 years will not be employed in dangerous work.

Forced Labor

15. The client will not employ forced labor, which consists of any work or service not voluntarily performed that is exacted from an individual under threat of force or penalty. This covers any kind of involuntary or compulsory labor, such as indentured labor, bonded labor or similar labor-contracting arrangements.

Occupational Health and Safety

16. The client will provide the workers with a safe and healthy work environment, taking into account inherent risks in its particular sector and specific classes of hazards in the client's work areas, including physical, chemical, biological, and radiological hazards. The client will take steps to prevent accidents, injury, and disease arising from, associated with, or occurring in the course of work by minimizing, so far as reasonably practicable, the causes of hazards. In a manner consistent with good international industry practice,³ the client will address areas, including: the identification of potential hazards to workers, particularly those that may be life-threatening; provision of preventive and protective measures, including modification, substitution, or elimination of hazardous conditions or substances; training of workers; documentation and reporting of occupational accidents, diseases, and incidents; and emergency prevention, preparedness and response arrangements.

³ Defined as the exercise of professional skill, diligence, prudence and foresight that would reasonably be expected from skilled and experienced professionals engaged in the same type of undertaking under the same or similar circumstances globally.

Non-Employee Workers

17. For purpose of this Performance Standard, “non-employee workers” refers to workers who are: (i) directly contracted by the client, or contracted through contractors or other intermediaries; and (ii) performing work directly related to core functions essential to the client’s products or services for a substantial duration. When the client contracts non-employee workers directly, the client will use commercially reasonable efforts to apply the requirements of this Performance Standard, except for paragraphs 6, 12, and 18. With respect to contractors or other intermediaries procuring non-employee workers, the client will use commercially reasonable efforts to: (i) ascertain that these contractors or intermediaries are reputable and legitimate enterprises; and (ii) require that these contractors or intermediaries apply the requirements of this Performance Standard, except for paragraphs 6, 12, and 13.

Supply Chain

18. The adverse impacts associated with supply chains will be considered where low labor cost is a factor in the competitiveness of the item supplied. The client will inquire about and address child labor and forced labor in its supply chain, consistent with paragraphs 14 and 15 above.

Attachment 2

Harnessing Global Forces to Create Decent Work: A Successful Experiment in the Cambodian Apparel Sector*

Sandra Polaski
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Introduction

For the past seven years, a path-breaking and successful policy experiment in the small southeast Asian nation of Cambodia has harnessed global forces to create employment and improve working conditions. The fundamental strategy is to improve labor conditions, verify the improvement through monitoring by a respected international organization and use the results to create a “safe haven” for production and sourcing by international firms who wish to avoid reputation risk. The policy has been pioneered in the apparel sector, which is the main exporting industry in Cambodia and the largest source of formal private sector employment.

The International Labour Organization (ILO), a specialized agency of the United Nations, conducts ongoing monitoring of conditions in the apparel factories.¹ The results are published in highly transparent reports that detail compliance or non-compliance by each factory with national labor laws and internationally agreed basic labor rights.² Until the end of 2004, these reports were used by the US government as a key input for decisions under an innovative scheme that allowed increased access to the US market in response to improved working conditions and labor practices. An important element of the experiment that was largely unanticipated but has proven critical to its ongoing success is the use of the ILO reports by private retail apparel firms that buy from Cambodian producers. These buyers, conscious of their brand reputations, use the reports to determine whether their supplier firms comply with labor standards, to encourage remediation of problems, and to shift orders if factories repeatedly fail to improve.

The project combines roles for national governments, international organizations, firms at the global and local level and trade unions in previously untried ways. The experiment warrants attention by policy makers elsewhere for two reasons. First, it introduces novel policy tools that can help developing countries insert themselves into the global production system and create needed employment without sacrificing decent wages and treatment for workers. These new policy tools now have a record of effectiveness that

* Originally presented at the conference “Decent Work, Social Policy and Development”, sponsored by the International Institute for Labor Studies, Geneva, November 2006.

can be examined and replicated by others. Second, the project relies primarily on private sector forces, while utilizing limited but essential public interventions to correct for market failures. The resulting system changes the incentives facing private actors, effectively aligning their interests more closely with public objectives.

As policy makers search for effective ways to harness global production systems for local development and employment objectives, the Cambodian experiment offers new and successful methods that can be replicated elsewhere. It also provides important analytical insights about the underlying mechanisms that determined the project's success.

Genesis of the Project

Cambodia is one of the least developed countries in the world. It entered the modern global economy late, partly because of civil strife from the 1960's through the 1980's. As the country stabilized in the 1990's, it sought to make up for lost time in its economic development. One important strategy aimed to transform a handful of state-owned textile and apparel factories into an export industry, to attract new foreign direct investment into the apparel sector, to earn foreign exchange and to create 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 typically the first step in the process of industrialization and Cambodia was eager to take it.

The global apparel trading system was governed for 40 years by a system that allowed countries to set quota limits on the textile and apparel exports from any one country that could enter their markets.³ The quota system was codified in the Agreement on Textiles and Clothing of the World Trade Organization (WTO), in force until January 2005.⁴ Because Cambodia was a latecomer to the apparel industry, it was not party to that system and therefore had no quotas. It was free to sell into the large, affluent markets of the US and EU, for example, but at the same time those countries were free to limit or cut off access at will in the absence of negotiated agreements. Notwithstanding that risk, willing investors from Hong Kong, Taiwan, China, South Korea and other countries bought, leased or built apparel factories in Cambodia. Buyers from the US and Europe also arrived, in part to circumvent the export limits they faced when purchasing from other countries under the global quota system.

The infant apparel industry grew rapidly. From virtually no apparel exports in 1994, exports had grown to almost half a billion dollars in value by 1998.⁵ The share going to the US increased rapidly, to the point that in 1998 the domestic US textile and apparel industries called for import restraints. The US government concurred and initiated negotiations with Cambodia to bring it under the quota system.

Meanwhile in Cambodia, the growing workforce in the apparel 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 of 1998, supportive labor groups in the US petitioned the US government to review claimed 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 US government was increasingly interested in linking trade privileges with support for labor rights.⁶ US and Cambodian negotiators worked out a three-year apparel trade agreement for the period 1999-2001 that established quota limits on the twelve largest categories of apparel exports. However, in a unique step, they agreed that if the Cambodian government were able to ensure 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.⁷ 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 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 government inspectors was not credible as a basis for the quota decisions. Alternatively, private for-profit and not-for-profit monitoring groups existed, but none were deemed to have the credibility to provide the basis for significant government decisions that would have broad economic impacts. To fill the gap, the two countries turned to the ILO, an arm of the United Nations system with responsibility for setting international labor standards and supervising compliance. The ILO operated a supervisory system that was 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 trade unions and others.⁸ The organization had never monitored the private sector and had never engaged in on-the-ground inspection of workplaces. The request from the US and Cambodia to take up a new role evoked a cautious response from the Director General of the organization, Juan Somavia, and provoked debate within the ILO bureaucracy and governing body.⁹ After a deliberative process, Somavia decided that the ILO should support a project that was seen to have value by the member states involved and that had the backing of both employers and trade unions in the target country.¹⁰

Key Mechanisms in the Strategy

Two of the main mechanisms on which the original project was based have been identified: the creation of a trade agreement that provided positive market access incentives as a reward for improved labor conditions; and the inauguration of a new role in private sector by an international agency.

Linking Trade and Labor Rights

The idea of linking trade privileges to labor standards had been discussed since at least the early twentieth century, but the first practical applications date from the mid-1980s.¹¹ The first such instruments to be created arose under the multilateral trading system, which from the early 1970s allowed countries to extend special trade preferences to developing countries for the purpose of aiding their development. Wealthy nations may extend lower tariffs or other market access privileges unilaterally to such countries without violating international trade rules under the WTO that forbid discrimination among trading partners. In 1983, the US made such additional trade privileges conditional on respect for labor rights by the developing country recipients.¹² In 1993, the US also linked labor provisions to a negotiated free trade agreement, in the form of a side agreement to the North American Free Trade Agreement (NAFTA).¹³ This pact included commitments by the trading partners to enforce their own labor laws, with the possibility of being fined or losing some of the trade benefits created by the pact if they failed to carry out that commitment.

Both types of instruments linked trade and labor rights through what can be viewed as a negative incentive. Countries were granted trade privileges, but the benefits could later be withdrawn for failure to comply with labor obligations.¹⁴ The US-Cambodia Textile Agreement, by contrast, created a positive incentive. Against a baseline level of access to the US market, additional quota would be granted annually for progress on labor rights in the previous period. The incentive was positive in that nothing would be lost but something could be gained through improvement of labor conditions. The arrangement 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 reward was enhanced by the close temporal connection between the behavior of firms and government in one year and the rewards that would flow from good behavior during the following year. Significantly, both government and private firms faced the same incentive to improve labor conditions.

Based on the sector's performance, the US government decided to award a 9% increase in quotas during 2000 and again in 2001.¹⁵ The parties were pleased with their experiment and agreed to extend the trade pact for three additional years, from 2002 through 2004. Quota bonuses of 9%, 12% and 18% were awarded for those years.

Monitoring of the Private Sector by the ILO

The second innovation mechanism in the Cambodian experiment is the novel role for the ILO. To make the quota decisions, the US needed credible and timely information on actual labor conditions in Cambodian apparel factories. The Cambodian government was not an effective source of such information. As noted above, Cambodia had been engaged in civil strife or outright war for much of the last 30 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 US\$28 per month.¹⁶ By contrast, the minimum wage in the apparel industry in Cambodia is \$50 per month, and the average monthly wage in the

sector is about \$72.¹⁷ By any account, the pay of government inspectors does not provide an acceptable minimum standard of living, and therefore second and third jobs that compete for inspectors' time are the norm, not the exception. Taking bribes from employers is also common. Under these circumstances, the role of the national public authorities in inspecting workplaces and ensuring compliance with labor laws was a goal to be pursued over the medium term. It was not a reliable source of information for the immediate purposes of the textile agreement. At the same time, a growing apparel sector that created jobs and profits was part of the solution to the problem of government capacity, as it would increase the tax base and resources for essential government functions. So while building public capacity to 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 1990's, the creation of corporate codes of conduct and the need to monitor their implementation created a body of experience among an array of private actors. They ranged from for-profit accounting organizations such as KPMG and PricewaterhouseCoopers (PWC) and specialized for-profit auditing groups like Intertek Testing Service, to non-profit social auditing groups such as Verité and non-profit multi-stakeholder groups like the Ethical Trading Initiative, Fair Labor Association and Social Accountability International. However none of these groups had established credibility at an international level and among the diverse groups affected by the textile agreement, including employers, investors, buyers, labor unions, consumers and governments. The entire field of social auditing is still at an 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 necessity of finding an agent to supply a missing function: provision of internationally credible workplace inspection and information to market participants. Although the ILO lacked specific experience in factory monitoring, it possessed an established record of neutrality and expertise and was acceptable to all concerned parties. The ILO was 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 1990's, labor markets became increasingly integrated as well, causing greater competition among 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 at home while improving standards abroad. It was natural that government policy makers grappling for means to address the new challenges would turn to the ILO to play new roles. For most of the 1990's, however, the new roles envisioned were in the public sphere, and entailed functions such as technical assistance and capacity building for ministries of labor in the developing world. The unprecedented US-Cambodia agreement, with its requirement for reliable, timely and credible information about actual factory conditions, pushed the ILO to move beyond its traditional public sphere. Arguably, this foray into the private domain may prove to be a critical element of

continued relevance for the ILO, as global production chains increasingly elude the effective control of national labor ministries and labor inspectorates.

How the Mechanisms Work

The experiment was put in place through two formal agreements: the textile agreement that began January 1, 1999 and an agreement between the ILO, the Cambodian government and Cambodian garment manufacturers to launch the monitoring initiative, signed on May 4, 2000.¹⁸ The two agreements operated independently, but in complementary ways. The potential quota bonus created an incentive for the Cambodian government and the factory owners to improve labor conditions in order to obtain economically valuable increases in access to the US market; and the ILO monitoring program provided critical information for the bonus decisions. However there were shortcomings in the basic arrangement launched by the two agreements that might have greatly limited its effectiveness. A key shortcoming was that the ILO monitoring program, as created, provided for voluntary participation by factories. By contrast, 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, to the extent that 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 non-participating 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 recognized these distortions quickly, as they began to emerge. It stepped in to remedy the shortcoming in the original plan design by issuing a regulation (the Cambodian term is *prakas*) that limited the availability of export quota to the US to those firms participating in the monitoring program.¹⁹ This resulted in full participation and allowed the ILO monitors to generate information on the entire sector. The Cambodian government’s innovative action demonstrates that even a relatively weak and resource-constrained government can find ways to leverage its power by creative use of those instruments that it does control, such as export licensing and issuance of quotas.

A second potential shortcoming was that the ILO 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 unsettled. After discussions with the multiple stakeholders, 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 a period of time was allowed for remediation of any problems found, the ILO monitors would re-inspect 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, with details of each area of non-compliance. This decision established a level of transparency regarding factory conditions that was significantly higher than that provided by any private monitoring programs that currently exist.

These two seemingly small public interventions, one by the Cambodian government to make participation in monitoring a requirement for receiving export privileges, and the other by the ILO to provide full transparency of monitoring results, together created a situation that was unprecedented in the realm of private sector compliance with labor norms. Once the monitoring and reporting system became fully functional, the two interventions resulted in the provision of extensive, specific information to all actors regarding labor conditions and legal compliance in the entire Cambodian apparel sector. This transparency changed the incentives facing private actors, including both the factories producing garments and the international firms that bought their products. The latter now knew the full range of labor conditions in their existing supplier firms and all other garment firms in the country.²⁰ Under conditions of transparency, the factory owners now had multiple incentives to come into compliance with labor laws and improve working conditions. They stood to gain increased market access to the US through the quota bonus system. They faced peer pressure from other firms, whose own quota bonus would be at risk if other factories failed to comply. Perhaps most importantly, international buyers who were concerned about working conditions and/or their brand reputations now were able to choose between supplier factories on the basis of good information about their labor practices.

Good information is a prerequisite for any well functioning market.²¹ The Cambodia experiment marks the first time that credible information about labor conditions in a developing country's workplaces has been widely accessible to both public and private actors at the local, national and international levels. The experiment provides an unprecedented opportunity to witness the effect 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 winning more market access to the US while improving labor conditions. A second effect, operating purely between private actors, was the shifting of orders to compliant firms. While the public incentive of quota increases was the 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.²² 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 US of items that were covered by quota limits increased by 44.8%, from a value of US\$433 million in 1999 to US\$627 million in 2002. Over the same period, exports of garments that were not covered by the quotas increased by 302%, albeit from a smaller base of US\$83 million in 1999 to US\$334 million in 2002.²³ This pattern indicates that buyers were attracted to place orders with factories that were compliant with labor norms even when they were making decisions on items that were not restricted by quota and thus would not benefit from the labor-based quota increases. Collectively, these buyer decisions shifted the composition of Cambodia's apparel exports. In 1999, only 19% of exports were of non-quota items, while by 2002, 53% of exports were not under quotas.

This experience led the Cambodian government and the country's apparel manufacturers to conclude that the value of good labor standards and transparency would survive the

end of the quota system.²⁴ In 2003, they asked the ILO to continue the monitoring program for another three years, beyond the end of the Agreement on Textiles and Clothing. As the end of the quota system neared in 2004, the World Bank Group's Foreign Investment Advisory Service (FIAS) conducted surveys among apparel buyers. These surveys revealed that buyers rated Cambodia's labor standards higher than those of regional competitors, and that the buyers would continue to purchase garments from Cambodia if credible monitoring by the ILO were to continue.²⁵ After quotas ended on January 1, 2005, the Cambodian government and the ILO developed a long-term plan to continue the monitoring program and eventually turn its operation over to an autonomous Cambodian monitoring organization. The current plan is to have a robust local organization that can maintain credibility with international actors in place by January 2009. The ILO will continue to supervise the monitoring project during a transition period through 2008, while building the capacity of a new Cambodian monitoring agency to assume responsibility thereafter. The project has been renamed "Better Factories Cambodia" and expanded to include training for factory managers on how to achieve and maintain good labor standards. The results of ILO monitoring are now reported through a sophisticated internet-based system that allows closer tracking of violations and improvements.²⁶ The Cambodian government ensured that the project will continue to operate on an industry-wide basis after the quotas expired by making continued participation in monitoring a condition for receiving export licenses.²⁷

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. While labor conditions are still far from perfect in the country's apparel factories, as discussed below, ILO inspections reveal any serious abuses, allowing buyers to insist on rapid remediation or shift orders to other factories with better practices. The detailed ILO factory monitoring reports that form the basis of the public reports discussed above are provided to the individual factories soon after the monitoring visit, to allow them to begin remediation. Many 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.²⁸

Although most apparel buyers have their own internal codes of conduct and undertake factory compliance inspections themselves or contract with for-profit or non-profit monitoring agencies to do so, none of these efforts have the high credibility of the ILO system. Purely self-regulatory schemes may 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 these outside 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, trade unions and employer organizations, has interests in the monitoring process that broadly correspond to the combined interests of the workers, firms and governments involved in the 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 actors that hold information to the contrary. This operates as a reality check and reinforcement of the credibility of the ILO. It is hard to imagine a purely self-regulatory scheme that could achieve this level of credibility.

Impact on Employment

The impact of the quota bonus and monitoring experiment has been positive for employment and working conditions in Cambodia's apparel sector by many measures.²⁹ At the most basic level, the increases in quota and the decisions by reputation-conscious buyers to source their products from Cambodian factories have been key drivers of a 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. By late 2006, apparel employment stood at 325,000.³⁰ These jobs make up a 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, aged 18 to 25, from rural households. To put the desirability of these jobs in context, the minimum monthly wage in the sector (US\$50) is greater than the entire average monthly household income in rural areas (US\$40).³¹ Average monthly apparel wages are about US\$72, and many workers earn more through production incentives and overtime. Remittances by workers to their families in the countryside have been credited with living many rural households out of poverty. According to an Asian Development Bank survey, 90 percent of those surveyed regularly send a major portion of their monthly income home to ensure that their families have enough food to eat and are able to send younger siblings to school rather than putting them to work.³²

Another measure of the impact of the experiment can be found in the ILO monitoring reports. Sixteen reports had been issued by mid-2006.³³ Each report covers a group of factories that were visited by the ILO monitors. After the first visit, the details of compliance or non-compliance with national labor laws and international labor standards are reported, in an aggregated form, for that group of factories. The ILO then allows those factories a period of several months for remediation of any problems found, while it visits 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 these findings, identifying each factory by name and noting whether it has complied with the suggestions or not.

The reports show that on their first visit, ILO monitors typically found a mixed pattern of compliance and non-compliance by factories.³⁴ Compliance was good in two key areas of basic labor rights: there was little or no child labor and no forced labor. Gender discrimination was not a widespread problem in hiring or wages, however discrimination on the basis of pregnancy was fairly common and isolated instances of sexual harassment were found. Widespread problems were found in incorrect payment of wages and

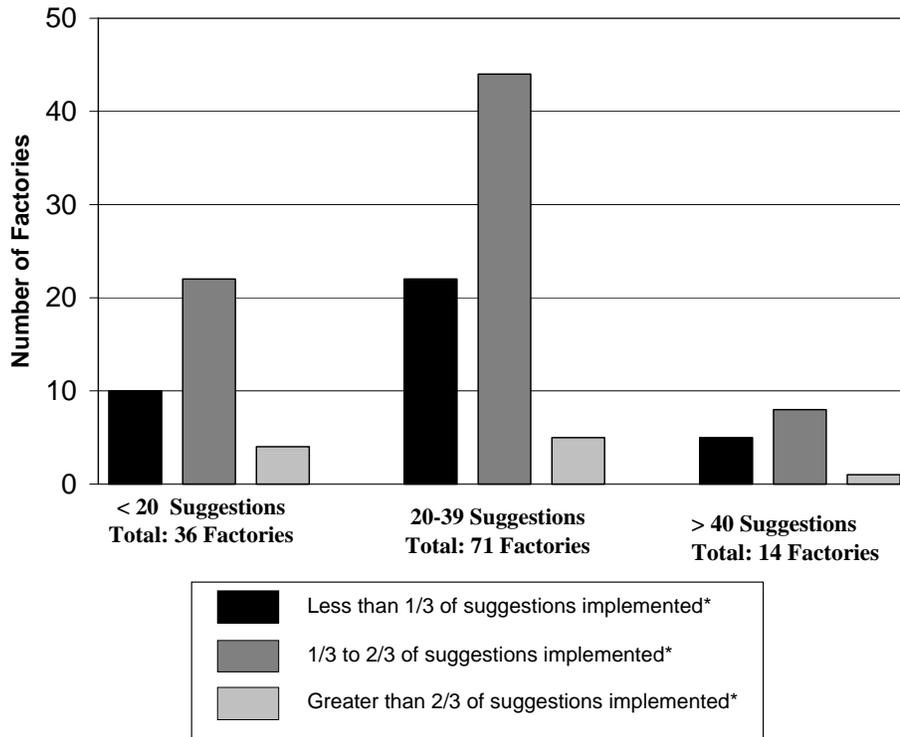
excessive hours or forced overtime. Violations of health and safety laws were common, including both minor and more serious infractions. Problems with freedom of association—the right to form unions and bargain collectively—were found in a relatively small number of factories, although the violations found were sometimes very serious.

The pattern of initial findings was in itself somewhat encouraging. Before the advent of the ILO monitoring project, a British Broadcasting Corporation (BBC) program had interviewed two ostensibly underage workers in a factory that supplied apparel products to Nike. While 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 and continues to do so. This demonstrates 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 sufficiently credible to counter the damaging report. The ILO's findings, by contrast, command global respect.

The ILO monitors made detailed suggestions to each factory to correct the deficiencies that were identified. Factories were subsequently re-inspected. At the first re-inspection, monitors found that some progress had been made by the majority of factories in correcting the problems identified. Sixty-one per cent had implemented between one-third and two-thirds of the ILO's suggested corrections, while an additional 8% 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 (there are 156 items on the checklist they use) 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 to ILO recommendations. The factories are sorted into four 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).

Figure 1

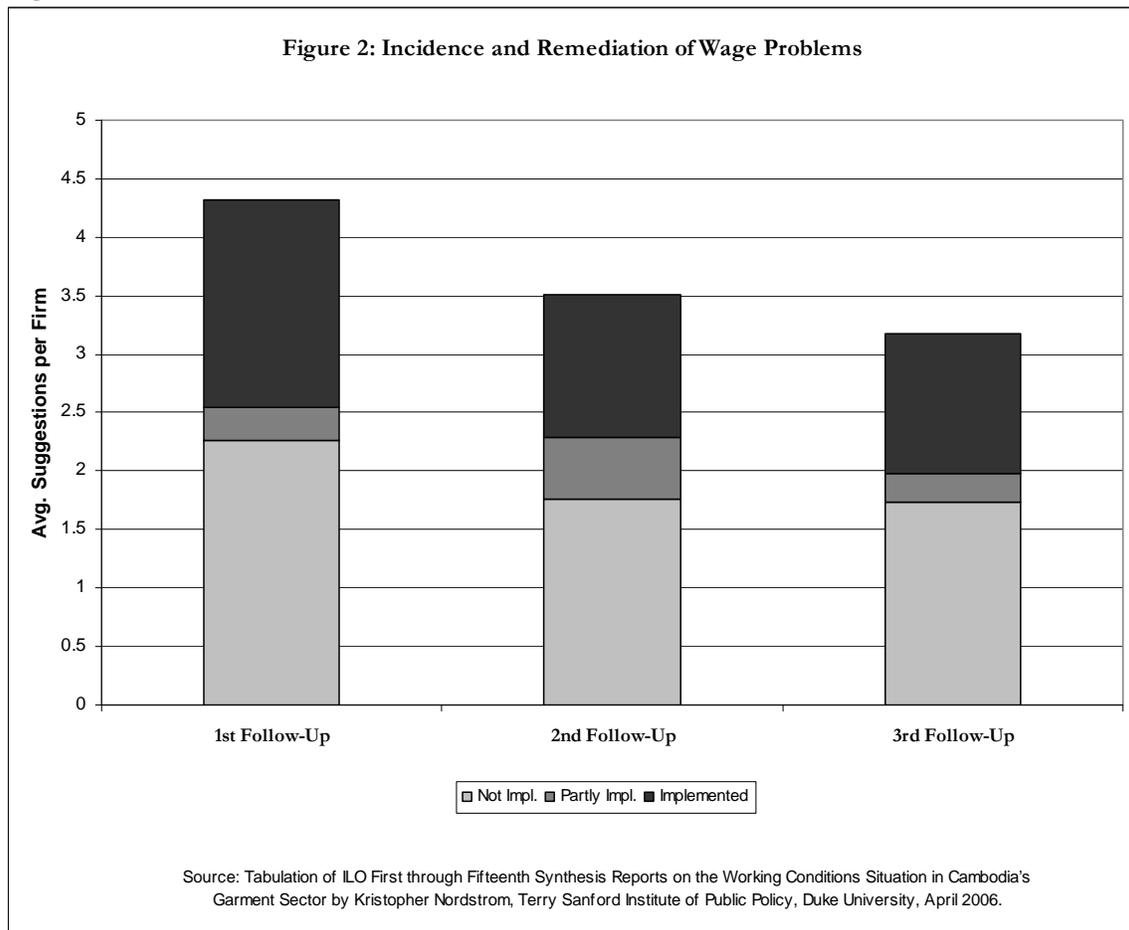
Figure 1: Reinspected Factories: Response to ILO Suggestions



* Includes suggestions partly implemented and in the process of being implemented.
 Source: Tabulations of ILO Third, Fifth, and Eighth Synthesis Reports on the Working Conditions Situation in Cambodia's Garment Sector

As factories have been revisited in ensuing years, there has been a general declining trend in the number of problems found. In some important areas, such as wages, compliance with laws on minimum wage and other payments has improved considerably. Figure 2 summarizes re-inspection results for wages. In the factories that had been inspected through October 2005, the number of violations found on each follow up visit declined.

Figure 2



In addition to improved compliance with wage laws, the ILO reports show progress over time on freedom of association and collective bargaining. Other measures tend to confirm this. For example, while there were few examples of unions successfully establishing themselves in apparel factories before the US-Cambodia textile agreement and the ILO monitoring program began, by 2004 there were about 500 registered factory level unions.³⁵ The ILO estimates that 40 to 50 percent of the 325,000 garment sector workforce belongs to unions.³⁶ The monitoring reports also document some progress in health and safety, although few firms were in full compliance with the law and ILO suggestions.

The ILO reports continue to provide a source of useful and reliable information about conditions in the factories and progress on remediation of problems. Although many problems remain, it is remarkable that so many factories have made rapid changes and corrections to practices that routinely confront apparel workers in many developing 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 US governments to fill gaps in Cambodia's regulatory regime that had hindered the implementation of labor laws. 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. However the law left many institutional and procedural lacunae that were meant to be filled in through regulations, known in Khmer as *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 thus 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 US governments. Progress on drafting and issuing the most critical *prakas* sometimes was used as a benchmark by the US in judging whether to award a quota bonus.³⁷ In drafting the procedural regulations, the US 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, union and employer rights and obligations.³⁸ The arbitration council *prakas* was issued and the body 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. Two hundred and seventy-five cases had been filed with the council between its establishment in 2003 and mid-2006.³⁹ A digest published by the council after its first year of existence showed that 85% of the disputes had been resolved, either through awards or agreement.⁴⁰ Large numbers of workers and managers have now had the experience of peaceful settlement of disputes based on neutral interpretation of laws and contracts, as well as the more intangible but significant experience of participation in a rules based system that serves their interests. Thus, the labor consultations mandated by the textile agreement provided an impetus and contributed to the articulation of institutions that extended the rule of law and dispute settlement in Cambodia. These mechanisms are likely to have positive spillover effects on the broader political 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.⁴¹

Benefits and Costs

Many of the benefits of the quota bonus and monitoring experiment are direct, quantifiable and substantial. The quota bonus itself constituted a clear benefit to the Cambodian government, apparel firms and workers. For example, in 2002, the value of the quota bonus was US\$56.4 million (calculated by multiplying the 9% quota bonus for

that year times the share of exports under quota, valued at US\$627 million).⁴² By the same calculation, about 13,000 jobs were created by the increased exports that year, and workers earned total wages of US\$9.5 million at those jobs. As the quota bonus grew to 12% in 2003 and 18% in 2004, the value to all parties increased dramatically. The earnings of apparel firms and workers also translated into increased tax revenue for the government. Beyond the quantifiable contribution of the quota bonuses, the risk mitigation that the good labor practices and monitoring offered to buyers led to their increased sourcing from Cambodia. Although it is impossible to calculate a precise level of orders attributable to the risk mitigation effect, the earlier discussion of growth in non-quota exports suggests that this effect was even larger than the quota increases, with attendant contributions to exports, employment, wages and taxes.

The ILO monitoring program has led to benefits for Cambodian apparel workers beyond the creation of jobs. 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, which in turn gives them the wherewithal to further improve wages, benefits and treatment through their collective bargaining strength.⁴³

The costs of the program have been surprisingly modest. The initial three-year monitoring project was funded at US\$1.4 million. The US and Cambodia governments contributed US\$1 million and US\$200,000, respectively, and the Garment Manufacturers Association of Cambodia contributed US\$200,000. Spread over three years, with an average of 200,000 workers in the sector, the annual cost per worker was US\$2.33 and the annual cost per factory was US\$2,333. These costs compare very favorably to private monitoring schemes in the region, where the cost of factory inspections and certification that the factory conforms to a buyer's code of conduct can range as high as \$10,000.⁴⁴ The current cost of the monitoring project, after additional features were added to assist factory managers and workers, is less than US\$3 per year for each worker, or US\$2800 for each factory.⁴⁵

The program has been cost effective primarily because of personnel costs. The project director and assistant director are hired by the ILO at competitive international salaries, reflecting the substantial experience and expertise required by the positions. However the monitors are hired locally in Cambodia, at salaries that are attractive by Cambodian standards, but very economical by international standards. The director trains the local monitors and exercises oversight to ensure that the monitoring meets international norms. The local monitors (there are currently about twenty) are carefully selected and generally have been praised by all parties.⁴⁶ Because the monitors are paid at levels that are attractive in Cambodia, they are less vulnerable to the temptation to corruption faced by low-paid government labor inspectors. (In addition, all inspections are carried out by teams of two and the teams visiting particular factories are rotated to minimize the risk of bribes.) The structure of salaries in the project makes it possible to carry out activities at a level of competence that commands international credibility while paying most 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 often flown in for inspections from distant locations with attendant travel, housing and per diem costs.

The cost-effectiveness of the local hires is further enhanced by their equally important non-monetary contributions. The local hires speak Khmer and thus are able to communicate with both workers and employers. As local residents, they are well positioned to meet with workers and unions away from the work place if necessary. By contrast, private auditors who are not locally based may have difficulty communicating with workers and may not inspire their confidence, particularly if the only contact is in the workplace where workers may feel intimidated by their employers. A final benefit of this approach is that the locally hired monitors acquire important technical, process and conflict management skills that add to the store of the society's human capital.

The distribution of costs of the Cambodia program was less than optimal until recently in one respect. International buyers, who gained substantial economic benefit from the project, did not contribute directly to its costs. In effect, the project provided reputation insurance for the buyers without requiring that they pay a premium. That deficiency has now been addressed, to some extent, as major international buyers have begun to contribute modest sums to sustain the project.

Prospects for the future

As already noted, the Cambodian government and apparel factory owners decided that there is an international market for good labor standards that are verified through credible, transparent monitoring. They have decided to continue the strategy indefinitely, despite the end of the quota system.⁴⁷ Financial support for the project has broadened considerably in recent years, as international development agencies witnessed the complementary gains in economic development, employment creation and poverty alleviation that Cambodia was able to achieve through this innovative approach. Funding continues to be provided by the Cambodian government and Cambodian garment industry, with small amounts contributed by the Cambodian trade unions. Now major additional funding is also provided by the World Bank, the Agence Française de Développement (AFD), the Asian Development Bank (ADB), and New Zealand's International Aid and Development Agency (NZAID). As mentioned above, the major international buyers of Cambodian garments also began to contribute to the costs of the program from 2005.⁴⁸

The transition in 2009 to a structure and program that does not involve the ILO will test the possibility of transferring the ILO's credibility to another organization. There is reason for optimism. From the beginning, the actual monitors have been Cambodian nationals, trained and supervised by ILO managers. They have now gained several years of experience. Local trade unions and NGOs can be expected to demand continued transparency and accuracy in the factory reports going forward. The government, the firms in the apparel sector and their international buyers will want the program to

maintain its global credibility, since this provides the key advantage enjoyed by the Cambodian industry in an increasingly competitive international environment.

Lessons and Conclusions

The Cambodian policy experiment can be judged as a success measured against its own objectives: to increase apparel exports, thereby improving economic growth, and to improve working conditions and worker rights in the country. The indicators of success in meeting these goals have been cited. A largely unanticipated benefit was the importance of the reputational advantage that international apparel buyers found under this regime. In fact, the policy continues beyond the temporal framework in which it was originally conceived, namely the apparel quota system that ended in 2005, primarily because of this benefit. The project also generated unanticipated spillover benefits to the wider society, as it fostered dialogue between employers, workers and government and created a neutral, credible dispute settlement mechanism that provided a rapid alternative to a court system plagued by weaknesses typical of low-income countries. The experience of participation and inclusion by groups such as workers, who had been largely excluded from decision making processes of the government and private firms, creates a precedent and expectation of wider democratic participation.

New policy ideas and their successful deployment are relatively rare in the international system. When such successes occur, it is useful to search for lessons that can be learned at the analytical level and to inform policy making elsewhere. Five distinct characteristics of the innovative Cambodian policy were essential to its success.

1. Positive incentives

An important innovation in Cambodia was the manner in which trade privileges were linked with improved labor rights. Labor provisions had been included in other trade agreements and trade preference programs by the US and some other governments, but those provisions operated as negative incentives.⁴⁹ In those arrangements, trade privileges were granted to the trading partner with the condition that they could later be revoked if governments failed to improve existing problems, if labor conditions deteriorated or if new violations were discovered. In negotiating terms, the privileges were “front-loaded”.

By contrast, the textile agreement with Cambodia created a positive incentive that operated prospectively. The additional market access (quota) was not granted until the Cambodian employers and government met pre-established benchmarks of progress on labor conditions, resolved specific problems and upgraded legal instruments. The improvements 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 recipient country, 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. The deterrent effect of a general and vague conditionality may be discounted by the recipient. From the perspective of the granting country, it may be politically unappealing to employ a negative incentive, because revoking privileges already granted can disrupt ongoing economic activities. Partly as a consequence of these considerations, negative incentives are typically employed only in cases of egregious abuse of labor rights. This can limit the efficacy of such systems to achieve incremental, 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 achieve. It allowed modest, feasible steps to be taken and rewarded rapidly, as part of the repeated annual exercise. This aspect of the policy design is particularly important, because many of the labor problems encountered in developing countries are difficult to solve in one stroke.

The precise incentive granted at the outset of the Cambodia experiment is not available because the quota system has ended. However many restrictions on developing countries' exports still exist in markets abroad and policy makers could find many other opportunities to link prospective trade benefits to progress on labor rights and other desirable developmental objectives. For example, bilateral free trade agreements, which typically phase out tariffs over a period of many years, could accelerate those tariff reductions, or offer tariff benefits beyond the basic reductions if agreed benchmarks were met on labor standards.

2. 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 ranged from major structural changes, such as the issuance of necessary regulations and creation of institutions to the remediation of specific, egregious problems in particular factories. Once the ILO monitoring reports became available, an overall goal in each period was the demonstration of effort and steady progress by factories in remedying any identified problems.

The short-term goals were agreed in consultations between the two governments, and included apparel factory managers and workers' organizations. The involvement of all relevant Cambodian actors in the discussions meant that the resulting goals were widely known. The specificity of goals meant that all actors understood what was expected. The challenge faced by the parties was to identify goals that were sufficiently ambitious to contribute to significant and sustained progress in labor rights, while recognizing the constraints on the Cambodian actors.

Policy makers seeking to replicate this approach should include a frequent consultative process that sets objectives and takes stock of progress. It would be desirable to include all affected actors in the consultations.

3. Role of an international intergovernmental organization

As noted above, the Cambodia monitoring program marked the first time 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.

The experience has 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 growth with social equity, and to advance trade while promoting acceptable levels of labor standards, the ILO could be called upon 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.

The role of the ILO is illustrative of a function that could be assigned to other intergovernmental agencies that deal with different substantive matters. It is not difficult to imagine a role in monitoring and oversight of private sector actors, including those engaged in self-regulation. As an example, an effort known as the Kimberly Process, a scheme to stop trade in diamonds that fuel and finance civil wars in Africa, recently agreed that self-regulatory efforts by the diamond industry required more aggressive oversight by governments and greater transparency of information about traded diamonds.⁵⁰ This role could be played efficiently by intergovernmental organizations.

4. Transparency

One aspect of the Cambodia monitoring program that has been indispensable to its success 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 equal access to the information generated. The reports served a multiplicity of purposes in the hands of different actors and reinforced the common interests they shared. Any future monitoring role for the ILO or other intergovernmental agency should replicate at least this level of transparency.

The question arises whether private auditing groups could substitute for an intergovernmental organization to provide monitoring with a similar degree of transparency and credibility. Currently, no private sector group has attempted this level

of transparency. Those groups that monitor labor conditions in factories abroad have been unwilling to identify the specific factories inspected and the findings, both positive and negative, in those factories. (Some multi-stakeholder monitoring groups, such as the Fair Labor Association, have improved their transparency in recent years, but reporting covers only a small percentage of factories or buyers.) Without specific information about a particular 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 the 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 adequate transparency and credibility. Unless private monitoring groups report with full transparency to all interested actors, it is unlikely that they could fill the role of providing sufficient information to improve the functioning of markets and generate the progress on overall performance that was achieved by the ILO in Cambodia.

5. Role of governments

The apparel industry in Cambodia was a major beneficiary of the policy experiment, but did not initiate it. The multiple firms in the sector faced a classic coordination problem in which all firms would be better off with increased market access in the form of quota and increased purchasing by international buyers. However individual firms did not want to lead the effort, without assured participation by all, to avoid bearing disproportionate costs of improving labor conditions. The role of the Cambodian and US governments in initiating the policy, and the role of the Cambodian government in requiring sector wide participation, were essential.

The Cambodian government had a strong self-interest in creating the policy and making it work. The self-interest encompassed economic, social and political objectives. In the economic realm, the gains to be achieved were increased exports, as a stimulus to overall economic growth, increased employment and increased fiscal revenues. The societal interest of the government was to improve the employment, incomes and working conditions of Cambodian workers. The apparel sector offers the best employment available to unskilled workers in Cambodia, and thus expanding the number of positions was a major goal of the government. The largely young, female workforce is mainly drawn from rural households. The women's remittances have a beneficial economic effect on those households and the countryside more broadly. At the political level, worker unrest was rising in the years after Cambodia achieved peace in 1991. In a polity where disputes had long been resolved through violence, the creation of a peaceful alternative to distributional disputes was a significant breakthrough.

Due to resource and capacity constraints, the government had very limited ability to achieve its goals through direct governmental interventions such as inspection, fines or judicial settlement of disputes. In this case, the government effectively leveraged the policy instruments it did possess, such as the ability to negotiate market access abroad and the granting of export licenses, to elicit greater compliance by firms. Even least developed countries such as Cambodia have instruments with which to achieve a more

favorable insertion into the global economy by leveraging international norms and intergovernmental capacity to their own purposes.

¹ The ILO is a specialized agency of the United Nations system.

² The member states of the ILO, currently 178 nations, have agreed that all workers have certain fundamental rights, regardless of the level of development of their country. These include the right to freedom of association and 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 Declaration on Fundamental Principles and Rights at Work*, Geneva, June 1998. Available at www.ilo.org.

³ The quota system dates back to the 1960's and reflected 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, successive 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 phase-out of the system, and this was finally agreed in the negotiations that created the World Trade Organization in 1995. The quota system was phased out over ten years and completely eliminated on January 1, 2005.

⁴ The Agreement on Textiles and Clothing succeeded the Multi-Fibre Arrangement or MFA in 1995.

⁵ "Cambodia: Selected Issues and Statistical Appendix", IMF Country Report No. 03/59, International Monetary Fund, Washington, DC, March 2003, p. 9.

⁶ Polaski, Sandra, "Protecting Labor Rights through Trade Agreements: An Analytical Guide", *Journal of International Law and Policy*, Vol. 10, No. 1 (Fall 2003), p. 14.

⁷ US-Cambodia Bilateral Textile Agreement, available at: http://199.88.185.106/tcc/data/commerce_html/TCC_2/Cambodiatextilebilat.html.

⁸ See ILO website, www.ilo.org.

⁹ The ILO is governed by a unique structure that includes the governments of the 178 member countries (controlling half of the votes in decisions), employers' organizations (one quarter of votes) and labor unions (one quarter of votes).

¹⁰ Conversation with the author, Geneva, Switzerland, January 19, 2000. See also Elliott, Kimberly Ann and Richard B. Freeman, *Can Labor Standards Improve under Globalization?* Washington, DC: Institute for International Economics, June 2003, p. 117.

¹¹ Polaski, op. cit., pp.13-15.

¹² Such programs are permitted under the Generalized System of Preferences (GSP) of the World Trade Organization. The European Union also created a similar link between respect for labor rights and market access under its GSP+ programs.

¹³ The North American Agreement on Labor Cooperation (NAALC), agreed between Canada, Mexico and the US in August 1993. Available at www.naalc.org.

¹⁴ Verma, Anil, “Global Labour Standards: Can we get from here to there?”, Centre for Industrial Relations and Rotman School of Management University of Toronto, December 2002. Available at: http://www.fu-berlin.de/iira2003/papers/track_3/Workshop_3_4_Verma.pdf

¹⁵ Elliott and Freeman, op. cit., pp. 117-118.

¹⁶ IMF Country Report No. 03/59, op. cit., p. 27.

¹⁷ ILO, Better Factories Cambodia, “Cambodian garment industry: one year later”, May 31, 2006. Available at <http://www.betterfactories.org> .

¹⁸ 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.

¹⁹ *Prakas* No. 108 MOC/M2001, Cambodian Ministry of Commerce, March 28, 2001.

²⁰ Interviews with factory managers and buyers, reported in Kolben, Kevin,” Trade, Monitoring, and the ILO: Working to Improve Conditions in Cambodia’s Garment Factories”, *Yale Human Rights & Development Law Journal*, Vol.7 (2004), p. 105-106.

²¹ 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 Frangsmyr (Stockholm: The Nobel Foundation, 2002), pp. 472-540.

²² Kolben, op. cit., p. 106.

²³ IMF Country Report No. 03/59, op. cit., p. 9.

²⁴ Siphana, Sok, 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.

²⁵ World Bank, “Overseas buyers plan to continue purchasing Cambodian garments after 31 December”, Press Release No. CMB2004/01, December 3, 2004.

²⁶ Agence France Presse, “Cambodia: UN labour body expands monitoring of Cambodia’s garment factories”, 11 February 2005.

²⁷ ILO, Better Factories Cambodia, “About Better Factories”. Available at <http://www.betterfactories.org>.

²⁸ Kolben, op. cit. pp.105-106.

²⁹ For example, an extensive list of positive results is included in a speech by Lorne W. Craner, US Assistant Secretary of State, “Corporate Social Responsibility at the State Department”, March 11, 2004. Available at: <http://www.state.gov/g/drl/rls/rm/30962.htm>

³⁰ ILO, Better Factories Cambodia, Quarterly Newsletter No. 6, October 2006, p.3. Available at <http://www.betterfactories.org>.

³¹ IMF Country Report No. 03/59, op. cit., p. 13.

³² Asian Development Bank, “Preventing Poverty and Empowering Female Garment Workers Affected by the International Trade Environment”. Available at: <http://www.adb.org/gender/country/cam005.asp>.

³³ ILO Synthesis Reports on the Working Conditions Situation in Cambodia's Garment Sector. Available at: www.ilo.org/public/english/dialogue/ifpdial/publ/cambodia.htm.

³⁴ Ibid.

³⁵ Raghwan, Raghwan, "Uncomfortable but Taking Part—Cambodia's Unions and the PRSP", in ILO, ed. "Trade Unions and Poverty Reduction Strategies", special issue of *Labour Education*, Vol. 2004/1-2, No. 134-135, pp. 55-58. Available at <http://www.ilo.org/public/english/dialogue/actrav/publ/134/index.htm>.

³⁶ ILO, Better Factories Cambodia, Quarterly Newsletter No. 6, October 2006, p.3 . Available at <http://www.betterfactories.org>.

³⁷ Public meetings between the US and Cambodian governments, June 4, 2001 and November 30, 2001, in which the author chaired the US government delegation.

³⁸ For example, *Prakas* No. 305 established procedures to determine the representation status of unions. Issued by MOSALVY (Cambodian Ministry of Social Affairs, Labor, Vocational Training and Youth Rehabilitation), November 22, 2001.

³⁹ See Arbitration Council web site at http://www.arbitrationcouncil.org/eng_index.htm

⁴⁰ Ibid, see "Digest #2" of 2004.

⁴¹ 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).

⁴² IMF, IMF Country Report No. 03/59, p. 9.

⁴³ Elliott and Freeman, op. cit., p. 118.

⁴⁴ 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.

⁴⁵ ILO, Better Factories Cambodia, "Funding". Available at <http://www.betterfactories.org>

⁴⁶ International Labor Organization and US 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 Labour Standards and the Cambodian Labour Law", Phnom Penh, February 2003.

⁴⁷ Financial Times, "Cambodia favoured in Asian labour survey", 3 December 2004.

⁴⁸ ILO, Better Factories Cambodia, "Funding". Available at <http://www.betterfactories.org>

⁴⁹ Polaski, op. cit., pp. 21-22.

⁵⁰ Financial Times, "Conflict diamond curbs agreed", November 10, 2006